



OFFICE OF  
REGULATION REVIEW

# **The use of cost litigation rules to improve the efficiency of the legal system**

**Submission to the Australian Law Reform Commission  
review of the litigation cost rules**



**PUBLIC SUBMISSION  
MARCH 1995**

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## **PREFACE**

The Attorney-General has asked the Australian Law Reform Commission (ALRC) to examine whether changes should be made to how costs are awarded in proceedings before federal courts and tribunals. The general rule that presently applies to civil litigation is that the loser pays the winner's legal costs — the cost indemnity rule. Review of this general rule was prompted by a recommendation of the Access to Justice Advisory Committee (AJAC 1994, p. 171).

The Office of Regulation Review (ORR) — located within the Industry Commission (IC) — is responsible for advising the Commonwealth Government on its regulation review programme.

# 1 AN ECONOMIC PERSPECTIVE ON LITIGATION

An economic approach to the analysis of litigation cost rules emphasises the indirect consequences of such rules for consumers and business. This stands in contrast to other approaches that tend to focus solely on direct effects — such as justice for the individual.

The economic approach is particularly relevant to the ALRC's review of litigation cost rules. This is so because the scope of the review is *federal* courts and tribunals, where cases and appeals determine precedents which affect predominantly business.

Private litigants perform an important (but unpaid) public service; the precedents that arise as a by-product of their trials can have wide implications. Each decision of a court provides information on the likely outcome of similar disputes in the future. A major new precedent may guide cases for many years to come and, more importantly, shape the commercial relations of countless consumers and businesses.

Legal precedents can be thought of as social capital — they are a stock of public knowledge that provides the community with well tested information about their legal rights and obligations (Posner 1992). Precedents combine the wisdom of many judges resolving a diversity of cases. They economise on information, temper any idiosyncrasies of individual judges, and make the decisions of the courts more predictable (Easterbrook 1988). As a general rule, for every dispute that goes to trial, ten are settled (Cooter and Rubinfeld 1989). Moreover, a solid body of precedent provides a firm footing for parties to sue and, importantly, encourages others not to transgress.

However, if case law is to remain relevant and effective, precedents must adapt as society changes. There will be more incentive to litigate when:

- there are major changes to statutes; or
- existing precedents have only limited application; or
- there are major technological or social changes.

The resulting surge in litigation will produce new precedents that reduce uncertainty and lessen the need for more litigation. This ebb and flow of litigation as society changes is a vital element in updating the legal system and maintaining its effectiveness.

Most litigation is driven by private concerns — parties receive only a small share of the value of new precedents. Thus, the broader social value of a case will have little sway on the private decision to sue or settle.

However, cost rules do affect the incentive to sue, and there are arguments that they should be used to promote the timely creation of new precedents. What is important is

that the ‘right’ cases are being litigated — that is, cases that are evenly balanced (Cooter and Rubinfeld 1989).

The courts can use the novel or closely fought facts or legal issues of a ‘right’ case to revisit precedents in light of contemporary values, legislative change and hindsight so as to improve on earlier treatments. Such a trial serves both private and social ends: a dispute is resolved and a new precedent may be produced to guide the conduct of many others.

From this perspective, ‘wrong’ cases are those where the court’s decision is predictable — in such instances, a trial serves little purpose. When the legal position is clear, cost rules should encourage parties to accept their situation and settle without going to court.

## 2 GOVERNMENT ASSISTANCE IN SETTING PRECEDENTS

Given the lack of private incentive to consider the social value of new precedents — as noted in Section 1 — there may be a role for government intervention to correct this market failure.

A common method of correcting market failure (such as under-supply of a good or service) is by government subsidy. This already occurs to some extent in the production of precedents by the government:

- providing judicial aid — through legal aid, *ex gratia* grants, the waiver of court costs, the funding of judicial infrastructure (building and wages) and other schemes (ALRC 1994, pp. 29-32) the government subsidises the production of litigation, and in the process, precedent; and
- creating administrative precedents — for example, tax rulings and press releases issued by the Australian Tax Office and practice notes, policy statements and media releases by the Australian Securities Commission seek to overcome the uncertainty created by a lack of judicial precedents.

A problem with administrative precedents (the dominant explicit form of government subsidy of precedents) is that in many cases their creation will tend to favour the body creating the precedents rather than serving the wider public interest. In contrast, judicial precedents tend to be made in a more transparent manner.

The issue of judicial aid (in its various forms) recurs throughout the ALRC's issues paper and is worth exploring in more detail.

Judicial aid, of which legal aid is the most common form, is not focussed on creating more widely applicable precedents. Instead, it is more focused on achieving justice in individual circumstances — "... the role of legal aid is to empower people to overcome the barriers to justice (AJAC 1994, p. 226)" — and surely has effects on income distribution. However, when formulating such redistributive devices, the effect on the efficiency of creating precedents should at least be acknowledged and considered. This seems not to have occurred in some of the issues raised in the discussion paper, particularly schemes to indemnify small parties against larger parties.

In addition to its equity goals, legal aid can be used to improve the efficiency of the legal system if it is appropriately targeted. The AJAC has moved some way towards acknowledging this point in recommending that:

The Commonwealth should establish a fund to provide assistance for test cases in the interests of disadvantaged groups and for large scale civil litigation involving many parties in different jurisdictions (1994, p. 257).

While there is already provision for Commonwealth assistance through the Attorney-General's Public Interest or Test Case scheme, it appears not to be very effective, perhaps because it is so targeted that too few precedents are created:

Although the terms of grant available in standard cases are the same as those for State Legal Aid, there is a discretion to grant an indemnity in respect of costs awarded against the applicant. ... An indemnity ... is only granted in the most exceptional circumstances. Indeed, there appears to have been only one such grant in ten years, for a case involving an application to the Privy Council (Crock 1988, p. 517).

There may be a case for increased government funds to be allocated to the production of valuable precedents that benefit the public generally, particularly where class actions may be ineffective in encouraging their production. The ORR stresses the need for the targeting to be aimed at test cases, where the public good aspect of precedent is greatest, rather than simply targeted at disadvantaged groups where the benefits of the litigation are largely private.<sup>1</sup>

Of course, if public money is spent on the creation of a public good, then new problems may arise in controlling the organisation that controls the funds. The ORR suggests that, for administrative cost-saving reasons, the body controlling such funds should be established within the Attorney-General's Department. It should be protected by a 'Chinese wall' from departmental or ministerial influence in deciding which cases to support. Also, there would be the need to put in place strict criteria about targeting cases of high precedential value with large public good elements. However, care has to be taken so that the threshold to consider a case as a test case is not too high, so that there continues to be an adequate ongoing supplementation of the stock of precedents.

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<sup>1</sup> Legal aid schemes should, in the interests of justice and equity, continue to be targeted at subsidising litigation for disadvantaged groups.

### 3 POSSIBLE REFORM OF THE LITIGATION COST RULES

The economic and social aspects of precedent setting — outlined in Section 1 — provide a useful perspective on the most appropriate objectives for formulating litigation cost rules. As noted by Priest (1982, p. 163), attention must be given to likely conflicts in objectives:

... courts and legislatures have used rules that shift liability for court costs and attorneys' fees to plaintiffs or defendants to achieve two different objectives: to encourage litigation by particular plaintiffs (in civil rights, pollution, and consumer litigation), and to regulate the volume of litigation (most commonly to encourage settlement). These goals are contradictory and in conflict ...

It is asking too much of one instrument, the litigation cost rules, to be targeted at more than one objective. The ORR considers that there should be only one goal ascribed to litigation cost rules — the efficiency of the legal system.

The efficiency of the legal system is determined by two elements; efficiency is achieved when legal *uncertainty* is minimised at acceptable *cost*. At least in the short term, these two elements pull in different directions:

- legal uncertainty can be reduced by encouraging cases to go to trial, hence creating precedents. This increases costs in the short term. However, over the longer term, this creation of precedents will have the effect of reducing costs associated with legal uncertainty because precedents will reduce the number of cases proceeding to trial as parties see no need to litigate on clearly decided points of law and fact.
- the costs of litigation can be reduced by encouraging parties to settle before going to trial. This, however, may mean that some cases which do not go to trial should have done so in order to establish precedents.

Focusing on efficiency as the single goal for litigation cost rules, the policy dilemma is to create a system of rules which balances the need to bring cases to trial, thereby establishing precedents, against the need to discourage from going to trial those cases which concern clearly decided points of law and fact.

While there may be another goal to encourage certain groups to bring their cases to trial, particularly disadvantaged persons, that should be done through more direct means than through the cost rules. Such means include altering:

- the law itself (such as shifting the incidence of liability and taxes);
- the magnitude of damages;
- the burden of producing evidence;
- the standard of proof; and



- court fees.

This section explores some of the options for the reform of the cost rules in order to encourage the establishment of efficient precedents; that is, the ‘correct’ volume of precedents of a robust quality.

### **3.1 The cost indemnity rule (the English rule) and the party-party rule (the American rule)**

The two most common cost rules are the cost indemnity rule (costs follow the event, loser pays), and the party-party rule (each party bears its own costs). Both of these rules involve compromises.

Rules can be assessed using a range of criteria. For example, whether they promote settlement, increase or decrease payments from defendants to plaintiffs, or how they affect the number of legal disputes (Gravelle 1993).

It is not clear which of the English or American rules is better at promoting the efficient production of precedents.<sup>2</sup> In comparison to the American rule, the English rule encourages a greater number of claims to be dropped as plaintiffs fear the burden of paying both parties’ costs. The effect of this is ambiguous. On one hand, the dropped claims may be vexatious or unreasonable and hence not worth litigating — such an outcome increases efficiency as it removes the need to litigate cases that will not create a useful precedent. On the other hand, the English rule tends to increase defence expenditures which, when coupled with a general risk aversion, may encourage people with meritorious claims to abandon their actions — such an outcome decreases efficiency because there will be an under-supply of precedents. As Snyder and Hughes (1990, p. 378) note:

The trade-off between greater litigation expenditures and the reduced likelihood of litigation raises related issues. The welfare effects depend on whether the additional expenditures at trial are socially productive (i.e., whether they serve to reduce legal error [by the creation of precedent] and thereby improve the reliability and appropriateness of the verdicts obtained). If the greater expenditures serve their purposes, then the English rule should be viewed in a more favourable light.<sup>3</sup>

While it is not clear which of the English or American rules is better, it is clear that neither provides sufficient incentive for parties to settle their dispute when legal liability is clear and there is agreement as to the likely outcome from trial. The next section explores ways in which to provide such an incentive to settle out of court in those cases having little precedential value.

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<sup>2</sup> This is evident from comparative data gathered from Florida’s medical malpractice litigation when, between June 1980 and September 1985, the English rule was adopted in place of the American rule (Snyder and Hughes 1990).

<sup>3</sup> Emphasis added.

### 3.2 The benefits from encouraging settlement

Given the need to encourage litigation that clarifies uncertain liabilities, an efficient system of cost rules would seek to discourage litigation on clearly decided points. That is, the cost rules can be used as a means of encouraging settlement in clear legal circumstances, saving both parties the time and costs involved in litigation.

#### *One way cost shifting — an offer-of-judgement rule*

While it is possible to reduce the cost of litigation by creating incentives to settle quickly, if settlement is ‘forced’ then the outcome may be far from efficient.

Offer-of-judgement rules (such as Rule 68 of Federal Civil Procedure in the United States and ‘payment into court’ in England) tend to operate thus (see also Diagram 1) — if:

- before the trial the defendant formally presents the plaintiff with a settlement; and
- the settlement offer is subsequently rejected; and
- the judgement awarded by the court is less than the offer; then
- the plaintiff must pay the costs that the defendant incurred after the offer was presented.

Interestingly, Thompson (1995) calls the equivalent Canadian<sup>4</sup> offer-of-judgement rule a “good faith” provision; it encourages people to settle, and only go to trial if they believe that the offer made to them is inadequate.

Intuitively, such a cost rule would appear to promote settlement, thus reducing the overall cost of litigation. However, such rules create some unfavourable side-effects:

Under an offer-of-judgement rule, a defendant gains from submitting a token offer regardless of the magnitude of its litigation expenses. The submission of a token offer imposes no costs on a defendant. Because the offer is unrealistically low, it will not be accepted. Yet, the submission alone gains a defendant some chance of recovering litigation expenses. ... Indeed, suits brought under favoured-plaintiffs statutes may be especially susceptible to token offers. In such suits, involving claims of discrimination or pollution, for example, it is difficult to prove actual damages. Nominal awards are often granted.

... But the rule’s principal effect ... is distributive: plaintiffs become worse off. Indeed Rule 68 is most likely to encourage settlement by those plaintiffs least able to withstand the adverse effect of paying the defendant’s litigation expenses (Priest 1982, p. 179).

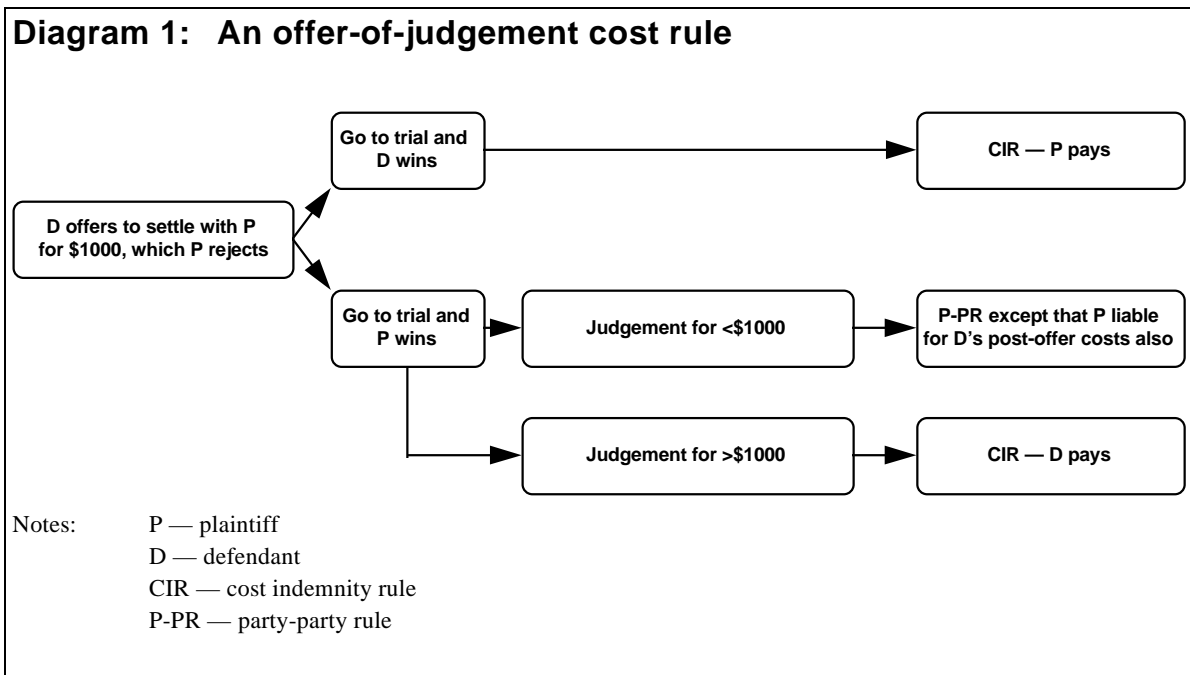
These problems occur because there is no avenue for the plaintiff to make a counter-offer; the position of defendants is strengthened by a one way cost-shifting rule.<sup>5</sup>

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<sup>4</sup> Available in most provinces.

<sup>5</sup> Anecdotal evidence suggests that Governments have incentives not to settle disputes when they should — whether it be for political, bureaucratic empire-building or other reasons such as insensitivity to costs. If true, a reversed offer of judgement rule may be a useful tool to overcome this tendency of government to be overly litigious. For example, a scheme could be

However, this weakness can be overcome by the adoption of a mutual cost-shifting rule (see below).



### *Mutual cost-shifting*

While one way cost shifting rules attempt to produce accurate and low cost judgements by encouraging settlement, this has proved elusive because they are biased in favour of the defendants. A mutual cost-shifting rule seeks to overcome this bias (Miller 1986; Spier 1994) by encouraging both the defendant and the plaintiff to make counter-offers till a settlement is reached.

The ORR supports the general thrust of the mutual cost-shifting rule flagged by the ALRC (1994, p. 58). This section extends and discusses such a proposal by considering:

- a suitable fall-back position for when parties do not wish to make offers prior to trial;
- the division of costs into pre- and post-offer divisions and ‘in-court’ costs; and

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implemented when a person (corporate and natural) is involved in a case against a Commonwealth department. Whether as the plaintiff or the defendant, if that person makes an offer to the department then the department would only recover costs if it is awarded damages above that of the offer. This judgement-of-offer rule would remove the incentive for departments to ‘over-spend’ in attempts to achieve their own goals.

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- awarding costs in those cases when there is a non-monetary award of damages.

A mutual cost-shifting scheme has to have a fall-back position to allow for situations when the two parties to a case do not wish, for whatever reason, to make a settlement offer. The scheme suggested by the ALRC was that a cost order would only ensue if, among other criteria, “the court was satisfied that the proceedings were brought vexatiously, frivolously or without reasonable cause (1994, p. 58)”. The vagueness of this criterion frustrates reasonable enforcement. Instead, the ORR suggests that if neither party proposes a formal settlement offer then the cost-indemnity (loser pays) rule should stand.

The ORR’s preferred form for a mutual cost-shifting rule is best explained by example — assume that the defendant makes a settlement offer of \$1000. The plaintiff rejects the offer but makes a counter-offer of \$2000 which the defendant rejects. Liability for pre- and post-offer costs would depend on the outcome of the trial.

Pre-offer costs would fall on the losing party according to the cost indemnity rule. The point at which pre-offer costs is determined is at the final offer before trial. This encourages parties to continue to make offers after their first or subsequent offers are rejected.

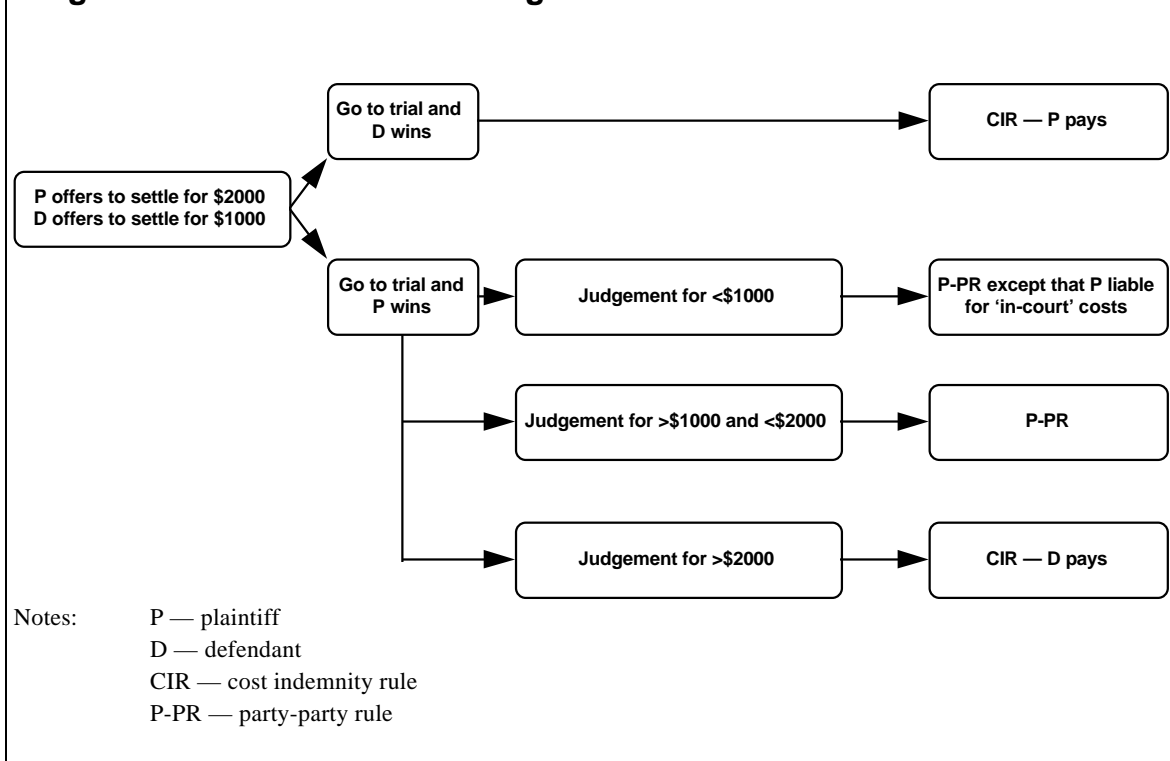
As set out in Diagram 2, post-offer costs would be determined in a more complex manner that departs from the traditional cost indemnity rule:

- if the defendant prevails then the plaintiff would pay both parties’ post-offer costs — the same outcome as the cost indemnity rule;
- if the plaintiff prevails for less than \$1000 then each party would be responsible for his or her own costs of legal advice and assistance generated outside the court. However, the plaintiff would be responsible for court-related disbursements,<sup>6</sup> court charges, transcript fees, and other costs arising from court procedures — in effect, the plaintiff is responsible for paying for their ‘day in court’;
- if the plaintiff prevails for an amount greater than \$1000 and less than or equal to \$2000 then neither party would be entitled to costs, so each party would be responsible for his or her own legal costs; and
- if the plaintiff prevails by an amount greater than \$2000 then the defendant would have to pay the plaintiff’s post-offer costs — the same outcome as the cost indemnity rule.<sup>7</sup>

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<sup>6</sup> Court-related cost disbursements may include barristers’ fees, travelling expenses on the day of trial, interpreter fees and the cost of engaging expert witnesses. This is discussed more thoroughly in ALRC (1994, p. 27).

<sup>7</sup> This model is similar to that proposed by the ALRC (1994, p. 58).

**Diagram 2: Mutual cost-shifting once offers are made**

While appearing radically different to the present cost indemnity rule, the strength of this proposed mutual cost-shifting rule is its commonality with the present rule; of the five outcomes available under this scheme, three are identical to the outcomes achieved under the general cost indemnity rule.<sup>8</sup> It is only when both parties should objectively have settled out of court that liability for costs are altered.

This scheme seeks to encourage parties to accept settlement offers; and is quick to penalise those parties who do not accept offers when it is reasonable to do so.<sup>9</sup> It ensures that neither side has an inherent advantage by allowing each party to neutralise the distributional effects of the other's offer by returning with a suitable counter-offer. This system provides an incentive to both parties to put a realistic offer on the bargaining table and accept realistic offers put to them, materially enhancing the possibility of agreement. Moreover, it seems likely that this scheme would provide greater incentives to make a generous offer because it encourages both parties

<sup>8</sup> The five outcomes are made up of the four shown in Diagram 2 and the specific case where neither party wishes to bargain and the cost indemnity rule operates by default.

<sup>9</sup> This model appears similar to that discussed in Issue 45 (ALRC 1994, p. 57); by modifying the cost order when the proceedings were commenced or defended without reasonable cause. Rather than relying on vague criteria such as categorising litigation as vexatious, frivolous or unreasonable, comparing a settlement offer to the final outcome more easily determines whether the state should condone such litigation.

to move toward the middle of the settlement range, where they are more likely to agree on a mutually beneficial settlement.

One possible problem with such a scheme is determining who ‘won’ when the judgement obtained includes a non-monetary award. The Advisory Committee on Civil Rules proposed the following test to overcome the perceived problem:

If the judgement obtained includes non-monetary relief, a determination that is more favourable to the offeree than was the offer shall be made only when the terms of the offer included all such monetary relief (Schwarzer 1992, p. 151).

The ORR considers that this would be a workable test in those cases where the judgement includes a non-monetary award.

### **3.3 Are there sufficient sanctions against predatory litigation?**

Even if the cost rules were modified along the lines suggested above, there is the important question as to whether they would overcome what many perceive as a tendency — especially by relatively powerful parties — to rely on excessive litigation.

Bluff and threats are part and parcel of legal disputes. There is much to gain from extensive bargaining because, for most parties, there is a diversity of outcomes that they may agree to.

In the first stage of the dispute, before lawyers are hired, the parties attempt to strengthen their hand by threatening each other with legal processes. In the second stage, their lawyers threaten to go to court. In a way, a trial is the result of a failure in negotiation (Tullock 1986).

One tactic is to appear to be very aggressive in the hope that the other side might be overwhelmed by the threat of heavy spending at trial and on subsequent appeal.

Such an approach, which does not necessarily reflect any particular merit of the legal case but rather a vexatious and strategic ruse by one of the parties, might not be fully discouraged by the reforms suggested in Section 3.2. Nevertheless, there are already substantial disincentives to persisting with such predatory litigation. In particular, if the aggressive party must carry out its threats when it has a weak legal case it is likely to suffer because, under the English rule, it must pay for the other party’s costs. A feature of the English rule is that it makes weak cases even weaker because losers pay as a consequence of any contest going to court.

However, a predatory approach to litigation may be aimed solely at extracting a settlement offer without any intention of going to court. In such cases, the defendant may offer some concession to save on the expected costs of responding, even if the chance of losing at trial seems slight.

A mutual cost shifting rule is an improvement on the English rule in penalising predatory appeals. For example, if a reasonable settlement offer is refused, the respondent is unlikely to have to pay the appellant's costs and is likely to be indemnified for most of his or her own costs even if the appeal succeeds.

Thus, the mutual cost-shifting rule is an extra hurdle for vexatious and predatory suits because costs are awarded by reference to pretrial settlement offers. Offer-based fee shifting rules encourage disclosure and thus facilitate settlement. Litigants are deterred from exaggerating their claims because exaggeration increases the likelihood of a trial and the expected costs contingent on a trial (Spier 1994). Moreover, if a reasonable settlement offer is made to the predatory litigant, he may be liable for the other party's court costs even if the predatory suit succeeds against the odds. Hence, the chances that such litigation will penalise the respondent is remote under a mutual offer of judgement rule.

Despite disincentives, some problems persist with vexatious and predatory suits, particularly if the initial loser takes the matter to higher courts of appeal. These problems are partly addressed by existing specific schemes.

- The costs of an appeal in civil or administrative law proceedings are at the discretion of the appellate court. Where the appeal succeeds on a ground not raised at the original trial, the successful appellant will ordinarily not be awarded costs of the appeal, although the court may allow him or her part of the costs of the original proceedings.<sup>10</sup>
- Most Australian jurisdictions have established statutory schemes to enable a court to issue a costs certificate to an unsuccessful respondent<sup>11</sup> in an appeal that succeeds on a point of law. A costs certificate entitles the respondent to an indemnity by the government administering the scheme against any costs awarded to the appellant. The court must be satisfied that it is proper for the respondent to be given a certificate. While the extent of the indemnity provided by a cost certificate varies between schemes, in most schemes the indemnity will be equal to the appellant's<sup>12</sup> costs of the appeal and the respondent's costs.

Anecdotal evidence suggests that these two schemes may, in practice, be far from effective. This is because:

- judges have tended not to exercise their discretion;
- counsel appear unaware of the existence of the funds, or are reluctant to ask that a cost certificate be awarded; and
- there may be insufficient funds in the statutory schemes.

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<sup>10</sup> *National Australia Bank Ltd v KDS Construction Services Pty Ltd* (1987) 163 CLR 668.

<sup>11</sup> The respondent is the party who won at first instance and who is responding to the appeal.

<sup>12</sup> The appellant is the party who lost at first instance and who is appealing that decision.

In summary, mechanisms have already been established to give some protection to persons who win a case in one court but are then taken by the loser through an appeal process to a higher court. But those mechanisms may not be used adequately to give sufficient assurance to weaker parties subject to litigation of a predatory nature. Accordingly, the ORR suggests that the adequacy of funds for appeals schemes be examined, and if necessary increased, and that judges and counsels should be made more aware of appeals support schemes.



## 4 CONCLUSION

It is essential that in considering reforms aimed at improving equity and access to justice the ALRC also give due weight to any implications for the efficient operation of the legal system.

The ORR suggests that changes to the cost indemnity rule and legal aid can improve the efficiency of the legal system, and in the process improve access to justice (whether that be through litigation or settlement).

Firstly, a separate body within the Attorney-General's Department should be given more scope to fund or indemnify parties in important public interest test cases — where it is quite clear that individuals lack sufficient incentive to pursue private litigation. This would encourage the production of important precedents.

Secondly, the ORR recommends that the cost indemnity rule should be modified to encourage parties to settle when their expectations of the outcome of litigation are very similar. The introduction of a mutual cost-shift rule would have three benefits. It would:

- encourage early settlement and discourage frivolous or vexatious litigation by penalising those parties who do not accept a reasonable settlement offer put to them;
- not penalise where the legal merits are fairly evenly balanced; and
- provide greater protection for reasonable litigants (those who are willing to settle when it is in their interests to do so) against well-resourced and unreasonable adversaries.

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