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-by-

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Civil Procedure Reconsidered

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The economic analysis of civil procedure can be enriched by a more thorough consideration of the productive functions of civil adjudication. The previous literature has recognized that civil adjudication does have products–conventionally described as dispute resolution services, plus precedents for future cases–but otherwise has tended to treat civil litigation as a tax on productive activity, or, worse yet, as unproductive or counter-productive rent-seeking activity.

While all of those perspectives can have their uses in certain contexts, they are all incomplete, because none captures an essential function of civil litigation within the legal system, which is *learning*, meaning the production of new knowledge or information, and not merely the exchange or revelation of pre-existing knowledge or information. Adding this perspective profoundly changes the economic analysis of civil litigation, which cannot thereafter be treated merely as a zero-sum (or negative-sum) game of strategic posturing and bargaining.

A more thorough consideration of the information-production function of civil adjudication presents a difficult and daunting task, because it requires more searching consideration of an obvious fact that has been recognized but not fully developed in the previous literature, which is that procedural law and substantive law act as both complements and substitutes for one another.[1] This means that a full economic analysis of procedural law necessarily must account for its interactions with the substantive law that is sought to be enforced, which is inherently a complex undertaking. That approach also cuts against the usual instincts of analysts in all fields, which is to carve up the subject of study into more easily digestible parts for examination.

Therefore, the primary objective of this paper is to show why it is essential to consider the substance-procedure interaction in order to arrive at useful results. The implications are profound, because the substance-procedure interaction exposes the information-production function that lies at the heart of the civil adjudicative process: because neither parties nor tribunals nor the legal system can "know" anything until the point of definitive adjudication, the adjudicative process itself functions creatively and productively, much like the price system in

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[1] This point is developed somewhat in Lewisch and Parker, *Procedure in American and European Law: A General Economic Analysis*, GMU School of Law Working Paper 07-40 (2007).

open markets. Moreover, as adjudication is a substitute for as well as a complement to substantive law (or ex ante contracting), decisions to defer (or not defer) information production into the adjudicative stage themselves are productive decisions of economic moment. Therefore, the tradeoff between ex ante investment (as through contractual provisions, rules of substantive law, or parties' decisions regarding their primary conduct) and ex post investment in adjudicative fact-finding is in no sense neglectable in the economic analysis of procedural law, but rather may be the single most important question to be examined.

In developing that thesis, this paper draws upon the insights of the Austrian economists, most notably Mises and Hayek. However, this is not a special "Austrian" perspective only, but a completely general point: once it is recognized that civil litigation creates a product in the form of new knowledge, then decisions to invest in litigation (versus its alternatives) must be treated not merely as "rent-seeking," but also as embodying some element of innovation, and thus are analogous to other investments in new knowledge, such as research and development, or exploration for natural resources. Because the incentives affecting such investment decisions necessarily will affect the supply and price of new knowledge, then the rules of civil adjudication, no less than those of any other legal regulatory structure, will affect welfare through their effects on the creation and production of new information through litigation, or its alternatives.

I. Returning to First Principles

Why is there procedural law? Conventionally, this question is answered by a trite truism that procedural law exists to enforce or carry out substantive law, and hence the older term for procedure of "adjective" law. However, this conventional answer masks the dual nature of procedure: yes, it carries out substantive law (a complement), but it also may replace a rule of substantive law (a substitute). How can that be?

The easiest illustration can be drawn from a simple two-party contract. In a sense, the terms of the contract are the "substantive" law for the contracting parties. But the parties may or may not be able to agree ex ante on all of the terms of the contract, or–more to the point of this paper–they may decide jointly that it is not worthwhile for them to specify all of the details of their bargain in advance, or even such major terms as the contract price. Instead, they may specify a process or procedure to address such questions as may (or may not) arise in the future. From the standpoint of economics, it does not matter whether the contracting parties explicitly appoint some third party to resolve an anticipated future contingency, or agree to submit to an arbitral agency, or, in default of those options, implicitly agree to litigate in the event of a future dispute. In each case, if the bargain underlying the contract is a productive activity, then so also are the parties's joint decisions on how much to invest in ex ante specification versus ex post disputation–these are decisions about investment in information.

Thus, the superficial appearance of civil adjudication as simple state-sponsored coercion can be misleading. In the contractual context, parties easily may avoid the coercive process by

contracting away from it, or simply not contracting at all. Few would argue that the complete absence of enforceable contracts is an acceptable state of affairs. We also can recognize that there are extra-legal enforcement alternatives, both coercive and non-coercive, such as mutual forbearance, reputational markets, moral suasion, or self-help, violent or otherwise. However, for some parties, those alternatives will not maximize their joint interest in contracting. Instead, some contracting parties could agree in their mutual interest ex ante to appoint a third party to adjudicate ex post disputes, with the possibility of coercive enforcement of the result. In that context, civil adjudication in public courts is only another option in an array of options from which the parties may choose, in their joint interest. And each of those choices, including ordinary civil litigation, is a productive choice.

While this effect is most transparent in the case of a simple two-party contract, actually it is entirely general. For what is "substantive" law aside from a specified set of consequences in the event that certain facts occur? The major bodies of non-contract law, such as tort, property, crime, and various public-law regulation, all follow that pattern. But what about the distinction between law and fact? That is another extension of the same continuum: whether a given question of fact has significance is a function of the "rules" of law, which usually are only partially specified in advance. So, nearly every question is actual adjudication is a "mixed" question of whether a particular event took place and what legal consequence (if any) that event connotes. Going back to the example of the two-party contract, any question of fact can be converted into a question of law by contractual provisions specifying the lack of legal consequence to a given fact, or entire sets of facts. The same is true of other bodies of substantive law.

II. Previous Economic Treatments of Civil Procedure

Previous economic treatments of civil procedure largely ignore or suppress the information-production function of civil adjudication.

One large body of literature is concerned primarily with a descriptive characterization of civil litigation as a strategic bargaining process, considering such matters as decisions to file suit, to settle or go to trial, and the like.[2] As the central feature of this literature is mutual estimates of expected outcomes in litigated matters, I will refer to it here as the "expected outcome" literature.

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[2] For an early survey of this literature, see Cooter and Rubinfeld, "Economic Analysis of Legal Disputes and their Resolution," 27 Journal of Economic Literature 1067-97 (1989). More recent summaries can be found in Kobayashi and Parker, "Civil Procedure: General" and the companion chapter by Parker and Kobayashi on "Evidence" in *Encyclopedia of Law and Economics* (Bouckhaert & deGeest eds.)(Edward Elgar: 2000); and in Sanchirico (ed.), *Procedural Law and Economics* (Volume 8 of Encyclopedia of Law and Economics, Second Edition) (Edward Elgar: 2012). Another source of more selected but excellent develpment of both this literature and the Posner model of direct and error costs is Bone, *Civil Procedure: The Economics of Civil Procedure* (West: 2003).

To the extent that this literature considers information economics at all, it is in terms of exchange or revelation of information held by each party, or the effects of asymmetrical information. However, revelation is not learning in the sense used in this paper, which is the creation of information that neither party may have possessed ex ante lite. And in these models, the only value of information lies in predicting what the third-party adjudicator may do. There is little attention to the problem of error by the adjudicating authority.

Another large body of literature has grown up around a pioneering 1973 article by Richard Posner,[3] which postulates a more normative model of the welfare consequences of civil litigation. In Posner's model, the "efficiency" of procedure is seen as requiring the minimization of the sum of "direct" costs and "error" costs, both of which have both private and social dimensions. In this framework, the recognition of "error" costs at least concedes that adjudicators may err, but it actually does not explain how such a thing might be observed, and the existing literature only partially develops the welfare consequences of both private and social error costs.

Similarly, Gordon Tullock's famous critique of the adversarial system, published in 1980 as *Trials on Trial*,[4] appears to take information supply as given exogenously to the litigation problem. In Tullock's model, every civil lawsuit has a "Mr. Right" and a "Mr. Wrong," and thus he criticizes adversarial procedure as inefficient because "in adversarial proceedings, a great deal of the resources are put in by someone who is attempting to mislead." (Tullock (1980), page 96), But he does not explain how observers know which is "Mr. Right" and "Mr. Wrong," nor even how the parties themselves know. In effect, Tullock assumes that this information somehow is provided exogenously to the litigants' decisions, perhaps by an idealized judge in the inquisitorial system. But the judge has to learn, too. How does the judge do so, and how do we know whether the judge is right or wrong?

In fairness to Tullock, he was making only a limited comparative point. Even that point is subject to substantial doubt.[5] However, the major contribution of Tullock's work has been in

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[3] Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Leg. Studies 399-458 (1973); and see the summary sources cited in note 2, above.

[4] Tullock, *Trials on Trial* (Columbia University Press 1980).

[5] My own experiments with Michael Block and others have shown that the actual structures of both the process and information production were more complex than previously appreciated. See Michael K. Block, Jeffrey S. Parker, Olga Vyborna, & Libor Ducek, *An Experimental Comparison of Adversarial versus Inquisitorial Procedural Regimes,* 2 Am. L. & Econ. Rev. 170-94 (2000). Further results from this series were reported in Michael K. Block & Jeffrey S. Parker, *Decision Making in the Absence of Successful Fact Finding: Theory and Experimental Evidence on Adversarial versus Inquisitorial Systems of Adjudication*, 24 Intl. Rev.

stimulating further thought–some critical and some supportive of Tullock[6]– that is beginning to identify the information-production features of civil litigation.

A following literature comparing the properties of adversarial versus inquisitorial procedure has produced important insights.[7] Adversarial procedure possesses an obvious resemblance to competition in the marketplace,[8] and following this analogy has produced a series of papers drawing on game-theoretic models to challenge Tullock by showing the comparative superiority of competitive production of the information supplied to tribunals, beginning with a 1986 paper by Milgrom and Roberts,[9] as extended in papers by Froeb and Kobayashi (1996 and 2001),[10] and supplemented in papers by Shinn (1998), Dewatripoint and Tirole (1999), Sanchirico (2001), and Yonai (2012).[11] The important advances in these models are in the recognition that information supply is a costly activity, and that both tribunals and litigants can be uninformed and imperfect. But perhaps the most important insight is that the information-supply properties of civil adjudication, especially in the competitive adversarial form, can

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L. & Econ. 89-105 (2004), and Jeffrey S. Parker & Peter Lewisch, *Materielle Wahrheitsfindung im Zivilprozess*, in 100 JAHRE ZPO: ÖKONOMISCHE ANLAYSE DES ZIVILPROZESSES (P. Lewisch & W. Rechberger eds.1998: Manz).

[6] Among the supportive papers, see Zywicki, "Spontaneous Order and the Common Law: Gordon Tullock's Critique," 135 *Public Choice* 35-58 (2008) and Parisi, "Rent-seeking through litigation: Adversarial and inquisitorial systems compared," 22 *International Review of Law and Economics* 193-216 (2002). However, as discussed below, considering the cost of evidence production and the nature of the decision-maker can change the picture.

[7] An excellent and up-to-date summary of this literature is given Froeb and Kobayashi, "Adversarial versus inquisitorial justice," in Sanchirico (ed.), *supra* note 2.

[8] See Lon L. Fuller, "The Forms and Limits of Adjudication," 92 Harv. L. Rev. 353 (1978).

[9] Paul Milgrom & John Roberts, *Relying on the Information of Interested Parties*, 17 RAND J. Econ. 18-32 (1986).

[10] Luke M. Froeb & Bruce H. Kobayashi, *Naive, Biased, yet Bayesian: Can Juries Interpret Selectively Produced Evidence?* , 12 J. L. Econ. & Org. 257-75 (1996); Luke M. Froeb & Bruce H. Kobayashi, *Evidence Production in Adversarial vs. Inquisitorial Regimes*, 70 Econ. Letters 267-72 (2001).

[11] Shin, "Adversarial and Inquisitorial Procedures in Arbitration," 28 RAND J. Econ. 378 (1998); Dewatripont and Tirole, "Advocates," 107 J. Pol. Econ. 1 (1999); Sanchirico, "Relying on the Information of Interested–and Potentially Dishonest–Parties, 3 Am. L. & Econ. Rev. 320 (2001); Yonai, "Trials as Markets for Truth: A Catallactic Approach to Comparative Legal Procedures" (Draft paper, April 2012, Lundy-Fetterman School of Business, Campbell Univ.).

replicate the information-impacting effects of free competition on the supply and price of commodities in the marketplace. Like other products, information supplied to litigation is not a free lunch, either. These insights lead directly to a consideration of the economics of information, as developed most notably by Hayek, discussed in the next section.

In a somewhat parallel development coming from the opposite direction of contract law and economics, papers by Scott and Triantis (2006) and by Sanchirico and Triantis (2008) have begun to develop the tradeoff between ex ante contract specification and ex post disputation.[12] This insight calls attention to the importance of opportunity costs and subjective valuation: because parties may differ in their ex ante ability to anticipate future disputes–and their opportunity costs of doing so–then the tradeoffs involved would seem to be inherently subjective. Thus, a one-size-fits-all approach to rules of civil adjudication, and especially those affecting the parties' incentives to produce information, seems unlikely to be satisfactory.

While the recognition remains imperfect, the more recent literature is beginning to come to grips with the profound effects of recognizing the information-production function of civil litigation. What this means is that the temptation to treat civil litigation as essentially a tax (as in Posner) or simple rent-seeking by one or another party (as in Tullock), must be rejected. Moreover, because information supplied to litigation is not only costly to produce (thus affecting the incentives to supply) but also diffused in nature, in the baseline case it cannot be "known" exogenously to the litigation process, but rather is learned through that process. Thus, in terms of Tullock's model, observers cannot "know" which is "Mr. Right" and "Mr. Wrong," and even the litigants themselves may not "know." Finding out which is which is an important part of what civil litigation produces, for the parties as well as the legal system. And, like commodities prices in the market, that knowledge is a particular of time and place, which neither the parties nor the legal system have adequate incentive to learn until the transaction–i.e, the adjudication–actually takes place.

III. The Economics of Information, Subjective Valuation, and Opportunity Costs

One of Hayek's great contributions to economics was to characterize the nature of information supply in the marketplace. His paper on *The Use of Knowledge in Society*[13] shows that the precise information needed to determine prices are never possessed by a single individual, and in fact are generated only by transactions in the marketplace. For this reason, valuation and allocation decisions by a central planner, no matter how well-informed, are all inferior to market transactions. The argument of this paper is that adjudicative facts are

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[12] Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 Yale L. J. 814 (2006); Chris William Sanchirico & George Triantis, *Evidentiary Arbitrage: The Fabrication of Evidence and the Verifiability of Contract Performance*, 24 J. L. Econ. & Org. 72 (2008).

[13] F.A. Hayek, *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519 (1945).

analogous to prices determined in the market, and thus are subjective to the similar economic effects of diffused information.

At first blush, readers may resist this analogy, because one of the most cherished myths about adjudication is that there is some absolute "truth"– or perhaps I should say a monopoly "truth"– to which the adjudicative process aspires. This is not even formally correct: what litigation actually does is to generate the information necessary to determine the legal rights and obligations of the parties, under some pre-existing set of rules or standards, which has very little to do with anyone's version of either "truth" or "justice." In fact, the material standards of adjudication may have less to do with historical accuracy than with generating optimal incentives for ex ante conduct.[14] And even when they have to do with historical events, and do not depend on the sometimes narrow perspectives of the substantive legal regime, those facts may themselves be inherently subjective, at least in the sense that they are meaningful only to the immediate parties.

Again the simple two-party contract helps to illustrate the point. Assume a contract for the sale of raw materials suitable for use in a manufacturer's unique process, and a dispute arises as to the suitability of a given shipment. The actual quality of the material is a matter of complete indifference to the rest of society, and may even be matter of indifference to the parties until a disruption of the manufacturer's operation occurs. It is hard to find any "objective" element in this dispute; the actual question for the legal system is what did the contracting parties "intend." Our current law may seek to objectify certain aspects of the dispute in order to make it more tractable, but, in pure theory, the "right" answer is the one that reflects the parties' subjective intent. And, for purposes of this paper, the key point is that the parties themselves may not have "known" ex ante which qualities of the raw material rendered it suitable to the manufacturer's needs, because it was not worth it to the parties themselves to invest in that information until the problem arose. In this sense, the parties's dispute in adjudication is analogous in Hayek's terms to a particular marketplace transaction, and is essentially subjective, in that it means something only to the immediate parties and only by their (perhaps) idiosyncratic standards.

There are two further consequences. First, given the inherently subjective nature of the inquiry, there is unlikely to be any dominantly optimal rule of either substantive contract law or civil procedural law to govern the parties' decisions to invest either ex ante or ex post in the information. As a first approximation, the parties themselves, and neither a future tribunal nor "society" in general, are likely to be in the superior to make those investment decisions. Furthermore, those decisions are likely to be further subjectified by the unique opportunity costs

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[14] For an excellent paper developing this point in the context of evidentiary rules, see Sanchirico, "Character Evidence and the Object of Trial," 101 Colum. L Rev. 1227 (2001); see also Jeffrey S. Parker, *Economics of Evidence and Proof*, in 1 Encyclopedia of Law and Society 524-27 (David S. Clark ed. 2007: Sage).

of each party.[15] Suppose, in the example, that the manufacturer is a baker uniquely skilled in the baking art but technically deficient specifying the technical characteristics of suitable flour known to his supplier. In that instance, it may not be worthwhile for the parties to specify the flour characteristics beyond "suitable," and certainly neither the legal system nor a later adjudicating tribunal is in a position to second-guess that decision.

Second, and despite the subjective nature of the costs involved, the future shadow of civil procedure rules as affecting the nature and cost of both ex ante and ex post information investments will affect the available quality and supply of information to any ex post dispute.[16] To take an extreme example from familiar civil procedure, the famous "work product" rule of *Hickman v. Taylor*[17] is based upon the Supreme Court's very explicit consideration of the effect that the opposite rule would have on the quality of information produced by the parties. In other words, incentives matter, but they matter different to differently-situated parties. Exactly how they matter is a function of subjective opportunity costs.

IV. A Thought Experiment in Coasian Enforcement: The Case of the Fractional Cow

This section attempts to make the insights of the previous three less abstract by applying them to a motivational example inspired by Coase's famous paper on *The Problem of Social Cost*.[18] Using Coase's systematic treatment of opportunity costs helps to show the generality of the points being made here, as it can be used as a basis for expanding the model beyond a simple two-party contract into other fields of law. The example also helps to fill two gaps left by Coase: one is costly enforcement of "Coasian bargains," which are suppressed in his analysis; the other is costly information, which he notes but sets aside. The thesis here is that the two are related to one another, and together they server to illuminate a previously-neglected function of civil adjudication.

My example of "The Case of the Fractional Cow" is inspired by Coase's hypothetical of the adjoining farmer and cattle rancher whose land uses affect on another. Specifically, Coase postulated that the size of the rancher's herd of cows affected the incidence or magnitude of the "externality" that the rancher's cows would escape from the ranch, stray over to the adjoining

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[15] One of the best early treatments of opportunity costs is Mises, *Human Action*. An excellent development of the concept as foundation for economic theory is James M. Buchanan, *Cost and Choice* (University of Chicago Press: 1969).

[16] On the general point, see Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 Am. Econ. Rev. 561 (1971).

[17] 329 U.S. 497 (1947).

[18] R.H. Coase, *The Problem of Social Cost*, 3 J. Law & Econ. 1-44 (1960), *reprinted in* R.H. COASE, THE FIRM, THE MARKET, AND THE LAW, at 95-156 (1988: Chicago).

farm, and damage the farmer's crops. Coase's purpose was to show that the joint product of the conflicting uses could be maximized under opposite legal entitlements respecting the "externality," provided that positive transaction costs did not prevent the rancher and farmer from reaching an optimal "Coasian bargain." Thus, whether ranchers were liable for straying cows or farmers were required to absorb their losses, under those conditions the parties could still maximize their joint product by contracting away from the starting rule of law.

My example writes a sequel to one variation of the "Coasian bargain," where the prospect of enforcement arises under that bargain. This highlights two aspects of the solution that Coase did not consider explicitly. First, while suppressing both transaction costs generally and information costs between the conflicting parties, Coase's statement of the problem assumes positive costs of legal policy formulation, in that the law can err in assigning the original legal entitlement. Second, what happens after the "Coasian bargain" is reached? In particular, what happens if one of the parties fails to live up to the Coasian bargain? Coase seemed to assume that the enforcement of both the original entitlements and the Coasian bargains between the parties were perfect and costless. Relaxing those assumptions is what begins to characterize the problem of civil procedure.

The most interesting case is where the likely alternative structures of the beginning legal entitlement–either that ranchers were liable for all crop damage caused by straying cows, or that farmers were required to absorb those costs–were both sub-optimal, because joint product was maximized by an agreement to control the size of the rancher's herd at some level above zero. So, let us assume that the optimal herd size is 2 cows, because increasing the herd to 3 cows increases marginal crop loss more than marginal ranch product, and similarly, a decrease in herd size reduces marginal ranch product more than marginal crop loss. This solution also assumes (as did Coase) that regulating herd size is the least-cost method of controlling the "externality." However, because the parties have chosen the intermediate solution, crop loss from cow straying is not reduced to zero, but presumably is compensated ex ante in the consideration paid in order to reach the Coasian bargain.

Now, what happens if one of the parties accuses the other of breaching the Coasian bargain? Suppose that the farmer sues or threatens to sue the rancher, claiming that the rancher exceeded the contractually-specified herd size, thus producing "excess" crop loss. This is where the characteristics of the procedural system, in a world of positive information costs, begin to have an effect.

In procedural systems featuring "strict" pleading rules that require plaintiffs to state the factual grounds of their case with particularity, the farmer may not have a litigable case at all, if the farmer knows only that his crops were trampled down. In systems with more "liberal" pleading rules and a right to pretrial discovery, the farmer may be allowed to bring his case and might actually win, if it turns out to be true that the rancher exceeded the agreed herd size. On the other hand, it could be argued that "liberal" pleading rules might encourage "frivolous" litigation, as the farmer's crops could have been trampled by vandals, or by one of the farmer's

careless farm workers. Or the same case may present both possibilities simultaneously: the rancher may have run too many cows, but the actual trampling of the crops was caused by a farm employee. In that case, both parties would have an interest in pretrial discovery from the other. These possibilities present problems of asymmetric information as to the actual merits of the case, and raise substantial questions as to the tradeoff between accuracy or "justice" on the one hand, and speed and expense of adjudication on the other.

But these are only the obvious, first-order problems. More subtle problems may appear. Depending upon the structure of the adjudication system, the decision maker may or may not be willing to explore some of the more exotic possibilities, such as whether the crops were trampled by incompetent crop-circle hoaxers, or whether scientific analysis of the crop field could distinguish cow-trampling from other forms of trampling. And there could be issues of credibility: the farmer may actually believe that the cows trampled his crops, and therefore failed to question his farm workers; or, the farmer may simply be a lying rent-seeker, who deliberately trampled his own crops, after they failed from some other cause, such as unfavorable weather. Or, the credibility of the rancher, and his business records, could be in question: if the rancher were deliberately cheating on the bargain, he may be unlikely to make an honest record of his cheating. Should he be permitted to present his own business records as proof that he observed the herd limitation? Should non-parties who dealt with the rancher be subpoenaed to produce records and testimony? Who is in the better position to decide whether to pursue these avenues of proof, and to assess the credibility of the results?

But even these questions are relatively conventional. Suppose that the facts, as developed, show that the rancher actually ran 3 cows on his property for one quarter of the year. This is the "fractional cow" problem, as we now have 2-1/4 cows per year. The ex ante bargaining of the parties may or may not have considered the "fractional cow" in specifying the contractual 2 cows. In that case, how is the contract to be construed? It is easy enough to say that the "intent of the parties" should govern. But how is that intent to be found? Is it subjective intent, as would be suggested by economic analysis? Or is it objective intent? And how much of that choice is influenced by information costs associated with ascertaining the parties' intent? If the parties actually never foresaw the "fractional cow" problem, then this question may not be answerable ex post. This raises the question, often encountered in procedural systems, of just how such a question should be resolved. Should court pretend that it is simply determining an historical fact? Or, should it recast the substantive rule, because the pre-existing rule is too costly to enforce with tolerable accuracy? Or, should it pretend that the question of fact is actually a question of law? Or, should it dismiss the case because the parties, or one of them, has failed in the burden of proof? These are all variations that are observed in practice.

From the economic point of view, the best solution to the "fractional cow" problem may have been for the parties to recognize and agree on a solution ex ante. If information and transaction costs are negligible, this could be the efficient solution. But in a world of positive transaction and information costs, it is a costly activity, and incurring that cost could exceed the benefits of a more precisely-specified contract. For example, suppose that the "fractional cow"

was a new calf. Did the parties mean to include calves in cows? If they failed to foresee that contingency, who should bear the resultant loss? Is there actually any way to "find" what the parties' ex ante intent was, or would have been?

Moreover, the parties' incentives to solve the problem ex ante are given in part by the features of the ex post procedural system, or, in other words, the assumed ex post procedural system is endogenous to the contracting parties' choices. In this respect, the procedural system can reduce economic efficiency by being too inexpensive. If it is the case that social efficiency would be promoting by ex ante bargaining to this level of detail, then the provision of a expeditious and inexpensive procedural system ex post reduces economic efficiency, because it still may be more costly in the deeper sense that coercive litigation can never replicate the exact result of ex post bargaining. On the other hand, an unduly expensive or unreliable litigation system may impair efficiency by encouraging parties to over-specify their ex ante bargains in terms of improbable contingencies.

The law and economics literature only recently has begun to address some of these problems, by developing in the contractual context the general proposition of substitution between substantive law (or contract terms) and procedural law, as a way of optimizing the endogenous tradeoff between ex ante bargaining and ex post litigation costs by the contracting parties.[19] However, including this perspective introduces an array of new considerations that have yet to be worked out completely.

In particular, considering the substitution of procedural rule specifications for substantive contract terms introduces a third party into the analysis–the adjudicating authority itself. If the contracting parties fully internalize all of the litigation costs, including those borne by the adjudicating authority, then private contracting can provide the efficient solution. In this situation, it seems clear that the parties' solution is efficient by hypothesis because it is Pareto-optmal, regardless of how outlandish it may appear to outside observers. Thus, the parties may decide to solve the case of the fractional cow by commissioning expensive new scientific research on distinguishing cow crop-trampling from other crop-trampling, or, at the other end of the spectrum, they may agree to be bound by local customs or mythologies, such as whether the crop-trampling occurred during a full moon. Either way, social policy has very little to say.

However, the parties' intent may not be so apparent. Moreover, the parties may well evince an intent to rely on the presumed expertise of an established tribunal (not necessarily a public court), which could be efficient to the parties (and to society), if the adjudicating tribunal faces lower marginal costs than the contracting parties themselves in selecting and implementing efficient procedural rules.

In contrast with the pure case where the adjudicating tribunal is merely a private agent for the contracting parties, most adjudicating tribunals in fact are repeat players who specialize in

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[19] *See* Section II, above.

dispute resolution, spread their production costs over a number of disputes, and thus have a comparative advantage over the contracting parties who, by definition, specialize elsewhere (farming and ranching, in Coase's example). To see the effect, we need not resolve the question whether dispute resolution is a public good that is more efficiently provided on a social scale, although that is one of the standard explanations for the public provision of courts to resolve civil disputes. Even private arbitral tribunals may provide economies of scale and skill in providing dispute-resolution services. Those economies may require that the tribunal adhere to repeat patterns of procedure. To take a crude example, suppose that the adjudicating tribunal has chosen the English language for its adjudications. If the parties instead choose Mandarin as their optimal language of ex post disputation from their point of view, the tribunal may be unable to provide the dispute-resolution services at a cost that the parties are willing to bear, simply because there are not enough disputants to justify a tribunal using Mandarin. This puts the contracting parties back into the problem of contracting under constraints imposed by the available adjudication choices ex post.

In the case of publicly-provided courts, this problem becomes even more severe. Publicly-provided systems vary in their amenability to contractual specification of procedural rules, but nearly all of them will draw the line somewhere, in order to maintain their basic competency as tribunals. Actual functioning systems are likely to have even more complex pricing structures. For example, public "common-law" courts in the Anglo-American system specialize in part in providing rules of law–substantive and procedural–for the benefit of the larger society. Part of the "price" paid by litigants for access to the publicly-subsidized courts may be the parties' provision of the facts of their dispute–or a certain quality of factual dispute–in exchange for the publicly-subsidized resolution.

However, as the public courts became less flexible in terms of the contracting parties' preferences for procedural rules, this reduces the range of choice available to the parties ex post. As contracts and disputes become more diverse, so also becomes the optimal ex post procedure for each given dispute. Reducing the range of choice among ex post procedural systems can also constrain the range of contractual choice ex ante, and thereby reduce the efficiencies obtainable in the joint product of ex ante bargaining and ex post disputation.

From this point of view, civil procedure rules applicable in public courts would appear to involve a tradeoff between the presumed social benefits to third parties of the provision of disputes for public adjudication versus the potential costs to litigants in the form of too much rigidity in the ex post procedures applied. As shown above, there is likely to be a wide range of optimal dispute-resolution procedures for a given dispute, and very little public interest in choosing among them, except perhaps to the extent that the parties' choices are so idiosyncratic as to impair to comparative advantage of the tribunal or constitute relative under-pricing. But it that is the case, it would seem to call for some pricing structure whereby the parties jointly could purchase "custom" procedures, even within the publicly-provided system.

So far, the discussion in this section is limited to the hypothetical Coasian contracting

situation. However, just how different are other areas of civil litigation? The portion of this discussion dealing with ex post bargains between the parties respecting litigation rules would seem to apply with equal force to any form of civil litigation, where over torts, contracts, property, or any other subject. Thus, to take just one current example, if the parties wish to take 20 depositions rather than 10, then why should even the public procedural rules forbid their stipulation to that effect? Particularly in the case of depositions, there is little to no "spillover" to the public tribunal.

At first blush, the non-contractual areas would appear to differ in terms of the ex ante/ex post tradeoff between information investments. However, this is not necessarily true: areas of tort or regulatory law certainly can involve ex ante agreements as to litigation procedures, including arbitral tribunals, or "assumption of risk" agreements, among others. Morever, the same temporal dynamic applies to all fields: even as default rules, the rules of civil procedure can relatively encourage or discourage parties ex ante to invest in information that may be useful either in future litigation, or in deciding whether to undertake a given activity or level of activity. This is the frontier of future research on the economics of civil procedure: working out whether and under what circumstances the existing rules or supposed "reforms" to civil procedure actually have adverse consequences for the primary activities of potential litigants. As this paper shows, that question extends far beyond the rules themselves or the interest groups that actually influence most procedural rules.

V. Some Implications for Current Debates

This section seeks to apply the information-production perspective brief to some current topics in civil procedure, primarily for the purpose of stimulating further research. As will be shown, applying that perspective can have profound effects on the terms of debate.

A. Adversarial versus Inquisitorial Procedure and "Managerial Judging"

The discussion above has considered the debate between adversarial versus inquisitorial procedure, which appears to have been the first one now profoundly affected by the information-production perspective, and in this sense is a paradigm for future research on a variety of topics in civil procedure.

The most recent research would seem to support the traditional American "adversarial" system, which gives extensive party autonomy and requires each party to bear its own costs of litigation. Only the immediate parties can know what is optimal procedure for their own dispute, which under subjective valuation is unique to them. There are two qualifications: (1) public subsidy, which seems minor; and (2) ex post strategic behavior, which is potentially significant, but could be excluded in cases of mutual agreement, either ex post or ex ante, and in other instances could be distinguished.

Law-and-economics researchers should take note that the current trend of our literature is somewhat at odds with the general trend in recent "reforms" to civil procedure, especially at the federal level, which for the past 30 years at least have reflected an incessant march towards more"managerial" judging and the suppression of some margins of party autonomy, especially in pretrial discovery. There also is a longer-standing drive toward more "uniformity" in civil procedure, first at the national level and more recently at the international level.[20] The information-production perspective developed in this paper indicate that all of these trends are misguided.

All of these trends overlook the basic insight from Hayek's work on information diffusion and production. In those cases (not all) where there ultimately is a "Mr. Right" and a "Mr. Wrong," that characterization itself may be an exogenously imposed construct of the legal system, and thus represent social friction rather than "justice." Moreover, even in such cases where it does represent the joint subjective valuation of the parties, "Mr. Wrong" does not necessarily know that he is "Mr. Wrong" ex ante lite. Like a consumption decision in the marketplace, an adjudicatory fact that one of the litigants is a "Mr. Wrong" is a particular of time and place, which neither party has an adequate incentive to learn until the transaction actually takes place. Thus, the essence of the civil litigation process, much like market processes, is to learn (i.e., to produce) information that did not previously exist. In that context, any form of economics would suggest that the competitive production of such information represented by an adversarial system with sharp incentives and some symmetrical access (perhaps through pre-trial discovery) produces a superior outcome to an inquisitorial system that more nearly resembles central planning or monopoly.

Furthermore, much of the brief for "inquisitorial" procedure seems to rest on the supposed "sophistication" of the career judge decisionmaker, as opposed to "naive" jurors or Anglo-American judges, who are vaguely accused by innuendi of being diletantes in the judging business, as they are appointing from the practicing bar.[21] But the "sophistication" of the decision-maker does not seem crucial to the relative performance of the rule systems.

At some level of competitive information production, the answer will become clear to all, and the danger with "expert" decision-makers is precisely their pseudo-sophistication, or what I have called the "Judge Judy" effect.[22] The more control by the "expert" decision-maker, the

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[20] For an analysis of the recent international trends, see Jeffrey S. Parker, "Comparative Civil Procedure and Transnational 'Harmonization': A Law-and-Economics Perspective," in Bork, Eger, & Schaefer, *Economic Analysis of Civil Procedure* 387-421, at 410-12 (Mohr Siebeck: 2009)(Proceedings of the 2008 Travemunder Symposium).

[21] See John H. Langbein, The German Advantage in Civil Procedure, 52 U. Chi. L. Rev. 823 (1985).

[22] See Parker, *supra* note 18.

more tendency there will be to substitute pre-judgment for the actual facts of the controversy. At the limit, this would entirely defeat the information-production function that lies at the heart of civil adjudication.

B. Contracting for Procedural Rules and Fora

A related point concerns the surprising degree of hostility, even within American courts, toward accepting litigants' efforts to customize the civil procedure rules of the public courts for their particular dispute. There appear to be very limited grounds for court to resist such efforts, and yet they do so.

Extending the previous discussion of party control, why not treat all rules of civil procedure as "default" rules rather than "mandatory" rules? This is not the current practice in American courts, and still less so elsewhere. Under current American rules, contracting parties may choose arbitration ex ante, and all parties generally (with some exceptions) may choose arbitration ex post. But they have only limited rights to "customize" the pubic rules for their own dispute. The rationale for this position presumably is that the parties somehow do not internalize the efficiency losses (e.g, less precedent, less familiarity of judges with the chosen rules), and therefore are taking more than their "fair share" of the public facility. But why not allow the parties jointly to "bargain" with the court over applicable rules? Judges may be bad agents for the public interest, but they are likely to be better than centralized rule-makers.

A "second-best" solution to the foregoing problems is provided by expanded enforcement of choice-of-forum clauses. All other things equal, the broader the range of procedural system choice available to the parties, the more efficient will be the resolution of disputes.

The more likely explanation for the courts' reticence to accept customization of procedure may be the same as any incumbent monopolist: innovation is a threat to the monopoly. It does seem to be a losing strategy, but the strange incentive structures of public judges may provide an explanation.

C. External Preclusive Effects from Civil Adjudications

The analysis of this paper would seem to disfavor giving any external effect (i.e., impact on third parties) of civil adjudications. This would call the current law of non-mutual collateral estoppel into question.[23] It also would call into question the doctrine of precedent (except in

[23] For an economic analysis of external effects, see Kobayashi, "Case Selection, External Effects, and the Trial/Settlement Decision," in Anderson (ed.), *Bridging the Settlement Gap* (JAI Press: 1996), pages 17-49, which is further extended in Kobayashi and Parker, *supra* note 2.

those cases of mutual repeat litigation),[24] and suggest that private arbitration should be preferred. To the extent that civil litigants mutually choose the public courts over private alternatives, it raises the question whether there is a "free rider" problem. The alternative explanation is that prior precedent has more value to the current litigants than the marginal costs of litigating in the public courts. These would appear to be fruitful competing hypotheses for future research. At present, there is only a very small public expenditure on the apparatus of civil procedure, and therefore most of the costs are borne by the parties (excluding external effects). Accordingly, even small changes in public adjudication rules may have dramatic effects on parties' choices of public versus private fora. We already know that there is extensive "forum shopping" within the public courts.

D. Remedial Structures

The information-production and subjective valuation aspects of this paper can help to achieve some analytical advance in helping to distinguish both substantive and procedure law on the one hand from what I will call "remedial structure" on the other.

To some extent, "remedial structure," i.e, the form and valuation of remedies given in civil litigation, as between damages and injunctive relief, is an established concept in the law-and-economics literature, usually framed as "property rights" (i.e., injunctive relief and specific performance), versus "liability rules" (damages). The importance of subjective valuation tends to favor the "property rights" type. However, there are two important qualifications in the ex post world: (1) strategic behavior by one or both litigants; or (2) exogenous change. The first problem seems endemic to torts, but it is possible that damages rules could be re-framed to more closely approach ex ante subjective valuations (e.g., insurance rates).

The new contributions made by this paper are two-fold. First, ex ante specifications, such as liquidated damages clauses or exclusions of certain types of remedies, should be favored by the courts, as they generally are. Second, explicitly distinguishing "remedial structure" from either substantive or procedural law as such helps to clarify several current debates that ostensibly are about "civil procedure reform," but in reality are problems of the remedial structure itself and therefore cannot be solved by changes to procedural rules. Several examples of this effect are developed in the following subsection.

E. The Scope and Expense of Pretrial "Discovery"

For the last several decades, there has been a constant drumbeat of criticism about the American system's proclivities toward "overdiscovery." Rules amendments since 1980 have sought to "limit" or "manage" discovery in various ways. However, it has not been shown that this is a serious social problem, either empirically or in theory. Costs of litigation, including

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[24] See Rubin, "Why is the Common Law Efficient?", 6 *Journal of Legal Studies* 51-63 (1977).

discovery costs, can go up simply due to changes in substantive or remedial law rather than any procedural dysfunction, and that seems the more plausible explanation.

Rather, the problem (if there is one) may lie in the remedial structure (remedies and their "objectified" measures) rather than the rules of procedure. If the remedial structure were consistent with subjective valuation (and if third-party preclusion benefits are exluded), then each side should have the appropriate incentive to request such discovery as is justified by its own subjective valuation of its case, provided that the requesting party internalized the full cost of its request. So, the real debate reduces to one of two things: (1) the remedial structure is mis-specified, in which case this is not a "procedure" problem as such, and no amount of procedural rule-changing can address it; or (2) the system is not sufficiently internalizing the costs of discovery to the requesting litigant, such that discovery requests are being used as extortion devices.[25] Assuming the second of these two problems, shifting discovery costs to the requester would seem to be the solution.

However, it has been suggested (e.g. Allen) that the procedural system is unable to shift costs accurately.[26] That may be true, but perfect accuracy is not necessary. As in other cases of moral hazard, it would seem that even partial "co-insurance" can help to mitigate the problem. Moreover, even though subjective, some of the opportunity costs of the responding party can be estimated with tolerable accuracy, or at least more accurately than the central-planning-style solutions that have been suggested to date.[27]

Many of the rule changes indicate that court-assisted coercion of one party by the other is not the fundamental problem. As noted above, the rise of "managerial judging" above the mutually-agreed preferences of opposing litigants is entirely inconsistent with the extortion hypothesis. Also, certain traditional discovery devices–such as the oral deposition–appear to have very little potential for unchecked abuse, because the bulk of the costs are borne by the discovering party, and the imposition on the opposing party (essentially, the opportunity costs of its deponent and lawyer) are observable on the basis of marketplace transactions. And yet, there appears to be equal emphasis on limiting the scope of both the more and less abusive methods of discovery. This suggests that the stronger explanation for the many recent discovery rule changes rests in public choice analysis of the pressure groups influencing the rulemaking outputs rather than the transaction costs of adjudication itself.

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[25] Bruce Kobayashi recently has presented a paper that begins to get at this problem. Kobayashi, *Law's Information Revolution as Procedural Reform: Predictive Search as a Solution to the* In Terrorem *Effect of Externalized Discovery Costs* (February 15, 2013).

[26] Allen and Guy, *Conley as a Special Case of Twombly and Iqbal: Exploring the Intersection of Evidence and Procedure and the Nature of Rules*, 115 Penn St. L. Rev. 1 (2010).

[27] See Redish and McNamara*, Back to the Future: Discovery Cost Allocation and Modern Procedural Theory,* 79 George Washington L. Rev. 773 (2011).

Much of the push to this style of "reform" seems to stem from the idea that litigants *jointly* would spend "too much" on their own litigation. If true, this may not be a problem of the procedural system, but rather a problem of lawyer agency costs or the substantive law's remedial structure, which in neither case can be solved by procedural rule change. Moreover, it seems unlikely to be caused by lawyer agency costs, as the provision of litigation representation is a highly competitive explicit market with widely observable results and strong reputation effects. This points to remedial structure (i.e., the nature and number of legal obligations imposed, or the measurement of the remedies applied, such as punitive damages) as the more fundamental problem.

A second-order problem is created by the possibility of counter-strategies on the part of some litigants to deliberately raise the cost of their own discovery response, in order either to exploit a discovery cost-shifting system (the "moral hazard," in reverse), or, under the current system, as a device to defeat discovery requests. A more complex back-shifting system may be necessary to defeat these strategies, but here again, the system need not be perfect in order to realign incentives.

As both subjective valuation and the information-production perspective seem to be important arguments against the assertion that there is "overdiscovery," then one answer may be that even tort litigation is partly the product of voluntary decisions to engage in a more or less litigation-producing activity. But if so, then the analysis here would suggest that this is not a problem for general public policy, based only on the idea that some sub-groups spend "too much" on litigation, unless there were some reason to believe that there was a disproportionate public subsidy to these interests. Again in this case, the appropriate inquiry is more likely to focus on substantive law or remedial structure rather than procedural law as such. In general, the cash subsidy to civil litigation in terms of public expenditure is quite small relative to public expenditures generally, and therefore an efficiency case must rest on the idea that some feature of the litigation system has created an adverse selection of disputes. So far as I am aware, no one has made that identification. And, as developed in the next section, most of the recent attention has been given over to creating a new problem rather than solving an old one.

F. Newly "Heightened" Standards of Pleading

Recent developments in federal law have produced a controversial new "plausibility" standard of pleading, generally known as the *Twombly-Iqbal* standard, which appears to be justified in part by the concerns about "overdiscovery" noted above. However, from the information-production perspective, the entire doctrine seems misguided.

As noted above, the entire "overdiscovery" critique itself is overdrawn. Moreover, if there are problems in the current system, they appear to be primarily informational problems and subjective valuation problems. If so, then removing the solution of such problems to the more remote and generalized phase of pleading seems highly unlikely to be efficient.

Deciding in the abstract, and without discovery, whether the plaintiff's claims are "plausible" turns Hayek upside down, by removing the decision-maker even farther away from the particulars of time and place, and relying on what amounts to nothing more than generalizations that, even if well-intentioned, are likely to be wrong.

Indeed, we are fairly confident that they will be wrong, because of the well-known selection effects in litigation: filed cases are not representative of all disputes; cases that proceed to advanced stages are even less so; and cases that proceed to trial are likely to be both unusual and, by the selection effect, "close calls," in the sense that more information–not less–is needed to resolve the dispute justly. Thus, truncating the process at an earlier phase will have a disproportionate effect on precisely the cases that need the most development.

Instead, the new standards of "plausible" pleading introduce a new problem of asymmetric error, by generating a higher level of false negatives, in which necessary evidence is held by the defending party. In contrast with the criminal procedure system, which assumes a high false negative rate, this type of asymmetric error creates serious problems for civil procedure. To the extent that the litigants deal with one another ex ante lite, it increases the incentive for either or both to "pre-discover" evidence that may or may not be needed for a future litigation that may or may not take place, or to take other costly steps to insure that they are a prospective defendant rather than a prospective plaintiff. Moreover, like other procedural rules, the new pleading standards may not be varied by contract, either ex ante or ex post. This seems counter-productive.

G. Class Actions

The recent growth in class actions and other types of "aggregate" or "mass" litigation would seem generally to be inconsistent with the perspective developed here. With the exception of the derivative suit (which harnesses the organizing force of business entities), most of these types of litigation are inefficient because they fail to account for particularized information and subjective valuation. The problem is exacerbated by such things as the "opt-out" rule for the formation of litigant classes, and the heavy-handed control exercised by the adjudicating judge. Here again, there is a false economy in coerced joinder, and mismatched means for solving the agency costs problems between the class and its lawyers, and within the class members themselves.

VI. Concluding Comments

Developing the information-production perspective on civil procedure can help to distinguish between two visions of the social role of civil litigation. As originally developed and practiced for most of the history of Anglo-American law, civil procedure was designed primarily to provide *an* available means, always readily displaced by mutual consent, for redressing disputes between private individuals concerning their respective rights and obligations. In terms of both information-generation and law formulation, it worked incrementally, giving coercive

solutions only as a last resort and only as necessary.

Of course, there were always some exceptions to the private-dispute-resolution model, as in constitutional litigation or in private litigation that raised questions of public authority. However, and especially within the past half-century, civil litigation increasing has come to be used as a tool of public policy, especially at the federal level. Perhaps for that reason, the rules of civil procedure today are increasingly viewed as involving public interests of aggregate welfare, and, in many instances, the underlying substantive law applied itself is designed to vindicate public rather than private interests. And yet, this same system continues to serve its traditional private dispute-resolution function. We may have come to a point where most private disputes perhaps should be committed to a separate set of tribunals that are designed to serve only this traditional function. Civil litigants themselves may be recognizing this fact, by increasingly choosing arbitration over litigation. The next phase in this development, perhaps presaged by some of the trade or industry based arbitration systems, may be the development of more general private systems of private law.

The analysis presented here represents only the first step toward a new direction of research on the economic analysis of civil procedure. But it is important to take that new direction. Analyses that treat civil litigation as merely a tax on productive activity, or purely rent-seeking behavior, miss an important creative and productive aspect of both the litigation process and its alternatives. Ignoring that aspect of the process when considering current and proposed rules of civil procedure would be certain to produce the wrong policy judgments.