A New Online Approach to Managing and Resolving Monetary Claims

By James F. Ring

Although most cases settle, most cases do not settle until the eve of trial.[1] Game theory—which involves a relatively rigorous approach to the subject of conflict—offers a relatively simple explanation for this phenomenon. Game theory suggests that litigation may, like most forms of conflict, be understood as a tacit bargaining process: each side has, and knows that the other has, incentives and excuses to posture until such time as the bargaining is about to be brought to an end. Utilizing this general approach to the subject, this article describes a mechanism that allows one party to place both parties in a position where the incentives and excuses for posturing fall away at a much earlier time.

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Studies indicate that two parties on opposite sides of a claim for money would both be better off if, without having to secure the other party's cooperation or consent, either party could access and use a mechanism or device that (1) would enable each party to commit to a confidential settlement proposal, and (2) would impose a settlement in the event that each party made a confidential proposal and those proposals matched or overlapped. For example, Babcock and Landeo describe a study in which test subjects who were able to use such a mechanism achieved settlements 69% of the time (as opposed to a 49% rate for test subjects that were limited to traditional forms of bargaining), settling at an earlier stage more than twice as often, and with litigation costs that were 37% lower.[2] Moreover, these studies suggest that, when such a mechanism is properly designed, it does more than increase settlements and reduce costs. It "generally leads to…payoffs that are more in line with the underlying merits of the case…."[3]

For purposes of analyzing how and why access to this type of mechanism produces a higher percentage of better settlements earlier, this article begins by summarizing an escrow mechanism that has similar properties, and then considers how a party's initiation and use of the mechanism serves to produce these results in various contexts. The escrow mechanism (the "System") can be initiated and used by one party without the other party's cooperation or consent. It involves a series of simple steps, each of which can be carried out online in the manner described below (a fully operational version of this System can be examined, tested, and used online at https://www.fair-outcomes.com/run_fpm/home.pl).

Summary of the Three-Step Process

Step 1: One party (a "First Party") uses the System to specify, in confidence, an amount of money ("*x*"), providing the System with a binding proposal to settle the claim for *x* by a fixed deadline (for example, within 30 days). The System will not disclose the value specified by the First Party unless the System determines that the other party (the "Second Party") has agreed to settle for *x* by the deadline. (This allows the First Party to propose a reasonable value for *x* without fear of prejudice, e.g., without fear that it will simply become a starting point for further demands if the matter does not settle.)

Step 2: The System provides the Second Party with an opportunity to confidentially specify an amount of money ("*y*") and agree to settle for *x* if *x* is equal to or more favorable to the Second Party than *y*. If it is, then the matter settles for *x*. If not, then the Second Party can continue revising *y* up until the deadline. The System will not disclose even that the Second Party has used the System unless the matter settles for *x*. (In combination with other features, these features deprive the Second Party of any incentive or excuse for failing to use the System to propose a reasonable value for *y* prior to the deadline.)

Step 3: If the matter does not settle for *x*, then the System will offer a party that has specified a value for *x* or *y* an affidavit confirming that value (but not revealing any value specified by the other party), and attesting to the fact that the other party had lost an opportunity to settle for that amount at that time. (In combination with other features, this makes proposing a reasonable value the most sensible strategy for each party, regardless of whether the other party follows that strategy.)

A Hypothetical Game

Consider a hypothetical situation in which a failure to settle would not result in a trial but, rather, in the flip of a fair coin, with "heads" yielding a $10,000 award to the Plaintiff, and "tails" yielding an award of zero, with no other possible outcomes. Since each party would independently recognize that it had a 50% chance of winning or losing $10,000, the Defendant could not reasonably be expected to settle for any number higher than $5,000, and the Plaintiff could not reasonably be expected to settle for less. A settlement of $5,000 would constitute what Schelling refers to as a "focal point."[4] Specifically, if we imposed

rules under which the parties could not communicate and under which the case would not settle unless both parties placed sealed bids that matched or crossed into a black box by a fixed deadline, self-interest would oblige a party who wished to settle to bid $5,000 by that deadline. A party that proposed a number more favorable to itself—even by a single dollar—would accomplish (and would know that it was accomplishing) the functional equivalent of proposing no number at all.

An important corollary is that changing the rules by allowing the parties to communicate and engage in traditional bargaining with one another does not change the outcome. Either party can effectively force an adversary that wishes to settle to bid $5,000 by the deadline by simply depositing a number itself and then refusing to communicate at all. (Note also that a party that bids $5,000 will have no basis for regret regardless of what then transpires because it will have proposed a settlement that was reasonable in light of the prevailing risks to both sides. In contrast, a party that fails to make a bid at $5,000 prior to the deadline would not know what its adversary had proposed and would face the prospect of recriminations and regret as the coin tumbled through the air.)

Litigation, Settlement, and the Politics of Regret

Litigation is less like a coin-flip than it is like a roll of dice: it may produce a variety of different outcomes. However, just as a party familiar with dice understands that certain outcomes are more probable than others, an experienced attorney should be able to assess the relative likelihood of various outcomes of litigation. He or she can independently identify a range within which both parties should be willing to settle, given the risks and costs faced by each side (a "focal range"). Facilitating assessments of that range is a central function of the common law. Game theorists have suggested that the primary function of institutions such as the common law is to allow two adversaries to independently arrive at similar assessments of that range.[5]

Opposing counsel may privately arrive at similar assessments of what would constitute a reasonable settlement range at a very early stage. However, each side has, and knows that the other has, a strong incentive to posture in an effort to influence its adversary's assessment and drive its adversary in a desired direction. Thus, neither views the other's declared position to be genuine, nor can either persuade the other of the genuineness of its own position. If either party offers a settlement that is well within that range prior to the parties' arrival at a key decision point, such as the eve of trial, that party's adversary will be excused for rejecting it and for interpreting it as a signal of weakness and as a starting point for demanding further concessions, all to the prejudice of the offering side. Similarly, until the parties arrive at a key decision point, an offer to negotiate, mediate, or use a traditional sealed-bid arrangement will often be rejected (in an effort to signal strength) or, in many cases, simply lead to a process of posturing.

In situations where no communication can be viewed as credible and an honest communication can be highly prejudicial, no meaningful communication can take place. This serves to offer one possible explanation for why, although the majority of cases settle, the majority do not settle until the eve of trial.[6] The eve of trial may be fairly viewed as a deadline similar to the deadline for using the black box hypothesized above: the incentives, justifications, and excuses for failing to propose or accept a settlement within a focal range fall away. As with the coin-flip game, a party that commits to a settlement that is clearly focal will—regardless of whether the case settles—have no basis for subsequent regret, while a party that fails to do so will face the prospect of recriminations and remorse, and cost, as the next phase unfolds.

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Strategic Aspects of the Three-Step Process

The System described above lets one party unilaterally place both parties in a position where the incentives and excuses for posturing fall away. It lets a party do this at any time (including prior to the filing of suit), without signaling weakness and—if that party confidentially commits to a settlement well within the focal range—without incurring any prejudice whatsoever if the matter does not settle by the deadline. The System has features that negate any incentive for either party to try to use it to bluff or posture (or to try to posture through a refusal to use the System). For example, a Second Party that fails to use the System to make a reasonable proposal will not credibly be able to cite any of the standard excuses that litigants typically cite, including a fear of signaling weakness or of losing hypothetical surplus. In the words of Schelling (1960, p. 160): "One constrains the [other's] choice by constraining one's own behavior."

If the case does not settle for the amount proposed by the initiating party (x), then a party that proposed a reasonable value for x or y can demonstrate, via an affidavit from the System, that its adversary had effectively walked away from a reasonable settlement. That party can then use that affidavit to justify devoting its resources to litigation and trial, to gain or maintain support from its constituents or from interested third parties, and to demonstrate, when the case is finally resolved, that all loss and expense incurred by the parties following the use of the System was attributable to its adversary's failure to accept a reasonable outcome that had been firmly placed

within its grasp through the use of the System. Conversely, a party that fails to make a reasonable proposal will be deprived of such justification, will be unable to make such a demonstration, and will not know whether it had walked away from a reasonable settlement unless and until its adversary elected to reveal that information.

Conclusion

The System's structure makes it readily apparent to both parties that—in order to pursue and protect one's self-interest, and even where the System is used far in advance of trial—the most sensible strategy for each party consists of using the System to commit to a settlement that is reasonable in view of the risks and costs faced by each side. A party that does so will either settle the case on terms that it deems to be acceptable or will be able to justify devoting its resources to litigation and— if it becomes necessary—rolling the dice at trial.

Endnotes

1. Spier, Kathryn E. (1992). "The Dynamics of Pretrial Negotiation." *Review of Economic Studies*, Vol. 59, No. 1, pp. 93-108.
2. Babcock, Linda C., and Claudia M. Landeo (2004). "Settlement Escrows: A Study of a Bilateral Bargaining Game." *Journal of Economic Behavior and Organization*, Vol. 53, No. 3, pp. 401-417.
3. Gertner, Roger H., and Geoffrey P. Miller (1995). "Settlement Escrows." *Journal of Legal Studies*, Vol. 24, Issue 1, pp. 87-122.
4. Schelling, Thomas C. (1960). *The Strategy of Conflict*. Cambridge, MA: Harvard University Press.
5. Myerson, Roger (2005). "Justice, Institutions, and Multiple Equilibria." Working Paper, University of Chicago (available online at _ http: / / home.uchicago.edu / ~rmyerson / research / justice.pdf).
6. See also, in this regard, pp. 31-36 of Alexander, Janet Cooper (1999). "The Administration of Justice in Commercial Disputes: Developments in the United States." *The Administration of Justice in Commercial Disputes.* Montréal: Thémis.

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