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## Games and Economic Behavior

www.elsevier.com/locate/geb

Optimal litigation strategies with observable case preparation<sup>☆</sup>Philippe Choné, Laurent Linnemer<sup>\*</sup>

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## ARTICLE INFO

## Article history:

Received 20 January 2009

Available online 20 March 2010

## JEL classification:

K410

## Keywords:

Case preparation

Settlement

Trial

Signaling

## ABSTRACT

This paper investigates the strategic effects of case preparation in litigation. Specifically, it shows how the pretrial efforts incurred by one party may alter its adversary's incentives to settle. We build a sequential game with one-sided asymmetric information where the informed party first decides to invest in case preparation, and the uninformed party then makes a settlement offer. Overinvestment, or bluff, always prevails in equilibrium: with positive probability, plaintiffs with weak cases take a chance on investing, and regret it in case of trial. Furthermore, due to the endogenous investment decision, the probability of trial may (locally) *decrease* with case strength. Overinvestment generates inefficient preparation costs, but may trigger more settlements, thereby reducing trial costs.

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## 1. Introduction

The vast majority of tort disputes never reach a trial verdict. Litigants, indeed, have mutual incentives to save on trial costs by settling out of court. Moreover, a settlement shortens the dispute and might help to keep it confidential.<sup>1</sup> For example, out of the 98,786 tort cases that were terminated in U.S. district courts during fiscal years 2002 and 2003, 1647 or 2% were decided by a bench or jury trial.<sup>2</sup> Data about settlement are most of the time not available but it is commonly believed that cases that go to trial involve larger damages.<sup>3</sup> The amount at stake in a settlement dispute can be very important: in March 2006 the Canadian firm Research In Motion who manufactures the Blackberry email device agreed to pay a \$612.5m settlement amount to end a patent dispute with NTP Inc., a little known Virginia firm.<sup>4</sup>

In this article, we examine how the incentives to settle are modified when litigants can enhance the strength of their case by investing in case preparation during the pretrial phase. We assume that pretrial efforts incurred by the parties can change the probability that the defendant will be found liable at trial and/or the damage awarded to the plaintiff should liability be established. The seminal contributions in the field, Bebchuk (1984) and Reinganum and Wilde (1986), assume that the expected award is fixed, but known to one party only. The former paper considers a screening game: the

<sup>☆</sup> We are grateful to the advisory editor and to the referees for their helpful suggestions. We are also grateful to seminar participants at the 2007 CESifo Area Conference on Applied Microeconomics, the 22nd Meeting of the European Economic Association in Budapest, the 2007 ASSET Meeting in Padova, as well as to Philippe Février and Thibaud Vergé for insightful comments.

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<sup>1</sup> See Daughety and Reinganum (1999) for the issue of confidentiality.

<sup>2</sup> Source: Bureau of Justice Statistics Bulletin, August 2005, NCJ 208713.

<sup>3</sup> See Black et al. (2005) and Chandra et al. (2005). Kaplan et al. (2008) use a data set from labor tribunals in Mexico that provides information about settled cases as well as tried cases. They find that about 70% of lawsuits are settled, 15% dropped and 15% go to trial. They find, however, that plaintiffs that go to trial receive significantly lower final payments. They explain this difference by a selection effect as workers who exaggerate their claims settle less often, and may be punished in terms of final-payment amounts.

<sup>4</sup> The settlement, which was not easy to reach, ended four years of legal dispute in the U.S. between the two companies. Maybe the largest amounts that make newspapers front pages correspond to drug related civil action trials but they do not necessarily lead to the largest amounts per plaintiff.

uninformed party (the defendant, say) makes a settlement offer, which is rejected by plaintiffs with strong cases. The latter paper studies a signaling game: the informed party makes an offer which positively depends on the strength of his case, and the defendant refuses to pay a larger settlement amount with a higher probability.<sup>5</sup>

With few exceptions, the subsequent literature has treated the expected award in court as exogenous. Litigants, however, do invest in case preparation with the purpose of improving their position at trial and, consequently, at the negotiation table. During the pretrial phase, the parties take various actions: getting additional evidence, taking thorough initial interviews and depositions, obtaining statements from witnesses, issuing interrogatories, selecting expert witnesses, etc. In practice, the precise form of pretrial preparation depends on the legal procedure in force.

To show how the investment in case preparation of one party can affect its adversary's incentives to settle, we build a sequential game, where the informed party first decides to invest, or not, in case preparation, and the uninformed litigant, after observing this decision, makes a take-it-or-leave-it settlement offer.<sup>6</sup> We assume that case preparation efforts entail a sunk cost, which is incurred during the pretrial phase, and that they are effective in raising or reducing the expected award (depending on the party who invests). Conditionally on the investment decision, litigants play a screening game with a continuum of types *à la* Bebchuk (1984), leading to settlement or trial.<sup>7</sup> The endogenous investment decision, however, introduces a signaling dimension. The informed party can potentially use the investment to manipulate the other side's beliefs and alter her incentives to settle.

The observability assumption is critical as it is the basis of the signaling mechanism. Admittedly, a party may not observe the exact amount of resources devoted by her adversary to prepare his case. At the very least, however, the counsel chosen by a litigant to assist him during the pretrial phase is known to the other party as counsels have many opportunities to interact during this phase. The counsel choice is a good indicator of case preparation expenses. Lawyer's fees vary substantially from one lawyer to another according to experience and reputation. For example, the Laffey Matrix<sup>8</sup> allows an experienced federal court litigator to charge twice as much as a junior associate. Hiring a prominent law firm rather than an ordinary attorney is a major strategic decision, and this choice is public information before the settlement offers are made.<sup>9</sup>

To present our findings, we suppose, for convenience, that the informed party is an injured plaintiff, and the uninformed party a potentially negligent defendant. Case preparation raises the value of the claim, but entails a sunk cost. We assume that, under symmetric information, only plaintiffs with strong cases do invest. For low expected damage types, the costs of case preparation exceed its return. In other words, the case preparation technology is tailored for plaintiffs with large damages.

Under asymmetric information, low-damage plaintiffs mimic plaintiffs with more serious cases in the hope of a larger settlement offer. Such an incentive is well understood by the defendant and, when total trial costs are not too large, a complex equilibrium pattern stands out. Plaintiffs with strong cases, who invest in case preparation under symmetric information, maintain this choice under asymmetric information. Plaintiffs with weak cases, who do not invest under symmetric information, however, are made indifferent between investing or not, and randomize between both options. When the defendant observes that the plaintiff has invested, she herself randomizes between a high and a low settlement offer. When she observes no investment, she makes a deterministic low offer. Plaintiffs with strong cases reject all equilibrium settlement offers and proceed to trial. Plaintiffs with weak cases can be further distinguished with respect to their settlement strategy. Plaintiffs with very weak cases accept all equilibrium offers (whether they have invested or not), and earn an informational rent. Intermediate types settle if and only if they have invested and the defendant offers a large amount. That is, these types settle more often out of court if they invest than if they do not.

Overinvestment in case preparation is generic, and its extent is constant across equilibria. Investment by weak plaintiffs is tantamount to *bluff*: a weak plaintiff who invests knows that he will regret it, should he receive the low offer and go to court. Plaintiffs with intermediate types go to court with positive probability, and indeed regret to have invested when a trial takes place. Strong and very weak plaintiffs, on the contrary, never regret their decision.

Furthermore, our model predicts that the probability of trial can decrease with the strength of the case. This is in sharp contrast with both Bebchuk (1984) and Reinganum and Wilde (1986) models, which predict that the probability of trial increases with the expected damages. Indeed, the more demanding the plaintiff, the less likely settlement occurs, otherwise all types of plaintiff would demand more. In our model, this logic fails because of a *selection effect*: the larger their expected damage, the larger their probability of investment and, in turn, the larger their probability of settlement. This strategic effect reduces trial costs, and may outweigh the socially inefficient increase in preparation sunk costs.

Finally, we examine the robustness of our results in a game where the investment in case preparation is continuous. As in the binary model, the probability of trial is driven by two forces that play in opposite directions: the selection effect

<sup>5</sup> See Spier (2007) and Daughety and Reinganum (2005) for comprehensive surveys.

<sup>6</sup> For a model with alternative offers, see Spier (1992).

<sup>7</sup> The informational asymmetry is one-sided. For models where both parties have private information, see Schweizer (1989) and Daughety and Reinganum (1994).

<sup>8</sup> A list of hourly rates (adapted each year to take into account inflation) for attorneys of varying experience levels prepared by the Civil Division of the United States Attorney's Office for the District of Columbia. This list is intended to be used in cases in which a fee-shifting statute permits the prevailing party to recover reasonable attorney's fees.

<sup>9</sup> Garoupa and Gomez-Pomar (2008) offer a number of explanations of why corporate clients acting as plaintiffs prefer to hire large law firms and resort to hourly fees arrangements. Our results may provide an extra rationale for such a policy: the reason why plaintiffs are ready to incur expensive attorney fees is that they use these sunk costs to signal the strength of their claims.

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