

# Split-awards and disputes: An experimental study of a strategic model of litigation

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Received 26 April 2004; received in revised form 3 May 2005; accepted 18 May 2005

Available online 5 June 2006

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## Abstract

This paper studies experimentally the impact of the split-award statute, where the state takes a share of the plaintiff's punitive damage award, on litigation outcomes. Our findings indicate that dispute rates are significantly lower when bargaining is performed under the split-award institution. Defendants' litigation losses and plaintiffs' net compensation are significantly reduced by the split-award statute.

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*JEL classification:* K41; C70; D82; C90

*Keywords:* Settlement; Bargaining; Litigation; Asymmetric information; Experiments

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## 1. Introduction

Tort reform in the U.S. has typically been motivated by the common perception that excessive punitive damage awards<sup>1</sup> have contributed to the escalation of liability insurance premiums.<sup>2</sup> Some reforms take the form of caps or limits on punitive damage awards while others mandate that a

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<sup>1</sup> Justice O'Connor stated that punitive damage awards had "skyrocketed" more than 30 times in the previous 10 years, with an increase in the highest award from \$250,000 to \$10,000,000 (Browning–Ferris Indus., Inc., v. Kelco Disposal, Inc., 492 U.S. 257, 282, 1989).

<sup>2</sup> In 1990, the total tort liability payments were approximately \$65 billion, of which 93.5 percent were made by liability insurers (O'Connell, 1994).

portion of the award be allocated to the plaintiff with the remainder going to the state.<sup>3</sup> These latter reforms, called “split-awards,” have been implemented in Alaska, California,<sup>4</sup> Georgia, Illinois, Indiana, Iowa, Missouri, Oregon, and Utah.<sup>5</sup> In addition, New Jersey and Texas have contemplated, but not yet adopted, split-award statutes (White, 2002).

Theoretical models of litigation have been developed to study the effects of split-awards on litigants’ behavior and likelihood of trial. However, there are no empirical tests of these models, perhaps because most litigation outcomes are partially or totally unobserved by researchers so that data sources are rarely available (Daughety, 2000). The proposed research is an attempt to test, using experimental methods, the effect of the split-award institution on the likelihood of trial and the level of care chosen by potential injurers. We adopt a simplified version of Landeo and Nikitin’s (2005) model as a theoretical framework.

Among previous formal studies of the split-award statute is the work of Kahan and Tuckman (1995). They construct a simultaneous-move game between a plaintiff and a defendant and find that, in the absence of agency problems between plaintiffs and lawyers, split-awards reduce the plaintiff’s litigation effort and expenses and, consequently, reduce the expected amount paid by the defendant.<sup>6</sup> Their framework does not allow for an analysis of the effects of split-awards on the likelihood of trial because the pre-trial bargaining stage is not explicitly modeled. Daughety and Reinganum (2003) examine the effects of the split-award reform on the likelihood of trial and settlement amounts by modeling the pre-trial bargaining as a strategic game of incomplete information between two Bayesian players, an informed defendant<sup>7</sup> and an uninformed plaintiff, using signaling and screening games set-ups. They find that holding filing constant, split-award statutes simultaneously lower settlement amounts and the likelihood of trial.

<sup>3</sup> The magnitude of the resources currently spent in the U.S. tort and, therefore, diverted from economic activities, has generated an urgency for further reform of the tort system. The 2004 Economic Report of the President devotes a whole chapter to the tort system, describing its effects and proposing reforms. “Expenditures in the U.S. tort system were \$233.4 billion in 2002, equal to 2.2 percent of gross domestic product (GDP), more than twice the amount spent on new automobiles in 2002. The expansive tort system has a considerable impact on the U.S. economy. Tort liability leads to lower spending on research and development, higher health care costs, and job losses” (Economic Report of the President, 2004, p. 203).

<sup>4</sup> On August 16, 2004, Governor Arnold Schwarzenegger signed the state budget legislation SB 1102 as an “urgency” matter, becoming effective immediately instead of 1 January of next year. The SB 1102 provided that 75 percent of all punitive damages were payable to the state; that is, split-awards were enacted in that legislation (Metropolitan News Enterprise, 2004). Given that California has approximately 10 percent of the U.S. population, the effects of this statute may have a great impact on the U.S. tort system.

<sup>5</sup> Statutes vary with the state: the base for computation of the state’s share can be the gross punitive award or the award net of attorney’s fees, the state’s share can be 50, 60 or 75 percent and, the destination of the state’s funds can be the Treasury, the Department of Human Services or indigent victims funds. For details, see Dodson (2000), Epstein (1994), Stevens (1994), and Sloane (1993). Legal commentators have focused their analyses of these statutes on their effects on the plaintiff’s windfall (i.e., any amount in excess of the costs of pursuing the punitive claim) and the constitutionality of the reform (Evans, 1998; Epstein, 1994; Stevens, 1994; Sloane, 1993). Commentators argue that in contrast to caps that reduce both the plaintiff’s windfall and the deterrence effect of the punitive awards, the split-award statute constitutes a “move toward effectuating the true purpose of punitive damages” (Sloane, 1993, p. 473). They claim that split-awards reduce the plaintiff’s windfall but maintain adequate levels of deterrence and punishment. In addition, split-awards allow the plaintiffs to receive a share of the awards for payment of attorney fees and rewards for their civil duty as “private attorney generals” (CN, 1993; Dodson, 2000; Evans, 1998; Epstein, 1994; Stevens, 1994; Sloane, 1993).

<sup>6</sup> If agency problems exist, the effects of split-awards are indeterminate.

<sup>7</sup> The defendant knows the true probability that he will be found liable for gross negligence and made to pay punitive damages should the case go to trial.

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