

# Settlements without Negotiation

## The Promise of Bargaining Protocols

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[Dear students: In this paper we propose a simple mechanism to regulate settlements—artificially allocating the bargaining power between the parties, for instance by awarding one of the litigants the power to make a take-it-or-leave-it offer. As it is well-known that most of the cases settle, our mechanism has the potential to be an important policy tool that can achieve various purposes. Section 1 presents our proposal and section 2 discusses various objectives that it can aim at—distributive justice, optimal deterrence, and lower trial expenses. Section 3 discusses possible concerns, such as the use of our mechanism in an adversarial system, administrative costs, and renegotiation.

As you will see below, this is a highly preliminary draft. Some of the arguments therein need to be refined and elaborated. Some parts, such as the section that will address concrete legal areas to implement our mechanism, have not been written yet. We nonetheless chose to present this research, as we believe that your feedback can improve the paper in meaningful ways. We thus look forward to your comments and reflections on the paper—they will be highly useful in further developing it].

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## 1. Overview of the proposed procedure

The gist of our proposal is to regulate the bargaining procedure, and indirectly, the bargaining power between the parties. It is well known that the vast majority of the cases settle.<sup>1</sup> As litigation expenses for both parties skyrocket,<sup>2</sup> avoiding litigation creates a surplus that can be shared between the parties.<sup>3</sup> The law, by and large, does not regulate the precise protocol of the bargaining, or the allocation of the potential surplus from bargaining. Of course, parties settle by the shadow of the substantive law. However, parties typically have a wide range to settle therein. We argue that by simple regulation of the bargaining procedure, the law can promote various social goals.

A numerical example can be illustrative. Consider a tort litigation and suppose that both parties share similar expectations regarding the outcome at trial, e.g., that the defendant's expected liability is 100. Suppose further that, should the case go to trial, the plaintiff's legal expenses are 30 and the defendant's costs are 20; and, following the American rule, that each party bears its own legal costs. After trial, and taking its legal expenses into account, the defendant expects to pay, then, 120; and the plaintiff likewise expects to receive 70. In principle, any settlement within this range will make both parties better off and therefore is feasible. Where would the parties meet in this range? We do not know and can only guess. Some people will say that the terms of the settlement depend on the relative bargaining power of the parties. In case the plaintiff has the bargaining power, the parties will likely settle in this example in the high range of 120; if the defendant has the bargaining power, the settlement will likely be in the low range of 70. Intermediate settlements, which reflect more balanced bargaining strength, are of course possible as well.

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<sup>1</sup> In the federal courts, for example, an estimated 2 percent of civil cases go to trial. Kathryn E. Spier, *Litigation*, in 1 HANDBOOK OF LAW AND ECONOMICS 259, 268 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

<sup>2</sup> *Id.*, at 262-64. See also STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 281 (2004) (“[I]n the United States the administrative costs of the liability system are large . . . for every dollar received by a victim, a dollar or more is spent delivering the dollar to him.”).

<sup>3</sup> The logic is similar to that presented by Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

This is a simplifying example, but it conveys a general lesson. Due to the sizeable legal expenses of both sides in the real-world,<sup>4</sup> parties can reach widely different settlements, depending on their relative bargaining power. This example thus indicates that the allocation of bargaining power between the parties is highly important, from practical and theoretical perspectives. In some cases, the relative bargaining power is biased in favor of one of the parties, presumably creating distributive concerns and compromising the goals that the substantive law aims at promoting. However, even if the parties have equal bargaining power,<sup>5</sup> we show below that the law can benefit from regulating their bargaining power.

Where does this bargaining power come from? Some may say that it is a matter of bargaining skills and experience. Others will point to outside factors such as the resources of the parties. Yet others, most notably game theorists, will emphasize the nature of the bargaining protocol such as who makes the final offer. In this paper, we will follow the latter perspective.

We present a simple and practical set of mechanisms to control the bargaining power in settlements negotiations—namely, by having the judge impose a bargaining protocol. While we elaborate on some of the properties of our proposal later, consider for now our aforementioned numerical example. The judge could grant the plaintiff, for instance, the power to use a single take-it-or-leave-it (TIOLI) offer. Technically, a TIOLI offer could be facilitated through the judge—such that the plaintiff submits a proposal to the judge, with a desired amount, and the defendant responds. Should the defendant accept, the parties settle per the terms that the plaintiff offered. Should the defendant reject, the parties can no longer negotiate a settlement. The plaintiff can of course drop the case following the defendant's rejection. But otherwise, the parties are bound to go to trial (and the court ought to disapprove any negotiated settlement<sup>6</sup>). As in other ultimatum games, awarding a TIOLI offer to the plaintiff means, in essence, that it receives the entire bargaining power, and the

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<sup>4</sup> In actuality legal expenses are as costly as in the foregoing example, i.e., in the range of ~0.3 of the expected judgment. Consider the standard, one-third, contingency fee. *E.g.*, Herbert M. Kritzer, *The Wages of Risk: The Returns of Contingency Fee Legal Practice*, 47 DEPAUL L. REV. 267, 285 (1998); see also *supra* note 2.

<sup>5</sup> In that case, in the abovementioned example the parties will settle for 95.

<sup>6</sup> One wonders whether the parties are really bound by such an arrangement. We discuss below this and other details and complications of our proposal.

parties are likely to settle for 120. This conclusion flows from the fact that rejecting a TIOLI offer means that the parties are bound to litigate—and in that case the defendant will face overall expenses of 120. Therefore, the defendant is better off taking every TIOLI offer below 120, and the plaintiff, who has the power to make a TIOLI offer in this example, can exploit this situation and offer 120. By the same token, a judge who enables the defendant to use a TIOLI offer in fact allocates the entire bargaining power to her, leading, in the foregoing numerical example, to a settlement of 70.<sup>7</sup> Even if the parties do not exactly conform to the foregoing, game-theoretical predictions,<sup>8</sup> there are reasons to believe that these predictions are, by and large, correct. Put differently, the assignment of a TIOLI offer to one of the parties would likely have a huge impact on the terms of the settlement.

Before proceeding to survey the various objectives that our proposal can serve, it is worth noting that employing a simple TIOLI offer—that allocates complete bargaining power to one of the parties—is by no means the only mechanism to allocate bargaining power. Simple modifications enable the judge to allocate the bargaining power in any way she sees fit. For instance, one may think that the desirable result in the foregoing example is a settlement of 100, which reflects the substantive law. This settlement is attainable if the settlement surplus—the savings in litigation costs—is allocated between the plaintiff and the defendant according to a ratio of 40:60. This relative bargaining power can be mimicked by a procedure in which the court will award the plaintiff the power to make a TIOLI offer 60% of the time; and provide the defendant with that power 40% of the time.<sup>9</sup> Such a procedure can easily be implemented by the judge—e.g., by tossing a weighted coin and accordingly award a TIOLI offer. There are, of course, other possible variations, a detailed examination of which is beyond the scope of this paper. Note, for example, that the weighted-coin TIOLI (WTIOLI) guarantees that the defendant pays the plaintiff a sum of 100—but only in expected values.<sup>10</sup> A more complicated mechanism, which is based on Ariel Rubinstein’s model and involves an infinite series of offers and counteroffers,<sup>11</sup> can

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<sup>7</sup> Likewise, such a defendant would have the option to drop its defense should the plaintiff reject its TIOLI offer.

<sup>8</sup> See also *infra* note 56. [Experimental references]

<sup>9</sup> Recall that when the plaintiff proposes, the defendant pays 120; when the defendant proposes, she pays 70.  $60\% * 120 + 40\% * 70 = 100$ .

<sup>10</sup> In actuality we should expect a 70 settlement 40% of the time and a 120 settlement 60% of the time.

<sup>11</sup> Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, 50 *ECONOMETRICA* 97 (1982).

predict an actual, certain settlement of 100.<sup>12</sup> These variations notwithstanding, in this paper we restrict attention to TIOLI and weighted-TIOLI mechanisms. The reason we restrict our attention to simple TIOLI mechanisms is not because we believe other mechanism are irrelevant or redundant. Quite to the contrary, the array from which a judge can choose a bargaining protocol is endless, and it stands to reason that in certain circumstances it can achieve objectives that are not reachable by the simple WTIOI mechanisms. Nevertheless, the WTIOI is a simple and powerful tool that is relatively easy to administer and achieve a wide array of social goals.

## 2. Objectives

This section discusses key social objectives that can be achieved through the proposed procedure—optimal deterrence, compensation, distributive goals, and administrative efficiency.

### *a. Distributive justice*

Should the legal system redistribute wealth or income? Many scholars have answered this question in the affirmative.<sup>13</sup> There are, however, strong counter-arguments. Kaplow and Shavell, for instance, famously argue that, in principle, legal rules should be efficient, leaving redistribution goals to the tax-and-transfer system.<sup>14</sup> Later contributions have raised more nuanced arguments in favor of redistribution through the legal system. Some stress, for instance, the comparative view, arguing that in some situations legal rules could be better at redistributing wealth than the tax-and-transfer system.<sup>15</sup> Others have

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<sup>12</sup> For instance, the plaintiff can make a settlement offer in the first round, and, if the defendant rejects, with some probability the case goes to trial and with the complementary probability the defendant gets to propose a settlement offer, and so on. Although there are infinite potential offers and counteroffers, the parties converge to the desired result at the first round. At least in its simplest form, this option assumes that both parties are informed as to the merits of the case and both have similar discount rates.

<sup>13</sup> For a survey see, *e.g.*, Ronen Avraham, et. al., *Revisiting the Roles of Legal Rules and Tax Rules in Income Redistribution: A Response to Kaplow & Shavell*, 89 IOWA L. REV. 1125, 1126 (2004).

<sup>14</sup> See generally LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (2002).

<sup>15</sup> Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157 (2003).

emphasized the unique benefits that redistribution through the legal system entails—e.g., broader access to justice.<sup>16</sup>

This debate has not been settled. But at least at the descriptive level, it seems that the goal of redistribution through the legal system guides, at least to some extent, both judges<sup>17</sup> and legislators.<sup>18</sup> Furthermore, it is hard to argue that income inequalities do not alter the outcome of the legal process. Most of the cases settle, and the terms of those settlements are affected by the parties' relative bargaining power. The proverbial description of a tort victim with a meritorious claim who was pressed to settle for a trifling amount is definitely a cause for concern among policymakers.<sup>19</sup>

To the plausible extent, then, that redistributive goals concern policymakers, we suggest that our mechanism can attain these goals. To demonstrate, consider the simple aforementioned example, where the substantive law mandates a payment of 100 from the defendant to the plaintiff and both parties are fully informed. As shown above, the bargaining range in this example spans from 70 to 120. A judge under our proposal can award the underdog, poor party—a plaintiff or the defendant—the power to propose a TIOLI offer. In that case, the other party, the upperdog, is forced to transfer to the underdog party the entire surplus from the settlement (on top of the transfer that the substantive law mandates). The poor who is forced to settle for an inconsequential sum under the current regime can now grab her rival's savings in litigation expenses. The rival party can of course refuse to settle—reintroducing income inequalities. But as the parties will be prevented from settling—the rich receives a *single* take-it-or-leave-it offer—there is no reason for the upperdog not to settle on the poor's terms. The irrevocable nature of the TIOLI offer, and the judge's commitment not to enforce settlements beyond the TIOLI offer, back-up the poor's threat to proceed to trial, notwithstanding her weak negotiation position. Thus,

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<sup>16</sup> Issachar Rosen-Zvi, *Just Fee Shifting*, 37 FLA. ST. U. L. REV. 717, 720 (2010).

<sup>17</sup> [Reference]

<sup>18</sup> An obvious example is small-claims courts—one of whose explicit purposes is to create a more favorable forum for the poor. [Reference]

<sup>19</sup> [References].

anticipating that the judge is committed not to approve any other settlement between the parties, the upperdog is better-off settling following the TIOLI offer.<sup>20</sup>

A similar logic applies to a more complicated, asymmetric information case. In asymmetric information settings, one of the parties is not fully informed and the other has superior information. Consider an example in which the poor, underdog party is uninformed and the upperdog has superior information. Granting a TIOLI offer to the underdog means that it can extract the settlement surplus from the upperdogs who choose to settle (even though, due to informational gaps, some TIOLI offers may well be rejected, resulting in a trial<sup>21</sup>). A similar dynamics exists in the reverse case, i.e., where the underdog has superior information and it also receives all bargaining power (through the TIOLI offer). In that case, the TIOLI offer would reflect the underdog's bargaining power, and in the instances in which the uninformed upperdog accepts the offer, the informed underdog would extract the entire settlement surplus (as before, due to asymmetries of information, the uninformed upperdog would have to reject some TIOLI offers).<sup>22</sup>

Finally, we would like to stress that, in principle, the underdog in our examples is not worse off when it receives complete bargaining power through our proposal.<sup>23</sup> Recall from the previous section that the party with the TIOLI offer can drop the case following a rejection of its offer—hence, under our proposal the underdog is not bound to go to trial. It may be that a defendant who adamantly refuses to settle a TIOLI offer would cause the plaintiff to drop its claims altogether.<sup>24</sup> But things are similar in the current state of affairs, where, in some cases, tenacious upperdogs force their rivals to drop their lawsuit (or accept their loss) where the rival cannot bear the expenses associated with actually going to trial.<sup>25</sup>

We maintain, then, that a simple procedural modification could elegantly redistribute wealth between the parties. Moreover, we believe that, compared to other common

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<sup>20</sup> This assumes that, should the defendant reject the TIOLI offer, the plaintiff is still better off going to trial. In more technical terms, if the underdog's lawsuit has a negative-expected-value (NEV), she would drop it following the defendant's refusal.

<sup>21</sup> This dynamics is captured by the well-known screening model of settlements, Lucian A. Bebchuk, *Litigation and Settlement under Imperfect Information*, 15 RAND J. ECON. 404 (1984).

<sup>22</sup> For this so-called signaling model see Jennifer Reinganum & Louis Wilde, *Settlement, Litigation, and the Allocation of Litigation Costs*, 17 RAND J. ECON. 557 (1986).

<sup>23</sup> We discuss later situations in which, after the TIOLI offer, new information arrives. *Infra* Section \*\*.

<sup>24</sup> And vice versa, a stubborn plaintiff can push the defendant to drop its defense.

<sup>25</sup> These are, in essence, NEV situations. *Supra* note 20 and accompanying text. [Examples and references]



mechanisms to redistribute wealth through the legal system, our proposal seems to possess some advantages. First, redistribution through the legal system is typically described as a substantive rule that favors the less well-off, from products liability rules to consumer lending laws and housing codes.<sup>26</sup> This means that attaining the redistribution goal forces policymakers to articulate a different (and arguably less efficient) substantive norm. By contrast, under our proposal the substantive norm remains intact, as redistribution is achieved through a modified procedure.<sup>27</sup> More generally, our mechanism seems to be easy to administer. Second, distributive-minded interventions could be ineffective where the poor have little bargaining power. Alternatively put, even if the legal rule favors the less well-off, upperdogs may contract around the pro-underdog rule in a way that could neuter its purpose.<sup>28</sup> By contrast, our proposal eliminates this concern as it directly reallocates, so to speak, the bargaining power between the parties.

In the foregoing we showed how our proposal could redistribute wealth between the parties, without discussing the concomitant changes in the incentives of the parties regarding the underlying norm and the overall efficiency of that norm. The next Section addresses this question.

*b. Optimal deterrence*

Law and economics' hallmark is efficiency. The allocation of substantive rights should reflect this principle. In tort law efficiency usually translates to optimal deterrence. A standard notion in torts, for instance, mandates that the law achieves optimal deterrence when defendants' liability equals the harm they inflict on others. Areas in which the

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<sup>26</sup> *E.g.*, Logue & Avraham, *supra* note 15, at 171-72.

<sup>27</sup> Of course, there are other avenues, in addition to our mechanism, to sidestep this problem. Redistribution could be achieved through various procedural interventions, other than bargaining protocols (*e.g.*, Rosen-Zvi, *supra* note 16, who proposes a progressive fee-shifting rule). More generally, redistributive rules need not be class-based, "designed to redistribute from a class of potential defendants to a class of potential plaintiffs"; rather, redistributive rules can be case-specific, *e.g.*, adjusting damages in a tort case to the parties' income. *See generally* Logue & Avraham, *supra* note 15, at 185-86 (discussing the problem of inaccuracy in redistributive rules).

The fact that we do not propose to modify the substantive norm also limits our proposal. Under our regime, for example, redistribution is limited to the sum of legal expenses of the parties, whereas redistribution through the substantive norm has no such monetary limits.

<sup>28</sup> For a discussion of this so-called contracting-around problem *supra* note 15, at 177-182.

damages are misaligned with the harm are, then, aberrations.<sup>29</sup> However, less attention has been given to the *process* through which rights are allocated per the substantive norm. As shown above, legal expenses comprise a sizeable proportion of the parties' overall expenses (at least for cases that make it to trial). The relative allocation of this burden, through settlements, is therefore crucial for the purpose of optimal deterrence.<sup>30</sup>

*Symmetric information example.* To demonstrate, consider the previous numerical example and suppose that the expected harm of 100 reflects the social harm that the defendant created. Suppose further, for simplicity, that it arises under a rule of strict liability. Note also that since the parties are likely to settle no litigation costs are actually expected. If the plaintiff has all bargaining power, the defendant ends up paying 120, leading to over-deterrence; if the defendant has all bargaining power, she ends up paying 70, i.e., under-deterrence prevails. Both options diverge from the optimal liability of 100. Of course, almost any other internal allocation of the bargaining power would result in a divergence between the settlement and the optimal liability.

This result is not inevitable. Bargaining protocols seem to be an easy mechanism to overcome these problems, opening up new options to achieve optimal deterrence. To demonstrate consider again our numerical example. An optimal result can be achieved through the following procedure: the court will award the plaintiff (the defendant) the power to make a TIOLI offer 60% (40%) of the time. When the plaintiff proposes, the defendant pays 120; when the defendant proposes, she pays 70. Given that the relative allocation of bargaining power (60%-40%), the defendant expects to pay on average  $60\% * 120 + 40\% * 70 = 100$ , the optimal liability. This example can be generalized to other cases in which both parties have similar information regarding the expected outcome at trial.<sup>31</sup> Note that, as in these symmetric information examples we expect no trials to take place, the social harm is indeed 100.<sup>32</sup> Importantly, note that the court need not know the

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<sup>29</sup> See generally Ariel Porat, *Misalignments in Tort Law*, 121 YALE L.J. 82 (2011).

<sup>30</sup> E.g., A. Mitchell Polinsky & Daniel L. Rubinfeld, *The Deterrent Effects of Settlements and Trials*, 8 INT. REV. LAW ECON. 109 (1988).

<sup>31</sup> Likewise, the same example could be generalized to cases in which the parties (knowingly) diverge on their expectations, as long as they are not too optimistic about their odds at trial.

<sup>32</sup> We later discuss situations in which trials take place—as it is plausible to think that legal expenses also constitute social harm, one should think how to allocate that harm. *Infra* notes \*\*\*.\*\*\* and accompanying text.

judgment—i.e., delve into the merits—when it assigns probabilities for the ultimatum game. It suffices to estimate the prospective trial costs of each side— $C_D$  and  $C_P$ . The plaintiff should propose a TIOLI offer  $\frac{C_P}{C_D+C_P}$  of the time (and the defendant should propose a TIOLI offer  $\frac{C_D}{C_D+C_P}$  of the time), in order to equalize the defendant's costs with the expected outcome at trial.<sup>33</sup>

The previous numerical example showed how our proposal can achieve optimal deterrence in the simple case where both parties share the same expectations regarding the outcome at trial. There might be other settings, and the exogenous allocation of bargaining power will not help in all cases. In particular, the allocation of bargaining power will be futile if regardless of the allocation if no settlement is likely to take place. Consider, for example, situations where the parties (knowingly) diverge on their expectations regarding trial, and this divergence prevents them from settling. In that case, the parties are bound to go to trial—they will not settle regardless of the relative bargaining power between them, and re-allocating that power would thus have no effect on the defendant's liability.<sup>34</sup>

*Asymmetric information.* Our proposal can also achieve optimal deterrence in other, seemingly more complex situations. We will illustrate through an asymmetric information example, where the plaintiff has private information regarding its level of damages (and that information will be resolved at trial). Suppose, for example, that there are two types of plaintiffs, severely and lightly injured, whose damages are respectively high and low, 120 and 80. Suppose further that these two types exist in equal proportions in the population of plaintiffs; and that litigation costs, should a trial take place, are, as before, 30 for the plaintiff (both types) and 20 for the defendant. Aside from the private information concerning damages, all other parameters are common knowledge. Suppose that the judge

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<sup>33</sup> One can verify that our numerical example satisfies the same equation, as  $30/(20+30)=60\%$ .

<sup>34</sup> Consider a case in which the plaintiff believes that its expected award at trial would be 150, and the defendant believes that the expected liability at trial is 50. Legal expenses, should the case go to trial, are, as before 30 for the plaintiff and 20 for the defendant (all these parameters are common knowledge). The defendant is thus willing to pay through a settlement up to 70 (its expected liability plus legal expenses); the plaintiff is willing to receive through a settlement at least 120 (its expected gain minus legal expenses). In that case, no range for a mutually beneficial bargain exists—the parties are slated to go to trial, notwithstanding their joint legal expenses. A different allocation of bargaining power will not alter this state of affairs. Note that, as all cases of this ilk go to trial, the defendant in this example perforce pays more than the substantive norm.

desires to allocate the bargaining power, and she can either provide the TIOLI power to the defendant, plaintiff, or mix the two options (e.g., by a weighted coin). What should the judge do?

One plausible concept of optimal deterrence in this case is that the defendant should calibrate its level of precautions to the average plaintiff,<sup>35</sup> or, in our case, be liable for 100 as both types of plaintiffs are equally represented in the population. Another plausible concept, and one which we prefer, is that the defendant should also take into account the litigation costs it entails. We will discuss these two concepts in turn.

Average harm. Consider first the notion that optimal deterrence should be calibrated simply to the average level of harm. Consider the two extreme options to implement our proposal, i.e., TIOLI to the plaintiff and TIOLI to the defendant. Under each option, the defendant's expected liability can be calculated. If the defendant holds the power to make a TIOLI offer, one can verify that he expects to pay 90—less than its liability for the average plaintiff.<sup>36</sup> If the plaintiff makes a TIOLI offer, then the defendant's expected payment is 120—more than it should, as by construction its rival enjoys superior bargaining power.<sup>37</sup> It is now easy to advise the judge to give a TIOLI offer to the defendant 2/3 of the

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<sup>35</sup> [Reference.]

<sup>36</sup> This result follows from the standards screening models. *Supra* note 21. The defendant can attempt to settle with both types—and a TIOLI settlement offer of 90 would achieve that goal (even the high-damages plaintiff expect to receive at trial, net of legal expense,  $120-30=90$ ). Alternatively, the defendant could offer a low settlement of 50, such that the low damages plaintiffs would take that offer (they expect to receive, after trial,  $80-30=50$ ). This offer would be rejected by the high-damages plaintiffs, who would rather go to trial—in which the defendant would pay, inclusive of legal expenses,  $120+20=140$ . As both types are equally represented in the population, a low settlement offer, of 50, means that the defendant expects to pay  $0.5*50+0.5*140=95$  (and half of the cases would go to trial). Hence, in this example the defendant is better off offering 90 and settle for sure with both types.

<sup>37</sup> This is a direct extension of signaling models. *Supra* note 22. The low-damages plaintiff would reveal its type and offer 100. The defendant would accept all these offers (as the defendant expects to pay after trial, inclusive of legal expenses,  $80+20=100$ ). The high-damages type would accordingly offer  $120+20=140$ , where the defendant would reject some offers and go to trial, in which he expects to pay  $120+20=140$ . Hence, given the equal proportion of both types, overall the defendant expects to pay  $0.5*100+0.5*140=120$ . As a side note, one can verify the proportion of high offers that will be accepted—in equilibrium, the defendant should reject high offers at a sufficient rate to deter the low-damages plaintiff from mimicking as high-damages, or:

$$100=140*q+(1-q)*50$$

Where  $q$  represents the proportion of high offers that are accepted by the defendant, the left hand side conveys the option, for the low-damages type, of revealing her type, and the right-hand side represents the value of mimicking (and risking trial). In this case  $q=5/9$ . As only the high-damages go to trial, in probability  $q$ , and the remainder settles, the overall rate of settlements is  $0.5+0.5*5/9=7/9$ . For a more detailed discussion of a similar, two-type setting see Shay Lavie & Avraham Tabbach, *Litigation Signals*, SANTA CLARA LAW REVIEW (forthcoming 2018).

time, and to the plaintiff 1/3 of the time, such that the expected liability of the defendant exactly equals 100 ( $2/3*90+1/3*120=100$ ).

There may be situations in which judge-induced bargaining protocols would not achieve optimal deterrence. In this asymmetric information example with the first concept of optimal deterrence (the average harm, regardless of litigation costs) the desired result stems from the fact that assigning bargaining power to the plaintiff results in over-deterrence, while assigning bargaining power to the defendant yields under-deterrence. However, in some cases both approaches would yield over-deterrence. A simple modification can demonstrate—if the plaintiff's legal expenses in the previous example are 10, rather than 30, the defendant's ability to extract a lower settlement diminishes, and, even where he has full bargaining power it expects to pay 105 (inclusive of trial costs, if the case proceeds to trial), greater than the average damages of 100. Nevertheless, our approach can at the least approximate the desirable outcome, deterrence-wise.

Harm plus litigation costs. We now return to the original asymmetric information example<sup>38</sup> and consider the same case with our second concept of optimal deterrence. This concept aims at imposing on the tortfeasor—the defendant—the average victim's harm *plus* the actual legal costs of both sides. The reason, as we pointed out, is that the behavior of the tortfeasor generated these social costs. Under this understanding of optimal deterrence it is easy to show that the judge should allocate the bargaining power to the uninformed defendant ~47% of the time—resulting in expected payment of ~105.9. This expected payment is identical to the total costs that the defendant inflicted, i.e., the harm to the average person (100) plus the actual litigation costs under this bargaining power allocation. Note that there is no litigation in this example if the defendant gets the TIOLI offer; and 2/9=22.22% litigation where the informed plaintiff gets the TIOLI offer, with costs of 50 for each case litigated.<sup>39</sup> Therefore, the expected litigation costs under this allocation of bargaining power are  $0.47*0+0.53*0.22*50=5.9$ , and the overall social costs are thus 105.9.

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<sup>38</sup> Expected liability of both types in this example is 120 and 80, and legal expenses are 30 for the plaintiff and 20 for the defendant. *Supra* notes 34-35 and accompanying text.

<sup>39</sup> For the way we derived the litigation rates under each option see *supra* notes 36-37.

Importantly, our second concept of optimal deterrence, which takes into account litigation costs, can achieve optimal deterrence even when the first concept cannot, i.e., even if external allocation of bargaining power cannot equalize the average damages with the defendant's payment. Consider the modified example, in which the plaintiff's legal expenses are 10, rather than 30. We showed above that our mechanism cannot attain the first concept of optimal deterrence under this modified example, as even with full bargaining power the defendant's liability (105) is greater than the average harm (100). However, one can show that taking actual litigation costs into account implies that awarding the defendant a TIOLI offer ~53% of the time would achieve an optimal result—in that case, the defendant's overall liability and the social costs, inclusive of actual litigation expenses, total 112. Of course, our mechanism can also be incorporated to other concepts of optimal deterrence.<sup>40</sup>

In sum, we have shown that our proposal controls the allocation of the settlement surplus, and thus can achieve, in a wide array of cases, optimal deterrence. In addition to this general proposition we would like to highlight the following points. First, the informational requirements from the judge to implement our mechanism are not insurmountable. As noted above, where the judge believes that both sides know each other's expectations regarding the outcome at trial, the only information the judge needs is the relative expected legal expenses of the parties.<sup>41</sup> This information seems to be widely available.<sup>42</sup> Importantly, judges need not know the actual (or even the expected) award at trial—hence, the judge can implement our proposal even in initial stages, where the court lacks information. In asymmetric information cases, judges who desire to implement our proposal need more information—in the previous numerical example,<sup>43</sup> for instance, the judge would need information regarding the expected award of different types of plaintiffs

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<sup>40</sup> We have not discussed the case in which the wrongdoer is the one who holds private information concerning its liability, e.g., less culpable and more culpable defendants. In that case, one may aim at forcing both types of defendants to pay the harm they inflicted. On the other hand, perhaps the social planner should improve the position of less culpable defendants, the “good” types, relative to more negligent ones. *Cf.*, Ivan P. L. P'ng, *Litigation, Liability and Incentives for Care*, 34 J. PUB. ECON. 61 (1987) (analyzing the ex-ante implications that loser-pays rules have on primary behavior along these lines).

<sup>41</sup> *Supra* note 33 and accompanying text.

<sup>42</sup> Plaintiffs' attorneys typically work on contingency fee, in the range of one-third. *Supra* note 4. Defense attorneys typically work on hourly fees, but these fees, and the plausible range of hours of work for certain types of cases seem to be known as well. [Reference]

<sup>43</sup> *Supra* notes 35-37 and accompanying text.

as well as their distribution in the population. However, at least in the theoretical literature that models asymmetric information situations, this information is typically considered common knowledge (at least from the parties' perspective). To stress: judges who assign a TIOLI offer to one of the parties in asymmetric information situations need not know the exact nature of that party, e.g., its level of damages and whether it has a meritorious case or not. Judges need only assess the odds that that party has a meritorious case. As a side note, we do believe that judges can typically distinguish between complete information (where the implementation of our mechanism is easier) and asymmetric information situations.<sup>44</sup>

Second, and even more importantly, the utility of our proposal in achieving optimal deterrence should be judged against the alternatives. Policymakers can in theory rectify optimal deterrence problems that stem from litigation expenses and uneven bargaining power by modifying the award at trial.<sup>45</sup> However, in the current state of affairs, parties mostly settle, and the possible range for settlements seems wide.<sup>46</sup> The precise settlement that the parties eventually reach, relative to the expected judgment, appears to be a black box for policymakers. As trial has not been realized, we do not know whether the plaintiff pushed the defendant to an excessive settlement (or vice versa) or not.<sup>47</sup> Hence, modifications to the substantive law can or cannot correct for litigation expenses and uneven bargaining power. At most, policymakers can assume the bargaining and then infer the relative strength of the settlement (and in that case, the substantive law may be adjusted to reinstate optimal deterrence). But any such assumption seems baseless.<sup>48</sup> As far as we

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<sup>44</sup> Indeed, the literature has suggested typical situations that suffer from asymmetric information, for instance, medical malpractice and employment discrimination. We elaborate on some of these issues in Lavie & Tabbach, *supra* note 37, at Part I. Also, the judge can infer the scope of the asymmetric information problem from the behavior of the parties—e.g., discovery requests.

<sup>45</sup> Examples?

<sup>46</sup> Recall the large proportion of litigation expenses relative to the judgment, *supra* note 4 and accompanying text, which widens the range for a mutually beneficial settlement.

<sup>47</sup> In theory, policymakers can record previous settlements, and compare their results to the award in actual, similar cases that made it to trial. But this approach, although it exists to some extent in the context of class actions [reference] seems highly cumbersome and inaccurate.

<sup>48</sup> This is, in essence, the common approach in the game-theoretical literature on settlements. This literature typically assumes that one of the parties has complete bargaining power—but this assumption seems to lack empirical foundations.

know, we are the first to offer a mechanism that attempts to control the black box of settlements—i.e., to directly regulate the bargaining power of the parties.

In the current state of affairs, in sum, we do not know how the parties allocate the surplus, nor can we control that allocation; our proposal is designed to achieve both ends at one stroke. Our approach may be imperfect, but it seems to outweigh the current state of affairs, providing at least some guidance and information regarding the way the parties allocate the settlement surplus, in the shadow of the substantive law.

*c. Compensation*

[Some argue that the law should provide complete compensation for the victim. This goal does not necessarily overlap with the foregoing goals we discussed. In the optimal deterrence sub-section, for example, we showed that the defendant can be forced to pay the entire harm it inflicted on the victim; but the victim does not necessarily receive this sum, as the defendant may incur some of these costs as trial expenses. In this subsection, we plan to show that our proposed mechanism can also achieve the compensation goal]

*d. Saving administrative costs*

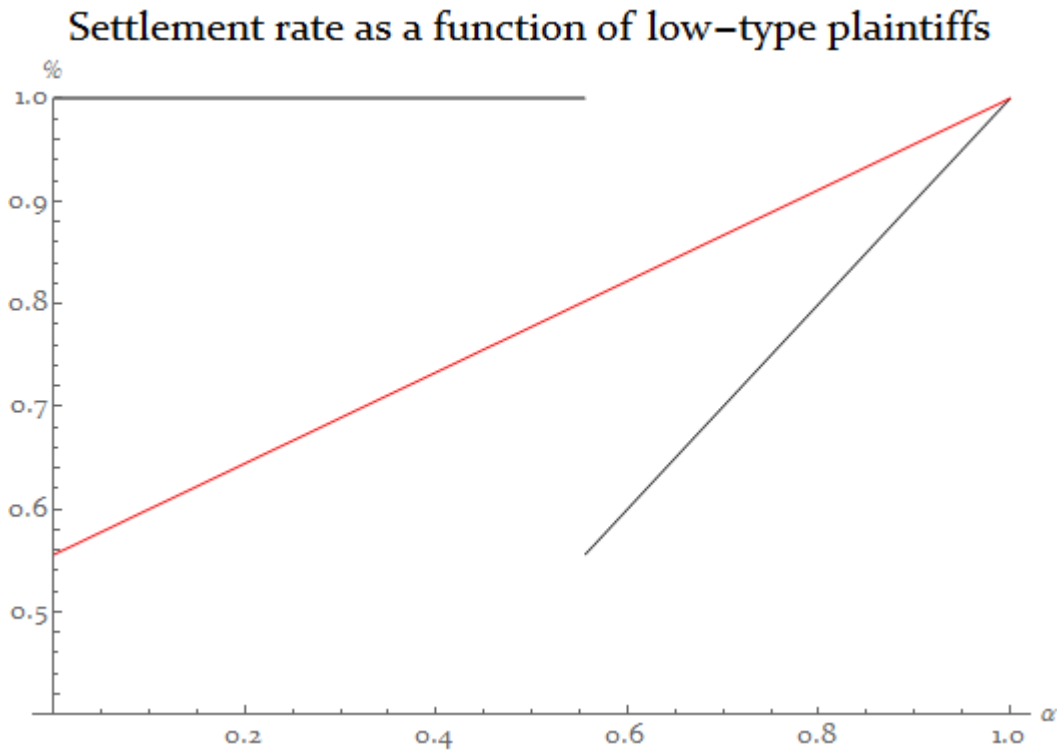
Our proposed mechanism can also be useful in saving judicial and administrative costs. In other words, it can induce the parties to settle, reducing the odds of going to trial under the current regime. To explore this argument, we will distinguish between different theoretical reasons for which parties may fail to settle, namely, asymmetric- and symmetric information situations.

*Asymmetric information.* Suppose that one of the parties has private information, and that the judge can observe the source of the asymmetric information and assess its manifestation in the population. Our numerical example can be useful—suppose that the judge can assess that the plaintiff has private information as to its damages, which will be resolved only at trial; that high- and low-damages plaintiffs expect to gain 120 and 80 at trial, respectively; that they are equally represented in the population; and that litigation cost are 30 for the plaintiff (both types) and 20 for the plaintiff. The judge can assign



bargaining power, through a TIOLI offer, to the plaintiff or the defendant, or it can mix. How should the judge allocate the TIOLI offer power if it aims at minimizing the trial rate? Under these (relatively mild) assumptions, it is easy to predict the odds that the parties will fail to achieve a settlement through our mechanism, under each option. Where the defendant gets the TIOLI offer power, no litigation is predicted;<sup>49</sup> where the privately-informed plaintiff has the TIOLI offer power, 7/9=77.78% of the cases settle.<sup>50</sup> In this example, then, awarding the plaintiff with a TIOLI offer minimizes the rate of trials.

This example can of course be generalized. The following graph demonstrates: The y-axis is the predicted rate of settlements, the x-axis is the relative proportion of low- and high-damages plaintiffs in the population; the red, smooth slope represents the rate of settlements if the TIOLI power is given to the plaintiff (“signaling”), and the black, fractured line represents the settlement rate if the TIOLI power is given to the defendant (“screening”):



<sup>49</sup> We showed this result above, *supra* note 36.

<sup>50</sup> We arrived at this result above, *supra* note 37.

By and large, as the proportion of low-damages plaintiffs increases, giving the TIOLI power to the plaintiff becomes more efficient than providing that power to the defendant (at least in terms of the sheer rate of settlements). Intuitively, when there are relatively less low-damages plaintiffs, a defendant who has bargaining power will prefer to propose a generous offer, which would induce both types to settle (hence the horizontal, black line).

*Symmetric information.* Suppose that the parties know each other's expectation regarding the outcome at trial (though their own expectations can diverge). If they are sufficiently over-optimistic, and there exists no mutually beneficial range for settlement, then a trial is likely, regardless of the internal allocation of bargaining power.<sup>51</sup>

A more interesting case, however, is where both parties share common beliefs regarding the outcome of the trial but they are not sufficiently over-optimistic, such that there exists a settlement range. In these cases, we would presume that the parties ought to settle—as both know the rival's assessment, and they can both benefit from accepting each other's offer and avoid a trial. If the parties settle in any case, then the introduction of our mechanism has no effect on trial rates. However, our simple mechanism seems to save the costs of bargaining even if the parties would reach a settlement at any rate. It stands to reason that even in situations where the parties have common knowledge about the outcome of the trial and their litigation costs, reaching a mutually beneficial agreement may be costly. Put differently, settlement negotiations are not costless. The parties haggle before they agree on a mutually beneficial allocation of the surplus. They have to prepare for the negotiation talks and hone the position that they will represent in the bargain.<sup>52</sup> While settlement negotiations are costly, we propose, as the title indicates, settlements without negotiation. Settlement is not costless under our proposal, but its costs seem minimal—one of the parties gets the opportunity to propose a take-it-or-leave-it offer, that party submits its offer, and the other party responds. None of the parties needs to prepare materials for the negotiations, meet and/or bargain over the terms of the deal.

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<sup>51</sup> We discussed a similar set-up in *supra* note 34 and accompanying text.

<sup>52</sup> [More on settlement costs, negotiation talks]

This leads us to a more profound point. Under certain conditions parties might not settle even in complete information situations in which the parties share the same expectations.<sup>53</sup> This inefficient outcome stems from the fact that settlements, as we have shown, are costly (though they are of course cheaper than going to trial). When the costs that the parties have to incur in order to negotiate and settle are taken into account, the likely result in those negotiations can be counter-productive to one of them. In that case, that party would prefer not to enter into settlement negotiations, and would rather go straight to trial. A numerical example can be helpful. Take our recurrent symmetric information example, where both parties are informed, the expected liability is 100, and the defendant and the plaintiff trial costs are, respectively, 20 and 30. The settlement range is thus 70-120. Suppose now that in actuality the defendant has all bargaining power, such that the parties are likely to settle for 70. Suppose further that each side has to spend 5 in order to enter into negotiation talks (preparing for negotiation, etc.). In that case the plaintiff has no reason to incur the settlement costs, as in this case she receives  $70$  (expected settlement)  $- 5$  (settlement costs)  $= 65$ , which is smaller than her expected award at trial (net of legal expenses),  $70$ . The plaintiff, then, would refuse to negotiate.<sup>54</sup>

Our proposed mechanism reduces settlement costs. Hence, it is capable of raising the settlement rate where both parties are fully informed and trial is costly, but negotiation costs inhibit a mutually beneficial settlement. In sum, if the parties settle in any case, then the introduction of our mechanism has no effect on trial rates. However, our mechanism may have an effect on the costs of reaching an agreement. If the parties fail to settle, our mechanism can reduce trial rates.

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Settlement terms are, by and large, an uncharted territory for policymakers. We suggest a simple mechanism to regulate settlements. The foregoing discussed various goals that our

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<sup>53</sup> See generally Luca Anderlini et al., *Costly Pretrial Agreements* (unpublished manuscript, 2017), available at <http://faculty.georgetown.edu/la2/>. Importantly, once the plaintiff in this example incurred the settlement costs (5), the defendant can push her to a settlement of 70 (a hold-up problem).

<sup>54</sup> The same logic applies in this example where the plaintiff has larger (but relatively small) bargaining power. More generally, the source of the problem is the “misalignment” between the distribution of negotiation costs and bargaining power. See Anderlini et al.

proposal can thus achieve—distributive justice, optimal deterrence, and savings in trial costs. This following section discusses potential concerns.

### 3. Concerns

We focus on several potential concerns, relating to the legitimacy of using our mechanism; to the potential waste of judicial resources; and the capacity of judges to commit to a TIOLI offer and prevent renegotiation.

#### *a. The role of courts*

The use of a judge-induced bargaining protocol may sound remote from the traditional role of Anglo-American judges. While we do not think that this is a serious flaw of our proposal, in this subsection we nonetheless raise and discuss potential objections along these lines. In particular, we view our proposal as only incrementally different from other, common practices.

One can argue that our proposal conflicts with the traditional role of trial judges. Moreover, our mechanism, which relies on game-theoretical foundations, perhaps constitutes an undesirable “gamification” of the legal process. In the TIOLI example, we envision a process in which the judge, in essence, would assign to one of the parties the role of the dictator in a standard ultimatum game. In the weighted TIOLI example we also ask the judge, in essence, to conduct a lottery, e.g., to toss a weighted coin in order to determine who would have the power to use a TIOLI offer.

We disagree with this line of arguments. The classic conception of the legal process is an adversarial game between rival litigants, from which the truth is revealed.<sup>55</sup> The introduction of an ultimatum game does not seem to materially change this classic

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<sup>55</sup> *E.g.*, Marvin E. Frankel, *The Adversary Judge*, 54 TEX. L. REV. 465, 468 (1976) (“a central core of [judging] defines the trial judge as the neutral, impartial . . . seeing that [the parties] observe the rules of the adversary game. The bedrock premise is that the adversary contest is the ideal way to achieve truth and a just result rested upon the truth.”).

conception.<sup>56</sup> In fact, our approach is in line with this description.<sup>57</sup> True, our mechanism does not directly help in revealing the truth; rather, it serves to promote social goals such as optimal deterrence or redistribution through the resolution of disputes. However, the notion that judges should actually decide all cases—rather than resolve disputes in the shadow of the law—seems in the current system outdated, even provocative.<sup>58</sup> Indeed, currently virtually all cases settle, and few reach trial. Moreover, most judges today view their role in large part as advancing settlements, resolving legal disputes in peaceful ways. It is common to describe the judicial role as actively “leading” or “encouraging” the parties to an irenic solution.<sup>59</sup> We also suggest that judges should take an active role in this process, albeit in a different manner. By actively advancing settlements in expectation of the outcome at trial, then, our proposal does not, for this matter, differ from a variety of other mechanisms that are currently used to resolve disputes without judicial rulings.<sup>60</sup>

In addition, while our proposal relies on game-theoretical foundations, other, existing mechanisms share a similar flavor. A notable example is Rule 68 of the Federal Rules of Civil Procedure. Rule 68 enables one party to offer a settlement, which, if rejected, can subject the rival party to pay the offeror costs if “the judgment that the offeree finally obtains is not more favorable than the unaccepted offer.”<sup>61</sup> We are likewise not bothered by the use of randomization and weighted lotteries by the judge. In many other, mostly procedural contexts, the law uses randomization—e.g., assigning judges to cases.<sup>62</sup>

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<sup>56</sup> We note here that, our foregoing description notwithstanding, *supra* note \*\* and accompanying text, the party who holds the TIOLI power does not need to exert its complete bargaining power. Rather, it can exercise mercy towards the rival party. Indeed, in other contexts experiments have shown that participants in ultimatum games do share some of their potential profits. [Reference]

<sup>57</sup> *Cf.*, Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374, 383 (1982) (goddess Justitia is depicted as impartial and unbiased—she is blindfolded to be protected from distractions and information that could bias or corrupt her).

<sup>58</sup> *Cf.*, Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073 (1984).

<sup>59</sup> [Reference]

<sup>60</sup> *See generally* Judith Resnik, *Managerial Judges*, 96 HARV. L. REV. 374 (1982) (focusing on pre-trial involvement).

<sup>61</sup> FED. R. CIV. P. 68(d). This arrangement invites a game-theoretical analysis. See, e.g., Lucian Arye Bebchuk and Howard F. Chang, *The Effect of Offer-of-Settlement Rules on the Terms of Settlement*, 28 J. LEGAL STUD. 489 (1999).

<sup>62</sup> One of us has surveyed such contexts, arguing that the use of randomization by the judiciary is not illegitimate in procedural settings. Shay Lavie, *Reverse Sampling: Holding Lotteries to Allocate the Proceeds of Small-Claims Class Actions*, 79 GEO. WASH. L. REV. 1065, 1079-87 (2011).

A related concern is that our proposal can be used to circumvent the substantive law. We do attempt at harnessing the wide settlement range to advance efficiency and distributive goals. Is it legitimate to assign bargaining power to advance these goals? Some of this discussion lies beyond the scope of this paper. We would like, though, to stress the following. First, we do not argue that judges should promote distributive and/or efficiency goals. Rather, to the extent one believes that judges should advance these goals, we provide an effective tool to do so. Indeed, judges already advance these goals, sometimes by adjusting the substantive law to the idiosyncratic characteristics of the litigating parties.<sup>63</sup> At the least, our proposal provides a transparent mechanism—whose use can be criticized by the appellate court—to achieve efficiency and distributive goals.

Second, our proposal could be justified as it promotes—rather than subverts—the substantive law. Along these lines, to the extent tort law aims at achieving deterrence, the law should interfere with the bargaining power of the parties in order to fully attain this goal (as discussed in Section \*\*). Likewise, the federal rules guide judges to “administer[] and employ[]” rules of procedure in order “to secure [] just, speedy, and inexpensive” proceedings.<sup>64</sup> Our mechanism can fulfill this legislative desire (as discussed in Section \*\*).

More generally, we emphasize again that our mechanism does not directly intervene in the substantive law. Where parties fail to settle through a TIOLI offer, the judge should render the same legal ruling she would have given under the regular regime.<sup>65</sup> The judge in our proposal does not even directly intervene in the terms of the settlement—all she needs to do is assigning the bargaining power and let the parties settle their dispute as they see fit. To the extent the substantive-procedure distinction has a meaning, and procedural interventions are more acceptable, our proposal resembles the latter.

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<sup>63</sup> [Example]

<sup>64</sup> FED. R. CIV. P. 1.

<sup>65</sup> See also *infra* note 70.

*b. Administrative costs*

A take-it-or-leave-it offer means that parties who reject that offer cannot settle thereafter. In the next subsection we discuss the validity of this statement, i.e., whether a TIOLI offer is vulnerable to renegotiation. In this subsection, we discuss the repercussions of an irrevocable refusal to a TIOLI offer.

One can argue that our proposal invites inefficient adjudication. Suppose that, at  $t_1$ , the judge assigned a TIOLI offer to one of the parties. That party proposed a settlement, but the rival party refused. Later, at  $t_2$ , the parties reach a settlement. However, our mechanism necessitates that this settlement would be invalidated, and the parties in this example should proceed to trial. Without our proposed mechanism, then, the parties would have reached a settlement at  $t_2$  and avoided trial. Our proposal, then, can encourage trials, wasting scarce judicial resources.

For the following reasons, we believe that this is an exaggerated criticism. First, this argument pertains only to administrative costs—as we have shown, our proposal can be useful to achieve other goals, such as distributive justice and optimal deterrence. Even if our proposal generates more trials, relative to the current regime, it may be worth its while. Second, recall that our proposal may well save trial costs (Section \*\*\*). Hence, even within the realm of administrative costs, it is not clear that the additional costs outweigh the administrative gains. To demonstrate, perhaps our proposal misses the opportunity to settle some cases at  $t_2$ , but it obtains more settlements at  $t_1$ . Put differently, there should be, at least in theory, a trade-off between more settlements at  $t_1$  and less settlement at  $t_2$ . If this is not the case, our proposal should be rejected as a means to save administration costs.

Third, and perhaps most importantly, the implementation of our proposal can and should be sensitive to the issue of administrative costs, i.e., to settlements that would have been reached after the TIOLI offer had been rejected. For that purpose, it is useful to think why the parties would want to settle at  $t_2$  but not at  $t_1$ . A prominent reason may be the introduction of new information—uninformed parties, for instance, may prefer to wait till the end of discovery proceedings in order to enjoy a better settlement. By the same logic, parties may be uncertain about the position of the presiding judge, and they may prefer to

wait and learn the judge's perspective, e.g., through preliminary orders.<sup>66</sup> This suggests that early TIOLI offers are risky, as they miss the opportunity to settle later on (should the offeree reject the offer), after more information is introduced. However, a TIOLI offer that is given to the parties not too early, e.g., after or during discovery proceedings, substantially reduces the concerns regarding missed opportunities to settle later. Finally, we note that our proposal can include a narrow exception that would enable judges to allow the parties to renegotiate, for instance, if substantial, unexpected information has been revealed.<sup>67</sup>

More generally, one wonders what is the optimal timing, throughout the life of a case, to implement our proposed mechanism. While we do not directly model here this tradeoff, we can point to some conflicting considerations. On the one hand, judges should implement the proposed mechanism relatively late, to avoid the aforementioned possibility of foregone opportunities to settle (due to the irrevocable nature of refusal to TIOLI offers)—e.g., after discovery proceedings. On the other hand, our proposal is more forceful where it is implemented early on, as in that case the parties' remaining expenses are larger—i.e., the surplus from a settlement, which can be regulated by the judge, is more meaningful.<sup>68</sup> At this point, we leave it to the judge to decide the exact timing for the implementation of our mechanism, in light of the foregoing considerations.<sup>69</sup>

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<sup>66</sup> E.g., Thomas D. Jeitschko & Byung-Cheol Kim, *Signaling, Learning, and Screening Prior to Trial: Informational Implications of Preliminary Injunctions*, 29 J.L. ECON. & ORG. 1085 (2012) (discussing, among other things, the learning effect that preliminary injunctions have).

<sup>67</sup> Along somewhat similar lines, the law enables exceptions to the preclusion rules. If, for instance, new information becomes available, the parties can open the outcome of the first proceedings. [new trial, ref.]

<sup>68</sup> The following example can drive this point home. Suppose, as before, a complete information case, where the expected liability is 100, and the defendant's and plaintiff's expenses are 20 and 30. Consider a judge who desires to redistribute money to the plaintiff, and assume that without legal intervention the defendant has full bargaining power. The judge can award the plaintiff a TIOLI offer early on—the defendant, in that case, is likely to settle for 120. Without any legal intervention, the defendant is likely to settle for 70 (or, the settlement range is 70-120). Suppose now that the legal expenses are equally incurred in two steps, at t1 and t2, and that the judge awards a TIOLI offer to the plaintiff later, before t2. In that case, by backward induction, the likely result is that the defendant would settle before t1 for 95. To explain, if the parties were to reach t2, the settlement range would be 85-110, and as the plaintiff holds the power to make a TIOLI offer, the defendant should expect to settle for 110. As the defendant (plaintiff) anticipates paying (gaining) 110 at t2, the parties can now settle at t1. The settlement range at t1 is 95-120, and as the *defendant* (by assumption) has all bargaining power, the outcome is 95. Note, then, that the re-distributive power of a TIOLI offer is smaller when it is applied before t2, compared to the case in which it is implemented before t1.

<sup>69</sup> There are other possible modification with regard to the implementation of our proposal. The judge can announce, at the outset, the exact timing and details of the bargaining protocol—e.g., “upon the conclusion of discovery proceeding, the defendant would have a TIOLI offer.” Or, the judge can announce those details later on, on the spot. A discussion of these modifications is beyond the scope of the current paper.



*c. Renegotiation*

The thorniest concern seems to be the ability of the parties to renegotiate. To demonstrate, consider a judge who desires to award the plaintiff complete bargaining power (e.g., due to distributive justice reasons), where in actuality the defendant has all bargaining power. Suppose, as in our recurrent example, that the settlement range is 70-120 (and that the parties have complete information). With the bargaining protocol that the judge assigned, the plaintiff, who artificially received all bargaining power, proposes a take-it-or-leave-it offer to settle for 120. The defendant refuses. Immediately thereafter, the defendant proposes to settle for 70. The plaintiff has all the reasons to agree, as at trial he anticipates to gain, net of legal expenses, 70. Alternatively put, where a TIOLI offer was rejected, the parties may be better off renegotiating—but such renegotiation undermines the policy goals that the TIOLI offer was meant to achieve. To maintain the efficacy of induced bargaining protocols, the renegotiation option should be eliminated. Is that possible?

As a prerequisite to avoid renegotiation, judges should be committed not to accept settlements aside from the delineated protocol. In the foregoing illustration, the judge should not accept the settlement that the parties agreed on after the defendant rejected the plaintiff's TIOLI offer.<sup>70</sup> Of course, from an ex-post perspective, *after* the defendant rejected the TIOLI offer, the parties are better off settling (and the judge is better off accepting that settlement). However, from an ex-ante perspective, such renegotiated settlements are destructive for the incentives of the parties to accept the TIOLI offer that the judge triggered. Could judges commit to the ex-ante perspective, and refuse to approve settlements that were reached in violation of the assigned protocol? We think that they could well do so. True, some have raised concerns about the capacity of judges to take the

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<sup>70</sup> As a side note, judges should also be committed to infer nothing from a rejection of a TIOLI offer. Otherwise, they invite strategic rejections. *Cf.*, Ronen Avraham & Abraham Wickelgren, *Third-Party Litigation Funding—A Signaling Model*, 63 DEPAUL L. REV. 233 (2014) (suggesting that judges should infer from third-party funding contracts, in order to induce funders to charge a lower interest by signaling the merits of a claim to the court, contrary to the common admissibility rules).

ex-ante, incentive-driven viewpoint.<sup>71</sup> However, these concerns have typically been raised in the context of inter-party agreements. As judges have a myriad of reasons to suspect the validity of these agreements, they tend not to fully respect them ex-post.<sup>72</sup> By contrast, in our example the judge is asked to respect *her* commitment, not the parties'. Under our proposed regime, the judge does not have to solicit the parties to agree to a certain protocol; rather, it should force on them the protocol, in order to advance broader policy goals. Hence, it seems easier for judges to assume the ex-ante perspective and respect their commitment not to approve settlements beyond the bargaining protocol. As a side note, judges are commonly (and successfully) asked to take the ex-ante perspective, and to give weight to long-term, institutional considerations over ex-post justice. The most notable example seems to be preclusion rules—litigants are, by and large, precluded from re-litigating a case, even if the first judge erred. Appeals rules share a similar logic—incorrect rulings may well survive appellate review, due to the desire to restrict appeals. Likewise, judges impose severe sanctions in order to deter potential wrongdoers other than the defendant herself.<sup>73</sup>

Given that it is plausible to believe that judges have the capacity to refuse independent settlements, we can eliminate the option of plain renegotiation. The parties will not attempt to approve a belated settlement as they understand that the judge is committed to the take-it-or-leave-it notion. In that sense, courts are well-positioned to avoid renegotiation. Can the parties covertly reach such a settlement, and circumvent the mandated bargaining protocol? As parties to a legal dispute regularly need the court's approval to their settlement, covert settlements seem unlikely. Take the foregoing example—suppose that the defendant rejects a TIOLI offer of 120; then, the parties renegotiate, and reach a covert settlement of 70. As the court is committed to its bargaining protocol, it will not approve the last settlement, and the parties indeed will not present their agreement to the judge. To practically achieve a settlement without the court's approval, the plaintiff, for instance, can

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<sup>71</sup> *E.g.*, Colter L. Paulson, *Evaluating Contracts for Customized Litigation by the Norms Underlying Civil Procedure*, 45 ARIZ. ST. L.J. 471, 525 (2013) (“courts usually determined the reasonableness of [a procedural agreement] by reference to the fairness of its effect in the lawsuit, rather than the ex ante fairness . . .”). We discuss this point in a previous paper, Lavie & Tabbach, *supra* note 37, at 46-49.

<sup>72</sup> *See generally id.* (discussing common reasons to invalidate procedural understandings, such as harm to third parties and incomplete and suspicious consent).

<sup>73</sup> [Ref.]

drop the lawsuit in exchange for a payment of 70 from the defendant.<sup>74</sup> The absence of judicial approval, however, can have adverse implications on the parties—suppose that, without the court’s approval, the settlement does not create *res judicata*, i.e., it does not preclude the plaintiff from filing the case again. In that case, after the covert settlement is executed and the plaintiff drops the case, the plaintiff has a reason to file again the same lawsuit, with the expected value of 70 (net of legal expenses).<sup>75</sup> Knowing that, the defendant will not enter into the renegotiated settlement from the get-go.<sup>76</sup> To further deter renegotiated settlements, they can be declared illegal, with a fine on the parties who negotiate a settlement after a refusal of a TIOLI offer under our regime.<sup>77</sup> This fine could be complemented by an exemption (or even a monetary reward) to the reporting party, to induce the parties to disclose the illegal settlement and further discourage renegotiation.<sup>78</sup>

It is important to emphasize that situations in which judicial approval is required are not infrequent. Two notable examples are class actions (and derivatives suits) and guilty pleas. After a lawsuit is certified as a class action, Rule 23(e) explicitly provides that “[t]he claims, issues, or defenses of a certified class may be settled, voluntarily dismissed, or

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<sup>74</sup> The same logic applies to other settlements in the range. Likewise, the defendant can take no action, yielding a default judgment against it (in exchange, perhaps, for a compensating payment from the plaintiff).

<sup>75</sup> *Cf.*, the discussion in Alon Klement & Zvika Neeman, *Against Compromise: A Mechanism Design Approach*, 21 J.L. ECON. & ORG. 285 (2005). Klement and Neeman propose a “pleading” mechanism in which the defendant has to plead whether it is liable or not, and if it denies liability the plaintiff chooses between dropping the case and litigating on the merits. *Id.*, at 300. Where the defendant denies liability, the parties may desire to renegotiate. Klement and Neeman, however, explain why these problems can be avoided:

The court can prevent such settlements by declaring [them] illegal and refusing to enforce . . . the plaintiff [then] would not be precluded from filing the lawsuit again, forcing the defendant to litigate the same claim that was presumably already settled. Similarly the defendant, for her part, may always refuse to perform her obligations according to the settlement agreement . . . Although the parties may rely on nonjudicial enforcement mechanisms, such mechanisms would usually be available only when the parties have continuous close relationships, in which case they would probably refrain from bringing their dispute to court in the first place . . . the court may supplement its refusal to enforce the settlement with a fine on one of the settling parties . . .

*Id.*, at 302.

<sup>76</sup> Again, the same logic holds in the reverse case. Suppose the parties agreed on a settlement in which the defendant takes no action and thus it suffers a default judgment in the amount of 100. As this judgment would have no preclusive effect, the defendant would be subject to the same lawsuit (with the expected liability of 100). Anticipating this state of affairs, the defendant will not agree to such an arrangement.

<sup>77</sup> *Cf.* Klement and Neeman’s discussion. *Id.*

<sup>78</sup> *Cf.* leniency programs in the context of antitrust law. [Ref.]

compromised *only with the court's approval*.<sup>79</sup> Similarly, a court in a criminal case must consider – and accept or reject – a plea agreement between the parties.<sup>80</sup> While these settings, guilty pleas and class actions, of course do not implicate a TIOLI offer, they nonetheless demonstrate the capacity of courts to monitor settlements and prevent the parties from entering into independent agreements. Indeed, renegotiation does not seem to be an actual problem in those areas—to demonstrate, even in the common situations in which courts reject class settlements and plea agreements, it does not seem that the parties manage to settle on the same terms independently.

Of course, there are subtle avenues to renegotiate and settle without the approval of the court. Along these lines, the parties can aim at a final judgment that reflects a renegotiated settlement. They can do so by “trading” their rights before the case goes to trial. Theoretically, the parties can trade their rights such that they “rig” a final judgment that is identical to their desired settlement. A straightforward example is a procedural agreement in which the defendant admits liability and in exchange the plaintiff reduces its damages demand. Other “settlements” can be more nuanced. The defendant can, for instance, agree to forego expert medical evidence and in exchange the plaintiff can dismiss her claim for punitive damages.<sup>81</sup> For several reasons, we do not believe that such techniques would be effective in circumventing the proposed take-it-or-leave-it regime.

First, it seems that courts can effectively monitor such procedural understandings. Importantly, such “settlements” cannot be based on unilateral moves by the parties, and they have to be approved by the judge, as procedural agreements. Suppose that the defendant admits liability in exchange for lower damages, and that the parties have no formal agreement. Once the defendant admits liability, the plaintiff has no incentive to ask for lower damages. Alternatively put, the parties have to solicit the court’s approval to their procedural contract.<sup>82</sup> The judge, in turn, can decipher the renegotiated settlement behind

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<sup>79</sup> FED. R. CIV. P. 23(e) (emphasis added). The approval requires “a hearing and [a positive] finding that [the settlement] is fair, reasonable, and adequate.” FED. R. CIV. P. 23(e)(2).

<sup>80</sup> FED. R. CRIM. P. 11.

<sup>81</sup> This example is based on an actual procedural understanding between the parties, and is taken from J.J. Prescott & Kathryn E. Spier, *A Comprehensive Theory of Civil Settlement*, 91 N.Y.U. L. REV. 59, 97 n.145 (2016). The trade could also be unilateral—e.g., the plaintiff drops claims.

<sup>82</sup> Unless, of course, they can move simultaneously. However, simultaneous moves do not seem to be prevalent in the litigation arena.

the parties' procedural agreement. It is easy to see that an agreement in which the defendant admits liability and the plaintiff lowers its damages demand is, in fact, a renegotiated settlement. Likewise, a case in which the defendant refused a TIOLI offer and immediately thereafter the plaintiff drops a seemingly important claim indicates renegotiation and invites the court to intervene in order to deter implicit agreements.<sup>83</sup> Our conclusion that the court could monitor renegotiation is corroborated by close examples in other settings. Take an actual case in which the parties agreed on a plea agreement, but then the prosecutor argued "for a harsher sentence than the one the prosecutor agreed," and the "defense counsel fails to object."<sup>84</sup> This implicit procedural tradeoff—the prosecutor inflates the sentence and the defendant agrees—indicates that the parties had been renegotiating after the court approved the first settlement, i.e., they circumvented the need to approve their new agreement in court. Indeed, courts are guided to invalidate such procedural maneuvers, even if there was "a strategically sound decision by defense counsel to forego an objection" to the larger sentence.<sup>85</sup> We believe that a similar monitoring can ensure the validity of our proposal. At the least, judicial monitoring of renegotiated settlements seems easier at later stages of adjudication, since the parties have less opportunities to exchange procedural rights.<sup>86</sup> In that sense, the foregoing discussion may also pertain to the optimal timing to implement the proposed mechanism—as it would be harder for the parties to circumvent the imposed bargaining protocol in final stages.<sup>87</sup>

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<sup>83</sup> The court can also penalize one of the parties to such an agreement. It can penalize the plaintiff, for instance, by refusing to entertain its remaining claims. More generally, as is demonstrated by this example, courts should be particularly mindful of instances in which the offeror, whose TIOLI offer was rejected, relinquishes her rights—indicating that the offeror/rejectee could not exploit her superior bargaining power due to the prospect of renegotiation with the rival.

<sup>84</sup> *State v. Miller*, 2005 WI App 114 [ref.]

<sup>85</sup> *Id.* Otherwise, such procedural tradeoffs are "tantamount to entering a renegotiated plea agreement." *Id.*

<sup>86</sup> Suppose that the parties are in the final stages of the process, and that a trial plan has been submitted. Procedural exchanges/unilateral waivers at that stage seem to be uncommon. By contrast, at the initial stages of the process, parties commonly add/waive claims, and actively engage in "procedural rulemaking" with their rival.

We also note here that the desire to illegally renegotiate is reduced if, in certain extreme circumstances, e.g., new and unexpected information that has been revealed, the judge can allow the parties to permissibly renegotiate. *Supra* note 67.

<sup>87</sup> *Cf.*, Klement & Neeman, *supra* note 75, at 302 (concluding that "setting of firm timetables, shortening the time between filing and trial, and front-loading litigation costs as closely as possible to the pleadings stage—all measures that could decrease the time available for renegotiation.").

Second, even if the court is not in a position to perfectly monitor against renegotiation, there are reasons to believe that such renegotiation entails non-trivial expenses and is perhaps not worthy of pursuing. First, even imperfect monitoring by the court leaves parties with the risk that their renegotiated agreement would not be respected—thus incentivizing them to play by the bargaining protocol that the court mandated.<sup>88</sup> Second, even if the parties manage to escape the court’s supervision, and renegotiate through a procedural trade-off, they may still have to go to trial on some of the issues. If the defendant agrees to forego expert medical evidence and in exchange the plaintiff dismisses her claim for punitive damages,<sup>89</sup> the parties should still adjudicate the defendant’s liability and the plaintiff’s damages.<sup>90</sup> This narrower adjudication still implicates legal expenses, rendering renegotiation less attractive. In sum, it takes nontrivial effort to successfully circumvent the judge, and this effort diminishes the parties’ incentives to renegotiate.

We conclude that, with judicial commitment to the imposed bargaining protocol and continuing monitoring, our mechanism should survive, by and large, renegotiation. At the end, this is an empirical question, which would only be resolved once judges would start implementing our proposal. The closest empirical settings—plea agreements and class action settlements—seem to raise no widespread renegotiation problems.<sup>91</sup>

#### 4. Concrete Applications

[In this section we purport to delineate concrete legal areas that seem most conducive to implementing our proposal. We think that small claims courts constitute one of those areas. Judges and policymakers have conspicuous redistributive motives in the context of small-claims courts, and these motives could easily be accomplished through our proposal,

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<sup>88</sup> In Lavie & Tabbach, *supra* note 21, at \*\*\*, we discuss the claim that the prospect that the judge would invalidate the parties’ procedural agreement inhibit them from entering into such agreement and partially explain the relative absence of complicated procedural deals.

<sup>89</sup> *Supra* note 81 and accompanying text.

<sup>90</sup> Even in the extreme example in which the defendant admits liability and the plaintiff lowers her damages request, the defendant can still challenge the plaintiff’s (reduced) damages award at trial.

<sup>91</sup> We discussed this issue with experts on criminal law and class actions, and conducted an independent research on Westlaw. In fact, the only evidence for renegotiation we found are some criminal cases in which the prosecutor deviates from the original agreement and the defendant fails to object. *Supra* note 84-85 and accompanying text.

namely, by assigning a TIOLI offer to the underdog. Moreover, small-claims adjudication is typically quick and simple, implicating little if any discovery proceedings. This implies that, by and large, little new information arrives throughout adjudication, and the opportunities for renegotiation are likewise minimal. While legal expenses may be small in these cases, they still comprise a non-trivial proportion of the claim.

Another concrete example could be assigning bargaining power to the class after certifying a class action (or a derivative suit)—as the certification process is relatively onerous, new information seems unlikely. As the parties already fashioned their dispute, to a large extent, e.g., they submitted their trial plan before certification, the opportunities for renegotiation are narrower. On the other hand, recurrent concerns have been raised regarding the superior bargaining power of the defendant in these situations, the tendency of class counsel to strike a sub-optimal deal, and the inability of courts to monitor the terms of that deal. Assigning bargaining power to the representative of the class could mitigate these concerns.]

## **5. Conclusion and Extensions**

[Our proposal aims at achieving different social goals through the regulation of bargaining protocols in settlements. A natural question that arises is whether our proposal can be implemented in other legal areas, and in particular, in the context of contracts. This question is beyond the scope of this paper, but it nonetheless deserves at least a short discussion. At first blush, it seems that the legal context is uniquely positioned to regulate the bargaining power of the parties. In typical contract areas there is no regulator/third-party who can effectively prescribe and enforce a bargaining protocol. Moreover, the concept of exogenously-imposed bargaining power seems particularly remote from the context of competitive markets].