Alternatives

TO THE HIGH COST OF LITIGATION

INTERNATIONAL INSTITUTE FOR CONFLICT PREVENTION & RESOLUTION VOL. 25 NO. 11 DECEMBER 2007

Alternatives TO THE HIGH COST OF LITIGATION

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Alternatives to the High Cost of Litigation (Print ISSN 1549-4373, Online ISSN 1549-4381) is a newsletter published 11 times a year by the International Institute for Conflict Prevention & Resolution and Wiley Periodicals, Inc., a Wiley Company, at Jossey-Bass. Jossey-Bass is a registered trademark of John Wiley & Sons, Inc.

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For reprint inquiries or to order reprints please call 201.748.8789 or E-mail reprints@wiley.com.

The annual subscription price is $190.00 for individuals and $253.00 for institutions. International Institute for Conflict Prevention & Resolution members receive *Alternatives to the High Cost of Litigation* as a benefit of membership. Members' changes in address should be sent to Membership and Administration, International Institute for Conflict Prevention & Resolution, 575 Lexington Avenue, 21st Floor, New York, NY 10022. Tel: 212.949.6490, fax: 212.949.8859; e-mail: info@cpradr.org. To order, please contact Customer Service at the address below, tel: 888.378.2537, or fax: 888.481.2665; E-mail: jbsubs@josseybass.com. POSTMASTER: Send address changes to *Alternatives to the High Cost of Litigation*, Jossey-Bass, 989 Market Street, 5th Floor, San Francisco, CA 94103-1741.

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DIGEST

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2007 APEX® AWARDS FOR PUBLICATION EXCELLENCE

Deal or No Deal? Or Perhaps a Better Deal? The Impact of Improved Information

BY DONALD R. PHILBIN JR.

NEGOTIATION

A spunky St. Louis grandmother and preschool teacher claims $1 million. Her unseen opponent offers her $38,000. As they work through previously undiscovered information, they conclude a "deal" at $272,000.

No, this deal doesn't settle a claim on the eve of trial. It concludes the 2006-07 season of the popular NBC television series, *Deal or No Deal.* There, contestants select one of 26 suitcases containing amounts between one cent and $1 million. The parties then discover the contents of the selected case by eliminating the other 25. (See www.nbc.com/Deal_or_No_Deal.)

Fun or annoying, the show gives a national audience exposure to the vagaries of valuation with incomplete information. Both the *Wall Street Journal* and National Public Radio have examined academic research into the probabilities issues the show presents.

Contestants begin with a one-in-26 chance—3.8%—of the 26 outcomes between $0.01 and $1 million. In the U.S. version of the show—which airs in more than 50 formats world-wide—each selection simultaneously reduces the total number of outcomes while increasing each of their probabilities. After selecting the first six cases, contestants know the odds of any single outcome have dropped to one in 20, or 5%, and hope that the top outcomes, including the hyped $1 million payoff, remain in play. An unseen "banker" calls at various points to offer settlement.

Of course, the offer varies depending on the expected value of the remaining suitcases. But the offers do not mathematically equal the net expected value of the remaining outcomes. And like all negotiations, psychology plays an important role—helping making this show a television event.

While negotiating claims in the shadow of the law are more complex, similarities abound. Litigants and contestants are routinely asked to make decisions with less than-perfect-information. That is not always bad—especially if time and transaction costs are associated with continued discovery. Perfect information may reveal a player's case to contain only $20.

Absent that certainty, however, contestants often have an opportunity to make a better deal. Of course, the reverse also is true. Many have taken the certainty of a sure deal when later—and perfect—information revealed more favorable outcomes.

So if "certain" decisions are impractical because perfect information is elusive or prohibitively expensive, how do we combine law, economics, and psychology to increase the probability of a more efficient deal?

(continued on page 181)

The author is an AV-rated attorney, mediator, arbitrator and consultant based in San Antonio. He is a former commercial litigator, general counsel and president of a $100 million dollar company. He is listed in *The Best Lawyers in America* (Alternative Dispute Resolution; Woodward/White 2007, 2008), and a member of the CPR Institute's Panels of Distinguished Neutrals. This article is based in part upon "The One-Minute Manager Prepares for Mediation: A Multidisciplinary Approach to Negotiation Preparation," which is slated for publication in the forthcoming Volume XIII of the *Harvard Negotiation Law Review.*

Published online in Wiley InterScience (www.interscience.wiley.com).
Alternatives DOI: 10.1002/alt

apists to try to retrain workers with severe cases to work in a different job. This technique can be effective because it gives the worker higher earning capacity and reduces the wage loss expense.

10) *Compare Prices.* Under this technique, employers periodically compare the prices of medical service providers, workers compensation insurance premiums, and attorneys. This technique can be effective whenever it helps them obtain the best service at the lowest cost.

AVOIDING EXPENSES

The techniques described above can help employers in a variety of conflict resolution settings.

Nonunion employers often provide their employees with a dispute resolution system that permits them to file a complaint to someone inside the company. A key advantage of resolving disputes internally is that both the employee and the employer can avoid the expense of legal fees.

These complaints often are resolved informally through discussions or mediation. During this process, the employer has the opportunity to explain to the employee directly what reports they have obtained from their company doctor or independent medical examination, as well as the implications of these reports.

If the employer and employee are unable to resolve their dispute internally, the employee always will have the right and option to hire an attorney, and file a complaint with the appropriate state agency. Where there is a union that represents the employees, it is more common that the union will advise the employee to file the complaint directly, with their own attorney or the state workers compensation bureau.

But even when this occurs, there is still a good chance that the dispute can be resolved short of an actual trial. Many states are implementing voluntary or mandatory mediation programs that provide a dispute resolution process. In these programs, the employer and employees and their legal representatives meet and attempt to resolve their dispute voluntarily. This is more expeditious, and the trial or hearing expenses can be avoided.

Typically the discussion in these dispute resolution meetings focuses on the likelihood of winning or losing the case, based on the medical and activity evidence that the parties have obtained.

In some cases, the parties may discuss whether there is light duty or favored work that is available and appropriate for the employee to return to work. The parties also may discuss the costs of alternative treatments and the appropriateness of vocational rehabilitation for the employee.

When a voluntary settlement is achieved, it may take the form of a lump sum settlement.

The bottom line is that there is a big advantage with voluntary dispute settlements: Often both parties are more satisfied with the outcome.

DOI 10.1002/alt.20201

Deal or No Deal?

(continued from front page)

Rigorous legal analysis is the foundation of case evaluation. Lawyers associate legal causes of action and remedies with party interests—for example, "We missed our quarterly numbers because they failed to deliver widgets on time." Not unlike *Deal,* a range of outcomes result. A breach of contract claim may yield benefit-of-the-bargain damages. An associated tort action may allow punitive damages that exceed that measure, but come with longer odds. Of course, defenses may reduce or eliminate any recovery.

Advising litigants that their outcomes range from $0.01 to $1 million is not that satisfying. Worse, psychologists remind us that we lock on the most favorable number—*Deal* contestants inevitably focus on the $1 million result, if for no other reason than to make decisions more manageable.

NO 'GOOD' CHANCE

But even with half the suitcases opened, contestants still do not have a "good" chance of winning $1 million. With nothing to lose, it makes good theatre. Faced with personal or economic injury and the transaction costs associated with improved information, one may reasonably search for ways to increase the likelihood of an efficient outcome without turning over every rock. We are comfortable making decisions with less-than-perfect information routinely—60% may be great for a new product launch but not for bet-the-company-litigation.

By layering economic analysis atop legal analysis, we begin to build economic scenarios. Economic analysis does not predict a certain outcome; it helps us analyze uncertain decisions by thinking in terms of the range of potential outcomes that might result if we tried the same claim 100 times.

Some outcomes will be high and others low, but the majority gravitates to the center of a bell curve. The contours of that curve can make a big difference, and modifying assumptions one-at-a-time tests sensitivity to each change.

In the process, the scenarios crystallize decisions. They can even be displayed graphically in a decision-tree format. See Chart I at the bottom of page 182. If we know that the $1, $200, $300, $500,000, and $1 million cases are unopened, and the chances of each outcome are equal at 20% each, the contestant faces this choice in the chart.

Assessing the Odds

The issue: What are your chances for a given outcome in a negotiation?

The problem: Legal analysis is hard enough. Layering economic analysis on top of it is daunting.

The bottom line: You're already valuing every negotiation move. Applying common economic principles to monitor yourself is common sense—with lessons learned from a game show.

(continued on next page)

Deal or No Deal?

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The unopened suitcases' net expected value, or NEV, is $300,100. But more than half of that value is dependent on a single outcome. With $1 million out, NEV falls to $125,125. So the spunky school teacher settles for the banker's sixth-round $272,000 offer, nine percent below NEV. A big win for anyone, even if the maximum $520,000 outcome would have come three rounds later—right before perfect information revealed that her case contained just $200.

MIND GAMES

There are obvious psychological principles at play. This contestant was fairly risk-seeking—she turned down two six-figure offers, $145,000 and $201,000. And that is not unusual for someone facing a sure gain. She also was overconfident.

The producers hype the $1 million outcome without much mention of the higher probability of something much lower. In fact, no one walked away with $1 million this season.

Outcomes vary widely in repeat play, but the spread between the offer and NEV on a normalized basis does not. The banker's opening bid is usually 35% or less of NEV. As contestants continue risking early offers to discover more perfect information, the gap between the offer and NEV closes, but not quickly. Contestants usually have to open 20 of the 26 suitcases, or 77%, by Round 5, to reach 80% of NEV. And in limited online play, it seems to take even longer. See Chart II below.

Negotiations also follow a ritualistic "dance" that is heavily influenced by improved information and time. Fixed price car deals have not caught on widely because we are accustomed to the dance—and we tend to suffer Winner's Curse if the dealer accepts an early offer.

In fact, some experts in the field say that subsequent negotiation offers take twice as long and concede half as much. Whatever the interval, few negotiators offer their best terms without some give and take.

PROCESS DESIGN ISSUES

If contestants and litigants are more satisfied with a process that recognizes a need to arrive at satisfactory outcomes incrementally by comparing real alternatives through improved information, how do we design a process that appeals to those interests?

Mediation is an obvious but incomplete answer because it covers such a wide range of practices. Some would say that mediators should simply keep the parties talking. Others would argue that the neutral needs to throw a cold-water evaluation on the contestant gunning for $1 million because no one has done it yet. Each has its place.

But what if the neutral were to guide the parties through a cathartic discussion of past events—probably the equivalent of their "day in court" since 98% settle pretrial—and turn their attention to the future through an elicitive probe of the range of outcomes, probabilities, and choices before them?

Deal contestants bring friends and family to advise them. Litigants have the advantage of repeat-playing lawyers that know the market—and the legal system essentially forces parties to write call-options for one another at prices that are negotiated between them or imposed by others.

Mediators are uniquely positioned to help parties explore informational disparities under an umbrella of confidentiality. Even without sharing the information—unless given permission to do so strategically—a mediator can better probe each side's outcome and probability assumptions with a more rounded view of the case. With or without transaction costs, a zone of potential agreement, or "ZOPA," may emerge from overlapping bell curves depicting the potential outcomes.

YOUR OPPONENT'S VIEW

And negotiation is not simply a matter of bracketing legally available remedies and running scenarios based on the probability of those outcomes. Psychology plays an important role. Even the best idea conveyed by an opponent will be heavily discounted.

In fact, a Cold War experiment quantified the extent of this "reactive devaluation." Soviet leader Mikhail Gorbachev made a proposal to reduce nuclear warheads by one-half, followed by further reductions over time. Researchers constructed a test attributing that proposal to President Ronald Reagan, a group of unknown strategists, and to Gorbachev himself. When attributed to the U.S. President, 90% reacted favorably. That dropped marginally when attributed to the third-party, to 80%, but dropped by more than half, to 44%, when attributed to the Soviet leader himself.

Planning for successful negotiations is a multifaceted endeavor. It cannot be done without rigorous legal analysis. Normalizing that analysis with probabilities crystallizes our own thoughts. More im-

CHART I: Using a Decision Tree

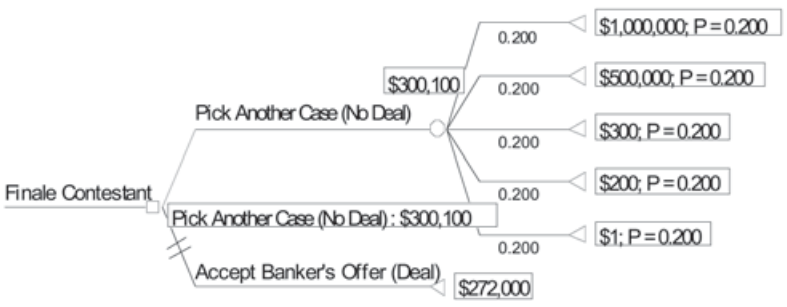
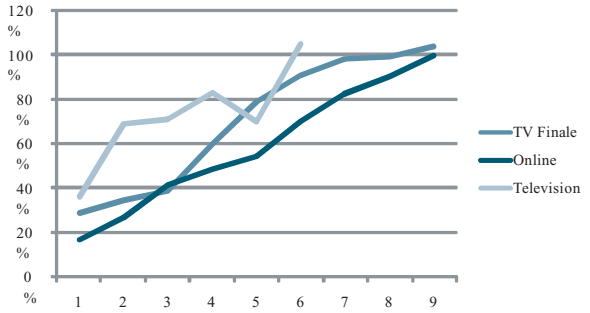


CHART II: Offer as a Percentage of NEV



Published online in Wiley InterScience (www.interscience.wiley.com).
Alternatives DOI: 10.1002/alt

portant, it helps us communicate the rationale for our positions to opponents and business decision-makers alike. Disagreements will likely focus on the assigned probabilities, but the analysis can test how far off those assumptions would actually have to be to erase the transaction cost-loaded ZOPA.

Recognizing that human differences are the spice of life, we would also do well to fold psychology into our planning and negotiation. That plan may include bringing in third-parties who can guide the journey through all of these disciplines.

Together, parties may decide to accomplish that goal by selecting a mediator who can assist with such analyses in caucus with attendant confidentiality. Others may chose to hire consultants to help plan strategic negotiating moves or to serve as settlement counsel so the generals can stay focused on the war. Peace is often made under threat of war, but it is rarely negotiated by the generals conducting it. Third-parties with a broad understanding of party interests and improved information help them find alternatives.

DOI 10.1002/alt.20202

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Mediation Is the Best Place to Constructively Test Party Aspirations

Mediation offers a safe and effective place to test party aspirations with a variety of tools. Under various statutory provisions protecting mediation, and evidentiary rules excluding settlement negotiations, parties can share background information with a mediator, enabling him or her not only to test the range of remedies associated with legal causes of action, but build economic models with those remedy brackets.

Economic models do not predict specific outcomes. Rather, they help us translate gut instincts like "good case" into probabilities. If we assume that the same case will be tried 100 times and begin to quantify the number of trials that might result in various outcomes, a form of bell curve starts to emerge. With no more than rough guesses as to the number of times a trial may result in high, medium, low, and zero outcomes, scenarios start to emerge.

The magic is not in the mathematical precision of the resulting economic calculations. It's in the conversations that the modeling facilitates.

Psychologically, we focus on information that reinforces our desired outcome. So if we want a $1 million recovery and perceive that we have a good case, we naturally combine the two to mean we have a good shot at $1 million.

Of course, the reverse also is true. If we are defending the claims, we may focus on $0 and believe our "good case" lies there. The highest probabilities may in fact lie between those two brackets.

Like *Deal or No Deal* contestants, our estimates may change with improved information. Skilled mediators can draw caucus discussions to these future outcomes and test their likelihoods, interactively using their own experience or case-specific information that others may be willing to share under the umbrella of mediation. Doing so hypothetically may help reduce the transaction costs associated with discovering information that would adjust these case assessments through traditional means.

In the right hands, economic tools can help turn mediation from a necessary and cathartic discussion of past events to a meaningful discussion of future outcomes based upon information shared under an umbrella of confidentiality. Appreciation of the psychological biases we all carry should only help tailor the way the process is conducted and any resultant offers are presented.

—Donald R. Philbin Jr.

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SEEKING TRANSPARENCY, INTERNATIONAL ARBITRATION USERS PROPOSE TO GATHER FEEDBACK

In an attempt to get more information circulated about arbitrators' talents, a group of international practitioners has developed a feedback form they hope will produce more confidence in the processes they rely on.

The form emanates from an ad hoc group established by participants in a private international arbitration list serv, and grew out of discussions earlier this year. It's still labeled a draft, and people involved with the process say they expect additional refinements.

The form also contemplates dissemination. A member of the ad hoc committee has produced a lengthy proposal for a commercial database that would address the gripes many practitioners have about the lack of information on arbitrators' experience and competence. As a result, the two separate but related projects reflect an increased focus on improving arbitration processes. The form and the proposed database would serve to address, and maybe solve, cross-border practitioners' chronic complaints over insufficient arbitrator information.

For now, the feedback form remains a discussion topic and is not yet in use. The ad hoc group has presented the form to a variety of law firms, companies, and international arbitration organizations for broader feedback, with a goal of institutional adoption.

[The CPR Institute, which publishes *Alternatives* with Jossey-Bass, has referred consideration of the feedback form to its arbitration committee, which will examine the form and discuss its potential use generally, and by CPR. CPR's Dispute Resolution Services Department routinely surveys arbitrators and parties in matters on which it works, but it has not used the new draft form.]

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