

The Defense Economist's Role in Litigation Settlement Negotiations*

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Introduction

There is substantial law and economics literature about the negotiation process leading to either settlements or trials (*see* Bebchuk 1984; Gould 1973; Landes 1971; Nalebuff 1987; Ordover and Rubinstein 1983, 1986; P'ng 1983; Reinganum and Wilde 1986; Rosenberg and Shavell 1985; Salant and Rest 1982; Shavell 1982; Schweizer 1989; Spier 1992; and Williams 1983). In this paper the author seeks to examine the special role an economist for the defense can play in assisting defense attorneys in this process. Although Ireland (1992) discussed the defense's use of a forensic economist as an expert witness during the trial, he did not examine the role of a defense economist during the pretrial negotiations (Pulsinelli 1983). The purpose of this paper is to examine the special role that a defense economist can play in pretrial negotiations.

The Defense Economist

Most legal disputes settle without proceeding to a trial. Typically, between 90 and 95 percent of all disputes are settled out of court (Cooter and Rubinfeld 1989; Galanter 1983; Priest and Klein 1984). Thus, the defense attorney's role in personal injury and wrongful death cases is to negotiate a settlement, usually on behalf of an insurance company. Spier (1992) examined how the settlement process works over time and how that process determines the efficiency of the negotiations. The defense bargains without full information if it does not have an independent review of the plaintiff's economic analysis, and therefore pretrial negotiations for the defendant can be ineffective (Spier 1994; Bebchuk 1984).

In this paper, the discussion of asymmetric information is furthered by examining what happens when the defense does not have full information on economic damages. Usually, the plaintiff presents information pertaining to economic damages in personal injury and wrongful death cases. The defense then responds, often without the use of an economist, to the plaintiff's request without fully analyzing the magnitude of the economic damages. Historically, the use of a defense economist was considered an admission of liability. This false liability implication played into the hands of the plaintiff

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attorneys. Clearly, it is in the plaintiff attorney's best interest to foster this belief. After all, it has been very successful in restricting the use of a defense economist in many legal disputes. Defendants hesitated to use economists during pretrial negotiations and seldom put a defense economist on the stand because of the false liability implication and because it could establish a lower bound for the financial award. Even if liability issues preclude presenting an expert economist as a witness, a consulting expert economist can substantially mitigate the informational disadvantage faced by the attorney for the defense (Ireland 1992).

Defendants may use a defense economist for at least two reasons. First, defense attorneys may recognize that without a professional review of damage claims, they may be subject to malpractice suits for not making every effort to mitigate damages. Secondly, insurance companies, in an attempt to reduce the cost of claims, may become less willing to settle without first having a defense economist review the plaintiff's demands.

In the next section is discussed the bargaining process when both sides have full information about economic damages. The liability issue is not a matter of concern with respect to economic damages.

The Negotiation Process

When personal injury and wrongful death cases settle prior to a trial, economic efficiency and legal justice can be attained. However, unnecessary trials may occur because it is not always in a party's best interest to tell the truth (Cooter 1991). For example, suppose in the absence of a defense economist's review, a plaintiff claims an economic loss greater than the actual loss. If the starting point of negotiations is based on these exaggerated claims, then of course final agreement might be reached at a level greater than the actual economic loss. Consequently, it is in the plaintiff's best interest not to tell the truth, expecting that the defense will not perform its own economic analysis. Perhaps this is why some economists working for the plaintiff have been called "hired guns" and will overstate damages.

A defense economist's review will encourage truth telling and deter litigants from exaggerating their claims, thus expediting settlement of a case (Spier 1994). The defense economist can demonstrate to both parties the actual economic loss, or narrow their differences, thus causing an agreement to be reached sooner. This will expose the potential "hired gun", and cause him to take a more professional approach to estimating damages.

Usually, if both sides to the dispute do not agree, and the case goes to trial, the plaintiff's economic expert is one of the last people to testify for the plaintiff. The plaintiff's exaggerated economic claims would be one of the last statements that a jury would hear. The defendant will cross-examine the plaintiff's economic expert and possibly point out any errors. However, the number has been put out there, and without a defense economist that number may be exaggerated.

Most cases, however, do not go to trial and instead rely on the negotiating skills of their attorneys. If the defense economist shows that the claim is exaggerated, then the defendant's negotiating position is enhanced. If the case does go to trial, then the defendant is given the opportunity to discredit the plaintiff during cross-examination or by calling his own expert to be the last witness to testify. Even during a trial, negotiations continue. Often, at the beginning of each day, or after a recess, the judge encourages both sides to negotiate a settlement.

A case can settle based on the testimony of an economic witness. Consequently, it may be in the plaintiff's interest to settle expeditiously for a lesser amount rather than risk a costly trial. On the other hand, the defendant's economic analysis may indicate that the plaintiff underestimated losses. Then it would behoove the defense to settle for the lesser amount rather than risk losing more at a trial. Essentially, the defendant's economic report keeps the plaintiff honest. If a trial does occur, then there is a chance that the plaintiff's economic analysis will be discredited, and the jury may award damages less than what the defense would have been willing to settle for before the trial. The defendant's economic analysis raises the plaintiff's opportunity cost of a trial by exposing the plaintiff's possible errors in calculating economic damages. This increased cost to the plaintiff plus the additional cost to the defense raises the likelihood of a settlement (Bebchuk 1984; Cooter and Rubinfeld 1989). Spier (1994) concurs by stating that rational and symmetrically informed parties to a dispute will settle rather than proceed to court. The defense economist helps provide symmetrical information, thus encouraging disputes to settle.

Often a plaintiff's attorney contacts an economist just prior to a trial date and immediately needs an economic evaluation. This can occur especially when liability is not an issue since the plaintiff is waiting for the defense's offer and the defense is waiting for the plaintiff's demands. Neither party wants to be the first to commit to a settlement offer. As a result, the trial date approaches, and the plaintiff now must get an economic analysis immediately. The rush job can lead to some errors and omissions that the plaintiff's economist just did not have time to discover and remove. For example, the plaintiff must estimate lost income without past income tax returns. The plaintiff's economist might use current pay stubs and assume that the plaintiff would have earned that amount for the rest of his work life expectancy. However, upon review of past income tax returns, it could be shown that those pay stubs reflect an increase in demand for labor of a seasonal job (construction) and do not reflect the annual salary of the plaintiff. The defense economist, in reviewing the analysis, recognizes these errors and omissions and provides the plaintiff with an opportunity to correct his evaluation prior to trial. With both sides recognizing that they are closer to an agreement than previously thought, the dispute often can be settled, and the trial can be avoided.

A defense economist can also influence the disputant's attitudes about the outcome of a trial, thus influencing the probability of settlements. For example, if the disputant becomes more pessimistic about the outcome of a trial, then the probability of a settlement will increase (Cooter and Rubinfeld 1989). A defense economist may make the plaintiff more pessimistic because there will be one more expert witness that could

expose a weakness in the plaintiff's economic analysis and cause something to go wrong. The discomfort level of the plaintiff will surely increase if the plaintiff's economist was aggressive in estimating lost damages. The defense economist increases the opportunity cost to the plaintiff, increases the level of pessimism of the plaintiff and thus increases the probability of an earlier settlement.

The plaintiff's bargaining power depends on the defendant's belief that he will lose more at a trial than the plaintiff was willing to accept. The defendant is more likely to reject a settlement and risk a trial if the defense economist shows that the plaintiff's economic analysis is wrong. This knowledge will in itself alter pretrial negotiations (Nalebuff 1987).

Signaling and the Defense Economist

As in any type of negotiations, signaling plays an important role in legal disputes. The effort put forth by one party acts as a signal to the other party, the court and if necessary the jury (Rubinfeld 1984; Rubinfeld and Sappington 1987). Hay (1995) developed a model of litigation and settlement where the level of effort in preparation, research, investigation and strategy affects the likelihood of winning at trial. Greater effort increases the probability that the judge or jury will favor that position since the greater effort increases information to the court and allows the court to make a knowledgeable decision (Cooter and Rubinfeld 1989).

The preparedness of the defense attorney, including his having a solid understanding of and capability to criticize the plaintiff's economist, will have a powerful signaling effect on the plaintiff's attorney in pretrial negotiations. The use of a defense economist sends a signal that the defendant will evaluate all claims pertaining to economic damages and that he will be negotiating knowing the true magnitude of the losses. A credible threat during negotiations is established as a defense attorney's reputation for using a defense economist becomes known in the legal community. This credible threat keeps the plaintiff's economist honest and eliminates the few so called "hired guns". The credible threat may cause the plaintiff to modify their demands. If the defendant's economist shows that the plaintiff is exaggerating his economic losses, then the foundation is formed that the plaintiff may also be exaggerating other aspects of his claim.

If a case does proceed to trial, the defendant's use of an economist shows an effort has been made to settle the case. This may increase the probability that the judge or jury will favor their position. In the absence of the defendant's economic information, the court's decision is based solely on information provided by the plaintiff's economist.

The size of the plaintiff's demand also acts as a signal (Reinganum and Wilde 1986). The larger the demand the more the plaintiff feels he can gain at trial. Rejecting demands also acts as a signal (Nalebuff 1987). Rejecting a large demand does not provide much information but rejecting a reasonable demand sends the signal that the defendant

has a strong case. A defendant can recognize if a demand is unreasonable if he has a defense economist examine the magnitude of damages.

The court's role prior to a trial should not be underestimated. Often the judge is a facilitator trying to get both sides to agree to a settlement. The judge's success in convincing both sides to agree may be enhanced if both sides have full economic information. If there are discrepancies, then the judge can determine where a compromise might be in order, thus avoiding a trial. Judicial moral suasion is limited in the absence of the defendant's economic review because the judge may not have a true assessment of economic damages.

The discovery process sends an important signal that can reduce informational asymmetry between the disputants and consequently increase the probability of settlement (Babchuk 1984). The use of a defense economist during the discovery process puts the plaintiff on notice early on that his economic claims will be scrutinized. The plaintiff now knows that any exaggerated claims will be recognized. As a result, his demands may be moderated and agreement may be reached sooner.

Agency Issues and the Defense Economist

Defense economists can be useful in resolving certain agency issues confronting defense attorneys. Miller (1987) suggests that lawyers may provide legal advice that better suits their own interest rather than the interest of their clients. A defense attorney may postpone a settlement in order to establish a reputation as a tough bargainer in the hopes of gaining new clients. The defense attorney may also keep a case going in order to obtain more billable hours. A defense economist, by providing information to the defense attorney, can help reconcile the financial conflict between the defense attorney and his client.

The information provided to the defense attorney by the defense economist alters the negotiating process toward the defendant. The defense attorney, in turn, gains a reputation for negotiating favorable settlements while billing fewer hours. Consequently, cost conscious insurance companies (which are repeat players), will retain the defense attorney more frequently. The increased demand for his services will allow rates to rise. This externality to the law firm can have a much greater monetary impact than the fees generated by billing more hours in any one specific case.

Precedents can be set in a legal dispute that are not precedents of law but of bargaining strategy. If a defense attorney always retains a defense economist, then he is setting a precedent that he will always review economic damages. Since an economist is automatically being used in all cases, the tacit liability assumption is eliminated. The plaintiff's economist, knowing that the defense attorney always uses an economist, will be kept honest and will base his estimates on sound and reasonable economic analysis.

Perloff and Rubinfeld (1987) discuss how defendants have more at stake than a plaintiff's attorney because they are more likely to be involved in these types of cases in

the future. Insurance companies or large corporations are litigated against more often because they have the ability to pay. Juries are more likely to award larger verdicts when large corporations are involved (Perloff and Rubinfeld 1987). Insurance companies and their clients might be more inclined to settle rather than incur the negative publicity of a law suit. Often, since the insurance company is involved in many suits, it looks at the process in a much more general view. Rubinfeld (1984) states that the defendant knows that large awards are random events. He maintains that a repeat player's main goal is to reduce the plaintiff's probability of victory in future cases on a point of law. Defendants are willing to settle a case rather than risk losing at trial where a precedent may be established that can be used against them in future cases. Because jury awards, although often large, are something that they cannot control, they are often better off settling rather than risking a jury verdict. The precedent set on a point of law can come back many times to haunt the insurance company.

The defense economist, by providing full information to the defendant, helps determine the reasonableness of the plaintiff's claims. Even though defendants want to settle to avoid setting a precedent on a point of law, knowing the true magnitude of losses puts them in a better position to negotiate a more favorable settlement. Both sides in effect know they are going to settle. The defense economist provides information that can modify the claimant's demands.

Since both sides have more complete information, the gap between the defendant and the plaintiff will be narrower. Hopefully, this will facilitate a settlement and thus avoid a trial.

Conclusion

While justice is supposed to be blind, having a good negotiator on your side can reduce the cost of personal injury and wrongful death suits. Negotiations are an ongoing process that continue even after a jury award. It has been argued in this paper that the defense attorney does not negotiate with full information without an economist's review to determine the magnitude of the loss. The defense economist provides valuable information to the defendant. This information not only can change each sides bargaining strategy; it can also facilitate a settlement that will avoid a trial.

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