

**No Free Lunch:
How Settlement Can Reduce the Legal System's Ability to Induce Efficient Behavior**

Abraham L. Wickelgren*
Federal Trade Commission
600 Pennsylvania Ave. NW, Mail Drop NJ 4264
Washington, DC 20580
awickelgren@ftc.gov
(202) 326-2470

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Abstract

While there is widespread agreement that it is better for cases to settle than go to trial, the arguments in favor of settlement have typically overlooked how settlement affects one of the most important functions of the legal system: influencing the behavior that gives rise to lawsuits. This essay argues that, in some cases, settlement can impair the ability of the legal system to deter harmful behavior without chilling desirable behavior. Where it exists, this effect is a fundamental property of settlement in that there is no way to change other legal rules to eliminate it. Because settlements also have important benefits, such as the saving of legal costs, this essay does not argue for any across the board prohibition of settlement. Rather, it suggests that judges should be more circumspect about encouraging settlements and that there may even be situations where some restrictions on settlement are warranted.

I. Introduction

There is widespread support for the idea that it is better for cases to settle than to go to trial. “Most lawyers, judges, and law professors think it is good that so few cases are tried...The reasons most commonly given for discouraging trials are that settlements conserve resources and enable parties to resolve their differences amicably. Settlements are said to reduce attorneys’ fees and court costs, free space on crowded dockets, speed relief to injured plaintiffs, and avoid the need for judges to decide difficult legal questions.”¹ While these arguments in favor of settlement are undoubtedly valid, they overlook the role that settlement plays in one of the most important functions of the legal system: influencing the behavior that gives rise to lawsuits.

Ideally, the legal system will deter people and firms from taking actions that cause more harm to others than the benefit those actions provide to themselves while not discouraging those activities whose benefits are greater than their harms. To accomplish this task, parties whose actions cause harm must expect that they will have to fully compensate the victims for that harm. That way, the party deciding whether to take some action will consider not just the benefits to herself, but also any harms that her action may cause others. Equally important, parties whose actions do not cause any harm must not be required to compensate a victim for some harm she has suffered that is caused by something else. This will prevent the threat of legal action from chilling desirable activities.

When analyzing the desirability of settlement, then, one must look beyond settlement’s effects after the filing of suit. One must ask how settlement affects the ability of the legal system to deter undesirable activities without chilling desirable ones. While many issues relating to settlement have received substantial attention, the vast majority of economic analyses of

¹ Jules Coleman and Charles Silver, *Justice in Settlements*, 4 Soc. Phil. & Pol. 102, 102-103 (1986).

settlement have focused on explaining why not all cases settle and on how different legal rules affect the likelihood of settlement.² The more basic question of whether or not settlement is necessarily desirable has received much less attention.³ Some scholars have argued that there may be too little settlement because parties do not care about the litigation costs they impose on the other side or the court when they refuse to settle.⁴ Others have noticed that under certain, fixed, legal rules, settlement can sometimes lead to less deterrence than trial.⁵ As these authors point out, however, in the settings they analyze, one can always change the rules governing

² See, for example, William M. Landes, *An Economic Analysis of the Courts*, 14 J. Law & Econ. 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Legal Stud. 399 (1973); Steven Shavell, *Suit, Settlement and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. Legal Stud. 55 (1982); Lucian A. Bebchuk, *Litigation and Settlement under Imperfect Information*, 15 RAND J. of Econ. 404 (1984); Robert Cooter and Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. Econ. Lit. 1067 (1989); and Kathryn E. Spier, *Pretrial Bargaining and the Design of Fee-Shifting Rules*, 25 RAND J. of Econ. 204 (1994).

³ Some legal scholars have criticized the judicial promotion of settlement. Owen M. Fiss, *Against Settlement*, 93 Yale L.J. 1073 (1984) was one of the first. His main objections to settlement were that settlements could be unfair due to an imbalance of power between the parties; that settlements may be made by agents who do not necessarily have the best interests of the parties at heart; and that settlements may create peace but do not necessarily create justice. Fiss's second criticism of settlement is quite valid, though I will not discuss it here since it does not relate to the issues I discuss in this essay. Fiss's first and the third criticisms do bear some relation to my argument. The problem with the imbalance of power argument is that one's power in settlement negotiations relates directly to one's power in litigation. If one party's lack of power leads them to accept an "unfair" settlement (however one defines fairness), it must be because this party expects a worse outcome should she have to litigate the case. That said, my argument against settlement is based on an imbalance of information between the parties (the defendant has more information about the likely result of the suit than does the plaintiff). This problem with this imbalance, however, is not that it leads the less informed party to do worse than she would do if she were to litigate the case to judgment. If that were the case, the less informed party (the plaintiff) would simply refuse to settle. Instead, the problem is that settlements between differentially informed parties can often make it more difficult for the threat of lawsuits to deter harmful behavior without also deterring valuable behavior. While this is something that potential plaintiffs should care about before they are injured, once they are injured and are engaged in settlement negotiations, plaintiffs bargain so as to maximize their recovery, not to improve the defendant's incentives to take only those actions that create more benefit than harm. While, in some sense, this argument can be seen as one manifestation of Fiss's claim that settlements create peace but not justice, Fiss did not explain his argument this way. Other legal articles questioning the wisdom of promoting settlement include Jules Coleman and Charles Silver, *Justice in Settlements*, 4 Soc. Phil. & Pol. 102 (1986); Stephen McG. Bundy, *The Policy in Favor of Settlement in an Adversary System*, 44 Hastings L.J. 1, 3-4 (1992); Marc Galanter and Mia Cahill, "Most Cases Settle": *Judicial Promotion and Regulation of Settlement*, 46 Stan. L. Rev. 1339 (1994); and Leandra Lederman, *Precedent Lost: Why Encourage Settlement and Why Permit Non-Party Involvement in Settlements*, 75 Notre Dame L. Rev. 221 (1999). None of these articles argue that settlement can reduce effectiveness of the legal system's ability to regulate behavior.

⁴ See Steven Shavell, *The Fundamental Divergence between the Private and the Social Motive to Use the Legal System*, 26 J. Legal Stud. 575 (1997) and Steven Shavell, *The Level of Litigation: Private Versus Social Optimality of Suit and Settlement*, 19 Int'l R. of Law and Econ. 99 (1999).

⁵ See A. Mitchell Polinsky and Daniel L. Rubinfeld, *The Deterrent Effects of Settlements and Trials*, 8 Int'l R. of Law and Econ. 109 (1988) and Kathryn E. Spier, *A Note on the Divergence between the Private and the Social Motive to Settle under a Negligence Rule*, 26 J. Legal Stud. 613 (1997).

damages so that settlement does not produce less deterrence than trial.⁶ That is, in these cases, there are better ways to maintain deterrence than by discouraging settlement. In this essay, by contrast, I show that settlement can fundamentally reduce the ability of the legal system to deter harmful behavior without chilling desirable behavior. This effect is more fundamental than the effects described in prior analyses because there is no way to alter the rules for awarding damages to correct for the problems that settlement creates.

The first case I consider, in Section III.A, is when the defendant has superior information about the damages that the plaintiff will receive at trial.⁷ When the defendant is deciding whether to take some action that might result in her being sued,⁸ her best estimate of what she might have to pay the plaintiff is what she expects the settlement or trial outcome to be. Because trials are structured to reveal all the relevant information that both parties have, the defendant will likely expect the trial outcome to closely reflect her superior information about the magnitude of the harm she will cause. If the parties settle, on the other hand, that settlement will probably not reflect all of the information the defendant has: the plaintiff cannot insist on a higher settlement when the defendant knows damages are likely to be large if the plaintiff does not know this information. As a result, the defendant will base her decision to act not on all the information she has, but rather only on the information she expects the plaintiff to have. This means that if the information that only the defendant has indicates that her action is significantly more harmful than the plaintiff will expect, the defendant can expect to settle the case for substantially less than the true level of harm her action will cause. This may lead her to engage

⁶ Ibid.

⁷ This situation will probably only occur in a minority of cases. I argue in Section III.B, however, that there are still many types of cases where the defendant may have superior information about the magnitude of damages.

⁸ More precisely, here I am speaking of the party that will become the defendant should it take an action that results in a lawsuit. For simplicity, I will just refer to this party as the defendant even though she is not a defendant at this stage.

in an activity that she knows will cause great harm only because she has the opportunity to settle the case without going to trial.

The second case occurs when the defendant has superior information about her culpability for the plaintiff's harm, and, thus, the probability that she will be found liable should the case proceed to trial. I show that, in this instance, the problem with settlement is that it can reduce the accuracy of the legal system. This is important because increasing the accuracy of the legal system is the only way to deter more harmful activity without also chilling more beneficial activity that could be mistaken for harmful activity. Settlement can reduce the accuracy of the legal system because culpable defendants have a greater incentive to settle than do blameless ones. Therefore, if settlement does not occur, the plaintiff is more likely to be against a blameless defendant. I show that this will often lead the plaintiff to put less effort into trial preparation, which will reduce the accuracy of the trial process. The less accurate the trial process, the less effective the legal system is at deterring harmful activity without chilling beneficial activity. Section IV.A provides a much more detailed explanation of this argument.

Notice that for settlement to lead to less deterrence of harmful activities or more chilling of desirable activities, the defendant, the party whose behavior is the subject of the lawsuit, must have better information about a critical aspect of the case than does the plaintiff. Therefore, these arguments do not suggest that all settlements create these problems. Moreover, even when settlement does impair the legal system's ability to appropriately influence behavior, because settlement does reduce legal costs, this essay does not advocate any explicit rule that restricts or prohibits settlement. Instead, the purpose of this essay is to identify this downside of settlement that has previously been ignored and to suggest that there are cases where judges might want to consider restricting settlement or, at least, not explicitly promoting it.

The next section describes how the legal system favors settlement over trial. Section III presents the analysis of how settlement can undermine deterrence (relative to the situation where all cases go to trial) when the defendant has superior information about the harm her action causes. Subsection A explains this theory. Subsection B discusses the types of cases where this theory is applicable. Section IV analyzes how settlement can lead to the chilling of desirable behavior (again, relative to the situation where all cases go to trial) when the defendant has superior information about whether or not her action is responsible for the plaintiff's harms. Again, subsection A explains this theory and subsection B discusses the types of cases where this theory is likely to be relevant. Section V discusses the implications these theories have for legal policy. In particular, rather than recommending any hard and fast rule against settlements, this section suggests that in some cases judges should have the discretion to not enforce settlement agreements. Section VI concludes.

II. Policy Tilt Toward Settlement

While many judges have viewed promotion of settlement as an important part of their judicial role for some time,⁹ promotion of settlement first became formally part of legal policy with the amendment of Rule 16 of the Federal Rules of Civil Procedure in 1983. This rule now suggests that judges may take action to encourage the parties to settle and allows judges to impose sanctions on parties who do not participate in pretrial settlement conferences.¹⁰ Rule 68

⁹ See Marc Galanter, *The Emergence of the Judge as a Mediator in Civil Cases*, 69 *Judicature* 256. Surveys of judges even before the 1983 amendment to Rule 16 revealed that over 75 percent of trial judges described themselves as interventionist in their promotion of settlement. This intervention was predominantly through subtle suggestions, though over 10 percent of judges reported using direct pressure to promote settlement. John Paul Ryan, Alan Ashman, Bruce D. Sales, and Sandra Shane-Dubow, *AMERICAN TRIAL JUDGES: THEIR WORK STYLES AND PERFORMANCE* 177 (1980).

¹⁰ Fed. R. Civ. P. 16

now also allows the judge to impose costs on a plaintiff who refused a settlement offer that turns out to be more favorable to her than the trial outcome.¹¹ The “plain purpose of Rule 68 is to encourage settlement and avoid litigation.”¹² Rule 26(f) requires attorneys to discuss the possibility of settlement with their clients.¹³ Even the Federal Rules of Evidence promote settlement. Under Rule 408, settlement offers and discussions are not admissible at trial to promote “the public policy favoring the compromise and settlement of disputes.”¹⁴ Congress has also endorsed the promotion of settlement. The Civil Justice Reform Act¹⁵ encourages judges to promote settlements as a way to reduce the expense and delay in the federal court system.¹⁶

While the public policy favoring settlement has some dissenters,¹⁷ it “has generally received enthusiastic support from the commentators and the courts.”¹⁸ The Supreme Court has repeatedly endorsed the idea that settlement is preferable to trial. As far back as the nineteenth century, the Court declared, “settlement in matters of litigation, or in dispute, without recourse to litigation, are generally favored.”¹⁹ Since that time, the Court has consistently emphasized the importance of the public policy rationale for settlements.²⁰ The next two sections, however, show that there are cases where there is a strong public policy rationale against settlements.

¹¹ Fed. R. Civ. P. 68.

¹² *Marek v. Chesney*, 473 U.S. 1, 5 (1985).

¹³ Fed. R. Civ. P. 26(f).

¹⁴ Fed R. Evid. 408 advisory committee’s note.

¹⁵ Civil Justice Reform Act of 1990, 28 U.S.C. §§ 471-482 (Supp. IV 1992).

¹⁶ For a complete description of all the mechanisms available to promote settlement, see Stephen McG. Bundy, *The Policy in Favor of Settlement in an Adversary System*, 44 *Hastings L.J.* 1, 3-4 (1992).

¹⁷ See, *Supra*, note 3.

¹⁸ Margaret Meriwether Cordray, *Settlement Agreements and the Supreme Court*, 48 *Hastings L.J.* 9, 36 (1996).

¹⁹ *St. Louis Mining and Milling Co. v. Montana Mining Co.*, 171 U.S. 650, 656 (1898).

²⁰ See *Williams v. First Nat’l Bank*, 216 U.S. 582, 595 (1910); *Marek v. Chesney*, 473 U.S. 1, 5 (1985); *Evans v. Jeff D.*, 475 U.S. 717, 736-38 (1986); and *McDermott Inc. v. AmClyde*, 114 S. Ct. 1461, 1467 (1994) among others. It should be noted, however, that some have argued that three recent Court decisions have not emphasized the importance of the policy favoring settlement as much as the Court has in the past, see Margaret Meriwether Cordray, *Settlement Agreements and the Supreme Court*, 48 *Hastings L.J.* 9, 36 (1996).

III. Settlement and Deterrence

A. The Theory

In both this section and the following one, Section IV, the analysis is confined to cases where a potential defendant has a choice to take some action (engage in some activity) that may cause her to be sued by some plaintiff.²¹ I restrict attention to suits for damages. Furthermore, I will make the standard assumption that the defendant decides to do this action if and only if her benefit from doing so exceeds her expectation of how much she is likely to pay in damages and legal costs (what I will call her expected liability). This assumption does not imply that the defendant only cares about money. Her benefit from the activity may be non-monetary. Similarly, this benefit could reflect any disutility the defendant feels from harming another person. The following argument also does not rely on the assumption that the defendant can necessarily predict with certainty the outcome of the trial or of settlement. What is required is that the defendant forms some estimate of the average costs of this action (her expected liability), so that she can weigh expected costs and benefits. In what follows, I will speak in terms of expected liability, but the reader should understand that this is only an average; the defendant usually will not know her exact liability precisely.

To analyze the effect of settlement on deterrence, I build on the asymmetric information model of settlement bargaining that has become the standard in the law and economics literature.²² Given that litigation is costly to both parties, if each party could perfectly predict the outcome of a trial, then there is a settlement (or a range of settlements) that both parties

²¹ I will use male pronouns for the plaintiff and female pronouns for the defendant.

²² See Lucian A. Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. of Econ. 404 (1984) for a mathematical model of settlement bargaining when one party has superior information about the likely trial outcome. This paper, like most, does not consider the defendant's decision about whether to do the act that results in the lawsuit.

would agree is preferable to going to trial. For example, if both parties know that the defendant will be found liable for \$100 in damages and both would have to spend \$20 litigating the case, any settlement where the defendant pays the plaintiff between \$80 and \$120 will make both sides better off than going to trial. In fact, even if the parties cannot predict with certainty the outcome of the trial (which is certainly the case), the preceding statement remains valid so long as both parties have similar estimates of the outcome of the trial. That is, if both parties think the defendant will probably have to pay the plaintiff \$100 at trial, then they will both think they will be better off on the average with a settlement between \$80 and \$120. Similarly, if the defendant and the plaintiff both think the defendant will probably be liable for damages of \$120, then they will settle for something between \$100 and \$140. The important thing to notice is that the range of possible settlements shifts up when the estimate of the likely damage award increases. This means that the defendant's action becomes more costly to her the greater the harm her action will cause.²³

If the defendant has much better information about the outcome of a trial than the plaintiff does, however, then this is not necessarily the case. Consider, for example, an antitrust case where the defendant, because she is very knowledgeable about the industry, has a very good idea of how much her anti-competitive conduct cost consumers. The plaintiff, on the other hand, may know that the defendant behaved anti-competitively, and so a court is very likely to find her liable, but may not have a very good idea of what prices would have been absent the anti-competitive conduct. If the case does not settle, however, the discovery and trial processes will likely uncover a great deal of the information that the defendant has about the damages from its

²³ In order to design a damage rule that provides perfect incentives, even when both the plaintiff and defendant are equally well-informed, one needs to know where in the settlement range the defendant expects the settlement to be. But, even if incentives are not perfect, with equally well-informed parties the defendant will have less incentive to do the action the greater its harm, even if she expects to settle the case.

anti-competitive conduct. That is, while both sides may have similar expectations about the probability of liability, the defendant probably has much more precise information about the magnitude of the damages a court will award should the case proceed to trial.

For example, the plaintiff may think that damages can be anywhere between \$50 and \$150, while the defendant may know exactly what (number between \$50 and \$150) her damages will be.²⁴ Of course, any given settlement offer will be more attractive to the defendant the higher she expects the damages awarded at trial to be. For example, if the plaintiff offered to settle for \$100, the defendant will prefer this to going to trial if she knows damages will be \$80 or more (since by going to trial she will have to also pay \$20 in legal costs). If she know that damages will be less than \$80, however, then she will reject this offer.²⁵ Of course, \$100 is not necessarily the best offer the plaintiff can make. But, no matter what offer he does make, the same reasoning implies that the defendant will only accept this offer if she knows the sum of the damages she will likely pay plus her legal costs will exceed this settlement offer. That is, a defendants who knows her action caused large harms will settle, while if she knows her action caused only a small amount of harm, then she will go to trial.

²⁴ While, this example assumes the defendant has perfect knowledge of damages, what is critical is simply that the defendant has better knowledge about what damages will be than does the plaintiff.

²⁵ Of course, in real settlement negotiations, there is more than one opportunity to settle. Nonetheless, even in these situations, defendants who know that damages will be large are more likely to settle than those who know damages will be small. The plaintiff cannot just assume that a defendant who resists settling for a given amount actually expects damages to be lower if the case goes to trial. If he did make this assumption, and thus offered to settle for less, then even a defendant who expects large damages could resist and obtain a lower settlement offer. That is, if a defendant who expects damages to be small is not more likely to have to go to trial than a defendant who expects damages to be large, then there is no reason for every defendant not to pretend in settlement negotiations that she expects damages to be small. If the plaintiff always believes her, he will end up settling for a small amount even when damages would have been quite high. Because this is not in the plaintiff's interest, he will not accept a lower settlement offer just because the defendant has already rejected a larger one. As a result, defendants who expect damages to be large have a much greater incentive accept any given settlement offer than those who expect damages to be small (because they will not do as well in a trial). Of course, this assumes that the defendant cannot, or does not wish to, reveal all the information she has about the likely damages during settlement negotiations. Certainly, before discovery the plaintiff has no way of knowing whether the defendant is hiding some information that might suggest damages are large. Moreover, the defendant may be hesitant to reveal too much information that might help the plaintiff should the case go to trial.

If the defendant knows the plaintiff's ability to make a settlement offer is completely unrestricted, then the defendant's expected liability for its action is capped at the magnitude of the settlement offer she expects the plaintiff will make. In our example, if the defendant expects the plaintiff will offer to settle for \$100, then she knows that she will never have to pay more than this. As a result, in this example the defendant will always do the action in question whenever her benefit from that activity exceeds \$100. This is true no matter how much harm this action may cause the plaintiff. Because the defendant can expect to receive a settlement offer, she has no incentive to tailor her decision to do this act to the actual level of harm whenever her benefit from the act exceeds the settlement offer she expects to receive. In our example, say the defendant's benefit from the activity is \$110. She will engage in the activity even if the harm it causes to the plaintiff is \$120 or even \$150 because she knows she can settle the lawsuit for \$100.

Of course, if her benefit is below the settlement offer she expects to receive (say \$80), then she will not do the act if she knows that actual damages will be large enough that she would want to settle.²⁶ In this case, she will compare her benefit to the actual damages (plus her legal costs) when deciding on whether to do the action or not. So, if her benefit is \$80, then she will engage in the activity if it causes harm of less than \$60 (because she will also have to pay \$20 in legal costs). Therefore, actual damages continue to affect deterrence when the defendant's benefit from the activity is low (below the expected settlement offer) but not when it is high (above the expected settlement offer).

This reduces the ability of the legal system to induce the defendant to act appropriately. When the defendant must pay all the costs associated with her action, then she will have the

²⁶ The plaintiff's settlement offer can still be optimal if the plaintiff does not know the defendant's benefit. If the defendant's benefit could be larger than this settlement offer, then there is nothing necessarily irrational about making a settlement offer that turns out to be larger than the defendant's benefit in some cases

incentive to do the act if and only if her benefits exceed the total costs. As demonstrated above, when damages equal the harm from the activity, settlement will weaken deterrence because of the way settlement acts like a cap on damages. More fundamentally, notice that there is no way to adjust the damage rule to solve this problem.²⁷ Say that we tried to increase the damages by some amount for every possible level of harm to correct this problem. This would naturally increase the optimal settlement amount that the plaintiff would accept (because her expected recovery at trial would increase). This, however, does not eliminate the damage cap effect of settlement; it only changes the monetary value of the cap. In our example, if damages were set to harm plus \$20, the plaintiff might offer to settle for \$120 rather than \$100. Notice that while the settlement amount is now larger, the defendant will still accept the settlement offer if she know the harm she causes exceeds \$80, just as before. (If the harm is \$80, then damages will be \$100 and she will also pay \$20 in legal costs, making the total cost of trial \$120 when harm is \$80). So, when the harm exceeds \$80, the defendant will still decide to do the activity if and only if her benefit exceeds the settlement amount (now \$120). Thus, her decision will still be the same whether the harm is \$80 or \$150. So, increasing the damages the defendant must pay at trial does not change the fact that the defendant will not consider the actual harm her action causes whenever that harm exceeds \$80 (or, more generally, when the harm is large enough to make accepting the settlement preferable to going to trial).

Of course, settlement does have a major offsetting advantage: it reduces legal costs. In many situations, when legal costs are substantial, these cost savings will outweigh the less efficient incentives that settlement necessarily creates. In our example, one situation where this

²⁷ See Abraham L. Wickelgren, *A Model of Welfare-Reducing Settlement*, Unpublished (2003) (available from the author upon request) for a formal proof of these results

would be true is where the defendant's benefit is greater than \$150. In this case, it is always efficient for the defendant to do the act when she can settle, so there is no reason to deter it.

That said, this would not happen as often as one might think. If settlement offers are regulated to prevent the lowball offers that create this problem, not all of the cases that would have settled will be litigated. Many of these cases will no longer exist because the defendant will not do the act that creates the lawsuit in the first place. By improving deterrence, limitations on settlement will reduce the number of cases filed. Because this reduces the increase in legal costs that settlement limitations create, there is much more scope for the benefits from improved incentives to outweigh the increased legal costs.²⁸ Coming back to our example, this will happen when the defendant's benefit from the act is just barely greater than the settlement amount (say it is \$101 in the case where the plaintiff makes an offer of \$100 because damages equal harm). Now, if settlement is prohibited, then the defendant will only do the act if it causes a harm of less than \$81 (so her damages plus legal costs will be less than \$101). So, the only cases that would have settled that now go to trial are those where the harm is between \$80 and \$81. All the other cases that would have settled, when the harm exceeds \$81, do not exist because the threat of liability now deters the defendant from doing the action.

Of course, prohibiting settlement, even in this case, is not always desirable. If the defendant's action causes a harm of less than \$101, then we do not want to deter it since the benefit exceeds the harm as long as there are no legal costs (because the case settles). On the other hand, prohibiting settlement to deter this activity is desirable if the activity causes a harm that exceeds \$101. Unfortunately, it is also true more generally that whether or not settlement is desirable depends on both the benefits and the harms of the activity, making it difficult to write a

²⁸ Wickelgren, *supra* note 26, shows that there cases where the incentive benefits of prohibiting settlement outweigh the legal costs saved for any settlement offer that actually results in some cases settling.

general rule that always allows settlement when and only when its advantages outweigh its disadvantages.

B. Domain of Application

Of course, this theory does not justify a blanket prohibition on settlement. In fact, in most cases, the central premise of the theory probably will not hold. Recall, that the main building block for the argument in the last section was that the defendant knows more about the harm that her activity causes than does the plaintiff. More precisely, the defendant must know more about the likely harm both when she does the act and when she is engaged in settlement negotiations than the plaintiff knows when she is in settlement negotiations.

In many cases, personal injury is an obvious example, this will almost never be true. A physically injured plaintiff can more easily determine the extent of her own injuries than can the defendant. Similarly, in most contract cases, the breached-against party will know more precisely than the breaching party what the harm from the breach was. That said, there are many classes of cases where the premises of the theory will often hold. In antitrust, as discussed in the preceding section, the defendant's greater knowledge of the market will usually put her in a much better position to compare the actual situation with the "but-for" world where there was no anti-competitive activity.

This problem can also occur in some tort cases. Say a defendant emits a chemical that affects the yields of crops on nearby farms. Because crop yields are quite variable, the plaintiff cannot simply compare his current yield to his normal yield to accurately determine how much the chemical affected his yields. Instead, the best evidence of the effect of the chemical on crop yields will probably come from knowledge of the chemical itself. This is information that the

defendant, the producer of the chemical, is in a much better position to know than is the plaintiff, putting her in a much better position to estimate compensatory damages.²⁹

IV. Settlement and the Chilling Effect

A. The Theory

The previous section showed how settlement could weaken deterrence when the defendant has an informational advantage about the magnitude of damages that a court will award. While, as argued above, such situations are important, they are probably less prevalent than cases where the defendant knows more than the plaintiff about the probability that the court will find her liable. This section analyzes this case and shows that settlement can reduce the legal system's ability to distinguish between legitimate and harmful activities, thereby making the tradeoff between under-detering harmful activities and chilling legitimate activities worse.

One example of the situation that I have in mind concerns a factory that emits a chemical into the air or water. Because the factory owner knows a great deal about her production process and has the opportunity to study it, she probably knows much more about whether this chemical causes cancer or not than do the people who live near the factory. If a person who lives near the factory gets cancer, he will not know whether the chemical emitted by the factory could have

²⁹A very similar effect can occur in contract cases. Consider contracts for the delivery of some input into a production process. If the defendant breaches by delivering a different input than what the contract specifies, the plaintiff will probably know. However, due to the plaintiff's duty to mitigate damages, he will often have to use the input anyway (if an alternate source is not available or is very costly). If many other factors, aside from the quality of this input, affect the plaintiff's output (some of which could be very hard to measure), his actual output with this input may not provide very good evidence of how much the substandard input reduced his output over what it would have been with the correct input. Much better evidence may come from evidence about the relative quality of the two inputs. The defendant, because she produces these goods, will have much better information about this issue than will the plaintiff. Similarly, if the contractually specified input represented a technological advance, then the plaintiff may not know what its production capabilities or costs would have been had the contract been performed. The defendant, because it was making the input, may know much more about its likely performance characteristics. This puts the defendant in a much better position than the plaintiff to estimate expectation damages.

caused his cancer or not. Say he sues the factory owner. While much of what the defendant knows will likely come out at trial (and maybe during discovery), at the time of the suit, the defendant knows much more about how likely she is to be found liable than does the plaintiff.

The argument that settlement can make it more difficult to deter harmful behavior without chilling harmless behavior has two main steps. First, I show that the possibility of settlement causes the plaintiff to prepare less for trial (if there is no settlement) than she would if settlement were prohibited. Second, I show that the less the plaintiff prepares for trial, the smaller is the difference between the expected liability for harmful behavior and the expected liability for harmless behavior. This, obviously, makes it harder to deter harmful behavior without chilling harmless behavior.

I now show that the possibility of settlement causes the plaintiff to prepare less for trial (the first step). First, notice that if the plaintiff makes a settlement offer, the defendant has a much stronger incentive to accept this offer if she has evidence that the chemical emitted by her factory might cause cancer than if she has strong evidence that the chemical is completely benign. The reason is that a defendant who knows the chemical she emitted causes cancer is more likely to be found liable at trial than is a defendant who knows the chemical she emitted is benign, making trial more costly for the former defendant than for the latter.³⁰ Of course, the plaintiff knows this, so if the defendant rejects the settlement offer, he will infer that it is more likely that the defendant has evidence that the chemical is benign than that she has evidence that it causes cancer.

³⁰ A simple example can illustrate this point. Say the damages will be \$1 million if the defendant is found liable for the plaintiff's cancer. If the defendant knows her chemical emission did not cause this cancer, then the probability that the court will mistakenly find her liable may be quite small, say 5-10 percent. On the other hand, if the chemical is carcinogenic, then the probability that the court will correctly find the defendant liable may be quite high, say 70-80 percent. Thus, a defendant whose chemical emission was dangerous will accept a settlement offer of \$700,000, and maybe even an offer of \$750,000, but if the defendant knows her chemical emission was benign, she will certainly reject this offer.

Now, consider the effect of this inference on the plaintiff's optimal litigation strategy. If the chemical is benign, then it will usually be the case that it will be quite hard, maybe impossible, for the plaintiff to find credible evidence that the chemical caused his cancer. Therefore, the more likely the plaintiff thinks it is that the chemical is benign, the less incentive he has to spend a lot of time and money searching for evidence that it is dangerous. That is, the plaintiff's effort in preparing for a case is likely to be more effective when the defendant really is responsible for the plaintiff's injury than when she is not. Because of this, the plaintiff will expend less effort the less likely she thinks it is that the defendant really is culpable.³¹ Because the defendant is less likely to be truly culpable if she has rejected a settlement offer than if no settlement is made, this establishes the first step of the argument: the possibility of settlement reduces the plaintiff's trial preparation effort.³²

I now turn to the second step in the argument, showing that less trial preparation effort leads to a smaller difference between the expected liability from committing harmful acts and the expected liability of committing harmless acts. Notice that the reason the plaintiff exerts less effort when he believes the defendant is more likely to be blameless is because his effort is less effective when the defendant is blameless than when she is responsible for the plaintiff's injury. Therefore, when the plaintiff prepares less for trial, this reduction in effort benefits the culpable defendant more than the blameless one.³³

³¹ Of course, there are many cases which are "slam-dunks" where the plaintiff does not need to do much preparation at all in order to win. In these cases, however, the plaintiff usually knows it is a "slam-dunk" so the asymmetry of information that this theory depends on is not present.

³² The possibility of settlement will not likely affect the defendant's trial preparation effort since the defendant knows whether she is culpable or blameless whether the plaintiff makes a settlement offer or not.

³³ For example, spending an additional 100 hours on the case might increase the plaintiff's chance of winning by 5 percent if the defendant is blameless but it might increase it by 10 percent if she is culpable. So, if the fact that the defendant rejected a settlement offer causes the plaintiff not to spend this extra 100 hours preparing, then the blameless defendant only has a 5 percent less chance of being found liable while the culpable defendant has a 10 percent less chance. The culpable defendant benefits more from this reduction in effort.

While the plaintiff's reduced incentive to prepare only occurs if the case does not settle, it actually affects the defendant's liability in all cases, whether they settle or not. A defendant who is responsible for the plaintiff's injury knows that if she rejects the settlement offer, the plaintiff will not work as hard to win the case. This reduces her chance of being found liable if she rejects the settlement and goes to trial. This reduces the amount the culpable defendant is willing to pay to settle the case. Since the plaintiff knows this, she has to make a smaller settlement offer.

When settlement is allowed, the plaintiff does not prepare as much if there is a trial and this benefits the culpable defendant more than the blameless one. This makes the difference between the culpable defendant's expected liability and the blameless defendant's expected liability is less when settlement is possible. This effect is critical. The factory owner will decide whether to emit the chemical by comparing her benefits from doing so (how much it reduces her production costs or increases her output) with the expected liability that results. This is true whether the evidence the factory owner has indicates that the chemical is carcinogenic or benign. If the chemical is benign, however, then society does not want to chill this obviously beneficial activity. If the chemical is carcinogenic, then it is quite possible that deterring this harmful activity is optimal (unless the benefits are also quite large). The bigger the difference between the expected liability faced by an owner that emits a dangerous chemical versus the expected liability faced by an owner whose chemical emissions are benign, the more likely the legal system can effectively deter the dangerous activity without chilling the benign one. For example, if the benefit from emitting a carcinogenic chemical is \$100,000 more than the benefit of emitting a benign chemical, then it is impossible to deter a defendant from emitting the

carcinogenic chemical without chilling the benign activity unless the difference in expected liability is at least \$100,000.

Of course, for any given damage rule, the impact of settlement is to reduce the defendant's expected liability because of the plaintiff's reduced incentive to engage in preparation effort should there be a trial. If the damage rule is flexible and can be adjusted based on whether or not settlement restricted or unrestricted, however, then it is always possible to adjust the damage rule such that culpable defendants (those whose activities are dangerous) face the same expected liability in either regime (restricted or unrestricted settlement). Since settlement tends to reduce the plaintiff's incentive to invest in preparation, however, the unrestricted settlement regime will have higher damages and lower preparation effort than the regime with some restrictions on settlement. If each combination produces the same expected liability for culpable defendants, the expected liability faced by blameless defendants in the unrestricted settlement regime will necessarily be greater. This follows because the lower level of plaintiff preparation effort when settlement is allowed does not benefit the blameless defendant as much as it benefits the culpable one. Another way to see this is to notice that, since unrestricted settlement reduces the difference in the expected liability facing culpable and blameless defendants, if the liability for culpable defendants is held constant, unrestricted settlement must increase the expected liability facing blameless defendants. That is, when the defendant has better information about her likelihood of being found liable than does the plaintiff, settlement worsens the tradeoff between under-detering dangerous activities and chilling legitimate activities.

As was the case in the prior theory, one should balance this cost of settlement against the benefit it provides in terms of reducing litigation costs. For many cases, especially those where

the defendant's informational advantage is not that great, the chilling costs of settlement may not be large. There is no reason to believe, however, that this will be true in general. In fact, one can show that when the range of possible benefits the defendant can get from her activity is quite small, the chilling effect from settlement will often outweigh the benefit that settlement provides by reducing legal costs.³⁴ The reason is that, to avoid completely chilling the harmless activity, the optimal damage rule when settlement is unrestricted leads to much more harmful activity. As a result, most of the cases that settle are cases that would not exist had settlement been restricted. In general, however, the tradeoff between the chilling cost of settlement and the litigation cost-saving benefit is quite complicated and probably varies a great deal by case. I discuss this issue further in Section V.

B. Domain of Application

As with the prior theory, the argument against unrestricted settlement in this theory does not apply in all cases. First, this argument requires that there is a harmless activity that could easily be mistaken for a harmful activity. Second, the trial process must be an imperfect, but still somewhat effective, means of distinguishing between the two activities. If the trial process were perfect, then blameless defendants would never be found liable, so there would never be any chilling. If the trial process were no more likely to find against a culpable defendant than against a blameless one, then substantial chilling of harmless activities would be inevitable whether settlement was restricted or not. Third, it must be important both to deter harmful activities and not to chill harmless ones. If the harmful activity is not either not very harmful or produces benefits that are almost as great as the harm that it causes, then society may not lose much by

³⁴ See Ezra Friedman and Abraham L. Wickelgren, *Chilling, Settlement, and the Accuracy of the Legal System*, <http://www.nber.org/~confer/2003/si2003/papers/le/friedman.pdf>, (2003) for a mathematical proof of this claim.

immunizing this activity from liability so as not to risk chilling legitimate activities that might be mistaken for this harmful activity. Alternatively, if the benefits from the harmless activity that could be mistaken for a harmful activity are very small, then it is probably not worth the extra legal costs from restricting settlement to avoid chilling this activity. It is only when minimizing the risk of both types of legal errors (not deterring the dangerous activity and chilling the beneficial activity) is quite important that we might want to restrict settlement in order to improve the legal system's ability to distinguish between the two types of activities.

One category of cases where it is very important to distinguish between culpable and blameless defendants is medical malpractice. A recent study by the American Medical Association (AMA) finds that more than 18 states are in "full blown medical malpractice insurance crises."³⁵ Some of the examples the study cites are:

- More than 50 percent of Arkansas physicians reported in a recent survey that they have been forced to reduce or discontinue one or more medical services in the last two years due to rapidly increasing medical liability premiums"
- Because of a legal climate making \$1 million-plus jury verdicts and settlements more common, an increasing number of Connecticut obstetricians are no longer delivering babies, and premiums for neurosurgeons and other high-risk specialists are more than \$100,000...
- Women with gynecological cancers in three rural Missouri towns now have to drive more than 100 miles because the only gynecological oncologist was forced to eliminate his rural outreach clinic due to increasing insurance premiums.³⁶

³⁵ <http://www.ama-assn.org/ama/pub/article/9255-7341.html>.

³⁶ Ibid.

Of course, the AMA's view is that liability should almost never force doctors to stop performing high-risk procedures or to stop practicing altogether. A less self-interested observer of these facts, however, would conclude that stopping some doctors from performing some procedures is probably desirable. While it is unlikely that 50 percent of all doctors in Arkansas are too dangerous or unqualified to practice medicine safely, it would be a mistake to eliminate the ability of medical malpractice lawsuits to block dangerous doctors from subjecting patients to unnecessary risks. On the other hand, it hurts both patients and doctors if competent doctors stop performing some procedures to avoid the risk of unjustified liability. In other words, it is very important that our legal system distinguish as accurately as possible which doctors are dangerous and which doctors are not, making it plausible that restrictions on medical malpractice settlements might be justified.

Chilling is also a major concern in the enforcement of antitrust laws, especially restrictions on predatory pricing or illegal vertical combinations. When predatory pricing does effectively block entry into a market, the losses to consumers can be substantial. On the other hand, threat of predatory pricing litigation can deter firms from charging low prices.³⁷ Similarly, while vertical mergers can sometimes cause significant anti-competitive harm, they can also sometimes bring great benefits to consumers. In these cases, allowing for settlement may make it more difficult to deter illegal activities without excessively chilling efficient legal behavior. Patent litigation is another example where one can imagine that it may be difficult to distinguish between legitimate innovation and patent infringement. When the legal system gets the wrong answer in either direction, incentives to innovate are significantly diminished. Because of the

³⁷ See Patrick Bolton, Joseph F. Brodley, and Michael H. Riordan, *Predatory Pricing: Strategic Theory and Legal Policy*, 88 Georgetown Law J. 2241 (2000) for a discussion of the issues surrounding predatory pricing.

importance of innovation, restricting settlement to enhance the accuracy of the legal system in this area may justify the added litigation costs that result.³⁸

There are also numerous examples where this theory of how settlements can be harmful is not applicable. In most criminal cases involving street crime, this theory does not justify restrictions on plea bargaining. Probably very little legitimate activity could be mistaken for armed robbery, for example. Another set of examples would be any case where the contentious issue is the identity of the party that committed the harmful act rather than whether the act itself was harmful. Where there is no possibility that the act was harmless, chilling is not a concern.

V. Legal Policy Implications

In cases where the premises of either theory hold, the theories have some important implications for the legal policy towards settlement. The general implication is that the standard presumption that the legal system should encourage settlement may not always be valid. This general observation, however, is not very helpful in specifying in what circumstances settlement should be restricted and what forms those restrictions should take. This section provides some discussion on both of these issues.

As the discussion in the domain of application sections suggests, it is probably very difficult to describe precisely the set of cases where the key premises of either theory are likely to hold. In addition, when these premises do hold, it is quite difficult, in the abstract, to say when the incentive benefits of restricting settlement are likely to outweigh the added legal costs. Because of this, any reappraisal of our legal policy towards settlement should probably not be enshrined in any hard and fast rules. Given how much the facts of each individual case affect

³⁸ There are potential antitrust reasons for opposing some patent settlements as well, particularly in the pharmaceutical area. See Jeremy Bulow, *The Gaming of Pharmaceutical Patents*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=412123 (2003).

whether that case is one where settlement should be restricted, the only feasible way to restrict settlement without creating a rule that is both over- and under-inclusive is to set up general guidelines but to give individual judges a great deal of discretion in regulating individual settlement agreements.

How might judges regulate or discourage settlement? The Federal Rules of Civil Procedure already give judges the ability to encourage settlement via Rules 16 and 68. The argument in this paper suggests that, at a minimum, judges should not always use these tools. Actively discouraging settlement presents a more difficult issue. One approach would be to limit the enforceability of the promise to terminate all litigation in connection with the case if a court found that such a promise was against public policy. The grounds for it being against public policy would be exactly the arguments presented in Section III and Section IV. That is, to determine whether to set aside a settlement agreement, a judge would have to determine if the defendant had superior information about either the likely damages or key facts that would determine liability. If so, and if this informational advantage existed when the defendant was deciding whether to do the activity that now is the subject of the lawsuit, then the judge will have to weigh the incentive benefits of restricting settlements against the added litigation costs that doing so would create.

It is worth pointing out that, under both theories, smaller settlements are more problematic than larger ones. When the defendant's informational advantage concerns the magnitude of the damages, the lower the settlement the lower the cap on expected liability. This creates a wider region of possible harm where the defendant's decision about whether to do the act is based on a comparison of the benefit to the settlement amount rather than on a comparison of the benefit to the actual harm she expects to cause. Similarly, if the defendant's informational

advantage concerns liability, then the smaller the settlement offer the more likely that a defendant who rejects such an offer is blameless. This means that the reduction in preparation effort caused by settlement will be even larger, leading to an even greater reduction in accuracy. Thus, under either theory, evidence that the settlement amount was quite large given the type of case should tend to make a judge lean against setting aside the settlement agreement.

Giving a judge discretion not to enforce the promise to terminate litigation in a settlement agreement would greatly limit the attractiveness of small settlements in cases where the parties felt the asymmetry of information was such that the settlement agreement might not be enforced. Specifically, the defendant would be reluctant to agree to pay a small settlement amount to the plaintiff since after the payment, the plaintiff might be able to continue the litigation if the judge rules that the plaintiff's promise to terminate litigation is unenforceable. Notice, however, that in some cases it is crucial that the judge only set aside the promise to terminate litigation. If the judge sets aside the entire settlement, then, since both parties agreed to the settlement, neither may have an incentive to breach the contract, which would bring the settlement agreement to the attention of the judge. While, in many cases, judges naturally become aware of settlement agreements, this is certainly not the case for settlements that occur before a suit is ever filed. In these cases, giving the plaintiff an incentive to breach the settlement agreement is essential to restricting such agreements.

The key problem with this approach is that not only may judges not be able to perfectly determine which settlements undermine deterrence or risk chilling sufficiently to warrant setting them aside, but that the parties themselves often may not be able to accurately predict if their settlement is likely to be enforced or not. This uncertainty could prevent settlements that do not have substantial adverse effects on deterrence nor contribute to the chilling of legitimate

activities. This drawback could be largely remedied by requiring a very high standard of proof, such as “clear and convincing evidence,” that a settlement is against public policy before a judge agrees to set it aside. While such a high standard of proof may greatly limit the effectiveness of this system at preventing harmful settlements, it would surely be more effective at preventing these settlements than the current system, and it would create only a minimal risk of undermining desirable settlements.³⁹ That is, this approach would represent an incremental improvement to the problem of excessive settlement.

Another approach to discouraging settlements, and the first one that would occur to most economists, would be to tax them. While taxes are often more efficient than direct regulation, in this case taxing settlements is probably not the best way to discourage them.⁴⁰ The main problem is that taxes are not very flexible. For example, while the theory shows that larger settlements weaken deterrence or increase chilling less than smaller ones, what constitutes a large or small settlement will vary a great deal across cases. Giving judges the flexibility to set aside a settlement allows them to vary this decision in accordance with the facts of the case much more than would a standard tax.⁴¹

Since, under both theories, the defendant must have an informational advantage over the plaintiff to make settlements harmful, judges should view post-discovery settlements much more favorably than pre-discovery settlements. In many cases, discovery will greatly reduce the defendant’s informational advantage. If discovery gives the plaintiff almost as much information

³⁹ This would also reduce the attractiveness to the plaintiff of attempting to continue litigation after agreeing to a settlement, so it would greatly limit the legal costs that this further hearing could create.

⁴⁰ See Louis Kaplow and Steven Shavell, *On the Superiority of Corrective Taxes to Quantity Regulation*, 4 Am. Law and Econ. Rev. 1 (2002) for a discussion of why, in general, taxes are superior to direct regulation. Their argument does not apply in this case because, unlike the case of a pollution tax, for example, the optimal tax here would depend on the benefits as well as the costs of settlement. As a result, the information requirements for a tax are no less severe than they are for direct regulation.

⁴¹ In principal, one could allow the judge to set the tax after examining the facts of the case, but this is then not very different from setting aside the settlement and having a trial that examines the facts of the case and assesses damages.

as it gives the defendant about the magnitude of the damages or the likelihood of liability, then settlements after discovery will not have the same negative effects on incentives as settlements before discovery. The reason is that now the plaintiff can adjust his settlement offer based on what he has learned about the likely damages or likelihood of liability. If discovery gives the plaintiff as much information about damages as the defendant had at the time she decided to do the act, then the magnitude of the settlement will vary with the harm the defendant expected to cause. This is what is necessary to induce the defendant to make an efficient decision about whether to engage in the activity in question. In the case where the dominant issue is the probability of liability, if the plaintiff knows for sure whether the defendant is culpable or blameless after discovery, then the defendant's response to his settlement offer will not affect his incentives to prepare for trial. Even if the plaintiff is still somewhat uncertain about the defendant's culpability, further effort at this point may not influence the accuracy of the outcome nearly as much as preparation effort prior to or during discovery. Settlements at this stage may not decrease the plaintiff's accuracy producing effort very much. Therefore, restrictions on pre-discovery settlements may often be sufficient (or close to sufficient) to solve the incentive problem described above. This further limits the increased legal costs necessary to improve deterrence or prevent excessive chilling of legitimate activities.

VI. Conclusions

This essay has argued that the settlement is not a free lunch. That is, while having cases settle rather than go to trial may reduce legal costs and the burden on the courts, it also comes with a real cost. At least in some cases, settlement can impair the legal system's effectiveness at

regulating behavior. This drawback is very important, otherwise the best way to reduce legal costs and the burden on the courts would be simply to prohibit lawsuits. Almost no one advocates this, of course, because doing so would greatly reduce people's and firms' incentive to care about the harm they cause to others. While the effect of settlement is much less drastic, one still must weigh its cost savings against its negative effects on both the deterrence of harmful activities and the chilling of beneficial ones. While these negative effects of settlement will not be present in every case, or even in most cases, they do exist in a significant number of cases. In such cases, legal policy should not necessarily encourage settlement. There may even be cases where settlement should be discouraged. Because determining exactly when the negative incentive effects of settlement outweigh the cost savings benefits depend on the precise details of any individual case, hard and fast rules regulating settlement are not desirable. This essay argues that a better alternative might be to give judges the discretion to consider not enforcing some settlement agreements.