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Exploiting Plaintiffs Through Settlement: Divide and Conquer.

Comment

by

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1 Introduction

Che and Spier [2007] consider a model of a single defendant and N plaintiffs where the total cost of litigation is fixed on the plaintiff side. As litigation cost is shared among the suing plaintiffs a plaintiff's settlement decision creates a negative externality on the others. Failure to internalize this externality can be exploited by the defendant by making discriminatory settlement offers ("divide and conquer strategy", see Segal [2003]).

Compared to the benchmark case without externalities, this leads to a redistribution in favour of the defendant and dilutes the defendant's incentives to take precaution. Although redistribution has no welfare effect per se, it nevertheless creates incentives for plaintiffs to organize (at a cost) in order to internalize the externalities. The welfare effect of diluted incentives depends on whether the defendant was over- or underdeterred to begin with. Assuming that incentives were right in the benchmark, policies which promote the internalization of externalities (e.g. by facilitating the organization of plaintiffs) or prevent defendants from exploiting them (e.g. by prohibiting discriminatory offers) are potentially welfare increasing. Yet, even then there is a trade-off as these policies lead to lower settlement rates in a setting of asymmetric information which pushes up society's cost of litigation.

Che and Spier [2007] find these results robust in several variations of their leading case. In the following, I shall briefly sketch their analysis but then focus on an extension - not considered in their paper- under which results are reversed.

2 Analysis

In their leading case, the authors assume that the defendant makes simultaneous take-it-or-leave-it settlement offers to the plaintiffs (case I in Figure 1).

		All the bargaining power with	
		Defendant	Plaintiff
Simultaneous offers	I	Leading Case: Prop 2+3 - Exploitation	III Extension: Prop 6 - Exploitation even worse
	II	Extension: Prop 5 - Exploitation even worse	IV (Not considered) - No exploitation

Figure 1: Variation of Timing and Bargaining Power.

In order to understand the intuition of their argument consider the following numerical example: Assume that there are only two plaintiffs ($N = 2$). If the suit goes to trial they will jointly collect damages of $D = 6$. Further assume that the cost of litigation is fixed for both the plaintiffs ($C_P = 4$) and the defendant ($C_D > 0$). In the benchmark case, plaintiffs will therefore jointly collect $D - C_P = 2$. If one plaintiff goes to trial alone, his payoff will be $D/N - C_P = -1$. If both go to trial, each will get $D/N - C_P/N = 1$. It follows that if one of the plaintiffs settles, the other does not have a credible threat to sue.¹ Hence the defendant can settle with both plaintiffs by making a settlement offer of 1 to one of the plaintiffs and 0 to the other. Total plaintiff recovery will therefore be less than in benchmark ($1 < 2$).

If the defendant approaches the plaintiffs sequentially (case II in Figure 1), exploitation will be even worse. Indeed, as A knows that if he rejects, B

¹i.e. $m = 2$ where m is the minimum number of plaintiffs who can credibly threaten to sue.

will accept, leading to zero payoff for A, he will accept a settlement offer of (slightly above) 0. But then plaintiff B will also get payoff 0 as, on his own, he has no credible threat to sue.

Even more surprisingly, also in the case where the plaintiffs make simultaneous take-it-or-leave-it settlement offers to the defendant a race to the bottom pushes total plaintiff recovery down to 0 (case III in Figure 1).

3 Sequential TIOLI offer by plaintiff

If the plaintiffs make sequential take-it-or-leave-it offers to the defendant (case IV in Figure 1) the result is reversed.

In the 2-plaintiff example in Figure 2, plaintiff 1 makes settlement offer a_1 which is either accepted or rejected. In case it is accepted, the defendant pays a_1 to plaintiff 1. Plaintiff 2 gets zero payoff as he does not have a credible threat to sue. If the offer of plaintiff 1 is rejected, plaintiff 2 makes offer a_2 which is either accepted or rejected. If it is accepted the defendant pays a_2 to plaintiff 2 while plaintiff 1 gets nothing as he has no credible threat to sue. If the defendant rejects, the two plaintiffs together will sue. This nets them a payoff of 1 each but causes costs of $6 + C_D$ to the defendant. Solving the game by backwards induction, it is straightforward to see that in equilibrium the defendant pays $6 + C_D$ to plaintiff 1 and 0 to plaintiff 2.²

This reverses the result of Che and Spier [2007]: There is no redistribution from the plaintiffs to the defendant. Rather it is plaintiff 1 who exploits plaintiff 2. Hence, plaintiff 1 is not interested to organize in order to internalize the externality. Incentives to take precaution are undiluted and total plaintiff recovery is as in benchmark.

It is possible to extend this result to the case of N plaintiffs (see Stremitzer [2007]): If no single plaintiff has a credible threat to sue ($m > 1$) then the first $N - m$ plaintiffs settle for D/N . Plaintiff $N - m + 1$ gets more ($mD/N + C_D$), exploiting the $m - 1$ remaining plaintiffs who receive 0 payoff. Total plaintiffs recovery and incentives are as in benchmark.

The reason why plaintiff $N - m + 1$ is in the position to exploit subsequent plaintiffs is his pivotal role in the settlement process. By accepting his offer, the defendant can make absolutely sure that there will be no trial. At the time when the defendant negotiates with plaintiff $N - m + 1$ all other settlement

²As the plaintiff has all the bargaining power he demands a settlement which just makes the defendant indifferent between settling and going to trial: $6 + C_D$.

Plaintiff/sequential $m=2=N$

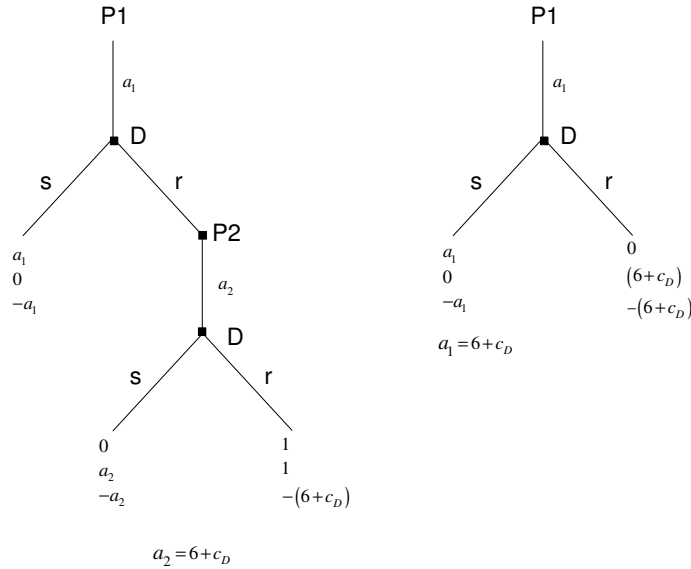


Figure 2: Sequential TIOLI-offer by plaintiff.

payments will already be sunk. Hence, no prior plaintiff can skim off part of the exploitation benefit of the pivotal plaintiff.

4 Conclusion

The analysis of the case where plaintiffs make sequential take-it-or-leave-it offers to the defendant suggests that the result of Che and Spier [2007] is sensitive to assumptions about the distribution of bargaining power.

Two arguments, however, can be raised in their defense. First, in order for the assumption of sequential offers to be plausible, there must be a way how plaintiffs gain knowledge of the game's history. As the defendant is the only party who is common to all settlement negotiations, one obvious source of information transmission would be the defendant, e.g. by showing the settlement contracts that he signed with other agents. Yet, while the

defendant has an interest to disclose this information in the case where he makes sequential take-it-or-leave-it offers to the plaintiffs, he has no such interest in the present case. Second, in the absence of any natural reasons it is unclear why a plaintiff volunteers to be the "Stackelberg follower". If plaintiffs undercut each other for being first, payoffs will be driven down to zero restoring the original result.

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