Alternative Dispute Resolution: An Economic Analysis

Steven Shavell
Introduction

• Examine
  – Why parties make use of ADR
  – What the social interest in ADR

• Economic Approach
  – Parties are rational and stylized models of behavior

• Distinction
  – ex ante ADR agreement(section1) and ex post ADR agreement(section2)

• Consider regimes in ex post ADR and make comparison
ex ante and ex post agreement

Ex ante ADR agreement

Dispute arise

Ex ante ADR agreement

time
Section 1: Ex ante ADR

• Why adopt ADR
  – Mutual Benefit (contract or other relationship)

• Three reasons why ADR is beneficial
  – A. Lower the cost or risk
  – B. Engender superior incentives through greater accuracy of result or other characteristics
  – C. Improved incentives to engage in disputes or refrain from that

• Such benefits not generally obtain ex post
Who tends to adopt ex ante ADR

• In contact before adverse event
  – Contractual relationship (problem of inadequate performance or breach)
  – Or, recognize the possibility of legal-disputes related outcomes
A. Reduction in Costs or Risk

• If cost reduction can be obtained by ADR, ex ante and ex post are equally advantage.

• Similarly, if ADR lower risk of attending disputes, this benefit can be obtained either ex ante or ex post.
B. Improvement in Incentives

• Induce a change in behavior that benefits both, by increasing joint value
  – Quality of performance assessed better under ADR
  – Or, different legal rule, etc.

• Incentives improvement by ADR must be ex ante
Example 1.

Assume contract price is that they split joint value
Courts unable to detect substandard but ADR can

<table>
<thead>
<tr>
<th>Performance</th>
<th>Good</th>
<th>Substandard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Buyer</td>
<td>1000</td>
<td>500</td>
</tr>
<tr>
<td>Contract Seller</td>
<td>400</td>
<td>300</td>
</tr>
<tr>
<td>Joint value</td>
<td>600</td>
<td>200</td>
</tr>
<tr>
<td>Price</td>
<td>700</td>
<td>400</td>
</tr>
<tr>
<td>Threat to seller</td>
<td>w/ ADR</td>
<td>w/o ADR</td>
</tr>
</tbody>
</table>

\[
\text{Price} = \frac{V + C}{2}
\]

<table>
<thead>
<tr>
<th>Buyer</th>
<th>Price high</th>
<th>Price low</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Good</td>
<td>300,300</td>
<td>0,600</td>
</tr>
<tr>
<td>Sub.</td>
<td>400,-200</td>
<td>100,100</td>
</tr>
</tbody>
</table>
C. Beneficial Changes in the Frequency of Disputes

• Given applicable law, too many action brought absorb resource but produce no benefit in behavior

• Ex ante ADR is a must to reduce frequency of disputes
D. Ex ante ADR & social policy

• The statement:

*Under ADR, both parties better off=>social welfare rise=>general policy should enforce ex ante ADR is subject to*

  – Agreement is not properly informed to one party
  – ADR would negatively affect third parties
D. Ex ante ADR & social policy

• No general basis for subsidy or active encouragement (information and externality)
• Cost of use of court not paid presently
• Law should enforce agreements that bypass the legal process is not paradox
  – The sensitivity of legal process to the particular situation of disputants is limited
Section 2: A. Ex post ADR

- Make ADR agreement if mutual beneficial
  - Promotion of settlement (information about trial outcome)
  - Reduction of dispute resolution costs (cheap substitute for trial)
  - Lower risk

- Append ADR to standard economic model of litigation

- Assumed cheaper and may convey information
Standard model of litigation

Figure 1
Standard model with voluntary ADR

**Figure 2**
Standard model with required non-binding ADR before trial

![Diagram](image)

**Figure 3**
B. Standard model of litigation

- Risk neutral: plaintiff brings suit if and only if expected judgment exceed his trial cost.
When is there a settlement

- Min. settlement acceptable to the plaintiff is less than max. settlement to the defendant

<table>
<thead>
<tr>
<th>Example 3</th>
<th>Plaintiff</th>
<th>Defendant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judgment amount</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Probability plaintiff win in their belief</td>
<td>0.7</td>
<td>0.7</td>
</tr>
<tr>
<td>Trial cost</td>
<td>1,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Expected gain / loss</td>
<td>6,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Acceptable if settlement amount</td>
<td>Greater</td>
<td>Less</td>
</tr>
</tbody>
</table>
Why there’s a room for settlement

• Each side pays trial cost
  – Plaintiff subtract from expected judgment(net)
  – Defendant add to expected judgment(pay)
  => Separate their acceptable settlement amount (hold the same belief)

• Their difference btw opinion is not far apart
  – settle if \( p_p x - t_p \leq p_d x + t_d \) => \( (p_p - p_d)x \leq t_p + t_d \)

• More specifically, difference btw their expected judgment amount not exceed sum of trial cost
C. Model w/ voluntary ADR

- Assume ADR involve cost, $a$, which is less than trial cost, $t$
- Bring suit if expected judgment exceed trial cost
- Condition of bringing suit not affected w/ voluntary ADR

Credible threat

Figure 2
What will occur if suit brought?

• First, be explicit about the nature of ADR
  – Belief about ADR outcome is probabilistic
  – ADR either plaintiff win or defendant win
  – ADR judgment known by both parties and equal to that would be awarded at trial
  – Outcome may alter the probabilistic beliefs about would occur in trial (conditional probability) => information provided by ADR
  • Three cases would be discussed
Three cases regarding information

• ADR perfectly predicts trial outcomes
  – The same Probabilistic beliefs about ADR and trial outcome

• ADR has no predictive value
  – ADR outcome is independent of trial outcome

• ADR has some predictive value
  – Change belief but not for sure
C-1. Perfect prediction

1. Immediate trial never occur, in favor of binding ADR for less cost and the same probability
2. Settle after nonbinding ADR
3. Binding = nonbinding

(1) x

(2) x

(3) Settle for 0 or judgment amount
C-1. Perfect prediction

• Reduced model is like standard model

• Thus, settle immediately if and only if the plaintiff’s expected judgment exceeds the defendant’s by less than the sum of ADR costs
C. 2. No predictive value

1. Never choose nonbinding ADR only costs
2. Binding ADR as a substitute for trial and belief divergence
3. Settlement would be preferred to others if condition holds
4. Compared with outcomes ADR not available, less trial and settlement because of presence of binding ADR

Figure 2
C. 3. ADR, an imperfect predictor

• If there’s nonbinding ADR, it may followed settlement or may not, depending on hoe beliefs affected by ADR outcome

• Four possible outcomes may occur
D. Model w/ nonbinding ADR required before trial

Suit brought if and only plaintiff’s expected gain from nonbinding ADR exceeds costs
D.1. Perfect prediction

- No constrain by requirement of nonbinding, since never go to trial immediately
- Thus, given suit has been brought, parties behave as there’s no requirement
- Settle immediately, if condition holds; or engage in ADR (indifferent)
- Suit will be more frequent than when ADR not required (cheap sub. but def. must submit)
D.2. No predictive value

- Use nonbinding ADR if the difference in their beliefs is large enough (Cost=ADR+trial)
- Less suit will be brought less than before
D. 3. ADR, an imperfect predictor

• Requirement may or may not affect outcome, depending on whether immediate trial would or would not have been chosen

• Tendency to bring suit depends how the ADR informative is
E. Comparison of Three Regimes

• Propensity to sue is the same in regimes w/o ADR and with voluntary ADR
• Propensity to sue depends on how informative the nonbinding ADR is
• ADR is a substitute for trial and settlement
  – information, cost of ADR and whether nonbinding is required before trial
F. Risk aversion

• If suit been brought, immediate settlement is more attractive. (reduce risk) trial and ADR involve risk
• If not settle immediately, binding ADR more attractive
• Variation of damage amount makes binding ADR attractive and more settlement after nonbinding ADR
• Less suit will be brought
G. Ex post ADR & social policy

• Don’t know that ADR made ex post advance parties’ welfare
  => cannot say ex post ADR should be enforced

• No clear argument for encouraging the use of nonbinding ADR before trial
  – Effect on behavior not known
  – Cost and tendency to bring suit could be disadvantageous
Conclusion

• Exchange of information during ADR
  – Neutral outsider
  – Know more about the case character that defeat client-lawyer agency problem

• Strong support for public encouragement of ADR
  – Cost lower than trial
    – Would be settled but go to ADR raise cost
    – Private parties can elect ADR for their own interest