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Preserving Value Through Mediation

Law360, New York (August 16, 2010) -- Too often, parties make decisions during settlement negotiations that end up costing them money. They may, for example, reject an offer, thinking they will receive or save more by proceeding with litigation. In many cases, however, their best option for preserving value would be to accept the resolution achieved through negotiation.

Linda R. Singer

There is empirical proof of this. In 2008, Randall Kiser of DecisionSet in Palo Alto, Calif., and Martin Asher and Blakely McShane of the Wharton School undertook a large-scale analysis of attorney-litigant decision-making.

In Let's Not Make a Deal: An Empirical Study of Decision Making in Unsuccessful Settlement Negotiations, the authors analyzed more than 2,000 California cases in which one party rejected the other's final demand or offer and proceeded to arbitration or trial. The study sought to determine whether the parties achieved results similar to or better than the settlement result they rejected.

Ignoring the time, costs and fees associated with trial, the authors compared the proposed settlement numbers with the eventual verdicts. They discovered that plaintiffs received an award equal to or less than the defendant's last settlement offer in 61.2 percent of the cases. In other words, in more than 60 percent of trials plaintiffs received less than what they could have received earlier by agreement, before adding fees and costs.

Defendants erred in fewer cases, paying more at trial than the plaintiff's last offer 24.3 percent of the time. But their mistakes were much larger. While the average verdict for plaintiffs was $43,100 less than the average offer, in almost a quarter of the cases, defendants paid an average of $1,140,000 more after trial than the settlement offer.

Kiser's results corroborate those of earlier, smaller studies by others. He validated them earlier this year by expanding his data from California to New York, with consistent results. Taken together, the results of all existing studies indicate that both the rate and size of valuation errors have increased in the past 40 years.

The primary causes of these costly errors are psychological, cognitive and organization biases that act as barriers to realistic thinking. While lawyers often speak of case valuations as if they were accountants — calculating back and

front pay or lost profits, compensatory and punitive damages — both advocates and the parties they represent fall prey to these barriers.

Some of these errors have their roots in emotion. A sense of anger and victimization for plaintiffs may expand, as time drags on, until it swamps the rest of a their identity and sense of self-worth. Defendants, too, often react emotionally to charges of illegal conduct, especially if the allegations involve discrimination or cheating out of legally earned pay. Decision-makers may feel the need to justify their initial decision and protect it from any questioning.

So-called "loss aversion" also comes into play, with both sides feeling they have invested too much in the dispute to relent and take a settlement. Although most of us recognize that rational decision-making should be forward-looking, it is difficult to avoid the losing gambler's error of throwing good money after bad.

There are cognitive barriers, too, that lead to poor decision-making. Parties may become anchored to a particular figure thrown out early on in a case by a lawyer, a client or even a spouse, and this will color impressions of a settlement offer. Overconfidence leads to an incorrect assessment of a situation, particularly with respect to a party's prospects at trial.

Parties may also engage in reactive devaluation and discount an offer from the other side, even if it is favorable, perhaps fearing they are missing a critical piece of information or that the offer is a Trojan horse, replete with hidden traps.

Finally, there are often organizational issues keeping parties from making correct decisions regarding settlement offers. A decision-maker, for example, is less likely to face internal criticism for declining a settlement offer and proceeding to trial than for taking the responsibility for settling, even if the consequence is a worse or more costly result.

There also may be concern about sending the wrong message to the organization about the correctness of the management decision that is being challenged. And, overwhelmingly, there is the belief that word of settlement will leak out, despite promises of confidentiality, and other copycat cases will come out of the woodwork.

Mediation: The Key to Overcoming Barriers

For all of the above reasons, parties involved in settlement negotiations may make costly errors, particularly with respect to decisions to reject an offer in favor of litigation. Yet, there is a tool designed for preventing these errors: mediation.

The purpose of mediation is to mitigate the panoply of barriers to realistic thinking. It can, for example, be used to remove emotion from the decision-making process. A good mediator will recognize emotional trigger points and act in advance to ensure that clients or their lawyers do not react defensively to what they may view on frontal attacks on their positions.

Mediators may be able to suggest creative solutions or frame potential options as opportunities rather than losses. By separating the parties and transmitting possible settlement offers, mediators can help to avoid reactive devaluation by floating ideas or even specific offers as hypothetical questions or possibilities, without identifying their source in the other room.

Mediators also balance overconfidence on either side, by providing a true valuation of parties' respective chances at trial. As an objective third party, a mediator may be the first person — perhaps the only person prior to a judge

and jury — in a position to introduce a dose of reality into the parties' respective overconfident predictions of their potential for improving their result if they decide not to settle.

Here, however, a mediator must tread a careful line. Premature or overly confrontational evaluations of parties' prospects may introduce their own barriers, and trigger a "fight or flight" reaction in counsel or clients that eliminates the chances for settlement.

Mediators who wish to avoid defensive reactions or shutting down on the part of both parties and their lawyers often bide their time and adopt indirect methods of valuation. They may show their skepticism by facial expressions or simply raising an eyebrow at optimistic predictions of liability or inflated damages.

When discussing alternatives to agreement, these mediators are more likely to ask questions than to state opinions. (For example, "How long do you expect that to take? And, if you win, do you expect them to appeal?" Or, "What do you see as the range of possible outcomes? How likely is each of them?")

Mediators also may use risk analysis or decision trees (a method with which business clients often are more familiar than their lawyers) to focus parties on the range of possible outcomes and the probability of success, adjusted for transaction costs and the time value of money (a minus for plaintiffs, a plus for defendants), as compared with the offers currently on the table.

When a plaintiff's lawyer projects an 80 percent chance of a liability finding, coupled with an 80 percent chance of being awarded damages in excess of the offer on the table, it may come as a surprise to the client to see that, even accepting those two predictions at face value, there is only a 64 percent chance of improving the offer after a full trial. (Of course, if the lawyer also projects an 80 percent chance of surviving summary judgment, the prediction of a better result drops to little better than flipping a coin.)

Another area in which mediators can play a key role is offering negotiation advice and helping to avoid self-defeating responses to inadequate proposals. Parties' reactions to overly inflated demands or inadequate offers can kill a potentially advantageous deal. Mediators often hear "That's an insulting offer!" or "That offer shows that they're not here in good faith!" Whether out of irritation or frustration, the response to such an offer is likely to be higher (or lower, depending on the party), because it is intended to send a message.

Predictably, the message is received with similar emotions. ("Go tell them to give us a realistic number!" or "We're not even going to dignify that number with a response!") and the parties descend into what mediator Anderson Little has called the "positional bargaining death spiral," where parties respond more and more negatively in reaction to their opponents' inadequate offers, leading to premature impasse.

Parties faced with what they perceive as offers that are wildly off the mark may not be in the frame of mind to consider logical case analysis. Nor can they be talked out of their negative reactions, which may well be justifiable. The question is how to expand the options for responding to inappropriate proposals in a manner designed to obtain enough information about what the other party would pay (or accept) in settlement, in order to permit a comparison with the likely range of settlement alternatives.

Counsel should be alert to their own reactions and to mediators' suggestions that they might try to form one or more offers that ignore their opponent's last move (or moves) and perhaps couples the offer with an explanation of a more appropriate bargaining range.

Alternatively, the mediator, who may have more information about the other side's settlement range than they are able to share, might suggest a range to both sides or ask them privately for the highest or lowest offers that would not receive such a negative reaction. Then the mediator might suggest a bargaining range.

Conclusion

Negotiation, especially mediator-assisted negotiation, is a mixed process, which seeks to overcome a variety of barriers to rational predictive decision-making. Much has been written about the ability of a skilled mediator to add value by focusing the parties on problem-solving and searches for win-win solutions.

Lawyers are only beginning to appreciate the range of psychological, cognitive, and organizational barriers to advantageous deal-making. By recognizing the results of the increased research into the effects of unsuccessful negotiations, advocates should be able to use third parties to overcome more of these barriers and obtain better results.

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