

# Econ INSIDE One

ECONOMIC THEORIES IN PRACTICE / JANUARY 2009

*By Martin Asher, Consultant to the firm, University of Pennsylvania, Wharton School*



## LET'S NOT MAKE A DEAL

This seems to be the mindset in many civil lawsuits. Of course, the decision is not that simple. In virtually every civil lawsuit, each party must decide whether to settle the case or go to trial, a decision that rests on each party's assessment of the likely trial outcome. That assessment involves an element of risk. We tested the accuracy of those assessments--i.e., did the parties accurately assess trial outcomes vs. settlement alternatives? Our study\* raises provocative questions as to why more cases do not settle once an offer is on the table.

We examined 2,054 California non-class action civil cases that were adjudicated and in which there was a settlement alternative for both plaintiff and defendant. Data consisted of all cases reported in Verdict Search California from 2002 to 2005 in which the parties' attorneys agreed on the amount of the pre-trial settlement offers and the final award, i.e., there was no dispute regarding the settlement alternatives and the ultimate outcome; approximately 20 percent of California litigation attorneys represented a party in the dataset cases. We compared parties' proposed settlement amounts with the final verdict and award to determine a) whether a party made a "decision error" in

deciding to go to trial/arbitration, and b) the magnitude of the financial gain or loss, in going to trial. Decision error occurred when a party rejected a settlement offer, went to trial, and the result was financially the same or worse than the (rejected) settlement offer. Decision error took three possible categorical values: plaintiff decision error, defendant decision error, and no decision error.

Among the 2,054 cases, the plaintiff made a decision error (i.e., received an award less than or equal to the last offer made by the defendant) in 61.2 percent of cases, and defendants made a decision error in 24.3 percent of cases. Significantly, while the defendant error rate is substantially lower, the average decision error cost was \$1.14 million, more than 26 times the average plaintiff error cost of approximately \$43,100.

Using stepwise multinomial logistic regression and bivariate analyses, we examined the relationship between decision error and a number of possible explanatory variables. It turned out that predictors describing the context of the case--case type (e.g., medical malpractice, personal injury, breach of contract, etc.), forum type (arbitration, jury trial, or

## LET'S NOT MAKE A DEAL - CONTINUED

bench trial), nature of damages (current, future, and punitive), and service of "Section 998 offers" by either party--were statistically significant and economically important. Interestingly, decision-making error was weakly associated with predictors describing each party (e.g., individual, corporation, etc.) attorney (e.g., years of experience, gender, size of law firm, etc.).

The nature of 998 offers and the fact that the presence of one or two 998 offers was an important factor in modeling both parties' decision error rates makes this variable worthy of discussion. In California civil suits, any party can issue a Section 998 offer to their adversary up to 10 days before trial begins. If the offer is accepted, the case settles at the offer's terms and conditions. If instead, the offer is rejected and the party receiving the offer does not receive a trial outcome better than the offer, then the party receiving the 998 offer is responsible for paying some of the offering party's costs and fees.

The presence of one or two 998 offers proved to be an important factor in modeling both parties' decision error rates. Although this cost-shifting proposal is designed to promote settlement, a 998 offer may inadvertently trigger a risk-seeking mentality in the party receiving the offer. Given the high frequency with which civil cases settle--and where 998 offers presumably served their intended purpose in successfully promoting compromises--here we may be observing that a 998 offer can have a polarizing effect on negotiations and ultimately raise error costs if the case does not settle. Serving a 998 offer reduced both the decision error and mean cost of error for the serving party but increased decision errors and expected error costs for the recipient party. Because a 998 offer reduces the serving party's

decision error but increases the recipient party's decision error, *ceteris paribus*, the presence of a 998 offer always reduced the probability of "no error." The bottom line: once the stakes have been raised via a 998 offer (particularly from the defendant), it is probably best to settle.

Though our study was not the first of its kind, estimates in terms of the frequency of each party's decision error were remarkably comparable to those reported by law professors Jeffrey Rachlinski and Samuel Gross & Kent Syverud. Despite the fact that each study's sample of cases was constructed using slightly different criteria, plaintiff decision error rates ranged from 56 to 65 percent, and defendant decision error rates ranged from 23 to 26 percent.

One key difference between our study and past research was the magnitude of the cost of a decision error, particularly for defendants. For example, using jury cases from 1981 to 1988, Rachlinski (1996) observed a mean cost of error of \$354,900, or 78 percent lower than the inflation-adjusted mean cost of error using our 2002 to 2005 data.

One may argue that perhaps our results are specific to the chosen time period. To place our results in a historical context, we also examined average demands, defendant offers and awards available in the Jury Verdicts Weekly in five-year increments from 1964 to 2004, for cases that met the same selection criteria as our 2002 to 2005 sample. It turns out that the prevalence of decision error increased somewhat over time. In 1964, plaintiff or defendant decision errors were made in 72.8 percent of cases; by 2004, at least one decision error was made in 86 percent of cases.

But the cost of decision errors increased substantially--a plaintiff decision error increased from approximately \$1,200 in 1964 to \$40,800 in 2004, and the cost of a defendant's error skyrocketed from approximately \$5,900 to \$649,100. In other words,

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error rates have increased moderately with time, but the cost of such an error has increased substantially, particularly for defendants.

Combining the historical results with the analyses from our study and studies like ours, several alarming observations can be made. In our dataset of relatively recent cases, more than half of plaintiffs and roughly one-quarter of defendants would have been financially better off not going to trial. In many industries (such as engineering, consulting and

medicine) being incorrect even 10 percent of the time is unacceptable, let alone 25 or 50 percent. Although there is evidence that the cost of a plaintiff decision has remained fairly constant over time since the 1980s after adjusting for inflation, the odds are clearly not in their favor once proceeding to trial. Conversely, while decision errors are less frequent on the part of defendants, the average cost of an error has increased substantially with time. Given the rate and cost of such errors, counsel might be well advised consider the settlement alternative more carefully.

\*The study was prepared by Randall Kiser, Martin Asher and Blakeley McShane and published in *Journal of Empirical Legal Studies*, Volume 5, Issue 3, 551-591, September 2008. Co-author Dr. Martin Asher is a special consultant to Econ One.

<sup>1</sup>Adjudicated cases are those where the dispute was decided by a judge, jury or arbitrator.

<sup>2</sup>The objective was to construct a database of relatively homogeneous cases. To that end, we excluded cases that were decided on procedural or technical grounds prior to adjudication based on merits (e.g., summary judgment, mistrial, etc.). Also, we removed class actions because of the unique dynamics of attorney/client relationships. If either side consisted of multiple parties, and the parties' settlement positions were not sufficiently allocated, these too were eliminated. Finally, we excluded cases in which there were typographical discrepancies on the face of the report.

<sup>3</sup>Under section 998(c), if a defendant's offer is rejected and the plaintiff does not obtain a more favorable judgment, the plaintiff is not entitled to recover court costs and must pay the offering defendant's costs from the time of the offer. Under section 998(d), if a plaintiff's offer is rejected and the defendant fails to obtain a more favorable judgment, then the court may award a "reasonable sum" to account for plaintiff's incurred expenses for expert witnesses. Also, Civil Code Section 3291 provides pre-judgment 10 percent interest on plaintiff's judgment beginning on the date of the plaintiff's initial 998 offer that is less than the trial judgment.

<sup>4</sup>Rachlinski, Jeffrey. Gains, Losses and the Psychology of Litigation. 70 S. Cal Rev. 113 (1996); Samuel Gross & Kent Syverud. Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial. 90 Michigan L. Rev. 319 (1991); Gross & Syverud (1996), *supra*.

By Martin Asher, Consultant to the firm, University of Pennsylvania, Wharton School,  
See *Journal of Empirical Legal Studies*, Volume 5, Issue 3, 551-591, September 2008 for the complete article.

By Phil Johnson, Economist, Econ One, Sacramento, CA

**ECONOMIST, PHIL JOHNSON HELPS WIN PRO BONO CASE FOR FOSTER FAMILIES SERVICES, ET AL.**

Econ One's Phil Johnson served as an economic expert for the plaintiffs in a recent case--California State Foster Parent Association, et al. v. John A. Wagner, Director of the California Department of Social Services, et al. The plaintiffs were a group of foster families who claimed that the State of California had failed to meet federal obligations to increase foster family home (FFH) reimbursements in line with increases in the cost of caring for a child. At issue was the net budget effect of an increase in reimbursement rates. The plaintiffs claimed that, were the State to increase its reimbursements and meet its obligations, much (or even all) of the State's incremental costs would be offset by the return of children to FFHs from



more expensive placements, such as group homes. Dr. Phil Johnson was retained to evaluate the effect on foster care costs if the State were to increase its reimbursements. In his expert report, Dr. Johnson demonstrated that the plaintiffs' claim was correct. His analysis quantified the cost savings that would arise from an increase in the number of lower cost FFH placements and the associated decrease in the number of placements in settings that provide more expensive, unneeded services. Dr. Johnson's findings were reflected in the judge's opinion, in which summary judgment was granted to the plaintiffs.

**"Problem Solver - Head."**

[OK, so we secretly liked our nickname in school.]



### *Carlos Armando Amado v. Microsoft Corp.*

This ongoing case involves post-trial litigation of a patent suit that Amado won against Microsoft. The patent at issue relates to the integration by Microsoft of spreadsheet and database functionality in its Office line of products. A jury found Microsoft liable for patent infringement and awarded damages. The trial judge also awarded Amado a permanent injunction against Microsoft continuing to infringe the patents but he stayed that injunction pending Microsoft's appeal. Following resolution of the appeal, the trial judge awarded damages for the period of the injunction based on the jury's award in the trial. This damage award was appealed by Microsoft. The Court of Appeals then ruled that the trial judge must consider damages for the period of the injunction based on the economic circumstances that were faced by the parties following trial, including bargaining positions that reflect the finding of liability and the difficulty of the Defendant to "immediately comply" with the injunction. Econ One was retained by Amado's counsel to analyze the economic circumstances and bargaining situation that would have been faced by the two parties, given the outcome of the trial and had the trial judge not stayed the injunction. Jeff Leitzinger filed a declaration that concluded that, given the circumstances, Microsoft would have been willing to pay a license fee of at least \$200 million rather than face the severe disruptions to its business that would have been caused by halting the licensing of much of its Office sales.

### *In re K-Dur Antitrust Litigation*

The plaintiffs in this case are a class of direct purchasers of the brand name prescription drug K-Dur 20. The plaintiffs allege that the defendants (generic manufacturers of K-Dur 20) violated the antitrust laws by entering into agreements with each other whereby payments were made to delay the market entry of certain generic versions of K-Dur 20. The plaintiffs claim that they paid artificially higher prices as a result of these alleged anti-competitive agreements. Econ One was retained by the plaintiffs' counsel to opine regarding class



certification issues, liability issues, and the calculation of damages. Jeff Leitzinger has submitted three expert reports and provided deposition testimony relating to class certification issues. Those issues included the likely impact of a delay in generic competition on the plaintiff class, the availability of economic methodologies and evidence--common to all class members--that would demonstrate impact in the form of overcharges, and whether overcharge damages could be calculated on a class-wide, aggregate basis using reliable methodologies. The class was certified earlier this year. Dr. Leitzinger also has submitted an expert report and a rebuttal report addressing monopoly power, relevant market, and aggregate overcharge damages.

### *American Express Travel Related Services Company, Inc. v. Visa U.S.A., Inc., et al.*

In *United States v. Visa U.S.A., et al.*, the Court found that Visa and MasterCard, together with their member banks, implemented and enforced illegal exclusionary agreements that required any U.S. bank that issued Visa or MasterCard general use credit cards to refuse to issue American Express (Amex) or Discover credit cards. Subsequently, Amex brought a civil action against Visa, MasterCard, and their member banks to recover damages arising from that anticompetitive conduct. Econ One was retained by counsel representing Amex to determine the amount of profit that Amex lost as a result of the defendants' conduct, as well as the continuing losses suffered by Amex as a result of the effects of that ongoing conduct. With the help of a team of over 20 Econ One staff members, Jeff Leitzinger submitted an expert report in July 2007, a rebuttal expert report in December 2007, and a declaration in March 2008. Dr. Leitzinger also provided two days of deposition testimony in January 2008. All

## *Econ One in Brief -Continued*

defendants ultimately settled prior to trial, with Amex receiving over \$4 billion--the largest damages recovery ever obtained in an antitrust case.

### *Gas sales agreements proposed by Enstar Natural Gas Company with ConocoPhillips and Marathon Oil*

In this proceeding before the Regulatory Commission of Alaska, Enstar Natural Gas Company, a gas distribution company, proposed two new supply agreements that would set its prices for gas supply in Cook Inlet based on levels in the Lower 48 states. Econ One was retained by Chugach Electric Association, an intervenor in the proceeding, to review and comment on Enstar's economic justifications regarding the reasonableness of its pricing provisions. Jeff Leitzinger offered both prepared and direct testimony before the Commission stating that the pricing provisions in the two agreements (1) would reverse the long-standing price advantage enjoyed by Cook Inlet gas users relative to gas consumers in the Lower 48 states and (2) were not supported with any reasonable economic justifications for doing so.

### *DealerTrack, Inc. v. RouteOne, LLC; David L. Huber, and Finance Express, LLC*

The parties in this ongoing case are providers of automated automobile loan application systems that allow auto dealers to send consumer loan applications to multiple lenders simultaneously. Before the development of these automated systems, auto dealers had to manually fill out and send separate loan applications (predominantly via facsimile) sequentially to lenders. DealerTrack has sued for patent infringement, alleging that both defendants have utilized its patented technology for sending multi-lender loan applications. Econ One was retained by the plaintiff's counsel to analyze possible damages. Charles Mahla estimated DealerTrack's damages as comprising both lost profits and lost royalties. Dr. Mahla's analysis focused on the fact that it was likely that, but for RouteOne's infringement, DealerTrack would have contracted with the four largest captive lenders, including GMAC and Toyota Motor Credit Corp. Dr.

Mahla has submitted an expert report and also provided deposition testimony.

### *Gonzalez, et al., v. State of Arizona, et al.*

Proposition 200, an Arizona state initiative passed in November 2004 as a way to prevent non-citizens from voting, requires (1) individuals to produce proof of citizenship before they may register to vote and (2) that all voters must show identification before they are allowed to vote at the polls. The Mexican American Legal Defense and Educational Fund filed a lawsuit on behalf of numerous individuals and organizations alleging that this proposition contains restrictions that impede U.S. citizens seeking to vote.

Econ One was retained by the plaintiffs' counsel to provide statistical analyses of the Arizona voter polls, rejected voter registration applications, and uncounted ballots. Based on the analyses he conducted, Louis Lanier testified at trial that Proposition 200 has resulted in the rejection of over 38,000 voter registration forms and thousands of ballots since its implementation in early 2005. Dr. Lanier also opined that the law has disproportionately affected the population of naturalized Hispanic citizens who are of voting age in Arizona. Sharon Fried, et al. v. ADT Security Services, Inc.

In this ongoing class action case, the plaintiffs (purchasers of home security systems) allege that the defendant fraudulently concealed its knowledge that its home security systems would fail to work after February 2008 due to the change from analog to digital technology. Econ One was retained by the plaintiffs' counsel to determine whether there was class-wide impact as a result of this alleged misconduct and also to measure damages arising from that misconduct. Dr. Russell Lamb has submitted an expert report and provided deposition testimony on both class certification issues and damages. *In re International Air Transportation Surcharge Antitrust Litigation*

The plaintiffs (a class of international air passengers) filed suit against four airlines (American, United, Virgin Atlantic, and British Airways) alleging that the airlines conspired to set the level of fuel surcharges

## *Econ One in Brief -Continued*

*on routes between the U.S. and the UK. Econ One was retained to measure damages owed to class members for use in settlement discussions. Russell Lamb, along with his staff in the Washington, DC office, analyzed 20 gigabytes of electronic data that contained records on more than 17 million coupons for Virgin Atlantic flights and more than 70 million coupons for British Airways flights. Dr. Lamb developed a regression model to measure the damages owed to class members that relied on ticket-level data controlling for advance purchases, Saturday night stays, and other factors affecting airline fares. This analysis, which Dr. Lamb testified about at a mediation hearing, contributed to a settlement result for class members of more than \$200 million.*

### *Special session of Alaska State Legislature on natural gas issues*

*This past summer, the Alaska State Legislature approved a license to TransCanada for the construction of a natural gas pipeline running from the North Slope in*

*Alaska to the Canadian province of Alberta. This license gives TransCanada access to \$500 million in Alaska state funds for engineering and pre-construction work. Once completed, the pipeline would be capable of delivering more than 4 billion cubic feet of gas per day to U.S. markets—approximately 6 percent of total U.S. consumption. Econ One was retained several years ago by the Alaska State Legislature to serve as its economic advisor on issues relating to the State’s attempts to commercialize North Slope gas resources. Barry Pulliam testified on two separate occasions this summer relating to the legislature’s consideration of the TransCanada proposal and license. On the first occasion, Mr. Pulliam, who was the first witness to testify, outlined the TransCanada proposal, discussed the economics of the tariff structures proposed by TransCanada, and highlighted issues for consideration by the legislature. On the second occasion, Mr. Pulliam testified regarding the viability of alternative projects designed to export Alaska gas via LNG to Asian markets.*

By Jane Kidd, Economist, Econ One, Houston, TX

**ECON ONE FINDS ALASKA CRUDE OIL PLAYED LITTLE ROLE IN THE WEST COAST'S INCREASE AT THE PUMP**

Senior Economist Jane Kidd has years of experience in issues related to the valuation of crude oil, natural gas, and petroleum products. She recently submitted a response to the FTC's request for public comment concerning the effects of the ban on the export of Alaska North Slope (ANS) crude oil and its repeal. Her report was presented as a case study in connection with the Commission's Petroleum Market Manipulation Rulemaking.

Contrary to the conclusions drawn by earlier studies, Ms. Kidd found that the repeal of the ban on ANS exports played little, if any, role in the increase in the price of ANS crude oil relative to world price levels during the 1990s. Rather, the increase in crude oil prices seen on the West Coast was due to a shift from

surplus to deficit indigenous crude oil production.

This shift, and the resulting increase in the relative West Coast prices, occurred well before the ANS export ban was repealed in mid-1996.

Exports of ANS crude effectively have ceased since the ban was repealed as a result of the West Coast's increasing reliance on imported foreign crude. Therefore, a re-imposition by the President of the ANS crude oil export ban alone likely would have no effect on West Coast supply fundamentals or crude oil prices.

See full article at [www.ftc.gov/os/comments/marketmanipulation/index.shtm](http://www.ftc.gov/os/comments/marketmanipulation/index.shtm)



**Some economists live in the books.  
We think the real world has a better view.**

By Martin Asher, Consultant to the firm, University of Pennsylvania, Wharton School

WHARTON PROFESSOR, ACCOMPLISHED  
ECONOMIST AND EXPERIENCED EXPERT,  
MARTIN ASHER JOINS ECON ONE.



Yes, the Ivy League has come to Econ One. Martin Asher, PhD, is not only an esteemed professor at the country's top business school, he has been consulting as an economic expert in antitrust for more than 20 years. Dr. Asher has provided expert economic testimony regarding allegations of price fixing and market allocation. His work includes analysis of class certification issues and construction of damages models. Dr. Asher was the court-appointed expert in the largest U.S. gender discrimination damages case. He also has conducted contract research and evaluation for the Commonwealth of Pennsylvania, Department of Public Welfare.

Dr. Asher has published numerous articles, including his most recent, an empirical analysis of

decision making  
in settlement  
negotiations,

which was featured in the New York Times. He has been Director of Research and Scholars Programs at the University of Pennsylvania's Wharton School since 2004 and Director of the Joseph Wharton Scholars Program since 2000.

As a consultant to the firm, Dr. Asher's experience and knowledge will provide the perfect complement to Econ One's existing research and consulting practice. We see it as smart business 101.

*Economic Theories in Practice*  
is written and published quarterly  
by Econ One Research Inc.  
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Los Angeles  
213.624-9600

Sacramento  
916.449-2860

Houston  
713.228-2700

Washington  
202.756-4958

