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The Verdict Valuation Paradox: Implications for Mass Torts



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Litigators routinely value individual cases in settlement negotiations based on the probability of succeeding at trial, the likely size of a verdict and the amount of avoided legal costs. Paradoxically, using past verdicts to value populations of mass tort claims can lead to erroneous valuations. Naively using verdicts in prior cases as benchmarks in mass tort cases fails to account for selection bias, which can grossly distort claim values. Research in law and economics into the selection of cases for trial provides a framework for understanding how choices that litigants make to settle or litigate affect observed verdict outcomes. This article identifies some important implications for the estimation of aggregate claim liabilities in mass tort cases.

Selection Effects in Tort Claims Valuation

The discounted-cash-flow valuation method can be used to value tort claims. The relevant cash flows result from expected future verdict awards or, alternatively, from settlements negotiated before a verdict is rendered, accounting for any costs incurred to litigate the claims. Economically rational plaintiffs will only accept settlement offers that exceed the expected value of a litigated outcome (discounted to account for expected timing and risk), less any costs to prosecute the case. Similarly, defendants will only accept settlements that are less than their expected value of a verdict, plus any associated defense costs. When these thresholds overlap, the parties may be able to negotiate a settlement within the overlapping range of values that are agreeable to both plaintiffs and defendants. By this logic, settlement values are a function of the risk-adjusted, discounted present value of awards expected through litigation. This explains why verdict val-

ues tend to be larger than settlements for similar cases. Relative to settlement, litigating to a verdict is risky, includes the possibility of no award and delays any recovery.

The problem with using observed verdicts as benchmarks for tort claim values is that they are not expected values and might not be representative. Expected verdict values must be adjusted for the likelihood of prevailing through trial, but even adjusted verdict values might not be representative because they are not observed for all claimants — only for those that choose not to settle.

The higher typical value of verdicts over settlements leads some to falsely believe that these different levels of compensation derive from weaker and stronger claims, respectively. This belief is unfounded. Whereas settlements provide a measure of expected values, verdict awards do not measure the compensation that claimants can expect in the tort system. Expected verdict values are a fraction of average realized verdict awards because they reflect the probability of prevailing through trial.

Economic analyses of decisions to settle reveal that claims that are actually litigated to verdict are not representative of all claims. Contrary to the naive view, they are not higher on average because they are necessarily the strongest, most highly valued claims. The claims that are litigated and result in verdicts are those in which the parties cannot agree on the strength of the claims in terms of the likelihood of prevailing and the expected amount of potential award. As litigation progresses, the parties learn more about the strength of the claims, increasing the likelihood of settlement, through which they may resolve uncertainty and avoid litigation costs. Research in law and economics into litigation outcomes predicts that plaintiffs' likelihood of winning a verdict at trial will trend 50/50, although only a smaller percentage of all

cases reach trial at all.¹ Empirical evidence generally bears out this prediction.²

This theory helps explain litigation outcomes and has profound implications for the valuation of filed claims. First, observed-verdict values in similar cases must be adjusted for the likelihood of reaching trial and prevailing. Second, such expected verdict amounts might not be presumed to be representative benchmarks for valuation for all claims. The choices that parties make to settle rather than to litigate results in a selection effect that could make verdicts unrepresentative benchmarks.

Careful analysis of claims history can reveal other potentially important selection effects in addition to those associated with past settlement decisions. For example, claims that are filed and litigated but have yet to reach trial (*i.e.*, pending cases) may differ from cases that choose settlement, and from cases litigated to verdict. In mass tort cases in particular, the expectation that claims will be resolved in a global settlement or in a bankruptcy changes the incentives to file, as well as the commercial incentives for attorneys to recruit claims. As a consequence, claims filed in anticipation of mass resolution outside of the tort system may differ materially from claims that were filed and resolved previously. Each of these selection effects have potentially important implications for claims valuation in mass torts.

Empirical Support for Selection Effects in Litigation

In their seminal 1984 article, George Priest and Benjamin Klein showed that the small number of cases that reach verdict are neither random nor representative, but rather are a selected sample of all disputes.³ They showed that this source of selection bias lies in the pre-trial negotiations between plaintiffs and defendants.⁴ Under rational expectations, setting aside the peculiarities of mass torts, the parties will agree on a settlement unless the difference between their estimated probability of prevailing at trial or expected verdict amount is sufficiently large, and the avoided litigation costs are sufficiently small.⁵ For example, if parties have a large disagreement about the probable outcome of a trial, the case is more likely to be litigated.

Conversely, disputes where the parties' disagreement about the outcome is small — whether in favor of the plaintiff or defendant — are more likely to settle in order to avoid litigation costs.⁶ This selection effect is exacerbated by the high cost of litigation. Rational actors will only litigate cases to verdict if the expected verdict award, less the associated litigation costs, is sufficiently higher than any settlement, which weeds out the lowest-value cases. The economics are reinforced by plaintiff attorneys who act as gatekeepers and

help decide the cases that go to trial. Because plaintiff attorneys are paid on a contingency-fee basis (a percentage of the settlement or verdict amounts), attorneys will only try cases with potential awards that exceed their litigation costs.⁷ Similarly, defendants may settle weaker cases for nuisance values to avoid litigation costs.

Therefore, litigated disputes will not constitute a random sampling of the underlying population of claims, but will skew toward those where there is a larger disagreement over the merit of the claims⁸ and those that have larger potential awards relative to litigation costs.⁹ Because of these sources of selection bias, it is difficult to infer claim values based on verdicts alone.¹⁰

Empirical research provides evidence of the presence of selection bias in verdicts. For example, using data on plaintiff verdicts in contested civil actions litigated to trial between 1959-79 in the Chicago metropolitan area, Priest and Klein showed that the trial outcomes are suggestive of selectivity; Priest provides similar evidence in successive studies.¹¹ Subsequent research provides support for the selection hypothesis more generally. For example, Peter Siegelman and John J. Donohue III documented in 1995 that plaintiff win rates in employment-discrimination disputes vary with the business cycle and are lower in recessions, when parties with weaker cases would be more likely to sue.¹² In 1995, Joel Waldfogel used a natural experiment provided by a random assignment of cases to judges to compare trial probabilities and plaintiff win rates across judges, and found evidence supporting selection bias.¹³ In 1998, he provided evidence that the relationship between tried cases and win rates generated by the litigation process is consistent with Priest's and Klein's 1984 theoretical framework, and is not consistent with that of alternative models of litigation.¹⁴

From the time of its original publication until the present day, Priest's and Klein's theory about the selection of cases for litigation remains an important benchmark for both theoretical and applied work in law and economics. The key implication that litigated cases differ systematically from settled cases has proved enduring and withstood the scrutiny of empirical tests. Priest's and Klein's piece from nearly four decades ago "has proven to be one of the most influential articles in legal scholarship" and one of the most influential law articles of all time.¹⁵

7 Henry S. Farber & Michelle J. White, "Medical Malpractice: An Empirical Examination of the Litigation Process," 22 *RAND J. of Econ.* 2 (1991).

8 Priest & Klein, *supra* n.3.

9 Wittman, *supra* n.1, pp. 313-52; Donald Wittman, "Is the Selection of Cases for Trial Biased?," *J. of Legal Studies* (1985), 14(1), pp. 185-214.

10 Joel Waldfogel, "The Selection Hypothesis and the Relationship Between Trial and Plaintiff Victory," *J. of Political Econ.* (1995), 103(2), pp. 229-60.

11 George L. Priest, "Reexamining the Selection Hypothesis: Learning from Wittman's Mistakes," *J. of Legal Studies* (1985), 14(1), pp. 215-243; George L. Priest, "Measuring Legal Change," *J. of Law, Econ. & Org.* (1987), 3(2), pp. 193-225.

12 Peter Siegelman & John J. Donohue III, "The Selection of Employment Discrimination Disputes for Litigation: Using Business Cycle Effects to Rest the Priest-Klein Hypothesis," *J. of Legal Studies* (1995), 24(2), pp. 427-62.

13 Waldfogel, *supra* n.10, pp. 229-60.

14 Joel Waldfogel, "Reconciling Asymmetric Information and Divergent Expectations Theories of Litigation," *J. of Law and Econ.* (1998), 41(2), pp. 451-76.

15 Daniel Klerman, "The Selection of 13th-Century Disputes for Litigation," *J. of Empirical Legal Studies* (2012), 9(2), pp. 320-46. Fred R. Shapiro ranks Priest and Klein the 99th of all law articles (see "The Most-Cited Law Review Articles Revisited," 71 *Chi-Kent L. Rev.* 751, 771 (1996)). Similarly, James E. Krier and Stewart J. Schwab rank Priest and Klein the 81st of all law articles (see "The Cathedral at Twenty-Five: Citations and Impressions," 106 *Yale L. J.* 2121, 2145 (1997)). William M. Landes and Richard A. Posner rank Priest and Klein the 28th of all articles in "predicted 'lifetime' citations" (see "Heavily Cited Articles in Law," 71 *Chi-Kent L. Rev.* 825, 838 (1996)).

1 From 1990-2014, the percentage of cases reaching trial in U.S. district courts ranged between 1.1 and 4.3 percent. Donald Wittman, "Dispute Resolution, Bargaining, and the Selection of Cases for Trial: A Study of the Generation of Biased and Unbiased Data," *J. of Legal Studies* (1988), 17(2), pp. 313-52.

2 George Priest & Benjamin Klein, "The Selection of Disputes for Litigation," *J. of Legal Studies* (1984), 13(1), pp. 1-55.

3 Priest & Klein, pp. 1-55. J.P. Gould, "The Economics of Legal Conflicts," *J. of Legal Studies* (1973), 2(2), pp. 279-300. Robert D. Cooter & Daniel L. Rubinfeld, "Economic Analysis of Legal Disputes and Their Resolution," *J. of Econ. Literature* (1989), 27(3), pp. 1067-97.

4 Priest & Klein, *supra* n.3, pp. 1-55.

5 Specifically, larger than the difference between litigation and settlement costs, scaled by the size of the expected judgment should a plaintiff verdict be rendered. Priest & Klein, *supra* n.3, p. 13.

6 As a corollary of this result, if the vast majority of litigated disputes are close cases, the probability of a plaintiff victory at trial will approach 50 percent. Priest & Klein, *supra* n.3.

Implications for Mass Torts

The presence of selection bias in verdicts has direct implications for the way that parties estimate the value of claims in mass tort bankruptcies. In this setting, it is often necessary to estimate the value of all pending and future claims for the purposes of confirming a bankruptcy plan or reaching a global resolution. The question of which resolutions to use as benchmarks to value claims in a mass tort case can be a contentious issue for the parties' experts.

In cases without an established settlement history, some experts may look to verdicts to establish the value of claims. In these cases, it is essential to adjust average verdicts for the probability of prevailing at trial. It is also important to consider the inherent selection bias in verdicts. Even an unbiased procedure to estimate average verdict values cannot be presumed to be representative of the claims population as a whole. If verdict outcomes are affected by selection bias, a reliable estimate of expected verdict values will also be biased.

There are also issues that arise in mass torts that can lead to additional modes of selection bias. For example, mass tort plaintiffs' attorneys have an incentive to focus early litigation efforts on cases with the highest expected damages. As a result, initial trial outcomes might not provide a reliable guide to estimate the value of the population of outstanding claims. Conversely, defendants may seek to settle weak claims at nuisance values to avoid litigation costs and set a low benchmark for anticipated future settlements. Similar competing problems of bias can arise through the selection of bellwether cases. In considering initial trial outcomes as benchmarks, it is important to consider these selection effects and ensure that the historically resolved claims are similar in severity and strength to the claims in the population being valued.

Another important source of selection bias in mass tort bankruptcies is the difference in the cost of litigating claims in the tort system as opposed to a bankruptcy proceeding. As previously discussed, plaintiffs will only bring cases in the tort system if the expected recovery is sufficiently higher than the cost of litigation. However, the cost of litigating an individual claim in the tort system can be very different from the cost of litigating that claim in a bankruptcy proceeding, which can result in claims being filed in a bankruptcy that would not be economically viable in the tort system.

For example, in the *Boy Scouts of America* bankruptcy, there were 2,000 sexual abuse cases filed in the tort system, but once a bankruptcy proceeding was established, more than 80,000 claims had been filed. In these cases, there is strong reason to suspect that the claims filed prior to the bankruptcy may materially differ from the bankruptcy claims. Historical claim resolutions would then provide an unreliable basis for estimating the value of the full population of claims.

Conclusion

Mass tort cases are ones in which claims valuation is commonly needed, and where experts may look to historical resolutions as a benchmark for claim values. Unfortunately, historically resolved claims, and verdicts

in particular, might not be representative of the universe of pending and future mass tort claims. Careful claims analysis is needed to ensure that appropriate benchmarks are chosen, and that verdict values are properly adjusted to avoid mis-valuing claims. **abi**

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