Bargaining with the judge: exploding terms in pre-trial settlements

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Introduction and motivation. Can litigants commit the judge to accept their settlement terms? More specifically, should judges agree to accept an undesirable term that is a prerequisite to the entire settlement? On its face, the answer is a sounding "no." Indeed, in class actions, where the parties' incentives are to inflate the plaintiff's fees (at the expense of the class's), the parties cannot bind the judge to their desired fees as a prerequisite to the entire settlement (Federal Rule of Civil Procedure, Rule 23(e)(2)(C)(iii); Israeli Class Actions Act, s. 18(g)(ii)). Put differently, under the current law, the judge can approve the settlement but has discretion to lower the fees. Likewise, parties to a criminal case cannot condition the settlement in a certain sentence.

But a deeper look reveals that reality is more nuanced. In the class action context, for instance, the parties cannot condition the settlement on the desired fee, but they can recommend the desired fee, and do so in actuality. Moreover, courts – which are interested in avoiding trials – seem to pay attention to these "recommendations." On the normative level, given the institutional interest in settlements, one wonders why shouldn't the parties reach a settlement that includes an "exploding" term, that is, condition the settlement on the judicial acceptance of one, pivotal term. Presumably, by accepting that pivotal term, the judge increases the odds of a settlement (and saves her own effort). Indeed, this simple question cuts across legal contexts. In class action settlements, parties can "recommend" the desired fee, but not condition the settlement thereon. The same holds for guilty pleas in the criminal context. In other settings, parties agree to settle – but condition that settlement on a waiver of filing fees. Parties who seek confidentiality can condition their settlement on sealing their agreement. We can also think of parties to arbitration who agree to settle – conditional on the arbitrator's willingness to lower her salary. And so on. To the best of our knowledge, these practical implications notwithstanding, there is no previous discussion of this question in the literature.

Intuition. We approach this question from a game-theoretical perspective. For simplicity, suppose that parties to arbitration agree to settle only conditional on a 10% discount of the arbitrator's fees. Moreover, they declare that, without the discount they cannot settle go to trial. Suppose also that the value of a settlement for the arbitrator's (time, effort, etc.) is greater than that one-tenth of her salary. Also, these parameters are common knowledge. What should the arbitrator do? Her short-term interest is accepting the settlement. But if she always agrees to lower her salary, she invites mimicking by parties that would have settled in any case, i.e., for whom the discount is not pivotal. Suppose that the arbitrator in our example lacks knowledge regarding the real settlement position of the parties, that is, whether they will settle regardless of the discount or not. Intuitively, the arbitrator should randomize between accepting and rejecting such that mimicking settling parties – who would have settled regardless of the 10% discount – are indifferent.

Model and preliminary results. We assume a standard, two-type screening asymmetric information model, where the defendant has private information regarding her expected damages. A proportion α of the population of defendants are strong (low-damages) and a proportion $1-\alpha$ are weak defendants (high-damages). The plaintiff makes a single take-it-or-leave-it offer, which, if

rejected, leads to a trial in which the plaintiff (defendant) incurs legal expenses C_P (C_D). We add to this standard model a second stage in which, if the parties have reached a settlement, they can join forces and propose a single offer to the judge to accept that settlement conditional on a benefit *B* from the judge. We assume that at that stage all relevant parameters are known (including the costs for the judge from going to trial), except that the judge does not know the precise proportion of strong defendants α.

We study three legal regimes. (A). The baseline regime: The parties cannot condition the settlement on an exploding term. This is, on its face, the current legal regime, at least on the books. (B). Discretionary approval: The parties can use such exploding terms, and the judge can accept these terms or not. In the latter case, the parties can settle again, without the exploding term. The foregoing regime seems to be common in practice, e.g., in the context of class actions. (C). Discretionary approval with mandatory trials: The parties can propose an exploding offer and the judge can either: accept that offer; decline (such that the parties can re-settle without the exploding term); or, decline and prevent the parties from re-settling, such that the parties are bound to go to trial.

Our analysis shows that the benefit *B* indeed induces settlement. Hence, in a first-best state the judge will provide that benefit *B* only to parties who would not have settled without it. In the foregoing two-type model, beyond a certain proportion of strong defendants in the population, $\alpha \geq \bar{a}$, all cases settle. Below it, $\alpha < \bar{a}$, all strong defendants go to trial (and only weak defendants settle). The benefit *B* reduces the cutoff $\bar{a}$ and allows more settlements. Where the judge is uninformed regarding α, the discretionary regime, which allows the judge to accept the exploding term in probability *p* and reject it with probability *1-p*, cannot, for most parameter values, improve upon the baseline regime. Indeed, as *p* becomes larger, more cases that would have gone to trial can now settle. However, nothing in this regime prevents mimicking, and the judge is forced to pay *B* to all those who would have settled in any case. However, in the third regime, where the judge can force a mandatory trial, we can find a socially efficient equilibrium. Those who genuinely would have gone to trial but the benefit *B* are not deterred from presenting an exploding offer to the judge. But the mimicking parties are – as in that case with a probability *1-p* they are now forced to go to trial.

We conclude, then, that the law can gain by allowing parties to negotiate exploding terms with the judge – but only where the judge can sanction mimicking by randomizing and forcing some cases to go to trial. On the other hand, the current practice, in which parties can "recommend" such terms and the judge has discretion whether to accept them or not, seems to be the worst. Finally, we briefly discuss the capacity of the judge to force trials and prevent renegotiation in concrete legal settings.

[This is a work-in-progress, and in this abstract we present our preliminary results. We will provide a full analysis by the time of the presentation]