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NO FREE LUNCH: HOW SETTLEMENT CAN REDUCE THE LEGAL SYSTEM'S ABILITY TO INDUCE EFFICIENT BEHAVIOR

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ABSTRACT

The belief that it is better for cases to settle than go to trial is widespread, but the arguments in favor of settlement typically overlook how settlement affects one of the most important functions of the legal system: deterring undesirable behavior that gives rise to lawsuits. This Essay argues that settlement can impair the ability of the legal system to deter harmful behavior without chilling desirable behavior. This effect is a fundamental property of settlement in that there is no way to change other legal rules to eliminate it. Because settlement also has important benefits such as the reducing legal costs and reducing uncertainty, this Essay does not argue for any across the board prohibition of settlement. Rather, it suggests that judges should be more circumspect about encouraging settlements and that there may be situations where some restrictions on settlement are warranted.

I. INTRODUCTION

There is widespread support for the idea that it is better for cases to settle than to go to trial.

Most lawyers, judges, and law professors think it is good that so few cases are tried. . . . The reasons most commonly given for discouraging trials are that settlements conserve resources and enable parties to resolve their differences amicably. Settlements are said to reduce attorneys' fees and court costs, free space on crowded dockets, speed relief to injured plaintiffs, and avoid the need for judges to decide difficult legal questions.¹
While these benefits of settlement are undoubtedly valid, these state-
ments look only at one side of the cost-benefit equation. After all, we
could reduce attorneys' fees and court costs and limit court dockets even
more effectively by simply prohibiting suit. We could get relief to injured
plaintiffs even faster by simply relying on first party insurance.\(^2\) Doing
so, however, would eliminate the unique benefit of the legal system: its
ability to influence the behavior that gives rise to lawsuits. Thus, to make
an appropriate judgment as to the wisdom of promoting settlement, one
must not simply look at how settlement reduces legal costs and delay, but
also examine how it affects the legal system's ability to regulate behavior.
This Essay does precisely that. In so doing, it demonstrates that in many,
though certainly not all situations, settlement can undermine the legal
system's effectiveness in inducing people and firms to behave in a way
that takes into account the effect of their actions on other people. That
is, settlement is not a “free lunch” but potentially comes at the significant
cost of undermining the incentives that we rely on the legal system to
create.

Ideally, the legal system will discourage actions that cause more harm
to others than the benefit they provide, yet encourage, or at least not
discourage, those activities whose benefits are greater than their harms.
To accomplish this task, the legal system attempts to ensure that parties
whose actions cause more harm than benefit will have to fully compen-
sate the harmed parties.\(^3\) Knowing that he or she will have to compen-
sate all others for any aggregate harm caused by the action, a party only
will undertake the action if his or her benefit from the action outweighs
the harm to others. Likewise, parties whose actions do not cause any
harm ought not be required to compensate a victim for harm caused by
something else; otherwise parties will be discouraged or chilled from un-
dertaking actions that are on net socially desirable. When we consider
that the legal system typically does not require third parties who are
helped by an action to compensate the actor, we see another argument in
favor of ensuring that actors are not forced to compensate others for
harms for which they are not responsible.

For these reasons, an analysis which only compares the direct *ex-post*
consequences of settlement with the direct *ex-post* consequences of liti-
gated cases will be incomplete. One must ask how settlement affects the
incentives of the involved parties to engage in the behavior that may lead
to a lawsuit in the first place. While many issues relating to settlement
have received substantial attention, the vast majority of economic analy-
yses of settlement have focused on explaining why not all cases settle and
on how different legal rules affect the likelihood of settlement.\(^4\) Receiv-

\(^3\) See Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Dis-
putes and Their Resolution,* 27 *J. Econ. Lit.* 1067, 1069 (1989).
\(^4\) See, e.g., Lucian A. Bebchuk, *Litigation and Settlement Under Imperfect Informa-
tion,* 15 *Rand J. of Econ.* 404, 404 (1984); Cooter & Rubinfeld, *supra* note 3, at 1075;
William M. Landes, *An Economic Analysis of the Courts,* 14 *J.L. & Econ.* 61, 61 (1971);
ing much less attention is the more basic question of whether or not settle-
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tlement is necessarily desirable. Some scholars have argued that there
may be too little settlement because parties do not care about the litiga-
tion costs they impose on other parties or the publicly funded courts by
refusing to settle. Others have noticed that under certain fixed legal
rules, allowing settlement can lead to less deterrence. As these authors
point out, however, in the settings they analyze, one can always change
the rules by increasing damages so that settlement does not produce less
deterrence than trial. That is, they argue there are better ways to main-
tain deterrence than by discouraging settlement.

Richard A. Posner, An Economic Approach to Legal Procedure and Judicial Administra-
tion, 2 J. LEGAL STUD. 399, 399 (1973); Steven Shavell, Suit, Settlement and Trial: A Theo-
retical Analysis under Alternative Methods for the Allocation of Legal Costs, 11 J. LEGAL
STUD. 55, 55 (1982); Kathryn E. Spier, Pretrial Bargaining and the Design of Fee-Shifting

5. Some legal scholars have criticized the judicial promotion of settlement. Owen M.
Fiss was one of the first. His main objections to settlement were that settlements could be
unfair due to an imbalance of power between the parties; that settlements may be made by
agents who do not necessarily have the best interests of the parties at heart; and that settle-
ments may create peace but do not necessarily create justice. Fiss, supra note 2, at 1075.
Fiss's second criticism of settlement is quite valid, though we will not discuss it here since it
does not relate to the issues we discuss in this Essay. Fiss's first and the third criticisms,
however, do bear some relation to our argument. The problem with the "imbalance of
power" argument is that one's power in settlement negotiations relates directly to one's
power in litigation. If one party's lack of power leads them to accept an "unfair" settle-
ment (however one defines fairness), it must be because this party expects a worse out-
come should she have to litigate the case. See generally Louis Kaplow & Steven Shavell,
Fairness Versus Welfare (2002). That said, our argument against settlement
is based on an imbalance of information between the parties in that the defendant has
more information about the likely result of the suit than does the plaintiff. The problem
with this imbalance, however, is not that it leads the less informed plaintiff to do worse
than she would do if she were to litigate the case to judgment. If that were the case, the
plaintiff would simply refuse to settle. Instead, the problem is that settlements between
differentially informed parties often can make it more difficult for the threat of lawsuits to
deter harmful behavior without also deterring valuable behavior. While this is something
that potential plaintiffs should care about before they are injured, once they are injured
and are engaged in settlement negotiations, plaintiffs bargain to maximize their recovery,
not to improve the defendant's incentives to only take those actions that create more bene-
fit than harm. While in some sense this argument can be seen as one manifestation of
Fiss's claim that settlements create peace but not justice, Fiss did not explain his argument
this way. See also Stephen McG. Bundy, The Policy in Favor of Settlement in an Adversary
System, 44 HASTINGS L.J. 1, 3-4 (1992); Coleman & Silver, supra note 1, at 102-03. None of
these articles argue that settlement can reduce effectiveness of the legal system's ability to
regulate behavior; Marc Galanter & Mia Cahill, "Most Cases Settle": Judicial Promotion
and Regulation of Settlement, 46 STAN. L. REV. 1339, 1339 (1994); Leandra Lederman,
Precedent Lost: Why Encourage Settlement and Why Permit Non-Party Involvement in Set-
tlements, 75 NOTRE DAME L. REV. 221, 222 (1999).

6. See Steven Shavell, The Fundamental Divergence between the Private and the So-
cial Motive to Use the Legal System, 26 J. LEGAL STUD. 575, 575 (1997); Steven Shavell,
The Level of Litigation: Private Versus Social Optimality of Suit and Settlement, 19 INT'L R.

7. See generally A. Mitchell Polinsky & Daniel L. Rubinfeld, The Deterrent Effects
of Settlements and Trials, 8 INT'L R. L. & ECON. 109 (1988); Kathryn E. Spier, A Note on the
Divergence Between the Private and the Social Motive to Settle under a Negligence Rule, 26
J. LEGAL STUD. 613, 614 (1997).

8. Spier, supra note 7, at 614.

9. Id.
In contrast, we argue that settlement can fundamentally reduce the ability of the legal system to deter harmful behavior without chilling desirable behavior. Even when the rules for awarding damages can be changed, when settlement is allowed there may be no way to alter the rules to maintain deterrence without creating undesirable chilling. This suggests that legal and economic scholars should examine rules promoting settlement much more critically than they currently do. In particular, this Essay provides guidance in assessing when settlement is most likely to have significant costs in terms of hampering the legal system’s ability to effectively regulate behavior. As will become clear, this cost is most likely to be significant for settlements that occur prior to significant discovery—exactly those settlements that save the most legal costs.

We first consider, in Section III.A, a scenario where the defendant has superior information about the damages the plaintiff will receive at trial.\(^{10}\) When the defendant\(^ {11}\) is deciding whether to take some action that might result in her being sued,\(^ {12}\) her best estimate of what she might have to pay the plaintiff is what she expects the settlement or trial outcome to be. Because trials are structured to reveal all the relevant evidence, the defendant likely will expect the trial outcome to reflect her information about the magnitude of the harm she has caused. Therefore, when she has engaged in more dangerous actions or believes that she is responsible for the harm suffered by the plaintiff, she will expect to pay more damages after the trial. On the other hand, a pre-trial settlement will probably not reflect all of the information the defendant has. The plaintiff cannot insist on a higher settlement when the defendant knows damages are likely to be large if the plaintiff does not know this information. As a result, when the defendant expects to settle if she is sued, she may expect to pay the same amount regardless of the harm caused by her actions. Thus, when the defendant engages in an action that is significantly more harmful than the plaintiff expects, the defendant can expect to settle the case for substantially less than the true level of harm caused. This may lead her to engage in an activity that she knows will cause great harm only because she has the opportunity to settle the case.

In the second scenario, the defendant has superior information about her culpability for the plaintiff’s harm, and, thus, the probability that she will be found liable should the case proceed to trial. We show that in this instance, allowing settlement tends to reduce the accuracy of the legal system and leads to either less deterrence of harmful activity or more chilling of beneficial activity that could be mistaken for harmful activity.

\(^{10}\) This situation will probably only occur in a minority of cases. There are still, however, many types of cases where the defendant may have superior information about the magnitude of damages. \textit{See Section III.B.}, \textit{infra}.

\(^{11}\) More precisely, here we are speaking of the party that would become the defendant in a lawsuit, even though she is not a defendant at this stage.

\(^{12}\) More precisely, here we are speaking of the party that will become the defendant should it take an action that results in a lawsuit. For simplicity, we will just refer to this party as the defendant even though she is not a defendant at this stage.
Settlement can reduce the accuracy of the legal system because culpable defendants have a greater incentive to settle than do blameless ones. Therefore, if settlement does not occur, the plaintiff will realize that he is more likely to be facing a blameless defendant. We argue this tends to cause the plaintiff to put less effort into trial preparation, which reduces the accuracy of the trial process. The less accurate the trial process, the less effective the legal system is at deterring harmful activity without chilling beneficial activity. Section IV.A. provides a more detailed and rigorous exposition of this argument.

Our argument that settlement tends to lead to less deterrence of harmful activities or more chilling of desirable activities relies on the premise that the defendant—the party whose behavior is the subject of the lawsuit—has better information about a critical aspect of the case than does the plaintiff. We do not, therefore, suggest that all settlements create these problems. For example, if neither party had any doubt regarding any of the consequences of the defendant’s actions, the argument would not apply. Even when settlement does impair the legal system’s ability to appropriately influence behavior, it does reduce legal costs, and we do not intend to argue that it will always be undesirable on balance and should always be discouraged. Instead, the purpose of this Essay is to identify this downside of settlement that previously has been ignored and to suggest that there are cases where judges might want to consider restricting settlement, or at least not explicitly promoting it. More generally, this Essay argues that our legal system should be aware of the costs of the policy tilt towards settlement.

Section II describes how the legal system favors settlement over trial. Section III presents the analysis of how settlement can undermine deterrence (relative to the situation where all cases go to trial) when the defendant has superior information about the harm her action causes. Part III.A. explains this theory. Part III.B. discusses the types of cases where this theory is applicable. Section IV then analyzes how settlement can lead to the chilling of desirable behavior (again, relative to the situation where all cases go to trial) when the defendant has superior information about whether or not her action is responsible for the plaintiff’s harms. Again, Part IV.A. explains this theory and Part IV.B. discusses the types of cases where this theory is likely to be relevant. Section V discusses the implications these theories have for legal policy and, rather than recommending any hard and fast rule against settlements, suggests that in some cases judges should have the discretion to not enforce settlement agreements. Section VI concludes that while settlement may reduce legal costs and the burden on the courts, it often comes at the price of reducing the accuracy and effectiveness of the legal system, and that settlement should not always be encouraged or even permitted.
II. POLICY TILT TOWARD SETTLEMENT

While many judges have viewed promotion of settlement as an important part of their judicial role for some time,\(^\text{13}\) promotion of settlement formally became part of legal policy with the amendment to Rule 16 of the Federal Rules of Civil Procedure in 1983.\(^\text{14}\) Rule 16 suggests that judges may take action to encourage the parties to settle and allows judges to impose sanctions on parties who do not participate in pretrial settlement conferences.\(^\text{15}\) Rule 68 also allows a judge to impose costs on a plaintiff who refuses a settlement offer that turns out to be more favorable to her than the outcome of a trial.\(^\text{16}\) The "plain purpose of Rule 68 is to encourage settlement and avoid litigation."\(^\text{17}\) Rule 26(f) requires attorneys to discuss the possibility of settlement with their clients.\(^\text{18}\) Even the Federal Rules of Evidence promote settlement.\(^\text{19}\) Under Rule 408, settlement offers and discussions are not admissible at trial to promote "the public policy favoring the compromise and settlement of disputes."\(^\text{20}\) Congress has also endorsed the promotion of settlement. The Civil Justice Reform Act\(^\text{21}\) encourages judges to promote settlements as a way to reduce the expense and delay in the federal court system.\(^\text{22}\)

While public policy favoring settlement has some dissenters,\(^\text{23}\) it "has generally received enthusiastic support from the commentators and the courts."\(^\text{24}\) The Supreme Court has repeatedly endorsed the idea that settlement is preferable to trial. As far back as the nineteenth century, the Court declared, "settlements of matters in litigation or in dispute without recourse to litigation are generally favored. . . ."\(^\text{25}\) Since that time, the Court has consistently emphasized the importance of the public policy

\(^{13}\) See Marc Galanter, The Emergence of the Judge as a Mediator in Civil Cases, 69 Judicature 257, 257 (1986). Surveys of judges, even before the 1983 amendment to Rule 16 of the Federal Rules of Civil Procedure, revealed that over seventy-five percent of trial judges described themselves as interventionist in their promotion of settlement. John Paul Ryan et al., American Trial Judges 177 (1980). This intervention was predominately through subtle suggestion, though over ten percent of judges reported using direct pressure to promote settlement. Id.


\(^{16}\) Fed. R. Civ. P. 68(d).

\(^{17}\) Marek v. Chesny, 473 U.S. 1, 5 (1985).


\(^{19}\) Fed. R. Evid. 408 advisory committee's note.

\(^{20}\) Id.


\(^{22}\) 28 U.S.C. § 473(a) (2006). For a complete description of all the mechanisms available to promote settlement, see McG. Bundy, supra note 5, at 3-4.

\(^{23}\) See supra note 5.

\(^{24}\) Margaret Meriwether Cordray, Settlement Agreements and the Supreme Court, 48 Hastings L.J. 9, 36 (1996).

\(^{25}\) St. Louis Mining and Milling Co. v. Mont. Mining Co., 171 U.S. 650, 656 (1898).
rationale for settlements. There are, however, cases where a strong public policy rationale against settlements exists.

III. SETTLEMENT AND DETERRENCE

A. The Theory

The next two Sections focus on a case where a potential defendant has a choice to engage in some activity or action that may cause her to be sued. We restrict attention to suits for damages. Furthermore, we will assume that a defendant acts rationally in her own best interest and decides to engage in activity if, and only if, her benefit from doing so exceeds her expectation of how much she is likely to pay in damages and legal costs (we refer to this as her "expected liability"). This assumption does not imply that the defendant only cares about money—her benefit from the activity may be non-monetary. Similarly, this benefit could reflect any disutility the defendant feels from harming another person. Furthermore, we are not assuming that the defendant can predict the outcome of the trial or of settlement with certainty. What is required is that the defendant forms some estimate of the average costs of her action so that she can weigh expected costs against benefits. We speak in terms of expected liability, which the reader should understand is only an average; the defendant usually will not know her exact liability.

To analyze the effect of settlement on deterrence, we start with a model of settlement bargaining under asymmetric information that has become the standard in the law and economics literature. Given that litigation is costly to both parties, if each party could perfectly predict the outcome of a trial, then there is a range of settlements that both parties would agree is preferable to going to trial. For example, if both parties know that the defendant would be found liable for $100 in damages and both would have to spend $20 litigating the case, any settlement where the defendant pays the plaintiff between $80 and $120 will make both sides better off than going to trial. In fact, even if the parties cannot predict with certainty the outcome of the trial (which is certainly the case), the preceding range remains valid so long as both parties have similar estimates of the outcome of the trial. That is, if both parties think the defendant would pay the plaintiff $100 at trial on average, then they would both expect to be better off on average with any settlement between $80 and $120. Similarly, if the defendant and the plaintiff both think the de-

26. See McDermott, Inc. v. AmClyde, 511 U.S. 202, 211 (1994); Evans v. Jeff D., 475 U.S. 717, 736-38 (1986); Marek v. Chesny, 473 U.S. 1, 5 (1985); Williams v. First Nat'l Bank, 216 U.S. 582, 595 (1910). It should be noted, however, that some have argued that three recent Supreme Court decisions have not emphasized the policy favoring settlement as much as in the past. See Cordray, supra note 24, at 36.

27. We use male pronouns for the plaintiff and female pronouns for the defendant.

28. See Bebchuk, supra note 4, at 404, for a mathematical model of settlement bargaining when one party has superior information about the likely trial outcome. This Essay, like most, does not consider the defendant's decision about whether to do the act that results in the lawsuit.
fendant would be liable for damages of $120, then they would both be willing to settle for something between $100 and $140. The important thing to notice is that if both parties share the same expectation of the award, when the estimate of the likely damage award increases, the values at which settlement will occur increases as well. When the parties share the same expectations and these expectations are correlated with the actual harm, the defendant's action becomes more costly to her as the harm her action causes becomes greater.²⁹

If the plaintiff does not have the same information as the defendant, however, this may not be the case. Consider, for example, an antitrust case where the defendant, because of her superior knowledge of the industry, has a very good idea of how much her anti-competitive conduct costs consumers. The plaintiff, on the other hand, may know that the defendant behaved anti-competitively but may not have a very good idea of what prices would have been absent the anti-competitive conduct. If the case does not settle, however, the discovery and trial processes likely will uncover a great deal of the information that the defendant has about the consequences of her anti-competitive conduct. While both sides may have similar expectations about the probability of liability, the defendant probably has much more precise information about the magnitude of the damages a court will award should the case proceed to trial.

For example, the plaintiff may think that damages could be anywhere between $50 and $150, while the defendant may know exactly what her damages would be.³⁰ Any given settlement offer will be more attractive to the defendant when she expects the damages awarded at trial to be higher. For example, if the plaintiff offered to settle for $100, the defendant will prefer to accept rather than go to trial if she knows damages will be $80 or more (since by going to trial she will have to also pay $20 in legal costs). If she knows that damages will be less than $80, however, she will be willing to reject the offer and go to trial.³¹ Of course, the

²⁹. In order to design a damage rule that provides perfect incentives, even when both the plaintiff and defendant are equally well-informed, one needs to know where in the settlement range the defendant expects the settlement to be. But even if incentives are not perfect, with equally well-informed parties, the greater the action's harm, the less the defendant has an incentive to act, even if she expects to settle the case.

³⁰. While this example assumes the defendant has perfect knowledge of damages, what is critical simply is that the defendant has better knowledge about what damages will be than does the plaintiff.

³¹. Of course, in real settlement negotiations, there is more than one opportunity to settle. Even in these situations, defendants who know that damages will be large are more likely to settle than those who know damages will be small. The plaintiff cannot just assume that a defendant who resists settling for a given amount actually expects damages to be lower if the case goes to trial. If he did make this assumption and offered to settle for less, then even a defendant who expects large damages could resist and obtain a lower settlement offer. That is, if a defendant who expects damages to be small is not more likely to have to go to trial than a defendant who expects damages to be large, there is no reason for every defendant not to pretend in settlement negotiations that she expects damages to be small. If the plaintiff always believes her, he will end up settling for a small amount even when damages would have been quite high. Because this is not in the plaintiff's interest, he will not accept a lower settlement offer just because the defendant has rejected a larger one. As a result, defendants who expect damages to be large have a much greater
plaintiff might wish to offer to settle for a higher or lower amount. But regardless of the plaintiff's offer, the same reasoning implies that the defendant will only accept the offer if she believes the sum of the damage award and her legal costs are likely to exceed the cost of accepting the offer. Everything else being equal, a defendant who knows her action caused a large amount of harm will settle; if she knows her action caused only a small amount of harm, she will go to trial.

If the defendant knows the plaintiff's settlement offer will not depend on the harm she actually caused, the defendant's expected liability for her action is capped at the magnitude of the settlement offer she expects the plaintiff will make. In our example, if the defendant expects the plaintiff will offer to settle for $100, she knows that she will never have to pay more than this, and will always do the action in question whenever her benefit from that activity exceeds $100. This is true no matter how much harm this action may cause the plaintiff. Because the defendant expects to receive a settlement offer that is lower than the actual harm, she does not have efficient incentive to avoid this activity.

In our example, say the defendant's benefit from the activity is $110. She will engage in the activity even if the harm it causes to the plaintiff is $120 or even $150 because she knows she can settle the lawsuit for $100. Furthermore, she has no incentive to take actions that would reduce the harm from $150 to $100, even if those actions would cost her very little.

Of course, if her benefit is below the settlement offer she expects the plaintiff to make, she will refrain from the activity she knows that actual damages will be large enough that she would want to settle. In this case, she will compare her benefit to the actual damages (plus her legal costs) when deciding whether to engage in the activity or not. So, if her benefit is $80, then she will engage in the activity if it causes harm of less than $60 (because she will also have to pay $20 in legal costs). Therefore, actual damages continue to affect deterrence when the defendant's benefit from the activity is low (below the expected settlement offer) but not when it is high (above the expected settlement offer).

This reduces the ability of the legal system to induce the defendant to act efficiently. When the defendant must pay all the costs associated with her action, she then will have the incentive to engage in the activity if, incentive to accept any given settlement offer than those who expect damages to be small. Of course, this assumes that the defendant cannot, or does not wish to, reveal all the information she has about the likely damages during settlement negotiations. Certainly, before discovery the plaintiff has no way of knowing whether the defendant is hiding some information that might suggest damages are large. Moreover, the defendant may be hesitant to reveal too much information that might help the plaintiff at trial.

33. Id. at 3, 10.
34. The plaintiff's settlement offer can still be optimal if the plaintiff does not know the defendant's benefit. If the defendant's benefit could be larger than this settlement offer, then there is nothing necessarily irrational about making a settlement offer that turns out to be larger than the defendant's benefit in some cases.
and only if, her benefits exceed the total costs. As demonstrated above, when damages equal the harm from the activity, settlement will weaken deterrence because settlement acts like a cap on damages. More fundamentally, notice that there is no way to adjust the damage rule to solve this problem. To increase the damages by some amount for every possible level of harm to correct this problem naturally would increase the settlement amount that the plaintiff would demand or accept, because his expected recovery at trial would increase. This, however, does not eliminate the damage cap effect of settlement; it only changes the monetary value of the cap. In our example, if damages were set to harm plus $30, the plaintiff might offer to settle for $130 rather than $100. Notice that while the settlement amount is now larger, the defendant will still accept the settlement offer if she knows the harm she causes exceeds $80, just as before. (If the harm is $80, damages will be $110 and legal costs $20, making the total cost of trial $130). When the harm exceeds $80, the defendant will still decide to do the activity if, and only if, her benefit exceeds the settlement amount (now $130). Her decision will still be the same whether the harm is $80 or $150. Increasing the damages the defendant must pay at trial does not change that the defendant will not consider the actual harm her action causes whenever that harm is large enough to make accepting the settlement preferable to going to trial. In addition, notice that by increasing damages, and thereby increasing the effective damage cap, we may now also chill socially desirable behavior. For example, if the defendant's benefit from doing an activity is $125, she may forego the activity that causes a harm of $80 because she expects to settle the case for $130.

Of course, settlement does have a major offsetting advantage: it reduces legal costs. In many situations, where legal costs are substantial, these savings will outweigh the less efficient incentives that settlement necessarily creates. In our example, one situation where this would be true is where the defendant's benefit is greater than $150. In this case, it is always efficient for the defendant the act when she can settle, so there is no reason to deter it. Likewise if the damage was always between $100 and $110, allowing settlement would also likely be efficient. Nonetheless, it is easy to overstate the costs saved by settlements. If allowing settlement leads to weaker deterrence, it also leads to more activity that results in lawsuits. By improving deterrence, limitations on settlement can reduce the number of cases filed. Because this reduces the increase in legal costs that settlement limitations create, there

35. See Wickelgren, supra note 32, at 3.
36. See id. for a formal proof of these results.
38. This is inefficient because the activity causes a harm of $80 and in legal costs of $40 for both sides, for a total cost of $120, less than the $125 benefit.
40. Id. at 4.
is much more scope for the benefits from improved incentives to outweigh the increased legal costs.\textsuperscript{41} Coming back to our example, this will happen when the defendant's benefit from the act is just barely greater than the settlement amount (say it is $101 in the case where the plaintiff makes an offer of $100 because damages equal harm). Now, if settlement is prohibited, the defendant will only do the act if it causes a harm of less than $81 (so her damages plus legal costs will be less than $101), so the only cases that would have settled that now go to trial are those where the harm is between $80 and $81. All the other cases that would have settled when the harm exceeds $81, do not exist because the threat of liability now deters the defendant from engaging in the activity.

Of course, prohibiting settlement, even in this case, is not always desirable. If the defendant's action causes a harm of less than $101, we do not want to deter it since the benefit exceeds the harm as long as there are no legal costs (because the case settles). On the other hand, prohibiting settlement to deter this activity is desirable if the activity causes a harm that exceeds $101. Unfortunately, more generally it is also true that whether settlement is desirable depends on both the benefits and the harms of the activity, making it difficult to write a general rule that always allows settlement when, and only when, its advantages outweigh its disadvantages.

\textbf{B. Domain of Application}

This theory does not justify a blanket prohibition on settlement. In many cases, the central premise of the theory probably will not hold. Recall that the main building block for the argument in the last section was that the defendant knows more about the harm that her activity causes than does the plaintiff. More precisely, the defendant must have some information about the likely harm—not shared by or with the plaintiff—both when she acts and when she is engaged in settlement negotiations.

In many cases, such as personal injury, this is unlikely to be true. A physically injured plaintiff can more easily determine the extent of her own injuries than can the defendant. Similarly, in many contract cases, the non-breaching party will know what the harm from the breach was more precisely, and the breaching party is unlikely to have any significant private information.\textsuperscript{42}

There are, however, many classes of cases where the premise of the theory often will hold. In antitrust, as discussed in the preceding section, the defendant's greater knowledge of the market will usually put her in a much better position to compare the actual situation with the "but-for" world where there was no anti-competitive activity.\textsuperscript{43} This problem also can occur in some tort cases. Say a defendant emits a chemical that af-

\textsuperscript{41} There are cases where the incentive benefits of prohibiting settlement outweigh the legal costs saved for any settlement offer that actually results in some cases settling. See generally Wickelgren, supra note 32.
\textsuperscript{42} But see infra note 44.
\textsuperscript{43} Wickelgren, supra note 32, at 2.
fects the yields of crops on nearby farms. Because crop yields are quite variable, the plaintiff cannot simply compare his current yield to his normal yield to accurately determine how much the chemical affected it. Instead, the best evidence of the effect of the chemical on crop yields will probably come from knowledge of the chemical itself. This is information that the defendant—the producer of the chemical—is in a much better position to know than the plaintiff, putting her in a much better position to estimate compensatory damages.

IV. SETTLEMENT AND THE CHILLING EFFECT

A. The Theory

The previous section showed how settlement can weaken deterrence when the defendant has an informational advantage about the magnitude of damages that a court will award. While such situations are important, they are probably less prevalent than cases where the defendant knows more than the plaintiff about the probability that the court will find her liable. This section analyzes this scenario and shows that settlement can reduce the legal system's ability to distinguish between legitimate and harmful activities, thereby worsening the tradeoff between under-deterring harmful activities and chilling legitimate ones.

One example concerns a factory that emits a chemical into the air or water. Because the factory owner knows a great deal about her production process, and may have superior access to scientists and engineers, she probably knows much more about whether this chemical causes cancer or other harms than do the people who live near the factory. If a person who lives near the factory gets cancer, he will not know whether the chemical emitted by the factory could have caused his cancer or not. If he sues the factory owner, much of what the defendant knows may come out at trial or during discovery, but at the time of the suit, the defendant knows much more about the likelihood that she will be found liable than does the plaintiff.

The argument that settlement can make it more difficult to deter harmful behavior without chilling harmless behavior has two steps. First, the

44. A very similar effect can occur in contract cases. Consider contracts for the delivery of some input into a production process. If the defendant breaches by delivering a different input than what the contract specifies, the plaintiff will probably know. However, due to the plaintiff's duty to mitigate damages, he will often have to use the input anyway (if an alternate source is not available or is very costly). If many other factors, aside from the quality of this input, affect the plaintiff's output (some of which could be very hard to measure), his actual output may not provide very good evidence of how much the defective input reduced his output over what it would have been with the correct input. Much better evidence may come from information about the relative quality of the two inputs. The defendant, because she produces these goods, will have much better information about this issue than will the plaintiff. Similarly, if the contractually-specified input represented a technological advance, then the plaintiff may not know what its production capabilities or costs would have been had the contract been performed. The defendant, as producer, may know much more about likely performance characteristics. This puts the defendant in a much better position than the plaintiff to estimate damages.
possibility of settlement causes the plaintiff to prepare less for trial (if there is no settlement) than she would if settlement were prohibited.

Second, when the plaintiff prepares less for trial, the difference between the amount that a harmful producer expects to pay and the amount a harmless producer expects to pay decreases. The possibility of settlements that might occur after much of the trial preparation has been completed clearly decreases the plaintiff's incentive to prepare for trial. If the plaintiff expects that there is a ninety percent chance the case will settle, then there is a ninety percent change that any efforts in preparation will be wasted.\textsuperscript{45} Less obviously, the possibility of early settlement can also reduce the plaintiff's trial preparation effort, even in cases that do not settle.\textsuperscript{46} To see this, we note that if the plaintiff makes a settlement offer, the defendant has a much stronger incentive to accept the offer when she has engaged in harmful behavior, and less incentive if her actions were harmless. For example, a defendant who knows the chemical she emitted causes cancer is more likely to be found liable at trial than is a defendant who knows the chemical she emitted is harmless, making trial more costly for the former defendant than for the latter.\textsuperscript{47} Thus, when a defendant rejects the plaintiff's offer, the plaintiff rationally infers that it is more likely that the defendant has evidence that the chemical is benign.

Consider the effect of this inference on the plaintiff's optimal litigation strategy. If the chemical is benign, it will be less likely that the plaintiff is able to find credible evidence that the chemical caused his cancer. The more likely the plaintiff thinks it is that the chemical is harmless, the less incentive he has to spend a lot of time and money searching for evidence that it is dangerous. That is, the plaintiff's trial preparation effort is likely to be more effective when the defendant really is responsible for the plaintiff's injury than when she is not.\textsuperscript{48} Because of this, the plaintiff will expend less effort when he thinks it is less likely that the defendant really is culpable.\textsuperscript{49} Because the defendant is less likely to be truly culpable if she has rejected a settlement offer than if no settlement is made, this establishes the first step of the argument: the possibility of settlement

\textsuperscript{45} Of course, this is less true for preparations which the defendant can observe, since these preparations might affect the settlement the plaintiff can get. A great deal of trial preparations, however, such as how much time is spent preparing witnesses, are not observable by the defendant, and will not affect the outcome if the case settles.

\textsuperscript{46} Friedman & Wickelgren, supra note 37, at 2.

\textsuperscript{47} To illustrate this point, say the damages will be $1 million if the defendant is found liable for the plaintiff's cancer. If the defendant knows her chemical emission did not cause this cancer, the probability that the court will mistakenly find her liable may be quite small, say five to ten percent. On the other hand, if the chemical is carcinogenic, the probability that the court will correctly find the defendant liable may be quite high, say seventy to eighty percent. Thus, a defendant whose chemical emission was dangerous will accept a large settlement offer but if the defendant knows her chemical emission was benign, she will certainly reject a large offer.

\textsuperscript{48} See Friedman & Wickelgren, supra note 37, at 1-2.

\textsuperscript{49} Of course, there are many cases which are "slam-dunks" where the plaintiff does not need to do much preparation at all in order to win. In these cases, however, the plaintiff usually knows it is a "slam-dunk" so the asymmetry of information theory on is not applicable.
reduces the plaintiff's trial preparation effort.\textsuperscript{50}

The less a plaintiff prepares for trial, the smaller the difference between the expected liability from committing harmful acts and the expected liability of committing harmless acts will be. Notice that the reason the plaintiff exerts less effort when he believes the defendant is more likely to be blameless is because his effort is less effective when the defendant is blameless than when she is responsible for the plaintiff's injury.\textsuperscript{51} Because the effort is more effective against a culpable defendant, any reduction in effort benefits the culpable defendant more than the blameless one.\textsuperscript{52}

The plaintiff's reduced incentive to prepare affects the defendant's expected liability in all cases, whether they settle or not. When settlement is allowed, both parties know that if a settlement offer is rejected, the plaintiff will have less incentive to prepare and will not work as hard to win the case.\textsuperscript{53} This reduces the chance that the defendant is found liable if she rejects the settlement and goes to trial, and likewise reduces the amount that a culpable defendant is willing to pay to settle the case.\textsuperscript{54} Since the plaintiff knows this, he tends to make a smaller settlement offer. Therefore, defendants who settle benefit from the fact that the plaintiff would exert less effort if his settlement offer were rejected.

A culpable defendant benefits more than a blameless one when the plaintiff does not prepare as much if there is certain to be a trial.\textsuperscript{55} This decreases the difference between the culpable defendant's expected liability and that of the blameless defendant whenever settlement is possible. Furthermore, allowing settlement can directly decrease the difference between the expected liability of culpable and blameless defendants.\textsuperscript{56} Both types of defendants pay the same amount when they accept a settlement offer, but since the culpable defendant would be more likely to lose at trial, a culpable defendant that accepts an offer saves more liability than a blameless defendant who accepts the same offer. In other words, to the extent that defendants are able to capture some of the \textit{ex-post} benefit of settlement, these are more likely to be captured by culpable defendants who have more to gain by settlement.

\textsuperscript{50} The possibility of settlement likely will not affect the defendant's trial preparation effort since the defendant knows if she is culpable or blameless whether the plaintiff makes a settlement offer or not.

\textsuperscript{51} Friedman \& Wickelgren, \textit{supra} note 37, at 4.

\textsuperscript{52} For example, spending an additional 100 hours on the case might increase the plaintiff's chance of winning by five percent if the defendant is blameless, but it might increase it by ten percent if she is culpable. If the fact that the defendant rejected a settlement offer causes the plaintiff not to spend this extra one-hundred hours preparing, then the blameless defendant only has a five percent less chance of being found liable while the culpable defendant has a ten percent less chance. The culpable defendant benefits more from this reduction in effort.

\textsuperscript{53} Friedman \& Wickelgren, \textit{supra} note 37, at 1.

\textsuperscript{54} \textit{Id.} at 2.

\textsuperscript{55} \textit{Id.}

\textsuperscript{56} \textit{Id.}
For any given damage rule, the impact of settlement is to reduce the expected liability of all defendants, either directly for those who do settle or indirectly through the plaintiff's reduced incentive to engage in preparation effort should there be a trial. If the damage rule is flexible, it would be possible to adjust it in the unrestricted regime, for example, by using a damage multiplier or punitive damages, so that culpable defendants face the same expected liability in either regime. Since settlement tends to reduce the plaintiff's incentive to invest in preparation, however, the unrestricted settlement regime will have higher damages and lower preparation effort than the restricted settlement regime. If each combination produces the same expected liability for culpable defendants, the expected liability faced by blameless defendants in the unrestricted settlement regime will necessarily be greater. This follows because the lower level of plaintiff preparation effort when settlement is allowed does not benefit the blameless defendant as much as it benefits the culpable one. Since unrestricted settlement reduces the difference in the expected liability faced by culpable and blameless defendants, if the liability for culpable defendants is held constant, unrestricted settlement must increase the expected liability faced by blameless defendants. That is, when the defendant has better information about her likelihood of being found liable than does the plaintiff, settlement worsens the tradeoff between under-deterring dangerous activities and chilling legitimate activities.

For example, since a rational, profit-maximizing factory owner will decide whether to emit chemicals by comparing her benefits from doing so (how much it reduces her production costs or increases her output) with the expected liability that results, decreasing the difference in expected liability either makes emitting a carcinogenic chemical more attractive or makes emitting a benign chemical less attractive. Thus, allowing settlement tends to make it more difficult to deter harmful behavior without also chilling harmless behavior. For example, if the benefit from emitting a carcinogenic chemical is $100,000 more than the benefit of emitting a benign chemical, then it is impossible to deter a defendant from emitting the carcinogenic chemical without chilling the benign activity unless the difference in expected liability is at least $100,000.

As in the scenario considered in the previous section, one should balance this cost of settlement against the benefit it provides in terms of reducing litigation costs. For many cases, especially those where the defendant's informational advantage is not great, the chilling costs of settlement may not be large. That said, we show in a more technical paper on this issue that when the range of possible benefits the defendant can get from her activity is quite small, the chilling effect from settlement will often outweigh the benefit that settlement provides by reducing legal

57. See id. at 2.
58. Id. at 1.
59. Id.
To avoid completely chilling the harmless activity, the optimal damage rule when settlement is unrestricted leads to much more harmful activity. As a result, the savings in litigation costs from cases that settle is almost completely cancelled out by an increase in costs from cases that would not exist had settlement been restricted. In general, however, the trade-off between the chilling cost of settlement and the litigation cost-saving benefit is quite complicated and probably varies a great deal by case. We discuss this issue further in Section V.

B. Domain of Application

Naturally, the effect discussed above will be more relevant to the desirability of settlement in some cases and less relevant in others. In some cases there may be no important benign activities that are in danger of being mistaken for harmful activity. In these cases it would be possible to encourage settlement to reduce legal costs while increasing penalties to maintain deterrence with no unwanted consequences. Likewise, if the trial process is costly, but perfectly accurate, there may be no decrease in accuracy and no increase in chilling associated with allowing or encouraging settlement. On the other hand, if the trial process is completely ineffective and is random in distinguishing between the activities, allowing settlement does not decrease accuracy or lead to more chilling. We will only care about this effect if it is important both to deter harmful activities and not to chill harmless ones. If the "harmful" activity is either not very harmful or produces benefits that are almost as great as the harm that it causes, then society may not lose much from the decrease in deterrence that comes from allowing settlement and holding punishment constant. In this case, however, it might be better still to immunize the activity from liability so as to save trial costs and not risk chilling legitimate activities that might be mistaken for the harmful activity. Alternatively, if the net benefits from the harmless activity that could be mistaken for the harmful activity are very small, then it is probably not worth the extra legal costs of restricting settlement to avoid chilling this activity. However, when minimizing the risk of both types of legal errors (not deterring the dangerous activity and chilling the beneficial activity) is important one might want to restrict settlement in order to improve the legal system's ability to distinguish between the two types of activities.

One category of cases where it is very important to distinguish between culpable and blameless defendants is medical malpractice. Clearly it is important to deter medical malpractice, yet it is vitally important that in

60. See generally id. The exact condition necessary for the proof is that effort by the plaintiff increases the likelihood in both absolute and relative terms that he prevails against a culpable defendant compared to the likelihood he prevails against a blameless defendant. For example, suppose a low-effort plaintiff has a forty percent chance of prevailing against a guilty defendant and a thirty percent chance of prevailing against a blameless defendant. If a high-effort plaintiff has an eighty percent chance of prevailing against a culpable defendant, our results will definitely hold if the high-effort plaintiff has less than a sixty percent chance of prevailing against a blameless defendant. Id. at 2.
doing so, society avoids or minimizes chilling the non-negligent provision of medical services. Both the costs of medical malpractice and the costs of chilling legitimate medicine are substantial. In the year 2000, a widely noted study published by the Institute of Medicine estimated that medical errors caused 98,000 deaths per year in the United States.61 On the other hand, a recent study by the American Medical Association (AMA) finds that more than eighteen states are in “full blown medical malpractice insurance crises.”62 Some of the examples the study cites are:

- More than 50 percent of Arkansas physicians reported in a recent survey that they have been forced to reduce or discontinue one or more medical services in the last two years due to rapidly increasing medical liability premiums.63

- Because of a legal climate making $1 million-plus jury verdicts and settlements more common, an increasing number of Connecticut obstetricians are no longer delivering babies, and premiums for neurosurgeons and other high-risk specialists are more than $100,000...64

- Women with gynecological cancers in three rural Missouri towns now have to drive more than 100 miles because the only local gynecological oncologist was forced to eliminate his rural outreach clinic due to increasing insurance premiums.65

The AMA’s view is that liability should almost never force doctors to stop performing high-risk procedures or to stop practicing altogether.66 While a less self-interested observer of these facts would conclude that stopping some doctors from performing some procedures is probably desirable, most probably would agree that it is unlikely that fifty percent of all doctors in Arkansas are too dangerous or unqualified to practice medicine safely. Thus, both patients and doctors are harmed by the chilling of legitimate medicine.67 On the other hand, the substantial costs of medical errors suggests that substantially reducing the deterrent effect of malpractice liability could also have disastrous effects.68 The substantial costs of both chilling and under-deterrence in the malpractice system suggests that it is very important that our legal system distinguish legitimate

61. To Err Is Human: Building a Safer Health System 25 (Linda T. Kohn et al. eds., 2000). For a discussion of the lack of substantial progress in reducing the death rate since the report was published, see Lucian L. Leape & Donald M. Berwick, Five Years After To Err Is Human: What Have We Learned?, 293 J. OF AM. MED. ASS’N 2384 (2005).


63. Id.

64. Id.

65. Id.

66. Id.

67. Id.

It is plausible that restrictions on medical malpractice settlements might be justified.

Chilling is also a major concern in the enforcement of antitrust laws, especially restrictions on predatory pricing or illegal vertical combinations. When predatory pricing effectively blocks entry into a market, the losses to consumers can be substantial. On the other hand, threat of predatory pricing litigation can chill legitimate price competition and increase the prices paid by consumers. The Supreme Court of the United States has directly noted the danger that predatory pricing litigation may chill legitimate price competition.

Similarly, while vertical mergers can sometimes cause significant anti-competitive harm, they are not per se illegal and sometimes can bring benefits to consumers. Just as it can be difficult to distinguish between pro-competitive price decreases and attempts to use predatory pricing to monopolize a market, it likewise can be quite difficult to distinguish between a merger that is intended to take advantage of legitimate efficiencies and a merger that is designed to inhibit competition. Our theory shows that allowing settlements may make it more difficult to deter illegal activities without excessively chilling efficient legal behavior, and allowing settlement may be undesirable in the antitrust context.

Patent litigation is another example where one can imagine that it may be difficult to distinguish between legitimate innovation and patent infringement. When the legal system gets the wrong answer in either direction, incentives to innovate are significantly diminished. In addition, finding a patent infringement when there is none tends to chill legitimate competition and increase prices for consumers. Because of the importance of innovation, restricting settlement to enhance the accuracy of the legal system in this area may justify the resulting added litigation costs.

On the other hand, there are also cases where this theory of how settlements can be harmful has little relevance. For example, there is very little legitimate activity that is likely to be mistaken for armed robbery, so this theory does not justify restrictions on plea bargaining in armed robbery or other street crimes. Another set of examples would be any case where

71. See id. for a discussion of the issues surrounding predatory pricing.
72. Matsushita Elec. Indus Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 594 (1986) ("[M]istaken inferences . . . are especially costly, because they chill the very conduct the antitrust laws are designed to protect.").
74. 54 AM. JR. 2D, Monopolies, Restraints of Trade, and Unfair Trade Practices § 7 (1996).
the contentious issue is the identity of the party that committed the harmful act rather than whether the act itself was harmful. Where there is no possibility that the act was harmless, chilling is not a concern. However, even where the reduction in accuracy from allowing settlement does not negatively affect efficiency through its effects on incentives, the increased penalties faced by the innocent might implicate broader justice concerns.

V. LEGAL POLICY IMPLICATIONS

The primary implication of the arguments put forward in this paper is that there are circumstances where the standard presumption that settlement should always be encouraged is not valid. We argue that allowing or encouraging settlement can be socially harmful when it is important that the courts distinguish between actions that are really harmful and actions that may appear harmful but are actually benign.

We do not argue, however, that settlement should always be discouraged or prohibited. In all but the most extreme cases, allowing settlement should lead to a decrease in legal costs. Depending on the importance of deterring the harmful activity and the undesirability of chilling the beneficial activity, the savings of legal costs can outweigh the decrease in deterrence and the increase in chilling. There will be cases where there may be very little decrease in accuracy from settlement, such as if the defendant has little private information about the outcome of the case, or if the courts either are very accurate or very inaccurate. Unfortunately, although the theory describes the conditions that make settlement more or less likely to be beneficial in the abstract, in practice it can be difficult to determine in which specific cases settlement will be desirable. Because of this, any reappraisal of our legal policy towards settlement probably should not be enshrined in any hard and fast rules. Given how much the facts of each individual case affect whether that case is one where settlement should be restricted, the only feasible way to restrict settlement without creating a rule that is both over- and under-inclusive is to set up general guidelines and give individual judges a great deal of discretion in regulating settlement agreements.

How might judges regulate or discourage settlement? The Federal Rules of Civil Procedure already give judges the ability to encourage settlement via Rules 16 and 68.76 The argument in this paper suggests that, at a minimum, judges should not use these tools in circumstances where settlement might lead to substantially decreased accuracy or increased chilling. Actively discouraging settlement presents a more difficult issue. Although the courts have the power to block a settlement which occurs after the case has already been filed,77 it would be very difficult for the court to block settlements that occur before a claim is filed. One solution would be to limit the enforceability of any waiver of rights to litigate in

connection with the case if a court found that settlements were undesirable and against public policy. The grounds for it being against public policy would be exactly the arguments presented in Sections III and IV. To determine whether to set aside a settlement agreement, a judge would use the theory explicated in this paper to weigh the incentive benefits of restricting settlements against the added litigation costs that doing so would create, keeping in mind that the final determination would depend on the amount of private information held by the defendant and the importance of avoiding chilling in the particular type of case. In so doing, judges would need to keep in mind the classes of cases where chilling is a particularly big concern, such as medical malpractice or antitrust.

It is worth pointing out that under both theories, smaller settlements (in terms of the proportion of the actual damages) are more problematic than larger ones. When a defendant's informational advantage concerns the magnitude of the damages, the lower the settlement the lower the cap on expected liability. This creates a wider range of possible harm where a defendant's decision about whether to do the act is based on a comparison of the benefit to the settlement amount rather than on a comparison of the benefit to the actual harm she expects to cause. Similarly, if a defendant's informational advantage concerns liability, the smaller the settlement offer the more likely that a defendant who rejects such an offer is blameless. This means that the reduction in preparation effort caused by settlement will be even larger, leading to an even greater reduction in accuracy. Under either theory, evidence that the settlement amount was quite large given the type of case should tend to make a judge lean against setting aside the settlement agreement.

Giving a judge discretion not to enforce the promise to terminate litigation in a settlement agreement would greatly limit the attractiveness of small settlements in cases where the parties believed the asymmetry of information was such that the settlement agreement might not be enforced. Specifically, a defendant would be reluctant to agree to pay a small settlement amount to the plaintiff, since after payment, the plaintiff might be able to continue the litigation if the judge rules that the plaintiff's promise to terminate litigation is unenforceable. Notice that the mechanism we propose is asymmetric; the judge may set aside a promise not to litigate, but not the payment for that promise. This is important to give the plaintiff an incentive to make a claim that the settlement is against public policy. If the judge simply sets aside the entire agreement, neither side will normally have an incentive to make such a claim, since the parties would not reach a settlement unless they thought it was better for both of them than going to trial.

78. Wickelgren, supra note 32, at 3.
79. In theory, the mechanism could be reversed: a judge could set aside the payment but enforce the promise not to litigate if the defendant brought the undesirable settlement to the judge's attention.
One key problem with this approach is that not only may judges not be able to perfectly determine which settlements undermine deterrence or risk chilling sufficiently to warrant setting them aside, but the parties themselves often may not be able to accurately predict if their settlement is likely to be enforced or not. This uncertainty could prevent settlements that neither have substantial adverse effects on deterrence nor contribute to the chilling of legitimate activities. However, the courts could develop a balancing test that takes into account the factors we discuss in this paper in determining when to overturn settlement agreements. Likewise, the courts could develop safe harbors, such as always enforcing settlement agreements in certain kinds of cases where chilling is thought not to be important, or always enforcing settlements that are for at least a certain percentage of the claim. Finally, the courts could set a high standard of proof, such as clear and convincing evidence, that a settlement is against public policy. While a high standard of proof limits the effectiveness of this system at preventing harmful settlements, it surely would be more effective at preventing these settlements than the current system, and it would create only a minimal risk of undermining desirable settlements. This approach would at least represent an incremental improvement to the problem of excessive settlement.

Another approach to discouraging settlements—and the first one that would occur to most economists—would be to tax them. While taxes are often more efficient than direct regulation, taxing settlements is probably not the best way to discourage them. The main problem is that taxes are not very flexible. For example, while the theory shows that larger settlements weaken deterrence or increase chilling less than smaller ones, what constitutes a large or small settlement will vary widely across cases. Giving judges the flexibility to set aside a settlement allows them to vary this decision in accordance with the facts of the case much more than would a standard tax.

Since under both theories, a defendant must have an informational advantage over the plaintiff to make settlements harmful, judges should view post-discovery settlements much more favorably than pre-discovery settlements. One would expect that in most cases, discovery will greatly reduce the defendant's informational advantage. If after discovery, the plaintiff has almost as much information as the defendant about the mag-

80. This would also reduce the attractiveness to the plaintiff of attempting to continue litigation after agreeing to a settlement, and it would greatly limit the legal costs that this further hearing could create.

81. See generally Louis Kaplow & Steven Shavell, On the Superiority of Corrective Taxes to Quantity Regulation, 4 AM. L. & ECON. REV. 1 (2002) for a discussion of why, in general, taxes are superior to direct regulation. Their argument does not apply in this case because unlike the case of a pollution tax, for example, the optimal tax here would depend on the benefits as well as the costs of settlement. As a result, the information requirements for a tax are no less severe than they are for direct regulation.

82. In principal, one could allow the judge to set the tax after examining the facts of the case, but this is then not fundamentally different from setting aside the settlement and having a trial that examines the facts of the case and assesses damages.

nitude of the damages or the likelihood of liability, then settlement after discovery will not have the same negative effects on incentives as settlement before discovery. Because the plaintiff can adjust his settlement offer based on what he has learned about the amount of damages or likelihood of liability, he will demand a greater settlement from a culpable defendant and will accept a smaller settlement from a blameless defendant.

When the settlement varies with the blameworthiness of a defendant’s action, sufficiently allowing settlement does not necessarily entail a dilution of deterrence or an increase in chilling. Even if the plaintiff has some uncertainty about the culpability or damages caused by the defendant, if the defendant does not have any remaining private information, the plaintiff cannot learn anything by the fact that the defendant has rejected or accepted the offer. Allowing settlement after the defendant has shared all private information will not decrease the effort of the plaintiff at trial. In practice, one might think that the defendant may have successfully hidden some incriminating evidence from discovery, yet may still have some fear that it would come out in trial. Nevertheless, one would expect the magnitude and importance of private information post-discovery to be much less than it is pre-discovery. Therefore, restrictions on pre-discovery settlements may often be sufficient (or close to sufficient) to solve the incentive problem described above. This further limits the increased legal costs necessary to improve deterrence or prevent excessive chilling of legitimate activities.

VI. CONCLUSION

This Essay has argued that settlement is not a “free lunch.” While having cases settle rather than go to trial may reduce legal costs and the burden on the courts, it often comes with the cost of reducing the accuracy of the legal system and degrading the system’s effectiveness at regulating behavior. Although we acknowledge that settlement usually involves a significant savings of resources, we argue that one must weigh the cost savings against the negative effects on both the deterrence of harmful activities and the chilling of beneficial ones. While these negative effects of settlement will not outweigh the benefits in every case, or maybe even in most cases, they will be substantial in a significant number of cases. In such instances, legal policy should not encourage settlement. We believe there are cases where settlement should be discouraged. Unfortunately it is not easy to develop hard and fast rules determining exactly when the negative incentive effects of settlement outweigh the cost savings benefits. Nevertheless, this Essay points out some general circumstances that tend to increase or decrease the desirability of settlement. We argue that judges should have discretion to discourage settlement when they believe it is likely to be harmful, but should be constrained by a combination of general guidelines, safe harbors, and a high standard of proof.