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SOME ASPECTS OF ECONOMIC ANALYSIS OF OUT-OF-COURT SETTLEMENT IN THE DISPUTE OF NEGATIVE EXPECTED VALUE – CASE OF REPUBLIC OF SERBIA

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Abstract

The main goal of a potential plaintiff who initiates a negative expected value dispute is to try to reach an agreement on an out-of-court settlement. The paper analyzes the behavior of parties in negative value disputes in the Republic of Serbia. The objective of this paper is to show economic analysis of out of court settlement; 1) in condition of symmetrical information and 2) in condition of asymmetrical information. First of all, we will present the literature regarding this topic using the historical analysis and synthesis method, after that, by using the methods of deduction and induction, descriptive, comparative and other scientific methods, on a case of Republic of Serbia we will show research problem. At the end we will give the results in conclusion.

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1. Introduction

Litigation is a less efficient means of resolving civil disputes than settlement. Namely, the settlement creates savings in litigation and opportunity costs of opposing parties, lawyers, judges and other participants in the litigation. The specificity of the legal system of the Republic of Serbia is the long duration of litigation and the reluctant acceptance of settlement as a way of resolving disputes, which leads to an increase in social costs.

Resolving disputes from a position of authority is accepted as a normal way of behaving. Also, the model of violent communication, the pattern of either-or behaviour, the unwillingness of people to accept responsibility for the resulting dispute, the inevitable "looking for the culprit", all this promotes the "litigation spirit" of citizens and their willingness to settle. (Petrušić. 2004: 42).

One of the reasons for the ineffectiveness of initiating litigation lies in the large number of pending cases from previous years, which represent a heavy burden for judges in civil cases. The number of old unsolved cases in civil matters increased from 2012 to 2016, and the growth trend of old unsolved cases was stopped in 2019. However, in 2020, there was an increase in the number of pending old cases to 27,733 (Supreme Court of Cassation, 2021: 35).

Namely, litigation in the Republic of Serbia shows a certain inflexibility, inefficiency and slowness. Article 11 of the Law on Civil Procedure of the Republic of Serbia ("Official Gazette of the RS", no. 72/2011, 49/2013 - decision US, 74/2013 - decision US, 55/2014, 87/2018 and 18/2020) proclaims the principle of peaceful settlement of disputes, by referring the parties to mediation or to the settlement of disputes by other peaceful means. Bearing in mind the ineffectiveness of litigation and the litigious mentality of the people of our country, it seems that there is a lack of stronger motivation for the application of alternative dispute resolution methods. Mediation also creates costs for the parties to the dispute, since it involves hiring a mediator (Article 20 of the Law on Mediation in Dispute Resolution, Official Gazette of RS, No. 55/2014), but these costs are lower compared to litigation costs. Peaceful settlement of disputes is proposed to the disputing parties at the preliminary hearing. This means that the parties to the dispute had to pay the costs of filing the lawsuit and the costs of responding to the lawsuit so that, after that, it was presented to them that the parties to the dispute could settle in the ways already mentioned.

Out-of-court settlement represents the most efficient method of dispute resolution since it creates minimal costs, significantly lower than mediation and litigation. However, in the Republic of Serbia, there is no separate legal act that deals

with this issue, but it is regulated by the Law on Obligations ("Official Gazette of SFRJ", no. 29/78, 39/85, 45/89 - decision of the Supreme Court of Justice and 57/89, "Official Gazette of the FRY", No. 31/93, "Official Gazette of the SCG", No. 1/2003 - Constitutional Charter and "Official Gazette of the RS", No. 18/2020), which, by Article 19, suggests to parties in an obligation relationship that they try to resolve disputes peacefully: through conciliation, mediation or in another way. An out-of-court settlement is a two-sided declaration of the will of the parties to the dispute, the conclusion of which, with minimal costs, ends the dispute. However, what creates uncertainty for the parties to the dispute is the fact that this contract has no enforceable effect, which means that, in the event of a violation of the out-of-court settlement agreement, enforcement can only be achieved in civil proceedings.

The reason for the large number of lawsuits, their long duration and the reluctant acceptance of out-of-court settlements lies in the already mentioned litigious mentality of citizens, but also in the fact that a number of lawsuits (usually with negative expected values) are initiated out of spite as an essential element of mentality; citizens of the Republic of Serbia often strive to satisfy non-economic goals in litigation.

All the previous data point to the fact that Serbian citizens prefer litigation rather than out-of-court settlement, that is, they resolve their disputes in the least efficient way. Bearing in mind the aforementioned litigation mentality, the method of distribution of litigation costs, the asymmetry of information between the parties to the dispute, the divisibility of the costs of the dispute, the initiation of litigation out of spite, it can be concluded that a number of disputes that are resolved before the court of first instance through litigation or court settlement or through an out-of-court settlement can have a negative expected value. Since such litigation brings no net benefit to the plaintiff (except in rare situations such as mistakes by judges, corrupt witnesses, etc.), the main goal of initiating such litigation is the plaintiff's attempt to extract an out-of-court settlement.

Since the economic analysis of law represents, still, an insufficiently developed scientific discipline in the Republic of Serbia, and there are no empirical data on the number of disputes or litigation of negative expected value, the main goal of the work is to determine, based on the existing literature and economic models, the conditions under which it is possible to achieve an out-of-court settlement in disputes with a negative expected value in the Republic of Serbia and to analyze the incentives for out-of-court settlement or litigation of the parties to the dispute that arise due to changes in the relevant variables of the economic model of out-of-court settlement.

The economic model of different expectations in the RS is modified by the assumption that the difference in expectations may be a consequence of information asymmetry, pessimism or the personal belief of the potential defendant about the plaintiff's litigation costs and the value of the damage suffered.

2. Literature Review

The largest number of authors dealing with the economic analysis of litigation, for many years, avoided the problems, issues and circumstances of disputes of negative expected value, focusing on settlement decisions or initiating litigations that have a net benefit. In the mid-1990s, authors began to deal with the causes and consequences of initiating such lawsuits (Bebchuk, 1996: 2). In a certain number of cases, the injured party will initiate a dispute, although the expected costs of the dispute are higher than the expected value of the dispute, to try to negotiate a settlement. The potential plaintiff is therefore aware of the high probability of defeat in the litigation but initiates the litigation. Negative expected value lawsuits are initiated by "aggressive" plaintiffs, to obtain a settlement offer from the defendant (Shavell, Kaplow, 1999: 43).

According to Spier (2007: 306), negative expected value litigation is characterized by the fact that the value of the expected verdict is low compared to the costs of initiating a lawsuit, the costs of disclosing information and other litigation costs. According to this author, the dispute of negative expected value exists in two cases: first, if the damage suffered by the injured party is significant but the probability of winning the lawsuit is low, that is, it tends to zero, and second, if the probability of winning the lawsuit of the injured party is high. but the damage suffered is small and approaches zero.

A significant factor in the initiation of disputes with a negative expected value is the asymmetry of information, that is, the potential defendant's lack of information in relation to the plaintiff. A potential defendant cannot, with certainty, determine whether the plaintiff is ready to continue this type of dispute before the court, but he can, for example, have information about the participation of plaintiffs who end negative expected value disputes with litigation, in the total number of plaintiffs. The higher this participation, the higher the probability of such litigation, but also the probability of reaching an out-of-court settlement. In other words, the actors "ride on the tail" of those prosecutors who are ready to bring the litigation into the stage of presentation of evidence (Shavell, 2004 : 420).

According to Miceli (2017: 292), these are pointless lawsuits, since there is a very low probability of a potential plaintiff winning a lawsuit. Namely, if the

potential plaintiff is rational, then the only value of the potential plaintiff's "victory" is to try to achieve an out-of-court settlement, because starting a lawsuit would be, from an economic point of view, completely pointless.

Delvin (2015: 223–225) believes that the "loser pays all" rule for the distribution of litigation costs discourages negative value lawsuits and increases the likelihood of initiating meritorious disputes. However, it should be borne in mind that every dispute with a negative expected value is not a frivolous suit (a dispute characterized by a low probability of a potential plaintiff winning a lawsuit). According to Hughes and Snyder (1995: 230), the "loser pays all" rule will deter a number of plaintiffs from initiating meritorious litigation that has a negative expected value conditioned by low litigation value and high litigation costs and if the probability of success in litigation is high; in the event of a lawsuit being lost (and if the probability of defeat is low), the potential plaintiff would have to bear the litigation costs of both parties. As a result, a number of cases that would have a positive expected value by applying the rule "each party pays their own" become disputes of negative value, when applying the rule "he who loses pays all".

According to Bebchuk and Chang (1996: 377-379), if a potential plaintiff can predict the value of the verdict, under the "loser pays all" rule, he will not initiate disputes of negative expected value, because he is aware that, in litigation, he would have to pay the total litigation costs. However, if there is uncertainty about the likelihood of the plaintiff winning or the assessment of the value of the dispute, a few such disputes will end up in court.

Loos (2005: 36) agrees with the fact that the application of the "loser pays all" rule shows superiority in deterring negative expected value litigation, compared to the "each party pays its own" rule. However, this finding applies in the case of neutrality at the risk of the parties to the dispute. The results change if we introduce the assumption that the plaintiff is risk averse. According to this author, the problem is not deterring such lawsuits, because a plaintiff who fears losing a lawsuit will, in case of risk aversion, be even more motivated not to take risks, since, in case of defeat, he has to pay the total litigation costs. The problem is that risk aversion can discourage plaintiffs from suing even in positive expected value disputes, because of the risk of paying the total litigation costs.

Bebchuk and Klement (2009: 2) established a set of assumptions under which a potential plaintiff will never be able to settle in a negative expected value dispute:

- Absence of information asymmetry.
- The plaintiff's litigation costs are indivisible.

• The defendant does not pay any costs in advance before the plaintiff.

• The plaintiff does not have a specific contract with the lawyer.

• The defendant does not have the reputation to continue with the litigation if no settlement is reached.

• The expected value of the judgment remains below the expected litigation costs throughout the duration of the litigation.

Violation of any of the mentioned assumptions opens the possibility of an out-of-court settlement in case of disputes with a negative expected value.

Rhee, J.R (2006: 632) considers that out-of-court settlement is functionally dependent on transaction (litigation) costs. High transaction costs in relation to the expected value of the dispute create conditions for settlement. An extreme case is reaching a settlement in disputes with a negative expected value. Also, small changes in the assessment of the probability of success in the litigation of the opposing parties can lead to a change in the incentives of the disputing parties in favor of settlement or litigation.

Cooter, Rubinfeld (1989: 1076), based on their model of economic analysis of the dispute, concluded that the scope for settlement increases with the increase in litigation costs, the decrease in the transaction costs of the settlement and the increase in the pessimism of the parties to the dispute. Also, the risk aversion of the litigants increases the value of the cooperative surplus, increasing the difference between the subjective values of the gain of the potential plaintiff and the loss of the potential defendant in the litigation.

Cross (2000: 19) believes that plaintiffs are, in general, economically rational beings, but that there are certain psychological and emotional factors in which they become irrational, i.e., they strive to achieve other goals in disputes of negative expected value, so they start litigation sacrificing economic interest. In that case, the plaintiff's goal is not to agree on a settlement, but to satisfy non-economic goals.

3. Economic analysis of out-of-court settlement in the dispute of negative expected value under conditions of symmetrical information in the Republic of Serbia

The possibility of a potential plaintiff to negotiate an out-of-court settlement in a negative expected value dispute in the Republic of Serbia is strongly influenced by several relevant factors, among which stand out: the rule for calculating litigation costs "he who loses, pays all" (Republic of Serbia), versus the rule "each party pays his own", subjective probabilities of success of the plaintiff and the defendant in the litigation, asymmetry of information about the essential elements of the dispute,

divisibility of the costs of the dispute, psychological and emotional factors, legal solutions and others. A rational potential plaintiff initiates a negative expected value dispute to try to extract a settlement, and if no settlement agreement is reached, he stops the dispute. Nevertheless, in certain situations, a few disputes with a negative expected value may end up in the courts of first instance.

The theory of economic analysis of litigation has given rise to many models that help to understand the mechanisms of action of the aforementioned factors on the behaviour of the parties to the dispute. Changes in the determinants of a dispute create negative expected value incentives for disputing parties to change their behaviour in terms of dispute resolution.

As one of the main motives of the plaintiff in negative expected value disputes is to try to agree on a settlement, a reasonable question can be raised as to whether a settlement is possible if the parties in the dispute have symmetrical information about all the essential elements of the dispute. The answer to this question can be given by the model of symmetric information (see Rosenberg, Shavell (1985), Cooter, Ulen, (2016: 430)). The initial assumptions of the model are as follows:

• Both sides in the dispute agree on the subjective probability of the plaintiff's victory in the lawsuit of negative value, so that the condition applies: Op = Od = 0, where: Op - the subjective probability of the plaintiff's victory in the lawsuit, and Od - the subjective probability of the plaintiff's victory in the lawsuit from the aspect the defendant;

• Both parties to the dispute agree on the expected value of the judgment – P;

• The parties to the dispute have different litigation costs (Fp ≠ Fd), so the condition applies that the defendant's litigation costs (Fd) are significantly higher than the plaintiff's litigation costs (Fp);

• Settlement negotiation costs (t) are equal to 0;

• The parties to the dispute are risk neutral.

The decisions of the parties to the dispute can be analyzed using the following example: The injured party did not use the sneakers according to the manufacturer's instructions, so they became unusable after a few days of use. The store rejected the complaint as unfounded. The question arises whether a rational potential plaintiff will try to initiate a consumer dispute, that is, to seek protection in court. Let the plaintiff's total litigation costs be Fp = 8000, and the defendant's total litigation costs Fd = 16000 (the assumption is that the seller is obliged to perform expensive tests, in order to confirm for sure that the shoes were not used according to the instructions, regardless of the outcome of the possible litigation). The cost of negotiating a

settlement is zero. The parties to the dispute agree on the probability of the plaintiff's victory so that the condition Op = Od = 0 holds and on the expected value of the verdict P (the price of the sneakers 7,000), so that the expected value of the verdict OpP = 0.

In the Republic of Serbia, the calculation of litigation costs is carried out according to the rule "he who loses pays everything". Now it can be analyzed what the incentives for settlement or litigation are of negative expected value, when the existing rule is applied, under conditions of disproportion in the amount of litigation costs of the disputing parties.

Using the initial assumptions of the example, the net litigation loss for the plaintiff can be calculated:

OpP - (1-Op) (Fp + Fd) = 0 – 1(8000 + 16000) = - 24000 (1),

while, under the given conditions of the model, the litigation does not create losses for the defendant, i.e.:

From (P + Fp + Fd) = 0 (2).

Condition (2) is valid for every value of Fp and Fd, which means that the disproportion in the amount of litigation costs of the parties to the dispute, under the rule "he who loses pays everything", does not create incentives for litigation or settlement. Namely, on the basis of conditions (1) and (2), under the given conditions of the model in the Republic of Serbia, it can be concluded that the rule "the loser pays all" will never create a cooperative surplus, so none of the parties to the dispute will be motivated to negotiate about the settlement. However, not only that, under the given conditions of the model, a rational potential plaintiff in the Republic of Serbia will never initiate a lawsuit of negative expected value, since, with probability 1, the potential defendant transfers all litigation costs to the potential plaintiff. The plaintiff's threat of litigation, in this case, is never credible.

However, if the rule for the distribution of litigation costs "each party pays its own" was applied in the Republic of Serbia, the incentives of the "injured" in connection with the negative expected value dispute would change, under the given conditions of the model. Namely, a potential plaintiff in a negative expected value dispute could settle if the defendant would not be able to pay its own litigation costs (the costs of responding to the lawsuit or the costs of expert testimony are, for example, high). The disproportion in the amount of litigation costs (Fd significantly higher compared to Fp) would create conditions for an out-of-court settlement, since litigation would create significantly greater losses for the defendant than a settlement. However, a necessary condition for an out-

of-court settlement is the credibility of the plaintiff's threat of litigation. If the defendant's cumulative litigation costs significantly exceed the plaintiff's cumulative litigation costs, the plaintiff can credibly threaten litigation, and thereby effect an out-of-court settlement. A credible threat of litigation, in this case, would imply that the plaintiff is willing to pay his litigation costs and initiate litigation with a negative expected value (see: Bebchuk, 1988 and Bebchuk, 1996).

From the plaintiff's point of view, the net loss from litigation, in this example, would be:

$OpJ - Fp = 0 - 8000 = -8000$ (3),

and from the aspect of the defendant:

$OdJ + Fd = 0 - 16000 = -16000$ (4).

Since initiating a negative expected value lawsuit would create a significantly greater loss for the defendant compared to the plaintiff, and since the costs of negotiating a settlement are zero, a rational potential defendant would be motivated to accept an out-of-court settlement, as this would minimize his losses. A potential rational plaintiff, aware of the fact that this is a negative expected value dispute, would accept the settlement since the litigation would create a loss for him.

Namely, in this model, the dispute would be ended by an out-of-court settlement, because such a solution would create a cooperative surplus (Cooter, Rubinfeld, 1989: 1075) which would be equal to savings in litigation costs ($CS = 8000 + 16000 = 24000$). if both parties in the dispute have equal bargaining power, a potential plaintiff would be willing to settle for any value equal to or greater than the sum of his threatened value with litigation (-8000) and half the value of the cooperative surplus, that is:

$N = -8000 + ½(8000+16000) = 4000$ (5).

At the same time, a rational potential defendant would offer the same amount, a value that would satisfy the potential plaintiff, minimizing his losses in a negative expected value dispute, since he would pay less than the amount he would pay in litigation.

However, an out-of-court settlement would only be agreed upon if the potential defendant judged the plaintiff's threat of litigation to be credible, that is, if the potential plaintiff paid the filing fee. Croson and Mnookin (1996) start from the assumption that part of the plaintiff's litigation costs, which are considered sunk costs, is predetermined. If the remainder of the litigation costs is less than the expected value of the verdict, the plaintiff credibly threatens litigation and, in this

way, creates the conditions for an out-of-court settlement.

The main disadvantage of the previous model is that it starts from symmetric information. The reality is that the parties to the dispute may have completely different beliefs about the value of the actual damage, as well as about the probability of victory and defeat in the eventual litigation. Also, negotiating a settlement can have its own costs (although negotiation costs are significantly lower than litigation costs, which would only lead to a reduction, but not to the disappearance of the cooperative surplus, under the rule "each party pays its own"). Likewise, the parties to the dispute are usually unequally informed about all the essential elements of the dispute, so they make decisions under conditions of information asymmetry. However, the previous model pointed to two very important facts:

1. The rule for calculating litigation costs in the Republic of Serbia "he who loses pays everything", under conditions of symmetrical information, under the given conditions of the model, favours the potential defendant, which represents the optimal solution, since the damage caused was not caused by the person who treats the injured person as a pest;
2. The application of the rule for the distribution of litigation costs "each party pays its own, in this model, creates incentives for settlement in disputes of negative value, with a disproportion in the amount of litigation costs ($Fp < Fd$) and leads to a redistribution of wealth in favour of the potential plaintiff.

4. Economic analysis of the dispute of negative expected value in the model of different expectations in the Republic of Serbia

The assumptions of the symmetric information model can be relaxed to allow disputing parties to have different perceptions of the outcome of the dispute, which is certainly more in line with reality. Based on the model of different beliefs (see: Landes (1971), Posner (1973), Gould (1973)) it is possible to analyze the incentives for out-of-court settlement or litigation in the Republic of Serbia.

The assumptions of the model are as follows:

- •Disputing parties have different perceptions of winning and losing in litigation ($Op \neq Od$)
- •Litigation costs of the parties to the dispute may be different ($Fp \neq Fd$)
- •The cost of negotiating a settlement (t) is equal to 0.
- •Both parties to the dispute are risk neutral.
- •Parties to the dispute do not hire lawyers (the calculation of the costs of legal services can change the incentives to start litigation with a negative expected value,

independent of the rules for calculating litigation costs).

Regarding the rule of distribution of litigation costs in the Republic of Serbia, the condition for initiating litigation can be presented as follows:

$OpP - (1-Op)(Fp + Fd) > 0$, that is: (6),

$OpP > (1-Op)(Fp + Fd)$ (7).

According to the rule for the distribution of litigation costs "each party pays its own", the condition for initiating litigation is as follows:

$OpP - Fp > 0$, that is: (8),

$OpP > Fp$ (9).

Therefore, a rational plaintiff initiates litigation only if it creates a net benefit for him, regardless of the rules for calculating litigation costs.

By analyzing condition (7) and condition (9), the condition under which the rule "each side pays its own" creates a higher net benefit from litigation compared to the rule "he who loses pays all" can be derived by manipulating their inequalities: (according to: Delvin, 2015: 224):

$Fp < (1-Op)(Fp + Fd)$ (10).

By arranging the expression (10), one can derive the probability of a plaintiff's victory in which the application of the "each party pays his own" rule creates greater incentives for the plaintiff to litigate compared to the "loser pays all" rule:

$Op < Fd / (Fp + Fd)$ (11).

The inequality from condition (10), under the assumption that litigation costs remain constant, show that the lower the probability of winning a lawsuit, the higher the probability that the inequality from condition (10) will be satisfied, i.e. that the plaintiff will start a lawsuit under the rule "each party pays his own", in relation to the rule "he who loses pays all".

If it is assumed that the negative expected value dispute is a consequence of the low probability of the plaintiff's victory in the lawsuit, then it is clear that at lower probabilities of the plaintiff's victory than the critical value Op* (where: $Op^* = Fd / (Fp + Fd)$), the rule "each party pays its own" motivates the initiation of litigation of negative expected value to a greater extent compared to the rule in the Republic of Serbia "he who loses pays all". This is a consequence of the fact that, the lower the subjective probability of the plaintiff's victory in the lawsuit is than the probability Op*, the higher the probability (1-Op) is that, according to the rule for calculating litigation costs in the Republic of Serbia, the plaintiff will have to pay both his costs and the litigation costs of the defendant. From the previous findings, a logical conclusion can be drawn that the application of the rule "who loses pays everything"

in the Republic of Serbia demotivates the initiation of litigation of negative expected value to a greater extent compared to the application of the rule "each party pays its own", if the negative value of the dispute is conditioned by a low subjective by the probability of the plaintiff's victory in the lawsuit.

With regard to the above, in order to deter potential plaintiffs from initiating such lawsuits, the American legal system, for example, introduced Federal Rule of Civil Procedure 11, which provides for sanctions for both litigants and attorneys if the lawsuit lacks sufficient legal basis, is not based on real facts or is submitted for improper purposes. According to Ward (1991, 1206), and if deterrence is the primary goal of the mentioned Rule, its real goal is to avoid costs, especially considering that the application of the rule itself produces additional costs, so litigation studies should analyze each case with special attention, in order to minimize social costs.

Analyzing expression (7), another important conclusion can be drawn: a number of meritorious disputes (high probability of victory Op) will not be ended by litigation in the Republic of Serbia, if the value of the verdict (damage) P tends to zero, with high litigation costs (Fp + Fd), that is, it will have a negative expected value. In that case, a rational potential plaintiff will not seek protection in court, unless, given the expected costs (Fp + Fd), the threshold of the expected verdict (P), the probability of victory (Op), or both values at the same time, increases, as potential litigation would lead to the creation of a net benefit for the injured party.

5. Final considerations

1. Litigation is the dominant way of resolving disputes in the Republic of Serbia. A number of initiated lawsuits are lawsuits with a negative expected value. The primary motive for initiating negative value litigation is the potential plaintiff's attempt to extract an out-of-court settlement. If the potential defendant is less well-informed than the potential plaintiff, the threat of litigation can become credible, when the room for a settlement opens.

2. In the model of completely symmetrical information about all the essential elements of the dispute, with a disproportion of litigation costs in favor of the potential defendant, an agreement on an out-of-court settlement will never be reached in the Republic of Serbia. The threat of litigation can never become credible, since the "loser pays all" rule for the distribution of litigation costs applies. If the "each party pays their own" rule is applied, the disparity in costs, in this model, can lead to an out-of-court settlement when there is a redistribution of wealth in favor of the potential plaintiff.

3. In the model of different expectations, assuming that the negative value

dispute is a consequence of the low probability of the plaintiff winning the lawsuit, at lower probabilities of the plaintiff winning the lawsuit than the critical value Op* (where: Op* = Fd / (Fp + Fd)), the number of initiated pointless litigation is lower in the Republic of Serbia than in countries that apply the rule for the distribution of litigation costs "each party pays its own". The lower the probability of winning, the higher the probability that the plaintiff will have to reimburse the opposing party's litigation costs.

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