Introduction

It seems self-evident that the potential for settlement of a case can be enhanced when the parties can agree on the range of “reasonable value” that the case presents. However, the concept of “reasonable value,” as an expression of a case’s worth, involves two different and potentially divergent components - “reasonableness” and “value” - and achieving agreement on both components, let alone one, can present a significant challenge, especially in complex or highly emotional cases.

“Decision analysis” is a neutral valuation method that applies basic mathematical calculations of risk to a litigated case’s various claims and at the various stages of decision-making in the litigation process. Such analysis produces a “risk-assessed value” that can then be used by a party as a component in their overall settlement assessment without locking in actual value or dictating settlement outcome.

“Reasonableness” Versus “Value”

The difference between “reasonableness” and “value” is significant. In law and philosophy, the idea of “reasonableness” has found “objective” expression in abstract concepts, such as the legal construct of a “reasonable person” standard and the philosophical construct of “right reason.” However, what any individual party perceives to be reasonable, and how that perception will impact decision-making, is highly subjective and differs with the circumstances and each party’s point of view.

In addition, when a party’s position is at odds with an opponent’s position, the likelihood of resistance to any input that is subjectively perceived as running counter to self-interest increases. Trying to convince that party that their position is the “unreasonable” one can be difficult, if not impossible. Adverse parties can be expected to rationalize and to marshal facts to support their respective positions. In fact, during heated settlement negotiations even an otherwise reasonable party might resist accepting even objectively verifiable facts and law if they are perceived as favoring the opposing party’s position.

“Value,” on the other hand, while certainly not entirely objective, is capable of being rendered less subjective than the vaguer and more elusive notion of reasonableness. This is in large part due to the fact that, unlike overall “reasonableness,” the ultimate “value” of a claim and its opposing defenses in the litigation setting is usually expressed in monetary terms, which is at least capable of being quantified. And once a realistic monetary range is assessed, however broad it may
be, the variation in what can be justified as being a “reasonable value” can be correspondingly narrowed.

It is for this reason that it usually best serves the ultimate interests of the parties in mediation to focus on assessing the actual risk-based value of claims and defenses, as opposed to the “reasonableness” of the parties’ respective positions. This is not to say that the merits of the parties’ claims and defenses, and how the parties perceive them, are insignificant or unimportant, but rather that expressing a relatively objective valuation of the claims and defenses in monetary terms more efficiently advances the mediating parties’ stated goal of trying to achieve settlement.

The timing of case valuation is also important as it is rarely the first thing that can be addressed in mediation. Parties often have “below the line” subjective non-monetary interests that may be influencing their decision-making. Examples on the plaintiff side might include anger, the need to feel appreciated or vindicated, a desire for “their day in court,” or for revenge. On the defense side, there can be multiple other competing interests at play, including such things as the impact of adverse publicity, issues of proportionality or contribution, a desire to avoid setting a bad precedent. The presence of unresolved non-monetary interests can stand in the way of acceptance of case valuation and settlement.

As a general rule, these interests, if operative, must be recognized, acknowledged and diffused in the mediation process before monetary negotiations become truly productive. Assuming that has been accomplished, the reining in of “below the line interests” can be more readily accomplished through what is called “interest-based” or “integrative” negotiation in order to help close a deal. For instance, addressing and valuing such non-monetary interests as the intangible worth of achieving closure, the worth of eliminating the risk of leaving a deal on the table, and the worth of avoiding the ultimate consequences of an adverse result, both economic and non-economic.

What Does “Value” Actually Mean?

The dictionary definition of “value” typically includes the following: (1) relative worth, merit or importance; (2) monetary or material worth, as in commerce or trade; (3) worth in terms of the amount of other things for which it can be exchanged; (4) equivalent worth or return in money; (5) estimated or assigned worth - valuation. See e.g., Webster’s Unabridged Dictionary 2nd Ed. (Random House 2001)

Opening demands and offers in litigation are usually expressed as a lump sum of money that represents the parties’ respective opening positions on the alleged worth or value of the case as a whole. As such, demands and offer manifest preliminary subjective negotiating positions, not objective final assessments of the actual value of a contested case. As studies have shown, litigated cases are settled more than 92% of the time, and results achieved at the trial of a case infrequently validate the settlement positions of both sides. Therefore, in the absence of settlement, one of the party’s case valuations is usually proved to be mistaken due to miscalculation of risk and/or value.
An opening settlement offer may not be communicated in response to an opening demand until negotiations actually start in earnest, such as at the beginning of a mediation session. For instance, a plaintiff may communicate an opening demand of $1,500,000 prior to a mediation, which the defense characterizes as being “absurd,” which draws an opening counter-offer of $45,000 in mediation, which the plaintiff protests is “insulting.” Protestations aside, such an exchange serves to establish the beginning (in the form of an obviously wide chasm between alleged case values) that sets the stage for the “competitive negotiation” or “distributive bargaining” that ultimately produces a settlement.

Opening lump sum demands and offers may or may not be broken down into the “component value” of the various claims that make up a complex case, and typically do not completely acknowledge the potential effect that the hurdles presented by each stage of the litigation process may have on “cumulative value.” One side or the other, or both, may be essentially in the dark at the commencement of negotiations about how the other party came up with their initial ascription of “case value.”

**Putting Decision Analysis To Practical Use**

Calculating various estimated risk-assessed values does not establish the actual value of a case, nor does it necessarily dictate or predict results. As an illustration of the wide-ranging possibilities for application of decision analysis, consider the fact that there is a World Rock, Paper, Scissors Society that conducts the World Rock, Paper Scissors Championships - really! The game participants simultaneously show either “rock” (a closed fist), “paper” (an open fist) or “scissors” (two split fingers). A rock “breaks” a scissor; a scissor “cuts” paper and paper “covers” rock. Afficionados have determined, essentially through application of detailed decision analysis as an aid to understanding predictive behavior, that the opening “throw” that produces the most consistent game success is “paper.” This is contrary to the tendency of most inexperienced people to start the game by throwing “rock,” thinking it is “stronger.” This decision analysis has given rise within the ranks of experienced players to the derisive slight, “rock is for rookies!” Who knew? Studies have also determined that people playing the game have a strong tendency not to throw the same thing three times in a row, and another tendency to repeat their opponent’s last move. msnbc.com, *Science Shows You How to Win at “Rock, Paper, Scissors”* (August 2011).

Another non-litigation application of decision analysis that more usefully illustrates decision analysis is playing poker, at least the way professionals approach that card game. The combination of cards that can be dealt to a player (and the table if it’s a “hold-em” or “stud” game) varies widely and unpredictably from hand to hand. However, every possible combination of cards carries with it a well-studied and predictable chance or probability of ultimate success. In addition, every hand of poker includes both component parts (the cards and their combinations) and cumulative risk (the
effect on risk assessment presented by each new card dealt during a hand. The value of the hand is set by, and varies with, the betting, which is directly affected by each player’s individual, and changing, assessment of risk.

One of the things that separates professional poker players from amateurs is the fact that professional card players study the chances of success for every possible combination of cards and every progression of cards dealt, and commit the risk assessments (both the initial and the progressively changing percentage chances of success) to memory. They can thus bring to bear on the game, and any combination of cards dealt throughout the progression of a hand, a more refined level of objective and rational assessment of possible outcomes and value.

However, no matter how accurate a poker player’s risk assessment is, even if completely accurate, it does not dictate or predict the actual outcome. It only informs the decision-making, including the betting and the strategic positions taken by the card player. In addition to pure risk assessment, there are numerous other variables that can come into play, such as bluffing, the quality of the opponent, “tells and reads” (discerning an opponent’s predictable pattern of play through close observation), irrational or over-exuberant plays, fatigue, loss of concentration, the size of the opponents “stack” (amount of money available to bet), etc.

Likewise, applying decision analysis to a complex case in the course of litigation does not predict or dictate the actual result of motions, trials or appeals, the demands or offers, or the outcome of negotiations. There are many other variables that may come into play, not the least of which is that parties often disagree about, and therefore embrace, different ideal values and different assessments of the chance of success or failure in court on each component claim, at each different stage, and on the case as a whole. Variations in the percentage chance of success or failure ascribed to any component claim or any stage in a complex case can dramatically affect the resulting overall value assessment calculation. There is also the matter of subjectively evaluating such factors as the opponent party, opposing counsel, the judge (especially in federal court) and the potential jury pool (which varies from venue to venue and case to case).

Nevertheless, if applied rationally and objectively at the right time, decision analysis can serve to reasonably inform assessments of value and the strategies to be adopted in the negotiation. It can also serve to inform an unreasonable or unrealistic party about whether their position is or is not supported by a relatively objective estimate. For instance, the simple notion that if there is a 50% chance of success at each stage (summary judgment, trial and appeal) the value of the case is half of the ideal value may be inaccurate. As demonstrated above, while that result, or something even better, might indeed be the ultimate outcome on any given day, that conclusion runs contrary to the known effect that confronting cumulative risks has on value.

In the final analysis, reasonable settlement value in litigation is ultimately the expression of a mutual agreement between opposing parties that is similar to the mutual win-win agreements reached by willing buyers and sellers in a freely competitive marketplace about the value of goods and services. Actual “market value” is realized at the intersection of the parties’ respective value
assessments (expressed in terms of price or cost). Understanding and applying objective risk-assessed value as part of settlement negotiations can increase the likelihood that a mutually agreed settlement, like a marketplace purchase, can be accepted by the settling parties as a win-win result.

**Component And Cumulative Effects Of Risk On Value**

When a case involves multiple claims, or multiple and varying burdens of proof, complete valuation requires application of a multi-variate analysis. Each claim may have a different amount of damages being claimed, a different set of defenses and a different chance of success. Correspondingly, each defense to each claim may also have varying chances of success. Likewise, each claim and defense may face a risk of being sustained or eliminated by a court when ruling on a motion before reaching trial, followed by a risk of being accepted or defeated at trial, which in turn may lead to the potential risk of being affirmed or overruled on appeal. The chance of successfully overcoming the risk presented by each stage of litigation varies because the nature of each decision to be made, the burden of producing evidence and the standard of review (decision-making) varies; for instance, a better than average chance of surviving summary judgment due to the presence of one or more issues of disputed material fact does not guarantee the same chance of obtaining a favorable verdict at trial before a jury charged with weighing and deciding the ultimate facts.

In order to realistically assess an overall value in the multiple claim case, consideration should also be given not only to the value of each component claim, but to the cumulative effect that risk has at each stage of the litigation process on each component claim. A realistic assessment of the value of the case as a whole reflects the ideally assumed value that would exist in absence of any valid defenses or other risks reduced by the impact that cumulative risk has on each component claim and defense at each stage of the litigation. Depending on the case, the resulting value assessment can range anywhere from a positive amount (albeit one usually below the ideal value) to a negative amount (one that can include loss of incurred expenses and payment of defense costs).

As an illustration of this point, consider a California law-based disability insurance bad faith case. The plaintiff is insured under a disability insurance policy that provides for payment of monthly benefits in the event the insured becomes disabled from working. The insurer has denied benefits and the plaintiff sues for breach of contract in an attempt to recover the unpaid benefits. In addition, the plaintiff asserts a claim for insurance bad faith, alleging unreasonable claim handling, and seeks to recover tort damages for emotional distress, attorney fees and expenses and punitive damages.

This type of case presents three different damage claims (contract damages, compensatory tort damages and punitive tort damages), each with different elements of proof and measures of damage, and also two different burdens of proof - preponderance of the evidence for the first two claims and the more demanding clear and convincing evidence requirement for the third. In addition, the punitive damage claim must pass muster under the exacting requirements of Civil Code §3294. Further, the viability of the compensatory tort and punitive damage claims is typically dependent on preliminarily establishing the right to recover the contract damages.
Such cases often involve potentially dispositive motions on such issues as key insurance policy term interpretation, the existence or non-existence of disability, the presence or absence of bad faith and whether or not punitive damages should be eliminated from the case as a matter of law. In order to realistically evaluate such a case, each component of the case lends itself to, and indeed requires, a separate valuation.

**Applying Decision Analysis In Order To Estimate Risked-based Value**

Risk and its potential cumulative effect on valuation can be illustrated by the simple example of flipping a two-sided coin. As an example, a new one dollar coin would be worth a dollar, its face value, to someone if it was given them. However, if getting it depends on predicting what side will come up when the coin is flipped - heads or tails - what is the actual “risk-assessed value” of the $1 coin? It is essentially the equivalent value or worth of the coin after accounting for the fact that one must encounter a risk that could render the coin worthless to that person. The answer is 50 cents because the mathematical chance of a flipped coin coming up heads, as opposed to tails, on a single flip is 50%. It is either going to land heads-up, in which case the person has a dollar, or tails-up, in which case the person ends up with zero; it is one or the other. This is not to say that the person encountering the risk will always come up with nothing, but rather that the coin will likely end up having no value to the person at least half the time.

What about the risk-assessed value of the coin if getting it depends on calling heads correctly twice in a row? It goes down to 25 cents because the effect of risk on multiple potential outcomes is cumulative - the 50% chance on the second flip is the same as the 50% chance on the first flip, so it has to be multiplied to accurately reflect taking the same risk two consecutive times. Therefore, the chance of getting the coin is now 50% x 50%, or .50 x .50, which is .25, or only a 25% chance that heads will come up twice in a row.

And the chance of heads coming up three flips in a row is correspondingly .50 x .50 x .50, or 12.5%. The risk-assessed value of the $1 coin when one wants it, but does not have it, and getting it depends on multiple flips coming up heads three times in a row, is 12 ½ cents. Even though the face value of the coin always remains $1, and there is a real chance the person may ultimately get that $1, a full value cannot be ascribed to the coin when having to overcome risk stands between the desire to have the coin and actually obtaining it. In the case of three flips in a row, one is likely to obtain the desired result only one out of every eight chances. Thus, the effect of risk multiplies as more risks are encountered, which correspondingly accelerates the reduction of risk-assessed value.

A simple outline of litigation risks would include having to survive any initial challenges to the pleading, surviving any dispositive motions, prevailing at trial and then prevailing on any appeal. Multiple claims joined in the complaint become sub-parts which may reflect different elements, burdens of proof and types and amounts of damages. The component claims either flow along in the process or they drop off depending on the outcome of litigation events. In applying decision analysis, a risk factor or percentage is assigned to each claim and to each event or stage in the process. If a party’s claims must confront summary judgment, then trial if the claims survive the motion, and then
an appeal, the process involves multiple risks and the cumulative mathematical effect of risk.

In our disability insurance bad faith case example, the risk of success or failure for each claim and element of damages, as well as each stage of litigation, will usually vary on account of the different claim elements and increasing burdens of proof. For instance, in purely general terms, the chance of prevailing on a breach of contract claim is thought in the abstract to be better than prevailing on a bad faith claim, which in turn is thought to be better than obtaining punitive damages. Therefore, the decision analysis involves multiple cumulative risk analysis, which can be refined by assigning varied percentage chances of success to each different element of potential recovery - compensatory contract damages, compensatory tort damages and punitive damages.

Just as with the cumulative effect of confronting multiple risks in the coin flip example, so with litigation, having to confront multiple risks as litigation progresses can cause a potentially significant reduction in the estimate of case value, the product being a risk-assessed value.

An estimated risk-assessed value will still remain positive even though the chance of prevailing is substantially less than 100%. However, the converse of each risk expressed as a percentage chance of success carries with it a corresponding chance of failure, in which case the defendant prevails and the resulting amount is predictably less than zero - plaintiff’s costs expended in pursuit of the claims would not be recovered, and as the losing party-plaintiff would become liable for at least the defendant’s allowable costs, if not more depending on the case.

Every case is different and must be considered on its individual merits and shortcomings. If, by example, a plaintiff estimates that their chance of defeating summary judgment is 50% that does not mean that the prospects at trial for all claims and damages going forward is the same. Prevailing on summary judgment might make the recovery of contract damages more likely, but not necessarily compensatory tort damages, and the recovery of punitive damages remains, from an historical perspective, statistically unlikely. Even if there is a relatively high likelihood of prevailing on appeal after trial, a favorable percentage of risk will continue to have a dampening effect on estimated value given the nature and effect of cumulative risk. For instance, predicting only a 50% chance of prevailing on summary judgment followed by a 70% chance of winning at trial produces only an overall cumulative chance of success of 35% (.50 x .70 = .35 or 35%). In this simple illustration, even an assumed 90% probability of prevailing on appeal reduces the predicted 35% chance to 31.5% overall (.35 x .90 = .315).

Decision analysis allows for developing multiple risk-assessed value scenarios by changing the risk values ascribable to the various claims and to the various stages of litigation in order to reflect and test different points of view, assumptions and corresponding value outcomes.

Conclusion

Decision analysis can be a useful tool for demonstrating a reasonable risk-assessed value in furtherance of achieving settlement. It is a method that can refine the value assessment process, and
can be revelatory in the right circumstances.

Applying decision analysis-based risk assessment is a neutral mathematical exercise that does not inherently favor one party or the other, or their respective positions. Likewise, it does not predict or dictate the outcome of actual events or the negotiations. There are many other important variables that come into play in the negotiation process.

Nevertheless, if applied rationally and objectively, decision analysis can serve to reasonably inform the assessment of value and the strategies adopted in the negotiation.¹

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¹ For additional information about valuation and decision-making techniques utilized in the mediation setting, see e.g., Golann et al., Mediating Legal Disputes: Effective Strategies for Neutrals and Advocates, Ch. 8, Decision Analysis, at pp. 162-177 (American Bar Association 2009), which provided some of the ideas expressed in this article.