

Settlements v. Judgements: A Prospect Theory Analysis

Acuerdos versus sentencias: Un análisis de la teoría prospectiva

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ABSTRACT: When the Rational Choice model reveals itself insufficient to explain why parties in judicialized Labor disputes in the Provincia de Buenos Aires prefer to settle over waiting for a final decision, the Prospect Theory provides a sound explanation: as Labor Law and Procedural Rules become applicable, they produce a visible cost-shift to the employer, so parties expect judges to decide in favor of the workers. In this scenario, the employer's perception of what is to be considered a cost and a benefit become altered, incentivizing her risk-aversion and leading her to bargain settlements that she wouldn't even consider otherwise.

KEYWORDS: Labor Law; Labor Procedure; Settlements and Decisions; Prospect Theory; Cost-Benefit Analysis.

RESUMEN: Cuando el modelo de Decisión Racional resulta insuficiente para explicar por qué las partes de un conflicto laboral judicializado en la Provincia de Buenos Aires prefieren acordar antes que esperar una decisión judicial, la Prospect Theory nos brinda una buena explicación: cuando las leyes

laborales y las normas procesales laborales resultan aplicables, se produce una traslación de costos hacia el empleador, por lo cual las partes esperan que los jueces resuelvan favoreciendo a los trabajadores. En este escenario, la percepción del empleador acerca de qué debe considerar como costo y como beneficio se ve alterada, incentivando su aversión al riesgo y llevándolo a negociar acuerdos que, de otro modo, no hubiera considerado.

PALABRAS CLAVE: Derecho del Trabajo; Derecho Procesal del Trabajo; Acuerdos y Sentencias; Prospect Theory; Análisis Costo-Beneficio.

JEL CODE: J23, J81.

INTRODUCTION

In 2014, the Suprema Corte de Justicia de la Provincia de Buenos Aires' decided to propose a change in Labor Procedural Rules. Their decision was based solely on the Justices' perception of a problem: parties decide to settle their disputes 80% of the time. As they expressed, their concern was that a decision such as that could only have the explanation that Labor judges are lazy.

The Justices assumed that those who go to Court to end their conflict do so because they couldn't settle it before. For this reason, it troubled them that, once the courts intervened, both parties preferred a settlement, which seemed irrational in their view. For this, it was self-evident that the courts' intervention was the cause for this sudden change in parties' revealed preferences before filing the lawsuit. For this reason, Suprema Corte's argument seemed irrefutable: the intervention of the Judiciary caused the preferences' change.

First, we compared the most laborious courts' statistical data - in this case, those that issue more judgments than others - with the average. Not shockingly, the *workaholic* courts kept a very similar proportion of a 75% preference for a settlement. If the Supreme Court hypothesis was any helpful at all, it could only explain some odd marginal cases but not the sheer preference. There was another explanation.

Both parties of the employment relationship know, at least superficially, their fundamental rights, duties, and obligations arising from its celebration, its execution, and its termination. Although that knowledge may be imperfect, both employer and employee are somehow aware of what they can expect from labor legislation. Thus, with well-defined property rights and low transaction costs, both parties can bargain a solution that would lead to the most efficient resource allocation¹ when a conflict strikes. But when bargaining is impossible or unproductive, the Labor courts' intervention introduces two new variables: litigation costs' particular distributive scheme, and a fair deal of uncertainty about how the judges will decide.

As we will show, this distributive pattern transfers litigation costs to the employer, leading to a societal perception that workers always win, and employers always lose in Labor courts. This belief shows that the initial uncertainty about what the judges will do is not that strong after all.

Considering all these elements, the classical rational decision model proved insufficient to explain the cause of these changing preferences. Aware of the classical model's limitations when analyzing flesh and blood human beings' behavior and

1 I'm referring to informal agreements since judicial or administrative intervention curtails the parties' bargaining power because it requires courts to analyze if the settlement is a fair deal.

accounting for empirical evidence, we considered a different variable: the likelihood that this scheme not only affects costs but also creates a framing effect on both parties, which alters their perception of what they consider as a gain and a loss.

With the last statement in mind, we inquired if the belief that judges favor workers and disfavor employers may be one of the reasons why the parties prefer to settle 80% of the time. Our focus addresses wrongful termination disputes since the motivations to settle may differ² in worker's compensation conflicts.

We start by briefly explaining the classical rational choice model's limitations in this regard. Then, we show how the substantive and adjective rules alter the procedural costs' distribution scheme, which creates the belief that the judges favor workers and disfavor employers. Finally, applying Behavioral Economics' add-ons, we explain the conclusion.

1. RATIONAL CHOICE MODEL

It is still surprising how the Law, so closely linked to behavior, lacks models to analyze how legal norms influence it. If we were to determine from the Legal Science what leads the inhabitants of any State to comply or not as the norms provide, we would soon realize that we don't have suitable tools for this essential kind of work. On the other hand, Economic Science has models that predict and explain how changes in the relative prices of products produce changes in suppliers' and buyers' behavior. Based on their assumed rationality, which leads them

- 2 In the case of legal and judicially assessed obligations, there are no rational reasons to deviate from the legal formula once the parties have the necessary parameters to calculate the benefits - salary, degree of disability, and age of the worker at the time of the claim or the first disabling manifestation -.

to try to obtain the best result or benefit from their actions, one of those models is the ancient Homo Economicus, today known as the Rational Choice model.

If we simplify any legal system, we can argue that it ties punishments and rewards to certain behaviors. Furthermore, we can consider these punishments as prices and these rewards as benefits. For this reason, if we assume that laws produce changes in human action's relative prices and benefits associated with them, we will find how logical it is to apply economic reasoning to legal questions. This is what Ronald Coase and Guido Calabresi had in mind while elaborating the seminal works of the Economic Analysis of Law.

Many academics addressed the question of why people sue or settle using Economics tools. As a matter of fact, and despite being almost 40 years old, any scholar – including me – addressing questions like the one presented here appeals to the model that Steve Shavell (1982) developed in *"Suit, Settlement, and Trial: A theoretical Analysis under alternative Methods for the Allocation of Legal Costs"*. In his work, Shavell used a basic sequential game, according to which, when faced with a conflict, the parties make the following decisions: a) the plaintiff to *sue*, or *not to sue* (case in which the conflict ends); b) the defendant to *settle* (actually, proposes an agreement because the model assumes that the plaintiff will accept it), or *not to settle* (in which case the procedure continues until the court issues a final judgment).

The Rational Choice model uses a simple Cost-Benefit Analysis to predict both decisions: a) when expected costs of litigation outstand its expected benefits, the plaintiff does not judicialize the conflict; otherwise, the plaintiff sues; b)

when expected costs of a trial outstand the expected costs of a settlement, the defendant proposes a settlement; otherwise, the defendant waits for a final decision.

As Shavell (2004, p. 401) explained, a conflict is settled when both parties formed the same beliefs about what the trial outcome could be, which looks somehow self-explaining. But, taking this argument from the Rational Choice perspective, if both expected the same outcome, why would they go to trial in the first place? Why did not the parties settle the conflict before when it was cheaper? Pushing this argument, a little further, if both parties decided to judicialize their conflict, is because, at least initially, they did not have the same belief about the outcome. Then, their belief changed as soon as they got to court, and in this regard, the Rational Choice Model proves useless to answer why.

But we know that as soon as they judicialize the conflict Labor Law and Labor Procedure rules come into play.

2. DESIGNING A REGULATORY REGIME

When designing a regulatory regime, lawmakers must choose between a default set of rules or an imperative set of rules. Argentinian lawmakers considered that imperative rules were the most suitable design to regulate labor relations. They assumed that the employer's market power would influence the bargain, harming the worker's rights. For this reason, Argentinian Labor laws are imperative, exhaustive, and noticeably worker protective.

Due to the protectionist tinge imposed by article 14 bis of the Constitution, Argentine labor legislation considers the worker very differently from the employer, up to the point

that the Federal Supreme Court of Justice has defined him as a *subject of preferential constitutional protection*.

Substantive labor legislation is built on this tutelary ideal, translated into a protective principle, which constitutes its conceptual framework. This principle turns operational through a set of tools, consisting of rules of interpretation in cases of controversy that can arise during the bargaining, execution, and termination of the employment contract, as well as during a judicial procedure. Within this set of tools, the rule of the most beneficial condition, the regime of irrevocability of labor rights³, the rule of doubt - in its two meanings -, and the procedural benefit of poverty⁴ arise. For this reason, the protective imprint of the substantive legislation inevitably extends to judicial processes.

From this set of rules, it turns out that, ultimately, the cost of Buenos Aires's labor judicial process is transferred, in the first instance, to the employer and, in the second instance, to the society.

Accordingly, the worker can obtain all the benefits of litigation and impose all its costs on third parties. As so, he has every incentive to prosecute any claim, even the ones with a negative expected value, as an *ex-ante*, he is indifferent about the outcome.

3 Related to the former, the irrevocability of rights and substitution of contractual clauses limits the parties' freedom of bargaining to agreements that exceed the minimum rights provided by legislation or collective agreements. If parties break the floor, those clauses are automatically replaced by the former.

4 To guarantee the exercise of the worker's rights, federal Labor legislation grants the worker and its heirs a benefit of gratuity in judicial and administrative processes. In turn, the Provincia de Buenos Aires procedural rules grant a broader benefit, generally called - to distinguish it from that - of poverty. In the case the worker loses, the employer must pay all experts' and his own lawyers' fees.

As can be seen, the main characteristic of the legislation applicable to the Labor judicial procedures reduces the cost for the worker of proving the controversial facts, assigning probative value to some manifestations or omissions, and forces judges to provide a favorable interpretation of the claims made by the employees. But this reduction in the cost of proving is only possible because, on the contrary, that same legislation increases the probative cost of the employer.

The worker files a lawsuit with a substantial advantage over his employer: his day in court is guaranteed even when he does not have the economic means to bear the cost, and he can enforce legal contractual clauses for his benefit even when they were different from those agreed upon and will have a favorable interpretation of his claim even in the existence of reasonable doubt, and the employer would not be able to defend himself presenting agreements or waivers of rights as evidence. No doubt he feels like a “winner.”

For this reason, the ones that must pay feel that, at least in his case, Justice has failed: even in the case of acquittal, the sense of injustice overwhelms the employer, because he will also have to pay the fees of the experts and lawyers who represented him in the unjustified process. These situations help build that belief, which has become a quasi-certainty, that employers lose in all lawsuits, regardless of the fairness or unfairness of the worker’s claim.

But that’s not all.

3. RATIONAL CHOICE MODEL FAILURE

We pointed out before that, although generally useful to predict and explain behavior, the Rational Choice model

fails to predict and explain it in this situation. I must say now that human rationality is quite distant from the unmistakable logic of the Vulcan Mr. Spock, whom the model seems to replicate. We, humans, act many times in ways that the model will consider *irrational*. But many of these *irrational* behaviors are reproduced in most of us, and as such, they cannot be attributed to mere failures in the logic of a given John or a Mabel. Hundreds of studies have shown regular people like you, and we act with our rationality, will, and self-interest limited by heuristics and biases that affect our decisions. Through the heuristic procedure, our mind develops solutions to questions using mental shortcuts, consciously or unconsciously based on the information it has, answers that may or may not be correct. The latter constitute cognitive biases.

Then, heuristics and biases affect rationality and, therefore, the behavior that the Homo Economicus model associates with it. In this way, we humans decide in ways that the Rational Choice model cannot explain. Hence the need to use a different one that considers its impact on human behavior. This is the realm of Behavioral Economics.

Insofar as it applies to legal issues, Behavioral Economics departs from the hypothetical behavior of the ideal model and looks up to one of real human behavior.

One of these models called the Prospect Theory⁵, is helpful to explain the parties' irrational change of perception about the outcome of their dispute.

One scenario plagued with inconsistencies between natural man's behavior and the ideal model's predictions is one of the decisions under uncertainty or risk. This is related to the

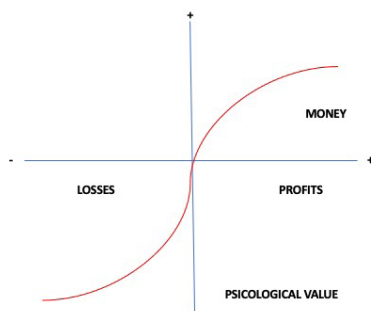
5 Developed by Daniel Kahneman and Amos Tversky.

ability to make decisions that maximize utility, according to the Swiss mathematician Daniel Bernoulli's expected utility model.

Kahneman and Tversky published 1979 a study in the *Econometric Magazine* called "*Prospect Theory: An Analysis of Decision Under Risk*." They proposed a low-risk decision-making model, an alternative to Bernoulli's.

In their theory, the authors explain that the certainty effect influences subjects' decisions in situations that offer them a high probability of obtaining profits - exploiting their aversion to risk - And, on the contrary, the reflection effect influences the ones of those who face situations of a high probability of suffering losses - exploiting their attraction or love for risk -. This theory assumes that the discomfort that results from a loss is more significant than the well-being obtained from a gain, contradicting the traditional idea about the equivalence of values of profits and losses. On the other hand, there is a framing effect, which occurs individually and sets a different reference point or status quo from which every person evaluates their alternatives.

In theory, the expected utility has a concave function in the upper right quadrant (profit area) and a convex function in the lower left quadrant (loss area). This characteristic is usually represented as follows:

Figure 1: Prospect Theory**Own Elaboration**

We stated before that from the Rational Choice Perspective, a settlement is possible when both parties to a conflict form the same beliefs about what the trial outcome could be. But the mere existence of a judicial procedure - even with Labor Law and Labor Procedure Law's cost-shifting scheme -, is self-evident that parties do not evaluate the outcome in the same way.

Applying the Prospect Theory, the result seems to be the same: being a zero-sum game whereby one of the parties is a winner to the same extent as the other is a loser, an agreement between them seems impossible since the defendant presumably will prefer to assume the risk of an eventual conviction to the certainty of a loss that settlement will produce. Are we missing anything? The extent of Labor Law and Labor Procedure's rules influence the reference point.

It is logical to assume that the setting, the legal norms, the degree of wealth, and even emotions constantly alter the status quo. In this regard, references tend to be shifted, altering the frame. In fact, in both collaborative and non-collaborative

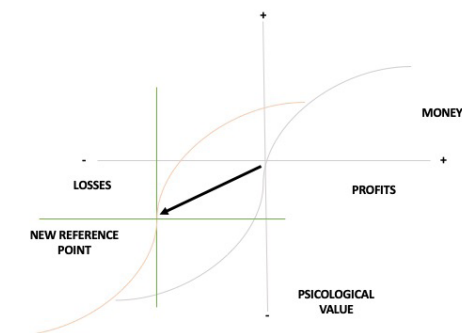
situations, it is easy to figure out that each party starts from a different status quo.

From this perspective, the concepts of what is a loss and what is a profit become blurry. So, we need to analyze them relative to the new reference points the Labor legislation created for both parties.

Returning to the hypothesis for a moment: the labor legislation, insofar as it transfers costs towards the employer, creates the perception that he will lose no matter what because he will be forced to pay at least all the expenses.

This shift of costs towards the employer produces an undoubted displacement of its reference point towards the area of losses and creates a new framework. Thus, a sued employer is likely to view as profit any sum that he can save from what he expects to close in the lawsuit. Hence, since it represents less than what he expects to pay if convicted, it feels like profit from his new reference point. Now, his risk aversion gets a hold and forces him to propose a settlement.

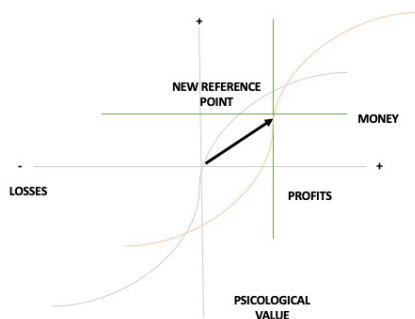
Figure 2: Labor legislation



Own Elaboration

But the belief affects the worker too: being in a situation of the near certainty of success, affected by an endowment effect, and influenced by his risk aversion, he will most likely agree to the proposed agreement.

Figure 3: New reference point



Own Elaboration

Later, parties are more likely to agree because, according to the individual reference points Labor Law created for them, and because of their increased risk aversion, they both perceive the settlement as a gain.

CONCLUSIONS

Throughout this work, we have analyzed the reasons that lead the parties to a judicial process to prefer to settle rather than wait for a court decision. For this, I decided to ignore the consideration of the Suprema Corte that judges' laziness produces this phenomenon.

Using Prospective Theory, we found an explanation. Although it has been handy to explain human behavior, the classical model of rational decision has presented some shortcomings. For this reason, without abandoning it altogether,

sometimes it is necessary to twist it to replicate actual human behavior.

The theory developed by Kahneman and Tversky has proven to be a helpful tool for analyzing human behavior. But it is common to overlook the influence that some external factors - such as legislation - can have on the parties' status quo.

Finding an explanation for seemingly irrational behavior can be tricky. A hasty conclusion about its origin can lead to wrong decisions or actions. In this case, it was proven that the legislation and not the judges - as the Buenos Aires Supreme Court held - cause this behavior. Then the Supreme Court, prey to its own biases, proposed changes in the legislation to force judges to step away from their laziness. Guess what? No changes were made to the set of tools that cause this abnormal situation. My prognosis is not good: if things change, they will change for the worse.

Being impatient, not giving the situation second thought, and looking for culprits, the Supreme Court could not see that the only real problem was its hasty conclusion.

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