Against Compromise: A Mechanism Design Approach

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Abstract

We solve for the settlement mechanism and fee shifting rule that minimize the likelihood of litigation yet maintain substantive social goals as justice and deterrence, prescribed by substantive law, under the assumption that the main dispute between the parties is about the defendant's liability. The solution turns out to be surprisingly simple: let the defendant plead liable or not. Instruct a defendant who admitted liability to pay the plaintiff the entire sum of damages. Then, if the plaintiff decides to proceed to trial although the defendant pleads not liable, shift all litigation costs to the loser in trial (following the English fee-shifting rule). Using a mechanism design approach we demonstrate that no other mechanism can implement a lower rate of litigation without undermining deterrence. We discuss our result in the context of recent legal reforms in the U.S. and U.K.