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Settlement Pressure

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Abstract

This paper cautions against extrapolation of traditional economic analysis of litigation to the problem of settlement pressure in high-stakes class action litigation. Existing economic models can explain the existence of settlement pressure by relying on notions of defendant risk aversion, but risk aversion is an inappropriate concept to apply directly to the large public corporations that actually face class action settlement pressure. Deeper insights into complex civil litigation involving corporations are likely to come from better understanding corporate – not individual – behavior and decision-making. © 2005 Elsevier Inc. All rights reserved.

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1. Introduction

“Settlement pressure” refers to the possibility that large-scale civil litigation, especially class action litigation, forces defendants to settle unmeritorious lawsuits rather than face possibly catastrophic outcomes at trial.¹ In this paper, I ask whether judicial concern with settlement pressure fits with traditional economic models of litigation. I conclude that concern with settlement pressure fits poorly with traditional economic analysis of litigation

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¹ See, e.g. *In re Bridgestone/Firestone, Inc. Tires Prods. Liab. Litig.*, 288 F.3d 1012, 1015-16 (7th Cir. 2002): “Both Ford and Firestone petitioned for interlocutory review under Fed. R. Civ. P. 23(f). We granted these requests because . . . the suit is exceedingly unlikely to be tried. Aggregating millions of claims on account of multiple products manufactured and sold across more than 10 years makes the case so unwieldy, and the stakes so large, that settlement becomes almost inevitable—and at a price that reflects the risk of a catastrophic judgment as much as, if not more than, the actual merit of the claims. Permitting appellate review before class certification can precipitate such a settlement is a principal function of Rule 23(f)”.

because risk aversion is typically a necessary (though not sufficient) condition for the existence of settlement pressure in those models.

The traditional economic model's dependence on risk aversion is conceptually problematic because real world concern with settlement pressure from class action litigation focuses exclusively on large corporate entities that cannot reasonably be described as "risk averse". Risk aversion is a term used to describe the risk preferences of cognitive "natural" persons, not "fictional" legal entities like corporations. Judicial concern with settlement pressure ignores potentially important distinctions between the legitimacy of concern with the risk aversion of natural persons and the legitimacy of concern with corporate hedging motives.

Much concern about settlement pressure traces to Chief Judge Posner's opinion in *In the Matter of Rhone-Poulenc Rorer*.² In that case, hemophiliacs brought an underlying tort lawsuit alleging that they contracted human immunodeficiency virus (HIV) from blood factors manufactured by defendant drug companies. The district court judge certified a class action with respect to the issue of drug company negligence. On appeal, the Seventh Circuit ordered de-certification.

Writing for the appellate court, Chief Judge Posner recognized that the defendants had prevailed in 12 of the 13 individual suits that had already gone to trial, strongly suggesting that the merits weighed in favor of the defendants. On this evidence, he assumed that the defendants would take the 300 remaining individual cases to trial as well. Given their record of trial victories, he estimated that the defendants might lose about 25 of the individual suits, with judgment in each of US\$ 5 million and total liability of US\$ 125 million. But class certification would drastically change the outlook for the defendants. Chief Judge Posner estimated that the defendants would face potentially 5000 plaintiffs, and a worst-case scenario liability of US\$ 25 billion. This worst-case scenario might bring bankruptcy. "They may not wish to roll these dice. That is putting it mildly. They will be under intense pressure to settle".³ In other words, Posner conjectured that defendant drug companies would have taken each of the individual plaintiffs to trial but to avoid the risk of massive loss from an adverse judgment at trial against the class, the defendants would settle with the certified class. It is in this sense that defendants are said to be "pressured" to settle by class certification.

Many subsequent cases have approved Chief Judge Posner's reasoning.⁴ In *Castano v. American Tobacco Co.*,⁵ the Fifth Circuit cited *Rhone-Poulenc Rorer* when it held that a class of nicotine-addicted plaintiffs failed the superiority requirement of Rule 23(b)(3): "In addition to skewing trial outcomes, class certification creates insurmountable pressure on defendants to settle, whereas individual trials would not. The risk of facing an all-or-nothing verdict presents too high a risk, even when the probability of an adverse judgment is low".⁶ Not all courts have approved of the settlement pressure theory. For example, the Second Circuit recently dismissed concern with settlement pressure, stating that the "effect

² *In the Matter of Rhone-Poulenc Rorer, Inc.*, 51 F.3d 1293 (7th Cir. 1995), cert. denied, 516 U.S. 867 (1995).

³ *Id.* at 1297–98.

⁴ See Silver (2003) for a thorough discussion of settlement pressure cases following *Rhone-Poulenc Rorer*.

⁵ 84 F.3d 734 (5th Cir 1996).

⁶ *Id.* at 746.

of certification on parties' leverage in settlement negotiations is a fact of life for class action litigants. While the sheer size of the class in this case may enhance this effect, this alone cannot defeat an otherwise proper certification".⁷

Commentators have split on the legitimacy of judicial concern with settlement pressure. Some argue that concern with settlement pressure reflects judicial resistance to the "legalized blackmail" of low probability class action suits.⁸ Others are more skeptical, arguing that courts (including the Seventh Circuit in *Rhone-Poulenc Rorer*) apply contradictory and inconsistent logic to the evaluation of "blackmail" settlements in large class action litigation, and rest their judgments on questionable empirical foundations.⁹

This paper's contribution is to demonstrate that risk aversion is a necessary (though not sufficient) condition for the existence of settlement pressure in the traditional economic model of litigation. This theoretical fact raises interesting questions because risk aversion is a concept that applies to natural persons, not corporations. How can a corporation – a legal fiction without a mind of its own – feel aversion to a bad trial outcome? If a corporation does not settle because of risk aversion, why do corporate directors and officers cause corporations under their management to settle large lawsuits? I suggest that proper foundations for judicial concern with settlement pressure can be better located in motives for corporate hedging than in traditional models of litigation.

The paper is organized as follows. Section 2 presents a simple model of settlement pressure to demonstrate that risk aversion is a necessary (though not sufficient) condition for settlement pressure in the traditional economic model of litigation. Section 3 analyzes the corporate hedging motives that underlie the existence of settlement pressure on corporations, since corporations (unlike natural persons) are not real entities that can be risk averse. Section 4 concludes.

2. A simple model of settlement pressure

2.1. No settlement pressure for risk neutral defendants

Chief Judge Posner conjectured in *Rhone-Poulenc Rorer* that a defendant who would have taken each of many individual plaintiffs to trial could be pressured to settle with a certified class. His conjecture can be reformulated in terms of basic economic analysis of litigation, a form of analysis that Posner helped originate.¹⁰ The insight that emerges from the basic model is that a *risk neutral* defendant is *never* subject to settlement pressure of the

⁷ *In re Visa Check/Mastermoney Antitrust Litigation*, 280 F.3d 124, 145 (2nd Cir. 2001).

⁸ See, e.g. Vairo (1997): "Judge Posner's opinion in *Rhone-Poulenc* squarely puts the legalized blackmail anti-class action bias on the table Judge Posner seeks to protect corporate defendants from plaintiff class action lawyers in cases where the plaintiffs appear to have an uphill battle in proving liability . . .". See also Priest (1997).

⁹ See Hay and Rosenberg (2000), Silver (2003), and Schwartz (2002).

¹⁰ I adopt the basic framework of the seminal models of the litigation process, in particular, Landes (1971), Gould (1973), and Posner (1973). The settlement pressure problem has received virtually no attention in the more recent economic literature. Indeed, most of the concern of prior economic analysis of settlement focuses on why settlement is not *more* prevalent, not why class certification pressures settlement. See Hay and Spier (1998) for a general review of the economic analysis of settlement.

type Posner describes in *Rhone-Poulenc Rorer*. In the standard model, acting “as if” risk aversion is a necessary (but not sufficient) condition for the existence of settlement pressure.

Let J be the size of judgment awarded to an individual plaintiff if that individual plaintiff wins her case. The probability of winning as perceived by the plaintiff is denoted P_p while the probability of winning perceived by the defendant is P_d .¹¹ Let C be the cost of taking an individual case to trial (e.g. legal fees, discovery costs, trial exhibits, travel expenses, expert witness fees, court costs, etc.), assumed the same for both plaintiffs and defendants. Assume for simplicity that the administrative cost of settling a case is zero.¹² If both plaintiffs and defendants are risk neutral, then the parties go to trial if and only if the plaintiff’s expected winnings from trial exceed the defendant’s expected losses. Formally, if and only if:

$$P_p J - C > P_d J + C \quad (1)$$

The left-hand side of the inequality is the expected gain to the plaintiff from trial. The plaintiff’s expected judgment is J times the probability of winning that judgment perceived by the plaintiff, P_p . This amount is reduced by the costs of going to trial to obtain that expected judgment, C . The right hand side of the inequality is the defendant’s expected loss from going to trial. The plaintiff’s expected judgment is J times the probability of winning that judgment perceived by the defendant P_d . This amount is increased by the costs of going to trial to defend against that expected judgment, C . Obviously, if the plaintiff’s expected gain from going to trial exceeds the defendant’s expected loss (remembering that both are risk neutral), there is no room for settlement.

Inequality (1) can be rewritten in the following form:

$$P_p - P_d > 2 \left(\frac{C}{J} \right) \quad (2)$$

Inspection of inequality (2) shows why there can never be settlement pressure from class certification when the defendant is risk neutral. If inequality (2) is satisfied for the risk neutral defendant in an individual case, then it must be satisfied for any number n of identical individual cases. It also must be satisfied for a class of size $N \gg n$ where the potential judgment is then N times the individual judgment and the costs of litigation are N times the costs of litigating one case. That is $P_p - P_d > 2(C/J) \Rightarrow P_p - P_d > 2(NC/NJ) = 2(C/J)$.

In fact, since both plaintiffs and defendants are likely to benefit from economies of scale, true litigation costs will be lower than $N \times C$ and risk neutral defendants will be even more likely to go to trial with a class than with an individual. That is when litigation costs rise more

¹¹ Different perceived probabilities of plaintiff victory may reflect asymmetric information about the merits of the case. A treatment of the reasons why asymmetric information might exist is beyond the scope of this article. See, e.g. Hay (1995). Different perceived probabilities also could reflect irrational optimism or pessimism or optimism. See, e.g. Heaton (2002). Other psychological hypotheses can further modify these assumptions. See, e.g. Korobkin and Guthrie (1994).

¹² While some models explicitly model the costs of settlement, most practitioners (including the writer) agree that these costs are very small in relation to the costs of litigation and the amount of judgment in large cases. Because it will not significantly affect the theoretical predictions, I simplify analysis by assuming that these costs are zero.

slowly than potential judgments (for example, in the square root of N rather than linearly in N) and parties are risk neutral there could be “trial pressure” from class certification, where a risk neutral defendant that would have settled with an individual plaintiff will take the class to trial.¹³

Similarly, there is no settlement pressure on risk neutral defendants even if class certification raises the probability of a plaintiff’s victory. This could occur if class certification allowed the plaintiff class to hire better attorneys, experts, etc. Looking at inequality (2), if both P_p and P_d rise by the same amount, any increase in the probability of plaintiff victory from class certification cancels out and has no effect on settlement. Indeed, if class certification raises P_p more than P_d (perhaps because of plaintiff optimism, see Heaton (2002)) then class certification will again create “trial pressure” that makes the case more likely to be tried, not settled.¹⁴

2.2. Risk aversion is a necessary but not sufficient condition for settlement pressure

To show that risk aversion is a necessary (though not sufficient) condition for settlement pressure, we can continue to assume that plaintiffs remain risk neutral while now assuming that the defendant is risk averse.¹⁵ In the standard analysis, risk aversion requires a “utility function” and the notion of “expected utility”.¹⁶ Let $U(\cdot)$ be the utility function of the defendant. The function $U(\cdot)$ describes the value or “utility” of a particular level of wealth to the defendant. Consider two alternatives. The first alternative is certain wealth in the amount W_1 . The second alternative is uncertain wealth of either W_2 with probability P or W_3 with probability $(1 - P)$. In expected utility analysis an individual with utility function $U(\cdot)$ prefers the first alternative to the second alternative if and only if:

$$U(W_1) > PU(W_2) + (1 - P)U(W_3) \quad (3)$$

An individual is risk averse if he always prefers the expected value of an uncertain outcome to the uncertain outcome itself. That is if

$$U(PW_2 + (1 - P)W_3) > PU(W_2) + (1 - P)U(W_3) \quad (4)$$

Inequality (4) holds if and only if the function $U(\cdot)$ is concave over the relevant wealth levels; that is an individual is risk averse if and only if his or her utility function is concave.

¹³ In this simple model, the effect is symmetric. Slower growth in litigation costs makes both risk neutral plaintiffs and defendants more likely to go to trial. In practice, the effect may be stronger for defendants, further underscoring that settlement pressure from class certification is implausible for defendants that act as if risk neutral. Rosenberg (2000), for example, argues that defendants have greater economies of scale in class litigation because plaintiffs’ claims are rarely 100% aggregated.

¹⁴ If class certification were to increase P_d more than P_p , then class certification could make settlement more likely even for risk neutral defendants. There seems to be no obvious reason why this should occur.

¹⁵ Of course, class plaintiffs (especially class plaintiffs’ counsel) could be modeled as risk averse as well. If so, they would have their own taste for settlement. See, e.g. Rosenberg (2000). I abstract from plaintiff risk aversion here for ease of exposition.

¹⁶ The basic set-up of expected utility and risk aversion presented here is standard, and can be explored further in any intermediate microeconomics text. See, e.g. Kreps (1990).

Only one more concept is necessary to move on to the discussion of settlement pressure. By the intermediate value theorem of calculus, and given $0 \leq P \leq 1$, there is a number W_c where $W_2 \leq W_c \leq W_3$ such that

$$U(W_c) = PU(W_2) + (1 - P)U(W_3) \quad (5)$$

In expected utility analysis, W_c is called the “certainty equivalent” of the uncertain outcome. That is a person with utility function $U(\cdot)$ will be indifferent between the uncertain prospect of W_2 with probability P , W_3 with probability $(1 - P)$ and the sure thing of W_c .

We can now model the settlement decision with risk aversion. Let W_d be the wealth of the defendant before settlement or trial, and let S be the settlement offer such that the defendant is indifferent between trial and settlement. Let all other variables remain as previously defined. Then the condition for trial analogous to (1) (remembering that plaintiffs remain risk neutral by assumption) is:

$$P_p J - C > S, \quad (6)$$

where

$$U(W_d - S) = P_d U(W_d - J - C) + (1 - P_d)U(W_d - C) \quad (7)$$

The left-hand side of inequality (6) is the same as the left-hand side of inequality (1) and simply gives the expected value of trial as perceived by the plaintiff. Since S is the largest settlement offer that defendant is willing to make, the case will go to trial if the expected value of trial as perceived by plaintiff is higher than largest settlement offer that the defendant is willing to make. Eq. (7) simply states the condition that S is the settlement offer that creates the “certainty equivalent” of trial. After settlement, defendant will be left with total wealth of $W_d - S$. If S is smaller than $P_p J - C$, then defendant’s settlement offer will be too low for the risk neutral plaintiff, whose expected gain from trial (even after costs C) is higher. Put another way, plaintiff’s settlement demand will be too high for defendant and defendant will prefer the trial to the settlement offer demanded by plaintiff.

Given this framework, it is easy to describe the settlement pressure scenario of *Rhone-Poulenc Rorer*. This is the case where the risk averse defendant would take individual cases to trial, but will settle with the class. Denote the settlement offer such that the risk averse defendant is indifferent between trial and settlement in an individual trial as S_{INDIV} and the settlement offer such that the risk averse defendant is indifferent between trial and settlement in a class action as S_{CLASS} . Then this situation occurs when:

$$P_p J - C > S_{INDIV}, \quad (8)$$

where

$$U(W_d - S_{INDIV}) = P_d U(W_d - J - C) + (1 - P_d)U(W_d - C) \quad (9)$$

and

$$S_{CLASS} > P_p N J - N C > N S_{INDIV}, \quad (10)$$

where

$$U(W_d - S_{CLASS}) = P_d U(W_d - N J - N C) + (1 - P_d)U(W_d - N C) \quad (11)$$

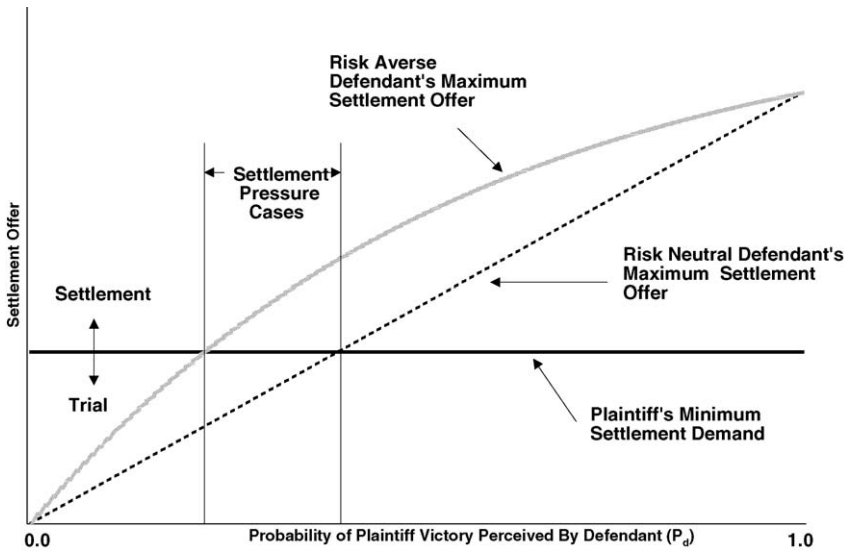


Fig. 1. Trial and settlement outcomes under risk neutrality and risk conversion.

Inequality (8) says that the defendant goes to trial against the individual plaintiff since the defendant’s maximum settlement offer is below the individual plaintiff’s minimum settlement offer. Inequality (10) says that when faced with a class action, the defendant settles because the defendant’s certainty equivalent settlement is above the plaintiff’s minimum settlement demand.¹⁷

By reference to our risk neutral benchmark, we can illustrate the existence of settlement pressure graphically. Settlement pressure cases are those cases that settle *only* because of risk aversion. In Fig. 1, the vertical axis shows class action settlement offers, holding constant J, C, N, W_d, P_p . The horizontal axis shows varying probabilities of plaintiff victory as perceived by the defendant, P_d . Fig. 1 further assumes that litigation costs rise with the square root of N , that is more slowly than linearly in the number of class members, a more realistic assumption that would tend to make trial more likely as described above in Section 2.1.

The thick bold line extending horizontally from the vertical axis is the risk neutral plaintiff’s minimum settlement demand, given J, C, N , and P_p and the assumption that litigation costs rise in the square root of N . Obviously, the plaintiff’s minimum settlement demand is a function of her perceived probability of victory, not defendant’s. Any settlement offer at or above this line should be acceptable to plaintiff and the case will settle. Any settlement offer below this line will be too low, plaintiff will reject it, and the case will go to trial.

¹⁷ In the risk neutral case, the class certification could not affect the settlement decision because the settlement decision depended only on the relation of $P_p - P_d$ to $2(C/J)$. Indeed, if litigation costs rise more slowly than linearly in N , aggregation of the class will make trial *more attractive* to the risk neutral defendant. Here, however, the aggregation of N claims does not simply increase the settlement offer to $N \times S_{INDIV}$. With risk aversion, the settlement that the risk averse defendant is willing to pay to avoid the risk of trial is higher. Of course, settlement is not the only possible outcome. See Fig. 1.

The dashed line is the risk neutral defendant's maximum settlement offer as a function of P_d , given J, C, N, W_d and the assumption that litigation costs rise in the square root of N . Because of risk neutrality, the maximum settlement offer rises linearly in P_d . When the risk neutral defendant's maximum settlement offer is below the plaintiff's minimum settlement offer, the case will go to trial. When the risk neutral defendant's maximum settlement offer is above the plaintiff's minimum settlement offer, the case will settle.

The lighter, curved line is the risk averse defendant's maximum settlement offer as a function of P_d , given J, C, N, W_d and the assumption that litigation costs rise in the square root of N . Because of risk aversion, the maximum settlement offer is a concave function of P_d . At the endpoints where the probability is perceived to be either 0 or 1, there is no uncertainty and the settlement offers of the risk neutral and risk averse defendants are equal (given J, C, N, W_d and the assumption about litigation costs). But when there is uncertainty (perceived probabilities strictly between 0 and 1), the risk averse defendant will always pay more than the risk neutral defendant will to avoid the risk of loss. All else equal, the risk averse defendant's maximum settlement offer will be strictly above the risk neutral plaintiff's maximum settlement offer when there is any uncertainty as to the plaintiff's victory.

It is now easy to see the "settlement pressure" cases, i.e. those cases that settle (do not go to trial) *only* because of risk aversion. In such cases, the risk neutral defendant's settlement offer falls below the plaintiff's minimum required offer. Because the risk averse defendant is always willing to pay more to settle than the risk neutral defendant, however, there is a range of cases that settles only because of risk aversion.

Of course, Fig. 1 also illustrates that "settlement pressure" cases are not the only ones possible. To the left of the settlement pressure cases are those cases that are taken to trial by both the risk neutral and the risk averse defendant. There plainly is no settlement pressure where there is no settlement. To the right of the settlement pressure cases are those that are settled by *both* risk neutral and risk averse defendants. Since risk neutral defendants are at least as likely to take the class to trial as individuals (and probably even more likely, given that litigation costs rise more slowly than linearly in the number of class members, N), none of these cases fit Judge Posner's conjecture. Of course, the risk averse defendant is willing to pay *more* than the risk neutral defendant to settle these cases. But such cases—since they are settled by both—do not raise the concerns expressed in *Rhone-Poulenc Rorer*.¹⁸

3. Settlement as corporate hedging

3.1. Corporations, not individuals

The prior section analyzed settlement pressure in the basic economic model of litigation. The flaw in traditional economic analysis of the settlement pressure problem, however, is

¹⁸ Recall that the problem in *Rhone-Poulenc Rorer* was that defendants would have been pressured to settle a class suit where they would otherwise have taken the individual cases to trial. Where the risk neutral defendant settles with the class as well, it is necessarily the case that he would have settled with the individuals, so this concern is not implicated.

that almost without exception the primary beneficiaries of judicial concern with settlement pressure are large public corporations. But risk aversion is a theoretical concept appropriate for *individuals*. Indeed, one of the principal justifications for the popularity of the corporate form is that it provides a mechanism that allows shareholders to diversify away the risks of individual corporations by holding many small investments in many public corporations, rather than a few large investments in a few corporations (see, e.g. Easterbrook and Fischel (1992)). Corporations must be analyzed differently from individuals.

Because corporations are not natural persons who feel risk aversion, the settlement pressure story must be more complicated than it appears through the lens of traditional economic analysis of litigation. True, settlement pressure cases are high stakes affairs, where corporate managers are “unwilling to bet their company that they are in the right” given the typically stratospheric amounts at risk.¹⁹ But this does not mean that corporations are risk averse. Rather, settlement is best viewed as a hedge, or insurance policy, against the risk of the consequences that could visit the firm in case of an adverse outcome at trial. Unfortunately, while it is obvious that corporations do often act “as if” risk averse by hedging risk and buying insurance, it is not at all obvious *why* they do so.²⁰ This makes it difficult to determine whether judicial concern with settlement pressure is legitimate or not.

3.2. Settlement pressure and corporate hedging motives

Corporations routinely buy insurance, and engage in a variety of more and less sophisticated hedging activities. That these same corporations seek to hedge the risk of an uncertain jury verdict by settlement is thus unsurprising, but why they do so is much less clear.

Two prevailing theories of corporate risk management have particular plausibility in the settlement pressure context. Both may explain why corporate managers may take actions that have the effect of hedging the *survival* of the firm—precisely the action taken in settling very high stakes litigation.²¹

First, corporate managers may hedge the survival of the firm to reduce expected costs of financial distress. Financial economists have long believed that the indirect costs of bankruptcy and financial distress may be large for firms that default on their debt and/or are forced to seek bankruptcy reorganization. Shareholders bear the expected costs of financial distress, and may benefit when the corporation hedges against catastrophic outcomes that will cause those costs to be incurred.²² A credible commitment to a policy of hedging catastrophic outcomes may also allow the firm to lower its borrowing costs and the severity of its bond covenants.²³ Shareholders may also desire the firm to hedge against events

¹⁹ *Blair v. Equifax Check Services, Inc.*, 181 F.3d 832, 834 (7th Cir. 1999) (Easterbrook, J.).

²⁰ Indeed, almost a third of one recent and thoughtful book on risk management is devoted to sorting out possible, and often conflicting, reasons why corporations might hedge. See Culp (2001). Culp also addresses the individual versus corporate notions of risk bearing discussed here, and can be consulted for further discussion of the corporate hedging motives discussed in this section.

²¹ Corporations routinely insure a wide range of risks, not just those that threaten firm survival. For an insightful discussion of corporate insurance strategy, see Doherty and Smith (1993).

²² See Fite and Pfeleiderer (1999).

²³ See, e.g. Smith and Stulz (1999), Stulz (1996).

that could cause insolvency because (at least under Delaware law) the fiduciary duty of a corporate insider may shift to the corporation's creditors when the corporation is insolvent or in "the vicinity of insolvency".²⁴ Shareholders who wish to avoid this shift (and keep fiduciary duties focused on them) may want their management to hedge outcomes that risk insolvency.

Second, though related, corporate managers may hedge the survival of the firm to shift risks of catastrophic failure away from those who cannot diversify it as well as corporate shareholders and bondholders. As [Smith and Mayers \(1993\)](#) write:

In addition to bondholders and stockholders, the managers, the employees, the suppliers, and even the customers all have a vested claim and interest—a form of investment (whether of physical or human capital)—in the company's continuation as a viable economic entity. Management and labor are likely to have a substantial investment of human capital in the company. The profitability of suppliers depends partly on the fortunes of the company buying its products. And even the buying decisions of customers, both actual and potential, can be influenced by their perceptions of the company's prospects.

Hedging the risks of corporate demise to protect non-shareholder/bondholder stakeholders can be justified as in the interests of shareholders if it lowers the required payments to those constituencies for their services, or otherwise increases the value of the firm.

Both theories – minimizing expected costs of financial distress and protecting non-shareholder/bondholder stakeholders – provide a possible foundation for the settlement pressure theory that need not rely on an overly stylized notion of a "risk averse" corporation. In the first theory, corporations will sometimes act "as if" risk averse to high stakes litigation and settle class lawsuits because the risk of a catastrophic verdict raises the probability that high costs of financial distress will be incurred. Alternatively, the first theory also supports a form of settlement pressure derived from a shareholder or manager preference to avoid the shift of fiduciary duty to creditors that could occur if an adverse trial outcome put the firm in the "vicinity of insolvency". The second theory creates concavities in the firm's value function by hedging risks of firm demise that would adversely impact non-shareholder constituencies, perhaps most notably managers, employees, and suppliers. Protection of these corporate constituencies is fairly easy to justify under corporate law, and is empirically likely given the generally consistent interest of undiversified corporate managers and these other groups.²⁵

But neither theory necessarily implies that judicial concern with settlement pressure is justified. Settlement is insurance and insurance is costly. Whether corporations should be left alone to pay such costs in the face of class certification depends on whether (from a social perspective) those costs are higher or lower than any benefits (from a social perspective) of the class action certification. Further analysis of that question is warranted.

²⁴ See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. LEXIS 215, Civ. A. No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991).

²⁵ These motives need not be pure. For example, some settlement may reflect an agency problem where managers settle largely to protect their own empires, inflicting the cost on shareholders who would prefer that the managers go to trial.

4. Conclusion

The pressure to settle large class action lawsuits has attracted increasing judicial concern and sympathy, particularly since Chief Judge Posner's 1995 opinion, *In the Matter of Rhone-Poulenc Rorer, Inc.* But a durable theory of settlement pressure (and a successful defense of judicial efforts to alleviate its effects) must rest on firmer ground than that offered by the basic economic model of litigation. While it is easy to show that risk aversion can lead to settlement pressure, the notions of risk aversion that support the standard model are unsuited to the large public corporations that are the primary beneficiaries of judicial concern with settlement pressure. There are ways to create settlement pressure by modifying a traditional model without risk aversion. For example, the addition of punitive damages that rise faster than linearly in the number of plaintiffs injured could create a form of settlement pressure from class certification, though empirical evidence may not support such an assumption. Overall, however, much like early corporate risk management research,²⁶ settlement pressure cases and commentary seem excessively colored by notions of individual risk aversion that are inappropriate in the corporate civil litigation context.

Proper foundations for judicial concern with settlement pressure must instead be found in motives for corporate hedging, in particular, the corporate motive to hedge the survival of the firm. Those motives have important implications for the settlement pressure theory and its proper place in civil procedure. Analyses of settlement pressure that do not fully confront the variety of possible interests that "pressure" settlement will fail to balance that pressure against the benefits of class certification and other procedural devices. The conflicting interests of managers, shareholders, bondholders, employees, suppliers, and customers on the one hand, and plaintiffs (often tort victims) on the other, do not admit easy or generalized answers. Still, a deeper look at the corporate hedging motives that cause settlement pressure is necessary to determine the proper scope of judicial concern with settlement pressure.

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²⁶ For a brief discussion of the early dependence of corporate hedging models on notions of individual risk aversion, see Culp and Miller (1999).

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