



Cognitive coherence and tort reform

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ABSTRACT

We experimentally study the effects of the split-award tort reform, where the state takes a share of the plaintiff's punitive damage award, on litigants' beliefs and bargaining outcomes. In addition, we study the formation of litigants' beliefs in a strategic environment. Our results provide support for coherence-based reasoning theories: coherence shifts in litigants' background beliefs (elicited before a role is assigned and after commitment to a choice at the pretrial bargaining stage) suggest bi-directionality between choices and beliefs. Our findings also suggest role-specific bias in the updating of plaintiffs' beliefs about firm's negligence. Finally, our findings indicate that split-awards affect plaintiffs' beliefs about fairness and lower out-of-court settlement amounts.

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1. Introduction

Punitive damage awards are primarily intended to punish defendants for their egregious conduct against society and to deter others from engaging in similar conduct in the future (Sloane, 1993).¹ There is a common perception that excessive punitive damage awards² have contributed to the escalation of liability insurance premiums and have generated financial

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¹ The exact words used to describe the standard of proof for punitive damages vary by jurisdiction (Landeo, Nikitin, & Baker, 2007b). In this paper, we use "gross negligence" to represent the punitive damage standard.

² Justice O'Connor stated that punitive damage awards had "skyrocketed" more than 30 times in the previous 10 years, with an increase in the highest award from \$250,000 to \$10,000,000 (Browning-Ferris Indus, Inc. v. Kelco Disposal, Inc., 492 US 257, 282, 1989).

burden on firms (White, 2004). This perception has motivated several tort reforms in US states (Sloane, 1993). Some reforms take the form of caps or limits on punitive damage awards while others mandate that a portion of the award be allocated to the plaintiff with the remainder going to the state. These latter reforms, called “split-awards” have been implemented in Alaska, California, Georgia, Illinois, Indiana, Iowa, Missouri, Oregon, and Utah.³ In addition, New Jersey and Texas have contemplated, but not yet adopted, split-award statutes (White, 2002).

Previous work on split-awards (Daughety & Reinganum, 2003; Landeo & Nikitin, 2006; Landeo, Nikitin, & Babcock, 2007a) suggests that this tort reform affects litigation outcomes. These statutes might reduce settlement amounts and increase the likelihood of out-of-court settlement. As a consequence, split-awards might also decrease the firm's expected litigation loss.⁴

Recent findings from social psychology on individual decision-making involving binary choices based on multiple judgments and beliefs (Simon, Pham, Le, & Holyoak, 2001; Simon, Snown, & Read, 2004b; Simon, Krawczyk, & Holyoak, 2004a; Simon, 2004; Holyoak & Simon, 1999) provide evidence on coherence-based reasoning: “[t]hroughout the decision-making process, the mental representation of the considerations undergoes gradual change and ultimately shifts toward a state of coherence with either one of the decision alternatives [...] As the hard case morphs into an easy one, the decision follows easily and confidently. The fact that decisions are ultimately based on skewed models and backed by high levels of confidence facilitates the making of the decision” (Simon, 2004, pp. 513, 517). Coherence-based reasoning theories suggest an alignment between beliefs and choices (even prior to the point of commitment to a decision), and a bi-directional relationship between choices and beliefs. Note that, in contrast to the cognitive dissonance view (Festinger, 1957), in which shifts serve only as post hoc rationalizations for decisions driven by other factors or different mechanisms (i.e., attitudes and preferences change due to post-decision regret), coherence-based reasoning theories suggest that shifts might occur prior to the commitment to a decision as a means of facilitating complex decision-making processes (Simon et al., 2001).

Given that decision-making involving many choices based on multiple judgments and beliefs is expected to be more complex than decision-making in binary-choice scenarios, we might infer that coherence-based reasoning mechanisms will also be present in multiple-choice environments (i.e., pretrial bargaining environments with a continuum of possible out-of-court settlement choices). If we apply the findings on coherence-based reasoning to the study of split-awards, then we might expect that this tort reform will also affect litigants' beliefs. Note that, under split-awards, lower settlement offers are accepted by the plaintiffs (and offered by the defendants). Given that coherence-based reasoning suggests that choices and beliefs should be aligned, if coherence shifts are driven by *quantitative* differences in out-of-court settlement choices, then we might expect smaller shifts in litigants' beliefs under split-awards. Previous work on split-awards, however, has overlooked the potential indirect effect of this statute on litigants' beliefs. Our research attempts to fill this gap.

Our paper experimentally studies the effects of the split-award tort reform on litigants' beliefs and bargaining outcomes using a complex legal environment, a controlled laboratory setting, and human subjects paid according to their performance. In addition, we study the formation of litigants' beliefs in a strategic environment (i.e., within a pretrial bargaining game between a plaintiff and a defendant and a continuum of possible out-of-court settlement choices). To the best of our knowledge, no experimental test has been previously conducted to assess coherence-based reasoning in strategic settings with multiple choices or to explore the interaction between public policy and coherence-based reasoning (for an assessment of coherence-based reasoning in *individual binary choices* using a complex legal case and internet-based experiments, see Simon et al., 2004b). Given that field data on pretrial bargaining processes are not available or are incomplete (Daughety, 2000), and belief formation is virtually impossible to be observed in real-world settings, conducting an experiment seems to be a valuable alternative.

The experiment encompasses a 2 (statute) \times 2 (role), between-subject design. The statutes are split-awards (where the plaintiff receives 25% of the court award) and no split-awards (where the plaintiff receives 100% of the court award). The roles are plaintiff and defendant.

We explore the formation of beliefs at a within-statute level (within-subject analysis), and the effects of split-awards on litigants' beliefs and bargaining outcomes at a between-statute level (between-subject analysis). First, at a within-statute level, we elicit subjects' beliefs and ask subjects to play a pretrial bargaining game. We assess coherence-based reasoning by analyzing bi-directionality between pretrial bargaining choices and background beliefs.⁵ Specifically, we evaluate whether the posterior background beliefs (elicited after a choice is made) differ from the prior background beliefs (elicited before a role is assigned and the information about the legal case is provided). We also assess whether these shifts reflect an alignment between posterior background beliefs and litigants' choices at the pretrial bargaining stage. Second, at a between-statute level, we assess whether split-awards affect litigants' shifts in background beliefs, the after-role beliefs about firm's negligence,

³ Statutes vary with the state: the base for computation of the state's share can be the gross punitive award or the award net of attorney's fees; the state's share can be 50%, 60% or 75%; the destination of the state's funds can be the Treasury, the Department of Human Services or indigent victims funds. For details, see Dodson (2000), Epstein (1994), Stevens (1994) and Sloane (1993).

⁴ Note that under split-awards, the plaintiff's award at trial is lower (and hence, plaintiffs are willing to accept lower settlement offers), but the defendant's loss at trial remains the same. The contract zone, defined as the range of settlement values that make both sides better off than not settling, is then larger. As a consequence, the likelihood of out-of-court settlement is higher under this statute. Note also that, given that out-of-court settlement amounts are lower and the likelihood of out-of-court settlement is higher, the firms' expected litigation losses will be lower under split-awards. Finally, note that the firm's level of care and filing of lawsuits have been kept constant in this analysis. See Landeo et al. (2007b) for an extension of this analysis under endogenous filing and firm's level of care.

⁵ Background beliefs refer to the subjects' beliefs about behavior of firms in the marketplace (such as firms' concerns about safety, firms' concerns about service quality), negligence of firms involved in product liability lawsuits, credibility of witnesses in lawsuit cases, among others. See the appendices for details. The appendices are available at: <http://www.arts.ualberta.ca/econweb/landeo/>.

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