

Setting a Course to Mediation Success: Accounting for Risk Aversion

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Our last article discussed how Navigator can help parties use more rigorous financial analysis of litigation costs to achieve mediation success.ⁱ This article reviews how Navigator can help parties evaluate their risk aversion and use that evaluation in deciding on settlements or partial settlement structures.

Risk Aversion Described

The mediation process requires lawyers and their clients (the “Parties”) to weigh settlement compared to litigating to a final adjudication. To determine whether settlement is worth pursuing, the Parties must calculate their view of the likely outcomes in litigation by multiplying the dollar amount of each outcome by its probability of success on liability and damage, and then subtracting the cost of litigation.ⁱⁱ That is a rational approach even though estimating dollar amounts and probabilities of success are necessarily uncertain.ⁱⁱⁱ

However, another important driver of settlement decision-making should also be considered: risk aversion.^{iv} Risk aversion is a cognitive bias that causes Parties (consciously or unconsciously) to be risk-averse when protecting what is perceived to be a sure gain, and risk-seeking when trying to avoid what is perceived to be sure loss. This can result in Parties in mediation choosing a settlement perceived as a gain *even if* pursuing the litigation gamble offers an equal or higher expected value.^v Conversely, Parties can choose pursuing litigation when the settlement option is perceived as a loss *even if* pursuing litigation risks an even greater loss.^{vi} This is consistent with the principle of loss aversion, which teaches that, for most of us, incurring losses is more painful than receiving gains is pleasant.^{vii}

Influence Of Risk Aversion in Mediation

The bias of risk aversion means that how the settlement option is framed (and thus perceived) can be a significant driver in settlement decision-making. Settlement options or concessions framed as gains relative to expected outcomes, or relative to the risk of *unexpected* outcomes or to other settlement objectives, will drive mediated resolutions; settlement options or demands framed as a relative loss will undercut reaching resolution.^{viii}

Just as importantly, risk aversion causes Parties not to credit a win in litigation at its expected value. Instead, risk averse Parties will discount the expected value of pursuing litigation to account for the risk

perceived. To compensate for this discount, the Party will have to receive a “risk premium” to pursue litigation instead of settlement.^{ix} Generally speaking, the larger the stakes in the litigation, the higher this risk premium will be.^x

Quantifying the risk premium (as a notional dollar amount) can help risk-averse Parties bridge gaps in reaching a settlement, in the same way that Parties can share “avoided litigation cost savings” in a settlement.^{xi} For a risk-averse Party, any settlement that reduces risk and captures some of this risk premium should be more productive than pursuing an adjudicated outcome with a discounted value.^{xii}

Accounting For Risk Aversion in Mediation Negotiations

Of course, not every Party has the same level, or consciousness, of risk aversion in mediation. And risk aversion is not necessarily a positive or negative influence in mediation. From Navigator’s standpoint, what is important is to help every Party *account* for risk aversion (from their own perspective and the other side’s) by (1) addressing *whether and how* decision-making in mediation is being affected by aversion to risk, (2) if so, quantifying the *risk premium* so they can assess more accurately the real (*i.e.* the discounted) value of their expected litigation outcomes in the case, and (3) ensuring that the *framing* of settlement options is not biasing settlement judgments based on risk aversion.

Even if sharing the risk premium cannot achieve a full settlement, evaluating each Party’s risk aversion in mediation can produce two types of partial settlements: First, a “high-low” award agreement that provides for the Parties to litigate to a final adjudication, but with a cap on defendant’s potential damages, and a floor for plaintiff’s potential recovery,^{xiii} and second, a “smooth” award agreement that provides for the Parties to litigate to a final adjudication, with plaintiff receiving a settlement payment regardless of the result and in exchange plaintiff giving up a negotiated percentage “haircut” on any positive result.^{xiv}

Conclusion

Navigator can help you set a course to mediation success by identifying and evaluating risk aversion and the resulting risk premium, and framing settlement options to account for cognitive bias. These steps can drive a full settlement or a partial settlement that optimizes the Parties’ returns and reduces their risks.

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- i [Setting-a-Course-for-Mediation-Success.pdf \(navmas.com\)](#)
 - ii See, e.g., J.J. Prescott and Kathryn E. Spier, *A Comprehensive Theory Of Civil Settlement*, 91 NYU Law Review 59, 69-70 (April 2016) (“Prescott and Spier Article”); John Bronsteen, *Some Thoughts About the Economics of Settlement*, 78 Fordham Law Review 1129, 1132 (2009) (“Bronstein Article”); <https://www.linkedin.com/pulse/mediation-tip-calculating-risk-adjusted-value-case-patrick-russell-pn3wc/> at 3 (illustrating the “product rule of probability”).
 - iii Bronstein Article, *supra*, at 1137; <https://www.linkedin.com/pulse/mediation-tip-need-risk-cost-assessment-patrick-russell-7w8me>, at 2-3, 5-6.
 - iv Prescott and Spier Article, *supra*, at 71; <https://www.linkedin.com/pulse/tips-meditation-advocacy-mediators-notebook-chapter-2-gary-caplan-vbqfc?> at 3-4.
 - v Prescott and Spier Article, *supra*, at 73; Keith N. Hylton, *Mutual Optimism and Risk Preferences in Litigation*, 75 INTERNATIONAL REVIEW OF LAW AND ECONOMICS PP. 2, 10 (2023), https://scholarship.law.bu.edu/faculty_scholarship/3621 (“Hylton Article”); Helen I. Doerpinghaus, Jia Hsing Jason Yeh, and Joan T. Schmit, *Risk Aversion, Negotiation, and Claims Settlement Strategies*, at p. 5 (September 2004), <https://ssrn.com/abstract=690121> or <http://dx.doi.org/10.2139/ssrn.690121>; Ian Weinstein, *Don’t Believe Everything You Think: Cognitive Bias in Legal Decision-Making*, Clinical L. Rev. 783, 785 and fn. 7, 797-98 (2002-2003)(“Weinstein Article”).
 - vi Hylton Article, *supra*, at 2, 10; Weinstein Article, *supra*, at 797-98; <https://www.linkedin.com/pulse/loss-aversion-framing-effects-out-court-settlements-natalie-cargill> at 1-2.
 - vii Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOLOGIST 341, 344 (1984); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 268-69

(1979); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE 453, 453 (1981); <https://www.linkedin.com/pulse/loss-aversion-framing-effects-out-court-settlements-natalie-cargill> at 1.

viii Jeffrey J. Rachinski, *Gains Losses and the Psychology of Litigation*, 70 S. Cal. L. Rev. 113, 118-19 (1996); Russell Korobkin and Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107,109 (1994), <https://repository.law.umich.edu/mlr/vol93/iss1/3>; Weinstein Article, *supra*, at 797-98; <https://www.linkedin.com/pulse/loss-aversion-framing-effects-out-court-settlements-natalie-cargill> at 1-2(Note that lawyers can be influenced by “framing” just like non-lawyers); [Mediation Tip: Calculating the Risk-Adjusted Value of a Case | LinkedIn](#), at p.1. *See also* Hylton Article, *supra*, at 19-20.

ix Prescott and Spier Article, *supra*, at 73.

x *Id.* at 74

xi *Id.* at 74.

xii Prescott and Spier Article, *supra*, at 75

xiii *Id.* at 86- 88 and fn. 107

xiv *Id.* at 94.