The Framing Effect

By Daniel R. Ritter

Is the Structure of Your Legal Department Pushing You to Gamble on Litigation?

Gambling on litigation is risky. Gambling on litigation is particularly risky for a corporate defendant because corporate defendants tend to pay a high price when they fail to settle with a plaintiff and lose at trial. *See* Jeffrey J. Rachlinski, *Gains, Losses and the Psychology of Litigation*, 70 S. Cal. L. Rev. 113, 154 (1996) (finding that when a jury award exceeded the plaintiff's final settlement offer, an average defendant paid an award of $553,518, but could have settled for $198,569).

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To make matters worse, in-house counsel's ability to identify risky options may be hampered when uncertainty is involved. *See* Rachlinski at 118 (questioning litigants' "ability to identify the most favorable options when risk and uncertainty are involved").

Instead of calculating the expected value of each course of action, an in-house counsel may act like a negotiator, who "rel[ies] on a variety of 'heuristics' or mental shortcuts to reduce the complexity and effort involved in the reasoning process." Russell Korobkin & Chris Guthrie, *Heuristics and Biases at the Bargaining Table*, 87 Marq. L. Rev. 795, 796 (2004). Also, like a negotia-

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tor, an in-house counsel may rely on these heuristics intuitively and unconsciously. *Id.* at 797. Relying on these heuristics may lure in-house counsel to gamble on litigation when the corporation may be better off settling.

This article warns that in-house counsel may be particularly susceptible to one heuristic: the framing component of prospect theory. By applying the framing component of prospect theory, readers will see when a corporate legal department's structure may cause in-house counsel to frame decisions unconsciously in a manner that leads to risky behavior.

Discussion

Under the framing component of prospect theory, individuals make risk-avoiding or risk-seeking choices, depending on the characterization of the decision as a loss or gain. *See* Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 Amer. Psychologist 341 (1984). An individual is risk averse when the individual accepts a sure thing "over a gamble that has higher or equal expectation." *Id.* at 341. An individual is risk-seeking when the individual rejects a sure thing in favor of a gamble of "lower or equal expectation." *Id.*

Framing options as losses tends to make individuals risk-seeking and "express a preference for the gamble over the sure loss," *id.* at 342, while framing options as gains tends to make individuals risk averse and express a preference for a sure gain over the gamble.

Research further suggests that when two equal choices are framed as losses, but one is framed as a sure loss and the other is framed as a gamble, individuals tend pick the gamble. *Id.* at 343. On the other hand, when two equal choices are framed as gains, but one is framed as a sure gain and the other is framed as a gamble, individuals tend to pick the sure gain.

To illustrate, this article reviews a set of problems by Daniel Kahneman and Amos Tversky. Kahneman and Tversky asked individuals to imagine that the United States is preparing for the outbreak of an unusual disease, which is expected to kill 600 people. *Id.* Two programs have been proposed to combat the disease. Individuals were asked to assume that the exact scientific estimates of the consequence of the programs are as follows.

Problem 1	If Program A is adopted, 200 people will be saved.
	If Program B is adopted, there is a one-third probability that 600 people will be saved and a two-thirds probability that no people will be saved.

Then individuals were asked which program they would pick to implement. This problem "implicitly adopts as a reference point a state of affairs in which the disease is allowed to take its toll of 600 lives." *Id.* And the outcomes of the programs are phrased as two possible gains, measured by the number of lives saved. As Kahneman and Tversky predicted, a majority of respondents (72 percent) were risk averse and preferred saving 200 lives for certain, rather than gambling on a one-third possibility of saving 600 lives. *Id.*

Next, Kahneman and Tversky offered the same scenario, but changed the description of the two programs:

Problem 2	If Program C is adopted, 400 people will die.
	If Program D is adopted, there is a one-third probability that nobody will die and a two-thirds probability that 600 people will die.

Unlike the problem above, this problem assumes a reference state in which no one dies from the disease. The best outcome is no loss and the alternatives are losses measured by the number of people that will die of the disease. "People who evaluate options in these terms are expected to show a risk seeking preference for the gamble (option D) over the sure loss of 400 lives." *Id.* As Kahneman and Tversky predicted, a majority of respondents (78 percent) were risk-seeking and picked the gamble, rather than the sure loss. *Id.*

In *Gains, Losses and the Psychology of Litigation*, Jeffrey J. Rachlinski applied these ideas to show how being a defendant influences a party's view of a settlement offer. 70 S. Cal. L. Rev. at 140. While plaintiffs are in the natural position of choosing between a sure gain by settling and the prospect of winning more at trial, defendants must "choose between a sure *loss* by settling and the prospect of *losing* more at trial." *Id.* at 129 (emphasis added). Thus, the role of a defendant in a lawsuit often leads parties "to reject settlement offers, preferring to gamble on trial." *Id.* at 144.

Not only do defendants naturally view settlements as losses, but also this article suggests that the structure of a corporate legal department may cause in-house counsel to frame decisions unconsciously in a manner that leads to risky behavior.

Settlement Committees Cause In-House Counsel to Frame Options Unconsciously as Losses, Which Leads to Risk-Seeking Decisions

Corporations often use settlement committees to review a case and determine liability. For example, a corporate legal department may have separate committees that handle different cases based on the value of a settlement offer.

By determining which committee reviews a case based on the value of a settlement offer, in-house counsel may be inclined to look at a settlement as a loss. For instance, if a matter is presented to a committee, in-house counsel know that if they vote to approve the settlement offer, the corporation will lose a sum of money in the form of a payment to the plaintiff. If a corporate legal department continues with litigation, however, the corporation may not have to pay any money to the plaintiff.

Also, in-house counsel typically present their case to settlement committees. The act of presenting a case shows that a corporation is evaluating the case for trial—or a gamble—instead of looking at how to save money and negotiate a settlement. Settlement committees push in-house counsel to judge the cost of a settlement, instead of considering the value saved by avoiding litigation. To illustrate this framing at the settlement level, members of a settlement committee may unconsciously look at a matter in these terms:

- If Option A (settlement) is adopted, the corporation will pay $3.33 million to the plaintiff.
- If Option B (continue with litigation) is adopted, there is a one-third probabil-

ity that the corporation will not pay any money to the plaintiff and two-thirds probability that the corporation will have to pay $5 million to the plaintiff.

Like an individual who is risk-seeking when options are framed as losses, legal departments may unconsciously prefer a gamble over the sure loss. This approach frames the best outcome as no loss, while the alternatives are losses measured by the amount of money a corporation would have to pay to the plaintiff. If a legal department allowed the effects of framing to characterize the options in these terms, one would expect a corporation to be risk-seeking and gamble on litigation over the sure loss of a $3.33 million settlement.

To improve promotion of settlements, legal departments could frame options as gains. In *Psychological Barriers to Litigation Settlement: An Experimental Approach*, Russell Korobkin and Chris Guthrie predicted that settlement rates depend on whether the offeree views the settlement offer as a gain or loss. 93 Mich. L. Rev. 107, 109 (1994). If an offeree views the settlement offer as a gain, the offeree will tend to prefer settlement, the sure amount, to trial. *Id.* But if the offeree views the settlement offer as a loss, the offeree will tend to prefer trial, the gamble. *Id.*

Although corporations are not always the offeree, if in-house counsel view settlements as gains, like Korobin and Guthrie's offeree, one would predict that a corporation's settlement committee would prefer settlement. To illustrate this analysis, members of a settlement committee could attempt to reframe the options of a case during settlement negotiations in the following terms:

- If Option C (settlement) is adopted, the corporation will save $1.67 million by settling for $3.33 million.
- If Option D (continue with litigation) is adopted, there is a one-third probability that the corporation will save $5 million—if the corporation wins at trial—and a two-thirds probability that no money will be saved, if the corporation loses.

Reframing options in this manner could help corporations adopt a reference point where no money is saved by continuing with litigation. The reframed options include two possible gains, but one of the options includes a two-thirds probability where no money is saved. If a corporate legal department evaluates the options in these terms, one would expect the corporation to be risk averse and prefer saving $1.67 million for sure through settlement over a gamble that offers a one-third probability of saving $5 million through litigation.

The act of presenting a case shows that a corporation is evaluating the case for trial—or a gamble—instead of looking at how to save money and negotiate a settlement. Settlement committees push in-house counsel to judge the cost of a settlement, instead of considering the value saved by avoiding litigation.

Unfortunately, reframing settlements as sure gains may be ineffective when a corporate legal department has managers making the ultimate decisions at the settlement committee meetings.

Managers Making the Ultimate Decision Further Encourages Risk-Seeking Decisions

A settlement committee's structure often includes a manager that makes the ultimate decision as to whether the corporation will make or accept a settlement offer. Giving managers this much authority may make a corporate legal department even more susceptible to risk-seeking behavior when the corporation is falling short of a target point—such as profit, liquidity, or sales.

Scholars have found that when corporations fall short of a target, the leaders make risk-seeking decisions. In *Managerial Perspectives on Risk and Risk Taking*, James G. March and Zur Shapira explain that managers frame decisions based on the corporate performance in relation to meeting a target point. 33 Mgmt. Sci. 1404 (1987). When a corporation is above a target point—such as profit, liquidity, or sales—managers are more likely to avoid risky decisions. *Id.* at 1413. However, when a corporation falls short of a target point, managers are more likely to make risk-seeking decisions. *Id.*

Applying March and Shapira's theory to a corporate legal department illustrates that a legal department may be further susceptible to risk-seeking behavior. Similar to how a litigant's role and expectations can influence risk-seeking behavior, a corporation's performance can influence a manager's risk-seeking behavior. And if the corporation is falling short of a target point, like the legal department going over the annual budget, the manager may be inclined to make risk-seeking decisions by not settling (and thus risking the possibility of losing more through litigation).

This behavior is not unusual. Corporations should not rush into settlements with every individual who brings a claim. But corporations should understand how a legal department's structure can cause in-house counsel to frame decisions unconsciously in a manner that leads to risky behavior and costly results.

Risk-Seeking Behavior Is Costly

In-house counsel must be efficient with resources to stay within the department's budget. But risk-seeking behavior can lead to costly results in two ways:

1. Corporate defendants who gamble on litigation use wasteful litigation strategies.
2. If a corporate defendant loses at trial, they tend to pay a high price for failing to settle with a plaintiff.

As mentioned at the beginning of this article, Rachlinski compared the jury awards with final settlement offers of 722 civil cases in three counties in California—San Francisco, San Mateo and Santa Clara counties between 1981 and 1988—and found that if a corporate defendant loses at trial, an average defendant paid an award of $553,518, but could have settled for $198,569. Rachlinski at 154. This risk-seeking behavior cost corporate defendants an average of $354,949 per case.

Similarly, Stephen E. Chappelear studied 1,200 civil cases in the Franklin County Court of Common Pleas in Columbus, Ohio between 1985 through 1997, and found that "[d]efendants also pay the price for not accepting what turn out to be favorable demands." *Jury Trials in the Heartland*, 32 U. Mich. J.L. Reform 241, 263 (1999). In one case, the plaintiff's final settlement offer was $350,000 and the defendant's offer was $10,000. *Id.* Rather than settling with the plaintiff, the defendant gambled and the jury returned a verdict of $625,906, the highest car crash verdict in Franklin County in 1997. *Id.* This risk-seeking behavior cost this defendant $225,906. *Id.*

Solutions: Outside Counsel and Practicing Decision Analysis Can Help In-House Counsel Avoid Costly Risk-Seeking Behavior

In-house counsel provide economic value to corporations. By being more familiar with the corporation's organizational and operational structure, in-house counsel can provide an economic advantage because they avoid a learning curve. Steven L. Schwarcz, *To Make or to Buy: In-House Lawyering and Value Creation*, 33 J. Corp. L. 497, 508–09 (2008).

However, when a corporate defendant is falling short of its target points, in-house counsel may be susceptible to risk-seeking behavior, ultimately resulting in economic loss overall. Finding a solution to overcome the framing effect during settlement negotiations is valuable to corporations.

Granting outside counsel settlement authority would immediately change the structure of corporate legal departments. A corporate legal department's structure arguably influences risk-seeking behavior. Again, settlement committees often put in-house counsel and managers in the position where if they vote to approve the settlement offer, the corporation loses money in the form of a payment to the plaintiff. Thus, granting outside counsel settlement authority eliminates the framing that takes place in a corporation's settlement committee.

To help overcome the framing effect, corporations may want to restructure their legal departments by giving settlement authority to outside counsel and participating in decision analysis.

Also, granting outside counsel settlement authority may further insulate a corporation from framing settlements as losses when the corporation is falling short of target points. Unlike managers in a corporate legal department, who may be susceptible to risk-seeking behavior when the corporation is falling short of target points, outside counsel should be focused on assessing each case efficiently and realistically.

Scholars have already explained that an attorney's role "insulates him [or her] from the client's emotions and permits constructive negotiation." Robert H. Mnookin, Scott R. Peppet, & Andrew S. Tulumello, *Beyond Winning: Negotiating to Create Value in Deals and Disputes*, 96 (Harvard Univ. Press 2000). Extending this notion to a corporate legal department, an outside counsel's role should insulate him or her from a situation where the corporation is falling short of target points.

Unfortunately, outsourcing settlement authority to outside counsel may not eliminate risk-seeking behavior during settlement negotiations. To overcome this framing problem, both in-house and outside counsel should participate in *decision analysis*. *Id.* at 232. Decision analysis is a "disciplined approach that identifies the separate issues that bear on the net expected outcome of the case, estimates in percentage terms a client's chance of prevailing on each of these issues, and isolates issues that require additional factual and legal research." *Id.* at 233–34.

For decision analysis to be effective, corporations should encourage both in-house and outside counsel to conduct legal research on specific legal issues and factors that "bear centrally on the net expected outcome of the case." *Id.* at 234. During this stage of decision analysis, in-house and outside counsel may want to represent these factors graphically in a *dependency diagram*. *Id.* A dependency diagram "identif[ies] the most critical uncertainties and relationships bearing on the net expected outcome of the case." *Id.* These diagrams should include *ultimate issues*—issues that may be dispositive as to damages or liability—and *influencing factors*—factors that may influence the probability that an ultimate issue will be resolved in a certain way. *Id.* at 234–35.

Considering these sources of uncertainty would assist a corporate legal department by changing their focus to the realistic expected value of case, instead of thinking about the initial loss of settlement.

Conclusion

A corporate legal department's structure may cause in-house counsel to frame decisions unconsciously in a manner that leads to risky behavior. To help overcome the framing effect, corporations may want to restructure their legal departments by giving settlement authority to outside counsel and participating in decision analysis.

In-house counsel should take note and protect themselves from unconsciously framing settlements as sure losses. At the same time, outside counsel should advise clients on how to avoid the effects of framing. This article may not be consistent with other attorneys' experiences. Any feedback regarding one's experiences with corporate legal departments or outside counsel would be valuable. Please feel free to reach me at dritter@smbtrials.com.