400 Park Avenue, 12th Floor
New York, NY 10017
navmas.com
Charles.platt@navmas.com

Setting a Course to Mediation Success:
Valuing Litigation Using A Real Options Analysis
Charles Platt

Our previous articles have discussed how rigorous financial and behavioral analysis can help parties achieve mediation success.[i] This article reviews how Navigator can help parties evaluate litigation using a real options analysis.

Different Ways to Evaluate A Case In Mediation

To evaluate a settlement proposal in mediation, lawyers and their clients (the "Parties") typically use a "standard model" to compare the settlement to the likely "litigation outcome" This model multiplies the estimated dollar amounts recoverable on each claim by its probability of success, and then subtracts the cost of litigation.[ii] While often relied upon, this model is inherently subjective and uncertain.[iii]

Some commentators have suggested a different way of valuing a case for settlement purposes. They would treat lawsuits like investment projects, and employ a "real options analysis" that values litigation as if it is a series of decision points in which the Parties have the option of adjusting their investment in the case in response to new developments.[iv] The extent to which the lawsuit's "real option settlement value" diverges from its "expected value" is driven by the potential variance in such new developments.[v]

The real options analysis can define litigation value with more precision by capturing how that value can change over time due to future legal, factual and procedural developments, and how the value can be greater or less than the expected outcome of the case at given point.[vi] As future developments occur, the Parties have the option to adjust their investment in the litigation based on their reassessment of the case value and how it may further change in the future.[vii] The greater the potential variance in these developments, the more the case value and the Parties' investments will change.[viii]

The Effect Of The Real Options Analysis In Mediation

This real options analysis reflects the reality that the expected outcome of litigation, against which settlement proposals are compared, should not be viewed as a static figure. The expected outcome is fluid and driven by the uncertain variances in developments still to come.[ix]

Moreover, using this real options analysis can explain why a lawsuit's value can increase as the level of uncertainty about future developments increases.[x] The Parties may decide to settle for amounts higher or lower than the expected value in the standard model because the more significant the developments waiting to occur, the larger the value of the plaintiff's option to continue or abandon the litigation." [xi] For example, if a claim hinges on the testimony of a single witness or on the outcome of a judicial ruling, the real options value of a claim just prior to the resolution of that uncertainty could be sharply higher or lower than the expected value of the claim using the standard model at that time.

Thus, a plaintiff in mediation may rationally reject a settlement and pursue a case from a financial point of view *even if* the case has a "negative expected value" for the plaintiff at that time (i.e. the expected overall cost of litigation exceeds the expected outcome). Like a call option, pursuing such a case would make financial sense *if* the plaintiff was then incurring relatively low litigation costs *and* there was a possibility that factual, legal or procedural developments would greatly increase the recoverable damages or the probability of success.[xii]

Similarly, using this real options analysis, it could make financial sense for a defendant to pay more for an early settlement in a mediation than is indicated by the expected litigation outcome at the time *if* there was considerable uncertainty as to how the case would develop factually, legally, or procedurally in the future.[xiii] A real options analysis would account for the price of uncertainty in case developments that might occur in that litigation.[xiv]

Conclusion

Navigator can help you set a course to mediation success by determining what potentially dramatic and valuable developments may still occur in the litigation case, and how those developments can have an important impact on valuing a case using a real options analysis.

This article is for marketing purposes only, does not constitute legal advice, and should not be relied upon as legal advice.

---

[i] Setting-a-Course-for-Mediation-Success.pdf (navmas.com); https://www.navmas.com/wp-content/uploads/2024/05/Navigator-Accounting-for-Risk-Aversion.pdf; https://www.navmas.com/wp-content/uploads/2024/05/Excessive-Optimism-In-Litigation-Outcomes.pdf; https://www.navmas.com/wp-content/uploads/2024/06/Information-Asymmetry-in-Mediation.pdf; https://www.navmas.com/wp-content/uploads/2024/06/Navigator-Framing-and-Anchoring-in-Mediation.pdf; www.navmas.com/setting-a-course-to-mediation-success-the-sunk-cost-fallacy/.

[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"); Joseph Grundfest and Peter H. Huang, *The Unexpected Value of Litigation,* 58 Stanford Law Review 1267, 1272 (4/11/2006) ("*Grundfest and Huang Article*"), available at http://ssrn.com/abstract=899098. https://www.linkedin.com/pulse/mediation-tip-calculating-risk-adjusted-valuecase-patrick-russell-pn3wc/ at 3 (illustrating the "product rule of probability"); Maya Steinitz, *How Much Is That Lawsuit In The Window? Pricing Legal Claims*, 66 Vanderbilt L. Rev. 1889, 1905-1906 (2013)("*Steinitz Article*").

[iii] *Steinitz Article, supra,* at 1909-1910; Robert J. Rhee, *A Price Theory of Legal Bargaining: An Inquiry into the Selection of Settlement and Litigation Under Uncertainty*, 56 Emory Law Journal 619, 638-639(2006)(“*Rhee Price Article*”).

[iv] *Grundfest and Huang Article, supra,* at 1270.

[v] *Id. at* 1276.

[vi] *Grundfest and Huang Article, supra,* at 1270-1271; *Grenadier Article, supra, at 3-4.*

[vii] *Grundfest and Huang Article, supra,* at 1275-76.

[viii] *Id.* at 1276; *Grenadier Article, supra, at 2.*

[ix] *Steinitz Article, supra,* at 1907-1908.

[x] *Grundfest and Huang Article, supra,* at 1270-1271; Robert J. Rhee, *The Effect of Risk on Legal Valuation*, 78 I. Colo. L. Rev. 193 (2007) (“*Rhee Risk Article*”); *Steinitz Article, supra,* at 1907-1908;

[xi] *Grundfest and Huang Article, supra,* at 1276; *Rhee Risk Article, supra,* at ___; *Steinitz Article, supra,* at 1908.

[xii] *Id.* at 1277; *Steinitz Article, supra,* at 1908.

[xiii] *Grundfest and Huang Article, supra,* at 1277.

[xiv] *Id*. at 1277-78