**Resolving Legal Disputes when Rationalities Collide**

Richard E. Wagner

Department of Economics, 3G4

George Mason University

Fairfax, VA 22030 USA

tel.: ++1-703-993-1132

fax: ++1-703-993-1133

[rwagner@gmu.edu](mailto:rwagner@gmu.edu)

http://mason.gmu.edu/~rwagner

**Abstract**

In bringing economic analysis to bear on whether a dispute is settled without trial, the presumed institutional setting is typically one of private property where the parties are residual claimants to their legal expenses. Many disputes, however, are between private and public parties. In these disputes there is a conflict between substantive rationalities because public parties are not residual claimants. Just as the substantive content of action can vary depending on whether the actor operates within a context of private or common property, so can the substance of dispute settlement vary. While a public actor cannot pocket legal expenses that are saved through settlement, the expenses of trial can serve as an investment in pursuing future political ambitions.

**Keywords**: dispute resolution; substantive rationality; private vs. public ordering; market conformability

**JEL Codes**: D23, D74, K40

**Resolving Legal Disputes when Rationalities Collide**

A sizeable literature exists on the resolution of legal disputes, which is summarized to good effect in Miceli (2005), and with that summary containing an extensive bibliography. That literature largely operates within the framework of a dispute between two market-based entities where both parties operate within the substantive rationality associated with private property. In many legal disputes, one party is a public entity which operates within the substantive rationality associated with collective or common property, as Wagner (2007) explains in his treatment of public squares and market squares. This essay explores how the economic principles of dispute resolution might be modified when one of the parties to a dispute is a public entity. To provide a point of analytical departure, I start with a quick summary of dispute resolution when both parties operate inside a framework of private property. The rest of the essay explores how the analysis of how the resolution of legal conflicts might be modified when one of the parties is a public entity. The essay closes by considering some of the constitutional-level issues that arise in light of the societal tectonics that can be generated in the presence of this clash between rationalities.

**1. Dispute Resolution between Private Parties**

Someone who buys a dilapidated hotel hires a construction firm to renovate the hotel. The contract calls for a series of payments corresponding to various stages of completion of the work. The construction firm hires workers and contracts for the delivery of materials. The renovation is projected to take two years. Shortly after renovation starts, the hotel’s owner discovers a considerable miscalculation in the financial projection on which the renovation was based. Correcting the mistake, however, lowers the expected value of renovation significantly. Consequently, the hotel owner revises the planned renovation and offers the owner of the construction firm a new contract, one that calls for less work, a later starting date, and a lower price. The owner of the construction firm refuses to accept the lower price, saying that the revised work plan and the different materials involved, along with complications due to the later starting date, warrants payment of the original price. The hotel owner refuses and demands that renovation proceed under the new plan, so the construction firm sues the hotel for the $20 million.

The logic of settlement looks at the situation from the point of view of each party and asks whether there are conditions under which both parties could gain by settling the case rather than going to trial. For the plaintiff, the object of a trial is to acquire the amount requested; for the defendant, the object is to avoid having to pay that amount. For a plaintiff, the expected gain from going to trial, PT, is PT = APP – EP, where A is the amount requested, PP is the probably of success expected by the plaintiff, and EP is the plaintiff’s expense in pursuing the trial. For a defendant, the similar relationship is DT = APD – ED. In this instance, A = $20 million. Suppose for each party the expected cost of pursuing a trial is $2 million. Further suppose that each party believes its chance of success at trial is 50 percent. Under these conditions, each party has the same net expected value from going to trial, $8 million.

The aggregate net value of going to trial is $16 million, but the award generated through the trial is $20 million. The other $4 million is dissipated through litigation. This dissipated amount illustrates the potential gain from settling the case. A settlement where the defendant paid the plaintiff $10 million would split the settlement range evenly, leaving each party with $2 million more than they could expect to obtain through trial. Any payment to the plaintiff between $8 million and $12 million would provide gains to both parties. The existence of a settlement range fits with the observation that most commercial disputes are settled without trial. But not all such disputes are settled, nor is there any reason to expect that they should all be settled. For instance, there is no necessary reason for both parties to have the same perception of the outcome of a trial. In dealing with expectations about particular events, there is no reason to think that the sum of probabilistic beliefs must add to one. Each party might be optimistic about the outcome of a trial, as illustrated by each party thinking that its chance of success was 80 percent. In this case the expected value of going to trial would be $14 million for each party. With trial now offering what the parties perceive to be an aggregate value of $28 million when only $20 million will be awarded, the settlement range vanishes amid the inconsistent perceptions. To be sure, there is good reason to think that such procedures as discovery and deposition operate to narrow the distance between perceptions; however, while the tendency to settle disputes is economically intelligible, settlement is not economically necessary.

What is particularly significant about this formulation is that both parties operate within a framework of private property where each entity owns the value consequences of its actions. The basis for settlement resides in the institutional framework of private property wherein the parties can pocked the legal expenses avoided by settling the dispute. This framework fits normal actions of private law involving disputes between two commercial entities. But a good number of disputes in modern societies are between private and collective entities. With collective entities, however, there is no ownership of the value consequences of collective action, at least within democratic regimes. To explore the resolution of such disputes, it is necessary to take into account differences in practical rationality between differently constituted entities.

**2. Form, Substance, and Rationality in Practical Action**

Economists typically work with a purely formal notion of rationality, as expressed by the axiom that people make consistent choices. This formal notion of rationality pays no attention to the context within which choices are made. It does this by presuming that all choices are made within a market context where people choose among options according to market prices. This context, however, applies only to a subset of all choices and interactions within a society. Political choices, for instance, are not made within this context even though public choice theorizing has tended to assume that they are to increase analytical tractability.

With respect to the preceding example, suppose the plaintiff is not a construction firm but an environmental control agency that is seeking to force the hotel owner to change the renovation in a manner that adds $20 million to the expenses of renovation while adding nothing of potential value to future customers. The hotel owner can sue the environmental agency. The market-based settlement calculus, however, does not apply in this context. It applies to the hotel owner, of course, but it does not apply to the environmental agency because the agency operates outside the purview of private property and residual claimacy. The agency still engages in economic calculation because it always faces choices, but the context of calculation differs through the absence of residual claimacy, which means, among other things, that there is no market valuation of the environmental agency that some owner can claim directly.

There is a formal logic of choice and there are substantive logics of practical action, as noted cogently by Pierre Bourdieu (1990, 1998). As a formal matter it is reasonable to presume that people prefer more of what they value over less. As a substantive matter, however, what is valued depends on the context within which action is taken. Among athletes, for instance, practice will be the form by which the athlete prepares for competition. The substance of that practice, however, will depend on the context of competition. For someone engaged in American-style football, weight lifting will be a significant component of practice. In contrast, someone engaged in billiards might not lift weights at all. There are many substantive logics of practice that can all be rendered sensible within a covering logic of form, as illustrated by Alasdair MacIntyre’s (1988) distinction between a rationality of excellence and a rationality of effectiveness.

The logic of practice must relate cost to choice along the lines sketched by Buchanan (1969). Cost is thus the value an actor places on the option that is displaced by virtue of choosing the alternative. The cost of choosing to settle a case is the value of the option that the chooser foregoes by choosing instead to go to trial. The relevant cost, however, pertains to a person who faces a choice, and that cost differs between frameworks of private property and collective property, as Ringa Raudla (2010) notes in her treatment of incorporating institutional considerations into the theory of public finance. For instance, someone who fishes on a private pond will tend to return immature fish to catch later while someone who fishes on a common pond will tend not to do that.

With respect to commercial disputants, it is reasonable to relate cost to perceptions of the comparative value of an enterprise in light of the options. With respect to the value of the enterprise in the preceding illustration when both parties agree on the 50-50 assessment of prospects of a trial, the value of the enterprise is $2 million higher with settlement than with trial. That value, moreover, accrues to the owner of the enterprise. While in a large firm it will be the director of a legal office that makes such decisions, that director will bear a clear agency relationship with the owner of the firm. With collective entities, however, at least of the democratic form, there is no market for ownership and so there is no value of the enterprise. It is still possible as a formal matter to treat collective entities as enterprises, but there is no market-based valuation of those enterprises. The relevant cost to the director of an environmental agency is not reflected in some calculation of enterprise value because there is no such value.

For such an agency, choices to settle or go to trial must be related not to some fictional construction of firm value but to the cost-gain calculus faced by the director of the agency, as modified by other political interests that the director values highly. There is still a formal logic of settlement, but the specific decisions regarding settlement are guided by the substantive logic of practice within a particular institutional framework. To get at substance requires that choices be related the chooser’s valuation of perceived options at the level of practical action. Both football players and billiards players will practice for forthcoming competitions, but the substance of their practices will differ. In similar fashion, someone who fishes in a common fishing ground will act differently than someone who fishes in a privately-owned pond.

**3. Dispute Resolution within a Mixed Economy**

In her perceptive treatment of *Systems of Survival*, Jane Jacobs (1992) explained that well-working societies operate with a delicate balance between what she described as commercial and guardian moral syndromes. While her distinction wasn’t identical to the distinction between commerce and government, it was close. She also explained that when the carriers of those syndromes commingle excessively, what she termed “monstrous moral hybrids” can arise. Such commingling comprises what is described as a mixed economy (Littlechild 1978)(Ikeda 1997). The central issue that such commingling must confront is whether it supports or revises the character of the economic order. While democratic systems are based on a logic of equality and mutuality, there are plenty of analytical grounds for recognizing that they also face pressures leading toward a re-feudalization of the economy. It was to forestall such re-feudalization that Walter Eucken (1952) articulated the principle of state action that was market conformable. Such market conformability in Eucken’s framework would present a barrier to the generation of monstrous moral hybrids in Jacobs’s framework.

When both parties to a dispute operate within a private property framework, they both speak the same language of profit-and-loss. For instance, the defendant might be the hotel owner after renovation and the plaintiff might be the owner of an adjacent marina who complains that height of the hotel blocks a view of the setting sun, thereby degrading the value of the rooftop restaurant. Both participants speak the language of profit-and-loss. While each would have understandable incentives to exaggerate their cases, that exaggeration is limited by their positions of residual claimants and the possibility that settlement might lead to higher net worth than trial.

The setting changes if the plaintiff is an environmental agency, or any political entity for that matter. The hotel still speaks the language of profit-and-loss, but the environmental agency speaks a different dialect, one that refers to social value that cannot materialize in anyone’s account in particular. What results instead are ideological appeals that resonate with targeted interest groups along the lines of Pareto’s (1935) treatment of ideology as amplified by Backhaus (1978) and as explored further in McLure (2007). In Pareto’s terms, we observe the agency filing suit against the hotel and we witness the agency advancing derivations or justifications based on claims of capturing social value. What we don’t know about are the underlying motivations that led to the agency choosing that course of action, and which Pareto called residues. The agency cannot claim to be trying to capture lost profits, and in this it is speaking truthfully because there are no profits that it can capture due to its status as a non-profit entity. But in speaking of securing the social interest, it is advancing a proposition that is incapable of falsification. The head of the agency might well aspire to run for public office, and sees this suit as a means of capturing favorable publicity. If so, the suit offers the head of the agency an investment at public expense in achieving that electoral outcome, though, of course, no person with such electoral aspirations would ever make such a declaration. In a suit between market participants, both parties can be honest and open in their aspirations. But when one party is a public entity, such rectitude necessarily and understandably recedes.

Disputes involving both private and public parties entail a form of Faustian bargain. Public parties can sue private parties without having to face the constraints upon the power to sue that private property imposes on market participants. In some instances reasonable public purposes might be secured by the deployment of that power. But that power can also be employed in the pursuit of the private advantages of those who wield that power, as perhaps illustrated by an attorney general who is able to parlay legal expenditures into investments in an effort to seek higher elected office.

It is doubtful that there is any resolution to this particular Faustian bargain. This form of the bargain bears a family resemblance to the problem of statistical decision theory as illustrated by Jerzzy Neyman’s (1950) treatment of the problem of the lady tasting tea. In that problem, a lady claims to be able to tell whether milk is added to tea that is already in the cup or whether tea is added to milk. It is in the nature of the problem setting that perfection is impossible. The greater the effort made to avoid granting the lady’s claim when she really can’t distinguish between the methods, the greater will be the frequency with which her claim will be rejected even though she can distinguish between the methods.

This problem setting has relevance for constitution of dispute resolution within society. Along the lines of Epstein (1985), a public agency might take private property under eminent domain, claiming that it had good public reason for doing so. After all, what else could it claim? The Fifth Amendment to the US Constitution requires that such takings be for public purposes only and that any such taking be accompanied by just compensation. It is easy enough to give a Coasian gloss on this procedure. The ability of the hotel to build upward might destroy scenic opportunities elsewhere that are valued more highly than what is created by adding to the height of the hotel. There is a simple market test for this proposition. But in the absence of a market test, the burden falls on the public processes through which agency actions are determined. Some of those processes might be more market conformable than other processes. In any case, relationships between market-based and public-based entities create a source of turbulence that is not present in relationships between market-based entities, due to differences in the substance of rational action.

**References**

Backhaus, Jürgen G. 1978. “Pareto and Public Choice.” *Public Choice* 33: 5-17.

Bourdieu, Pierre. 1990. *The Logic of Practice*. Stanford, CA: Stanford University Press.

Bourdieu, Pierre. 1998. *Practical Reason: On the Theory of Action*. Stanford, CA: Stanford University Press.

Buchanan, James M. 1969. *Cost and Choice*. Chicago: Markham.

Epstein, Richard A. 1985. Takings: Private Property and the Power of Eminent Domain. Cambridge: Harvard University Press.

Eucken, Walter. 1952. *Grundsätze der Wirtschaftpolitik*. Tübingen: J. C. B. Mohr.

Ikeda, Sanford. 1997. *Dynamics of the Mixed Economy*. London: Routledge.

Jacobs, Jane. 1992. *Systems of Survival*. New York: Random House.

Littlechild, Steven C. 1978. *The Fallacy of the Mixed Economy*. London: Institute of Economic Affairs.

MacIntyre, Alasdair. 1988. *Whose Justice? Which Rationality?* Notre Dame, IN: University of Notre Dame Press.

McLure, M. 2007. *The Paretian School and Italian Fiscal Sociology*. Basingstoke, UK: Palgrave Macmillan.

Miceli, Thomas J. 2005. “Dispute Resolution.” In Jürgen G. Backhaus, ed., *The Elgar Companion to Law and Economics*, 2nd ed. (Cheltenham, UK: Edward Elgar), pp. 293-403.

Neyman, Jerzzy. 1950. *First Course in Probability and Statistics*. New York: Henry Holt.

Pareto, Vilfredo. 1916 [1935]. *The Mind and Society: A Treatise on General Sociology*. New York: Harcourt Brace.

Raudla, Ringa. 2010. Governing the Budgetary Commons: What can we Learn from Elinor Ostrom? *European Journal of Law and Economics* 30: 201-21.

Wagner, Richard E. 2007. *Fiscal Sociology and the Theory of Public Finance*. Cheltenham, UK: Edward Elgar.