Unit 1 Decision Theory Assignment 1 (First of two assignments in this unit.)

Read Chapter 1 of the text.

Here are two problems. Be prepared to answer questions about the first, “Simple Settlement” in class. The second is your first homework problem, due Thursday, September 4. In both of these, pay attention to the issue of risk aversion and also to sensitivity analysis. In Howling’s Book Deal consider also the problem of valuing contract terms.

**Simple Settlement Problem**

You are an associate working with Bill, a senior partner, defending a lawsuit for Imperial

Mining & Petroleum (IMP). You are at a meeting with Sheila, IMP’s in-house counsel, to

discuss Paula Plaintiff’s settlement demand, which is a “nonnegotiable” $1.1 million.

Bill suggests that the demand should not be accepted. Why? First of all, the plaintiff has

only a 50-50 chance of prevailing on liability. Second, if she prevails, her damages are only $1

million. Trial costs would only be $50,000. Thus, he concludes, the $1.1 million request is

ridiculous. Sheila asks if there is any more serious downside to rejecting the demand. Bill

suggests that there is a slight chance — only 10% — that a jury would award punitive damages,

for a total recovery (compensatory plus punitive damages) of $25 million, but, he continues, this

is indeed a remote possibility, and, moreover, it must be downplayed in the light of the fact that

the plaintiff has only a 50% chance of prevailing on liability in the first place.

How might you contribute to this conversation?

**Howling’s Book Deal**

You are currently negotiating a book publishing deal on behalf of your client, K.J.

Howling, a writer of moderate repute who specializes in horror stories.

Your client is basically happy with the standard form contract offered by the publisher,

Scattered House Press (SHP). There is, however, an important exception. Howling would like to have a clause removed from the contract under which SHP would have automatic rights to publish any sequel, on the same royalty terms as the contract now under negotiation. In response to this request, SHP has replied affirmatively, but only on the condition that Howling be willing to give SHP half the royalties from any sale of movie rights on the first book. (The current standard form contract would let Howling keep all the movie rights.) As you discuss this swap of contract terms with Howling, you come to agree on the following:

First, none of this matters unless the first book is a hit, which has a probability of 10%.

Second, if the book is a hit, there will definitely be a sequel (which Howling has already

outlined). If Howling is able to bargain freely on the sequel, she stands to make about

$1,000,000 on the new book, but she would only make about $500,000 if she were bound by the current term. (The reason is that, if the first book is a hit, she will be able to obtain better royalty terms than she can now.)

Third, if the book is a hit, then there is a 20% chance that a year or two later some movie

studio will pick Howling’s book as the basis for preparing a movie script. In that event, the movie rights would be worth about $10,000,000.

*Advise Howling on whether to accept the proposed swap of contract term*s. In preparing

your advice, be sure that you do each of the following:

Write down the decision tree for this problem.

Solve it. (Be sure briefly to explain your work in some fashion that will communicate to

Howling how you reached your conclusion.)

In addition, you should feel free to make any additional comments you think appropriate in advising Howling. (This is not required; if you do add remarks, be brief, e.g., a paragraph or so.)

After these exercises I will discuss Bayes’ theorem, using “urn problems” for illustration, as well as the value of information. Applying Bayes’ theorem to a decision tree is sometimes called “flipping” the decision tree.

There are several interesting legal cases which we will also discuss in class after the exercises. Please go online to find the cases and some of the extensive discussion which they have engendered.

*People v. Collins*, 438 P. 2d 33 (68 Cal. 2d 319 1968)

Amongst the important issues here are the sources of the numbers and the independence of events.

*Smith v. Rapid Transit, Inc.* 317 Mass. 469, 58 N.E.2d 754 (1945)

This has sometimes been referred to as the case of the “Blue Bus” after its presentation in hypothetical form by Nesson, a professor at Harvard Law School. What are the policy considerations? Who do you think has the better argument, Nesson, the Kent Law School Blogger, or Tribe? (You will find these arguments online.) Would letting the plaintiff prevail induce the bus company to put illuminated signs on its busses? Would that solve the problem?

*Helling v. Carey* 83 Wash. 2d 514, 519 P.2d 981 (1974) Barbara Helling sued two ophthalmologists, Thomas Carey and Robert Laughlin, for medical malpractice.

This case and the preceding raise interesting issues in the Economic Analysis of Law. Unfortunately, I have not included this fascinating chapter of the text in the course due to lack of time but you may enjoy reading it. If any of the questions raised there arouse your interest, you may make it part of your research project and presentation. (I used this case for the first midterm in this course in the fall of 2011.)