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Can Simple Mechanism Design Results be Used to Implement the Proportionality Standard in Discovery?

Comment

Holger Spamann*

1 Introduction

In his thought-provoking article, Jonah Gelbach (2016) considers mechanisms to implement the revision of rule 26(b)(1) of the US Federal Rules of Civil Procedure (FRCP). Starting December 1, 2015, FRCP 26(b)(1) will restrict discovery in federal civil litigation to that which is "proportional to the needs of the case." Gelbach suggests that judges ask the litigants to participate in a mechanism to determine proportionality.

Gelbach first shows that if judges had the information that many models of litigation assume they (or the legislator) have, then judges could administer a mechanism that would implement discovery if and only if it makes both litigants subjectively better off. This privately ex post efficient mechanism makes both parties better off, such that both litigants would participate voluntarily. Moreover, the mechanism is budget neutral in expectation (i.e., on average, the court would not lose or gain money). In this sense, this mechanism would mimick frictionless Coasean bargaining between the litigants. In addition, this mechanism could implement distributional outcomes other than the Coasean.

Gelbach emphasizes that in reality judges are unlikely to have this much information. The "Nirvana mechanism" described above is also vulnerable to collusion between the litigants. Gelbach therefore suggests three simpler alternatives: a second-price auction, posted prices, and split the difference. These feasible mechanisms, however, do not always implement the ex post efficient discovery level and/or may have undesirable distributional consequences. Gelbach's sobering conclusion is that, realistically, judges will find it difficult to implement FRCP 26(b)(1) and similar provisions in a principled way, with or without mechanism design.

Gelbach's analysis proceeds from three fundamental methodological choices. First, Gelbach models litigation with divergent expectations due to divergent priors of the litigants. As Gelbach notes, this approach had fallen out of fashion but is now resurgent. This is a salutary development because divergent priors are supported by empirical evidence on litigant over-optimism (e.g., Goodman-Delahunty et al. 2010; Eigen and Listokin 2012) and are able to explain phenomena that have eluded asymmetric information models (e.g., Prescott, Spier,

* Harvard Law School. I thank Jonah Gelbach and Kathy Spier for generous feedback on a draft of this comment.

and Yoon 2014). I will not comment further on this first choice except as it interacts with the third described below.

Second, Gelbach does not confine himself to an analysis of existing procedures or any particular alternative. Rather, Gelbach applies the tools of formal mechanism design to devise the best possible procedure given the information available. Third, Gelbach defines "best" as what seems best to the litigants in the litigation at hand, to the exclusion of social interests that transcend the parties, particularly ex ante incentive effects. I strongly support Gelbach's second choice, and hope he will revisit the third in future work.

2 Mechanism Design: Taking Information Requirements Seriously

Gelbach's article is part of a small but important literature applying formal mechanism design to law. This application is natural because the legal system is the ultimate mechanism or collection of mechanisms: Legal design is mechanism design. Thinking rigorously and creatively about it is a healthy antidote to the caricature conservative reflex that what exists must (already) be efficient.

Formal mechanism design may appear abstract or fanciful. Its information requirements for the designer may seem daunting. But Gelbach's deepest point is that the information requirements are not specific to mechanism design. This point cannot be emphasized enough. Other formal models embody strong information requirements as well. This is not the fault of the models. Law's instructions to legal decision-makers implicitly require a lot of information. For example, the new FRCP 26(b)(1) implicitly assumes that the judge in any given case has the information required to assess what is "proportional to the needs of the case." Gelbach rightly insists that *if* the judge actually had even a subset of this information, then the "Nirvana mechanism" could achieve the first-best. The difference between standard modelling and mechanism design is that only the latter explicitly makes the best of whatever information both approaches assume the actors to have.

In the real world, formal mechanism design may run into unforeseen problems that simpler models of existing institutions avoid. That is, the output of mechanism design may obey what is colloquially known as "the law of unintended consequences." Technically speaking, existing institutions may unwittingly respect additional constraints that are not explicitly specified but subsumed in sweeping ad hoc restrictions in simple models. Mechanism design may violate those unstated constraints by pushing the boundaries of the explicit specifications. This can lead to disaster if mechanism design is uncritically applied in the real world.

Even if it were practically useless, however, mechanism design would still be helpful for theorists trying to understand which difficulties existing institutions avoid. Moreover, recent advances in mechanism design address many theoretical pitfalls, and mechanisms can be tested in confined environments before being adopted across the legal system. As to the first point, robust mechanism design promises to eliminate extreme information requirements and vulnerability to collusion (Bergemann and Morris 2012; Laffont and Martimort 2000).

As to the second point, experimentation need not be mandated by law. Individual judges can experiment with different mechanisms within the broad confines of the law, and private firms can offer mechanisms as well. To be adopted by an individual judge, a mechanism must be costless not just on average but in any individual case because judges do not have the power to promise lump sum transfers from the court. This alone would rule out Gelbach's "Nirvana mechanism," even if judges had the required information. In fact, individual judges are arguably restricted to revenue-neutral mechanisms. This would also rule out the second-price auction. Private firms do not face this constraint; it is sufficient that they break even on average (plus an appropriate margin). Unlike the judge, they cannot coerce litigants to participate or affect the initial assignment of rights. But private firms can offer mechanisms that make both litigants better off in expectation given the existing assignment of rights, and some have begun to do so. They could, for example, offer Gelbach's "Nirvana mechanism," if they had the requisite information. The success of arbitration shows that private resolution of disputes can be very successful. Of course, persuading a litigant to participate in a voluntary mechanism may reproduce the very bargaining problems that the mechanism is designed to avoid. In this respect, court-mandated mechanisms do better.

3 The Mechanism's Objective: Private vs. Social Optimality

A mechanism implements the objective chosen by the designer. Gelbach considers mechanisms to implement the level of discovery that is privately optimal for the two litigants.

As a preliminary matter, it bears pointing out that discovery can make both litigants better off only if the litigants have divergent priors. Otherwise, one litigant must necessarily be worse off because discovery – and litigation as a whole -- is a zero sum game, or rather a negative sum game once its costs are taken into account. Even with divergent priors, the litigants are collectively better off merely in a subjective sense (unless they get consumption utility from continuing litigation, perhaps akin to gambling). In an objective sense, at least one of them misjudges the expected value of the suit. In this objective sense, the privately optimal discovery is no discovery because negative sum games are objectively wasteful. Is it a reasonable goal for the law to implement the subjectively optimal level of an objectively wasteful activity?

Moreover, private and social interests do not generally coincide in litigation. Litigation has important social functions that transcend the parties in any given dispute. From an economic point of view, litigation sets important incentives for behaviour outside of litigation. Litigants do not internalize these incentive effects. Hence what is optimal for them can diverge dramatically from what is optimal for society (Shavell 1982, 1997). In setting and interpreting the rules, maximizing social interests is generally the more appealing objective, for obvious reasons.

Gelbach explicitly acknowledges this divergence but puts it aside because it would only strengthen his ultimate point, while complicating the exposition. His ultimate point is that even the narrowest objective of maximizing the litigants'

financial interests cannot be implemented with the information realistically available to the judge (section 6): "[W]hile mechanism design could do great things for a court with great information, it may be of limited help for one with limited information."

This bleak conclusion, however, follows only because Gelbach evaluates mechanism design's contribution under an extremely – arguably excessively – demanding standard. It is true that a court with limited information cannot *objectively* achieve *all* of the appealing features of the "Nirvana mechanism" or even the simpler mechanisms. But some of these features would be objectively achieved even by an ignorant court, and others would be achieved according to the *subjective* beliefs of the court or other mechanism designer. In particular, a court requires no information to achieve ex post efficiency using either the "Nirvana mechanism" or a second-price auction. That is, any court can implement privately optimal discovery with these mechanisms.

Information is required only for setting appropriate lump-sum transfers. One problem with inaccurate transfers is that they may violate one of the litigants' interim participation constraints, i.e., one litigant may find it against her interest to participate. But since the court can compel participation, this problem is arguably without consequence. Ignorance's more serious problem is that objectively inaccurate transfers will have undesired distributional effects. This risk, however, does not compel inaction or, more to the point, counsel against the use of the mechanism. It merely requires the mechanism designer setting the transfers to consider the consequences of erring on one side or another and weigh them according to some criterion. In particular, the designer might have subjective probability beliefs about the errors, which could be used to minimize some loss function. For lack of a better alternative, this is what people do all the time, including the litigants in Gelbach's model. Mechanism design can help people – and courts – do the best with what they have.

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