13 Preclusion

Robert G. Bone

1. Introduction

The law of preclusion deals with the effect of a lawsuit on future litigation. There are two types of preclusion: claim preclusion (also called “res judicata” or “rules of merger and bar”) and issue preclusion (also called “collateral estoppel”). Claim preclusion bars a plaintiff from bringing a second suit seeking relief for essentially the same dispute against the same defendant. Issue preclusion prevents a party from relitigating an issue that has already been fully and fairly litigated and determined in a previous lawsuit.

Preclusion rules are said to promote judicial economy, repose, and decisional consistency. Claim preclusion and issue preclusion achieve these goals in different ways. The purpose of claim preclusion is to prevent a plaintiff from splitting up a single lawsuit into separate suits. The purpose of issue preclusion is to prevent wasteful relitigation of factual and legal issues that have already been litigated and decided in a previous suit.

To illustrate, suppose a patient P believes she was injured by the negligence of her doctor D. P sues D for negligence, and loses. Claim preclusion bars P from suing D a second time for breach of contract (or negligence) dealing with the same treatment. This result also holds if P wins her first suit and wants to sue again, perhaps to obtain more damages.

Now suppose that the jury in P’s first suit actually determines that D negligently practiced medicine without adequate training, and suppose that D treated P for another illness. P now sues D for negligence in the course of that treatment. Claim preclusion does not apply to bar P from bringing this second suit since it deals with a different matter than the first. Issue preclusion might apply, however, and bind D to the determination of negligence in the first suit, assuming that the issue of inadequate training is common to both.

In brief, there are four requirements for claim preclusion. First, the initial lawsuit must have ended in a final judgment on the merits. Second, it must be the case that the plaintiff could have included in the first lawsuit the new matter (for example, new causes of action, new theories, new

1 This entry is based on the treatment of preclusion in Bone (2003), at 232–58.
remedies, and so on) that she raises for the first time in a second suit. Third, the new matter must be closely enough related to the subject matter of the first suit that it should have been raised in that suit. How close the relationship need be is a subject of some disagreement and it is discussed briefly below. Fourth, claim preclusion, unlike issue preclusion, almost always requires that the parties be the same in the second suit as in the first.

There are three legal requirements for issue preclusion. First, issue preclusion normally requires a final judgment in the first suit, although it sometimes applies when the first suit ends in a settlement. Second, the issue in the second suit to which preclusion applies must be identical to an issue actually raised in the first suit. Third, the identical issue in the first suit must have been actually litigated, actually decided, and essential to the judgment in that suit.

It is important to note that issue preclusion, unlike claim preclusion, can apply even if there is a different party in the second suit. This is known as nonmutual issue preclusion and it is the focus of much of the economic literature, as described below. The following discussion first explores the economics of claim preclusion and then discusses some aspects of issue preclusion.

2. Claim Preclusion

2.1 Claim Preclusion by Agreement

The policies underlying claim preclusion – judicial economy, repose, and decisional consistency – assume that parties would litigate a dispute repeatedly if preclusion rules did not stop them. Hay (1993) questions this assumption. He argues that the prospect of costly relitigation will cause rational parties to settle the first suit and, as part of their settlement, to agree not to relitigate.² If parties do this, however, there will be only one round of litigation and thus no reason to be concerned

² To illustrate, suppose that P sues D for medical malpractice in the first suit. Suppose as well that P and D agree on P’s likelihood of success, \( p \), and the expected trial award, \( w \). Also, suppose that P expects to spend \( c_p \) and D expects to spend \( c_D \) litigating the suit all the way through trial. Finally, for simplicity, assume that all the rounds of litigation are mutually independent and that the costs of litigation for each round are the same; in other words, \( p, c_p, \) and \( c_D \) remain constant. For P to be willing to sue initially, it must be the case that \( pw - c_p > 0 \). Since first-round litigation costs are sunk, P should be willing to file again if she loses the first lawsuit because \( pw - c_p > 0 \) holds for the second round too. Now suppose that P wins the first lawsuit and receives a judgment of \( w \). D should be willing to file a second lawsuit to set aside the judgment if the expected loss from the second lawsuit is less than the judgment; in other words, if \( pw + c_D < w \). Combining these two
about multiple suits. It follows that claim preclusion rules must be justified on grounds other than judicial economy, repose, and decisional consistency.

Hay discusses two justifications. The first has to do with reducing error costs. In the absence of a claim preclusion rule, the settlement in the first round will be affected by the prospect of relitigation in multiple future rounds. The bargaining power conferred by the threat of future relitigation is not always symmetrically distributed, and when it is not, the first round settlement is likely to be skewed in favor of the party with the advantage. Formal claim preclusion rules remove this distortion.

The second reason for claim preclusion rules has to do with reducing the transaction costs of negotiating a private preclusion agreement. These transaction costs can be substantial because parties must devise some way to bind themselves to their promises. A breach of contract claim will not do because it simply replicates the relitigation problem that the parties seek to avoid. There are ways to handle this problem informally, but they can be complicated to design. For example, the parties might give penalty bonds in escrow and instruct the escrow agent to forfeit the bond if a party seeks to relitigate. Agreeing on the amount of the bond and the precise structure of the escrow arrangement can be costly and a formal preclusion rule avoids those costs.

This transaction cost argument calls for formal claim preclusion rules that mimic what most parties would agree to without them. Otherwise, parties would simply contract around the formal rules and recreate the transaction costs that the rules were meant to avoid. It seems reasonable to assume that most parties would agree to only one round of litigation and therefore current claim preclusion rules that limit parties to one round probably make sense on this ground.

2.2 Scope of Claim Preclusion

Claim preclusion rules preclude a second lawsuit only when the subject matter of the second suit is closely enough related to the subject matter of the first suit to warrant a normative conclusion that the plaintiff should have brought all matters together in the first suit. Current law recognizes two different approaches to defining the requisite relational proximity.

\[ p \text{ satisfies: } 1 - \frac{c_p}{w} > p > \frac{c_s}{w}. \]

Bone (2003) suggests, without rigorous proof, that the equilibrium of this multi-round litigation game is a first-round settlement that depends on each party’s evaluation of his opponent’s “staying power;” that is, the number of rounds his opponent would be willing to litigate assessed from the perspective of the first round. The party with greater “staying power” will get a more favorable settlement.
The narrow approach, still used in some states, is called the “legal right” test. This test holds that a plaintiff must bring in one lawsuit those elements that make up a single legal right. For example, a plaintiff could sue first for breach of a copyright license and then for copyright infringement in a second suit involving the same underlying events if the law recognized breach of contract as a different “legal right” than infringement of copyright.

The broad approach, used in the federal courts and in several states, is called the “transaction test.” This test holds that a plaintiff must bring in one lawsuit all those elements that are transactionally related. Roughly speaking, this includes all causes of action, remedies, and factual and legal theories that arise from the same transaction or series of related transactions. In the copyright example, a court applying the transaction test would likely preclude the second lawsuit (for copyright infringement) after final judgment in the first lawsuit (for breach of contract) if the two causes of action arise from the same real world factual dispute.

Bone (2003) informally analyzes how broad the claim preclusion rules should be. If the first suit settles, the parties are likely to include all the transactionally related aspects of their dispute in that single settlement. Therefore, it makes sense to adopt the transaction test in this case, since it is the rule to which the parties are likely to agree on their own if they bargained for a claim preclusion rule as part of their settlement.

If the suit goes to trial, however, the matter is more complicated. A broader rule encourages plaintiffs to combine more related elements in one lawsuit and thus creates incentives to construct more complicated suits. In general, the more complicated the suit, the higher the costs of litigating it. A broad rule therefore saves costs by preventing a second suit, but increases costs by encouraging a more complicated first suit. A narrow rule has the opposite effect. If the plaintiff wins her first suit and obtains all the relief she seeks, there will be no further litigation and the narrow rule will have saved the cost of litigating a complicated suit in the first round. On the other hand, if the plaintiff loses her first suit and brings a second suit, as permitted by the narrow rule, there will be a second round of litigation and additional litigation cost. Thus, the relative advantage of a broad rule over a narrow rule depends on the relative cost of litigating a complicated versus a simple first suit, the cost of litigating a second suit if the plaintiff loses the first, and the probability the plaintiff wins a simple first suit (and thus does not proceed with a second suit).\(^4\)

\(^4\) One can formalize this result very roughly as follows. Suppose that the plaintiff can bring either of two lawsuits – a small suit that satisfies the legal right test but leaves transactionally related material out (call that \(LS_{\text{min}}\)) and a larger suit that
3 Issue Preclusion

The argument that private agreement might make formal rules unnecessary is much weaker for issue preclusion than for claim preclusion. Parties are likely to have difficulty agreeing on issue preclusion rules as part of a settlement. Unlike claim preclusion, issue preclusion applies to lawsuits that deal with entirely different disputes but happen to involve the same issue. This broad reach makes the prediction of future suits more difficult and thus the valuation of an issue preclusion clause more uncertain. The resulting uncertainty increases the risk that the parties’ valuations will diverge sufficiently to scuttle agreement. Furthermore, the parties themselves cannot bind nonparties to issue preclusion rules by contract, so nonmutual preclusion rules must be imposed by law.

The following discussion focuses on issue preclusion rules when at least one party differs between the first and second suits, and reviews the economic literature on nonmutual issue preclusion and nonparty preclusion.\(^5\)

satisfies the transaction test and includes all transactionally related causes of action, legal and factual theories, and so on (call that \(LS_{\text{max}}\)). Let \(p\) be the plaintiff’s probability of success for \(LS_{\text{min}}\). To simplify, suppose that the plaintiff would file \(LS_{\text{min}}\) if the legal right test were in effect and \(LS_{\text{max}}\) if the transaction test were in effect. (It is not too difficult to endogenize this choice, but it would complicate the analysis.) Also, assume the plaintiff can get all the relief she seeks through either \(LS_{\text{min}}\) or \(LS_{\text{max}}\). Let \(c\) be the total cost to litigate \(LS_{\text{min}}\) through trial and \(c + k\) the total cost to litigate \(LS_{\text{max}}\) through trial and let \(d\) be the total cost of a second suit that the plaintiff would bring if the legal right test were in effect and the plaintiff lost \(LS_{\text{min}}\).

Assuming the plaintiff tries all these lawsuits, the expected cost of the legal right test is \(pc + (1 - p)(c + d)\), and the expected cost of the transaction test is \(c + k\). Therefore, the legal right test is superior to the transaction test if: \(c + k > pc + (1 - p)(c + d)\). Reducing this expression, the condition is:

\[
p > \frac{(d - k)}{ld}.
\]

\(^5\) Issue preclusion differs from *stare decisis*. *Stare decisis* refers to a judicial obligation to give weight to previous decisions of the same issue in analogous situations. Unlike issue preclusion, *stare decisis* allows the judge to depart from the previous decision if she believes that the issue should be decided differently after giving the earlier decision appropriate weight. Issue preclusion affords the judge no such freedom: if issue preclusion applies, the judge *must* follow the decision in the previous suit whether or not she thinks it is correct. There is some discussion of *stare decisis* in the economic literature (Kornhauser 1989; Macey 1989). Rasmusen (1994), for example, shows that judges with an interest in maximizing their own influence over legal policy could settle into an equilibrium in which they all give weight to past decisions, expecting their own decisions to be given similar weight in the future. While each judge has an incentive to defect in Rasmusen’s model, they all end up cooperating in equilibrium, a common result for an indefinitely repeated game. Rasmusen’s model of *stare decisis*, however, does not transfer neatly to
3.1 Nonmutual Issue Preclusion

Traditionally, issue preclusion was limited by the doctrine of mutuality of estoppel, and the mutuality doctrine is still the law in some states. The mutuality doctrine limits the availability of issue preclusion to those parties who would have been precluded themselves had the issue been determined the other way. In effect, it enforces a kind of symmetry or equality principle: both parties to the second suit must have been at risk of preclusion from the first suit (depending on how the first decision came out).

The problem with the mutuality doctrine is that it drastically limits the availability of preclusion when the precluding party was not a party to the first suit. The reason is that a nonparty to the first suit is rarely subject to preclusion herself. As discussed in Section 3.2 below, a nonparty can be precluded only if she was in “privity” with a party to the first suit. Each person is said to have a right to her own personal “day in court,” so privity seldom exists.

To illustrate, suppose P-1 sues D for negligent design of an automobile and the jury finds that D failed to use reasonable care. Suppose now that P-2 sues D for negligent design of the same type of automobile. Under the mutuality doctrine, P-2 can use issue preclusion against D only if P-2 would have been precluded herself had the issue been decided the other way. But P-2 would not have been precluded because she is not in privity with P-1, the party to the first suit. Privity requires actual control over P-1’s litigation choices or a close representational relationship with P-1. Assuming P-2 is a stranger to P-1, neither of these requirements is satisfied. Therefore, since P-2 would not have been precluded had the issue of reasonable care come out the other way, the mutuality doctrine prevents P-2 from using preclusion against D.

The federal courts (and the courts of many states) have abolished the mutuality doctrine. In these jurisdictions, it is possible for P-2 to preclude D in our example even though P-2 would not have been precluded by D had the issue been decided the other way. This use of issue preclusion by a nonparty to the first suit is called “nonmutual issue preclusion.” There are two types of nonmutual issue preclusion: defensive and offensive. The defensive type involves use of nonmutual issue preclusion by a defendant in the second suit (who was not a party to the first suit). The offensive type involves use of nonmutual issue preclusion by a plaintiff in the second suit.
(who was not a party to the first suit). The negligent design hypothetical above is an example of offensive nonmutual issue preclusion.

When analyzing nonmutual issue preclusion, it is useful to consider trial effects separately from settlement effects.

3.1.1 Trial effects If all lawsuits had to be tried and none could settle, the benefits of nonmutual preclusion would be clear. Nonmutual preclusion saves the litigation costs of adjudicating the same issue repeatedly and avoids inconsistent decisions. The United States Supreme Court focused on these benefits when it abolished the mutuality doctrine and permitted defensive use of nonmutual preclusion in *Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation*, 402 US 313 (1971), and the Court emphasized the benefits again when it extended its *Blonder-Tongue* holding to permit offensive use of nonmutual preclusion in *Parklane Hosiery v. Shore*, 439 US 322 (1979).

Still, the case for switching to nonmutual preclusion is far from obvious because nonmutual preclusion also creates costs. Commentators have recognized the problems for some time (Currie 1957; Ratliff 1988, analyzing what he calls the “option effect”). Three types of cost are analyzed in the literature. First, the availability of nonmutual preclusion inflates the likelihood of success in later suits, thereby skewing the results in those suits toward the plaintiff (Currie 1957, at 285–9; Note 1978). Second, it creates incentives for plaintiffs to wait before suing to take advantage of possibly favorable decisions in earlier suits, and this strategy discourages efficient joinder (Currie 1957, at 285–9; Hay 1993, at 49). Third, offensive nonmutual issue preclusion creates asymmetric litigation investment in early suits, which skews the results in the defendant’s favor (Spurr 1991).

The first type of cost can be illustrated with the negligent automobile design hypothetical above. Assume there are 100 injured automobile owners, P-1 through P-100, and they sue D *seriatim*. Assume that in the absence of preclusion, each plaintiff’s chance of success is \( p \). Finally, to simplify the analysis, assume that all the lawsuits turn exclusively on the issue of reasonable care, so each plaintiff is sure to recover if she proves a lack of reasonable care. Under these circumstances, P-1’s probability of success is \( p \). If the mutuality doctrine applies (and ignoring possible *stare decisis* effects), all the lawsuits are independent of one another, so each plaintiff’s likelihood of success is \( p \), as it should be.

However, if offensive nonmutual issue preclusion applies, P-2 wins if P-1 wins and also if P-2 wins on her own (which becomes relevant only if P-1 loses). Thus, P-2’s probability of success is \( 1 - (1 - p)^2 \). By the same reasoning, P-3 has three ways to win: if P-1 wins, if P-2 wins, and if P-3 wins on her own. Therefore, P-3’s chance of success is \( 1 - (1 - p)^3 \). More
generally, $P-k$’s chance of success is $1 - (1 - p)^k$, which is greater than $p$ for $p > 0$ and $k \geq 2$. Thus, nonmutual preclusion benefits plaintiffs later in the litigation queue.\(^6\)

The second type of cost is related to the first. Given that later suits have a higher probability of success \textit{ex ante}, plaintiffs have incentives to wait and see what happens in the early suits, even when intervention or joinder in those early suits would be efficient from a social point of view. To see why, consider our design negligence situation. When deciding whether to join with $P-1$ in the first suit, $P-2$ will compare the benefit of sharing litigation expenses with $P-1$ by joining with the benefit of a second chance to win by staying out. Suppose the expected trial award for $P-1$ and for $P-2$ is $w$ and the probability of success for each is $p$ without preclusion. Suppose that $P-1$ and $P-2$ each have litigation costs of $c$ and that $D$ has litigation costs of $d$ when they sue separately, and those litigation costs increase to $c + \epsilon$ and $d + \epsilon$ if $P-1$ and $P-2$ sue jointly. Finally, assume that $P-1$ and $P-2$ split the costs of their joint lawsuit equally, so each pays $(c + \epsilon)/2$.

On these assumptions, if $P-2$ joins $P-1$ in the first suit, $P-2$’s expected gain is: $pw - (c + \epsilon)/2$. If $P-2$ stays out and waits to see what happens in $P-1$’s suit, $P-2$’s expected gain is: $[1 - (1 - p^2)]w - (1 - p)c$. Therefore, $P-2$ waits if and only if: $[1 - (1 - p^2)]w - (1 - p)c > pw - (c + \epsilon)/2$. This expression reduces to $w > [(1 - 2p)c - \epsilon]/(2(p - p^2))$; in other words, $P-2$ waits only if the stakes ($w$) are large enough. And if $P-2$ waits instead of joining, total litigation costs increase by $(1 - p)(c + d) - 2\epsilon$. To give a numerical example, suppose $p = 0.5$, $c = d = \$10,000$ and $\epsilon = \$2000$. $P-2$ will wait out $P-1$’s suit for all $w$, and $P-2$’s waiting adds litigation costs of $\$6000$.\(^7\)

As for the third type of cost, nonmutual issue preclusion creates asymmetric stakes, which can lead to greater litigation investment by whichever party to the first suit has the larger amount at stake. Since a party who invests more than her opponent is more likely to win, a difference in litigation investment will produce an error risk skewed in favor of the party who invests more. The mutuality doctrine, by eliminating preclusive effects, reduces the litigation investment differential and thus the skewed error risk.

Spurr (1991) confirms this result formally. He uses a simple model in

\(^6\) In response to this concern, the United States Supreme Court in \textit{Parklane Hosiery v. Shore}, 439 US 322 (1979), counseled against allowing offensive non-mutual preclusion when there are prior inconsistent decisions.

\(^7\) The \textit{Parklane Hosiery} Court tried to deal with this problem by denying preclusion to a plaintiff who adopts a wait-and-see strategy.
which the plaintiff’s likelihood of success is a function of the ratio of plaintiff’s to defendant’s litigation expenditures, \( F(c_p/c_D) \), and solves for a Nash equilibrium. Spurr shows that a defendant in the first suit will spend more than the plaintiff when the defendant is at risk of being precluded in future suits (under a nonmutual issue preclusion rule), and that the defendant will do so whether or not it can also preclude subsequent plaintiffs if it wins (under a nonparty preclusion rule).

Even so, the fact that the defendant invests more than the plaintiff and thus stands a better chance of winning is not necessarily a problem for deterrence. This is so because defendant’s additional litigation costs can offset to some extent the deterrence-reducing effect of skewed error. Deterrence is a function of defendant’s total expected loss (\( p_w + c_D \)), and expected loss depends not only on the expected trial award (\( p_w \)), but also on litigation costs (\( c_D \)). Even if skewed error in defendant’s favor reduces the expected trial award by reducing plaintiff’s likelihood of success (\( p \)), the asymmetric stakes increase litigation costs (\( c_D \)) and thus offset this adverse effect to some extent.

Spurr (1991) analyzes the impact of different combinations of preclusion rules on defendant’s aggregate expected loss over multiple suits. He shows, for example, that adding nonparty preclusion to a system that already has nonmutual preclusion might reduce expected loss. His discussion, however, has limited usefulness for evaluating the effect of nonmutual issue preclusion on deterrence, since he does not examine the most relevant scenario, in which the rule that bars nonparty preclusion remains constant while mutuality is abolished and nonmutual preclusion allowed.\(^8\)

### 3.1.2 Settlement effects

Issue preclusion does not apply when the first lawsuit settles before an issue is decided, since then there is no decision that can have preclusive effects. This means that one must evaluate nonmutual preclusion in a world of settlement by how the threat of preclusion in future suits affects the parties’ incentives to settle earlier suits.

Che and Yi (1993), Hay (1993), and Note (1992) explore these incentives and settlement effects. Che and Yi use a two-stage model in which a single defendant is sued sequentially by two separate plaintiffs in two different lawsuits. Each plaintiff has private information about damages and the defendant makes a take-it-or-leave-it offer. The authors analyze

---

\(^8\) Spurr does find that the defendant has a lower aggregate expected loss in a system with both nonmutual issue preclusion and nonparty preclusion than in a system with no preclusive effects at all (i.e., with the mutuality doctrine and no nonparty preclusion) (Spurr 1991, at 56–7).
the results for both correlated decisions and correlated damages. For one-way correlation against the defendant, which is produced by allowing offensive nonmutual preclusion but denying nonparty preclusion, the defendant’s settlement offer and the settlement rate are always greater in the first period compared to a system with no preclusion at all. This result is intuitive. The defendant can only lose and never gain from correlated decisions and therefore always increases its first-stage offer relative to the situation with no preclusion, and this increases the settlement rate. (This result ignores the additional effect of *stare decisis*, which can favor the defendant.)

In the Che-Yi model, litigation costs and probability of success are exogenously specified. Hay (1993) treats these variables as endogenous. Like Spurr (1991), Hay reasons that the risk of being precluded in future rounds will pressure the defendant to invest much more than the plaintiff in the first round, and the resulting asymmetry will reduce the plaintiff’s probability of success. He then argues that a lower probability of success is likely to produce a lower settlement, especially if the defendant bargains hard for settlement at the low end of the range (Hay 1993, at 45–8).

Che and Yi also find that symmetric two-way correlation, which is produced by nonmutual preclusion combined with nonparty preclusion, increases both the defendant’s settlement offer and the settlement rate in the first period if and only if the plaintiff’s winning probability in the first period exceeds a threshold level (Che and Yi 1993, at 406–7). Che and Yi draw two conclusions from these findings. First, they argue that defendants have incentives to invest heavily in the first period when they expect a lawsuit to set an important precedent (and plaintiffs do as well if they can organize) (Che and Yi 1993, at 408–10). Second, they argue that nonmutual offensive issue preclusion without nonparty preclusion encourages nuisance suits by increasing defendant’s settlement offer in the first period, thereby making suit more attractive for plaintiffs with weak cases (Che and Yi 1993, at 410–13). However, nonmutual preclusion with nonparty preclusion or defensive nonmutual preclusion without nonparty preclusion deters nuisance suits by reducing defendant’s first period offer in a weak case.

Moreover, Hay argues that the defendant has an incentive to bargain hard in order to cultivate a reputation for hard bargaining, which can pay off for settlements in other suits. By contrast, the plaintiff, as a one-shot litigant, has nothing to gain from bargaining hard. The combination of hard bargaining by the defendant and normal bargaining by the plaintiff is likely to yield a settlement in the lower half of the settlement range. This point is important to Hay’s result. To see why, consider the following example. Suppose that P-1’s probability of success is \( p \) without preclusion and \( q \) with preclusion \( (p > q) \). Assume that the expected trial award conditional on success is \( w \). Suppose P-1 invests \( c \) and D invests \( d \) in the absence of preclusion and suppose that D invests \( d + k \) with preclusion. (This is a simplification and ignores strategic interaction effects.) The settlement range in the absence of preclusion is: \([pw - c, pw + d]\). Assuming equal bargaining power, the
Since settlement generates no preclusive effect, Hay argues, the second plaintiff is in roughly the same position as the first and therefore at a similar disadvantage. This repeats for each plaintiff, although the asymmetry of litigation investment diminishes with each round (since fewer suits remain to be litigated). As a result, the aggregate settlement amount the defendant pays to all plaintiffs can be less than what the defendant would pay in the absence of preclusion. Thus, in Hay’s model, the defendant benefits from offensive nonmutual issue preclusion, even though the plaintiffs would benefit if all the cases went to trial.¹¹

Note (1992) reaches the opposite result. It argues that offensive nonmutual issue preclusion advantages plaintiffs in settlement by giving them a way to “extort” more from the defendant than they could without preclusion. To illustrate, consider the above example involving 100 plaintiffs each with a negligence claim against D, an automobile manufacturer. D knows that if it loses P-1’s suit, it loses all 99 subsequent suits (assuming, as the example did, that all lawsuits turn exclusively on the issue of reasonable care). Therefore, D should be willing to pay a premium to settle the first suit and avoid the preclusive effect in 99 future suits. The same is true for P-2’s suit. D should be willing to pay a premium to settle this suit, again in order to avoid the preclusive effect in 98 subsequent suits. And so on. The result is that the defendant faces an expected liability in the aggregate greater than what it would have faced in the absence of preclusion. The Note author concludes that although offensive nonmutual issue preclusion benefits later plaintiffs in the queue when all cases go to trial, it benefits earlier plaintiffs when the cases settle instead (Note 1992, at 1943–4).

One way to reconcile Note (1992) with Hay (1993) is to recognize that the Note author makes litigation investment and probability of success

Nash bargaining solution is: \( pw + (d - c)/2 \). The settlement range in the presence of preclusion is: \([qw - c, qw + d + k]\). Assuming equal bargaining power, the Nash bargaining solution is: \( qw + (d - c + k)/2 = pw + (d - c)/2 - [(p - q)w - k/2] \). Thus, preclusion reduces the settlement amount only when \( p - q > k/2w \). However, if one adds hard bargaining and assumes that it does not scuttle settlement, then P-1 will settle for close to \( qw - c \), which is less than \( pw - c \).

¹¹ Hay’s results are sensitive to a number of factors that can vary. For example, they depend on settlement negotiations succeeding in the individual suits, but D’s hard bargaining strategy can be an obstacle to successful settlement if it angers the plaintiff. Hay also assumes that all the plaintiffs are one-shot litigants, but each of the plaintiff’s attorneys is a repeat player and might benefit from developing a hard bargaining reputation. Also, plaintiffs might cooperate, but as Hay points out, offensive nonmutual issue preclusion creates incentives to free ride, which discourages cooperation (Hay 1993, at 48–50).
exogenous variables and ignores outcome effects due to asymmetric litigation investment. A more complete analysis would model both effects – the extortion effect discussed in the Note, and the investment effect discussed in Hay (1993). Although the net result is not entirely clear, it is possible that for a large enough number of lawsuits the extortion effect will dominate, assuming that the function relating differential investment to probability of success is concave. If this prediction is correct, the most significant cost of offensive nonmutual issue preclusion could be settlements improperly skewed against the defendant.

3.2 Nonparty Preclusion

3.2.1 Overview  The American law of preclusion rarely binds persons who were not parties. The nonparty must be in “privity” with a party to the first suit. Generally speaking, privity exists when the nonparty controls the party’s litigation choices in the first suit, when the nonparty actually agrees to have the party represent her interests, or when the nonparty is “virtually represented” by the party to the first suit. The control needed for preclusion must be almost total, and virtual representation is very difficult to establish. The United States Supreme Court has held that each person has a due process right to her own personal day in court, and this principle severely restricts the occasions in which a nonparty can be precluded. And in a recent case, the Court dealt a severe blow to virtual representation as a doctrine of federal preclusion law.

3.2.2 Trial effects  Assume first that all cases go to trial. The benefits of a broad nonparty preclusion rule are obvious: it saves the costs of repeatedly litigating the same issue and provides greater decisional consistency.

To illustrate, suppose that D, a drug company, mass markets a drug that turns out to cause serious injury, and suppose that 1000 users of the drug (P-1 through P-1000), all of whom suffer from the same type of injury and are strangers to one another, sue D separately, each alleging a products liability claim. Suppose in P-1’s suit, D proves that the drug could not possibly cause the type of injury. Because of the very narrow nonparty preclusion rules, P-2 can litigate the identical causation issue again, and so

---

12 There are two other situations not relevant to our discussion here. A nonparty can be precluded when the court properly certifies a class action in the first suit and the “nonparty” is a member of the class, and also when the nonparty is a successor in interest to property that was the subject of the decision in the first suit.

Procedural law and economics

can P-3 and all the other 997 plaintiffs. A rule that allows nonparty preclusion saves these relitigation costs and also prevents inconsistent decisions of the issue.

However, these benefits must be compared to the costs. Bone (1993) analyzes the costs of a nonparty preclusion rule when all cases go to trial. Two types of cost must be considered. First, a nonparty preclusion rule increases risk-bearing costs by making defendant’s total expected liability more uncertain. Second, nonparty preclusion can create asymmetric stakes that benefit the plaintiff.

Consider the effect on risk-bearing costs. To simplify the analysis, assume that causation is the only difficult issue in the 1000 lawsuits and that it is decisive both ways. In other words, assume that the defendant loses all the lawsuits if P-1 wins on causation and that defendant wins all the lawsuits if P-1 loses. Consider a “complete relitigation system,” one that denies nonparty preclusion and nonmutual preclusion (i.e., applies the mutuality doctrine). In a complete relitigation system, the causation issue is guaranteed to be tried 1000 times (assuming, as we do here, that all cases go to trial). The defendant will lose sometimes and win sometimes. More precisely, if the probability of success on the issue is \( p \), the number of lawsuits is \( n \) (\( n = 1000 \) in the example above), and all suits are mutually independent, the defendant will expect to lose \( np \) and win \( (1 - p)n \). If the expected trial award for each plaintiff is \( w \), defendant’s aggregate expected liability (ignoring litigation costs) is \( npw \) and the average liability per suit is \( npw/n = pw \).

Compare what happens in a “complete preclusion system,” one that allows both nonparty preclusion and nonmutual preclusion. In a complete preclusion system, the decision of the causation issue in the first suit is determinative of all the rest. Since the probability of a defendant loss is \( p \), the defendant’s aggregate expected liability over \( n \) lawsuits is \( npw \) and the average liability per suit is \( pw \), exactly the same as it was for the complete relitigation system. Thus, switching from a complete relitigation system to a complete preclusion system does not alter the defendant’s expected liability.

However, it does alter the risk of litigation. In a complete relitigation system, all possible combinations of wins and losses occur with some probability. The result is a binomial distribution, in which the probability of \( x \) wins and \( n - x \) losses is given by: \( \frac{n!}{x!(n - x)!}p^x(1 - p)^{n-x} \). The mean of this distribution is \( np \), and the variance is \( np(1 - p) \). By contrast, in a complete preclusion system, only two possible outcomes can occur: either the defendant loses all \( n \) lawsuits, or the defendant wins all \( n \) lawsuits. The former happens with probability \( p \), and the latter with probability \( 1 - p \). The mean of this two-point distribution is \( np \), the same as for a relitigation system (which is why expected liability is the same). However,
the variance is \( p(n - np)^2 + (1 - p)(np - 0)^2 = n^2p(1 - p) \). Thus, the variance is much greater for a complete preclusion system than for a complete relitigation system; in this simple model, it is \( n \) times greater. And higher variance creates risk-bearing costs for risk-averse actors.

Posner (1992) discusses the second type of cost, skewed error from asymmetric litigation investment. He argues that nonparty preclusion, like nonmutual preclusion, generates asymmetric stakes in the first lawsuit. With nonparty preclusion, D in our drug example wins all 1000 suits if it wins the causation issue in the first suit. Therefore, D has 1000\( w \) at stake in the first suit. P-1, by contrast, has nothing to lose or gain from future suits, so her stake is only \( w \). With more at stake, D will invest more and be more likely to win14 (Posner 1992, at § 21.11).

Thus, a nonparty preclusion rule saves litigation costs, but also creates risk-bearing costs and error costs due to skewed outcomes. It is reasonable to suppose, however, that the cost-saving benefits will exceed the additional risk-bearing and error costs for a large enough number of lawsuits.15 For one thing, marginal risk-bearing costs probably diminish with the number of lawsuits, whereas marginal litigation costs are likely to remain roughly constant. Moreover, in actual litigation, the common issue is likely not to be dispositive in the way we assumed for our simple example. When the common issue is not dispositive, additional risk-bearing costs from a non-party preclusion rule will be less because other issues already generate risk.

As for Posner’s argument about skewed error, several factors are likely to mitigate the adverse effect (Bone 1993, at 251–6). First, nonparty preclusion gives P-2 through P-1000 a stake in P-1’s suit and thus mitigates the free-rider effect and encourages cooperation among plaintiffs. With cooperation, the amount at stake on plaintiff’s side increases. Second, attorneys in mass tort cases tend to collect many clients on a contingency fee basis. As a result, the

---

14 Posner also notes that D might be able to control which P goes to trial first (by delaying some suits and speeding up others). If so, D will have an incentive to go to trial first against a P-1 with the weakest causation evidence or the poorest attorney, thereby adding to its likelihood of success and compounding the expected error cost.

15 This analysis assumes individual lawsuits and all-or-nothing preclusion rules. It is worth noting some other possibilities that might strike a superior balance between benefit and cost. For example, one might require the trial of a number of individual suits and then bind future parties to the most commonly recurring decision of the issue. Although this increases litigation costs, it reduces risk-bearing costs. Also, one might aggregate a number of individual suits together in a single litigation and then bind future parties to the decision of the issue in that aggregated suit. This increases litigation costs but it also reduces error costs by increasing the plaintiffs’ stakes in the first suit.
attorney for P-1 is likely to have hundreds of other plaintiffs as clients and thus will litigate P-1’s suit with an eye to potential benefits in future suits. Third, the effect of litigation investment on likelihood of success is subject to declining marginal returns. If $w$ is already large, as one might expect in a personal injury drug case, P-1 is likely to invest a great deal in the litigation, and any additional investment by D due to fear of nonparty preclusion is not likely to make a huge difference to the outcome.

3.2.3 Settlement effects The foregoing analysis assumed trials. If the suits settle instead, nonparty preclusion must be evaluated by how it affects the quantity and quality of settlements. There is not much economic literature on this subject, perhaps because nonparty preclusion is not a significant feature of American preclusion law. The following is a very rough analysis of what might happen if nonparty preclusion were added to a system that already allowed nonmutual preclusion.

As was discussed in Section 3.1.2 above, nonmutual preclusion has two countervailing effects on the defendant’s maximum settlement offer: a preclusion effect that raises expected costs and thus increases the offer, and an asymmetric-investment effect that depresses plaintiff’s likelihood of success and thus reduces the offer. Adding nonparty preclusion to this system has at least two additional effects. First, it encourages cooperation on the plaintiff’s side, which can reduce the investment asymmetry and thus increase the defendant’s maximum offer. Second, nonparty preclusion gives the defendant an added benefit from litigating the issue, which should cause the defendant to reduce its maximum offer.

It is unclear how these effects net out. If the investment asymmetry distortion is already small because of the declining marginal utility of litigation investment, the second effect might dominate. In that case, defendant’s maximum offer would decrease and the settlement range narrow, which probably makes settlement less likely. As for settlement amount, empowering cooperation among plaintiffs should make it more difficult for the defendant to use a hard bargaining strategy successfully (see Section 3.1.2 above), which might increase the settlement amount. However, defendant’s maximum offer decreases more than plaintiff’s minimum demand increases when the second effect dominates. And this should reduce the midpoint of the settlement range and thus the settlement amount, assuming equal bargaining power.\footnote{See Rosenberg (2002) for additional discussion of the trial and settlement effects of preclusion in large-scale litigation, especially the strategic effects of a complete preclusion system.}
One thing is clear. There is a pressing need for more work on nonparty preclusion, especially its settlement effects. It seems, however, that the economic arguments for some form of nonparty preclusion in large-scale litigation are strong.17

Bibliography
Rasmussen, Eric, Judicial Legitimacy as a Repeated Game, 10 J.L. ECON. & ORG. 63 (1994).

17 It is important to note, however, that the restrictive approach to nonparty preclusion in American law is probably anchored to a rights-based theory of participation rather than to a utilitarian theory. For a description and critique of the rights-based approach, see Bone (1993).