

## How to better predict judgments<sup>1</sup>

A lawyer's task includes predicting judgments. Clients frequently want to know his or her likelihood of winning a case. But predictions are difficult to make. Difficulties in predicting acceptability of evidence aside, predicting judgments is most difficult if a decisive legal issue has never been decided upon by a supreme court. A lawyer quite commonly is left to tell his client that there are valid arguments for as well as against winning such a case. This doesn't help the client very much. It is virtually impossible to say: "There is an 85% probability for the court deciding in your favor". A German proverb doesn't say for nothing "At high sea and in court you are in god's hands". However, the better substantiated a prediction the better a client's position to say whether or not it is worth the risk of going to court.

Though more of a theory, a possible solution to this problem might be to commission a survey of legal experts on the likelihood of a case's outcome. Surveys, however, are so time consuming and expensive that they do not qualify as a solution.

A different approach to this problem is based on experimental economy.<sup>2</sup> The basis of the idea is this: to turn man's profit motivation to one's advantage and use it in forecasts. More specifically: issue stock which is rewarded with a certain amount of money, provided a certain event occurs (subsequently called contract). Such a contract would be similar to a betting voucher. It could be traded at an automated exchange and thus develop a certain market value. This market value would predict, just like the odds do in a bet, how likely it is (in the public's eye) for a certain event to take place. Just as with futures in commodities, participants will raise the money needed for any payout.

Sport serves as a model to show how this could work. A contract could be worded like this: "One Euro will be paid if the soccer club Bayern Munich wins the Champions League next year." This contract could be traded at an automated exchange, allowing anyone to buy and sell contracts just as is done with stock. Contracts would gain a certain market value at the exchange. A sample price of 15 Cent would indicate that the market (the public) predicts a 15% probability of Bayern Munich winning the Champions League next year. The accuracy of a forecast is determined by comparing predictions of the past with events that actually took

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<sup>1</sup> I would like to thank Mr. Rupert Kindermann for translating this article into English.

<sup>2</sup> Vernon L. Smith is one of the pioneers on this subject. In 2002 he received the Nobel Prize for this work.

place. Provided this method of forecasting works out then an event should occur 15 out of 100 times if the market predicted it with a 15% probability. Research into sport betting done to date indicates a relatively high accuracy of public (market) predictions (in sport betting).<sup>3</sup>

The idea of trading a contract at an exchange can be applied to many similar problems. Since 1998 contracts are being traded at the University of Iowa, USA. The “College of Business” runs „Iowa Electronics Markets” (abbreviated: IEM)<sup>4</sup> that continuously trades in contracts on various political and economic questions. Current values of such contracts are available on the Internet. In 2003 IEM offered contracts on the outcome of California’s governor election which read, in essence, “Arnold Schwarzenegger will win”. After Schwarzenegger’s victory one dollar was paid for every contract. The contract’s value, prior to election date, indicated Schwarzenegger’s chances as seen by the public. If a contract’s value was 80 cents the market assumed that Schwarzenegger has about an 80% chance to win the election.<sup>5</sup> A host of such examples, in addition to IEM, shows that trade in contracts is technically possible on a wide range of topics. The Hollywood Stock Exchange (HSX) for instance deals contracts on future Oscar winners.<sup>6</sup>

Similarly, it is technically possible for an automated exchange to issue and trade contracts on legal issues. A contract could have been issued on a case (in the meantime concluded) concerning the German Aviation Act at the Federal Constitutional Court, reading as follows:<sup>7</sup> “The Federal Constitutional Court will declare unconstitutional to authorize armed forces – with reference to Sec. 14 Para 3 German Aviation Act – to shoot down an airplane by use of force of arms (proceeding 1 BvR 357/05). Owners of contracts will receive one Euro if the Federal Constitutional Court decides like this. No payment occurs if the proceeding ends differently.” The contract’s market value would have provided a means to estimate the public’s view on the likelihood of the Federal Constitutional Court to declare such a regulation as unconstitutional.<sup>8</sup>

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<sup>3</sup> James Surowiecki, *Die Weisheit der Vielen* (The Wisdom of Crowds), 2005, pg. 41.

<sup>4</sup> <http://www.biz.uiowa.edu/iem/>.

<sup>5</sup> Sample taken from James Surowiecki, *Die Weisheit der Vielen* (The Wisdom of Crowds), 2005, pg. 41.

<sup>6</sup> [www.hsx.com](http://www.hsx.com).

<sup>7</sup> Bundesverfassungsgericht (Federal Constitutional Court), judgment February 15, 2006 (case reference: 1 BvR 357/05).

<sup>8</sup> This idea could be fine tuned by issuing different contracts which offer different scenarios of how this proceeding could end. By applying calculations used in discounting interests on reserves, price differences would give a clue as to the length of proceedings, as estimated by the public.

A completely new tool would be available to lawyers in consulting their clients once a great many contracts were issued by an automated exchange. Lawyers were able to check (via Internet) and utilize public (market) predictions of a great many legal issues when advising their clients. A number of advantages could be had by creating an exchange for contracts in legal questions:

- ? Lawyers could give a client a specific number (namely the market's prediction) if a client wanted to know his or her likelihood of winning a case. Such numbers might not always be correct and even be manipulated. Overall, however, this would be an advance over and above the current situation.
- ? Clients would be in a better position to objectively decide on filing a suit or not.
- ? In a court case with open (undecided as yet) legal issues, the ruling court would be in a better position to offer convincing arguments in favor of a specific settlement proposition and thereby aid in amicably settling a case.
- ? Legal costs insurances will have more certainty in answering the question: to finance or not to finance a case.
- ? Politicians would have more time to prepare for the outcome of politically important court cases.
- ? To a certain extent legal uncertainty itself will be quantified. This is better, in general, than not to quantify legal uncertainty at all as a decision will be based on a broader sampling of information. For example: once an investor knows that the market estimates a certain risk as "low" he may decide to run with the remaining risk while, on the other hand, he might have refrained from investing in a case, simply because of the complete uncertainty of legal issues.
- ? Given a big enough market, companies will be able to insure with this exchange against legal risks, just as farmers can insure against bad weather or low prices of their produce. Such an insurance would allow to enter legal risks which otherwise, because of legal uncertainties, would be avoided.
- ? Finally, such a model can be used educationally at universities – e.g. in seminars. It should aid in students dealing with such conflicts more thoroughly as results will be evident in a much shorter period of time.

Looking at these advantages it would be welcomed if legislators, lawyers, universities as well as other interested parties would work toward establishing, in the near future, a liquid exchange in legal matters.