Signaling, Learning, and Screening Prior to Trial: Informational Implications of Preliminary Injunctions

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Preliminary injunctions (PIs) are important in litigation in many settings, including antitrust, copyright, patent, trademark, employment and labor relations, and contracts. The filing of a PI and the court’s ruling generate information that can impact settlement. We find that some plaintiffs request a PI to signal bounds on their damages in order to elicit better settlement offers. As a result, the parties are more likely to come to an out-of-court agreement permitting the disputed activity, compared to when a PI is motivated solely by defensive reasons to avert immediate damages during trial. Although the grant of a PI reduces ex post incentives for potential litigants to settle, this is more than offset by an increase in settlement upon a denial. Thus, ex ante, learning leads to more settlement. Nevertheless, the anticipation of learning and increased chances of settlement do not affect the initial filing decision.

1. Introduction
A preliminary injunction (PI) is a court order that is requested in the course of litigation in order to restrain a party from a disputed activity until the case is decided, either by a settlement agreement or through an ultimate finding by the court. PIs are a common tool used in litigation throughout many areas of the law such as patent, copyright, trademark and antitrust litigation, including antimonopoly and merger cases, as well as in labor, employment, and contract law.

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In this article, we study informational implications of the strategic use of PIs in corporate litigation. We find that when there is private information about the plaintiff’s damages, the motion for a PI signals bounds of the damage levels to the defendant. As a result, PIs are more readily requested when compared with the initial motivation that solely relies on the prevention of current damages because the filing decision serves to elicit more generous settlement terms from the defendant. Despite the costs entailed by such signaling, this may nonetheless be overall welfare increasing as it can increase the likelihood that the parties come to an agreement allowing the defendant to proceed. In particular, although fewer high-damage cases will be settled out-of-court, this can be more than offset by a greater number of lower damage cases that settle and no longer burden the courts.

In addition to deriving the signaling implications of requesting a PI, we consider the informational effects that arise in the wake of the hearing on the motion and the court’s ruling, as litigants glean information about the case strength and reassess their chances of ultimately prevailing at trial. When the court declines to enjoin the defendant and denies the request for a PI, litigants’ beliefs that the plaintiff will ultimately prevail at trial are diminished. As a consequence, lower settlement offers are made by the defendant, yet these are accepted with greater frequency, precisely because the alternative of continued litigation is less attractive to the plaintiff.

Furthermore, we find that although the anticipation of learning about the merits of the case need not affect the primary motivation for filing for a PI, the hearing and the court’s ruling nonetheless unambiguously increase the ex ante likelihood that litigants will come to an out-of-court settlement. This result suggests that PIs in particular, as well as other pretrial motions in general, should possibly be facilitated. Although seeking preliminary relief creates an added expense in the process of litigation, we find that the higher costs of a full trial can be saved due to the greater likelihood of obtaining an out-of-court settlement.

1.1 Related Literature

Corporate litigation is recognized as an important tool in competition, and there is an extensive literature in economics on how strategic information transmission affects parties’ optimal strategies leading up to and during the

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1. This is similar to Spier (1992) and Daughety and Reinganum (2002) where by accepting or rejecting settlement offers defendants reveal information about their types; and it is similar to Posey (1998), who studies the signaling value of hiring an attorney and Choné and Linnemer (2010), who consider signaling through pretrial investment in case preparation, which in their model results in augmented expected damage awards by a fixed factor.

2. In making a ruling, the court is required to justify its finding. Thus, “In granting or refusing an interlocutory injunction, the court must . . . state the findings and conclusions that support its action” Fed. R. Civ. P. 52(a)(2); similar rules apply in States’ courts.
course of litigation. Yet, despite the importance and frequent use of preliminary injunctions in court proceedings, the analysis of PIs as an integral part of a plaintiff’s strategy at trial has by-and-large been eschewed in the economics literature on litigation. A notable exception is Lanjouw and Lerner's (2001) study on patent infringement litigation. Recognizing the costs associated with litigating PIs, they show that a patent holder may be motivated to ask for a PI in order to impose financial stress on the defendant. As a result, financially weak infringers who face the additional costs associated with the PI are more readily willing to abandon their course of action. In noting that “in a world with uncertainty about case quality, a PI hearing may be a relatively cheap way to obtain information about how a court would rule in an eventual trial” (p. 586), they identify an important informational role of PIs, but they do not consider the implications of this on the process of litigation. Another study is Boyce and Hollis (2007), who model how PIs in patent cases may be used as collusive mechanisms by taking advantage of specific damage rules. However, in their model, there is no uncertainty concerning players’ payoffs and information dissemination plays no role.

In contrast to the economics literature, there is a large body of legal scholarship on preliminary relief. Most studies focus on specific legal aspects of PIs—for example, the burden of proof attached to establishing a valid claim—some of which we review below when discussing criteria for the grant of a PI. However, here too, there is little formal discussion of the role of PIs in information dissemination and learning. Two exceptions are Brooks and Schwartz (2005) and Lichtman (2003), who both allude to the role that PIs can play in generating and disseminating information in order to affect litigation and settlement.

Brooks and Schwartz observe that “[s]trategic use of preliminary injunctions by plaintiffs is not uncommon. Parties often pursue preliminary actions, knowing that they are likely to get the same judge at the final stage . . . and that judge is unlikely to switch her views of the merits subsequently. This may improve a party’s bargaining power in settlement negotiations” (p. 386). In our model, we capture the fact that the court’s ruling reveals information about the merits of the case in the eyes of the court. The court’s ruling, thus, affects the parties’ bargaining positions. However, we do not find support for the implied motivation for requesting a PI. Indeed, compared to a benchmark in which

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4. Although these authors recognize the importance of uncertainty and the dissemination of information in the course of litigation, neither of the studies examine this role of PIs. Lichtman considers how a particular form of uncertainty about damage levels affects normative implications of the Learned Hand rule and other cost-benefit analyses used in courts; and Brooks and Schwartz (2005) focus on efficiency implications of liability versus property rules in the application of injunctive relief.
the court’s ruling on the PI is statistically independent of an eventual ruling at trial, the filing motivation is unaffected by potential learning. That is, the anticipation of a PI ruling itself does not affect the incentives for requesting a PI—with the same set of plaintiff types pursuing a PI in either case. This is not that surprising since the plaintiff recognizes that the PI ruling will weaken his position upon a denial—a risk that is just offset by the potential upside of a grant of the PI.

Lichtman notes that “[p]reliminary hearings—whether or not they lead to injunctions—surely do promote settlement by increasing the information available to the parties” (p. 202). Despite the anticipation of learning not providing an added incentive to request a PI, we find that the court’s ruling nonetheless unambiguously increases the *ex ante* likelihood that litigants will come to an out-of-court settlement. However, in our model, this augmentation is not symmetric. In particular, the increased probability of an out-of-court settlement subsequent to a denial is sufficiently great to outweigh a reduced probability of a settlement following a grant due to the differential impact of marginal versus inframarginal types.

### 1.2 Criteria Used for Granting a PI

When a plaintiff requests a PI, the court weighs four factors in determining how to rule on the motion: (1) the likelihood with which the plaintiff will prevail at trial, (2) whether the plaintiff suffers irreparable harm if the defendant is not enjoined, (3) the overall balance of harm between the plaintiff and the defendant, and (4) the public interest.5

Concerning the public interest, the most important consideration is upholding the law, which is actually addressed by the first factor (see, e.g., *Cunningham 1995*).6 Hence, the fourth criterion is more narrowly construed and generally addresses how nonparties are affected by the PI. Indeed, in the areas of most interest to us, the public interest rarely factors into a ruling on the PI,7 and some argue that the third and fourth criteria be merged to assess the overall effect of a ruling on potential harm (see, e.g., *Lewis 1993/1994*).

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5. In addition to the four-factor test outlined here, some circuits generally have a bias toward preserving the *status quo*. That is, if the defendant has not yet embarked on the disputed action the court is more likely to grant a PI than if the disputed activity has been ongoing for some time (see, e.g., *Lee 2001*). Our analysis captures both these cases because we postulate a generic propensity toward a granting of the PI.

6. For instance, in weighing a PI request by Sanofi against Apotex to bar a generic rival drug to Sanofi’s blood-thinning drug Plavix, Judge Stein wrote in his ruling that “Although there are competing and substantial public interests at stake on both sides of this litigation, the balance of those competing public interests slightly favors Sanofi. The public interest in lower priced drugs is balanced by a significant public interest in encouraging the massive investment in research and development that is required before a new drug can be developed and brought to market.” *Sanofi-Synthelabo, Inc. v. Apotex Inc.*, 488 F. Supp. 2d 317 (S.D.N.Y. 2006), aff’d, 470 F.3d 1368 (Fed. Cir. 2006).

7. Cases where the public interest has been cited in denying a PI generally involve severe disruptions of supply chains or other strong adverse effects to nonlitigants (see, e.g., *Shapiro 1993*).
In determining the overall balance of harm, the court assesses whether the expected damages from an erroneous grant outweigh the expected damages from an erroneous denial. In so doing, the court must explicitly assess the first criterion, namely the likelihood that the plaintiff ultimately prevails at trial. Moreover, as indicated by the second criterion, it is incumbent upon the plaintiff to demonstrate that the harm suffered is “irreparable.”

Irreparable harm is immediate if, for example, the plaintiff is at risk of going bankrupt or the defendant may become judgment proof. However, the mere fact that damages could be hard to assess (e.g., damages are not verifiable) may result in subsequent remedies being “intolerably random.” (Lichtman 2003, p. 198)—leading to a finding of irreparable harm. Indeed, especially relevant for our settings, the following have been found to establish irreparable harm: potential loss of market share, potential loss of market advantages, damage to reputation, loss of goodwill, confusion in the market place, or the encouragement of others to infringe. In fact, in many instances, including patent, trademark, and copyright cases, the plaintiff is “entitled to a legal presumption of irreparable harm [upon a] ‘strong showing’ of likelihood of success” (Shapiro 1993, p. 337). Thus, for most settings of concern to us, the critical factor for a successful motion is the first criterion—establishing the merits of the case. Indeed, Leubsdorf (2007, p. 35) states in regard to preliminary relief in general (not just in corporate litigation) that “[u]nder existing law as well as under the Leubsdorf–Posner formulation, the strength of the plaintiff’s case . . . is an important, perhaps the most important, factor in determining whether the plaintiff can obtain preliminary relief.”

Traditionally the threshold for granting a PI was highest in patent-infringement cases compared with other intellectual and industrial property disputes (Cunningham 1995). However, since its inception in 1982, the Federal Circuit Court of Appeals—which has jurisdiction over patent infringement cases—has lowered the burden of proof for granting a PI from “beyond question” to a standard of “reasonable likelihood.” With this in mind, we now

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8. This is known as the Leubsdorf–Posner balancing rule. Indeed, Judge Posner’s ruling in American Hospital Supply Corp. v. Hospital Products Ltd., 780 F2d 589, 593 (7th Cir. 1986) goes so far as to state that: “This formula . . . is not offered as a new legal standard . . . . It is actually just a distillation of the familiar four (sometimes five) factor test that courts use in deciding whether to grant a preliminary injunction.” See also Leubsdorf (1978). Assessing expected damages has recently been given some renewed attention in that in Winter v. NRDC, 555 US 7, the Supreme Court held that irreparable damages would not just have to be “possible” but would have to be “likely.”


10. See also Lichtman (2003) and especially Samuelson and Bebenek (2010) for a critique of this practice in the context of copyright law.

11. Cf. Atlas Power Co. v. Ireco Chemicals, 773 F.2d 1230, 227 U.S.P.Q. 289 (Fed. Cir. 1985). Consequently, there was an increase in the use of PIs (Shapiro 1993; Shehaded and Stewart 2001) as well as an increase in the likelihood of PIs being granted from roughly 40% to over 60% for the 10-year period after the establishment of the court (Cunningham 1995); similarly in the data from
turn to an analysis of informational implications of the use of PIs in corporate litigation.

2. The Basic Model

The legal conflict under consideration involves a plaintiff firm (of male gender) and a defendant firm (of female gender), both of whom are risk neutral. Absent the legal dispute firms earn a constant discounted profit stream of $\Pi_i$, where $i \in \{p, d\}$, with p and d being mnemonics for the plaintiff and defendant. The implication of the constant discounted profit stream is that litigants have a base payoff of $\Pi_i$ at any point in time, independent of which stage of the litigation process is reached.

The conflict begins when in order to secure a benefit $b$, the defendant embarks on allegedly unlawful actions that adversely affect the plaintiff firm, for example, a purported patent, copyright, or trademark infringement, or actions in violation of civil antitrust, employment or labor laws, or a breach of contract. Due to the actions of the defendant, the plaintiff suffers damages of $x$. These damages may be correlated with $b$, but they are unverifiable in that they reflect the plaintiff’s subjective assessment of counterfactuals concerning his future payoffs. Moreover, the precise extent of these damages are private information of the plaintiff; the defendant knows only the distribution of possible damages, denoted by $F(x)$ with differentiable density $f(x)$ on $[x, \bar{x}]$; where $F(x)$ satisfies the reverse monotone hazard rate condition (MHRC), that is, $f/F$ is nonincreasing. $F(\cdot)$ may either reflect a priori beliefs about damages or is the result of remaining uncertainty after some prior unsuccessful settlement negotiations, which are not formally modeled as they do not affect the use of the preliminary injunction. In contrast, the defendant’s benefit $b$ is common knowledge.

The interaction between the parties goes through three phases, depicted in Figure 1.

For simplicity, we assume that in the first phase (i.e., the pretrial motion phase), no damages occur, as these would be sunk in any event and therefore not affect the litigants’ strategies. In this phase, upon incurring a cost of $c_{PI}$, patent-infringement cases studied in Lanjouw and Lerner (2001) roughly half of the PIs requested were granted.

12. In many settings, $b$ is private information. However, since the size of $b$ has no direct bearing on the strategic use of the PI for informational purposes, common knowledge about $b$ does not affect our analysis whenever $b$ and $F(\cdot)$ are unrelated. A relation between $b$ and $F(\cdot)$ is to be expected especially in civil antitrust cases and possibly also in IP cases (in which case the degree of harm inflicted might also be subject to strategic considerations by the defendant); but less so in contract disputes, where the party being accused of breach generally takes actions in light of outside opportunities. In any event, assuming a relation between $b$ and $F(\cdot)$, while maintaining that $b$ is also private information, requires that the model account for higher-order beliefs (i.e., the beliefs that the plaintiff has about the defendant’s beliefs about $x$), making the model needlessly cumbersome.

13. There are no court costs associated with the motion. However, the plaintiff must still overcome the burden of proof and in doing so the plaintiff locks himself into specific legal
the plaintiff can request preliminary injunctive relief to enjoin the defendant so as to stave off the damages that accrue in the course of further litigation in the second phase, $\tau$. That is, $\tau \in (0, 1)$ denotes the portion of the total damages from the disputed action that accrue during the second phase and are thus subject to the PI, whereas the remainder $(1 - \tau)$ proportion of damages accrue in the final phase (the posttrial phase) and are thus subject to final adjudication by the court.

In order to focus on the informational implications tied to the use of PIs, we consider their basic “defensive” role designed to prevent current damages and abstract from their “offensive” use in which the request is designed to harm the defendant. Therefore, we assume that no costs are incurred by the defendant firm in the course of a PI hearing and no benefits accrue to the defendant in the second phase since otherwise the plaintiff’s filing decision is confounded by how legal costs and a possible grant of the PI affect the defendant’s bargaining position in settlement negotiations.

There are two sources of uncertainty in the model. The first is the uncertainty that comes about because the damages suffered by the plaintiff are unverifiable strategies and arguments. As a consequence, the costs of preparing the motion can be substantial as it is labor intensive necessitating considerable attorney time at an accelerated rate. Indeed, Lanjouw and Lerner’s empirical findings suggest that PIs “may be available only to financially stronger plaintiffs” (p. 575) as those who file for a PI tend to be twice as large as those who do not file in terms of cash and equivalents and other measures. Consequently, some practitioners caution against the use of PIs due to their costs (see, e.g., Johnson 2002).

14. These damages may be quite substantial as subsequent litigation may last very long (e.g., the patent infringement case of Polaroid against Kodak lasted well over a decade).

15. In Section 5.2, where we briefly address legal remedies in addition to equitable relief, we also discuss benefits that accrue concurrent to the legal proceedings.
private information. Specifically, the defendant does not know what type of plaintiff she is facing and the plaintiff is unable to convincingly reveal his type. This is the source of asymmetric information between the parties that can result in a failure of out-of-court settlement, which then leads to a trial. This source of uncertainty also leads to the augmented use of the PI request as a means to convey information, that is, to signal bounds on damages, in order to facilitate out-of-court settlement.

The second source of uncertainty is given by both parties’ common uncertainty about the legal merits of the case. This source of uncertainty does not directly affect the probability of an out-of-court settlement since these beliefs are held commonly by both parties. However, it affects the possible terms of an out-of-court settlement, as it is a measure of the relative strengths of the two parties—and this has implications for the strategic use of the PI request.

In characterizing the three phases of the model, we now describe how the two sources of uncertainty are affected by and affect the parties’ actions. At the outset of the first phase, the plaintiff decides whether or not to seek a PI against the defendant. In equilibrium, this decision depends on the damage level $x$, with only plaintiff types who have sufficiently high damages seeking preliminary injunctive relief. Thus, the decision to file allows some inferences about the plaintiff’s type.

If a PI is sought, a hearing on the motion ensues upon which the court either dismisses the motion or enjoins the defendant. To keep the model tractable, we assume that evidence submitted during the hearing contains no (further) information about the plaintiff’s damages. This assumption is warranted to the degree that the plaintiff’s main objective at the PI hearing is to establish a strong showing on the merits of his case, which frequently then establishes a presumption of harm. Moreover, to the extent that the plaintiff presents evidence of damages, the focus is primarily on showing that harm is irreparable. Nevertheless, our assumption can be seen as limiting since the plaintiff always has an incentive to substantiate before the court and the defendant a high level of damages. Because we abstract from this possibility, the court’s ruling on the motion is necessarily independent of $x$ and we thus let $\gamma$ denote the belief that each party commonly holds that a request for a PI is granted.  

As for the second source of uncertainty—uncertainty about the strength of the case—we initially suppose that the hearing and court’s ruling on a PI are uninformative about the court’s view of the underlying case, which allows us to isolate the signaling aspects of a PI request that alleviate asymmetric information between the parties. However, in Section 4, we extend the analysis by considering how the hearing and the court’s ruling on the PI allow both parties to learn about the merits of the case—information that is used to draw

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16. It is possible to include an updating of beliefs on damages that is specifically conditioned on the hearing or the ruling, but this significantly complicates the model and does not overturn the findings of the simpler structure.
inferences about the court’s possible ultimate ruling should the case go through to final adjudication.

There are two stages in the second phase, beginning with settlement negotiations and culminating in the trial and final adjudication should an out-of-court settlement agreement not be reached. Specifically, upon observing whether the plaintiff moved for the PI the defendant updates her beliefs about the damages suffered by the plaintiff. And (in the extended model in Section 4) upon observing the court’s subsequent ruling on a PI request she updates her beliefs about the strength of the case. Based on her updated beliefs, the defendant then makes a take-it-or-leave-it offer for a settlement, denoted by SO, that allows the disputed behavior to continue in the final phase. That is, the defendant offers to buy the right that the plaintiff claims to be entitled to. If the plaintiff accepts the given settlement offer, the game ends with an out-of-court settlement.17

If an out-of-court settlement agreement is not reached, the trial stage is entered during which litigation costs of $c_i, i \in \{p, d\}$ associated with the actual trial are incurred. Each party bears its own costs regardless of the outcome at trial, that is, the American fee rule is assumed.

For purposes of greater clarity, we assume that the court only considers equitable relief. That is, the court determines the legality of the disputed activity and then issues or denies a permanent injunction.18 In particular, there are two possible underlying states concerning the case. In the “valid” state, the plaintiff wins if it comes to a final ruling at trial. That is, the court rules in favor of the plaintiff by permanently enjoining the defendant firm, resulting in continuation payoffs equal to the base profits $\Pi_i$ for both firms. Alternatively, in the “invalid” state the court—when called upon—finds in favor of the defendant, ruling the disputed behavior to be permissible in which case base payoffs are modified by $-(1-\tau)x$ and $b$, respectively. The prior probability that both parties commonly hold that the case is valid is given by $\nu$.

We conclude by assuring that litigation is a credible option for both parties. For the defendant, this is the case whenever the cost of litigation is smaller than the potential gain from her actions weighted by the probability that she prevails in court (i.e., whenever $c_d < (1 - \nu)b$). Similarly, pursuing litigation is credible for all plaintiff types whenever the cost of litigation is less than the smallest level of posttrial damages weighted by the probability of winning the case (i.e., $c_p < \nu(1 - \tau)x$).

17. Indeed, it is not unusual for a trial to be agreed to be stayed after a PI ruling specifically so that the litigants have a chance to come to a settlement agreement, see, for example, Grundfos Pumps v. Laing Thermotech, No. C-07-4033 JSW, Stipulation and Order (1) Entering Preliminary Injunction and (2) Ninety Day Stay (N. D. Cal. Oct. 26, 2008)—a case that was indeed then settled.

18. Depending on the type of the case, litigants may also consider other pretrial motions and the court may also consider other remedies. For instance, in the data considered in Bizjak and Coles (1995), while over two thirds of cases are filed seeking (only) equitable relief, the remainder expressly (also) seek monetary damages (i.e., legal relief). We briefly address this in Section 5.2.
Before presenting informational concerns that arise in filing for a PI, we briefly consider the plaintiff’s basic motivation for filing for a PI. That is, we derive the benchmark threshold for filing for a PI when the sole objective is to avert the damages that accrue during the trial phase. Specifically, a plaintiff who refrains from seeking a PI suffers damages of $\tau x$ during the trial phase. These damages can be averted by filing for a PI at the cost of $c_{PI}$, provided that the court issues a favorable ruling on the PI and (tentatively) enjoins the defendant, which occurs with probability $\gamma$. Thus, a plaintiff files for a PI whenever

$$
\Pi_p - c_{PI} - (1-\gamma)\tau x > \Pi_p - \tau x
\quad \iff \quad c_{PI} < \gamma \tau x.
$$

Abstracting from trivial cases in which the filing for a PI is so cheap that the plaintiff chooses to file regardless of the level of damages, or so costly that none is ever sought, the benchmark motivation for filing for a PI is given by

Benchmark (Myopic/Defensive) Filing Decision:

$$
\begin{align*}
P & \text{ for } x \geq \hat{x}_B := \frac{c_{PI}}{\gamma \tau} \quad (\Pi), \\
N & \text{ for } x < \hat{x}_B := \frac{c_{PI}}{\gamma \tau},
\end{align*}
$$

where PI designates that a request is filed, whereas $N$ identifies the case in which no PI is sought, and $\hat{x}_B \in (x, \tau)$ denotes the threshold (benchmark) level of damages above which a PI is sought. As noted above, the benchmark use of filing for a PI is purely defensive. We now consider how informational considerations affect the plaintiff’s filing decision and, thus, alter the threshold type.

3. Signaling and Screening Prior to Trial

The analysis of the benchmark demonstrates that plaintiff types suffering relatively low damages (below $\hat{x}_B = \frac{c_{PI}}{\gamma \tau}$) refrain from incurring the cost of requesting a PI, whereas those with high damages incur the cost by filing for a PI. Thus, the defendant recognizes that filing for a PI reveals information about the damages suffered by the plaintiff. This, of course, affects the possible settlement offers that the defendant is willing to entertain. Because filing for a PI affects the possible terms of a settlement, the plaintiff, in turn, takes this into consideration when formulating the decision on whether to request a PI—that is, the plaintiff may use the PI to signal bounds on his damage levels.

With these informational dynamics in mind, we analyze the litigants’ optimal strategies while hypothesizing that in equilibrium, it is known that plaintiff types below a certain threshold level of damages do not file for a PI, whereas those above do. That is, we make use of the following initial conjecture, which is verified in equilibrium.

Conjecture 1. (Monotonicity in Filing for PI). There exists a damage level $\hat{x}$ such that any plaintiff with damages below $\hat{x}$ does not file for a PI, whereas all others do.
3.1 Screening: The Defendant’s Optimal Settlement Offer

Using backward induction, we begin our analysis at the outset of the second phase of litigation. At this stage, the court has already issued its ruling on any PI request if a PI was sought. The proportion \( \tau \) of damages are sunk so that proposed settlement offers concern the remaining \( (1 - \tau) \) proportion of damages that are yet to accrue.

To determine the defendant’s optimal settlement offer, it must first be established when a plaintiff is willing to accept a proposed settlement. To this end, let \( V \) denote the plaintiff’s expected payoff. When accepting an arbitrary settlement offer of \( SO \), his payoff is given by the (time invariant) constant base payoff \( \Pi_p \), augmented by the amount of the settlement offer \( SO \), and diminished by future losses due to the continued actions of the defendant firm \( (1 - \tau)x \), that is, \( V^S = \Pi_p + SO - (1 - \tau)x \), where the superscript \( S \) denotes the out-of-court settlement. 19

In contrast, if the plaintiff proceeds to trial his payoff consists of the base payoff \( \Pi_p \), diminished by the costs of litigation \( c_p \), and the costs associated with a possible ruling against him at court \( (1 - \nu)(1 - \tau)x \). That is, \( V^T = \Pi_p - c_p - (1 - \nu)(1 - \tau)x \), where the superscript \( T \) denotes the decision to go to trial.

Define \( x^S \) as the damage level suffered by the plaintiff firm that is just willing to accept a given settlement offer \( SO \). The plaintiff accepts the settlement offer whenever \( V^S \geq V^T \), so the marginal plaintiff type is implied by

\[
x^S := \frac{SO + c_p}{\nu(1 - \tau)},
\]

with all plaintiff types with \( x \leq x^S \) settling out-of-court.

In light of the defendant’s uncertainty about the plaintiff’s damages, in order to determine the optimal offer, she must estimate the likelihood that a settlement offer is accepted, given the history of the game. On the basis of Conjecture 1, the defendant updates her beliefs about the damage level suffered by the plaintiff upon observing the plaintiff’s decision on whether or not to file for a PI. Letting \( H \in \{PI, N\} \) denote the history of a PI having been requested (PI) or not (N), and letting \( \hat{x}^c \) denote the defendant’s conjecture about the plaintiff’s cutoff for filing a PI, the defendant’s posterior beliefs about the possible damage levels suffered by the plaintiff are given by

\[
F^H(x) := \begin{cases} 
\frac{F(x) - F(\hat{x}^c)}{1 - F(\hat{x}^c)} & x \in [\hat{x}^c, \pi] \text{ and } H = PI, \\
\frac{F(x)}{F(\pi)} & x \in [\pi, \hat{x}^c] \text{ and } H = N.
\end{cases}
\]

Given these beliefs, the (subjective) probability that a plaintiff accepts a given settlement offer \( SO \) is thus given by \( F^H(x^S) \).

Consider now the defendant’s optimal settlement offer. If the litigants settle out-of-court, the defendant pays out \( SO \), the case is dropped and the defendant

19. In equilibrium, settlement offers are history dependent and are denoted by \( SO^H \) with \( H \) indexing the history of the game. In analyzing the plaintiff’s actions, we consider arbitrary offers \( SO \).
receives her benefit of $b$, yielding a payoff of $\Pi_d - SO + b$. If settlement is not reached, the defendant incurs litigation costs $c_d$ but stands a chance to prevail at trial so that the defendant’s payoff is $\Pi_d - c_d + (1 - \nu)b$. Hence, the defendant’s (history dependent) expected payoff from making a settlement offer $SO$ is

$$\Pi_d + F^H(x^S)(-SO + b) + (1 - F^H(x^S))(-c_d + (1 - \nu)b).$$

It is worth noting that if the defendant’s benefits are very large, her strategy is to simply buy off the plaintiff. Also, if her benefits are very low, she will not make any settlement offer to a plaintiff who has revealed relatively high damages by filing for a PI. In either of these extreme cases, the plaintiff makes a filing decision independent of the defendant’s strategy and we therefore abstract from these cases.

Having determined the defendant’s subjective expected payoff, we can derive the settlement offer she proposes. Making use of the relationship between $SO$ and $x^S$ given in equation (3), the first-order condition of the defendant’s problem for interior solutions is given by

$$F^H(x^S) + x^S = \frac{\nu b + c_d + c_p}{\nu(1 - \tau)}.$$  

(5)

From this, the defendant’s optimal settlement offers follow.

**Lemma 1 (Screening).** Given beliefs $\hat{x}$, the defendant’s unique optimal terms of settlement as a function of the plaintiff’s filing decision, denoted by $SO^H$, with $H \in \{PI,N\}$ are

$$SO^H(\hat{x}) = \begin{cases} \nu(1 - \tau)x^H(\hat{x}) - c_p & \text{if } F^H(\hat{x}) + x^H < \frac{\nu b + c_d + c_p}{\nu(1 - \tau)}, \\ \nu(1 - \tau)x^N - c_p & \text{else,} \end{cases}$$  

(6)

with the amounts $x^N$ and $x^PI$ being implied by equation (5) in conjunction with equation (4).

If the condition on the top branch of $SO^N$ is met, then no interior solution to the defendant’s problem exists when no PI is sought, given the defendant’s beliefs about the threshold for filing. In this case, she simply offers to buy the plaintiff off in light of the perceived level of damages. Otherwise the interior solution is implied by the bottom branch of $SO^N$.

Lemma 1 shows how a defendant’s optimal settlement offer is affected by her beliefs about the damage level caused by the action. As a result, the defendant makes distinct settlement offers depending on whether a PI is requested or not.

### 3.2 Signaling: The Plaintiff’s Decision to File

Given the defendant’s possible settlement offers as a function of her beliefs about the threshold plaintiff type $\hat{x}$ and the history of whether a PI is requested or not, we derive the plaintiff’s choice whether or not to file for a PI. Once
the plaintiff files suit against the defendant without the motion for a PI, he cannot avoid the trial phase damages (the right-hand side of equation (1)). Subsequently, the plaintiff can either accept the proposed settlement terms \( SO^V \) or proceed to trial. In the latter case, the payoff is equal to \( \Pi_p - \tau x - c_p - (1 - \nu)(1 - \tau)x \).

Alternatively, by Lemma 1, the plaintiff can agree to the out-of-court settlement and drop the case, suffering damages of \( (1 - \tau)x \). In this case, the payoff is \( \Pi_p - \tau x + SO^V - (1 - \tau)x = \Pi_p - \tau x - c_p - (1 - \tau)(x - \nu \min\{\hat{x}^N, \hat{x}\}) \). By construction of the settlement offer, a plaintiff with damages below \( \min\{\hat{x}^N, \hat{x}\} \) prefers to settle, whereas one with greater damages proceeds to trial. In summary, letting \( V^N \) denote the plaintiff’s expected payoff from not filing a motion for a PI,

\[
V^N = \begin{cases} 
V^N_T(x) := \Pi_p - \tau x - c_p - (1 - \tau)(1 - \nu)x, & x > \min\{\hat{x}^N, \hat{x}\}, \\
V^N_S(x|\hat{x}) := \Pi_p - \tau x - c_p - (1 - \tau)(x - \nu \min\{\hat{x}^N, \hat{x}\}), & x \leq \min\{\hat{x}^N, \hat{x}\}; 
\end{cases}
\tag{7}
\]

where, as before, the superscript \( S \) designates an out-of-court settlement, whereas \( T \) denotes a continuation to trial.

If the plaintiff seeks a PI, then the defendant draws the inference that the plaintiff’s damage levels are high and therefore offers \( SO^\Pi \). Filing for a PI entails the immediate cost of \( c_p \), whereas with probability \( \gamma \) a favorable ruling will stave off the trial phase damages of \( \tau x \) (the left-hand side of equation (1)). Regardless of the ruling on the PI, if the plaintiff proceeds to trial, he incurs an additional expenditure of \( c_p \), with the possible ultimate ruling in favor of the plaintiff averting damages of \( (1 - \tau)x \) with probability \( \nu \). Otherwise, if settlement is agreed to, he receives an additional payoff of \( SO^\Pi - (1 - \tau)x \). The latter dominates the former for all plaintiff types with \( x \leq \hat{x}^\Pi \). Hence, letting \( V^{\Pi} \) denote the plaintiff’s expected continuation payoff when requesting a PI,

\[
V^\Pi = \begin{cases} 
V^\Pi_T(x) := \Pi_p - c_p - (1 - \gamma)\tau x - c_p - (1 - \tau)(1 - \nu)x, & x > \hat{x}^\Pi(\hat{x}), \\
V^\Pi_S(x|\hat{x}) := \Pi_p - c_p - (1 - \gamma)\tau x - c_p - (1 - \tau)(x - \nu \hat{x}^\Pi(\hat{x})), & x \leq \hat{x}^\Pi(\hat{x}); 
\end{cases}
\tag{8}
\]

The plaintiff bases his filing decision on whichever payoff, \( V^{\Pi} \) or \( V^N \), is greater, given his type.

### 3.3 Signaling Equilibrium

Having derived the litigants’ incentives, we now consider the equilibrium and demonstrate the existence and uniqueness of a signaling equilibrium. This requires that there is a unique pair \( (\hat{x}, \hat{x}) \) with \( \hat{x} = \hat{x} \). That is, in equilibrium, the defendant’s conjecture about the plaintiff’s actions must be consistent with the actual decision to request a PI.

**Proposition 1** (Equilibrium Existence and Uniqueness). There exists a proportion of damages accruing in the trial phase \( \hat{x} := \frac{1}{1+\tau} \) such that whenever \( \tau > \hat{x} \), there exists a unique sequential equilibrium.
To understand the intuition for a minimum proportion of damages accruing in the trial phase (τ), suppose that only a small fraction of the total damages accrue during litigation. Then plaintiff types with very high-damage levels request a PI in the hopes of preventing current damages, while those with intermediate damage levels proceed directly to trial without the motion for a PI. However, plaintiff types with very low damages may file for a PI simply to receive a very high settlement offer in response to a filing decision, resulting in a nonmonotonic filing decision. Because settlement offers are primarily driven by the marginal plaintiff type who files (rather than the inframarginal types), much of the subsequent analysis for this case remains similar to the current analysis. However, the derivation and exposition become much less tractable and it is no longer clear that uniqueness of the equilibrium is assured.

The intuition for the uniqueness of the equilibrium when τ > ˜τ, is that the higher is the defendant’s belief concerning the threshold type, the higher is the settlement offer that is made, which, in turn, lowers the threshold for making worthwhile the expense of filing for a PI. That is, the plaintiff’s incentive to file for a PI moves in the opposite direction of the defendant’s belief about the threshold, assuring a unique crossing, and thus a unique equilibrium.

The plaintiff’s equilibrium payoff as a function of his type is depicted in Figure 2.

For the case depicted (i.e., with xN < ˜x) the plaintiff’s strategy is given by

\[
\text{Filing and Settlement Decisions:} \begin{cases} 
\text{PI} & \text{if } x \in (x^{\text{PI}}, \tilde{x}], \\
\text{S} & \text{if } x \in (\tilde{x}, x^{\text{PI}}]; \\
\text{N} & \text{if } x \in \left(\tilde{x}, x^{\text{PI}}\right]. 
\end{cases}
\]

That is, upon filing for a PI, the defendant proposes settlement terms that any plaintiff type with \(x \leq x^{\text{PI}}\) accepts; those with higher damages proceed to

\[
V(x) = \max\{V_{\text{S}}(x), V_{\text{T}}(x), V_{\text{PI}, \text{S}}(x), V_{\text{PI}, \text{T}}(x)\}.
\]
trial. When not filing for a PI, the defendant makes a reduced settlement offer which types with \( x \leq x_N \) accept.

**Theorem 1.** (Signaling Prior to Trial). In the unique equilibrium, some plaintiff types incur the cost of filing for a PI solely to signal that they do not have low damages in anticipation of thereby obtaining the high settlement offer before settling out-of-court.

The intuition behind the signaling aspect of the equilibrium is that filing for a PI separates the plaintiff types into two groups (cf. Figure 2). The group that incurred the cost of filing for a PI are offered better settlement terms. Thus, recalling the benchmark threshold type for filing for a PI, \( \hat{x}_B \), given in equation (2), a plaintiff of type \( x \in [\hat{x}, \hat{x}_B] \) files for a PI solely in order to differentiate himself from lower damage plaintiff types in anticipation of obtaining a more favorable settlement offer, which is then accepted forsaking the possibility of a subsequent trial. While it is also the case that plaintiff types with \( x \in [\hat{x}_B, x_{PI}] \) file for a PI and then subsequently settle, these are not engaged in signaling, as they would have incurred the cost of filing for a PI even absent any potential settlement. In sum, whenever \( x \in [\hat{x}, \hat{x}_B] \), the plaintiff incurs the cost associated with requesting a PI, not to ward off current harm due to the action of the defendant, but rather as a means of obtaining favorable settlement terms from the defendant in the settlement stage, as the costly filing decision is a credible way to signal that the plaintiff’s damages are not low.

A concern encountered in all signaling models is potential welfare losses implied by costly signaling. Due to the important defensive role of PIs in the nonsignaling ranges of damages, eliminating the option of PIs to prevent potentially costly signaling is not an appropriate benchmark consideration for welfare implications of the strategic (i.e., signaling) use of filing for PIs. Instead, to ascertain welfare implications of signaling, it is worth considering how the case plays out when litigants are myopic and are unaware of the potential strategic signaling use of filing for a PI. Remarkably, such a comparison reveals that the overall welfare effects of the signaling use of filing for a PI may be positive.

**Theorem 2** (Signaling and Increased Likelihood of Settlement). The probability of out-of-court settlement increases due to signaling compared with the nonsignaling benchmark, whenever

\[
\frac{F(\hat{x}_B) - \max\{F(\hat{x}), F(x^N)\}}{F(x_{PI}^B) - F(x_{PI})} > 1,
\]

where \( x_{PI} := x_{PI}(\hat{x} = \hat{x}_B) \) is the threshold for settling when offers are made that are consistent with the benchmark (myopic) filing decision \( \hat{x}_B \), given in equation (2).

The intuition behind the theorem is that the threshold for filing is lower in the signaling equilibrium than in the nonsignaling benchmark. On the one
hand, this lowers the settlement offer to plaintiff types who file for the PI so that out-of-court settlement becomes less likely among those who file for purely defensive (i.e., nonstrategic) reasons. This is welfare decreasing in that for these cases, litigants incur trial costs and the court system incurs the costs of administering the trial. On the other hand, however, all plaintiff types that are engaged in signaling will now settle. If the benchmark settlement offer made to plaintiffs who did not file for a PI was insufficiently generous to guarantee an out-of-court settlement (i.e., $x^N < \hat{x}_B$), then plaintiff types in the range of $x \in \left[ \max\{x^N, \hat{x}\}, \hat{x}_B \right]$ settle only in the signaling equilibrium, whereas in the benchmark, they proceed to trial. Whenever the mass of intermediate-damage plaintiff types who end up settling solely due to signaling (i.e., the numerator of equation (9)) outweighs the mass of high-damage plaintiff types who no longer are made an acceptable settlement offer (i.e., the denominator of equation (9)), the overall welfare effects of signaling are positive, provided that the costs of initially filing for the PI do not exceed the savings from discontinued litigation upon settlement. The reason behind this is that signaling increases the likelihood of out-of-court settlement and, thus, reduces the costs associated with proceeding to trial. The incidence of increased settlement due to signaling is illustrated in the following example.

**Example** Consider a uniform distribution of damages, that is, $F(x) = \frac{x - x}{x - x}$ and suppose that $\tau > \frac{\hat{x}}{2}$. Then $x^{PI}_B = \frac{1}{2} \left( \hat{x}_B + \frac{\nu b + c + \nu d}{\nu (1 - \tau)} \right)$, whereas $x^{PI}_s = \frac{1}{2} \left( \hat{x} + \frac{\nu b + c + \nu d}{\nu (1 - \tau)} \right)$ so the welfare losses associated with high damage plaintiff types who no longer settle out-of-court are proportional to $F(x^{PI}_B) - F(x^{PI}_s) = \frac{1}{2} \left( \hat{x}_B - \hat{x} \right) \frac{\nu b + c + \nu d}{\nu (1 - \tau)}$. Moreover, a sufficient condition for there to be an increase in the number of cases settled out-of-court is that $\hat{x} > x^{N}\overline{20}$ since then the gains for intermediate range plaintiff types who now settle are proportional to $F(\hat{x}_B) - F(\hat{x}) = \frac{1}{2} \left( \hat{x}_B - \hat{x} \right) \frac{\nu b + c + \nu d}{\nu (1 - \tau)}$, yielding a net increase that is proportional to $\frac{1}{2} \left( \hat{x}_B - \hat{x} \right) \frac{\nu b + c + \nu d}{\nu (1 - \tau)} > 0$.

Note that we consider welfare in a narrow sense confined to the particulars of the litigation modeled. Thus, we abstract from potential welfare gains that may accrue in some legal settings due to increased overall legal clarity should a court make a final ruling (see, e.g., Farrell and Merges 2004 or Lemley and Shapiro 2005 concerning the potential value of obtaining final rulings in patent cases). However, if the public good value of legal clarity is positively correlated with damages, then signaling has the added beneficial effect of shifting settlement toward lower damage cases, with a greater number of high-damage cases obtaining a final adjudication in the court.

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20. The necessary and sufficient condition is that $\frac{1}{2} (\hat{x}_B + \hat{x}) > x^N$. 
4. The Extended Model: Learning

Thus far, it has been assumed that a hearing on a PI request and the subsequent court ruling—either approval or denial of the requested injunctive relief—has no informational implications. Strictly speaking, this means that from an informational standpoint, the PI ruling is pure noise. In fact, however, both plaintiff and defendant reveal information in the hearing and the resulting court ruling is generally regarded as being indicative of the final ruling that the court makes if the case proceeds to trial. The court’s ruling, for instance, may reflect the court’s best assessment of the merits of the case, which is correlated with the true state of the world concerning the case; and it may also be the case that a judge becomes reluctant to subsequently change her views of the merits, as the quotation by Brooks and Schwartz in the introduction might suggest. In any event, as the underlying facts of the case and their legal implications are yet to be further developed in the course of ongoing discovery, the ruling on preliminary injunctive relief cannot be a prefect predictor of the final finding.\(^{21}\)

To formalize this, we denote by \(\alpha\) the frequency with which a PI is denied, even though a subsequent ruling by the court would find for the plaintiff (i.e., when the case is valid). And \(\beta\) gives the frequency with which a defendant is initially enjoined, even though the court would rule in favor of the defendant upon further consideration at trial (i.e., the case is invalid).\(^{22}\) Table 1, then, shows the likelihood matrix for the ruling on PIs, given the true state of the world.

Given the relationship between PI rulings and the underlying case strength, the probability that a PI is granted when it is filed is

\[
\gamma := \nu(1 - \alpha) + (1 - \nu)\beta.
\]

After a suit is brought, the parties revise their beliefs about the case strength on the basis of whether a PI is filed and, whenever this is done, what the court’s ruling on the request is. Posterior beliefs are denoted by \(\nu^H\), where \(H \in \{N,G,D\}\) is the case history, with \(N\) denoting that no request for a PI is filed, and \(G\) and \(D\) denoting the court’s decision to either grant (\(G\)) or deny

\(^{21}\) In fact, the court may reverse itself on findings and conclusions that were used in the ruling on the PI motion. See Boylston Housing Corp. v. O’Toole, 74 N.E.2d 288, (1947); Nader v. Volpe, 466 F.2d 261, (D.C. Cir. 1972).

\(^{22}\) If one takes the view that—in hindsight—a PI ruling is erroneous when it differs from a final ruling a trial, then a PI grant in an invalid case is referred to as Type-I error, false positive, or \(\alpha\) error, while denial followed by a finding for the plaintiff is called a Type-II error, false negative, or \(\beta\) error. Our notation is evocative of the third convention.
a request. By Bayes’ rule, the updated belief about the likelihood of the plaintiff ultimately prevailing at trial is given by
\[
\nu^H = \begin{cases} 
\frac{(1-\alpha)}{\nu(1-\alpha)+(1-\beta)} & \text{for } H = G, \\
\frac{\alpha}{\nu + (1-\nu)(1-\beta)} & \text{for } H = D, \\
\nu & \text{for } H = N.
\end{cases}
\] (10)

Finally, while we acknowledge that there may be a systematic court bias in one direction or the other, we assume that a ruling in favor of the PI is always good news for the plaintiff, whereas a ruling against the PI is always good news for the defendant. That is, \(\nu^D < \nu < \nu^G\), which requires that \(\alpha + \beta < 1\).

4.1 Screening and Settlement after Learning
Since the filing decision precedes the court’s ruling, the defendant’s posterior beliefs about the damage level of the plaintiff are captured by the same updating procedure as before (see equation (4)), given that there exists a threshold level of damages above which a PI is sought.\(^{23}\) If no PI is sought, no learning takes place concerning the case strength and the analysis of the previous section continues to hold. Thus, given beliefs about the threshold for filing, the settlement offer derived previously for the case when no PI is sought remains the same (cf. Lemma 1).

However, upon filing for a PI, the subsequent hearing and the court’s ruling on the request allows litigants to reassess the case strength, which impacts the plaintiff’s willingness to settle. Hence, the defendant’s settlement offer is influenced by the hearing and the ruling on the PI. Specifically, optimal (interior) settlement offers after a PI is requested are given by
\[
\text{SO}^\text{PI} (\hat{\chi}) = \begin{cases} 
\text{SO}^G (\hat{\chi}) := \nu^G (1-\tau)x^G (\hat{\chi}) - c_p, \\
\text{SO}^D (\hat{\chi}) := \nu^D (1-\tau)x^D (\hat{\chi}) - c_p,
\end{cases}
\] (11)
with \(x^G\) and \(x^D\) being implied by equation (4) in conjunction with equation (5) when posterior beliefs (equation (10)) replace prior beliefs (Lemma 1).

The impact of these settlement offers on the likelihood of the case proceeding to trial is illustrated in Figure 3 and formalized in the following theorem.

---

\(^{23}\) Again, we conjecture at this point that a monotone equilibrium filing decision exists—a conjecture that is verified subsequently.
Theorem 3 (Out-of-Court Settlement after Learning). Compared with settlement rates in the benchmark without learning, out-of-court settlement is more likely after a PI is denied and less likely after a PI is granted.

To understand Theorem 3, note that a plaintiff who is granted the PI is more optimistic about winning the case than a plaintiff who is denied the motion (i.e., $\nu^D < \nu^G$). In response, the defendant makes a higher out-of-court settlement offer upon a grant of the PI. However, in light of the defendant’s uncertainty about the plaintiff’s type, this increased settlement offer must be paid not only to the threshold type but also to all inframarginal types. Consequently, the defendant’s equilibrium offer in response to a grant falls short of what would be needed to offset the increased confidence of the threshold type, and the overall measure of plaintiff types that are willing to settle is diminished, that is, $x^G \leq x^D$.

Conversely, when a PI is denied, it becomes cheaper to buy off the plaintiff and some of the implied savings on inframarginal types are used to increase the threshold type who is made an acceptable out-of-court settlement offer.

In sum, out-of-court settlement becomes more likely after a PI is denied, whereas settlement is less likely after a PI is granted. In particular, plaintiff types with damages $x \in [x^G, x^D]$ settle only upon having their PI request denied compared to when a PI is granted (see Figure 3).

Theorem 3 suggests that having a high threshold for granting a PI may be advantageous in terms of its facilitation of out-of-court settlement. However, to substantiate this, one needs to solve for the equilibrium filing decision since the equilibrium filing decision is made in anticipation of the implications that learning has on subsequent settlement and trial decisions.

4.2 Equilibrium in Anticipation of Learning

We now consider how learning about the case strength on the basis of the court’s ruling on the PI affects the signaling equilibrium. The equilibrium is derived as was done previously when there were no informational implications of the court ruling.

Consider first the plaintiff’s payoffs. If no PI is sought, no learning takes place concerning the case strength and the analysis of the previous section continues to hold. Thus, payoffs are the same as before and equation (7) captures the plaintiff’s payoffs for the case that no PI is requested. However, the following modification of the plaintiff’s payoffs (formerly equation (8)) after filing for a PI must be made:

---

24. To be sure, we are specifically referencing out-of-court settlement that entails the defendant obtaining from the plaintiff the right to resume the disputed actions. A separate issue is that upon a grant the defendant may stop pursuing the action altogether because both settlement and litigation are too expensive in light of the court’s initial assessment of the case. We touch upon this in Section 5.1.
\[
V^{\text{PI},G} = \begin{cases}
V^{G,T}(x) := \Pi_p - c_p - (1 - \gamma)\tau x - c_p - (1 - \tau)(1 - \nu^G)x, & x > x^G(\xi);
V^{G,S}(x|\xi) := \Pi_p - c_p - (1 - \gamma)\tau x - c_p - (1 - \tau) \times (x - \nu^G x^G(\xi)), & x < x^G(\xi),
\end{cases}
\]

when a PI is granted; whereas
\[
V^{\text{PI},D} = \begin{cases}
V^{D,T}(x) := \Pi_p - c_p - (1 - \gamma)\tau x - c_p - (1 - \tau)(1 - \nu^D)x, & x > x^D(\xi);
V^{D,S}(x|\xi) := \Pi_p - c_p - (1 - \gamma)\tau x - c_p - (1 - \tau) \times (x - \nu^D x^D(\xi)), & x < x^D(\xi)
\end{cases}
\]

when the PI is denied.

**Proposition 2 (Existence and Uniqueness with Learning).** When \(\tau > \bar{\tau}\), there exists a unique signaling equilibrium, where \(\bar{\tau}\) is as in Proposition 1.

To differentiate this case from the model without learning, we denote the critical threshold plaintiff type who is indifferent between filing and not by \(\hat{x}'\). The plaintiff’s equilibrium payoff as a function of his type is depicted in Figure 4.

The plaintiff’s strategy is given by

\[
\begin{align*}
\text{Filing and Settlement Decisions:} & \\
\text{PI} & \\
\begin{cases}
G & \text{for } x > x^G, \\
S & \text{for } x \in (\hat{x}', x^G];
\end{cases} & \\
\begin{cases}
D & \text{for } x > x^D, \\
S & \text{for } x \in (\hat{x}', x^D];
\end{cases} & \\
\begin{cases}
T & \text{for } x \in (x^N, \hat{x}'], \\
S & \text{for } x \in [x, x^N].
\end{cases}
\end{align*}
\]

**Figure 4.** Plaintiff’s Payoffs with Learning Depend on the Court’s Ruling for \(x \geq \hat{x}'\).
That is, absent a motion for a PI, the defendant proposes settlement terms which plaintiff types with $x \leq x^N$ accept. Upon filing for a PI, litigants base their subsequent actions on the court’s ruling. If the request is denied, a modest settlement offer is made which nonetheless all but possibly the very highest type accept, as the likelihood of them prevailing at trial is sufficiently diminished. In contrast, upon a grant of the PI, a higher settlement offer is made, which nevertheless is rejected by a greater number of plaintiff types (possibly even all),\textsuperscript{25} as these now stand a good chance of obtaining a final ruling in their favor.

Although the plaintiff’s payoffs are affected by the court’s ruling because settlement offers and subsequent out-of-court settlement are affected by the court’s ruling, this need not impact the incentive to file for a PI in the first place. For instance, for a uniform distribution of damages, the decision to file is not affected by the anticipated frequencies $\alpha$ and $\beta$ because the expectation of the settlement offer is independent of these. This yields the following theorem.

\textit{Theorem 4 (Signaling Independent of Learning).} Despite the fact that learning affects the subsequent settlement decisions, the threshold filing decision can be unaffected by the anticipation of information and learning from the PI hearing and subsequent ruling.

Although the incentive to file is unaffected by the anticipation of learning, this does not imply that the increased likelihood of settling out-of-court upon the denial is offset by the decreased probability of an out-of-court settlement following a granting in terms of the overall probability that the litigants settle out-of-court. In fact, the ex ante probability that the case ends in an out-of-court settlement after a PI is filed and ruled upon is unambiguously higher compared with the case where a ruling does not reveal information about the case strength.

\textit{Theorem 5 (Increased Out-of-Court Settlement due to Learning).} The overall likelihood of out-of-court settlement when litigants learn about the case strength due to a hearing and ruling on a PI request is strictly greater when compared with the case in which the PI hearing and ruling carry no informational implications when damages are distributed uniformly.\textsuperscript{26} That is, the decreased expected number of cases settled out-of-court upon a grant is more than offset by the increased expected number of cases that settle following a denial.

The intuition for the result of an increase in the likelihood of out-of-court settlement is directly tied to the insights established by Theorem 3. There it is

\textsuperscript{25} We remark upon such “corner” settlements in Section 5.1.

\textsuperscript{26} Indeed, the result also holds for other distributions, for example, the power distribution, but in the proof, we restrict ourselves to the closed-form representations obtained for the uniform distribution.
shown that the defendant is willing to trade off the amount of the settlement offer with the likelihood that settlement takes place. The former affects all plaintiff types who settle (marginal and inframarginal types); the latter is determined only by the marginal type. Because the number of inframarginal types is smaller when a PI is denied, the defendant’s adjustment toward achieving more out-of-court settlement is more pronounced following a denial of the PI when compared with a grant. Thus, although a ruling in favor of the plaintiff decreases the likelihood of out-of-court settlement, the increased likelihood of out-of-court settlement after a PI denial leads to a greater likelihood of settlement overall—which substantiates Lichtman’s assertion, quoted in the introduction, that hearings promote settlement.

5. Extensions

5.1 Corner Solutions and Dropping the Case
An immediate implication of learning about the case strength and the resulting shift in settlement offers is that even if interior solutions are assumed for the base model, this assumption need no longer hold. In particular, there are two cases worth discussing. First, when a PI is denied, even the plaintiff type with the highest possible damages \( \bar{x} \) may become sufficiently pessimistic about prevailing at trial that he accepts the proposed equilibrium settlement offer, that is, \( \bar{x} \leq \bar{x}^D \) so the defendant simply buys the plaintiff off. Second, when a PI is granted, the plaintiff’s chances at prevailing at trial become so high that no settlement can be reached, that is, \( x^G \leq \hat{x} \) so the defendant and plaintiff automatically proceed to trial without considering settlement.

Thus, whenever the denial of a PI leads to certain settlement (i.e., \( \min\{\bar{x}, \bar{x}^D(\hat{x}^G)\} = \bar{x} \)), learning leads to fewer plaintiff types filing for a PI (i.e., \( \hat{x} > \hat{x}^* \)). Conversely, if the grant of a PI precludes settlement (i.e., \( \max\{\hat{x}, x^G(\hat{x})\} = \hat{x} \)), then learning leads to more plaintiff types filing.

Somewhat distinct from these scenarios is another possibility, namely, that when a PI is granted, the defendant’s chances of prevailing at trial become so small that she is better off ending the case by discontinuing the disputed actions in an effort to have the plaintiff drop the case, that is, \( b < \frac{\hat{c}}{1-\nu} \). In this instance, requesting a PI will surely strongly reduce the likelihood that a case proceeds to trial—regardless of the court’s ruling—because the denial of the PI leads to an increase in settlement, whereas the granting of the PI leads to the defendant abandoning the disputed course of action.

Because this scenario postulates relatively low benefits \( b \), our analysis holds without qualification when benefits are relatively high; and otherwise, only the highest damage cases in which a PI has been denied result in further litigation.

5.2 Legal Remedies and Injunction Bonds
In the main analysis, we restrict attention to equitable relief. However, in many cases, the party that ultimately prevails at trial may also be entitled to damage awards. Incorporating this in the analysis can affect the parties’ incentives to settle or proceed to trial (it may, thus, also affect possible corner solutions), but
this would leave the qualitative analysis unaffected. Nevertheless, there are two aspects in which legal remedies specifically affect informational implications of requesting preliminary relief.

First, in some cases, a plaintiff who ultimately prevails at trial can also collect damage awards from the defendant in compensation for harm that accrued during the trial phase (treble damages, in fact, in civil antitrust cases). This diminishes the nonstrategic incentive for requesting a PI because anticipated trial-phase damages are effectively reduced to $\tau x - \nu \tilde{\tau} x$, where $\tilde{\tau} x$ denotes (the plaintiff’s beliefs about) the court’s assessment of the damages that are to be reimbursed. The corollary to this reduction in the nonstrategic use of PIs is of course that the signaling role of filing for a PI is increased.

Second, sometimes a wrongfully enjoined defendant has a right to compensation from the plaintiff. In particular, when having a PI granted, the plaintiff may be asked to post a bond. If the plaintiff prevails at trial (or a settlement agreement is reached), the amount of the bond is returned to the plaintiff. However, if final judgment goes against the plaintiff and it is thus determined that the defendant was wrongfully enjoined, the bond is forfeited and paid out to the defendant to compensate her for the loss of benefits during the trial phase. In our analysis, we assumed that no benefits accrue to the defendant during the trial phase, so this point would be moot. If, in departure from this assumption, we require a bond of $B$ to be posted upon the grant of a PI, then this decreases the plaintiff’s payoff from requesting a PI by $\gamma (1 - \nu^D) B$. Again, the implication is that the signaling role of filing for a PI becomes more pronounced. However, this is somewhat offset by the newly created incentive of the offensive use of the PI since now under a grant the defendant is deprived of immediate benefits, which induces a higher settlement offer.

5.3 The British Rule in the Allocation of Litigation Costs

Under the American fee rule, each party bears its own litigation costs regardless of the outcome at trial, which has been assumed throughout the article. Under the alternative British rule, in contrast, the losing party bears all the litigation costs. A change in the governing rule in the allocation of litigation costs affects the litigants’ payoffs and thus their decisions concerning settlement offers and the motion for a PI. Specifically, assuming that trial costs are reimbursed, but costs associated with the PI are not, the plaintiff who goes directly to trial without filing for a PI need not pay his litigation cost $c_p$ if he wins the case, whereas he must additionally bear the defendant’s litigation cost $c_d$ given a loss at trial. That is, the rule change from the American to the British rule has the net impact of $\nu^H c_p - (1 - \nu^H) c_d$ on the plaintiff’s expected payoff of going to trial, where $H \in \{G, D\}$. Hence, the likelihood of a filing for a PI and of an out-of-court settlement hinge upon the relative magnitude of litigation costs, the prior, and the posterior beliefs. For simplicity, assuming that $c_p = c_d = c$, the rule change has the net impact of $c (2 \nu^H - 1)$ on the expected payoff of going to trial. For the case of $c (1 - 2 \nu^D) > 0 > c (1 - 2 \nu^G)$, the cost-governing rule change from American to British rules can make
out-of-court settlement even more likely when a PI is denied, but less likely when it is granted, compared with the previous analysis.

This analysis continues to hold even if some of the costs associated with the PI are also ruled to be reimbursable; although if such a ruling also applies to costs incurred by the defendant (which for simplicity, we have assumed to be zero), then the initial filing for a PI and a continuation through trial become less likely as the plaintiff’s expected payoffs are diminished accordingly.

6. Discussion

Preliminary injunctions are an integral part of a litigant’s legal strategy in various instances, such as in civil antitrust, patent, copyright, trademark, employment and labor relations, and contract cases. The primary legal rationale for a PI is its defensive use to give a plaintiff, the opportunity to avert damage that the disputed behavior is causing while the litigants prepare for and pursue a court trial. This motivation is reflected in our model in that plaintiffs with high damages are inclined to file a request for a PI, whereas those with low damages do not. Although there has been some discussion of the offensive use of PIs elsewhere, we show that plaintiffs have an incentive to use the filing of a PI strategically even when considering the defensive use of PIs. In particular, we find that some plaintiffs more readily file for a PI to affect settlement terms, and overall settlement is more likely to occur due to the information that is generated by a ruling on the PI.

In light of our findings, it is worth noting the recent case Winter v. Natural Resources Defense Council (NRDC), Inc, 555 US 7. For this case, the Ninth Circuit Court’s formulation of the PI standard was rejected by the Supreme Court as being “too lenient” since a plaintiff only had to demonstrate the possibility of irreparable harm, whereas the court held that the plaintiff’s burden is to show that irreparable injury is likely, absent an injunction. From the perspective that this is a heightening of the standard for obtaining a PI, our model suggests two things. First, as fewer PIs may be requested, less learning takes place early on and, hence, in accordance with Theorem 5, out-of-court settlement may decrease. In contrast, however, there may well exist a countervailing effect as there is an increase in the signaling value of the request for a PI, which may increase the number of cases that are settled out of court, in line with Theorem 2. Also, Theorem 3 implies that settlement may also increase if arguments are more strongly focused on the merits of the case after the post-Winter PI ruling; the converse will be true when the likelihood of harm is the main issue disputed.

Although the future implications of the Winter case remain to be seen, some findings of this article are potentially testable using past cases. The

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27. A few caveats are worth mentioning. Foremost, it should be recognized that litigation often times involves larger strategies with claims and competing counter-claims made between litigants, and—as the offensive use of PIs illustrates—pretrial motions are sometimes filed for reasons that have little to do with averting harm or conveying information. Moreover, as discussed in Section
empirical predictions of the model implied by learning are readily established. Conditioned on a ruling on a given PI request, the incidence of settlement allowing the disputed action to continue should be more prevalent upon a denial compared with a granting of the PI because in the former case, the defendant exploits the diminished legal position of the plaintiff to achieve more out-of-court settlements. As a case in point, consider the Plavix patent infringement case briefly mentioned in Section 1. There, the parties initially attempted, but failed, to reach an acceptable settlement agreement. Thereafter, a PI was requested, which was then granted. The case subsequently went to trial for a final adjudication without further settlement talks taking place. In contrast, Amazon.com obtained a PI against barnesandnoble.com in a dispute alleging infringement involving Amazon’s “1-Click” checkout. Only upon the PI being reversed on appeal did the parties come to a settlement agreement, which allowed barnesandnoble.com to utilize a form of express checkout.

In both these cases, the initial court ruling on the PI request was appealed. In the former, it led to the PI being affirmed then the case went to trial, whereas in the latter, it led to the PI being lifted then the case being settled. In general, the fact that PI rulings can be appealed suggests a potentially fruitful analysis of the model implications. Indeed, in contrast to the cited cases, instances in which ultimately a settlement agreement is reached after a PI is first declined, but later granted on appeal, should be rare; both cases have a greater likelihood of settling after an initial decline of the PI (so that they are not appealed) and also because cases are less likely to be settled after the final grant of the PI.

Empirical verification concerning signaling and settlement are also possible but may be harder to obtain because of data limitations due to private (i.e., nonobservable) information concerning damages. However, if it is possible to distinguish between cases with greater uncertainty about damages and those with less uncertainty, then the former will more frequently have requests for preliminary relief since PI filings are also used to overcome uncertainty about damages by signaling bounds on damages. Moreover, if damages can be ascertained (or reasonably well estimated) ex post—that is, after settlement takes place—then the signaling role of PIs should result in a negative correlation between the incidence of a PI being requested and the terms of settlement since signaling shifts settlement to lower damage cases. Last, because signaling is tied to the cost of filing for a PI and signaling can increase the likelihood of out-of-court settlement, there should be a positive correlation between the costs incurred in requesting a PI and the subsequent likelihood of settlement.

5.1, depending on the stakes of the case, corner solutions may arise and cases might in effect just be dropped. For instance, in the contemporaneous multi-jurisdictional litigation between Apple and Samsung concerning Samsung’s Galaxy (smart phone and tablet) product line, PI’s were issued against sales of the Galaxy in Germany and in Australia. In both these instances, Samsung has proposed to modify its product offering in an attempt to have Apple drop the case. Ascertaining the resolution of cases may sometimes also become difficult when agreements are kept secret.
Appendix

Proof of Lemma 1. Note first that since $F$ has the reverse MHRC, so do posterior beliefs $\nu^T$, which ensures the uniqueness of $\hat{x}$ for a given history. Moreover, given the assumption that a defendant is willing to make an offer to a plaintiff type who files, but is unwilling to buy him off, an interior solution follows for the history in which a PI was sought. This establishes $SO^{PI}(\hat{x})$.

If a PI is not sought, then surely terms of settlement are proposed. If the condition on the top branch in equation (6) is met, then no interior solution to the defendant’s problem exists, given her beliefs about the threshold for filing. In this case, the defendant offers full compensation for the perceived damages. Otherwise, the interior solution is implied by the bottom branch.

Proof of Proposition 1. Equations (7) and (8) jointly determine the set of all possible critical thresholds $\hat{x}$ that leave the plaintiff indifferent between requesting a PI and not, given any beliefs that the defendant may have. Since a defendant will never offer more than is absolutely necessary to induce the plaintiff to accept a settlement offer for any set of beliefs $\min\{x^N(\hat{x}), \hat{x}\} = x^N(\hat{x})$. That is, the threshold plaintiff—when refraining from filing—will at best only just be bought off. Therefore, $V^{N,T}(\hat{x}) \geq V^{N,S}(\hat{x}|\hat{x})$, $\forall \hat{x}$.

Moreover, having postulated that the defendant’s benefits are sufficiently high to warrant making an offer to the plaintiff who files for a PI, $V^{PL,S}(\hat{x}|\hat{x})$ must be at least as large as $V^{PI,T}(\hat{x})$. And therefore, in equilibrium, the threshold plaintiff type must be indifferent between going straight to trial without filing for a PI and filing for a PI followed by an out-of-court settlement. In sum, at the threshold, $V^{N,T}(\hat{x}) \leq V^{N,T}(\hat{x}) = V^{PL,S}(\hat{x})$.

Since, for any beliefs $\hat{x}$, $V^{N,T}$ and $V^{PL,S}$ are linear in $x$, they intersect only once and whenever $\tau > \frac{\nu}{\tau + \nu} = \hat{\nu}$ and the latter is flatter so the monotonicity of the filing decision holds (i.e., Conjecture 1 is verified). Hence, for any belief $\hat{x}$, there exists a function that determines the threshold type $\hat{x}$, call this function $\hat{x} = \theta(\hat{x})$: $[x, \hat{x}] \rightarrow [\hat{x}, \hat{x}]$, which is implied by $V^{N,T}(0) = V^{PL,S}(0|\hat{x})$, that is,

$$\hat{x} = \theta(\hat{x}) = \frac{c^\text{PI} - \nu(1 - \tau)x^\text{PI}(\hat{x})}{\gamma(1 - \tau) - \nu}, \quad (A1)$$

where from equation (5) in conjunctions with equation (4) $x^{PI}(\hat{x})$ is implied by

$$Z(x^{PI}, \hat{x}) := \frac{\nu b + c_d + c_p}{\nu(1 - \tau)} - \frac{F(x^{PI}) - F(\hat{x})}{F(x^{PI})} - x^{PI} = 0.$$

Since the density of prior beliefs is continuous, $x^{PI}(\hat{x})$ is continuous, and therefore so is $\theta(\hat{x})$. Hence, by Brouwer’s fixed point theorem, there exists an equilibrium. Moreover, $\frac{d\theta}{d\hat{x}} = -\frac{Z_{x^{PI}}}{Z_{\hat{x}^{PI}}}$ is positive since the denominator is negative by the sufficiency of the defendant’s first-order condition, due to the reverse MHRC, and the numerator is positive since $\frac{f(\hat{x})}{f(x^{PI})} > 0$. Hence, $\theta(\cdot)$ is downward sloping and thus the fixed point giving the equilibrium is unique.
Proof of Theorem 1. Note that equation (A1) can be rearranged to yield
\[
\hat{x} = \frac{c_{\text{PI}}}{\gamma^*} - \frac{\nu(1 - \tau)}{\gamma^*} (x^\text{PI} - \hat{x}) < \frac{c_{\text{PI}}}{\gamma^*} = \hat{x}_B,
\] (A2)

implying that plaintiffs of type \( x \in [\hat{x}, \hat{x}_B) \) use the filing for a PI as a means to signal to the defendant that they do not have low damages.

Proof of Theorem 3. The reverse MHRC on the distribution of damage levels implies that \( x^G \leq x^D \), as can be seen when substituting \( v^G \) and \( v^D \) for \( \nu \) in equation (5). Hence, plaintiff types with damages \( x \in [x^G, x^D] \) settle only upon having their PI request denied compared with when a PI is granted.

Proof of Proposition 2. The method of proof is as before. In determining the threshold plaintiff type who is indifferent between requesting a PI and proceeding straight to trial, the relevant payoff used to determine the filing decision is given by the expectation across equations (12) and (13), as the filing decision necessarily precedes the court’s ruling on the PI. Consequently, noting that \( \gamma v^G = \nu(1 - \alpha) \) and \( (1 - \gamma)v^D = \nu \alpha \) from equation (10)
\[
E[V^{\text{PL},S}] = \Pi_p - c_{\text{PI}} - (1 - \gamma)\tau x - c_p - (1 - \tau)(x - \nu((1 - \alpha)x^G(\hat{x}') + \alpha x^D(\hat{x}))).
\] (A3)

After setting \( V^{N,T}(0) = E[V^{\text{PL},S}(0|\hat{x}')] \), the remainder of the proof follows the proof of Proposition 1 \( \text{mutatis mutandis} \).

Proof of Theorem 4. We prove the theorem using the case of uniformly distributed damages, but the result also applies to other distributions. Recall from equation (A2) that for the case without learning
\[
\hat{x} = \frac{c_{\text{PI}}}{\gamma^*} - \frac{\nu(1 - \tau)}{\gamma^*} (x^\text{PI} - \hat{x}).
\]

In contrast, when there is learning, \( \hat{x}' \) is implied by equations (7) and (A3). Specifically, \( V^{N,T}(\hat{x}') = E[V^{\text{PL},S}(\hat{x}'|\hat{x}')] \), yields
\[
\hat{x}' = \frac{c_{\text{PI}}}{\gamma^*} - \frac{\nu(1 - \tau)}{\gamma^*} ((1 - \alpha)x^G + \alpha x^D - \hat{x}').
\] (A4)

From equation (5) the cutoff for out-of-court settlement given a uniform distribution of damages is of the same form independent of learning and is given by
\[
x^H = \frac{1}{2} \left( y + \frac{v^D b + c_d + c_p}{v^D (1 - \tau)} \right), \quad y \in \{\hat{x}, \hat{x}'\}.
\] (A5)

Thus, using equation (10),
\[
(1 - \alpha)x^G + \alpha x^D = \frac{1}{2} \left( \hat{x}' + (1 - \alpha) \frac{v^G b + c_d + c_p}{v^G (1 - \tau)} + \alpha \frac{v^D b + c_d + c_p}{v^D (1 - \tau)} \right)
= \frac{1}{2} \left( \hat{x}' + \frac{v^b + c_d + c_p}{v(1 - \tau)} + (1 - \gamma) \frac{v^b + c_d + c_p}{v(1 - \tau)} \right).
\]
and by substituting back into equation (A4) and comparing to equation (A2), it follows that $\hat{x} = \hat{x}'$.

Proof of Theorem 5. For the uniform distribution, the ex ante likelihood of out-of-court settlement after filing is directly proportional to $x^H$. For the case with learning the expected probability of an out-of-court settlement after filing is therefore proportional to $\gamma x^G + (1 - \gamma)x^D$, whereas it is similarly proportional to $x^{PI}$ for the case without learning. Now notice that starting from equation (A5) and using the fact that $\hat{x} = \hat{x}'$,

$$\gamma x^G + (1 - \gamma)x^D > x^{PI} \iff \gamma x \nu^G + (1 - \gamma)x \nu^D > 1 \nu \iff \gamma^2 \alpha + (1 - \gamma)^2 > \alpha$$

and the result follows.

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