Many legal disputes are resolved through settlement. The goal of this article is to propose a new determinant of the likelihood of settlement. Specifically, we argue that inefficient trials can be simply explained by the time and money that litigants need to invest in the pretrial phase, where relevant information is discovered, experts consultants are deposed and parties spend time in pre-trial negotiation. Previous studies assumed that the negotiation only takes place before any expenses are incurred. Conversely, our main assumption is that parties must incur ex ante transaction costs (time) to prepare for the Coasian negotiation. In other words, the source of inefficiency in this model is a version of the hold-up problem. Our main result is that strategic interaction in the presence of ex ante costs may lead to trial without recurring to disagreement over the likelihood of prevailing at trial or to private information. In our setup pretrial costs play a critical role. Hence a natural question to ask is whether a different allocation of these costs leads to more or less efficient outcomes. In what follows we compare specific allocations of litigation costs. We consider the four system discussed by Shavell (1982): the American rule (each side bears its own costs), the English rule (the losing side bears all costs), the rule favoring the Plaintiff (he pays only his own cost if he loses and nothing otherwise), and the rule favoring the Defendant (she pays only her own costs if she loses and nothing otherwise). We find that, surprisingly, our main results is unaffected by the cost allocation system. The vast literature on litigation, pretrial negotiation and fee shifting began with the standard economic theory of litigation, developed by Landes (1971), Posner (1973) and Gould (1973). These authors concluded that the risk attitude is the main determinant of settlement. Together with Shavell (1982) the previous papers explained costly litigation as the result of different views on the likelihood of prevailing at trial. In this setting fee shifting amplifies the effect of optimism, making litigants less likely to settle. “Under the English rule, a litigant is forced to take into account the other side's litigation costs to the extent that she risks losing the case, making her more willing to settle. But conversely, she is freed of her own litigation cost to the extent that she hopes to win, making her less likely to settle. Since litigants are disproportionately drawn from the population of optimist, the latter effect tends to outweigh the former. Indeed, in the limiting case when both parties are fully confident of winning, neither expects to pay any costs at all and settlement is impossible” (Katz and Sanchirico, 2010 p.14).

More recently other papers have extended this setting by endogenizing the level of trial expenditures should a trial take place (see Braeutigam-Owen-Panzar, 1984; Plott, 1987; Cooter and Rubinfeld ,1989; Froeb and Kobayashi 1996).

The previous strand of the literature has been criticized since it assumed that each party knows the other's reservation value. Accordingly, a second group of models instead creates disagreements through private information, allowing for rational beliefs (see for instance P'Ng, 1983; Bebchuk, 1984; Reinganum and Wilde, 1986; Nalebuff, 1987; Schweizer, 1989; Spier, 1992; Spier, 1994a; Spier, 1994b; Gong and McAfee, 2000).

Asymmetric information model confirmed the disagreements model's result that the British rule generally discourages settlement when the private information concerns

the likelihood of the plaintiff's prevailing in a trial (Bebchuk, 1984), but not when the private information regards the level of damages suffered by the plaintiff (Reinganum and Wilde, 1986). Similarly to us Reinganum and Wilde (1986) find that the probability of trial is only a function of the total litigation costs implying that settlement is independent of the extent of fee shifting. Donohue (1991, a,b) also predicted that different rules would have identical effects. He argues that the rules are irrelevant as long as the involved parties free to sign a private contract specifying the Pareto optimal rule applicable to the court. However, the fact that the parties have come to litigation in the first place, casts doubt on the presumption that they are bargaining in a Coasian fashion (Katz and Sanchirico, 2010 p.5). Surprisingly, we find the same result also assuming that parties have to incur some ex ante costs, before they reach the stage in which the actual negotiation occurs.