**Citation:**

Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549-84 (2003).

**Other Sources:**

[http://ssrn.com/abstract=490401](http://ssrn.com/abstract%3D490401)

**Key words:**

contract law, tort law, law and economics, litigation, governance, franchising, arbitration

**Abstract:**

If we define the deterrence benefits from contract enforcement as avoided harms net of avoidance costs, we should expect contracting parties to choose the dispute resolution forum that provides the greatest difference between deterrence benefits and dispute resolution costs. We apply this framework to franchise contracts and conduct an empirical analysis of the determinants of arbitration agreements among franchising parties. Although it is obvious that contracting parties have an incentive to choose arbitration in order to reduce dispute resolution costs, there have been no studies of the importance of deterrence concerns. We examine the deterrence hypothesis and find a great deal of support for it. Our results suggest that deterrence factors outweigh litigation costs in the design of dispute resolution agreements. We find that the probability of arbitration is significantly higher when the parties rely on implicit contract terms for governance and compliance with those terms is difficult to ensure.