Privatizing Civil Justice: Commercial Arbitration and the Civil Justice System

Christopher R. Drahozal

The subject of this conference is civil justice reform proposals. We’ve heard a lot about things in the system that may or may not need fixing, and the types of litigation that are going to be coming. My take on this today is, look, there are things that litigants are not happy with in the civil justice system. We know that because they are opting out of the civil justice system, the public court system, and going to private dispute resolution. They are using arbitration. That’s the aspect of Alternative Dispute Resolution that I focus on: opting out of, or, as I call it, privatizing, civil justice. Arbitration is a form of private dispute resolution. The parties to the case hire their own judges to decide their disputes.

I don’t know how many of you are fans of the TV show Seinfeld. There was an episode a couple of years ago that nicely illustrates what arbitration is in an interesting way. It was an episode called The Seven,¹ which was when George Costanza wanted to name a child “Seven” after Mickey Mantle’s baseball number. What happened was that Elaine, Julia Louis-Dreyfus, is buying this girl’s Schwinn bike, the kind that my sister had when I was growing up, from a used goods store. As she takes it down off the wall display, it falls on her and she hurts her neck. She complains the whole way home. She goes back to Jerry’s apartment, complaining that her neck is killing her, and she says, “You know, right now I would give that bike to the first person who could make my neck feel better.” If you’ve seen the show, Kramer, the goofy guy played by Michael Richards, mumbles some mumbo-jumbo, walks up to her, twists her neck, and she says, “Wow, my neck feels great. You did it, Kramer. Wow!”

Then he turns to her and says, “Send the bike over anytime.” So they have a dispute. This is actually a fun show, and I don’t know how much of this is intentional, but I have to give the writers credit, because there’s a lot of stuff going on just in this part of the episode. There are actually a lot of contract issues here. Elaine’s argument is, “Wait a minute, I wasn’t serious about this. This wasn’t a serious offer I was making. It was a joke.” This is Lucy v. Zehmer,² right, the guy who jokingly sold the family farm, the objective versus subjective theory of contract.

Kramer’s response is, “Wait a minute, oral promises need to be enforced. We have to be able to take each other at our word.” In other words, this is the statute of frauds, and the policies underlying the statute of frauds. You may think this is weird, but students generally do not get excited about contracts, so I really try to put it in a context that appeals to them. Nothing personal to

Christopher R. Drahozal, Associate Professor of Law, University of Kansas.
those of my former students who are sitting in, but it's true. Sometime I'll tell you about the missing scenes from *Star Wars* that perfectly illustrate commercial impracticability versus frustration of purpose, but that's not really relevant here.

Anyway, Kramer and Elaine have this dispute. It's an offer and acceptance contract dispute. Jerry says, "We need to find somebody to resolve this dispute." He says, "Let's get an impartial mediator to resolve this. Someone with no emotional attachment, a heart so dark it cannot be swayed by pity, emotion, or human compassion of any kind," describing all of you that I have met here, by the way. On the show, they go to his next-door neighbor Newman, who is an obnoxious mail carrier. Newman makes Elaine and Kramer promise to abide by whatever he decides. Newman talks about the statute of frauds, how important it is to enforce promises, all that good contract law stuff. Then he says, "All right, here's my decision, I order you to cut the bike down the middle and you each get half," very Solomonicly resolving the dispute. Keeping in the biblical theme, Elaine says, "Sure, go ahead," because, she's disgusted with the whole thing by now. Kramer says, "Oh, no, this bike needs to be kept together. Give it to her instead of doing it." Then, as Solomon did, Newman says, "All right, Kramer, you get to keep the bike," and that's how it ends up being resolved.

Now, this is not mediation. Jerry calls it "impartial mediation," but it's not. Mediation is when you have a facilitator who helps the parties come to an agreement. That's not what happened here. This is arbitration. Arbitration is where a purportedly neutral third party decides the dispute. Arbitration is becoming much more prevalent, as I suspect you are aware. Increasingly, parties are putting arbitration clauses in their contracts and are essentially opting out of the legal system for those classes of disputes that are subject to the arbitration agreement. Again, that's the title of the talk, privatizing civil justice.

I will warn you, by the way, my wife looked at my talk, and she said, "The introduction was great," and then she stopped reading it because the rest wasn't very interesting. So you've gotten the good part, just so there is no misleading going on here. First, I'll just give you a general overview or introduction to commercial arbitration. Second, I'm going to talk about an economic approach, or thinking about this in economic terms, why parties agree to arbitrate. Some of it, hopefully, will sound like things that Henry has talked about with those of you who have been through his program. But, again, as George Priest was saying yesterday, it's just intuitive to a large degree. I'm not an economist, I'm very much a lawyer, so my economics is at the very least intuitive to me, and hopefully intuitive to other people as well. The third topic I'm going to talk about is the incentives that arbitrators face. This actually fits fairly nicely with Andy Hanssen's talk yesterday where he looked at institutional characteristics and how they affect the incentives of judges to decide cases. What I'm going to talk about is the institutional characteristics facing arbitrators, private judges, and how that may affect their decisions. Finally, depending on how much time we have, I will talk about what lessons we might be able to take from this discussion of arbitration for possible reforms of the civil justice.
system. In the extreme, as one of you said, “Well, if we do this, I’m out of a job.” We’ll talk about that, whether we should just privatize the whole thing. There are actually people who argue for that position, which I’m not going to do with you, but it seems to be interesting and worthy of discussion.

I. INTRODUCTION TO COMMERCIAL ARBITRATION

The *Seinfeld* example, which was hopefully more amusing than me talking about usual arbitration procedures, is different from the norm in a variety of ways. One way in which it’s different is that the parties didn’t agree to arbitrate until after the dispute arose. That is permissible, and it happens. Parties can agree after the fact to submit their disputes to arbitration, but it’s not very common. By that point, the parties have fairly divergent views or interests in trying to resolve the dispute, and it’s much less likely they will agree after the dispute arises to submit their dispute to arbitration. What’s far more common is that the parties will agree, when signing the contract, to submit any disputes that later arise to arbitration, which we call pre-dispute arbitration clauses. If you look at the statistics of the various arbitration institutions, it’s far more common that the proceedings they administer are of that sort, rather than agreements submitting the dispute to arbitration after the fact.

As I’ve said, there is certainly a lot of anecdotal evidence suggesting that arbitration is becoming more widely used than it has in the past, but it’s really hard to get good evidence of just how widespread agreements to arbitrate are. You can look at the caseload filings at arbitration institutions and see that the numbers have gone up, but it’s a lot harder to find out what parties are agreeing to before the fact. Why? Well, because they agreed to them in their contracts. Contracts generally are not the sort of thing you can look at by going down to the county courthouse or getting on the Internet. Contracts are usually confidential, so it’s hard for economists to collect data on how widespread the use of arbitration agreements is in contracts.

There have been some estimates from various places, and I don’t know the basis for all these things, but the most common area where arbitration is used is in international contracts. International arbitration has a long pedigree, and there are estimates that upwards of ninety percent of international contracts contain arbitration clauses. That is not surprising. People from different countries may be distrustful of each other’s legal system, and a compromise is, “We’ll arbitrate someplace that’s neutral to everybody and we’ll have a neutral arbitrator do it.” Arbitration appears all the time in international contracts.

It’s a lot harder to find data on domestic contracts, again, because these things are not publicly available. There is one area where they are publicly available, at least one area that I’ve looked at a little bit, and that is in franchise contracts or franchise agreements. There are thirteen states that require franchisors to file franchise agreements publicly with the Department of Commerce, or somebody like that, before they sell franchises in the state. It’s analogous to a securities offering. A securities offering must
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be filed, and there are several states, Minnesota (from where I collected the data) is one, that require franchisors to make that sort of filing. I went to the Department of Commerce to look at franchise agreements. It turns out that a lot of franchise agreements provide for arbitration, although, frankly, I was surprised there weren't more. Slightly less than half of franchise contracts provide for arbitration, and the franchises that I looked at are big nationwide ones that have a lot of contracts, like McDonald's and Dairy Queen, so their contracts account for a lot of the arbitration clauses.\(^6\) They're fairly widely used, but not across the board.

The other point is, it looks like the use of arbitration is increasing in franchise contracts, which would be consistent with anecdotal reports about the increasing use of arbitration generally. Other people have looked at this in previous years: There was a Senate study in 1971,\(^7\) and a business professor did a study in 1993.\(^8\) The numbers aren't directly comparable because we used very different samples and looked at different contracts and different types of franchise agreements. Nonetheless, there is some evidence that the use of arbitration is, in fact, going up. Whether that applies to other contracts, again, it's hard to get the data, but it wouldn't surprise me.

As a legal matter, arbitration clauses are now fully enforceable in most courts. The Federal Arbitration Act applies to all contracts that evidence a transaction involving commerce,\(^9\) basically just about anything that has any effect on interstate business. Section 2 of the Federal Arbitration Act makes arbitration agreements, both submission agreements and pre-dispute arbitration agreements, fully enforceable.\(^10\) And as some of you may well have experienced, the Federal Arbitration Act goes beyond that to preempt state laws that cut away from the enforceability of arbitration agreements. *Southland Corp. v. Keating*,\(^11\) back in 1984, and a series of subsequent cases, established that federal law preempted state legislation that made certain types of claims nonarbitrable, made certain arbitration agreements not enforceable, or even required advance notice or conspicuous notice of the fact that there is an arbitration clause in the contract. There is now a broad and, as the Supreme Court describes it, "emphatic" federal policy in favor of arbitration.\(^12\) That doesn't mean there are no grounds on which you can challenge an arbitration agreement, but it has to be a generally applicable state law ground, like duress or fraud. You can't do anything, and parties can't argue anything specific to arbitration. If the state statute said you can't arbitrate franchise disputes, to the extent that applied to transactions in interstate commerce, which franchises almost always would, that would be preempted.

As a general matter, arbitration is a matter of the parties' contract. What that means, among other things, is that the parties, by their agreement, can specify what procedures will be followed. One nice thing about actually looking at arbitration clauses is that you can see what the parties specify. The other source of that information is the rules that the arbitration institutions promulgate, but those rules don't necessarily tell us what is actually done because the parties can change those rules by their agreement. I'll talk about some of the changes that you see in arbitration clauses later.
There are several ways in which arbitration generally differs from litigation. First, in arbitration, the parties get to pick the judge. Parties may want to try to pick their judge in court litigation, or at least pick the court, but usually cases are assigned to judges. Obviously, arbitration is different because the parties agree on who will be the judge. That may, and probably does, affect how arbitrators decide cases. The second difference is that arbitration, at least traditionally, has been seen as much less formal in its procedure than court litigation. For example, in arbitration, there are no juries, the rules of evidence don’t apply, and the parties have the flexibility to change things if they want. This is also evidenced by the fact that there is much less discovery in arbitration. The third difference is, effectively, there is much less judicial review of arbitration awards than there is of trial court, or even intermediate appellate court, decisions. This is because there is really no right to appeal in arbitration. There are some limited grounds such as fraud, bias, or failure to admit evidence on which courts can refuse to enforce or vacate arbitration awards, but there is little or no merits review of the arbitrator’s decision. Essentially, the arbitrator’s decision is final in most cases. I’ll come back to each of these differences as we go forward and talk a little bit more about them.

II. WHY PARTIES AGREE TO ARBITRATE

If parties don’t put any dispute resolution clause in their contract, the dispute will, by default, be resolved in court. Arbitration is something that requires an affirmative action on the part of the parties to agree to arbitrate. The question is, why do parties do that? The assumption that I’m going to start with in talking about this is that we’ve got two well-informed, sophisticated parties, and there is enough at stake that they’re going to take this seriously and figure out their options. I want to start with why those parties might agree to arbitration, and then go from there into talking about arbitration involving consumers where those assumptions don’t really work.

What sort of decision rule would sophisticated parties use in deciding whether to arbitrate? This is something that those of you who have gone through Henry’s program should know. Even those of you who were here just for this conference should be familiar with this because Andy Hanssen talked about it.\textsuperscript{13} In deciding whether to arbitrate, you compare the marginal cost with the marginal benefit. If the marginal benefit of arbitration exceeds the marginal cost of arbitration, then you arbitrate. The more important question, the more interesting question, is, what are the marginal costs and benefits of arbitration? That’s the sort of economic decision rule that we’re going to talk about. It makes some intuitive sense. We compare court litigation to arbitration and decide which is better for us. What are the costs and benefits that the parties are going to think about? My guess is we could come up with a whole bunch of them, but I really want to talk about those that seem to be the most important differences in choosing between arbitration and court litigation.

First, there may be different costs of dispute resolution. One of the most commonly touted advantages of arbitration is that it’s cheaper than litigation. Whether
that's always true, it seems to me, is not necessarily the case. Certainly, for international arbitration, practitioners say that it actually can be much more expensive to go through an international arbitration proceeding than it would be to litigate in court. You have to pay expensive lawyers who have to travel all over the world. Plus, you have to pay expensive arbitrators, so some forms of arbitration may actually be more expensive than court litigation. Other forms of arbitration may be cheaper, but the cost difference between court litigation and arbitration is one thing that the parties are going to consider.

A second way arbitration can differ from court litigation is that the parties may expect the outcome of the case to be different: One or the other may be more accurate in trying to resolve the parties' dispute. Just as an illustration, I think Bruce Foudree suggested this morning that there are arbitration institutions gearing up for Y2K problems. You all are now relatively well educated on the Y2K problem, at least relative to much of the judiciary. But if you could hire a Y2K expert to resolve your dispute, he or she may be able to resolve it more accurately than a generalist judge who doesn't deal with that sort of stuff all the time. What are the implications of that different outcome? One possible implication is a change in expected compensation: Claimants may think they are more or less likely to win. Thus, the claimant may expect to get more compensation in arbitration, or it may expect to get less. The flip side of that is the respondent may expect to pay more or may expect to pay less.

The other difference is something that I don't think you see discussed much in the arbitration literature. There are a lot of people who criticize arbitration as big businesses using private judges to reduce their liability. You don't have juries awarding huge damage sums. You have arbitrators awarding less, and that's argued to be bad because individuals aren't fully compensated. That may be right, but another consequence that doesn't usually get talked about is that the expected outcome of future litigation can affect how the parties behave under their contract. If you have a contract where the parties agree to arbitrate, the respondent in an arbitration may think, "You know, this arbitrator is going to rule in my favor no matter what happens, so why should I do a good job under the contract?" If we think the law affects how parties behave, changing the expected application of that law through the dispute resolution device can also affect how the parties behave under the contract. If the arbitrator is more likely to enforce the contract, there may be greater deterrence of wrongdoing and that's beneficial. If the arbitrator is less likely to enforce the contract, there may be less deterrence. That is different from the wealth transfer of who gets compensated and who doesn't. That can actually make the parties as a whole better or worse off. All of those aspects, marginal costs or marginal benefits, depending upon the party's perspective, underlie the decision of whether to arbitrate or litigate.

I have a couple of examples to go through that hopefully will make that a little bit clearer. The first one is simple. This is a case where both parties will benefit from arbitration. If they go to court, it's going to cost them, say, $500 more in legal fees than if they arbitrate, so arbitration saves them $500. It makes them $500 better off. The
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parties think the outcome of the arbitration proceeding will be the same as litigation, so we’re putting that variable aside for now. Will the parties agree to arbitrate here? Yes, it makes sense for them to agree to arbitrate. It makes both parties better off. They both save $500. You would expect them to agree to arbitrate. This is an easy case where everybody benefits.

There is a lot of discussion of arbitration in the literature, particularly in the legal literature. For many of those who are pro-arbitration, this is what the world looks like: Everybody’s better off by arbitration because it reduces everybody’s legal fees. It’s a cheaper, faster, better way to resolve disputes so, of course, we should have arbitration. Again, that may be the case sometimes. Frankly, I’m skeptical that it’s really the case a lot of the time anymore, especially with things like consumer arbitration.

The second case is a little harder: Only one party benefits from arbitration. In this example, one party, $P_1$, is a lot better off by arbitration because it saves $1000 in legal fees, but the other party, $P_2$, is actually made worse off. It’s going to cost $P_2$ $500 more to arbitrate than to go to court. You might see this, for example, in franchise contracts which require arbitration at the franchisor’s home office, its headquarters. That’s great for the franchisor. Its litigation is all centralized in one place. It doesn’t have to travel, and its witnesses don’t have to travel. That can save the franchisor a lot of money. It’s not so good for the franchisee. For example, Dairy Queen requires arbitration in Minnesota. If the franchisee is in California, that provision would increase its cost of arbitration, right? If the franchisee could sue, it would sue in California, but now it has to travel to Minnesota.

Here, it is not the case that both parties are made better off by arbitration. Does that mean there won’t be arbitration? On these facts, again assuming the outcome of the proceeding is going to be the same, it would make sense for the parties to agree to arbitrate. Why? Well, because $P_1$ will be able to pay $P_2$ more than $500 but less than $1000, so that $P_2$ is also better off by agreeing to arbitrate. Even though the arbitration agreement itself makes $P_2$ worse off, because of the deal the parties can strike, they may still agree to arbitrate. This is the Coase Theorem\textsuperscript{15} mentioned yesterday, which those of you who have been through the program have heard about. Assuming no transaction costs or low transaction costs, you’d expect the parties to make a deal here. The parties, on the whole, are better off, right? Their overall dispute resolution costs go down $500 from arbitration, so there is some wealth gain there. They should be able to split those cost savings and decide that arbitration is in their best interests. We would then expect $P_1$ to make some sort of payment to $P_2$ to induce $P_2$ to agree to arbitrate.

As an illustration of this, there was a relatively recent Alabama case involving a finance company that offered credit to its customers.\textsuperscript{16} The basic interest rate under the credit agreement, or the default interest rate, was 18.96% APR, sort of what you usually hear.\textsuperscript{17} But the credit agreement stated that if the customer agrees to arbitration, it would only charge 16.96% APR.\textsuperscript{18} It seems to me that this is a case where the finance company is probably better off using arbitration and the customer may be worse off with arbitration,
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as opposed to litigation. But the finance company is trying to make it up to the customers by trying to compensate them for what they would lose by agreeing to arbitrate. Again, the Coasean solution would be that you would expect the parties to agree to arbitrate. You can flip these numbers and get the opposite result. If $P_1$ is only $500 better off by agreeing to arbitrate, and $P_2$ is $1000 worse off, they are not going to be able to make a deal. Arbitration here, on the whole, makes the parties $500 worse off than they would have been otherwise. $P_1$ will not be able to pay $P_2$ enough to make up the difference. $P_1$ will not pay $P_2$ $1000 because it’s only worth $500 to $P_1$. In this case, we would not expect the parties to arbitrate.

If I really wanted to be formal, there are nice mathematical models that illustrate the same point.\textsuperscript{19} That is beyond my ability to do, and almost beyond my ability to understand, but the point is the same. It seems to me, just using a simple illustration, that the bottom line here would be that one-sided arbitration agreements may nonetheless make sense for parties, particularly sophisticated parties, to enter into, because there will be some sort of transfer payment between the party that benefits and the party that doesn’t.

So why does this matter? What can we learn from this approach? I think it is useful in trying to understand why certain things might be done in arbitration and why certain aspects of arbitration might be the way they are. So, for example, there is usually much less discovery in arbitration than there would be in court proceedings. As it turns out, there is usually some focused document production, document exchange, few depositions, almost no third-party discovery, and that’s about it. That is a lot less than parties could get in court litigation. Why would they agree to do that? We heard Professor Carrington’s talk yesterday about the tremendous benefits that discovery can bring in improving the accuracy of the judicial process.\textsuperscript{20} If you have this information being exchanged, you will get better results, so why would parties in arbitration agree to give it up? The reason might be that it’s expensive. There are trade-offs that parties need to make in deciding how to have their disputes resolved. Yes, discovery may improve the accuracy of the process, it may give more compensation to claimants, and it may increase deterrence benefits. But those improvements come at a cost, which is lawyers spending days and days and days in depositions, and thousands and hundreds of thousands of documents being exchanged. It’s not free. It seems to me, the fact that sophisticated parties in arbitration agree not to have that sort of discovery suggests that the benefits from it are outweighed by the costs, in their view, at least in the sorts of disputes subject to arbitration.

You can find a similar sort of thing with the appeals process: There is no right to appeal an arbitration. Those of you who are appellate judges presumably would think, and my guess is the trial court judges might disagree with you, that appeals make the process more accurate: We get better results, we fix the trial court’s errors, the compensation will be better allocated, and there will be more deterrence of wrongdoing. So why don’t we have arbitration appeals panels? The answer is, it’s costly. You have
to hire more arbitrators. That costs money. Again, this suggests to me that in arbitration, the parties don’t think it’s worth spending the extra money to get the errors fixed. There is actually a further aspect of that, which is something else that you all do both at the trial and appeals level: You make law. You issue decisions that can be precedent, either persuasive or binding, in other cases. In arbitration, why would parties want to hire a judge to make precedent for another case? The costs are borne by the current parties to arbitration, but the benefits go to later parties. Economically it may not make sense for them to hire judges to make law because the benefits will go elsewhere.

A final implication of this, getting into some actual cases now, is that it is fairly common in the franchise arbitration agreements I have looked at, that the parties will exclude certain sorts of claims from arbitration. These are called “carve-outs.” Certain claims can go to court and everything else is arbitrated. Another form these things can take is “options.” The franchisor has the option to go to court or to arbitrate for certain types of claims. In arbitration clauses and franchise contracts, the most common example is trademark disputes. Over sixty percent of the arbitration clauses that I looked at exclude trademark disputes from arbitration and say you go straight to court for a trademark dispute. Everything else, to oversimplify it, goes to arbitration.21

Other common carve-outs cover actions to collect money and foreclosure actions. There have been a couple of courts that have found those clauses unconscionable; either unconscionable and therefore unenforceable, or unenforceable because there is no mutuality in the arbitration agreement. One side has to arbitrate everything, but the other side doesn’t. There is a West Virginia case22 and a Montana case23 that held those sorts of clauses make the whole arbitration agreement unenforceable. Most courts reject that and uphold these sorts of clauses.24

My reaction is that carve-outs should be enforceable. If you think about it from the basic model or framework for understanding why parties agree to arbitration, you can understand why. The reason why certain types of claims are excluded from arbitration is because the costs and benefits of dispute resolution are different. For some types of claims, arbitration is better. For other claims, court litigation is better. Again, trademark infringement is a good example where the franchisor, or the party alleging infringement, is going to want a temporary restraining order or preliminary injunction stopping the misuse of the trademark right away. They need fast action. Courts are well suited to do that: You folks are there all the time. They can find you. They know who you are. Arbitration is not well suited for that sort of remedy. The first thing the parties have to do before they can arbitrate is agree on an arbitrator and that takes time, especially if the other party doesn’t want to go along with it. Plus, even if the arbitrator grants preliminary relief, the prevailing party may still need to go to court in order to get the court to enforce it. For emergency type actions, arbitration doesn’t really work very well. Some arbitration institutions try to deal with that by setting up standing panels and things like that, but in general, arbitration doesn’t work well for emergency actions. You would expect to find claims requiring judicial action to be carved out of the arbitration clause,
allowing the party to go to court to seek that sort of action. That’s what happens, and there are sound business reasons for doing it. It doesn’t seem to me that there is any reason why that shouldn’t be enforceable. It makes perfect economic sense.

So far I’ve assumed here that we are talking about sophisticated parties. Both parties are informed, know what’s going on, and can really make a sound decision as to whether they should arbitrate or go to court. A fast growing area of arbitration use is where that is not the case, where consumers or employees agree to arbitrate. How does that affect this discussion? How should that affect whether it makes sense for the parties to arbitrate or, more specifically, for courts to enforce their agreements to arbitrate? In the cases where it makes sense to arbitrate, the presumption should be that courts would enforce it. How does the consumer dispute change that? This is not really a good forum to get into a lengthy discussion on things like contracts of adhesion, but I do have a couple of general things to say.

First, it seems to me that differences in bargaining power between the parties aren’t enough to raise questions about whether the agreement to arbitrate should be enforceable. If the parties have different bargaining power, one may get more of the surplus, that is, the $500 benefit from arbitrating. $P_1$ has lots of bargaining power here. $P_1$ is going to get most of the $500 benefit from arbitration, but that doesn’t mean $P_2$ is going to get taken advantage of. If there is just unequal bargaining power, $P_2$ may get $501 to arbitrate, but it still makes $P_1$ better off than before, so unequal bargaining power alone isn’t going to be enough.

You might start having problems, and this is a very real concern in consumer and employee cases, when there are differences in information, or information asymmetry. The employer or the company has a lot better information than the consumer. What you see generally in the economic literature of arbitration is that economists will acknowledge that the unequal information is a possible ground for being concerned about enforcing arbitration agreements.25

First, you would expect to find responses to the unequal information. You would expect to see things like Consumer Reports talking about arbitration, which they do. A recent issue of Consumer Reports had a big article addressed to consumers about making sure they check to see if there’s an arbitration clause in their contract.26 That can tend to counteract the information asymmetry.

Second, arbitration institutions themselves have a very strong incentive to counteract unfairness in the arbitration process. Their livelihood, essentially, depends on the continued acceptability of arbitration. If courts stop enforcing arbitration clauses or if Congress steps in and excludes broad classes of disputes from arbitration, they take a real hit, so they have an incentive to make sure that doesn’t happen.

Finally, I don’t think I can really tell you whether consumer arbitration agreements should be enforced or not. What I do think important to keep in mind is that courts that decide not to enforce arbitration agreements, for whatever reason, perhaps justifiably, can impose costs on the parties. Courts can’t just hold something unconscionable without
consequences. Given that sophisticated parties find these arbitration agreements beneficial, it seems to me that there is evidence that they may be beneficial to unsophisticated parties as well. You should at least keep in mind that there may be costs to not enforcing them. The costs may be worth taking. It is not my place to tell you one way or the other, but there are costs there that need to be taken into account.

III. THE INCENTIVES OF ARBITRATORS

The incentive of the arbitrator is to get picked and to get picked again and again, because they don’t get paid unless they get picked by the parties. The incentives created by this institutional structure would be for them to make decisions that are acceptable to the parties. There is a market for dispute resolution services. Arbitrators compete with each other to be selected. You don’t have similar market competition in the judiciary. What effects can that have? Part of the folklore about arbitration is that arbitrators split the baby. This is Newman cutting the bicycle in half, literally. The rationale is that they want to make both parties happy so they get picked again. Maybe so, but that makes sense only if that is what the parties would want in advance for their decision-making to be. Parties aren’t stupid. They are not going to say, “Oh, well, yeah, this guy was really nice to us in this claim, let’s pick him in the future.” What they want is someone who is going to decide the claim fairly. That’s what the empirical evidence suggests, that the arbitrators generally do not split the baby.27

Another concern about this market in dispute resolution services is that it’s going to tend to favor repeat players like corporations, employers who arbitrate all the time, as opposed to employees or consumers who are one-shot players. Again, there is certainly some theoretical basis for it. Gordon Tullock, for example, talks about this potential problem.28 This is the same reason why I couldn’t get a roofer to come out to look at my house. I couldn’t even get him to return my phone calls here in Lawrence. Why is that? Well, they wanted to work for the contractors who would hire them again in the future. They didn’t want to come work for me, who was basically a one-shot player. That is the same concern in arbitration, the arbitrator is going to favor the repeat players who will be in a position to hire them again rather than the one-shot players who aren’t. That assumes not only a difference in frequency in being involved in the process, but also a difference of information. If the one-shot player has enough information about the arbitrator, it will veto him or her through one of the standard selection techniques. It’s not only that there are repeat players, but the repeat players must also have better information.

I have a couple of thoughts on that. The first is that plaintiffs’ attorneys are repeat players, too. There are franchising attorneys who spend their whole career representing franchisees of a particular franchisor. They presumably are as repeat a player as that franchisor. If that’s the case, the argument falls apart. Second, the arbitration institutions out there, such as the American Arbitration Association, JAMS, National Arbitration Forum, and CPR Institute for Dispute Resolution, have a really strong interest in making sure this doesn’t happen. These institutions make money by providing administrative
services for arbitration. If there is no arbitration, they don’t make any money. They have very strong incentives to make sure that arbitration is acceptable and to promote the use of arbitration. So what are they going to be worried about? One thing they will worry about is if courts stop enforcing their awards. They have a reputational interest here, too. If the courts stop enforcing the awards issued by the American Arbitration Association, clients are going to stop using the American Arbitration Association. Why waste your time going through the AAA proceeding if the award is not going to be enforced anyway? So there’s a very strong incentive to make sure that it gets enforced.

The institutions also have an incentive to try to ensure that the arbitration process is fair. This is particularly true when plaintiffs’ lawyers are repeat players, such as the plaintiffs’ employment bar. In fact, what you see is JAMS has come out with minimum standards of procedural fairness in employment arbitration, basically saying, “We will only administer claims that are fair, that have unbiased arbitrators, that have full remedies available, that have convenient locations, and the like.” Other arbitration institutions have done the same. One thing you might keep an eye on, if you are ever asked to look at arbitration clauses, is whether it is administered to by an institution or not. If it’s administered to by an institution, there are good incentives to keep the process fair. If it’s not, it’s like the Hooters case out of the Fourth Circuit. In that case, a Hooters restaurant manager was accused of sexual harassment. Hooters had its own internal program, and the arbitrator selection procedure was that you could pick any name you want off of a list, but Hooters got to pick who goes on the list. You can be more skeptical of the process when it’s internally administered than when it’s not.

IV. PRIVATIZING CIVIL JUSTICE

The final point is there are some economists who have advocated privatizing the whole lot of you and replacing everything with arbitration. Then, institutions will develop to make sure awards are enforced, and institutions will develop to replace the system of precedent that’s out there now. I’m skeptical of that. As my evidence, I would look at international arbitration. The same economists are saying, you have this international commercial law now, the Lex Mercatoria, it’s a private law-making system, and it’s a great way of doing things. The problem is, parties don’t want to use it. If you look at international arbitration clauses, nobody agrees to use the Lex Mercatoria because nobody knows what it is. You have these scattered international arbitration awards published all over the place. Attorneys can’t advise their clients on the law. There is a ton of uncertainty, and, to bring this full circle from where George Priest started, what happens when you have uncertainty? You have a lot more litigation. It seems to me that the thought about privatizing the whole civil justice system is going to potentially result in a huge explosion of litigation because there would be so much uncertainty about the law.
Drahozal

Notes

2. 84 S.E.2d 516 (Va. 1954).
10. See id.
17. See id. at 1412.
18. See id. at 1413.
25. See, e.g., Shavell, supra note 19, at 8.
27. See Orley Ashenfelter, Arbitration, in 1 New Palgrave Dictionary of Economics and the Law 88, 91 (Peter Newman, ed., 1998) ("The evidence now available indicates that [splitting the difference] is not the way that arbitrators behave in any actual ongoing arbitration system.").


34. See Priest, *supra* note 3.