

# The Dispute Resolution Market

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## INTRODUCTION

Since the days of 1979 when Landes and Posner published their seminal paper on “Adjudication as a Private Good,” it has become increasingly common to think of adjudication as a service that is offered in markets which may be more or less competitive.<sup>1</sup> The most obvious illustration supporting this view, and one to which Landes and Posner referred to explicitly, is, of course, arbitration.<sup>2</sup> Under the Federal Arbitration Act of 1925, arbitration agreements representing the parties’ choice of the tribunal that best fits their interests are valid and enforceable.<sup>3</sup> Several arbitral institutions and numerous actual and want-to-be arbitrators have built their businesses and compete for disputes that they can resolve on this legal basis.<sup>4</sup>

For a long time, the world of adjudication through public courts was based on the opposing principle of “non-ouster.” Under this doctrine, not only arbitration agreements,<sup>5</sup> but also contractual forum selection clauses that re-allocated

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1. See William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979).

2. *Id.* at 245-53.

3. 9 U.S.C. § 2 (2012); *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983) (“[Q]uestions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration.”).

4. See *infra* Part IV.C.

5. *Home Ins. Co. v. Morse*, 87 U.S. (20 Wall.) 445, 450-51 (1874); *Tobey v. Cnty. of Bristol*, 23 F. Cas. 1313, 1321 (C.C.D. Mass. 1845); *Meacham v. Jamestown, F. & C. R. Co.*, 105 N.E. 653, 656 (N.Y. 1914); *Gitler v. Russian Co.*, 108 N.Y.S. 793, 794 (App. Div. 1908).

cases between courts were held to be against public policy and were therefore unenforceable.<sup>6</sup> The doctrine of non-ouster had the practical effect that courts were both shielded from competition and excluded from participating in it. This state of the law changed in 1972 when the U.S. Supreme Court embraced the principle of party autonomy regarding choice of a judicial forum in the seminal case of *M/S Bremen v. Zapata Off-Shore Company*.<sup>7</sup> With this decision and others that followed,<sup>8</sup> freedom of contract, which already governed the substantive law, was transposed to the sphere of civil procedure. Since another seminal Supreme Court decision issued in 1991 in the case of *Carnival Cruise Lines v. Shute*, there is no doubt that forum selection clauses in contracts will generally be enforced in American courts, even if they are part of boilerplate used in transactions with consumers.<sup>9</sup>

Four decades after the *Bremen* decision was handed down, forum selection is once again attracting the interest of

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6. *Morse*, 87 U.S. (20 Wall.) at 451; *Nashua River Paper Co. v. Hammermill Paper Co.*, 111 N.E. 678, 679-81 (Mass. 1916); *Nute v. Hamilton Mut. Ins. Co.*, 72 Mass. (6 Gray) 174, 181-83 (1856). For a review of the case law, see James T. Gilbert, *Choice of Forum Clauses in International and Interstate Contracts*, 65 KY. L.J. 1, 7-12 (1976); Leandra Lederman, *Viva Zapata!: Toward a Rational System of Forum-Selection Clause Enforcement in Diversity Cases*, 66 N.Y.U. L. REV. 422, 427-28 (1991).

7. *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 8-15 (1972); cf. Gilbert, *supra* note 6, at 24-28.

8. *Stewart Org., Inc. v. Ricoh Corp.*, 487 U.S. 22 (1988); *Royal Bed & Spring Co. v. Famossul Industria*, 906 F.2d 45, 48-53 (1st Cir. 1990); *Nw. Nat'l Ins. Co. v. Donovan*, 916 F.2d 372, 373-78 (7th Cir. 1990); *Hodes v. S.N.C. Achille Lauro ed Altrigestione*, 858 F.2d 905, 912-16 (3rd Cir. 1988).

9. *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 593-94 (1991); cf. Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700, 707-12 (1992); Walter W. Heiser, *Forum Selection Clauses in Federal Courts: Limitations on Enforcement After Stewart and Carnival Cruise*, 45 FLA. L. REV. 553 (1993); Jeffrey A. Liesemer, *Carnival's Got the Fun . . . And the Forum: A New Look at Choice-Of-Forum Clauses and the Unconscionability Doctrine After Carnival Cruise Lines, Inc. v. Shute*, 53 U. PITT. L. REV. 1025 (1992); Edward A. Purcell, Jr., *Geography as a Litigation Weapon: Consumers, Forum-Selection Clauses, and the Rehnquist Court*, 40 UCLA L. REV. 423 (1992); Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure*, 25 CORNELL INT'L L.J. 51 (1992).

scholars.<sup>10</sup> This time, the issue is no longer whether such agreements are enforceable, but what the real-world effect of freedom of choice has been in the recent past and what it will be in the foreseeable future. To what degree have the parties availed themselves of their freedom of choice? Did their choices affect the distribution of cases between courts? How have judges and lawmakers reacted to possible shifts in demand for judicial services offered by particular judicial systems? In answering these questions, there is a lot to discover, as several jurisdictions have deliberately entered the competition for disputes.<sup>11</sup> The tipping point came when the State of New York set up the business court division of its court system in order to attract high-profile cases.<sup>12</sup> Other states have since followed suit, albeit sometimes with less success, and competitive forces remain strong to the present day.

Along with all the enthusiasm about interjurisdictional competition, another line of analysis exists that seems to cover exactly the same ground but from a different perspective. On this view, competition between courts is tolerable at best but not desirable, as it opens up the space for forum shopping. Courts will try to outperform each other in becoming ever more plaintiff-friendly. A pertinent example is patent litigation.<sup>13</sup> In patent litigation, there are a handful of districts that attract a disproportionate amount of the infringement cases in the country. These so-called “rocket-docket” courts seem to achieve their success, at least in part,

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10. See Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 CORNELL L. REV. 1 (2008); Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts*, 30 CARDOZO L. REV. 1475 (2009) [hereinafter Eisenberg & Miller, *Flight to New York*].

11. See Saurabh Vishnubhakat, *Reconceiving the Patent Rocket Docket: An Empirical Study of Infringement Litigation 1985–2010*, 11 J. MARSHALL REV. INTELL. PROP. L. 58 (2011).

12. See *infra* Part IV.D.

13. See Vishnubhakat, *supra* note 11; see also Xuan-Thao Nguyen, *Justice Scalia's "Renegade Jurisdiction": Lessons for Patent Law Reform*, 83 TUL. L. REV. 111, 125–34 (2008).

by favoring plaintiffs over the legitimate interests of defendants.<sup>14</sup>

The question as to how these two worlds—the bright side of interjurisdictional competition and the grim version of forum shopping—relate to each other is still unexplored. It seems that the same phenomenon that is in one instance celebrated as promoting procedural efficiency through competition between civil justice systems is condemned in another for opening the door to strategic choice of forum and a resulting degradation of judicial standards. This Article makes the claim that the core issue raised by interjurisdictional competition for disputes is identical to the parallel phenomena of competition for corporate charters and for bankruptcy filings. Through a process that has correctly been classified as competitive, the state of Delaware managed to attract the better part of incorporations in the U.S., leading to a dominance of Delaware's corporate law over the corporate laws of all other states.<sup>15</sup> Beginning in the 1990s, a similar development was observed in bankruptcy law, where Delaware, together with New York, began to outperform other jurisdictions by offering rules and decisions more friendly to the bankruptcy bar and the interests of current management.<sup>16</sup> The case of corporate charter business has been examined by extensive literature that explicitly draws on the economic concept of competition to answer the question whether the so-called "Delaware-effect" instigated a race to the top, toward an optimal corporate law, or rather instigated a race to the bottom, i.e. a corporate law

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14. See Vishnubhakat, *supra* note 11.

15. For discussions, compare ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993), and Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985), with Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775 (2002), and Lucian Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999).

16. LYNN M. LOPUCKI, *COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS* 49-76, 124-28, 137-38 (2005) [hereinafter LOPUCKI, *COURTING FAILURE*]; Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 40-41 (2007).

that benefits managers at the expense of shareholders.<sup>17</sup> Professor LoPucki has eloquently raised the proposition that, in the bankruptcy context, competition for cases is a bad thing and should prompt a response, but this proposition has never triggered a nearly as thorough and broad debate for corporate law.<sup>18</sup> With respect to the choice between different systems of dispute resolution, however, the topic has been ignored altogether.

The present Article fills this void. It brings the two topics of interjurisdictional competition and forum shopping together and asks whether one hypothesis or the other provides a more adequate account of reality. With regard to decisions that choose from a menu of mechanisms of dispute resolution, it is essential to draw a distinction between unilateral and bilateral choice. In one instance, the choice is made unilaterally by one party only—typically the plaintiff—while in the other, the choice is made together by the consent of both parties. It will be argued that this feature, whether the forum is selected by only one party or by both disputants, makes all the difference. In essence, unilateral choice, inevitable as it may be, is something the legal system needs to worry about and should take care to limit and rein in. In contrast, bilateral choices made by both parties deserve to be given full deference. Consensual choice of forum not only implements the preferences of the parties, but also stimulates a competitive process of constant improvement of dispute resolution processes.

Before exploring the distinction between unilateral and bilateral choice in more detail, it is helpful to clarify the concept of competition as applied to adjudication and judicial dispute resolution. Part I of the Article identifies the core of the concept of competition that was developed with a view to private markets for goods and services, not for governmental

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17. For the proposition of a race to the bottom, see William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L. J.* 663, 664-66 (1974). For the opposing view opposing view of a race to the top, see Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251, 254-62 (1977). For more nuanced discussions, see the sources cited *supra* note 15.

18. See sources cited *supra* note 16. *But see* Douglas G. Baird & Robert K. Rasmussen, *Beyond Recidivism*, 54 *BUFF. L. REV.* 343 (2006).

functions such as judicial dispute resolution by public courts that are charged with enforcing the law. Nonetheless, competition has been outgrowing these narrow confines and has developed into an economic concept that is able to capture a broader range of human activities, including the adjudication of disputes. It is therefore legitimate to speak of a market for adjudication and of judicial dispute resolution as a product.

Part II identifies the demand side and the supply side of the dispute resolution market and introduces the basic distinction between unilateral and bilateral competition. As will be shown, this distinction is not a conceptual idea that is tied to a particular legal or economic theory that may be accepted or rejected for one reason or another, but rather the distinction presents itself a feature ingrained in the structure of real-world disputes.

The Article then hones in on unilateral competition. Part III supplies an in-depth analysis of the mechanics and effects of unilateral forum choice. At a theoretical level, it explores the plaintiff's considerations in making the decision to file suit in one court rather than another. It then confronts the theoretical model with reality and examines the evidence that supports the existence of unilateral competition. As will be explained in more detail below, it is justified to assume that some courts, to a degree at least, respond to the demand of plaintiffs for a friendly court, thus setting off a process that may adequately be described as competitive. Part III concludes in posing the ultimate normative question of whether unilateral competition is a good or bad thing. And the answer is clear: unrestrained unilateral competition sets off a race to the bottom in the sense of a depreciation of the procedural standards necessary for the accurate enforcement of the law. For this reason, courts and lawmakers are well advised to curtail unilateral competition as best they can.

Part IV of the Article explores another world, namely the one of bilateral choice, in which the parties agree to have their dispute litigated or arbitrated in a particular court or arbitral tribunal. This world can exist only because the disputants, in spite of all the antagonism between them, harbor a set of shared interests that they draw on when they agree on the choice of a court or tribunal. The essential point

here is that parties making a consensual choice in favor of a particular court seek to optimize the accurate enforcement of their bargain, i.e. of the commercial contract that later turns into the subject matter of their dispute. Courts intending to be responsive to this kind of bilateral demand voiced by both parties together must therefore offer processes that promise a high degree of accuracy coupled with low costs of dispute resolution, in other words, a process that optimizes its benefits and its costs. While it would be too strong a claim to suggest that judges mimic the behavior of suppliers catering to a private market for services, there is evidence from some jurisdictions that courts and lawmakers, often stimulated by the local bar, pulled together in order to make their systems more “attractive” to potential litigants. The analysis of bilateral competition concludes with posing the same normative question that was used to evaluate unilateral forum choice, i.e. whether consensual forum choice is desirable. The answer is straightforward and affirmative. Inasmuch as parties strive to balance the benefits and costs of dispute resolution, they help to optimize the incentives to comply with the terms of their bargain. To the extent that courts respond to this type of demand, a process of constant improvement of mechanisms of dispute resolution is set off that may adequately be described as a race to the top.

The optimistic conclusion of Part IV (that bilateral competition is desirable as a means of improving the quality of judicial services) is clouded by some caveats and qualifications that are the focus of Part V. One such caveat results from network effects. Parties seem to make the choice for a particular forum not in isolation, but in conjunction with the choice of the applicable substantive law. The substantive law and the judicial services of a particular jurisdiction are “sold” as a package, and these packages become all the more attractive as the number of users increases. The results are first-mover and lock-in effects: jurisdictions that used to be among the most attractive in the past may be able to defend their position over their competitors, notwithstanding the inferior quality of the services they offer today.

Another serious problem is caused by the principal-agent relationship existing between uninformed parties and their

attorneys.<sup>19</sup> In most cases, at least, clients are unable to make informed choices between courts and thus have to rely on the advice of lawyers. The resulting agency relationship creates room for the attorney-agent to exploit the lack of information on the part of the principal-client for his or her own gain by advising the client to file suit in a court that is not in the client's best interest but is beneficial to the attorney. Finally, unfettered competition in the market of adjudication, even if it is stimulated by bilateral choices, may lead to negative externalities between jurisdictions.<sup>20</sup> The "acquiring" jurisdiction may be forced to use public funds to subsidize the judicial resolution of disputes that arose in another jurisdiction, while the "ceding" jurisdiction loses control over the enforcement of its laws. Together, these effects suggest that competition in the area of dispute resolution services will never be perfect and possibly should not even try to be.

The Article concludes with the question of whether states may be able to compete on both levels, i.e. in the area dominated by unilateral choice, as well as in the market for consensual forum selection. Surprisingly, the answer may be in the affirmative. The key is to bifurcate the court structure and to offer a specialized division of the judiciary to litigants who are jointly looking for the most efficient mechanism to enforce their bargain. The remaining courts of general jurisdiction may then be left to compete in the market of unilateral forum choice by adapting their rules and procedures in an effort to attract more claims.

## I. COMPETITION BETWEEN CIVIL JUSTICE SYSTEMS?

### A. *The Concept of Competition, as Applied to Dispute Resolution*

In economics, "competition" is not merely a descriptive concept but also a normative one, denoting something positive and desirable. The first fundamental theorem of welfare economics asserts that a market with perfect

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19. See *infra* Part V.B.

20. See *infra* Part V.C.

competition yields Pareto-optimal outcomes.<sup>21</sup> Perfect competition is characterized by large numbers of small firms competing for customers in markets to which free access is guaranteed. Each supplier must take the price as given as he is too small to affect it with his own supply so that price equals marginal cost, and profits are zero.<sup>22</sup>

These conditions are obviously not satisfied in the market for judicial services, to which access is regulated, where the number of suppliers is limited, where market participants are working on fixed salaries, and where valuable services may be offered for a price significantly below cost. On the other hand, it would be too easy to discard the notion of competition of judicial systems altogether. The existence of competition in the market for judicial services was particularly obvious in the days of Adam Smith, who wrote in his *The Wealth of Nations*:

The fees of court seem originally to have been the principal support of the different courts of justice in England. Each court endeavored to draw to itself as much business as it could, and was, upon that account, willing to take cognisance of many suits which were not originally intended to fall under its jurisdiction. . . . In consequence of such fictions it came, in many cases, to depend altogether upon the parties before what court they would choose to have their cause tried; and each court endeavoured, by superior dispatch and impartiality, to draw to itself as many causes as it could. The present admirable constitution of the courts of justice in England was, perhaps, originally in a great measure formed by this emulation which anciently took place between their respective judges; each judge endeavouring to give, in his own court, the speediest and most effectual remedy which the law would admit for every sort of injustice.<sup>23</sup>

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21. Joseph E. Stiglitz, *The Invisible Hand and Modern Welfare Economics* 2-3 (Nat'l Bureau of Econ. Research, Working Paper No. 3641, 1991).

22. PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 149 (19th ed. 2010).

23. 2 ADAM SMITH, *THE WEALTH OF NATIONS* 208 (J.M. Dent & Sons Ltd. 1960) (1776). As to the details of this system of judicial remuneration and its consequences for the development of the common law, see Daniel Klerman, *Jurisdictional Competition and the Evolution of the Common Law*, 74 U. CHI. L. REV. 1179 (2007).

In his standard elaboration of the concept of competition, George Stigler defines competition as “a rivalry between individuals (or groups or nations) [that] arises whenever two or more parties strive for something that all cannot obtain.”<sup>24</sup> He added that “a concept that is applicable to two cobblers or a thousand ship owners or to tribes and nations is necessarily loosely drawn.”<sup>25</sup> On the basis of his broad definition, the existence of competition in the market of legal services is obvious: courts, arbitral institutions, arbitrators, and mediators compete for cases, disputants compete for competent decision-makers, and plaintiffs compete for the forum most sympathetic to their claims. Alas, one might be confident that the “invisible hand” of competition leads to optimal outcomes that cannot be improved without lowering someone’s utility.<sup>26</sup>

The question explored in this Article is: does it really work this way with regard to civil justice systems? The analysis to follow is not limited to civil justice systems in the technical sense of the term, i.e. public officials vested with the powers of government, sitting in public courts, and deciding cases under rules of law. While the choice between systems of judicial dispute resolution remains at the core, the market for judicial services cannot be analyzed without regard to the numerous offerings of “alternative”—meaning non-judicial—methods of dispute resolution. As private

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24. George J. Stigler, *Competition*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS 51, 51 (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008).

25. *Id.*

26. 1 SMITH, *supra* note 23, at 13 (“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens. Even a beggar does not depend upon it entirely. The charity of well-disposed people, indeed, supplies him with the whole fund of his subsistence. But though this principle ultimately provides him with all the necessaries of life which he has occasion for, it neither does nor can provide him with them as he has occasion for them. The greater part of his occasional wants are supplied in the same manner as those of other people, by treaty, by barter, and by purchase. With the money which one man gives him he purchases food. The old clothes which another bestows upon him he exchanges for other old clothes which suit him better, or for lodging, or for food, or for money, with which he can buy either food, clothes, or lodging, as he has occasion.”).

parties offering alternative dispute resolution services operate in private markets, they must be accounted for in a meaningful analysis of competition between judicial systems. The real market to analyze is not the market for judicial services but, more broadly, the market for dispute resolution services. That includes not only the settling of disputes via arbitration, but also the many varieties of alternative dispute resolution, such as expert proceedings, conciliation, mediation, etc. The parties to a dispute are confronted with a rich menu of options, ranging from simple face-to-face negotiations to highly stylized litigation in public court. These options are never perfect substitutes for one another, and some of them are not substitutes at all, as they may be combined to form a multi-layered mechanism of dispute resolution. Many disputes start out with negotiations between the parties that may then lead to mediation, and from there to arbitration, in order to reach the courts after the award was made and an application for leave to enforce was filed.

The fact that the different products available on the market for dispute resolution services may be substitutes for one another but may also be combined complicates the analysis.<sup>27</sup> The presentation to follow will not explore the various tools and mechanisms of alternative dispute resolution in detail, but will focus on solely judicial disposition of disputes and arbitration instead. In doing so, arbitration is understood to be close to a perfect substitute for judicial resolution of disputes.

### B. *The Tiebout Model of Systems Competition*

The basic concepts of welfare economics have been applied to rivaling governments and countries, building on the Tiebout model of competition for the supply of public goods.<sup>28</sup> Within this framework, people and businesses shop

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27. See Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1, 12-19 (1995).

28. For the original discussion of this model, see the pathbreaking piece by Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). For an application of the ideas of systems' competition to the legal field, see Anthony Ogus, *The Economic Approach: Competition between Legal Systems*,

around for the jurisdiction or community whose mix of benefits and burdens best meets their preferences.<sup>29</sup> Local governments are sellers of public goods to citizens and businesses, and they charge a price for the bundle of goods offered in the form of taxes levied on their customers. On the demand side, firms and citizens pick the combination of taxes and public goods that best satisfy their preferences. This drives lawmakers and regulators to improve the mix of taxes and public goods they offer in order to attract new citizens and firms. This process continues up to the point where local governments approach their optimal composition and size.<sup>30</sup> Over time, competition weeds out those governments that do a poor job, i.e. those which charge excessive taxes compared to the poor quality of public goods they can offer.

### C. *Systems Competition in Dispute Resolution*

Tiebout's conclusions are based on the assumption, that he made explicitly, that consumer-voters are fully mobile and will move to the community that best satisfies their preferences.<sup>31</sup> However, this assumption is completely unrealistic, particularly in the international context where linguistic, cultural, and institutional differences make movements from one country to another complicated and fraught with high transaction costs.<sup>32</sup> With regard to the market for dispute resolution services, however, the assumption that the switch from one jurisdiction to another

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in *COMPARATIVE LAW: A HANDBOOK* 155, 155-67 (Esin Örüçü & David Nelken eds., 2007); see also Anthony Ogus, *Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law*, 48 *INT'L & COMP. L.Q.* 405 (1999). For a modern treatment, see Hans-Werner Sinn, *The New Systems Competition* 1-2 (Nat'l Bureau of Econ. Research, Working Paper No. 8747, 2002).

29. Tiebout, *supra* note 28, at 418 (“[T]he consumer-voter moves to that community whose local government best satisfies his set of preferences.”).

30. *Id.* at 419 (“[C]ommunities below the optimum size seek to attract new residents to lower average costs. Those above optimum size do just the opposite. Those at an optimum try to keep their populations constant.”).

31. *Id.*

32. Cf. Robert Inman & Daniel Rubinfeld, *Federalism*, in 5 *ENCYCLOPEDIA OF LAW AND ECONOMICS* 661, 673-74 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

can be made at low cost may actually be valid. The choice of a particular court or other dispute resolution mechanism does not force citizens to physically leave their jurisdiction in order to relocate elsewhere. Rather, similar to the case of choice of law, firms and consumers may make “virtual” choices, i.e. opt in favor of a mechanism of dispute resolution without changing their permanent affiliation with a particular jurisdiction and its system of civil justice.<sup>33</sup> The disputants are therefore able to import dispute resolution services by opting in favor of one system of civil justice or arbitral dispute resolution rather than another.

The analogy to choice of law is not complete, however, because processes of dispute resolution normally necessitate the physical presence of the disputants or their representatives at a single location, e.g., the court. In this sense, there is still an element of “voting with one’s feet” involved. The burden associated with such travel requirements is far from the one attached to moving one’s residence or seat to another jurisdiction. Still, as we shall see, the costs of “moving” to another jurisdiction temporarily in order to use mechanisms of dispute resolution there play a role in the calculus of the parties when they make the relevant choices.<sup>34</sup>

Another assumption made in Tiebout’s model analogizing competition in private markets with competition between jurisdictions is that there are no spill-overs between jurisdictions, i.e. “no external economies or diseconomies between communities.”<sup>35</sup> The hypothesis that the competitive behavior of the various jurisdictions does not cause effects outside the respective community is realistic with regard to the resolution of a dispute between the parties involved. However, dispute resolution is not the only good produced by civil justice systems. Another function of the court system is to clarify and amplify the law, to develop it into new areas, and to change existing rules where this turns out to be

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33. For a full exploration of this argument, see Gerhard Wagner, *The Economics of Harmonization: The Case of Contract Law*, 39 COMMON MKT. L. REV. 995, 1007-11 (2002).

34. See *infra* Part III.D.1.

35. Tiebout, *supra* note 28, at 419.

necessary.<sup>36</sup> To the extent that competition in the litigation market shifts demand from one jurisdiction to another, the number of cases and court decisions in the ceding jurisdiction declines, and the amplification and rule-making functions of the courts suffer. These consequences raise serious issues that need to be addressed once the dynamics of systems competition in the litigation market have been explored.<sup>37</sup>

## II. THE MARKET FOR DISPUTE RESOLUTION SERVICES

### A. *The Supply Side of the Market for Dispute Resolution*

Assuming that the product traded in the litigation market is dispute resolution, it is essential to identify demand and supply. Who demands what from whom as a supplier? Subject to the above qualification, that mediation and other supplemental forms of alternative dispute resolution are ignored,<sup>38</sup> the supply side of the market for dispute resolution consists of courts and arbitrators who compete for business in the form of cases brought to them for the purpose of decision-making.

### B. *The Demand for Dispute Resolution*

#### 1. The Distinction Between Unilateral and Bilateral Demand

If courts and arbitrators form the supply side of the market for dispute resolution, who is on the demand side? The question is worth asking because, per definition, a dispute requires at least two parties. The presence of several parties on one side of the supply-and-demand relation may be unproblematic, as long as the interests of the parties are well aligned with each other. This is not true in the case of a dispute, as the interests of the parties there are antagonistic by their very nature. In fact, both parties are competing against each other for a favorable outcome of the dispute

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36. See Bruce H. Kobayashi & Jeffrey S. Parker, *Civil Procedure: General*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra* note 32, at 16; Landes & Posner, *supra* note 1, at 236.

37. See *infra* Part V.C.

38. See *supra* Part I.A.

resolution process. In the familiar case of a money claim, everything the plaintiff wins, the defendant loses, and vice versa. On the other hand, it would be wrong to think that the interests of the disputants are fully antagonistic, as there will be areas of overlapping concerns. Most importantly, both parties will want to limit the costs of whatever dispute resolution mechanism they choose.

The distinction between shared and antagonistic interests of potential litigants maps onto two different types of demand for dispute resolution services. In the case of unilateral demand, only one party, typically the plaintiff, acts upon her preferences, while in the other category of bilateral demand, both parties have to fit their preferences together in order to make a joint decision in favor of a court or other dispute resolution mechanism. As they have to agree on how to make that choice, their demand is bilateral.

Generally, the choice between several competent courts or, more broadly, civil justice systems is for the plaintiff to make. Absent an agreement of the parties creating an obligation to use arbitration rather than litigation, and without a forum selection clause vesting exclusive jurisdiction in a particular court, the potential plaintiff has the privilege of making a unilateral choice. The default rule in civil procedure provides that, absent valid agreements made by the parties, the plaintiff has the authority to pick the court that will hear and decide the case. In this type of situation, the demand side of the market for dispute resolution services is populated by potential plaintiffs only.

The case of bilateral demand is analogous to the case, familiar from the substantive law of contract, that the parties deviate from default rules. Today, most legal systems allow the parties to derogate from the general law of civil procedure in various ways, even though no jurisdiction has gone as far as to enforce derogative agreements across the board.<sup>39</sup> In particular, the parties are authorized to vest an arbitral tribunal or a public court with exclusive jurisdiction, derogating the jurisdiction of all other courts that would have

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39. Cf. Daphna Kapeliuk & Alon Klement, *Contractualizing Procedure* 8-13 (Dec. 31, 2008), available at <http://ssrn.com/abstract=1323056>.

been competent otherwise.<sup>40</sup> In this type of situation, the choice is made by the disputants together, as both sides have to agree to use one court rather than another. Even so, the interests of the parties in the outcome of the dispute resolution process remain antagonistic; the agreement extends only to the person or institution that serves as the decision-maker and to the nature of the dispute-resolution process.

## 2. Ex Ante and Ex Post Agreements

It is tempting to link the distinction between unilateral and bilateral choices to the other distinction between ex ante and ex post agreements on dispute resolution. Where the parties are in a contractual relationship with one another, there is the option of agreeing on the competent court ex ante, before a dispute has arisen. In practice, the parties regularly include in their commercial contracts forum selection or arbitration clauses fixing the mode and place of dispute resolution. Obviously, transaction costs are much lower in this situation than in the state ex post. In the situation ex ante, the parties sit together anyway and negotiate their commercial contract. The forum selection or arbitration clause is just one element in a set of contested issues that the parties must settle in order to close the deal. The fact that the parties have to resolve a multitude of issues makes it easier to compromise on any one of them, as it is possible to compensate a "loss" here with a "gain" there. Even more importantly, in the situation ex ante, the facts and circumstances of the dispute that will arise in the future are still unknown. Neither party can anticipate whether he or she will find himself or herself in the role of the plaintiff or that of the defendant;<sup>41</sup> whether he or she will have a stronger interest in confidentiality or in full disclosure; whether it will be important to him or her to enforce the judgment in a particular jurisdiction, or to resist enforcement in another, etc. To borrow a term from John Rawls, the parties negotiate behind a veil of ignorance because they are unable to know

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40. See sources cited *supra* notes 7-9.

41. This Article assumes a female plaintiff and a male defendant.

their position as plaintiff or defendant, the strengths and weaknesses of their claims or defenses, or their collateral interests in the litigation that might arise in the future.<sup>42</sup> This makes it easier to reach an agreement.

Private ordering *ex ante* is only possible where the parties have been in a relationship, contractual or otherwise, before the dispute arose. Where there was no contract or other legal relationship prior to the dispute, as is true in most cases involving torts and similar claims, the parties may still agree on a dispute resolution mechanism *ex post*. In this situation, the veil of ignorance regarding the nature of the dispute has been lifted, the roles as plaintiff or defendant have become clear, the stakes are obvious, the parties are in a bilateral monopoly because the only potential contracting partner is the opponent, and they need to agree on a single issue: the court or tribunal in which to litigate or arbitrate the dispute. While such agreements are possible and do occur in the real world, they are difficult to negotiate and involve high transaction costs.<sup>43</sup>

In most instances, unilateral choice of the dispute resolution mechanism will involve claims of non-contractual nature, and bilateral choice will concern claims that have grown out of contractual relationships. However, the fit between the categories is not perfect. Even parties who were in a contractual relationship with one another, but failed to agree on a dispute resolution clause *ex ante*, always retain the option to come together *ex post* and fix jurisdiction with a particular court or arbitral tribunal with regard to a dispute that has already arisen.

### C. *Two Types of Competition*

The distinction between the two types of demand—unilateral demand and bilateral demand—is central to an

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42. JOHN RAWLS, *A THEORY OF JUSTICE* 118 (1971).

43. See Lewis L. Maltby, *Out of the Frying Pan, Into the Fire: The Feasibility of Post-Dispute Employment Arbitration Agreements*, 30 WM. MITCHELL L. REV. 313, 322 (2003) (reporting the finding of his survey that less than 10% of AAA arbitrations involving disputes between businesses were the result of post-dispute agreements).

analysis of competition in the market for dispute resolution, even though it is mostly ignored in the literature.<sup>44</sup> From a descriptive as well as a normative point of view, the outcome reached in a competitive process is contingent upon the input in terms of preferences. To take an example from an unrelated area: if consumers have a preference for high-powered cars, the supply side of the automobile market will accommodate such preferences, and more cars with the appropriate features will be sold. From a dynamic perspective, more resources will be channeled into researching and developing high-powered cars, and a whole industry may be led onto this path. If, on the other hand, consumers had a strong preference for fuel efficiency, then demand would favor other types of cars, the automakers would compete to match this kind of demand, and, in the long term, resources would be channeled into research for more fuel-efficient cars. Over time, one group of consumers may shift from one preference towards the other and back, as has happened in the U.S. several times in response to major changes in oil prices.

In the same manner, the competitive process will yield different outcomes, depending on whether plaintiffs alone or both parties together represent the demand side. Where plaintiffs have the demand side to themselves, only their preferences count, and the supply side, e.g., courts and arbitrators, will compete to meet these preferences and nobody else's. If, on the other hand, both parties share in the demand side, they will articulate only those preferences that they share, and these will be different from any one party's preferences. Again, the supply side in the market for dispute resolution services will react to the articulated preferences of actors on the demand side, and the competitive process will be shaped accordingly. As we shall see, both categories of competition exist in the real world, generating different outcomes and prompting different concerns.

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44. It is laudable that some authors dealing with issues of competition between justice systems make it clear that they only talk about bilateral competition. *See, e.g.,* Dammann & Hansmann, *supra* note 10, at 6 (“[W]e limit our focus to litigation in which all parties consent to employing the foreign court.”); *see also id.* at 15.

## III. UNILATERAL COMPETITION FOR A FRIENDLY COURT

A. *The Options and Why They Matter*

Where there is no choice between courts or between judicial and arbitral dispute resolution, there can be no competition. In a world without arbitration and with clear and straight jurisdictional rules that vest jurisdiction for a given case in one court only, plaintiffs would have to live with whatever court was competent. Yet, in reality, the reverse is true, as plaintiffs have a choice between multiple courts that are competent to hear and decide their case, in addition to the option to shun the court system altogether and turn to arbitration.

Within the U.S., the range of options available to a plaintiff is particularly broad, thanks to the federal structure of the nation and the double-tiered judicial system it maintains. As a consequence, the case that only one forum is competent to hear and decide a particular dispute is not the rule, but a rare exception, and the choice between the several courts that have jurisdiction may well be outcome-determinative. Each state within the Union operates its own court system, its own choice of law rules, and distinct systems of tort and contract law. The legal rules allocating jurisdiction are largely left to the states, as long as basic constitutional guarantees are observed.<sup>45</sup> In addition to the judicial systems of the several states, there is a federal system with its own courts and rules of jurisdiction. Even though a federal court is bound to apply the same choice of law rules<sup>46</sup> and the same substantive law as the state court of the state in which the federal court is located,<sup>47</sup> outcomes might still be different, depending on whether a case is brought in state court or in federal court.

B. *The Plaintiff's Calculus*

Rational and self-interested claimants make the decision of where to file suit with a view towards maximizing their

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45. See *Int'l Shoe Co. v. Washington*, 326 U.S. 310 (1945).

46. *E.g.*, *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487 (1941).

47. *E.g.*, *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938).

chances of winning and minimizing the costs they are expected to bear. The immediate costs of using the court system are the fees charged by the court plus the fees charged by legal counsel for representation in the forum in question. Both items together represent the administrative costs ( $c^a$ ) of using the court's services. To the extent that they must be borne by the plaintiff, they are the plaintiff's expected administrative costs ( $c^{pa}$ ). This item is understood to be independent of the design of the cost allocation rule enforced by an individual court. Within the domain of the American rule,  $c^{pa}$  represents the filing fee to be paid by the plaintiff plus the sum of attorney's fees the plaintiff expects to invest in the litigation. Within jurisdictions following the English rule on cost allocation,  $c^{pa}$  denotes the expected share of the costs that the court will allocate to the plaintiff.

The calculations a rational plaintiff would make in order to select the optimal court are a simple extension of expected value analysis. Let the probability that plaintiff ultimately wins a favorable judgment be  $p$ , the amount of damages awarded be  $X$ , and the administrative costs she is expected to bear be  $c^{pa}$ ; then the plaintiff will bring suit whenever  $pX - c^{pa} > 0$ .<sup>48</sup>

In a situation where the plaintiff has a range of options of where to file suit, and provided that the several courts competent to try the case differ in their treatment of the case and in the probability that the plaintiff will ultimately prevail, the calculus needs to be applied with respect to each competent court. In a scenario with two courts, Court 1 and Court 2, the plaintiff would need to estimate her chances of prevailing in Court 1 and in Court 2 ( $p^1$  and  $p^2$ ), estimate the damages that are likely to be awarded by the two courts ( $X^1$  and  $X^2$ ), and the amount of legal costs she is likely to have to bear following suit in either forum ( $c^{pa1}$  and  $c^{pa2}$ ). The estimated value of litigation in Court 1 would be  $p^1X^1 - c^{pa1}$  and the estimated value of litigation in Court 2 would be equal to  $p^2X^2 - c^{pa2}$ . The plaintiff would file in Court 1 if the expected value of litigation there would be greater than the expected value of litigation in Court 2:  $p^1X^1 - c^{pa1} > p^2X^2 -$

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48. For a thorough treatment, see Kathrin E. Spier, *Litigation*, in 1 HANDBOOK OF LAW AND ECONOMICS 259, 264-65 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

$cpa2$ . In the reverse case, when  $p^2X^2 - cpa2 > p^1X^1 - cpa1$ , the plaintiff would turn to Court 2. In theory, these same calculations could be run with any number of courts that compete for jurisdiction.

It needs to be mentioned that rational plaintiffs would have no interest in maximizing the expected value of the judgment as such.<sup>49</sup> What plaintiffs really care about is the sum of money that they can ultimately recover from the defendant. In order to be able to do so, it is crucial to select a court whose judgments carry a high chance of actual recovery. While forum selection can do nothing to make defendants richer than they really are, the law of execution may vary between jurisdictions and the ability to enforce a judgment abroad may also differ from country to country. Therefore, rational plaintiffs would select the court with a view of maximizing the likelihood of actual recovery of any sum awarded from the defendant, minus costs.

### C. *Additional Variables*

#### 1. Delay

The conventional model outlined above fails to include a number of variables that are relevant in making the choice between suing in one court rather than another. One such item is the cost of delay. Inevitably, dispute resolution takes time, but the amount of time it takes to reach a final decision or other resolution of a dispute varies from mechanism to mechanism and from court to court. In the familiar case of a claim for money, the losses incurred by the plaintiff while waiting for a decision enforcing her claim are at least equal to foregone interest that could have been earned from an early investment of the money. Plaintiffs, whose financial structure includes debt that could have been repaid by using the proceeds from the claim, incur damages equal to the interest payments that they have to make on the respective amount of their outstanding debt. Where large sums are involved, an unresolved dispute may block certain options of corporate restructuring, such as a merger with another company. In extreme cases, plaintiffs may even face

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49. For a more thorough discussion, see *infra* Part IV.A.2.

insolvency due to the long delay in resolving disputes around claims of high value. Such losses caused by the delay of dispute resolution may be offset by awards of pre-judgment interest and rights to damages, but their availability and scope depends on the jurisdiction and on the substantive law chosen by the parties.<sup>50</sup> Even where these remedies are available, they tend to be under-compensatory, especially where the stakes are high. If the net costs of delay are denoted  $c^d$ , rational plaintiffs would choose between different courts by comparing  $p^1X^1 - c^{pa1} - c^{pd1}$  with  $p^2X^2 - c^{pa2} - c^{pd2}$ .

## 2. Collateral Harm

Another important concern relates to the benefits and the harms generated by the process of dispute resolution itself, regardless of the outcome and the costs it takes to achieve it. The existing literature acknowledges the fact that litigation may have “external effects” that need to be evaluated and included in the plaintiff’s calculus.<sup>51</sup> These authors focus on the effects the decision in a single case may have on the resolution of future cases between the same litigants.

One example relates to the familiar situation where the defendant faces a large number of suits that are all based on the same fact pattern. Such a scenario is standard in products liability cases involving design defects. If the design of a mass-produced commodity has been found to be defective by a respected court in a single case, the defense in all the other cases becomes much more difficult to sustain. After the highest-ranking court of the relevant jurisdiction has found the product to be defective, litigation in the mass of cases still pending at lower levels is practically over. In such a setting, the defendant’s stakes in the first case that comes up for decision greatly exceed the value of the subject matter in dispute between the two parties to this lawsuit. An adverse judgment in one particular case would have large negative

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50. Cf. William E. Nelson, *Contract Litigation and the Elite Bar in New York City, 1960-1980*, 39 EMORY L.J. 413, 421-22 (1990) (comparing the rate of prejudgment interest available from courts in New York with the market rates, which were substantially higher).

51. See Kobayashi & Parker, *supra* note 36, at 9-12.

external effects for the defendant and yield corresponding gains for all the other actual and potential plaintiffs who were injured by the same kind of product. Of course, the reverse case, where the additional loss affects a single plaintiff, while the gains accrue to a multitude of defendants, is conceivable too.

Gains and losses to the disputants may also be caused by the procedure itself, regardless of its effects on other similar cases. The most obvious example involves the disclosure of confidential information. A party might have an interest not to disclose certain facts in open court, even if this forum may lean in her direction and the disclosure would increase her chances of prevailing. Plaintiffs are well advised to consider this aspect while making the choice between different courts and tribunals, as the selection of a process that allows for broad discovery will increase the willingness of the defendant to agree to a generous settlement.

The harms or benefits caused by the process of dispute resolution as such, in ways other than increasing or decreasing the chances of persuading the decision-maker, are “collateral” to the litigation or arbitration. The threat of inflicting collateral harm on the opponent may be used as leverage in settlement negotiations, increasing the chances of winning a generous payment. But even if settlement is not the issue, collateral harms and benefits are clearly relevant. A celebrity might avoid courts of a jurisdiction simply because of the intensive media attention that must be expected if trial is held there.

In a complete model of the plaintiff’s decision on where to file suit, the collateral harms and benefits would have to be reflected and expressed in variables. This is not without difficulty, however, as the complex and diverse collateral effects of litigation in a particular forum need to be identified and their strengths estimated. The resulting variable would have to be a compound of at least two subcategories of external effects:

1. The expected gain a favorable resolution of the dispute has on other similar claims of the plaintiff, both those already pending or to be brought in the future, and vice versa for an outcome that is adverse to the plaintiff’s interests.

2. The expected gains from a procedure that imposes collateral harm on the defendant, and thus increases his willingness to settle and the amount he is prepared to agree in settlement, minus any losses the procedure may force on the plaintiff.

In order to avoid the complexities associated with such estimations, the net value of collateral harms and benefits, as perceived by the plaintiff *ex ante*, shall be captured in the variable  $Z$ , which represents the aggregate of collateral costs and benefits, and may therefore be positive or negative.

The aggregate of these variables must be added to the expected value of litigation in one court or another, so that the plaintiff compares  $p^1X^1 - cp^1 - cp^1d + Zp^1$  with  $p^2X^2 - cp^2 - cp^2d + Zp^2$  and will file suit in Court 2 if  $p^2X^2 - cp^2 - cp^2d + Zp^2 > p^1X^1 - cp^1 - cp^1d + Zp^1$ .

#### D. *Evidence of Unilateral Competition*

Up to this point, the analysis was purely theoretical, exploring the concerns and considerations of a rational plaintiff who is faced with a menu of courts and tribunals to choose from. The upshot was that plaintiffs try to maximize the difference between the expected judgment and the sum of administrative costs, costs of delay, and collateral effects. The question now is whether there is evidence suggesting that this is an adequate description of the decision-making process real-world plaintiffs go through.

##### 1. Hometown Bias

In reality, most plaintiffs do not engage in extensive expected value analysis but form intuitions about the most favorable courts and then compare the expected value of litigation in the two or three most promising venues. In doing so, plaintiffs will reason from the assumption that the court spatially closest to them—their “home court”—will be the easiest one to persuade. Litigation in one’s home court offers palpable advantages that work to increase the chance of prevailing. In many cases, the plaintiff will retain counsel practicing in the same jurisdiction, so that litigating “at home” obviates the need to retain another or additional counsel for representation elsewhere. For the plaintiff’s

officers and employees, it is clearly more convenient to litigate at the seat of the company than in a far-away place. The plaintiff's evidence may be located close to its own residence or seat, so that it is easier and safer to present it there. Finally, the local judges, even if not biased against foreign defendants, may at least see to it that they do not prejudice local plaintiffs.

By the same measure that these concerns work to the advantage of the plaintiff, they tend to disfavor the defendant; he may have to deal with a judiciary biased against his interests, he needs to seek out, instruct, and pay counsel at a distant locale, his officers and employees will have to travel to a distant court if so required, and the defendant's evidence must be shipped there, at his own cost and risk. These factors taken together suggest that litigating "at home" is the best option available because it maximizes the net expected outcome for the plaintiff.

These considerations regarding the calculus a hypothetical plaintiff will go through in making the decision of where to file a lawsuit are confirmed by the historical development of American law and empirical evidence gathered from the legal landscape of the United States. In fact, the concern for local bias of the state courts was the major motivation for the introduction of diversity jurisdiction of the federal courts in cases involving matters of state law only under Article III, Section 2 of the U.S. Constitution.<sup>52</sup> The canonical explanation goes back to John Marshall:

However true the fact may be, that the tribunals of the states will administer justice as impartially as those of the nation, to parties of every description, it is not less true that the constitution itself either entertains apprehensions on this subject, or views with such indulgence the possible fears and apprehensions of suitors, that it has established national tribunals for the decision of controversies between aliens and a citizen, or between citizens of different states.<sup>53</sup>

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52. See Henry J. Friendly, *The Historic Basis of Diversity Jurisdiction*, 41 HARV. L. REV. 483, 492-97 (1928).

53. *Bank of United States v. Deveaux*, 9 U.S. (5 Cranch) 61, 87 (1809) (Marshall, C.J.); see also *Guar. Trust Co. of N.Y. v. York*, 326 U.S. 99, 111-12 (1945).

An additional concern that led the framers was their belief that the federal courts were more sympathetic to, and supportive of, land owners and large commercial enterprises operating across state lines.<sup>54</sup>

The hometown bias is difficult to confirm empirically. With regard to international litigation involving foreign parties in American courts, empirical studies have yielded opposing results, with one study suggesting that foreign parties fare worse than domestic ones<sup>55</sup> while other studies found that their win rates were actually higher than the one of domestic parties.<sup>56</sup> However, even the authors of these optimistic studies were cautious to add that “we never said or implied that anti-foreign bias is nonexistent.”<sup>57</sup> Rather, they maintained that case selection was driving the results, as foreign parties who fear the bias of local courts will be more willing to settle and litigate to trial only the strongest cases.<sup>58</sup> As long as the strength of this effect remains in the unknown, it seems impossible to draw strong conclusions from empirical findings. In contrast, the perception of the lawyers who are representing parties in litigation unequivocally confirms the existence of hometown bias. Contemporaneous surveys of practitioners reveal that the preferences for, or the aversions against, local biases are strong factors in the making of forum selection decisions. Even though local bias loomed larger for defense attorneys than for plaintiffs’ attorneys, 44.9% of the members of the plaintiffs’ bar who had responded to a survey still confessed that local bias was a major factor in their decision-making.<sup>59</sup>

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54. John P. Frank, *Historical Bases of the Federal Judicial System*, 13 LAW & CONTEMP. PROBS. 3, 27 (1948).

55. Kimberley A. Moore, *Xenophobia in American Courts*, 97 NW. U. L. REV. 1497, 1503-06, 1509-14 (2003).

56. Kevin M. Clermont & Theodore Eisenberg, *Xenophilia or Xenophobia in U.S. Courts? Before and After 9/11*, 4 J. EMP. LEGAL STUD. 441, 443 (2007) [hereinafter Clermont & Eisenberg, *Xenophilia or Xenophobia*]; Kevin M. Clermont & Theodore Eisenberg, *Xenophilia in American Courts*, 109 HARV. L. REV. 1120, 1124-25 (1996).

57. Clermont & Eisenberg, *Xenophilia or Xenophobia*, *supra* note 56, at 445.

58. *Id.*

59. Neal Miller, *An Empirical Study of Removal Cases under Diversity and Federal Question Jurisdiction*, 41 AM. U. L. REV. 369, 400, 408-09 (1992) (“50.7%

Interestingly, the only other factor with an even stronger impact on the forum selection decision was reported to be “attorney convenience”<sup>60</sup>—a point worth coming back to when examining the effects the principal-agent-relationship between client and attorney has on such decisions.<sup>61</sup>

## 2. Forum Shopping

In most cases involving corporate defendants, the range of courts where suit may be brought is much wider than a mere choice between state and federal courts, however, as corporations that operate nationwide are subject to the jurisdiction of each and every state within the Union. Given that the state courts, as well as the federal district courts, apply the procedural law and the choice of law rules of the state in which they sit,<sup>62</sup> there is much to gain from having one court rather than another hear and decide a case. Local choice of law rules tend to favor the application of local substantive law, so that forum selection is a mere conduit for a choice of the substantive law. This framework provides members of the plaintiffs’ bar representing groups of victims who were harmed in different states with the chance of exploiting the differences between the local regimes in a broad variety of jurisdictions and to file suit under the tort law that offers the most favorable combination in terms of liability, damages, and procedure.<sup>63</sup> Even though this option has been narrowed down by the Class Action Fairness Act of 2005, it remains intact with regard to the choice between the

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of the responding defense attorneys said that bias against out-of-state litigants was present in their cases. . . . [A] number of plaintiff counsel agreed that there is bias against out-of-state defendants. Interestingly, this perception of bias is one of the few factors which correlates closely with plaintiff counsel’s legal experience, measured by year of bar admission.”).

60. *See id.* at 400-03.

61. *See infra* Part V.B.

62. *See, e.g., Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496 (1941).

63. This is true in spite of the limits on choice of law imposed by *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985). *See* Carol Rice Andrews, *The Personal Jurisdiction Problem Overlooked in the National Debate about “Class Action Fairness,”* 58 SMU L. REV. 1313, 1320-25 (2005).

federal district courts and with regard to claims for less than \$5 million.<sup>64</sup>

The combination of the three principles of (1) diversity between the legal regimes of the several states, with (2) jurisdictional equality of all the courts in the nation, and (3) allocation of the right to choose the competent court to the plaintiff, generates a pro-plaintiff bias. This effect has been confirmed by empirical studies. Clermont and Eisenberg have found a strong pro-plaintiff effect if cases are tried in the forum of the plaintiff's choice, rather than in another one to which the case was transferred.<sup>65</sup> One of their studies focused on cases initially filed in a federal district court, with one group being tried in the court where the original suit was filed, while another one was transferred to another forum under 28 U.S.C. § 1404(a). While the plaintiff's win rate was 58% in the court where the suit originated, it was only 29% in the courts to which the case was transferred. The authors conclude that "venue is worth fighting over because outcome often turns on forum."<sup>66</sup> The same effect was discovered in another study that compared the win rates for plaintiffs in state courts and the win rates in cases that had originated in state court but had later been removed to the federal courts under 28 U.S.C. § 1441. While the win rates for plaintiffs in cases decided by state courts is around 71%, it drops to 33% in cases that originated in a state court system, but were then moved to a federal court.<sup>67</sup> Even though part of the

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64. See Richard A. Nagareda, *Class Action Fairness Act: Aggregation and Its Discontents: Class Settlement Pressure, Class-Wide Arbitration, and CAFA*, 106 COLUM. L. REV. 1872, 1910-22 (2006); Edward F. Sherman, *Class Actions After the Class Action Fairness Act of 2005*, 80 TUL. L. REV. 1593, 1595-97 (2006); Sarah S. Vance, *A Primer on the Class Action Fairness Act of 2005*, 80 TUL. L. REV. 1617, 1620 (2006); Thomas E. Willing & Shannon R. Wheatman, *Attorney Choice of Forum in Class Action Litigation: What Difference does it Make?*, 81 NOTRE DAME L. REV. 591 (2006) (discussing empirical data regarding the choice of forum decisions made by plaintiffs' attorneys in class actions before and after CAFA).

65. See Kevin M. Clermont & Theodore Eisenberg, *Exorcising the Evil of Forum-Shopping*, 80 CORNELL L. REV. 1507, 1511-13 (1995).

66. *Id.* at 1508.

67. Kevin M. Clermont & Theodore Eisenberg, *Do Case Outcomes Really Reveal Anything About the Legal System? Win Rates and Removal Jurisdiction*, 83 CORNELL L. REV. 581, 593 (1998). While the original data used by the authors compare win rates in federal courts only, the win rate for plaintiffs in suits filed

explanation for these differences is the selection effect—the set of cases that remain in the court where they were filed is different from the ones that were removed and/or transferred—the conclusion that forum matters still holds.<sup>68</sup> Apart from the selection effect, other factors are at work: judicial bias, familiarity and convenience, the rules of procedure, the applicable choice of law, and the contents of the substantive law.<sup>69</sup> It is part of the professional duty of plaintiff's counsel to exploit the variation between different courts by filing where the likelihood of winning is the highest, or more precisely, where the expected value of the claim is maximized.<sup>70</sup>

#### E. *The Supply Side to Unilateral Competition*

The supply side of the market for unilateral choice of court is populated by the judges and lawmakers in the jurisdictions that compete for exercising authority over the case at hand. Their incentives will be explored in more detail below.<sup>71</sup> In the present context, it is sufficient to point to anecdotal evidence that supports the proposition that judges and lawmakers in some, certainly not all, jurisdictions are in the business of attracting claims, particularly in the area of personal injury litigation.

This seems to be true for so-called “hellhole jurisdictions,” primarily located in the south-east, along the coast of the Gulf of Mexico, where courts are said to be more or less strongly biased against corporate defendants, particularly in personal injury suits.<sup>72</sup> The motives of the

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in federal courts is roughly the same as the one in suits filed and decided in state court. *Id.* at 596.

68. *Id.* at 596-99.

69. *Id.* at 599-600.

70. See Kevin M. Clermont & Theodore Eisenberg, *Litigation Realities*, 88 CORNELL L. REV. 119, 122-25 (2002).

71. See *infra* Part IV.B.2.

72. See Stephan Wilske & Todd J. Fox, *The So-Called ‘Judicial Hellholes’ in US Jurisdictions and Possible Means to Avoid Them*, 2 DISP. RESOL. INT’L 235, 235, 239-40 (2008); AMERICAN TORT REFORM FOUNDATION (ATRF), JUDICIAL HELLHOLES (Aug. 18, 2014), <http://www.judicialhellholes.org>.

courts and lawmakers in these jurisdictions are not entirely clear. However, there are allegations that the objective of benefiting the local plaintiffs' bar at the expense of out-of-state corporate defendants plays a role, particularly in states where judges are elected by the general population and must rely on donations for their electoral campaigns.<sup>73</sup> Because local practitioners are the prime contributors to campaigns for judicial office, they represent the constituency of the judges. Given that local attorneys derive a substantial share of their revenues from contingency fees earned in lawsuits brought against out-of-state corporations it is not unimaginable that the local judiciary is responsive to its interest in generous standards for attributing liability and awarding damages. With a view to the State of Mississippi a federal judge of the Fifth Circuit noted explicitly that "its courts have become a Mecca for plaintiffs' claims against out-of-state businesses."<sup>74</sup>

Such characterizations are not uncontroversial as commentators have criticized the surveys underlying the reports on judicial hellholes as seriously flawed.<sup>75</sup> For present purposes, it is not necessary to take sides in this controversy, as it suffices to find variation between the courts of different jurisdictions, together with evidence suggesting that the differences are not a matter of happenstance but of deliberate actions of decision-makers. As to the first point of variation

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73. See the statement of Judge Richard Neely of West Virginia in RICHARD NEELY, *THE PRODUCT LIABILITY MESS: HOW BUSINESS CAN BE RESCUED FROM THE POLITICS OF STATE COURTS* 4 (1988) ("The anarchy that currently prevails among American state jurisdictions absolutely guarantees *politically* that no line of any sort will be drawn. After all, I'm not the only appellate judge who wants to sleep at night. As long as I am allowed to redistribute wealth from out-of-state companies to in-state plaintiffs, I shall continue to do so. Not only is my sleep enhanced when I give someone else's money away, but so is my job security, because the in-state plaintiffs, their families and their friends will reelect me.").

74. *Arnold v. State Farm Fire & Cas. Co.*, 277 F.3d 772, 774 (5th Cir. 2001).

75. See Theodore Eisenberg, *U.S. Chamber of Commerce Liability Survey: Inaccurate, Unfair, and Bad for Business*, 6 J. EMPIRICAL LEGAL STUD. 969, 983-85 (2009); Marc Galanter, *Real World Torts: An Antidote to Anecdote*, 55 MD. L. REV. 1093, at 1103-05 (1996); Jeffrey J. Rachlinski, *Evidence-Based Law*, 96 CORNELL L. REV. 901, 916-17 (2011); Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—and Why Not?*, 140 U. PA. L. REV. 1147, 1149 (1992).

between courts, there is no reasonable doubt that there are “magnet” jurisdictions attracting a disproportionate number of personal injury suits in general, and of large, aggregated cases in particular. The reason for the gravitational pull exerted by these jurisdictions must be that the expected judgment for plaintiffs is higher than elsewhere.<sup>76</sup> This is confirmed by a recent survey of blockbuster punitive damages awards, i.e. awards exceeding \$100 million in nominal dollars. The study found that 41 of the 99 highest punitive damages awards in history were awarded by courts in just two states—California and Texas—while New York’s courts rendered only 2 such awards.<sup>77</sup> For each citizen, the average amount of such blockbuster awards in 2008 dollars was \$136 in New York, \$629 in Texas and \$1,429 in California.<sup>78</sup>

For obvious reasons, the motives of judges sitting in such magnet jurisdictions are difficult to investigate. A famous member of the plaintiffs’ bar in Mississippi characterized his state as a “magic jurisdiction” where the judiciary was elected with “verdict money” so that it was almost impossible for out-of-state defendants to get a fair trial.<sup>79</sup> This suggests that the motive behind plaintiff-friendly decisions may really

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76. Samuel Issacharoff & Geoffrey P. Miller, *Will Aggregate Litigation Come to Europe?*, 62 VAND. L. REV. 179, 190 (2009) (“The post-*Shutts* [Phillips Petroleum Co. v. Shutts, 472 U.S. 797 (1985)] world, however, allowed each local jurisdiction to test its experimental regime not within its geographic boundaries, but wherever similarly situated claimants might happen to be found. Once we add differences in local rules governing aggregation, different legal cultures across the range of potential jurisdictions, the possibility of untoward influence with locally elected judges in some locales, and a range of other such experimental variables, the potential for strategic manipulation of forum becomes ever present. The results were repeated criticisms, some no doubt well founded, of certain choice places being a ‘magnet forum’ or, less benignly, a ‘judicial hellhole’ for the ensnared defendant.”).

77. Alison F. Del Rossi & W. Kip Viscusi, *The Changing Landscape of Blockbuster Punitive Damages Awards*, 12 AM. L. & ECON. REV. 116, 130 (2010).

78. *Id.*

79. The citation is ascribed to Richard Scruggs, in *The Prudential Ins. Co. of America, Asbestos for Lunch* 5, (June 11, 2002), cited in Mark A. Behrens & Cary Silverman, *Now Open for Business: The Transformation of Mississippi’s Legal Climate*, 24 MISS. C. L. REV. 393, 394 (2005); see also Benjamin Reid et al., *Tobacco Lawyers’ Roundtable: A Report from the Front Lines*, 51 DEPAUL L. REV. 543, 545 (2001).

be the desire to attract claims. But even if this were otherwise, the suggestion that a demand side responsive to the plaintiffs' interests does exist may still hold water. Even if every single judge is solely motivated by the honest motive to apply the law, the perception as to what the law says and requires will differ between judges. The motive of plaintiff-friendly judges to further the interests of victims, for example, may lead to judgments that are indistinguishable from outcomes reached by judges who act on the desire to attract claims. For a competitive process to unfold, it does not matter what the underlying motive is as long as courts differ systematically in their attitudes towards plaintiffs so that one court consistently performs better in the eyes of plaintiffs than another. Competition for a plaintiff-friendly court will develop where there is variance between the courts and jurisdictions.

F. *Is Unilateral Competition Desirable?*

Even though the striving of plaintiffs for the court most conducive to their cause may be couched in the terms of competition, it is not the kind of competition economists envisage for an efficient economy and society, as it does not maximize social welfare. From a normative point of view, unilateral competition is a failure because the interplay of supply and demand does not promote social welfare. The outcome cannot be otherwise as the private welfare function of the plaintiff is different from the social welfare function. While plaintiffs care about the prospect of winning, the social welfare function is based not on the number of successful suits but on optimal enforcement of the incentive structure created by the substantive law of contract or by the parties in their agreements.<sup>80</sup> Where the good to be maximized is the number of successful suits brought, competition will force courts and lawmakers to treat plaintiffs ever more favorably. A court that would just rubber-stamp the suits filed, and award judgment for plaintiff without any further ado, would be the most desirable because it produced the most output at the least cost.

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80. See *infra* Part IV.A.4.

Within the realm of dispute resolution, the pursuit of plaintiff's self-interest does not, through the working of the invisible hand, promote social welfare, but rather sets off a race to the bottom.<sup>81</sup> The general presumption that pursuit of individualistic goals furthers the common good does not hold where the counterpart at the other end of the transaction fails to do the same and is willing instead to accommodate the first parties' interests at the expense of third parties. This is exactly what is happening in the realm of unilateral competition for judicial services; plaintiffs want to win, courts that are friendly to their interests follow suit, and the balance must be paid by defendants who, in the extreme, are being denied their right to a fair trial.

This general feature that renders unilateral competition for judicial services undesirable may be present in other areas of legal administration as well. With regard to the competition of states for corporate charters, it is a matter of some dispute whether that race is headed towards the bottom or rather to the top, i.e. competition for a corporate law that helps to maximize social welfare.<sup>82</sup> This is a valid question to ask, as the decision to incorporate or reincorporate in one state rather than another is often not made by the owners of the corporation but by the management. To the extent that the interests of managers differ from those of the shareholders, competition for corporate charters may lead to suboptimal outcomes. However, this discussion cannot be taken up in the present context, as there are major factors working to rein in unilateral competition in the market for corporate charters, such as the involvement of the SEC and the control of management by shareholders and capital markets. Such controls are absent from the market for judicial services.

The closest real-world analogy to unilateral competition in the market for dispute resolution may be the competition of firms for the most favorable bankruptcy forum. Here, too, it has been argued that allowing corporations to choose the bankruptcy court overseeing the reorganization has

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81. See sources cited *supra* note 17.

82. See *supra* note 15 and accompanying sources.

corrupted the bankruptcy system to the benefit of those who make these choices, i.e. the incumbent management of insolvent companies.<sup>83</sup> The race to the bottom competition that resulted from unilateral choice of the bankruptcy forum has favored those courts that adopted a passive attitude, rubber-stamping management's proposals regarding asset sales, critical vendor lists, and prepackaged plans.<sup>84</sup>

#### IV. BILATERAL COMPETITION FOR OPTIMAL DISPUTE RESOLUTION

As we have seen, in a model of unilateral forum choice, the incentives faced by the plaintiff will lead her to choose the court where her chances of prevailing and of securing a high award are maximized and the expected costs of dispute resolution to be borne by the plaintiff are minimized.<sup>85</sup> Bilateral competition will lead to different outcomes because the interests and incentives of both parties, rather than only the plaintiff's, enter the equation.

##### A. *The Demand Side: Shared Interests of the Parties*

What are the incentives that lead the parties in making their choice between one court and another in the situation *ex ante*? Given that a plaintiff wants to maximize the expected payoff from litigation, one might be tempted to think that the parties will want to maximize their joint profit from litigation, in terms of maximizing the size of the award. This proposition is wrong. It implies that the parties seek to reap the benefit of their bargain in the form of sums awarded in court judgments rendered down the road, after a dispute has arisen and has been resolved through litigation. Because litigation is a zero-sum game that causes costs, delay and collateral harm, maximizing the number of disputes does not maximize the parties' joint surplus from their contract but rather harms their interests.

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83. See *supra* note 16 and accompanying sources.

84. See LOPUCKI, *COURTING FAILURE*, *supra* note 16, at 137 (citing attorney M. Blake Cleary of the firm Young, Conaway, Stargatt & Taylor).

85. *E.g.*, *supra* Part III.B.

1. Accurate Enforcement—Efficient Predispute Behavior

In the situation *ex ante*, it is in the interest of both parties to maximize the joint benefit from their contract. In an ideal world, the parties would write a completely specified contract that covers every contingency and set up an incentive scheme that induces behavior that maximizes the joint surplus.<sup>86</sup> The same could be achieved by limiting express contractual language to specific issues only and to rely on default rules for the rest—provided that these default rules promoted efficient solutions. Under the assumption that the parties' contract or any composite of contract provisions and default rules generates incentives which induce behavior that maximizes the pie, and therefore leads to an efficient allocation of resources, the proper function of the courts is to enforce the parties' bargain. An efficient contract will only lead to efficient behavior if breaches of contract are sanctioned by a court imposing the proper remedy, e.g. expectation damages.<sup>87</sup> The court provides the enforcement mechanism that makes the incentives set up by contract or by law sharp. In absence of this enforcement mechanism, the parties would have no legal incentive to comply with the obligations they assumed under the contract. They would resort to self-help remedies, which must be costlier than the civil justice system as otherwise the parties would use them anyway.

While it is obvious that false negatives, i.e. the rejection of valid claims for damages based on breach of contract, undermine the incentives to perform rather than breach, the same has been shown to be true for false positives. If a court grants a claim for damages even though the defendant was not in breach, incentives to perform will be weakened, not

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86. STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 292, 339-41 (2004) [hereinafter SHAVELL, FOUNDATIONS].

87. Even though matters are far more complicated, expectation damages are the proper remedy for breach of contract in many standard cases. *See id.* at 304-09.

strengthened.<sup>88</sup> For a party facing the decision to perform or breach, the crucial yardstick is not the absolute probability of being held liable in case of breach, but the difference between the expected sanction in case of breach and the expected sanction in case of performance. If a court awarded damages for breach of contract randomly, i.e. with a probability of 0.5 regardless of whether there really was a breach, the expected sanction would not influence the parties' behavior at all. Because it would not make a difference in court whether the promisor performed or breached, she would have no financial incentive not to breach where her private gain exceeded her private costs.

In a similar vein, one could imagine that efficient enforcement of contractual obligations requires a court to award damages for breach of contract in the largest conceivable amount. Such a view is mistaken as well. Damages in excess of expectation damages, for example, undermine the incentives the expectation damages remedy is designed to generate.<sup>89</sup> A court that awarded damages greater than losses would create incentives to perform on a contract even where it would be more efficient not to do so, as the costs of performance incurred by the promisor would exceed the harm suffered by the promisee in case of breach. As much as the parties who negotiate a contract have no reason to increase the damage measure beyond expectation damages, there is no reason for them to pick a court that is likely to impose a supra-compensatory remedy.

Rational parties to a contract are interested in putting into practice the incentive scheme established in their contract, i.e. induce behavior such as delivery of the goods and performance of the services that were promised, payment of the price, etc., where this is the efficient thing to do. They have no interest in anything more or less.

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88. See Louis Kaplow, *The Value of Accuracy in Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307, 348 (1994); Louis Kaplow & Steven Shavell, *Accuracy in the Determination of Liability*, 37 J.L. & ECON. 1, 2-3 (1994).

89. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 150-55 (8th ed. 2011) [hereinafter POSNER, *ECONOMIC ANALYSIS*]; Robert L. Birmingham, *Breach of Contract, Damages Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284-86 (1970); Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON., 466, 470-72, 487 (1980).

Consequently, the dispute resolution mechanism of their choice would enforce the provisions of their bargain and of efficient default rules accurately. In doing so, it would deter inefficient behavior and create incentives to maximize the joint gains from the contract. Therefore, the demand of the parties in the situation *ex ante* is for an accurate court or tribunal. Disregarding costs for the moment, this means a court that allows only valid claims in the amount warranted and rejects all invalid claims.

The answer to the question as to what the parties maximize when they negotiate a forum selection or arbitration clause *ex ante* is therefore straightforward: they maximize the gains from trade in the form of inducements to comply with efficient terms in their contract.<sup>90</sup> Other than in the situation *ex post*, the behavior of the parties, e.g., the decision whether to take precautions that make performance more likely or not to do so and instead prepare for breach, is not a fact of the past, but involves options for future actions. The court or tribunal chosen by the parties defines the payoff that will be derived from the choice of one of these options, e.g. breaching the contract, by imposing a monetary sanction.

It is essential to bear in mind that the gains from enforcement of efficient contracts, in the form identified above, may only be reaped in the course of the execution of the contract and before a dispute has even arisen. Once the act that the contract was designed to deter has been committed, e.g. once the promise to perform has been broken, accuracy becomes irrelevant for the parties. Of course, the judgment of the competent decision-maker affects the distribution of wealth between the parties, which explains why they compete for the court most favorable to their interests.<sup>91</sup> However, any gains from efficient pre-dispute behavior have already been lost. In case the promisor expects

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90. See generally Christopher R. Drahozal, "Unfair" Arbitration Clauses, 2001 U. ILL. L. REV. 695, 745-47 (2001) [hereinafter Drahozal, *Unfair Clauses*]; Keith N. Hylton, *Agreements to Waive or Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209, 218-19 (2000); Louis Kaplow, *Private Versus Social Costs in Bringing Suit*, 15 J. LEGAL STUD. 371 (1986); Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11. J. LEGAL STUD. 333 (1982).

91. See *supra* Part III.B.D.

to get away in court even though his decision to breach the contract was opportunistic, i.e. performance would have been the course of action maximizing the pie, he will commit the breach. After the contract has been breached opportunistically, the losses incurred as a consequence thereof are sunk costs that cannot be avoided or retrieved by an accurate decision *ex post*. In the world *ex post*, accurate decisions are important only as guideposts for future parties, similarly situated, who are informed about the sanction to be expected in case of opportunistic breach.<sup>92</sup> For the parties to the present dispute, this positive externality remains irrelevant. However, in the world *ex ante*, when the present disputants agreed on the court or tribunal competent to hear and decide disputes of the future, they were able to anticipate the size of the possible sanction and the probability that it will be imposed in case—and only in case—of an opportunistic breach. Therefore, any gains from an optimal decision-making process that may accrue to the present disputants are predicated on the assumption that the parties, at the time of contracting, know about the level of accuracy supplied by the decision-maker of their choice.<sup>93</sup> It is only then that they are in a position to reap the benefits of accuracy in the form of better incentives to take care and to facilitate performance.

Achieving the goal of accurate enforcement of contractual agreements is not a one-way street where the parties focus on the substantive provisions first and then turn to the dispute resolution clause in order to identify the court best able to enforce their bargain. The two issues of contract drafting and enforcement are intertwined since better drafting may reduce the demands for the courts that are called upon to enforce the contract when a dispute arises in the future.<sup>94</sup> If the parties were able to write an unequivocal contract that no reasonable decision-maker could ever

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92. See *infra* Part V.C.1.

93. See Louis Kaplow, *Accuracy in Adjudication*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 24, at 2.

94. See Albert Choi & George Triantis, *Completing Contracts in the Shadow of Costly Verification*, 37 J. LEGAL STUD. 503, 517, 523-24 (2008); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L. J. 814, 817-18, 830 (2006).

misconstrue, their only concern would be to avoid a corrupt court. In reality, however, it is impossible to draft complete and unequivocal contracts, which is another way of saying that drafting complete contracts would involve transaction costs that would outweigh the gains made from completeness in the form of benefits from added accuracy. Thus, the parties need to balance the investments made in more accurate contract drafting against the costs of dispute resolution to be expected down the road. The higher the costs of drafting more precise contract language and the lower the costs of accurate judicial enforcement, the more the parties will want to rely on the judicial process rather than run up transaction costs in the process of negotiating their contract.

## 2. Enforcement of Judgments

The concern of rational contract parties is not with accurate decisions as such, in the form of a nicely reasoned document created by a court.<sup>95</sup> In reality, the dispute may be far from over after judgment has been rendered. This is not because appeals may be available, as appellate procedures are meant to enhance accuracy given a certain budget of administrative funds and resources.<sup>96</sup> Sure enough, the common interest in accuracy must be targeted at the final judgment in a given case with the design and performance of the appeals process taken into account.

From the perspective of the parties *ex ante*, the gains from accuracy are based on incentives to behave properly, e.g. to render performance rather than to breach a contract where this is the efficient course of conduct. In order to provide the appropriate incentives to do so, the promisor must be confronted with a credible sanction. In case of breach, a credible sanction requires not only that the court would recognize it as such—and award the remedies stipulated in the contract or supplied by legal default rules—but also that, in cases where the losing defendant does not comply voluntarily, the judgment will be enforced against him by the competent authorities. Only if the defendant can be certain

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95. *But cf. supra* note 88 and accompanying sources.

96. See Steven Shavell, *The Appeals Process as a Means of Error Correction*, 24 J. LEGAL STUD. 379 (1995) [hereinafter Shavell, *Error Correction*].

that, in the case of non-performance, a court will hold him in breach, award expectation damages to the plaintiff, and collect by force the sum awarded plus costs and interest, does the defendant face the right incentives to make the decision to either perform or breach.

Assuming by way of illustration that the expectation interest of the plaintiff-promisee is 100 and the costs of performance to the promisor are 90, efficiency requires that the contract be performed. The defendant-promisor will do so if he can be certain that, in case of non-performance, the court will accurately hold him in breach of contract, enter a judgment in the amount of 100, and force him to pay this sum to the plaintiff in the course of execution. However, if the probability for the plaintiff-promisor to prevail in a suit for breach of contract was only 85%, the expected judgment would be worth 85, which is less than the cost of performance. As a consequence, the defendant has no incentive to perform instead of committing breach, even though breach is not desirable from a social point of view. The same inefficient result would be obtained if the court ruled accurately on the merits and awarded damages in the amount of 100, but where the probability of recovery in execution was only 85%.

In well-organized jurisdictions, execution of judgments is assured so that the only concern about collectability is whether the defendant is solvent, i.e. has assets sufficient to cover the sum awarded in judgment. The choice of venue or the one between arbitration and litigation can do very little about judgment-proof defendants, even though the effects of asset limitations on incentives to take care and not to breach contracts are serious and well known.<sup>97</sup> This is different in the international context, where picking the right court may pave the way towards full recovery in execution, while a favorable judgment rendered by the “wrong” forum may prove to be worthless. This is why practitioners specialized in international litigation select the forum with a view to making recovery in execution more likely. The same concern explains why arbitration is so successful in the market for resolution of international disputes: arbitral awards enjoy a

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97. Steven Shavell, *The Judgment Proof Problem*, 6 INT'L REV. L. & ECON. 45, 45-46, 54 (1986).

privilege over court judgments when it comes to recognition and enforcement abroad. Only arbitral awards are subject to the uniform regime of the New York Convention of 1958,<sup>98</sup> while the recognition and enforcement of a judgment of a foreign court remains in the discretion of the lawmakers and judges in the jurisdiction where enforcement is sought.

During the last decade, efforts were made to remedy this situation under the purview of the Hague Conference on Private International Law. The goal was to supplement the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards by a sister convention, which would govern jurisdiction and the recognition and enforcement of foreign judgments.<sup>99</sup> Due to deep differences in opinion between the governments of the U.S. and Europe on how to allocate personal jurisdiction in the international arena, this attempt failed rather spectacularly. The final outcome was not a proposal for a convention covering the two topics of jurisdiction and enforcement, but rather a narrow instrument dealing with forum selection clauses only.<sup>100</sup> The effort made at the Hague Convention provides evidence of how large issues of enforcement and collectability loom in international transactions. The Hague Convention on Choice of Court Clauses at least provides the parties with a device to fix jurisdiction by agreement and to safeguard enforcement of judgments rendered by the court of their choice. In doing so, it places litigation based on consensual forum selection on an equal footing with arbitration that is based on agreements to arbitrate. This helps to stimulate bilateral competition for the best system of dispute resolution across the litigation/arbitration divide.

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98. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 38.

99. See Arthur T. von Mehren, *Drafting a Convention on International Jurisdiction and the Effects of Foreign Judgments Acceptable World-wide: Can the Hague Conference Project Succeed?*, 49 AM. J. COMP. L. 191, 193-94, 200 (2001); Arthur T. von Mehren, *Recognition and Enforcement of Foreign Judgments: A New Approach for the Hague Conference?*, 57 L. & CONTEMP. PROBS. 271, 271-73 (1994); CATHERINE KESSEDJIAN, *INTERNATIONAL JURISDICTION AND FOREIGN JUDGMENTS IN CIVIL AND COMMERCIAL MATTERS* (1997), [http://www.hcch.net/upload/wop/jdgm\\_pd7.pdf](http://www.hcch.net/upload/wop/jdgm_pd7.pdf).

100. See Andrea Schulz, *The 2005 Hague Convention on Choice of Court Clauses*, 12 ILSA J. INT'L & COMP. L. 433 (2006).

### 3. The Tradeoff Between Accuracy and Costs

It would be wrong to think that rational parties would be interested in maximizing the accuracy of outcomes in litigation. Looking back at the variables that determine the unilateral decisions made by plaintiffs, the administrative costs of dispute resolution remain a concern here as well. However, while the plaintiff, when acting unilaterally, only cares about the expected cost to her, the parties together share the interest to limit and minimize the joint cost of litigation.

There is a tradeoff between accuracy and costs in the sense that accuracy is increased when greater resources are spent on litigation.<sup>101</sup> Thus, the efficient outcome involves an exercise in balancing the gains from accuracy against its costs. One way to formulate the rule is that the parties should choose the dispute resolution mechanism that maximizes the difference between deterrence benefits and dispute resolution costs.<sup>102</sup> It makes no difference, but is easier to put into mathematical terms, to turn the calculus around and to target the minimization of the sum of administrative and error costs:  $\min c^a + c^e$ .<sup>103</sup> It is essential to bear in mind that, other than in the case of administrative costs, the costs of error ( $c^e$ ) are incurred not in the course of litigation or thereafter but *ex ante*, before a dispute arises.<sup>104</sup> The costs of error come in the currency of distorted incentives to behave efficiently, i.e. to comply with an efficient rule or contractual provision.

As in the case of unilateral competition, an analysis focusing only on the administrative costs of dispute resolution is too narrow. In addition to these, the loss to the plaintiff caused by the delay in dispute resolution and any collateral harm incurred by both parties in the course of the

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101. See Hylton, *supra* note 90, at 213; Kaplow, *supra* note 88, at 348-54; Spier, *supra* note 48, at 283.

102. Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549, 550 (2003).

103. ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 417 (5th ed. 2008).

104. See *supra* Part IV.A.1.

process must be taken into account. Applying the nomenclature used above, the complete formula would read:  $\min c^{(e)} + c_{ja} + c_{jd} + Z_j$ .<sup>105</sup> In the real world, the parties will not strive to devise the forum that minimizes the outcome of this formula, but rather compare one court to another in order to identify the superior forum, i.e. the one that performs better in balancing accuracy and costs. Given a choice between Court 1 and Court 2, the parties will prefer Court 1 if  $c_{(e1)} + c_{ja1} + c_{jd1} + Z_{j1} < c_{(e2)} + c_{j2} + c_{jd2} + Z_{j2}$  and vice versa.

The objective to minimize the sum of error costs, administrative costs, costs of delay, and collateral harm will lead rational parties to make a joint and reasoned choice between different courts or other mechanisms of dispute resolution. It is just another way of maximizing the pie, one where the pie allows for the possibility of disputes and therefore includes the costs of dispute resolution.

#### 4. Alignment of the Private and the Social Interest

Disregarding externalities,<sup>106</sup> parties maximizing the contractual pie maximize social welfare at the same time. Therefore, the same calculus can be applied by the courts: a court should increase its efforts for accuracy up to the point where the cost of a marginal increase in administrative expenses is equal to the benefits in terms of the gains from more efficient performance of contractual obligations. Because the benefits associated with more accurate enforcement of the law depend on the foreseeability of the court's ultimate decision for the parties *ex ante*, they will vary with context. Where the gain from more accurate adjudication is small or even non-existent, as may be the case with quantum issues where parties are only able to foresee average harm, the court should refrain from investing its

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105. It must be borne in mind that  $Z$  captures not only collateral harm but also collateral gain, as outlined above in Part III. C. 2., and may therefore be either positive or negative. Should the aggregation of collateral costs and collateral benefits represented in  $Z$  lead to a negative value (meaning that in total a collateral gain is given) the formula must read:  $\min c^{(e)} + c_{ja} + c_{jd} - Z_j$ .

106. *See infra* Part V.C.

resources in order to achieve a higher level of accuracy.<sup>107</sup>

B. *The Supply Side: Incentives of Judges, Lawmakers, and Arbitrators*

In the previous section, it has been pointed out that there is a demand for an optimal court in the sense of a dispute resolution mechanism that maximizes the difference between the gains from more efficient behavior due to the threat of accurate enforcement of efficient rules and agreements, and the administrative and collateral costs of whatever dispute resolution mechanism the parties chose. The analysis now turns to the supply side of the market. The fact that there is a demand for an optimal court would remain inconsequential if it did not meet a supply side that was responsive to this demand.

1. The Price of Judicial Services

An initial problem with framing the choice between courts in parallel to a transaction in an ordinary services market is that a market price for judicial services does not exist. Judicial services are not priced in proportion to cost so that supply and demand can never reach a competitive equilibrium that maximizes social welfare. Courts typically charge only nominal fees for their services that fall far short of covering the full costs of the civil justice system. The larger share of these costs is shouldered by the government and ultimately by the taxpayer as the funder of public infrastructure. Regardless of the absolute level of the fees charged, no court sets its fees in proportion to the amount of judicial sweat that goes into resolving a particular claim. Fees are not even meant to serve as an equivalent or at least an approximation of market prices.

2. Judges' Incentives

The shape and outcomes of competition in the market for judicial services depends on the behavior of the judges, which

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107. See Louis Kaplow & Steven Shavell, *Accuracy in the Assessment of Damages*, 39 J. L. & ECON. 191 (1996) (demonstrating that accuracy in the calculation of damages may not be worthwhile in many settings).

in turn is a function of their incentives. While the processes for the selection of judges vary greatly across jurisdictions, no jurisdiction subjects judges to selection by the potential disputants, i.e. by the firms and individuals who have become their “clients.” Once judges have been appointed, they are not paid in proportion to the effort they invest in a given case, let alone that their income reflected whether they did a good or a poor job on the cases assigned to them. Other than in the days of Adam Smith, who described the English courts of the 18th century,<sup>108</sup> judges are no longer paid out of the fees paid into their court by the litigants. Rather, they operate within a framework of constitutional and administrative law that insulates them from the forces of the market. In such an environment, judges do not have a financial incentive to increase demand for their services. Therefore, it is unwarranted to characterize their practice as one of “selling” the service of dispute resolution in a competitive market.

However, in a more modest way that does not aim for allocative efficiency through the operation of perfectly competitive markets, it remains legitimate to think of the judiciary as forming the supply side in a market for dispute resolution services. Even though judges have no financial motive to provide work of high quality, they care about both popularity and prestige. They want to be respected for their abilities by the public at large and by their peer groups including fellow judges and members of the bar.<sup>109</sup> This incentive is particularly strong in jurisdictions where judges are recruited from the ranks of the bar. In these jurisdictions, the peer group of judges continues to be their former colleagues. In England, for instance, the newly appointed judges remain members of the barrister chambers in which they had been working with their colleagues before their calls to the bench. These judges will be concerned about the reputation they continue to enjoy among their former

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108. See 1 SMITH, *supra* note 23.

109. See Robert D. Cooter, *The Objectives of Private and Public Judges*, 41 PUB. CHOICE 107, 129 (1983); Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1, 13-15 (1993) [hereinafter Posner, *Judges and Justices*]; cf. RICHARD A. POSNER, HOW JUDGES THINK 35-40 (2008).

brothers-in-arms. These non-pecuniary goals do entice judges to work much harder than they would have to in order keep their offices. In addition, judges have an incentive to avoid the reversal of their decisions by appellate courts, if only because they enjoy the power to decide what is wrong and what is right.<sup>110</sup>

More detailed findings would depend on a thorough exploration of the incentive structure faced by judges, and they would vary from jurisdiction to jurisdiction, in accordance with the variance in procedures for judicial appointments, rules on tenure and salary, working hours, promotion, independence, etc. As a general proposition it still seems plausible to assume that judges have an interest in deciding challenging and important cases, and in doing this in a way that supports a good reputation among their peers. In a loose sense, therefore, there is competition between individual judges as well as between courts and jurisdictions.

### 3. Lawmakers' Incentives

Judges are not the only actors on the supply side of the market for dispute resolution. Lawmakers are another group whose actions and omissions bear on the quality of dispute resolution services available in a given jurisdiction. Consciously or not, judges and legislators are working together to define the product of judicial dispute resolution as it is offered in a particular locale. In many jurisdictions, the fees charged by courts for the filing and processing of claims are set not by the judiciary, but by the legislature. Often, the legislature also enacts the rules of procedure and determines the size and the organization of the judiciary. In some jurisdictions, legislative committees vote judges into office so that the legislature also determines the composition of the judiciary. It is obvious that these decisions bear heavily on the performance of the court system.<sup>111</sup>

A complete picture of the market for judicial services therefore has to include the members of the legislature and would need to analyze their incentives. This is easier said than done as it requires an exploration into the incentive

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110. See Posner, *Judges and Justices*, *supra* note 109, at 15-23.

111. See *supra* Part III.E.

structure of individual members of the legislature, the aggregation of these incentives into a majority position, a model explaining the interaction of the legislative majority with the executive branch, and finally an idea of how the executive branch forms preferences and acts upon them. While it is impossible to develop a theory of legislative behavior in the present context,<sup>112</sup> it remains possible to explore reasonable hypotheses with regard to the subject matter under consideration. The pivotal question is whether lawmakers have an interest in making their jurisdiction attractive to those parties who are considering it as the jurisdiction of their choice.

The answer is in the affirmative. Even without assuming any preferences regarding the substance of the legal rules in force in a given jurisdiction, lawmakers will take an interest in the enforcement of whichever rules they put in place. Law enforcement, in the sense of applying the law made by the legislature to the facts they were meant to govern, is foremost the business of the courts. Quite obviously, the domestic courts offer the greatest assurance that the domestic law will be applied properly. This explains the tendency of states and countries to extend the jurisdiction of their courts as far as possible through long-arm statutes or other tools.<sup>113</sup>

In addition, lawmakers take an interest in the well-being of the local bar. Either *de facto* or *de jure*, lawyers are restricted to a single jurisdiction or a small number of jurisdictions. This means that litigators depend for their fee revenue on the business of the local courts. If the local courts remain idle, the income of litigators declines. This explains why lawyers in general, and those working in litigation departments in particular, have a strong interest in keeping their courts busy. In a legal environment that allows the disputants to opt out of a particular jurisdiction through a forum selection or arbitration clause, lawyers cannot force contracting parties into their courts. Rather, they must see to it that the local courts are attractive enough not to drive parties away and even to attract more litigants. But why

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112. For an overview, see POSNER, *ECONOMIC ANALYSIS*, *supra* note 89, at 716-20. For a more elaborate treatment, see ROBERT D. COOTER, *THE STRATEGIC CONSTITUTION* 15-78 (2000).

113. *See supra* Part III.D.

should a legislature accommodate this concern? Part of the answer lies in the fact that legal work is a professional service that generates substantial revenues for local suppliers. Lawmakers have an interest in keeping those revenues within “their” economy, and to export them by attracting demand from elsewhere. The well-being and growth of the legal industry keeps voters working in law firms happy, it has positive spill-over effects for other local suppliers such as restaurants and hotels, but also for sellers of real estate and office space, and it contributes directly to the public budget in the form of tax revenues.

In addition to these beneficial effects for the local economy, there is also a public-choice story to be told, as lawyers are a small group with well-aligned and well-defined interests that have proven to be more successful in the political arena than large groups with conflicting and ill-defined interests.<sup>114</sup> This effect is particularly pronounced in the case of attorneys because they tend to control the legislature’s judicial committee, where the important decisions in matters relating to legal services are made. There is empirical evidence that litigators have indeed managed to voice their interests quite powerfully and to advertise their domestic justice system as particularly “competitive.”<sup>115</sup>

#### 4. Arbitrators, Arbitration Institutions, and the Framers of Arbitration Acts

Arbitration is an easy case for competition in the market for dispute resolution services because the supply side is composed of self-interested individuals and institutions that offer their services on a private market.<sup>116</sup> In analyzing the supply side of the market for arbitration it is important not

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114. See MANCUR OLSON, JR., *THE LOGIC OF COLLECTIVE ACTION* 22-36 (1965).

115. THE LAW SOCIETY OF ENGLAND AND WALES, *ENGLAND AND WALES: JURISDICTION OF CHOICE* (2007), sponsored by the law firms of Herbert Smith, Norton Rose and Eversheds, available at [https://www.haitz-rechtsanwaelte.de/de/newsarchiv/data/aktuelles\\_4\\_2.pdf](https://www.haitz-rechtsanwaelte.de/de/newsarchiv/data/aktuelles_4_2.pdf).

116. Cf. Peter B. Rutlege, *Toward a Contractual Approach for Arbitral Immunity*, 39 GA. L. REV. 151, 161-65 (2004) (“These markets for dispute resolution services (both domestic and international) are marked by fierce competition among suppliers.”).

to focus exclusively on the arbitrators as individuals and to view them as the only competitors of judges sitting in courts of law. Rather, the market for arbitration includes arbitral institutions that offer the service of administering arbitral proceedings and serve as intermediaries between the disputants and individual arbitrators ready to accept appointments to tribunals. A recent empirical survey has found that 86% of the awards rendered by arbitral tribunals were made within proceedings administered by an arbitration institution, while the remaining 14% were rendered in ad hoc arbitrations which involve no institution but only a freelance tribunal.<sup>117</sup> Thus, one must expect competition to unfold on three dimensions, namely between individual arbitrators, between arbitration institutions, and finally between the world of arbitration (i.e. institutions and individuals taken together on the one side) and the public courts whose jurisdiction may be derogated on the other.

Any doubts that competition between arbitral institutions such as the AAA,<sup>118</sup> JAMS,<sup>119</sup> ICC,<sup>120</sup> and LCIA<sup>121</sup> actually exists are immediately dispelled by a glance at their websites where the institutions advertise their services in the same manner as other profit-making organizations do.<sup>122</sup> Intensive competition characterizes the market for individual arbitrators too. Practitioners and academics alike compete for lucrative appointments in the arbitration market by participating in conferences, publishing books and articles

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117. PRICEWATERHOUSECOOPERS, *INTERNATIONAL ARBITRATION: CORPORATE ATTITUDES AND PRACTICES* 15 (Queen Mary Univ. of London, ed. 2008), available at [http://pwc.co.uk/en\\_UK/uk/assets/pdf/pwc-international-arbitration-2008.pdf](http://pwc.co.uk/en_UK/uk/assets/pdf/pwc-international-arbitration-2008.pdf).

118. American Arbitration Association, <http://www.adr.org> (last visited Aug. 28, 2014).

119. The registered name is “JAMS—The Resolution Experts.” Originally, JAMS was an acronym for Judicial Arbitration and Mediation services. See <http://www.jamsadr.com/about-the-jams-name> (last visited Aug. 28, 2014).

120. International Chamber of Commerce, International Court of Arbitration, <http://www.iccwbo.org/court> (last visited Aug. 28, 2014).

121. The London Court of International Arbitration, <http://www.lcia.org> (last visited Aug. 28, 2014).

122. See PRICEWATERHOUSECOOPERS, *supra* note 117, at 15 (listing the shares of the different arbitration institutions of the global market of international arbitration).

on arbitration, and trying to build up a reputation by serving on tribunals in a way that they hope the parties will appreciate.<sup>123</sup>

There is also evidence of competition between jurisdictions to attract arbitral proceedings, i.e. arbitrations that are conducted in one particular jurisdiction rather than another.<sup>124</sup> It is no secret that the major jurisdictions serving as seats for international arbitrations, particularly England, France, and Switzerland, are eager to outperform each other. To this end, none of the “big three” resolved to adopt UNCITRAL’s Model Law on International Commercial Arbitration,<sup>125</sup> as such a move would bite off any competitive edge that the English, French or Swiss laws of arbitration may have, or be perceived to have, over their competitors. France and Switzerland even went as far as to enact special rules for international arbitrations, which differ from the legal framework that applies to arbitrating domestic disputes.<sup>126</sup> The separation of the law of arbitration into two distinct areas carries the respective legislature’s intention of attracting international arbitrations on its face.

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123. Edward Brunet, *Replacing Folklore Arbitration with a Contract Model of Arbitration*, 74 TUL. L. REV. 39, 52 (1999).

124. KLAUS PETER BERGER, INTERNATIONAL ECONOMIC ARBITRATION 6 (1993); Christopher R. Drahozal, *Arbitrator Selection and Regulatory Competition in International Arbitration Law*, in TOWARDS A SCIENCE OF INTERNATIONAL ARBITRATION: COLLECTED EMPIRICAL RESEARCH 167, 174 (Christopher R. Drahozal & Richard W. Naimark eds., 2005); Christopher R. Drahozal, *Regulatory Competition and the Location of International Arbitration Proceedings*, 24 INT’L REV. L. & ECON. 371, 373 (2004).

125. United Nations, UNCITRAL MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION (1994), available at [http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671_Ebook.pdf).

126. The motives underlying this split are rarely explained in public. Cf. JEAN-FRANÇOIS PLOUDRET & SÉBASTIAN BESSON, COMPARATIVE LAW OF INTERNATIONAL ARBITRATION, 25-28 (Stephen V. Berti & Annette Ponti trans., 2007).

C. *Evidence of Competition Between Adjudication and Arbitration*

1. Claims and Empirical Findings

Within the literature on arbitration, it is commonly taken for granted that arbitration clauses are a staple in commercial contracts and that hardly any business makes do without them.<sup>127</sup> This claim must be too strong, however, as it cannot explain why courts are still busy resolving commercial cases. The proposition that arbitration is superior to litigation is impossible to confirm or refute, as empirical research is particularly difficult in this area. Even though arbitral institutions publish statistics, these do not include the number of ad-hoc arbitrations that remain in the dark. In addition, knowledge of the number of cases resolved in arbitration has little informational value as long as the total number of disputes, including those that are never filed with a court or arbitral institution, but are resolved by way of negotiation, mediation, and other forms of alternative dispute resolution, remains unknown.<sup>128</sup>

These cautionary remarks are confirmed by a recent empirical survey conducted by Eisenberg and Miller of contracts filed with the SEC. Their research revealed that only 20% of international contracts, and no more than 11% of domestic contracts, included arbitration clauses.<sup>129</sup> A European study on the choice of dispute resolution

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127. Cf. REDFERN & HUNTER ON INTERNATIONAL ARBITRATION, ¶ 1.01 (5th ed. 2009) (“International Arbitration has become the principal method of resolving disputes between States, individuals, and corporations in almost every aspect of international trade, commerce, and investment.”).

128. See Christopher R. Drahozal, *Arbitration by the Numbers: The State of Empirical Research on International Commercial Arbitration*, 22 *ARB. INT’L* 291, 294-95 (2006).

129. Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 *DEPAUL L. REV.* 335 (2007) [hereinafter Eisenberg & Miller, *Flight from Arbitration*]. For a critique of this study, arguing that the flight from arbitration does not happen, see Christopher R. Drahozal & Stephen J. Ware, *Why Do Businesses Use (or Not Use) Arbitration Clauses?*, 25 *OHIO ST. J. ON DISP. RESOL.* 433, 446-76 (2010).

mechanisms in cross-border transactions based on telephone interviews with one hundred businesses suggests that, in Europe, the demand for arbitration is higher. 63% of respondents said that they preferred arbitration to litigation in court.<sup>130</sup>

These findings should not come as a surprise. As has been explored above, the choice between different mechanisms of dispute resolution involves a range of complex variables. In making the choice between arbitration and litigation, the parties must compare the efficiency gains from the accurate enforcement of the incentive structure set up in their contract with the sum of administrative costs, losses from delay, collateral harm with respect to both, and the performance of a hypothetical tribunal and of the competent court. The better the performance of the judicial system within the dimensions of accuracy, administrative cost, delay, and collateral harm, the more favorably it compares to arbitration. Given the variation between jurisdictions, it would be surprising if the results were homogenous.

## 2. International Arbitration

The empirical study cited above confirms the unanimous view that arbitration clauses are more popular in international transactions than in domestic ones.<sup>131</sup> Parties are averse to litigating in the courts of their respective opponents for fear of judicial bias<sup>132</sup> and in order to avoid the use of a foreign language, the retention of foreign counsel, and many other inconveniences that reduce the party's chance of winning in a foreign court. In the international context, arbitration is the only way to secure a truly neutral decision-maker and to thus provide for accuracy in decision-

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130. STEFAN VOGENAUER & CHRISTOPHER HODGES, CIVIL JUSTICE SYSTEMS IN EUROPE: IMPLICATIONS FOR CHOICE OF FORUM AND CHOICE OF CONTRACT LAW 45 (2008), available at <http://denning.law.ox.ac.uk/iecl/pdfs/Oxford%20Civil%20Justice%20Survey%20-%20Summary%20of%20Results,%20Final.pdf>.

131. See Eisenberg & Miller, *Flight from Arbitration*, *supra* note 129, at 341-42.

132. See *supra* Part III.D.1. But see Eisenberg & Miller, *Flight from Arbitration*, *supra* note 129, at 341-42 (doubting that any such bias exists in American courts).

making and the resulting incentives for welfare-enhancing behavior.

A related point that has already been mentioned is the privilege arbitral awards enjoy in the area of cross-border enforcement.<sup>133</sup> Even if one compares international arbitration to litigation in the best public court available in terms of even-handedness and accuracy, arbitration has an inherent advantage, as arbitral awards are easily enforceable across borders under the New York Convention, whereas judgments of public courts are not.

### 3. Domestic Arbitration

Within the context of domestic disputes, enforceability of judicial decisions is assured, and the need to avoid a biased or even hostile decision-maker is much weaker. But still, a substantial number of disputants choose arbitration. In some jurisdictions, arbitration has become a thorn in the side of the public court system so that judges and lawmakers engage in reforms in order to regain market share. Explaining what particular features of the domestic litigation system the parties seek to contract out of is anything but easy, and the answer will vary across jurisdictions. With regard to the American market,<sup>134</sup> however, arbitration promises some additional advantages it misses elsewhere, namely of foreclosing class actions,<sup>135</sup> of curtailing discovery,<sup>136</sup> and of getting rid of juries as decision-makers.<sup>137</sup>

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133. See *supra* Part IV.A.2.

134. See, e.g., the RAND study by DOUGLAS SHONZ ET AL., BUSINESS-TO-BUSINESS ARBITRATION IN THE UNITED STATES, PERCEPTIONS OF CORPORATE COUNSEL (2011).

135. See *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011). As to New York law, see *Ranieri v. Bell Atl. Mobile*, 759 N.Y.S.2d 448 (App. Div. 2003). Christopher Drahozal and Stephen Ware found that “all of the arbitration clauses in consumer contracts (20 of 20, or 100%) contained a class arbitration waiver.” Drahozal & Ware, *supra* note 129, at 444.

136. As to the limits, see *Cole v. Burns Int’l Sec. Serv.*, 105 F.3d 1465, 1482 (D.C. Cir. 1997).

137. See SHONZ ET AL., *supra* note 134, at 15-16; Drahozal, *Unfair Clauses*, *supra* note 90, 710-12.

Beyond these special features, a strong factor weighing in favor of arbitration as compared to litigation is confidentiality.<sup>138</sup> Proceedings in public court are just that—open to the public—so that third parties and journalists have a right to attend and observe them and to inform the public accordingly. In contrast, arbitral proceedings are typically kept private so that no one apart from the parties, their advisors, and the arbitrators, obtain knowledge of the facts disclosed and discussed in the course of the proceedings. The arbitration rules of many institutions impose additional duties of confidentiality on parties, counsel, and arbitrators.<sup>139</sup> Together, these rules foreclose the most important source of collateral harm that the parties might otherwise suffer in the process of dispute resolution.<sup>140</sup>

A second advantage of domestic arbitration as compared to litigation is the right to choose the decision-makers in person, rather than choosing a court as an institution.<sup>141</sup> In the selection process, they may consider a range of concerns, such as their preference for a lawyer familiar with the legal issues raised by the particular case, or for an industry insider, or the desire to sidestep strict legal analysis by

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138. SHONZ ET AL., *supra* note 134, at 18-19.

139. Rule 23 AAA Commercial Arbitration Rules, *available at* <http://www.adr.org/sp.asp?id=22440#R23> (“The arbitrator and the AAA shall maintain the privacy of the hearings unless the law provides to the contrary . . . It shall be discretionary with the arbitrator to determine the propriety of the attendance of any other person other than a party and its representatives.”); Rule 26 JAMS Comprehensive Arbitration Rules and Procedures, *available at* <http://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules> (“JAMS and the Arbitrator shall maintain the confidential nature of the Arbitration proceeding and the Award, including the Hearing, except as necessary in connection with a judicial challenge to or enforcement of an Award, or unless otherwise required by law or judicial decision . . . The Arbitrator may exclude any non-Party from any part of a Hearing.”); Art. 26 (3) ICC Arbitration and ADR Rules, *available at* <http://www.iccwbo.org> (“Save with the approval of the arbitral tribunal and the parties, persons not involved in the proceedings shall not be admitted.”). Art. 22 (3) ICC Arbitration Rules adds that “the arbitral tribunal may make orders concerning the confidentiality of the arbitration proceedings or of any other matters in connection with the arbitration and may take measures for protecting trade secrets and confidential information.”

140. *See supra* Part III.C.2.

141. SHONZ ET AL., *supra* note 134, at 16-17.

avoiding the involvement of lawyers as arbitrators. The opportunity to choose the decision-maker promotes the joint interest in accuracy, in the sense of enforcement of the incentive scheme set up by the parties in their contract.<sup>142</sup>

Still, the advantage of arbitration in terms of accuracy is not beyond doubt. It has been suggested that arbitrators are reluctant to actually decide cases on the merits and to stick faithfully to the contract they are called upon to enforce.<sup>143</sup> They may have an incentive to seek compromises by entering quasi-Solomonic awards—that do no more than splitting the difference—because they want to avoid antagonizing one of the parties. Disappointing one of the disputants by entering a clear-cut decision against it may cause this party to resist that decision-maker's future appointments as arbitrator in other cases. Because arbitrators depend on future business, they will want to avoid such an outcome. Plausible as this theory may sound, it seems difficult to accept that potential disputants share the interest in clear-cut decisions reached under a resolute application of the relevant contractual and legal rules *ex ante*, but forget about this preference *ex post* and sanction arbitrators who live up to this interest by refusing their reappointment.<sup>144</sup>

The other concerns that are frequently put forward to explain the attractiveness of arbitration—savings in costs and time—turn out to be weak upon closer inspection.<sup>145</sup> As far as costs are concerned, much depends on the court system that arbitration is compared to. In any case, the fees charged by three self-employed professionals serving as arbitrators will almost always be higher than the fees charged by a court subsidized by the public. Whether it is possible to make up this structural disadvantage by getting rid of the costly

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142. See *supra* Part IV.A.1.3.

143. SHONZ ET AL., *supra* note 134, at 11-12; Brunet, *supra* note 123, at 42-47.

144. Cf. Stephanie E. Keer & Richard W. Naimark, *Arbitrators Do Not "Split the Baby"—Empirical Evidence from International Business Arbitrations*, 18 J. INT'L ARB. 573 (2001). The RAND study found that corporate counsel thought that arbitrators tended to come out in the middle even though the data gathered from a sample of arbitral awards did not support this fear. Cf. SHONZ ET AL., *supra* note 134, at 11-12.

145. See Drahozal & Ware, *supra* note 129, at 447-49.

appeals processes available in the public system will depend on the individual case. The same reasoning is more or less true for the alleged advantage in delay. Arbitral proceedings may drag on for a long time as it is necessary to coordinate the calendars of at least five professional lawyers, i.e. the two attorneys representing the parties plus the three lawyers serving as arbitrators. In addition, much depends on the particular procedure that is chosen in arbitration. While trade association arbitration follows a no-frills approach that streamlines procedures, focuses on documents, and dispenses with discovery,<sup>146</sup> arbitration of international commercial disputes resembles litigation in court more and more. In as much as arbitration assumes the style of litigation, the potential for substantial savings in cost and time is lost.<sup>147</sup>

In summary, the advantages of arbitration as compared to litigation in public court in the domestic context come in the form of reduced administrative costs, less collateral harm thanks to confidentiality, and greater accuracy. These conclusions were confirmed by the above-cited survey of European businesses. Even though the study was premised exclusively on cross-border transactions, 63% of respondents said that they preferred arbitration because of confidentiality, 21% because of speed, and 3% because of costs.<sup>148</sup>

#### D. *Evidence of Competition Between Civil Justice Systems*

Western systems of civil procedure acknowledge and protect the freedom of the parties to vest jurisdiction in the court of their choice.<sup>149</sup> In practice, many parties make use of

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146. See Brunet, *supra* note 123, at 51-61.

147. Thomas J. Stipanowich, *Arbitration: The "New Litigation,"* 2010 U. ILL. L. REV. 1, 6-7, 11-20 (2010); see also Richard Chernick et al., *The Future of Commercial Arbitration*, 9 PEPP. DISP. RESOL. L. J. 415, 416-22 (2009).

148. VOGENAUER & HODGES, *supra* note 130, at 46.

149. Compare Council Regulation (EU) No. 1215/2012 of 12 Dec. 2012, art. 25, 2012 O.J. (L 351) (providing for strict enforcement of forum-selection clauses, provided that certain formal requirements have been complied with), with *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 593 (1991), and *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972) (providing examples of American courts enforcing forum-selection clauses).

this freedom, as forum selection clauses are a staple in international and domestic transactions. The question is whether the parties, in ascribing jurisdiction, act on the preferences identified above, i.e. that they search for a forum that offers the best balance of accuracy and costs. There is empirical evidence suggesting that this is in fact the case.

A recent survey by Eisenberg and Miller of contracts filed with the SEC in connection with “current reports” involved no less than 2,865 contracts of different variety that were analyzed with regard to their choice-of-law and choice-of-forum clauses.<sup>150</sup> The authors found that the correlation between the choice-of-forum and choice-of-law decision was close to perfect, i.e. 100%.<sup>151</sup> The fact that the parties align their choice-of-law and choice-of-forum decisions supports the proposition that they search for the optimal mix of accuracy in adjudication and litigation costs. It is fair to assume that the court sitting in the jurisdiction, the law of which was chosen, is in the best position to apply that law accurately, and at low cost, as its judges are the ones with the greatest proficiency in the applicable law. For this reason, the best option the parties have is to vest jurisdiction in the courts of the state whose law they choose.

As to the choice between jurisdictions, the study revealed that New York law was chosen in 46% of all contracts,<sup>152</sup> and that 41% of the contracts containing a forum-selection clause designated the New York courts.<sup>153</sup> The dominance of New York as a venue for commercial litigation is not the result of happenstance but rather the product of many factors, which are similar to those that made London, Paris, Zurich, and Geneva popular locations for international arbitrations.<sup>154</sup> As the commercial capital of the U.S. and host to the nation’s leading law firms, New York City is a natural pick for corporate executives and their advisors, if only for its

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150. Eisenberg & Miller, *Flight to New York*, *supra* note 10, at 1487-89.

151. *Id.* at 1506.

152. The rate was even higher if merger contracts were excluded with their disproportionate share of clauses invoking Delaware law. *Id.* at 1489-92.

153. *Id.* at 1504.

154. *See infra* Part V.A.

proximity.<sup>155</sup> For this reason, New York's courts were able to develop skills and gain experience in the resolution of commercial disputes that attracted even more business.<sup>156</sup>

The judges and lawmakers in the State of New York contributed their own share in making the city the preferred venue for business litigation. The most important policy choices made in New York to strengthen the jurisdiction as a venue for the resolution of commercial disputes was to honor choice of law and forum selection clauses as long as they remain within the bounds set by the exceptions of public policy and fraud in the inducement, which in turn are construed narrowly and applied with great care.<sup>157</sup>

On top of that, in the course of the 1990s, New York created the Commercial Division of its Supreme Court, first in New York County and later in other districts of the state. The idea behind this initiative was to offer high-quality judicial services for the resolution of high-stakes commercial cases in an effort to attract more such business to the state. Today, the Commercial Division advertises its services in a similar manner to private arbitration institutions.<sup>158</sup> In the judgment of the legal community in New York, the Commercial Division manages to live up to this self-description, as it is regarded as an "unqualified success."<sup>159</sup>

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155. For a full development of the "New York Hypothesis," see Eisenberg & Miller, *Flight to New York*, *supra* note 10, at 1481-87.

156. As to network effects, see *infra*, Part V.A.

157. See Geoffrey P. Miller & Theodore Eisenberg, *The Market for Contracts*, 30 CARDOZO L. REV. 2073, 2080-92 (2009).

158. Commercial Division N.Y. Supreme Court, History, <http://nycourts.gov/courts/comdiv/history.shtml> ("The Commercial Division serves as a forum for resolution of complicated commercial disputes. Successful resolution of these disputes requires particular expertise across the broad and complex expanse of commercial law. . . . The caseload of the Division is thus very demanding, requiring of the court scholarship in commercial law, experience in the management of complex cases, and a wealth of energy. The Commercial Division has actively sought to employ advanced technology to assist in handling its caseload effectively.").

159. Mitchell L. Bach & Lee Applebaum, *A History of the Creation and Jurisdiction of Business Courts in the Last Decade*, 60 BUS. LAWYER 147, 158 (2004) (quoting Tamara Loomis, *Commercial Division: High-Profile Case Casts Spotlight on Well-Regarded Court*, N.Y.L.J. June 20, 2002, at 5).

### E. *Is Bilateral Competition Desirable?*

#### 1. Accuracy of Adjudication Promotes Social Welfare

The question remains whether competition between the courts of different jurisdictions, as well as between judicial and arbitral resolution of disputes, promotes social welfare. With regard to unilateral choice of forum the answer has been in the negative.<sup>160</sup> Bilateral competition is different. Rational parties are interested in maximizing the pie through the choice of efficient contract terms and default rules. For the incentive schemes set up by the parties and the lawmakers to work, there must be an enforcement mechanism that sanctions non-compliance, but leaves compliant parties alone. In fact, the law and economics literature always assumes, without saying so, that the efficient incentive scheme set up by the substantive law or the parties' agreement is enforced accurately in cases of non-compliance. More precisely, for the incentive schemes of the substantive law to work, there must be a procedural mechanism that sanctions offenders and spares innocent parties.<sup>161</sup>

On this view, society at large is nothing but a large group of potential litigants. In parallel to the two parties to a contract, rational members of society would choose the court that promises to enforce efficient contracts and efficient legal rules accurately, subject to cost. The parties' incentives to choose an accurate court are congruent with the social interest in courts that minimize the costs of error.<sup>162</sup>

#### 2. A Race to the Top

If it is true that the parties jointly prefer courts and tribunals that render accurate decisions, more precisely, that balance accuracy and costs in an optimal way, and that arbitrators, judges and lawmakers respond to this demand, then bilateral competition results in a race to the top. Bilateral competition creates incentives for the decision-

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160. *See supra* Part III.F.

161. *See supra* Part IV.A.1.

162. *See* COOTER & ULEN, *supra* note 103.

makers in the judicial systems and in arbitral institutions to improve accuracy up to the point where further advances come at a cost that outweighs the benefits. The result is a dynamic process that favors those courts and institutions that are best in balancing accuracy and costs and that are most responsive to whatever other preferences the parties might have jointly. While unilateral competition imposes costs on society, bilateral competition promotes welfare.

### 3. Efficient Courts and Inefficient Law

The proposition that accuracy in adjudication promotes social welfare only holds true if the substantive law governing the subject matter of the dispute promotes social welfare too. The private interest in accuracy maps on to the corresponding social interest only if the contract that stands to be enforced is itself efficient. On the assumption that the parties wrote a contract that maximizes social welfare, the accurate enforcement of such a contract maximizes social welfare as well. It is generally assumed that the parties write efficient contracts, but not all disputes involve contractual obligations. Where the suit is based on tort or some other statutory or judge-made rule of non-contractual liability, accuracy in dispute resolution contributes to social welfare only if the rule itself is efficient. The meticulous enforcement of an inefficient rule does not promote social welfare but does just the opposite.

If the assumption of efficient substantive rules is relaxed, matters become more complicated. Where the parties are authorized to contract around the inefficient rule, they will do so and search for a court that promises to accurately implement their agreement instead of the legal rule. Where the inefficient substantive rule is mandatory, the parties will be lost in public court, regardless of the forum they happen to choose. However, they might still be able to get away with a contractual derogation from the inefficient rule if they find a decision-maker willing to enforce their bargain. Arbitrators may be prepared to do just that in an effort to compete away business from the courts.

## V. IMPEDIMENTS TO EFFICIENT MARKETS IN DISPUTE RESOLUTION

A. *Network Effects*

The evidence from the world of international arbitration as well as from the litigation market within the United States suggests that the race to the top is seriously delayed by network effects that help established jurisdictions to defend their advantage, even if outperformed by other, less-established ones.<sup>163</sup> Network externalities explain why markets for consumer electronic appliances such as personal computers, DVD-players, and smart phones tend to gravitate towards a small number of technological standards, or even a single one. In essence, the more consumers become members of a community of users of a particular product standard, the more valuable such products become for all the members of the community. With the presence of network effects, markets are subject to first-mover and lock-in effects. Firms that are successful in establishing a network of users may defend their position much more easily than they would otherwise because their customers face substantial costs of switching to another product-standard, even if the latter is superior.

The same forces operating with regard to certain products that cause the market to gravitate towards a small number of technological standards have been shown to be at work in the market for corporate charters, where the persistent domination of Delaware is best explained by the first-mover advantage.<sup>164</sup> Contract terms are another

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163. See *supra* Part IV.D.

164. For a historical account of the development leading to the dominance of Delaware replacing New Jersey as the front runner in the charter business market, see Cary, *supra* note 17, at 664-65; see also Lucian Arye Bebchuck, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. R. 1437, 1443 (1992); David Charny, *Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L. L.J. 423, 427-28 (1991); Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 213-14 (2006).

“product” that is susceptible to network effects.<sup>165</sup> The more parties use a particular system of contract law, the greater the system’s utility for the users. However, the additional utility generated by a popular system of contract law is not generated by abstract legal rules, but by the day-to-day work of courts and commentators.<sup>166</sup> Where contracts made under a particular law are plenty, disputes will tend to be numerous too, so that the courts find enough cases to apply, clarify, and amplify abstract legal standards. The legal profession collaborates with the courts in this enterprise, and gains in expertise and experience as well.

What is true for contract terms is also true for arbitration and adjudication. In fact, contract terms and judicial dispute resolution are bundled together, as the precise meaning and validity of contract terms and default rules cannot be determined without reference to case law developed by the courts.<sup>167</sup> Rational parties interested in accurate enforcement of their bargain are well-advised to select the dispute resolution mechanism and the applicable law in tandem, as a package, rather than one after another. As empirical studies have revealed, choice of law and choice of forum are bundled together so that everything that has been said with regard to the choice of contract terms also applies to the choice of judicial services.<sup>168</sup>

As a consequence, the market for judicial services will be haunted by network effects as well. The history of the business courts in the United States provides an example as it suggests that the market for high-quality judicial services is subject to serious first-mover effects.<sup>169</sup> Even though the example of New York was copied by many other states, these “subsequent movers” never managed to break the dominance

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165. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774-89 (1995).

166. *Id.* at 775-79, 782-84 (detailing “interpretive network externalities” and “legal services network externalities,” respectively).

167. See *supra* Part IV.D.

168. See Eisenberg & Miller, *Flight to New York*, *supra*, note 10, at 1487-89, 1509-10.

169. For a brief history of New York’s Commercial Division, see Commercial Division N.Y. Supreme Court, *supra* note 158 and accompanying text.

of New York.<sup>170</sup> The same is true in the market for international arbitrations that is dominated by a small set of well-established venues, i.e. Zurich, Geneva, Paris, and London.<sup>171</sup> It takes time and persistent diligence to build up a reputation for excellence in business litigation and in the support of international arbitral proceedings. The better the quality of the law, the richer the case law interpreting and applying the substantive and procedural rules; and the broader the experience of the courts, the more attractive a jurisdiction becomes as the preferred venue for business litigation, commercial arbitration, or incorporation of companies. Once a jurisdiction and its courts have gained an edge over competitors, it becomes extremely difficult for the latter to catch up and to lure litigants into their own courts and arbitration venues.

If network effects do exist in the market for dispute resolution, then the conclusion that competition in this market will result in a race to the top must be qualified. The first-mover and lock-in effects prevent the actors on the demand side of the market, i.e. the parties seeking dispute resolution services, from selecting offers which are superior to the established ones on a stand-alone basis, but lack the positive network effects that come with an entrenched market position.<sup>172</sup> As a consequence, well-established jurisdictions may be able to defend their position and continue dominating the market even though they are well off the mark, i.e. fail to satisfy the parties' preferences to the greatest extent at least cost.

## B. *Agency Problems*

### 1. Drafting Dispute Resolution Clauses

The preceding analysis was premised on the parameters that rational parties use in making the choice between different mechanisms or institutions of dispute resolution such as courts and arbitral tribunals. In reality, however, it

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170. For an overview of the landscape of the business courts, see Bach & Applebaum, *supra* note 159, at 160-228.

171. *See supra* Part IV.D.

172. Klausner, *supra* note 165, at 789-825.

is a rare exception that the parties negotiate and agree on a dispute resolution clause in person. In real-world transactions, at least the technical provisions of contracts are normally drafted and negotiated by attorneys, not by the parties themselves. More sophisticated parties will take an interest even in these clauses and probably bring in-house counsel to the negotiating table in order to oversee the process, but this is only done where the stakes are high. In the remaining cases, the attorney remains in charge and advises the client about the perceived benefits and costs of one option or another.

## 2. Lawyers as Agents of Their Clients

It is received wisdom that the relationship between the client and his lawyer creates a principal-agent problem.<sup>173</sup> The incentives of lawyer and client are not identical as the lawyer has an interest in maximizing her income from fees, whereas the client is interested in maximizing the balance of the sum received on his claim in settlement or upon litigation minus the costs involved in the process, including the fees charged by his lawyer. In addition, the lawyer, as the agent, enjoys an informational advantage over her client with regard to the legal issues involved, including the parameters that should enter the choice-of-law and choice-of-forum decisions to be made by the client. Thus, the client is unable to fully observe his lawyer and to sanction deviations from the course of action that is in his best interest, and the lawyer is in a position to exploit her client. The distortion of the lawyer's incentives and the resultant losses to the client have been explored at length with regard to areas such as remuneration of lawyers, particularly the choice between hourly fees and contingency fees, and the decision to either

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173. See COOTER & ULEN, *supra* note 103, at 431-34; Dammann & Hansmann, *supra* note 10, at 17-18; Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509, 527-29 (1994); Geoffrey P. Miller, *Some Agency Issues in Settlement*, 16 J. LEGAL. STUD. 189 (1987).

settle or litigate.<sup>174</sup> In contrast, the principal-agent problems involved in the choice of forum or other dispute resolution mechanisms have not been the subject of systematic exploration as of yet.<sup>175</sup>

### 3. The Choice-of-Forum Decision

For a self-interested lawyer who wants to maximize fee revenue, the overriding objective is to keep herself in business and not to lose the client to somebody else. Otherwise, there will be no fees to earn at all. The prime objective of not losing the client to a competing lawyer would be inconsequential if lawyers were admitted in any court anywhere, but this is not reality. All over the world, lawyers are admitted only in the courts of a particular jurisdiction and are thus not authorized to represent the client in courts outside of this jurisdiction. Within the U.S., lawyers are restricted to the jurisdiction in which they are licensed to practice, and while ownership of multiple licenses is possible, attorneys practicing in a multitude of states are the exception.<sup>176</sup> Even absent regulations tying lawyers to particular courts and areas, clients are well advised to retain the services of local counsel as procedural rules and actual court practices vary from jurisdiction to jurisdiction and from court to court. It is highly risky and may even amount to malpractice if a lawyer represents a client in a court of whose routine and procedure she knows nothing about. For these reasons, the preference for hometown justice that has been identified as an important heuristic in cases of unilateral forum choice by rational plaintiffs<sup>177</sup> will be much stronger in attorneys than in their clients.

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174. COOTER & ULEN, *supra* note 103, at 431-34 (exploring the incentives under various billing mechanisms); Miller, *supra* note 173 (exploring the distortion of incentives to settle); cf. SHAVELL, FOUNDATIONS, *supra* note 86, at 435-37.

175. See David P. Kessler & Daniel L. Rubinfeld, *Empirical Study of the Civil Justice System*, in 1 HANDBOOK OF LAW AND ECONOMICS, *supra* note 48, at 375-77 (analysing the choice of law and choice of forum decisions without taking the agency problem into account).

176. Regarding choice of forum in disputes involving corporate law, cf. Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999, 1010-11 (1994).

177. See *supra* Part III.D.1.

The fact that lawyers have a strong incentive for hometown justice is bad news for competition between judicial systems. Even if counsel realizes that an out-of-state court is superior to the municipal one, she will resist advising the client to take advantage of the foreign court because that would involve sending him to a competitor. This pessimistic conclusion need not be the end of the story, as the legal profession has evolved in ways that mitigate the anti-competitive tendency of local practice. The emergence and growth of large law firms operating nationwide and internationally tends to alleviate the preference for hometown justice. A law firm that has offices in every major jurisdiction need not fear losing the client upon the recommendation of turning to a foreign venue. The local office at the seat of the optimal court could take over the client, and the firm would not lose any revenue.

Even within firms with offices in many jurisdictions, it would be naive to think that the trend towards hometown justice simply goes away. Large law firms are anything but a family business contributing to a common pool of revenue, but are rather a more or less tight band of local offices. There definitely remains inter-office competition between local offices as well as intra-office competition between partners practicing in the same office. As a consequence, a partner practicing in jurisdiction *A* will not feel indifferent about losing a client to a colleague practicing in an office of the same firm in jurisdiction *B*, even if the courts in *B* outperform those in *A*. This may explain the strong demand for arbitration in international commercial cases involving sophisticated parties. In contrast to litigation in public courts, representing a client in arbitration does not require that counsel be admitted to the bar at the seat of arbitration. Resorting to arbitration enables counsel to correctly advise the client to opt out of the local court system without the risk of losing him to a competitor.

### C. *Externalities*

#### 1. Demonstrating and Developing the Law

Dispute resolution is not the sole function of judicial systems. It is helpful to further differentiate the so-called

rulemaking function of the judicial system into two sub-categories, one being the interpretation and application of the law to individual disputes, the second being the development of new legal rules.

The interpretation and application of abstract legal norms to specific fact patterns informs the public, including potential litigants of the future, about the legal rules, standards, and requirements, as they apply to actual behavior. The display of the “law in action,” or rather, “the law as it applies to individual cases,” to parties in a similar position as the current litigants yields important benefits. Those parties who are already entangled in a dispute similar to the one that was just resolved receive valuable guidance as to the prospective outcome of litigation in their own case. This enables the parties to form realistic expectations about the probabilities of winning or losing, which in turn furthers their chances of reaching an amicable settlement. Needless to say, early settlement promotes the interests of both the litigants and the public, as it helps to save substantial resources that would otherwise be spent on litigation.

Furthermore, publicized decisions of the courts help parties who still find themselves in the position *ex ante*, in the course of negotiating their contract, to draft their contract in accordance with their preferences. Where the court, in a prior judgment, interpreted a default rule, they may want to contract around it; where the court interpreted contract language, the litigants of the future will know better which words and phrases to use and which to avoid. Where the subject matter of the prior dispute involved a mandatory rule, the parties might want to avoid its application by using a different legal framework that does better in translating their preferences into a viable legal instrument.

The benefits just described are not being generated by the interpretation and application of the law as such, but by its interpretation and application under the eyes of the public and by a competent authority. If the courts kept their decisions secret, potential disputants would be left without a blueprint for the resolution of their disputes and without guidance for adjusting their behavior. However, the publication of judicial decisions is not the only thing that matters; another one is the requirement that they are made

by a competent body wielding sovereign power. It does not help much if three law professors draw together, form a panel, try a case, and then publish their interpretation of the law and its application to an individual fact pattern. Private judicial bodies lack the power necessary to interpret and apply the law with public authority, and are thus unable to establish precedent that provides guidance for disputes of the future.

The same considerations also apply to the rulemaking function in the narrow and technical sense, i.e. the development of the law into new areas not anticipated by the courts and lawmakers of the past. Again, any benefits of judicial development of the law and the making of new rules depend on published legal opinions. Bold decisions would remain inconsequential if they were taken privately and remained “in camera.”

## 2. Externalities of Arbitration

The fact that the choice of dispute resolution mechanisms other than litigation in court may do harm to the amplification and rulemaking functions of the courts is well known from the interface of litigation and arbitration. One striking illustration is the drying up of the stream of court decisions in disputes between securities dealers and their clients after the U.S. Supreme Court reversed its course in the case of *Shearson/American Express, Inc. v. McMahon* and affirmed the arbitrability of statutory claims arising under the Securities Exchange Act of 1934.<sup>178</sup> On its face, this decision strengthened the role of party autonomy in honoring arbitration agreements, but in reality it led to a complete shift away from litigation in public court to the benefit of arbitration organized by the exchanges or under the auspices

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178. *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 227-38 (1987). The authority of the parties to refer disputes to arbitration includes claims arising under the RICO Act. 18 U.S.C. § 1961 et seq. (2012); *Shearson*, 482 U.S. at 242; *Kowalski v. Chi. Tribune Co.*, 854 F.2d 168, 173 (7th Cir. 1988) (Posner, J.). Prior decisions held that RICO claims were not arbitrable. *S.A. Mineracao da Trindade-Samitri v. Utah Int'l, Inc.*, 745 F.2d 190, 196 (2d Cir. 1984).

of the NASD and, today, of FINRA.<sup>179</sup>

With regard to the externality problem, the crucial point is not the often-heard criticism that securities arbitration disadvantages the “one-shotter” plaintiff to the benefit of the repeat player,<sup>180</sup> but the dearth of public trials and rulings accessible to the public that results from taking whole categories of disputes private by way of arbitration. While it is true that the NASD and FINRA tried to address this concern by requiring that awards be published,<sup>181</sup> publication is of little value because more than 90% of the awards rendered in securities arbitration come without reasons.<sup>182</sup> Arbitral decisions that do not disclose the underlying reasoning and that, consequently, do not cite any precedent are practically worthless as contributions to the amplification and development of the law.<sup>183</sup>

The disinterest in reasoned opinions and the avoidance of precedent that characterizes securities arbitration does not characterize arbitration in general, as arbitral routine in other areas may be entirely different. Arbitral tribunals dealing with employment disputes routinely provide reasons and draw on precedent, primarily in the form of judicial

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179. See William W. Park, *Amending the Federal Arbitration Act*, 13 AM. REV. INT'L ARB. 75, 105-06 (2002); Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1107 (1993).

180. Marc Galanter, *Why the Haves Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95 (1974); cf. Edward Brunet & Jennifer J. Johnson, *Substantive Fairness in Securities Arbitration*, 76 U. CIN. L. REV. 459, 486-91 (2008); David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 60-66 (1997). *But see* Drahozal, *Unfair Clauses*, *supra* note 90, at 749-71.

181. FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA), CODE OF ARBITRATION PROCEDURE FOR CUSTOMER DISPUTES § 12904(h) (2013) (“All awards shall be made publicly available.”).

182. Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 123, 144 (2005); W. Mark C. Weidemaier, *Judging Lite: How Arbitrators Use and Create Precedent*, 90 N.C. L. REV. 1091, 1104 (2012).

183. Brunet & Johnson, *supra* note 180, at 472-74.

decisions, to support their legal conclusions.<sup>184</sup> But even then, the decision of an arbitral tribunal is not the same as a judgment of a court of law.<sup>185</sup> It cannot be challenged on appeal, so that decisions of intermediate courts of appeal that may serve as a laboratory for testing the available options and supporting arguments never happen. On the assumption that the appeals process is not a legal nicety, but an effort not only in improving accuracy of decision-making but also at amplifying and developing the law at least cost,<sup>186</sup> an arbitral system of dispute resolution misses out entirely. The point is not that arbitrators do worse than courts of first instance or even appellate judges. If they were, the parties would be ill-advised to contract out of the court system in favor of arbitration and one could trust that, over time, the parties would remedy the problem and come back to the judicial system. The point is rather that the parties choose a dispute resolution mechanism that may be good for them individually, without taking account of the interest of the general public, i.e. future litigants, in authoritative interpretation and application, as well as the development of the law.<sup>187</sup> The arbitrators and the parties who have to pay for their services take a free ride on the efforts of the public courts to interpret, amplify, and develop the law.

The free-riding of the parties to arbitral proceedings on the public court system is rather harmless as long as there is a constant stream of judicial opinions. Obviously, not only money but also court decisions are subject to the law of decreasing marginal utility. If a judicial system decides a few thousand civil cases per year, society can easily dispense with a dozen, a hundred, or even a thousand cases that go to arbitration. But this is true only if these cases are drawn more or less at random from the pool of all disputes so that the courts still see cases of all varieties. Problems arise if arbitration is so pervasive in one particular area that there

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184. Weidemaier, *supra* note 182, at 1111-24.

185. See W. Mark C. Weidemaier, *Toward a Theory of Precedent in Arbitration*, 51 WM. & MARY L. REV. 1895, 1947-49, 1952 (2010).

186. See Shavell, *Error Correction*, *supra* note 96, at 415-17.

187. See Landes & Posner, *supra* note 1, at 248-49; Shavell, *Error Correction*, *supra* note 96, at 424.

are no more court decisions to guide arbitral decision making at all. In the U.S., this has been the outcome in the area of securities litigation against brokers, but also with regard to some types of consumer transactions where arbitration has become de-facto mandatory.<sup>188</sup>

### 3. Opting into the Court System of Another Jurisdiction

The frustration of the rule-demonstration and rule-making functions of judicial dispute resolution is not limited to agreements steering cases away from the courts and towards arbitral tribunals. The same problem may arise where the parties opt out of the court system of one jurisdiction and into the judicial system of another.<sup>189</sup> To the extent that the prorogated court applies the law of another jurisdiction rather than its own, its decision will not count as precedent in the courts of the derogated jurisdiction. But even if this were otherwise and the judges in the derogated jurisdiction paid attention to the rulings of their brothers and sisters abroad, the judges of the prorogated court have little incentive to invest their scarce resources in terms of time and energy into the amplification and the development of foreign law. It is received wisdom that the quality of judicial decisions made under foreign law is not the same as the one of decisions applying the *lex fori*.<sup>190</sup> The courts of the derogated jurisdiction, in turn, accord no precedential, or even persuasive, value to decisions reached in other jurisdictions.

There is an obvious way to circumvent all these concerns, and that is to realign forum selection and choice of law by opting into the substantive law of the same jurisdiction that also hosts the forum. The court will then apply its own law

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188. See Linda J. Demaine & Deborah R. Hensler, "Volunteering" to Arbitrate Through Predispute Arbitration Clauses: The Average Consumer's Experience, 67 *LAW & CONTEMP. PROBS.* 55, 62 (2004); Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 *STAN. L. REV.* 1631, 1638 (2005).

189. See Dammann & Hansmann, *supra* note 10, at 18-20.

190. Th. M. De Boer, *Facultative Choice of Law*, in 257 *COLLECTED COURSES OF THE HAGUE ACADEMY OF INTERNATIONAL LAW* 223, 316-28 (1997).

with the same diligence and care as in purely domestic cases, and the precedential value of the decision that is ultimately reached is out of the question. In fact, empirical studies have shown that most parties make forum selection decisions that map onto their choice of law decisions.<sup>191</sup> In theory, one could imagine an outcome where the parties escape from an individual jurisdiction in large numbers, choosing foreign law and selecting the respective court system so that the courts in the derogated jurisdiction are rendered idle.

Such a scenario would create problems for both jurisdictions. The winning jurisdiction that attracts all the additional business from abroad will suffer from a winner's curse of a special variety as the perceived advantage of judicial services will clog its courts and delay the resolution of the disputes brought by its own citizens and taxpayers. The host jurisdiction would be forced to counteract this effect by raising court fees to the level necessary to cover costs or to adopt a split fee system; one for domestic and international transactions involving at least one of its own citizens and another schedule with elevated fees for cases between two foreign parties.<sup>192</sup> The net effect for the host jurisdiction will still be positive since importing disputes from abroad amounts to an export of legal services that creates local revenue and contributes to the public purse through sales and income taxes.

Even if the balance for the host jurisdiction may remain positive, the net effect for the derogated jurisdiction is necessarily, and unavoidably, negative. On the realistic assumption that citizens turning to foreign courts are forced to solicit the services of the bar in the country of destination, the flight from one jurisdiction amounts to an import of legal services that must be compensated for by exports of other goods and services. Furthermore, a jurisdiction that lost its judicial business to a competitor would cut off the stream of judicial decisions that illustrate, amplify, and develop the law. It would abdicate essential parts of its sovereign power to another jurisdiction that gained the upper hand in the

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191. See Eisenberg & Miller, *Flight to New York*, *supra* note 10, at 1487-90.

192. This option is explored and embraced by Dammann & Hansmann, *supra* note 10, at 59-69. It must be noted that there are serious constitutional restrictions that may destroy the proposal of differentiated court fees.

development of the law governing private transactions. On the assumption that state law is shaped by the preferences of the respective constituency, these preferences would be frustrated.

## VI. THE CHOICE BETWEEN UNILATERAL AND BILATERAL COMPETITION

The preceding analysis of competition of judicial systems has led to split results: while unilateral competition of plaintiffs for a favorable court will instigate a race to the bottom, bilateral competition of both parties for an optimal court rather suggests a race to the top that offers the best tradeoff of accuracy and costs. The forces created by the two kinds of competition are not congruent; rather, they pull in opposite directions. While the unilateral demand of plaintiffs leads courts to adopt ever more expansive rules of jurisdiction and fact-gathering, and ever more victim-friendly rules on choice of law, aggregation of claims, and liability to the detriment of defendants based outside of the jurisdiction, bilateral competition creates incentives to accurately enforce the bargain made by the parties, as well as to implement efficient rules of law. It seems that jurisdictions must make a choice whether they want to compete on one dimension or the other, as an open heart for plaintiffs is at odds with striving for accuracy. Lawmakers and judges need to decide whether to afford plaintiffs ever more generous protection or whether to strictly enforce the contracts made by the parties and efficient rules of law that apply to the facts of the case at hand.

Against this background, it comes as a surprise that the empirical findings of Eisenberg and Miller on the most popular venues for business litigation are contradicting the ranking of state liability systems by the U.S. Chamber of Commerce.<sup>193</sup> In this survey, New York performs poorly, occupying the twenty-third rank among the states,<sup>194</sup> while it

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193. Eisenberg & Miller, *Flight to New York*, *supra* note 10, at 1500.

194. U.S. CHAMBER OF COMMERCE, 2010 STATE LIABILITY SYSTEMS RANKING STUDY, 14, 89 [hereinafter U.S. CHAMBER OF COMMERCE], *available at* [http://court.state.de.us/Superior/pdf/harris\\_2010.pdf](http://court.state.de.us/Superior/pdf/harris_2010.pdf).

was identified as the preferred venue for commercial litigation in the U.S.<sup>195</sup> How can that be? The fact that New York performed so well in Eisenberg and Miller's study and so poorly in the eyes of the Chamber of Commerce suggests that one of studies must have gotten it wrong. If jurisdictions must make a choice whether to engage in unilateral competition for more claims or in bilateral competition for better outcomes, one would expect that New York ranked first, or last, or occupied whatever rank in between, as long as it was the same in both studies.

However, there might be an explanation for the opposite findings that is consistent with the empirical findings of both surveys. The source of the conflict seems to be that the Eisenberg and Miller study focused on conflicts that grew out of commercial contracts,<sup>196</sup> while the U.S. Chamber of Commerce's ranking is based on the full range of disputes, prominently including suits for damages in personal injury cases, class actions, and mass torts.<sup>197</sup> As a top priority for state legislatures, the Chamber's study nominates tort reform and caps on damages—two topics that are close to irrelevant for commercial litigation.<sup>198</sup> It may well be that New York, by creating the Commercial Division of its Supreme Court, managed to set contract litigation apart from other disputes in general, and from tort litigation in particular. If this were true, the state managed to compete on two fronts at the same time, namely for tort plaintiffs who make the unilateral decision in favor of a friendly forum, and for commercial parties negotiating a forum selection clause in search of a court that strikes the optimal balance between accuracy and costs.

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195. Eisenberg & Miller, *Flight to New York*, *supra* note 10, at 1503-09.

196. *Id.* at 1487-89.

197. U.S. CHAMBER OF COMMERCE, *supra* note 194, at 23, 25-26 (naming the treatment of tort litigation, class actions and mass consolidation suits, and damages among the key elements of the rankings).

198. *Id.* at 16.