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Ex ante Contracts to Arbitrate Tort Claims - A law and economics perspective

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A law and economics perspective

De overeenkomst ex ante tot arbitrage bij  
vorderingen uit onrechtmatige daad  
Een rechtseconomisch perspectief

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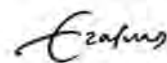
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ALMA MATER STUDIORUM  
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Universität Hamburg



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European Doctorate in Law and Economics

**“*ex ante* Contracts to Arbitrate Tort Claims, A Law and Economics Perspective.”**

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## **List of Abbreviations**

### Abbreviations. Definitions.

AAA. American Arbitration Association.

ADR. Alternative Dispute Resolution.

ALI. American Law Institute.

B2B. Business to Business

B2C. Business to Consumer.

BROLD. Business Rule of Law Dashboard.

CAM. Milan Chamber of Arbitration.

CC. Control of Corruption.

CCBE. Council of Bars and law Societies of Europe.

CCCP. California Code of Civil Procedure.

CEPEJ. Council of European Commission for the efficiency of justice.

CLII. Cornell Legal Information Institute.

CRS. Colorado Revised Statutes.

CTIA. Cellular Telecommunications and Internet Association.

DB. Doing Business Index.

DCC. Dutch Civil Code (Nieuw Burgerlijk Wetboek).

DIS. Deutsches Institut für Schiedsgerichtswesen (German Institution of Arbitration).

DOJ. Department of Justice.

EC. European Commission.

EU. European Union.

EUROSTAT. European Statistical Office.

FAA. United States Arbitration Act (Federal Arbitration Act), 9. U.S.C. 1, (1925).

FCCP. French Code of Civil Procedure.

FDI. Foreign Direct Investment in Regulatory Restrictiveness Indicator.

FIFA. Fédération Internationale de Football Association

FRCP. Federal Rules of Civil Procedure.

GCI. Global Competitiveness Index.

GE. Government Effectiveness.  
GRI. Global Rights Index.  
IAB. Investments Across Borders Indicator.  
ICC. International Chamber of Commerce.  
ICCA. International Council for Commercial Arbitration.  
ICCP. Italian Code of Civil Procedure.  
IEF. Index of Economic Freedom.  
ILC. Index of Legal Certainty.  
ITUC. International Trade Union Confederation.  
LCIA. London Court of International Arbitration.  
MFN. Most Favorite Nation.  
NAI. Netherlands Arbitrage Institute.  
NPV. Political Stability and Absence of Violence/Terrorism.  
NY Convention. Convention on the Recognition and Enforcement of Arbitral Awards, (The New York Convention) June 10, 1958, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38.  
OECD. Organisation for Economic Co-operation and Development.  
OS. One Shotter.  
PETL. Principle of European Tort Law.  
RL. Rule of Law.  
RP. Repeat Player.  
RQ. Regulatory Quality.  
SCOTUS. Supreme Court of the United States.  
STRI. Service Trade Restrictiveness Index.  
TFEU. Treaty on the Functioning of the European Union.  
TLI. Transnational Legal Indicator.  
UC Hastings. University of California Hastings.  
UCM. Unobserved Components Model.  
UK. United Kingdom.  
UNCITRAL Model Law. Model Law on International Commercial Arbitration (1985), with amendments as adopted in 2006.

UNCITRAL. United Nations Commission on International Trade Law.

US. United States.

USCC. US Chamber of Commerce.

VA. Voice and Accountability.

WGI. World Governance Indicator.

WJP. World Justice Project rule of Law Index.

ZPO. German Code of Civil Procedure (Zivilprozessordnung).



**Summary:**

This research project concerns an analysis of the use of ex ante contracts to arbitrate tort claims using law and economics methodologies. More specifically this involves an analysis of claims which are purely domestic in nature and have no choice of law issues which could fall under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958. This research takes up a niche space within the topics of arbitration, tort law, contract law, comparative law judicial systems and competition law. The composition of this project includes several discrete articles which address several sub-topics within the framework of ex ante contracts to arbitrate tort claims. The first substantive article uses a comparative methodology to assess several nations arbitration laws. Because of the “black box” that is arbitration, there is a need to look at proxy measurements. In each nation considered, ex ante contracts to arbitrate tort claims are used to varying degrees, however there is a lack of convergence on legal norms for domestic arbitration. Specifically, there is a large gap between the narrow approaches of the European nations considered and the United States broad deference to arbitration. There is little information which is publicly available to assess the use of arbitration for tort claims provided by arbitration tribunals, and that proxy measurements considered, which are a poor second-best option. This helps to identify why a theoretical approach to researching this topic is necessary. The second article uses a traditional law and economics methodology to assess the use of arbitration for tort claims. These ex-ante contracts can influence the standard economic model of negligence first identified by Judge Learned Hand. This chapter identifies a theoretical framework under which repeat player tortfeasors can behave strategically in arbitration in ways which are unavailable in litigation. Strategic behavior may lead to negative externalities for third parties and society. The use of arbitration for tort claims has the potential to frustrate the development of efficient due care standards and may allow repeat player tortfeasors to avoid taking efficient levels of care. The next article concerns the use of arbitration for mass tort claims, in which four theoretical scenarios are considered, adjudication with a collective action procedure and without, and arbitration with a collective action procedure and without. This assessment shows there is a need to weigh the various costs and benefits of each procedure and the potential for a collectivized claim to lead to the production of public goods from litigation which may have positive externalities. When a collectivized claim lacks the ability to lead to the production of public goods from litigation, the economic rationale for claims to be arbitrated is higher. When individual claims are positive in value there is less of an economic incentive for collectivizing claims. The final chapter addresses how the collusive use of ex ante contracts to arbitrate tort claims across an industry may lead to the selective development of law, shirking from taking care, and that it is in itself a form of price fixing. By using a comparative competition law methodology, a comparison of various aspects concerning United States law and European Union law, demonstrate in theory that there is a higher likelihood of conspiracies to use ex ante contracts to arbitrate tort claims being successful in the United States than within the European Union. This research also demonstrates how arbitrage strategies are more likely to be effectively used by industry to increase enforcement errors.



## Samenvatting:

Dit onderzoeksproject betreft een rechtseconomische analyse van het gebruik van ex ante contractuele arbitragebedingen aangaande vorderingen uit onrechtmatige daad. Meer specifiek betreft het een analyse van vorderingen die uitsluitend nationaalrechtelijk zijn en waarbij het niet gaat om rechtskeuzekwesties die kunnen vallen onder het Verdrag over de erkenning en tenuitvoerlegging van buitenlandse scheidsrechterlijke uitspraken, New York, 1958. Dit onderzoek gaat in op een niche-ruimte binnen de onderwerpen arbitrage, onrechtmatige daad, contractenrecht, rechtsvergelijking en mededingingsrecht. Het project omvat afzonderlijke artikelen die ingaan op enkele onderwerpen binnen het kader van ex ante arbitragebedingen aangaande specifieke vorderingen uit onrechtmatige daad. Het eerste artikel gebruikt een vergelijkende methodologie voor het onderzoeken van het arbitragerecht van verschillende landen. Vanwege de “zwarte doos” die arbitrage is, is het noodzakelijk om te kijken naar alternatieve indicatoren. In elk onderzocht land worden ex ante arbitragebedingen aangaande vorderingen uit onrechtmatige daad in uiteenlopende mate gebruikt, maar er is een gebrek aan convergentie inzake juridische normen voor nationale arbitrage. Voor wat betreft arbitrage is er met name een grote kloof tussen de terughoudende benadering in de onderzochte Europese landen en de ruime toepassing in de Verenigde Staten. Er wordt weinig informatie verstrekt door arbitrage-tribunalen die algemeen beschikbaar is voor onderzoek naar het gebruik van arbitrage voor vorderingen uit onrechtmatige daad en de onderzochte alternatieve indicatoren zijn een ontoereikende tweede keuze-optie. Dit maakt duidelijk waarom een theoretische benadering voor het onderzoek naar dit onderwerp noodzakelijk is. Het tweede artikel gebruikt een traditionele rechtseconomische methodologie voor onderzoek naar het gebruik van arbitrage voor vorderingen uit onrechtmatige daad. Deze ex ante contracten kunnen van invloed zijn op het standaard economisch model van onzorgvuldigheid zoals vormgegeven door rechter Learned Hand. Dit hoofdstuk biedt een theoretisch kader, waarbinnen schadeveroorzakende grote procespartijen (repeat players) zich strategisch kunnen gedragen bij arbitrage op manieren die niet beschikbaar zijn bij normale procesvoering. Strategisch gedrag kan leiden tot negatieve gevolgen voor derden en de samenleving. Het gebruik van arbitrage voor vorderingen uit onrechtmatige daad kan ertoe leiden, dat de ontwikkeling van efficiënte zorgvuldigheidsstandaarden wordt gefrustreerd en dat schadeveroorzakende “repeat players” nalaten om efficiënte zorgvuldigheidsmaatregelen te nemen. Het volgende artikel betreft het gebruik van arbitrage voor massavorderingen uit onrechtmatige daad, waarbij vier theoretische scenario’s worden overwogen, berechting met en zonder een procedure voor groepsacties en arbitrage met en zonder een procedure voor groepsacties. Dit onderzoek laat zien dat het nodig is om de verschillende kosten en baten van elke procedure af te wegen en toont de mogelijkheid dat een groepsvordering leidt tot de productie van publieke goederen uit procesvoering, wat positieve gevolgen kan hebben. Als een groepsvordering niet kan leiden tot de productie van publieke goederen uit procesvoering, is de economische reden voor arbitrage voor vorderingen groter. Als individuele vorderingen een positieve waarde hebben, is er een geringere economische prikkel voor groepsvorderingen. Het laatste hoofdstuk behandelt hoe een afstemming van het gebruik van ex ante arbitragebedingen van betreffende vorderingen uit onrechtmatige daad binnen een industrie kan leiden tot selectieve rechtsontwikkeling, onttrekking aan zorgverplichtingen en dat dit in zichzelf een vorm is van prijsafspraken. Door het gebruik van een rechtsvergelijkende methodologie betreffende het mededingingsrecht laat een vergelijking van verschillende aspecten van het recht van de Verenigde Staten en van de Europese Unie in theorie zien, dat het waarschijnlijker is dat samenzweringen voor het gebruik van ex ante contracten voor arbitrage van vorderingen uit onrechtmatige daad meer succesvol zijn in de

Verenigde Staten dan binnen de Europese Unie. Dit onderzoek laat ook zien hoe arbitragestrategieën waarschijnlijk door de industrie effectief worden gebruikt ter bevordering van ontduiking van handhaving.

## **Chapter 1. “An Introduction to the Law and Economics of Arbitrating Tort Claims.”**

### 1. Introduction.

The subject of tort law has been considered by several respected law and economics scholars, as has the subject of arbitration. However, the subject of arbitrating tort claims has been less considered. The topic is very narrowly construed within the context used here, *ex ante* contracts to arbitrate tort claims. While this topic may be niche and narrowly applicable in its scope, the reality is that arbitration is used to adjudicate tort claims, and it appears poised to be expanded in use, especially as a method for states to lower the burden of cases on public judicial systems. While many law and economics scholars have written about tort law and contract law, and several law and economics articles directly address the use of arbitration for commercial disputes, the specific treatment by law and economics scholars of the use of *ex ante* contracts to arbitrate tort claims has generally been addressed as a subtopic when looking into contract law, tort law, competition law, dispute resolution, and other areas of related law. The reality is that the use of *ex ante* contracts to arbitrate tort claims involves many areas of law, which the law and economics literature still needs to capture the implications of fully. While legal scholars have examined the expanded use of arbitration for tort claims, much of this analysis is strictly legal and generally fails to capture the implications of the use of arbitration for tort claims.<sup>1</sup> Economic analysis of law research has not been pinpointed on how the use of arbitration for tort claims, contracted over *ex ante*, affects the

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<sup>1</sup> Legal scholars have often framed issues concerning the arbitration of tort claims under consumer, service, or employment law. Some of these researchers have used law and economic methodologies or empirical methods. See: ALDERMAN 2001 (consumer); ALDERMAN 2003 (consumer); BINGHAM 1997 (employment); COLVIN 2018(employment); DEMAINE and HENSLER 2004 (consumer); DRAHOZAL 2000 (empirical); DRAHOZAL 2007 (consumer); DRAHOZAL and FRIEL 2002 (consumer); DRAHOZAL and WARE 2010 (firms); EISENBERG and HILL 2003 (employment); EISENBERG et al. 2008 (consumer); ESTLUND 2018 (consumer and employment); HORTON and CHANDRASEKHAR 2015 (consumer, empirical); JUNG 2013 (consumer, empirical); KORN and ROSENBERG 2012 (class consumer arbitration); LESLIE 2017 (consumer); MANIA 2019 (consumer); SCHMITZ 2012 (consumer); SEIN 2011 (consumer); STERNLIGHT and JENSEN 2004 (class consumer arbitration); SZALAI 2018 (consumer); TANYILDIZ 2018 (torts); THORNBURG 2004 (torts); TRIPP 2011 (medical service); WARDHAUGH 2013 (consumer); WARE 1994 (punitive damages); WARE 1998 (rules); and WARE 2001 (consumer).

incentives of parties to take care, to act strategically, to influence social welfare, or to collude in manipulating markets with specific regards to the arbitration of tort claims. While some of these issues have certainly been addressed within the law and economics literature within a larger context, there has been a large gap in the literature concerning the use of *ex ante* contracts to use arbitration specifically for tort claims, and this research seeks to fill this very niche, very specific space.

Recent legal developments have brought the issue into renewed public debate. From a comparative perspective, there is a divergence in approaches to using arbitration to determine tort liability. For instance, in the United States (US), a consumer contract with T-Mobile in 2022 for cell phones and cell phone service includes an arbitration clause that states in part, "By accepting these T&Cs, you are agreeing to resolve any dispute with us through binding arbitration... and to waive your rights to a jury trial and to participate in any class action suit."<sup>2</sup> In the Netherlands, the T-Mobile consumer contract does not contain any such language related to arbitration, and even if it did, it would be unenforceable under EU law.<sup>3</sup>

This research is concerned with how *ex ante* contracts to use arbitration for tort claims affect the economic goals of tort law, with regards to how contract law, competition law, and judicial systems are affected by this specific use of arbitration. Because the arbitration of tort claims has the potential to further or hinder the economic goals of tort law, it is necessary to consider whether it is welfare enhancing, and if so, how? This topic has yet to be fully addressed in the law and economics literature. Rather, this very niche topic has been addressed in passing, or as part of a

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<sup>2</sup> T-MOBILE USA USER AGREEMENT 2022 T-Mobile USA now allows for an opt-out of binding arbitration but limits the courts available to US consumers to small claims courts.

<sup>3</sup> T-MOBILE NETHERLANDS USER AGREEMENT 2022. Interestingly, the T-Mobile Netherlands user agreement does contain liability limiting provisions.

wider analysis, most notably by HYLTON, POSNER, SHAVELL, and LANDES and POSNER, although the approaches used to analyze the use of *ex ante* arbitration contracts for tort claims are part of a larger analysis of the use of arbitration in general.<sup>4</sup> The broader discipline of law and economics has addressed many of the present issues; however, this is often within a distinct analysis of other related topics. Importantly, the existing literature does not specifically analyze the role of strategic behavior by repeat players (RP) in the arbitration of tort claims, the possibility for collusive behavior in the use of *ex ante* arbitration contracts for tort claims, or the full scope of the social welfare implications of the use of *ex ante* contracts to arbitrate tort claims within the context of mass tort claims. There is also a lack of comparative legal research concerning the use of *ex ante* arbitration contracts for tort claims. Considering the lack of literature on this specific topic of the use of *ex ante* arbitration contracts for tort claims from a law and economics perspective, developing a deeper understanding of the separate literature on the law and economics of torts, contracts, and arbitration is necessary to develop a reasoned framework for analyzing the arbitrability of tort claims from a law and economics perspective. This research is relevant because there is an increasing divergence in approaches to the use of *ex ante* arbitration contracts for tort claims, and this coincides with the increased use of *ex ante* contracts to arbitrate tort claims in the US and the developing of consumer rights law within the European Union (EU). This growing divergence is fertile ground to develop a deeper understanding of the law and economics of *ex ante* contracts to use arbitration for tort claims, which should, in turn, be useful for practitioners, lawmakers, and academics, who work in this intersection of tort law, contract law, alternative dispute resolution (ADR), and other related areas of law. While various approaches exist to imposing liability for torts, some common legal and economic principles may be more influential

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<sup>4</sup> See: HYLTON 2004; HYLTON 2000; HYLTON 2016; SHAVELL 1995; SHAVELL 2004, POSNER 2011; and LANDES and POSNER 1979.

in forming public policy toward such claims. An analysis of tort law will identify philosophical and economic rationales for developing legal norms for tort liability. An analysis of the role of arbitration as a potential ADR process, as used within the context of contractual disputes, is also necessary.

Law and economics scholars have devoted a great deal of attention to the analysis of legal disputes in litigation.<sup>5</sup> The topic of international commercial arbitration and a comparison of costs and benefits of using commercial arbitration or litigation have also be addressed by law and economics scholars.<sup>6</sup> Because of the lack of academic research concerning the use of arbitration for purely domestic tort claims, this research aims to fill a gap in the current literature concerning this specific and niche topic. A general discussion of the positive and negative attributes of the use of litigation and commercial arbitration is not within the scope of this research, rather the focus on this research concerns how the use of arbitration for domestic tort claims may have both positive and negative effects on the public good, which can be considered as a discrete subtopic within the literature comparing arbitration and litigation.

It is well known that individuals in litigation often have a different utility function than society, thus many scholars have written about how there is a tension between a public welfare optimal amount of litigation and the actual amount of litigation. According to Spier, “the main purpose of the court system is to facilitate value-creating activities and deter value-destroying activities through the enforcement of contracts and laws”, however, “[t]he private decisions of the plaintiff and defendant to invest time and money in a lawsuit are not generally aligned with the interests of

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<sup>5</sup> See POSNER 2014, COOTER and ULEN 2016, SPIER 2007.

<sup>6</sup> See VAN AAKEN, and BROUDE 2016, FAURE and MA 2019. POSNER 2014,

society as a whole.”<sup>7</sup> Thus, there are numerous situation which occur where the parties in a dispute have private interests which preclude court intervention in some disputes which, if adjudicated, could lead to the production of public goods from litigation which benefit society.

This research is not designed to consider all of the ways in which there is an underproduction of public goods due to the divergence in interests in the litigation of claims between public and private welfare, rather it is designed to explore a specific subcategory of these situations of divergence which may occur when arbitration is used for purely domestic tort claims. It is important to acknowledge that not all disputes are capable of leading to the production of public goods from the litigation process. This research specifically aims to highlight how the enforcement of some types of ex ante contracts to arbitrate tort claims may actually be value destroying. While there are both costs and benefits from individual claims being adjudicated in a state administered court, legal theory generally believes disputes which cannot be settled by the individual disputants peacefully should not be allowed to lead to force or violence or other socially undesirable behavior on the part of the parties, but rather the state takes a role in adjudicating the dispute between the parties to promote public welfare and peace within society. The adjudication of disputes benefits society, such as providing a clear legal standard for conduct which serves as focal points for individuals and firms to take into account when making their choices or removing disputes from ancient talionic concepts of retribution. Properly functioning courts exist because they make society better off. But the incentives of individuals and firms to use the court systems, or not, is not always in line with what is best for society, or in other words, promotes the public good. This research is narrowly focused and looks at a niche topic which does not directly address all the potential benefits or costs of litigation, although this research does concern the individual’s or

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<sup>7</sup> SPIER 2007, p. 262, 265.

firm's assessment of the care they take given a legal duty to take care, and how individuals or firms look at the expected values of their legal claims when making decisions to litigate or arbitrate tort claims and take these costs into account when deciding to include or accept an arbitration clause in their contracts or not.

This is a niche topic which only concerns only the use of ex ante contracts to arbitrate tort claims in purely domestic disputes. This analysis is not intended to look at tort claims which are arbitrated using ex post arbitration contracts, nor simply the use of litigation to adjudicate tort claims, nor other contractual disputes which do not involve tort claims. While it is possible that some of this research is relevant to other areas of law which do not include the narrowly construed ex ante contracts for arbitration setting, it is not the aim of this research, nor within its scope, to look beyond the implications of the use of arbitration except within the context of ex ante contracts to arbitrate tort claims in the domestic setting. While there may be a need to consider the implications of this research for topics outside of the scope of ex ante contracts to use arbitration for domestic tort claims, those topics are beyond the scope of this research. However, this research does demonstrate how there are ripe issues which academics, particularly those using a law and economics methodology, should be considering which concern the use of arbitration for tort claims because of the potential for this specific use of arbitration to be value destroying, or subject to the manipulation efforts of repeat players through strategic behavior in the arbitration setting which are not socially welfare optimal.

The goal of this introductory chapter is to identify the key legal issues which are relevant to the arbitration of tort claims, identify common themes which reach across the interrelated articles, discuss some of the possible economic effects of arbitrating tort claims, and consider what potential problems may result from the use of arbitration for tort claims. This introductory chapter

frames several research questions, which are addressed in discrete articles, which are presented as chapters. These chapters address related subtopics (comparative law, strategic behavior, mass tort claims, and competition law) within the subject of the arbitrability of tort claims and were originally composed as standalone articles. Because of the scope and approach of this research, the law and economics literature concerning collective actions, civil procedure, competition law, and behavioral law and economics is also considered throughout the chapters composing this book. This topic takes up a niche within the subjects of tort law, contract law, procedural law, ADR, comparative law, and competition law. It is thus limited in its scope to the specific scenarios considered here. However, some insights from this research may be relevant to areas of law that are not considered here. Importantly, this research focuses only on *ex ante* contracts to arbitrate. Specifically, this research relates to tort claims with no international basis from which the New York Convention (NY Convention) on the enforcement of foreign arbitral awards could be applicable.<sup>8</sup> Only tort claims which arise out of a pre dispute contractual relationship between parties within a state are relevant to this research. This research is also limited to contractual relationships, which can be characterized as being between individuals, employee unions, and firms, either through service contracts, contracts for the sale of goods, or to a more limited extent, employment contracts. More generally, this research focuses on contracts to arbitrate tort claims between unsophisticated parties involved in a single dispute and sophisticated parties involved in numerous, sometimes similar, disputes.

This research is structured as a series of chapters that address subtopics within this area of law and economics. Specifically, these chapters address: 1) a comparative analysis of the source of

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<sup>8</sup> NEW YORK CONVENTION 1958.

arbitration law and the demand for third party adjudication in six states, 2) the strategic use of arbitration for tort claims, 3) the use of arbitration for mass tort claims from a public welfare perspective, and 4) the potential for the collusive use of arbitration contracts which cover tort claims within an industry. These chapters were individually written to show how incentives to take care to prevent accidents may be distorted or supported by the use of arbitration in tort claims and how this distortion or support of incentives to take care has economic consequences for individuals, firms, judicial systems, and society.

## 2. A Modern Society with Modern Torts.

The advance of technology necessitates a reaction from the law. While tort law developed based on concepts of trespass, tort law now encompasses a wide range of issues. When we think about tort law, we often consider the law involving accidents. The French philosopher PAUL VIRILIO has written about how technology changes our world and how these changes create new moral dilemmas for inhabitants of the modern world. With each new invention, a new accident is also invented.

“To invent the sailing ship or the steamer is to invent the shipwreck. To invent the train is to invent the rail accident of derailment. To invent the family automobile is to produce the pile-up on the highway.”<sup>9</sup>

Each of these accidents has the potential to harm innocent parties not responsible for the activity which causes the harm. At the same time, the sailing ship, the train, and the automobile all bring benefits to society. Any legal reaction to new types of accidents must also consider the potential benefits of the new activity or product, not only the potential costs.

A fundamental question of legal systems concerns how the changing world changes the duties individuals and firms are responsible for and to whom they are responsible. Reasonableness is

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<sup>9</sup> VIRILIO 2007, p. 10.

often the standard that the common law uses to impose a duty. How should the law react when the reasonable person standard becomes inefficient in measuring the care which an individual can take given a changing world? As the efficient standard of care becomes more complex, so does the likelihood that the law will be unable to determine the efficient standard of care *ex ante*. This relates to how quickly the reasonable person will respond to societal changes. For legal systems to make efficient standards, the law must change to account for new technologies and practices and provide individuals with some idea about what reasonableness is at any given time. A reasonableness standard implies a connection to the community of the location where the conduct in question occurred, i.e., the standard concerns what a reasonable person living in the jurisdiction would do. Legal systems, however, are not necessarily designed to quickly adjust to a changing society, a characteristic which may reflect institutional preferences for continuity. Institutionally, the law, or legal systems, rarely changes its approach by creating novel legal doctrines; rather, the law often incorporates existing legal doctrine into its review of novel legal issues. Indeed, the development of the law often involves identifying an “old solution” to be applied to a “new problem”. Thus, the reuse of old legal doctrine in addressing new legal dilemmas is not true “legal innovation”, but rather an expansion of existing legal doctrine.

### 3. The Borderland Between Tort and Contract.

“Between actions plainly *ex contractu* and those as clearly *ex delicto* there exists what has been termed a border-land, where the lines of distinction are shadowy and obscure, and the tort and the contract so approach each other, and become so nearly coincident as to make their practical separation somewhat difficult.”<sup>10</sup>

In 1882 Judge Finch of the New York Court of Appeals identified the problem of distinguishing between tort and contract, a problem which is not yet fully resolved. Variations in laws across

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<sup>10</sup> *Rich v. New York Cent. & H.R.R. Co.*, (1882).

borders make a comparative study of this issue even more "shadowy". Consider how a tort is defined. A standardized, all-encompassing definition of tort is hard to pin down. Contract law has become more standardized than tort law due to the development of international legal norms in commercial trade.<sup>11</sup> Tort law is more inward looking, often considering what the community standard for conduct is.<sup>12</sup> The use of arbitration clauses that cover tort disputes arising in contract makes this area of law particularly "obscure" in the sense that clear distinctions between tort and contract may be hard to identify, and the overlapping of tort and contract claims may make determining the rule or standard more difficult. It poses a question as to which laws governing mixed private claims should be given deference when there is a conflict or inconsistency in laws. Torts is an area of law which covers a wide range of issues, often involving negligence. According to Merriam Webster, a tort is "a wrongful act other than a breach of contract for which relief may be obtained in the form of damages or an injunction".<sup>13</sup> This definition of tort is slightly different from other legal definitions. The Cornell Legal Information Institute (CLII) defines a tort as "an act or omission that gives rise to injury or harm to another and amounts to a civil wrong for which courts impose liability".<sup>14</sup> What exactly a tort is will depend on which jurisdiction is being considered. For instance, in common law jurisdictions, the tort of negligence normally includes the elements of duty, breach, causation, and harm. These elements may vary depending on the nature of the duty involved and the relationship between the victim and tortfeasor. Civil law jurisdiction may take a similar yet distinct approach to the elements of negligence. For example,

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<sup>11</sup> According to BERMAN and KAUFMAN, "international trade terms relating to allocation of risk of loss or damage to goods, clauses in bills of lading, in marine insurance policies and certificates, and in letter of credit, arbitration clauses, and other devices used in export and import are generally understood by trading enterprises throughout the world and are governed by similar legal rules in virtually all countries". BERMAN AND KAUFMAN 1978, p. 221.

<sup>12</sup> For a discussion of the reasonable person standard as a community standard in negligence claims, see: GILLES 2001.

<sup>13</sup> MERRIAM WEBSTER ONLINE DICTIONARY 2022. Definition of tort.

<sup>14</sup> CLII 2022. Definition of Tort.

in the Netherlands, "Article 6:162 of the Dutch Civil Code" (DCC) "states that the party who commits a tort towards another is obligated to compensate the losses, which the other party suffers as a result" and the claim "must meet five requirements: unlawfulness, attributability, loss, causality and relativity".<sup>15</sup> Variations in tort law across borders show how the line between tort and contract may be further obscured when making a comparative analysis in arbitrating tort claims.

The legal culture of each state influences the definition of a tort and the elements of a tort. In common law jurisdictions, the elements of a tort may be defined through precedential deference to judicial rulings or found within a written statute or law. In civil law jurisdictions, the source of tort law is found in a code that outlines the elements of the civil offense, and judges fill in gaps in the code or interpret the code in a new light, or adhere to the doctrine of precedent known as *jurisprudence constante*, rather than through the doctrine of precedent known as *stare decisis* which common law jurisdiction adhere to. Because there is a difference in each state's definition, interpretation, and legal development of what a tort entails, no definition universally applies or crosses all borders.

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<sup>15</sup> VAN VUGT 2022. DCCP art. 6.

Article 6:162 of the DCCP defines a tortious act as,

"1. A person who commits a tortious act (unlawful act) against another person that can be attributed to him, must repair the damage that this other person has suffered as a result thereof.

2. As a tortious act is regarded a violation of someone else's right (entitlement) and an act or omission in violation of a duty imposed by law or of what according to unwritten law has to be regarded as proper social conduct, always as far as there was no justification for this behaviour.

3. A tortious act can be attributed to the tortfeasor [the person committing the tortious act] if it results from his fault or from a cause for which he is accountable by virtue of law or generally accepted principles (common opinion)." DCCP art. 6.

Additionally, under DCCP art. 6:163 "There is no obligation to repair the damage on the ground of a tortious act if the violated standard of behaviour does not intend to offer protection against damage as suffered by the injured person." DCCP art. 6. English translation available at <http://www.dutchcivillaw.com/civilcodebook066.htm>.

Some definitions of tort include a requirement that tort should not be considered a breach of contract. A claim in contract and a claim in tort may have to be pled as separate claims, depending on the jurisdiction. One benefit of separating the claims is that it clarifies the determination of damages for each claim.<sup>16</sup> There may be additional elements of each claim which are not common. In a contract claim, one would need to prove the existence of the contract, the breach of the contract, and remedies for the breach. In tort, as mentioned, the elements are general duty, breach, causation, and harm for a negligence claim.

Two issues in the intersection of contract and tort worth considering are the nature of the claim and whether the contractual relationship between parties imposed a specific duty that would not have otherwise been owed by either party to the other. According to Lord Macmillan, "[t]he fact that there is a contractual relationship between the parties which may give rise to an action for breach of contract does not exclude the co-existence of a right of action founded on negligence as between the same parties independently of the contract though arising out of the relationship in fact brought about by the contract".<sup>17</sup> While claims in contract and tort are distinct, some torts claims are causally prerequisite on a contractual relationship which in turn imposes some duty or standard of care for which a breach may bring rise to a claim in tort. In other words, the "foreseeable victim" of a negligent act may only be identified through a contractual relationship in some circumstances. In other instances, the parties to a contract owe a "duty to the world" regardless of the existence of a contractual relationship or not.<sup>18</sup> The imposition of a duty may

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<sup>16</sup> This is particularly true when punitive damages are available for tort claims but not contract claims. Some countries, like the Netherlands, use the same methodology for computing damages for tort and contract claims. DCCP art. 6:96.

<sup>17</sup> *Donoghue v Stevenson*, (1932), p. 471.

<sup>18</sup> In the US, the distinction between duties to the world and duties to foreseeable victims has been embodied in the now famous case out of New York, *Palsgraf v. Long Island R.R.*, (1928), in which judges Cardozo and Andrews ruled differently on what duty is owed. According to CARDI, "The elements of the debate between Judges Cardozo and Andrews in *Palsgraf* are canonical: (1) What is the nature of duty – is it relational or act centered? (2) Is plaintiff-

depend on the type of tort being alleged and, potentially, the relationship between the victim and the tortfeasor.

There are different approaches not only across national jurisdictions but also within nations. In the US, multiple approaches are taken to deal with the issue of overlapping tort claims and contract claims. For example, at the federal level in the US, the United States Supreme Court (SCOTUS) in *Chesapeake & O. RY Co. v. A.F. Thompson Mfg. Co.*, a 1926 case concerning a federal statute regulating common carriers, identified a duty of care for common carriers when they enter into a contract to transport goods from which a common law negligence claim in tort could arise.<sup>19</sup> Essentially, a breach of a contract to deliver goods in the same condition in which they were received by a common carrier gives rise to a negligence claim in tort, but the requirement to prove "negligence in fact" remains, and the reporting of damage requirement found in the federal statute was not merely "a rule of liability without fault" and thus "the burden of proving the carrier's negligence" remained "one of the facts essential to recovery" under the common law tort of negligence.<sup>20</sup> At the state level in the US, there are variations of the rule for if a claim must be argued in contract or tort. The California Supreme Court has addressed the difference between tort and contract, commenting that "conduct amounting to a breach of contract becomes tortious only when it also violates an independent duty arising from principles of tort law".<sup>21</sup> The California Supreme Court has also found that "[a] tort may grow out of or make part of, or be coincident with a contract" and "the fact there existed a contract between the plaintiffs and the defendant would

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foreseeability a duty inquiry or an aspect of proximate cause? (3) Is a court or a jury the proper arbiter of foreseeability?" CARDI 2011, p. 1873.

<sup>19</sup> *Chesapeake & O. RY Co. v. A.F. Thompson Mfg. Co.* (1926).

<sup>20</sup> *Chesapeake & O. RY Co. v. A.F. Thompson Mfg. Co.* (1926).

<sup>21</sup> *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.*, (1994).

not immune the latter from the penalty that is ordinarily visited upon tortfeasors".<sup>22</sup> In New York, "[a] tort may arise from the breach of a legal duty independent of the contract, but merely alleging that the breach of contract duty arose from a lack of due care will not transform a simple breach of contract into a tort".<sup>23</sup> In Colorado, "some special relationships by their nature automatically trigger an independent duty of care that supports a tort action even when the parties have entered into a contractual relationship"; however, "a party suffering only economic loss from the breach of an express or implied contractual duty may not assert a tort claim for such a breach absent an independent duty of care under tort law".<sup>24</sup> These are just a few distinctions between tort and contract in which divergent approaches have been taken within the US states. While many of the tort claims are common across states in the US, there are variations in how tort law is applied and what claims in tort are available at the state level. AVRAHAM has published the "Database of State Tort Law Reform" with regular updates since 2006, which maps how each state has taken steps to reform tort laws.<sup>25</sup> The variation in the tort reforms taken across states is further evidence of the diversity of approaches used by courts in determining tort liability in the US.

The American Law Institute (ALI) was formed in 1923 and has published restatements of the law in several subjects, including torts. The Restatement of Torts, Second, has been a widely cited source of legal doctrine. Although the Restatement of Torts is not a binding legal authority in the US, it has become a heavyweight in terms of its persuasive authority. The Restatement of Torts is often cited by judges in their rulings. According to the Restatement of Torts Second, "negligence is conduct which falls below the standard established by law for the protection of others against

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<sup>22</sup> *Jones v. Kelly*, (1929).

<sup>23</sup> *Sommer v. Fed. Signal Corp.*, (1992).

<sup>24</sup> *Town of Alma v. AZCO Const., Inc.*, (2000).

<sup>25</sup> AVRAHAM 2018.

unreasonable risk of harm” and “does not include conduct recklessly disregarding the interests of others”.<sup>26</sup> The adoption of specific standards found in the Restatements of Torts is not universal across the US, although the 2<sup>nd</sup> edition has been widely recognized in law, be it piecemeal, across the US.

Much like how the ALI has sought to harmonize US legal standards, the European Group on Tort Law has worked to harmonize tort law across Europe.<sup>27</sup> Their mission statement reads in part, “The European Group on Tort Law aims to contribute to the enhancement and harmonization of tort law in Europe through the framework provided by its Principles of European Tort Law (PETL) and its related and ongoing research, and in particular to provide a principled basis for rationalisation and innovation at national and EU level”.<sup>28</sup> The European Group on Tort Law seeks to identify “a common law of Europe” within a framework of “fundamental principles” accepted across Europe.<sup>29</sup> The line between a tort and a breach of contract will depend on which rule has been adopted in a given jurisdiction. This is true whether one looks within the US or Europe or between the US and Europe.

The distinction between tort and contract is more complex if one considers the types of tort claims that have developed specifically in consumer, service, and employment contracts. These contracts have been central to the debate over what contracts to arbitrate should be enforced. The contractual relationships formed in these types of contracts may also impose a legal duty, and the existence of a duty may mean a particular tort claim is or is not available when the parties cause harm to each

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<sup>26</sup> ALI 1979, § 282.

<sup>27</sup> EUROPEAN GROUP ON TORT LAW 2022.

<sup>28</sup> EUROPEAN GROUP ON TORT LAW 2022.

<sup>29</sup> EUROPEAN GROUP ON TORT LAW 2005.

other. A state's approach in these areas of law is another source of divergence across borders. The distinctions between tort and contract claims are not always easily settled.

#### 4. The Development of Tort Law.

Torts cover a wide range of legal situations where injuries have occurred. As previously mentioned, according to the CLII, “[a] tort is an act or omission that gives rise to injury or harm to another and amounts to a civil wrong for which courts impose liability”.<sup>30</sup> Furthermore, “There are numerous specific torts including trespass, assault, battery, negligence, products liability, and intentional infliction of emotional distress”, among a number of various tort claims.<sup>31</sup> The wide range of legal claims covered by the term tort has resulted in various academic and legal developments in the subject.

##### 4.1 Common Law and Civil Law Legal Traditions.

The two main legal systems considered within this analysis are civil law and common law jurisdictions. While there are numerous differences between the two systems, the most significant distinction in tort law is the role of courts in adjudicating a claim. In civil jurisdictions, laws are found nearly exclusively within the written law or statutory law.<sup>32</sup> The common law, in contrast, is based not only on statutes but also on legal precedents created by judicial rulings. The concept of *stare decisis* in common law jurisdictions binds courts to stand by the previous rulings of judges on similar factual matters.<sup>33</sup> In civil jurisdictions, judges have varying degrees of discretion to implement broadly stated legislation.<sup>34</sup> Civil law traditions may rely on doctrines such as

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<sup>30</sup> CLII, Definition of Tort.

<sup>31</sup> CLII.

<sup>32</sup> For a historical comparison between common law and civil law jurisdictions, see: DAINOW 1966.

<sup>33</sup> DAINOW 1966, p. 429. See: DOUGLASS 1949 concerning the use of *stare decisis* in US courts.

<sup>34</sup> DAINOW 1966, p. 431.

*jurisprudence constante* or *arret de principe*, which give less weight to prior judicial decisions than the doctrine of *stare decisis*.<sup>35</sup> Law and Economics scholars have postulated a theory that the common law produces efficient outcomes, in part due to the discretionary role of judges in developing precedent.<sup>36</sup> In some civil law jurisdictions, judges' discretion has been limited because of historical abuses by the judiciary, and precedent is a more limited part of the legal system.<sup>37</sup> Importantly, both common and civil law traditions provide judges with opportunities to be creative in addressing novel legal dilemmas.

The differences in the two systems have not resulted in vastly different outcomes. DAINOW wrote in 1966 that “[e]ven though it be admitted that the civil law and the common law started from opposite extremes, it is sometimes said that as a result of the movements each has made in the direction of the other, there is no longer much difference between them” yet “[i]f it is true that the results are so close to each other, the methods used to reach them are nevertheless extremely divergent, and the matter is not that simple”.<sup>38</sup> More than 50 years later, the matter is still not that simple. Even if the two systems have produced similar outcomes, the different paths taken reflect strong preferences for how the judiciary functions, and these preferences may cause a variation in outcomes of legal dispute.

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<sup>35</sup> According to PARISI and FON, *jurisprudence constante* is “the doctrine under which a court is required to take past decisions into account only if there is sufficient uniformity in previous case law” where “no single decision binds a court and relevance is given to split case law.” PARISI and FON p. 80.

<sup>36</sup> See: RUBIN 1977; PRIEST 1977; and PARISI and FON 2009.

<sup>37</sup> ROBINSON et al. 1985, when addressing the legal history of Europe, specifically the French Civil Code, comment, “The strong feeling which had imbued the Code that judges should limit themselves to the administration of its provisions, and not usurp the place of the legislator, was expressed in Article 5, which forbids any judicial pronouncement on a matter before the court by way of a general disposition have effect for the future.” ROBINSON et al. 1985, § 16.5.2. PARISI and FON also comment that, “strict historical conceptions of separation of powers” developed in the 19<sup>th</sup> century which afforded little discretion to judges, out of a “general distrust of courts” which were historically subject to manipulation by monarchies. This general distrust in the judiciary resulted in “legislative provisions” which “had to be formulated and interpreted as mathematical canons to avoid any room for discretion or arbitrary decisions in the judiciary.” PARISI and FON 2009, p. 80.

<sup>38</sup> DAINOW 1966, p. 434.

The process by which the courts produce public goods from litigation (such as rule production, interpretation, and gap filling) and how they determine tort liability will influence the economic effects of the use of arbitration for tort claims. When the legal system uses courts to create public goods, the impact of arbitration increases because arbitration can divert the inputs for courts to be creative. A prohibition on arbitration may also increase the cases heard in front of the court and increase system costs to the public. Balancing the need for efficient rules, outcomes, and input is "not that simple".

#### 4.2 What is a Tort?

Modern tort law has developed in both common law and civil law legal traditions, at least in part, as a response to the increased mechanization, industrialization, and consumption of goods based on technological advances. While the historical context of tort claims seems to have been a narrow subject, the industrial revolution created a multitude of new potential claims based on harm caused by the operation of industrial activities or the use of modern machines and tools. In the common law context, tort claims include causes of action for intentional torts, negligence torts, and strict liability torts. In civil law jurisdictions, concepts of torts are similar to those of common law jurisdictions. Intentional torts include assault, battery, false imprisonment, conversion, intentional infliction of emotional distress, fraud, trespass, and defamation. Negligence torts generally cover accident claims and malpractice claims. Strict Liability torts cover product liability, animal attacks, and harm caused by dangerous activities. The list is non-exhaustive; however, showing a range of tort claims is useful. From a common law practitioner's point of view, there may be several causes of action in tort surrounding a single accident. Generally, to prove a tort claim in a common law court, the victim must show four elements, duty, breach of duty, causation (cause in fact and but for causation), and harm. Each specific tort claim may have its unique elements. For intentional

torts, a question of intent is also an element. Civil law jurisdictions have advanced in similarity to the changes in technology, although perhaps through different means than through court created precedent under the doctrine of *stare decisis*. Courts in both common law and civil law jurisdictions create public goods, either in the form of precedent, rule interpretation, gap filling, and the creation of publicly known information.<sup>39</sup> Thus, we can consider that tort law results from various inputs from individual victims and tortfeasors, firms, judges, legislators, and society in both common law and civil law jurisdictions.

#### 4.3 Historical Developments in Tort Law.

In 1908 PUTNEY wrote on the definition and history of torts, commenting that "[t]he early history of the law of torts, after its separation from criminal law, is embraced in the history of the action of trespass" and further a "[r]ight of action for injuries which cannot be brought within the scope of trespass owe their origin to the famous Statute of Westminster II passed in 1285".<sup>40</sup> PUTNEY earlier notes how the term torts "itself has only come into general use during the past half century", which places the emergence of tort law as a general topic of jurisprudence within the past 200 years of human society.<sup>41</sup> According to PUTNEY, "[t]he field of the law of torts is very broad, overlapping the field of criminal law on the one side, and that of contracts on the other".<sup>42</sup> Putney further quotes Justice HOLMES, who commented that "the law regards the infliction of temporal damages by the responsible person as actionable, if under the circumstances known to him the danger of his act is manifest according to common experience, or according to his own experience

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<sup>39</sup> According to VAN BOOM, "In tort law, civil law courts may assume a role that complements the role assumed by the legislature. Where codes give leeway for case-law to create, develop, and innovate in tort law, courts will fill the space. Where the legislature is active, courts may assume a more subservient role. It must be noted, however, that there is no single concept of power balance in civil law tort systems. In some countries, courts may be more willing than in others to show initiative where the legislature fails to act." VAN BOOM 2012, p. 13.

<sup>40</sup> PUTNEY 1908, p. 20. STATUTE OF WESTMINSTER 1285.

<sup>41</sup> PUTNEY 1908, p. 11.

<sup>42</sup> PUTNEY 1908, p. 11.

if it more than common, except on cases where upon special grounds of policy the law refuses to protect the plaintiff or grants a privilege to the defendant”.<sup>43</sup> The law of torts has changed considerably since 1908, as have the circumstances of daily life and the concept of common experience.

If the legal development of tort law is relatively recent, the social needs related to the problems now associated with tort law are not. The normative sources for tort law, according to GEISTFELD, can be found within “the conventional historical account, the talionic norms of revenge that governed behavior in the state of nature were the original source of the common law, but then wholly rejected by the modern tort system as an uncivilized form of punishment that is irrelevant to the distinctive tort problem of allocating responsibility for accidental harms”.<sup>44</sup> However, a normative evaluation of tort law must also consider that “[b]y enforcing the compensatory right, the tort system engages in a normative practice of reciprocity that can be justified by the liberal egalitarian principle that each person has an equal right to autonomy or self-determination, making each responsible for the costs of his or her autonomous choices.”<sup>45</sup> In this sense, modern tort law does grow from more broadly drawn notions of fairness and responsibility.

The law of negligence, a subcategory of torts, has likewise changed drastically since PUTNEY addressed the subject in 1908. In 1985 PRIEST wrote when addressing the subject of enterprise liability that “[m]odern tort law generates complicated legal and economic issues-of industrywide apportionment of liability, probabilistic causation, and retroactive liability- that would have appeared bizarre to a lawyer dealing with defective products in the 1950s whose practice was one

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<sup>43</sup> PUTNEY 1908, p. 12, quoting HOLMES 1897.

<sup>44</sup> GEISTFELD 2016, p. 1592.

<sup>45</sup> GEISTFELD 2016, p. 1593.

of warranty interpretation and routine negligence.”<sup>46</sup> The world has changed and will continue to change. These changes caused a reaction in the law, and there is no doubt that future changes in society will bring about future changes in the law. This process continues as the world changes with the development of new technology, scientific discoveries, novel practices, and newfound knowledge.<sup>47</sup>

The law is an inherently reactionary institution. The law generally does not examine *ex ante* potential harms created by new technologies and practices. Only after a new technology emerges is there a reaction in the law to regulate the technology and externalities caused by the technology. There were no state imposed safety standards for automobiles before Karl Friedrich Benz invented the first automobile. There were no state imposed regulations on railroads before the locomotive was created. In many ways, the law is a backward-looking institution, considering new dangers only after they have materialized. SCHÄFER comments, “[b]efore the industrial revolution tort law was a rather unimportant field” however, “[w]ith steam engines, modern traffic (locomotive, motor vehicles) and hazardous products the number and severity of accidents rose dramatically” which “gave rise to the development of modern tort law, especially the negligence doctrine and the slow expansion of strict liability for risks caused by very dangerous activities”.<sup>48</sup> Yet liability is not a novel concept to modern law, as we can see that even in Hammurabi’s code which dates to 1700 B.C.E., there were provisions for punishment for negligent acts, particularly under provision 229 of the code which provides that “[i]f a builder build a house for some one, and does not construct it properly, and the house which he built fall in and kill its owner, then that builder

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<sup>46</sup> PRIEST 1985, p. 462.

<sup>47</sup> See: R. KEETON 1962, on creative continuity.

<sup>48</sup> SCHÄFER 1998, p. 570.

shall be put to death.”<sup>49</sup> While the liability for violating code 229 in ancient Babylonia seems rather harsh, it non the less highlights that standards of care and liability for failure to take care have been integral to legal regimes since ancient times, although those standards of care have not remained static. According to RUBIN, "for the common law to remain efficient, it must change as conditions change; changes in the common law require that some cases be litigated".<sup>50</sup> In the past century, the law has reacted to these technological changes with "further expansion of tort law like product liability, liability for medical malpractice, environmental liability, liability for torts in the marketplace, extended liability of the corporation".<sup>51</sup> However, there is no uniform legal standard of care to which all legal systems adhere. This variation of the standard of care provides a fertile ground to explore how different standards and practices produce different legal outcomes and different economic incentives to take care.

##### 5. The Economic Analysis of Tort Law.

The philosophical goal of tort law can be seen as providing compensation to those who have suffered harm from accidents. While there are a number of intentional torts for which intention may be an element, when considering negligence and product liability, the issue of intention is not necessarily considered, although issues pertaining to willful and wanton acts may be at play in any given tort claim, particularly as part of the computation of damages. In 1970, CALABRESI identified the economic goal of tort law as the minimization of the costs of accidents, or more precisely, the minimization of the primary, secondary, and tertiary costs of accidents.<sup>52</sup> CALABRESI identified that the “principle function of accident law is to reduce the sum of the

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<sup>49</sup> HAMMURABI’S CODE 1700 BCE, § 229.

<sup>50</sup> RUBIN 1977, p. 51.

<sup>51</sup> SCHÄFER 1998, p. 570

<sup>52</sup> CALABRESI 1970, pp. 26-28.

costs of accidents and the costs of avoiding accidents.”<sup>53</sup> From focusing on this goal of tort law, the minimization of the costs of accidents, much of the subsequent focus of this research flows. COOTER and ULEN comment on how the economic goal of tort law is to use “liability to internalize externalities created by high transaction costs”.<sup>54</sup> DARI-MATTIACCI and PARISI comment that “economic analysis suggests that the primary reason for utilizing the tort system is to allow risk-creating activities to be carried out only if the social value of the activity justifies the risk created.”<sup>55</sup> Tort law is generally used to address those instances where negative externalities have caused private harm.

If we consider a state's legal system's role in determining rules, we see that there are many ways to deal with the same or similar problems. Legal systems can use one or a combination of these rules and regulations to make those creating negative externalities internalize them. CALABRESI and MELAMED discussed in their seminal paper “The Cathedral” how different rules can produce different economic outcomes.<sup>56</sup> According to DARI-MATTIACCI and PARISI, “[t]he positive economic theory of tort law maintains that the common law of torts is best explained as if judges are trying to promote efficient resource allocation, i.e., maximize efficiency”.<sup>57</sup> Importantly, much of the economic analysis of tort law concerns or is consistent with CALABRESI’s view on limiting the costs of accidents.

### 5.1 The Role of Due Care Incentives.

While there are potential issues concerning fairness and justice in determining compensation to victims, the economic analysis of tort law is better focused on the deterrence incentives which the

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<sup>53</sup> CALABRESI 1970, p. 26.

<sup>54</sup> COOTER and ULEN 2016, p. 204.

<sup>55</sup> DARI-MATTIACCI and PARISI 2006, p. 2.

<sup>56</sup> CALABRESI and MELAMED 1972.

<sup>57</sup> DARI-MATTIACCI and PARISI 2006, p. 1.

awarding of damages creates, as the potential for liability forces potential tortfeasors into taking account the costs of taking care and the costs of failing to take care. If tortfeasors are not forced to internalize the costs of accidents they contribute to, then they have an economic incentive to continue as they are. If tortfeasors are forced into internalizing the costs of accidents that they create or contribute to, they will have an economic incentive to take care to avoid accidents.

As previously mentioned, law and economics scholars have postulated a theory of the efficiency of the common law. The efficiency of the common law relies to a certain extent on the process by which courts determine liability for tort claims, although perhaps to a lesser extent than contract claims. Part of this theory postulates that litigation through courts and the adherence to the doctrine of *stare decisis* acts as a type of feedback loop, with the function being related to the legal dilemmas of society.<sup>58</sup> PRIEST and RUBIN later expanded the efficiency of the common law hypothesis. This theory postulates that the common law creates efficient rules through the process of adjudication of private claims. In the area of tort law, the doctrine of *jurisprudence constante* used in civil law traditions has a similar but distinct role in leading to the refinement and development of efficient due care standards in tort law.<sup>59</sup>

One of the issues regarding the arbitration of tort claims concerns how the diversion of tort claims from public to private courts changes the incentives of the victim and injurer in taking due care and undertaking an efficient level of activity. Different jurisdictions have different liability rules.

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<sup>58</sup> PRIEST 1977. RUBIN 1977.

<sup>59</sup> According to PAISI and FON, “Due to the nature of common law, the boundaries of legal remedies and the domain of legal protection have changed over time. A large number of situations that were outside the domain of existing legal remedies have been granted remedial protection over time. Following different doctrines of precedent, such as *jurisprudence constante*, similar processes of evolution have affected the boundaries of legal rules and remedies in civil law systems. For example, causes of action in torts have historically increased in number and scope of application under both common and CIVIL law systems. Yet in other areas of law, the domain of legal remedies has not experienced similar expansion.” PARISI and FON 2009, p 97.

The main rules used are: 1) No Liability; 2) Strict Liability; 3) Negligence; 4) Negligence with contributory negligence; 5) Strict liability with contributory negligence; and 6) Comparative negligence. When comparing strict liability and negligence, SHAVELL has commented that although "both forms of liability result in the same, socially optimal behavior...they differ in terms of what courts need to know to apply them", where "under strict liability the court need only determine the magnitude of loss that occurred, whereas under the negligence rule a court must" additionally "calculate the socially optimal level of due care".<sup>60</sup> COOTER and ULEN, when considering the "efficiency of incentives created by liability rules" assuming "perfect compensation and legal standards equal to efficient precaution", generally find the following concerning the use of these common rules.<sup>61</sup> No liability rules result in the victim having an efficient incentive to take precaution and the injurer having no incentive to take precaution, with the victim having an efficient incentive to take the correct activity level and the injurer not having an efficient incentive to take the correct activity level.<sup>62</sup> Strict liability rules result in the victim having an inefficient incentive to take precaution and the injurer having an efficient incentive to take precaution, with the victim having an inefficient incentive to take the correct activity level and the injurer having an efficient incentive to take the correct activity level.<sup>63</sup> This is the mirror of the incentives for victims found under a no liability rule. Negligence rules result in the victim having an efficient incentive to take precaution and the injurer having an efficient incentive to take precaution, with the victim having an efficient incentive to take the correct activity level and the injurer not having an efficient incentive to take the correct activity level.<sup>64</sup> Negligence with

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<sup>60</sup> SHAVELL 2004, p. 181.

<sup>61</sup> COOTER and ULEN 2016, p. 204.

<sup>62</sup> COOTER and ULEN 2016, p. 204.

<sup>63</sup> COOTER and ULEN 2016, p. 204.

<sup>64</sup> COOTER and ULEN 2016, p. 204.

contributory negligence rules results in the victim having an efficient incentive to take precaution, the injurer having an efficient incentive to take precaution, the victim having an efficient incentive to take the correct activity level, and the injurer not having an efficient incentive to take the correct activity level.<sup>65</sup> This mirrors the incentives for injurers found in a negligence rule without a defense of contributory negligence. Strict liability with contributory negligence rules results in the victim having an efficient incentive to take precaution, the injurer having an efficient incentive to take precaution, and the victim having an inefficient incentive to take the correct activity level and the injurer having an efficient incentive to take the correct activity level.<sup>66</sup> Strict liability with contributory negligence and negligence rules both result in the same incentives for injurers to take precautions. Comparative negligence rules result in the victim having an efficient incentive to take precaution and the injurer having an efficient incentive to take precaution, with the victim having an efficient incentive to take the correct activity level and the injurer not having an efficient incentive to take the correct activity level.<sup>67</sup> It is also important to recognize that multiple approaches or types of tort claims may be at play in a jurisdiction, where claims in tort for damages caused by a defective product may be based on both strict liability and negligence, and as discussed, a claim under strict liability may have defenses of contributory negligence. This means that even under a strict liability rule, there may be a need to consider due care standards. The result of incentives to take care or engage in the optimal level of activity found in various negligence and liability rules shows that no single rule may guarantee efficient outcomes. However, it does demonstrate the multiple tools in the law of torts that can be used to align the private incentives of individuals and firms to take care with the public interest in minimizing the costs of accidents.

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<sup>65</sup> COOTER and ULEN 2016, p. 204.

<sup>66</sup> COOTER and ULEN 2016, p. 204.

<sup>67</sup> COOTER and ULEN 2016, p. 204.

Considering that each of these rules for dealing with tort claims produces different combinations of incentives, will the use of arbitration distort any of these incentives? As the rules of strict liability and no liability are the only two rules with no due care standards involved, in so far as they do not have any defense of contributory negligence, there is an overwhelming need to consider if incentives to take care found in tort law are efficient when the claims are diverted to arbitration. If the use of arbitration allows one of the parties involved to change an efficient incentive to an inefficient incentive, they can further externalize the costs of accidents which they contributed to or the cost of taking care. If the arbitration process changes from an inefficient incentive to an efficient incentive, arbitration may be more economically efficient for determining liability in tort claims than courts if the parties more fully internalize the cost of negative externalities and precautions. The issue of an efficient incentive is more complex than it seems. Within the question of finding a rule or standard with an efficient incentive, there is a need to consider what compensation should be given to a victim when harm occurs and what the legal standard of efficient precaution should be for both the potential tortfeasor and the victim.

Private contracting and information asymmetry add yet another twist to the issue. Tort law is further complicated by the role of contractual relationships between the victim and the tortfeasor. The most common type of situation where this happens is in the sale and use of consumer products. When considering product liability under several legal rules, COOTER and ULEN find the role of information to be a key factor in determining what product consumers will prefer. While “perfectly informed consumers will choose the most efficient product under a rule of no liability”, “imperfectly informed consumers will not necessarily choose the most efficient product under a rule of no liability”.<sup>68</sup> COOTER and ULEN comment on why there is good reason to use strict

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<sup>68</sup> COOTER and ULEN 2016, p. 226.

liability for defective products, as “imperfectly informed consumers will choose the most efficient product under a rule of strict liability” as “the cost of liability will be captured in the price, thus directing consumers toward efficiency despite having imperfect information”.<sup>69</sup> In response to OI’s analysis of product liability under a “full information assumption”, GOLDBERG comments that “[i]n a world with imperfect consumer information concerning the risks of product failure (that is, the world in which we live), public policy makers face a difficult tradeoff” between giving legal preference to individuals who know of a risky product or activity and still want to consume it, and other individuals who “incorrectly perceive the risk” of products and activities “they would otherwise be unwilling to take”.<sup>70</sup> The issue of error by the court must also be considered within the economic analysis of tort law. An error by the court can cause parties to take inefficient precautions or engage in excessive activity levels and may influence how parties utilize the appeals process.<sup>71</sup> The magnitude of the error is related to the effect on the incentive to take due care and provides false or misleading information to consumers.

Ideally, tort laws will lead to both an efficient taking of care and an efficient activity level, but this ideal situation cannot be easily attained. Some scholars have suggested that care level is much more feasible to regulate than activity level, and thus the focus of any economic analysis of tort law is better set towards providing efficient incentives to take care.<sup>72</sup> According to DARI-MATTIACCI and PARISI, “no threshold of ‘optimal activity level’ is generally invoked by legal rules as a liability allocation mechanism”.<sup>73</sup> Accordingly, the analysis of the use of arbitration for

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<sup>69</sup> COOTER and ULEN 2016, p. 226.

<sup>70</sup> GOLDBERG 1974, p. 687. OI 1973. OI 1974.

<sup>71</sup> SHAVELL 2004, p. 458.

<sup>72</sup> According to “Shavell’s theorem on activity level...no negligence rule exists which can give both parties efficient incentives with respect to activity level.” DARI-MATTIACCI and PARISI 2006, p. 14. See: SHAVELL 1980.

<sup>73</sup> DARI-MATTIACCI and PARISI 2006, p. 14.

tort claims contained within this research does not focus on the activity levels of victims and tortfeasors; rather, the focus is on the incentives of victims and tortfeasors to take care.

### 5.2 The use of Collective Action Procedures for Mass Tort Claims.

Administration costs of litigating tort claims also play a role in economic efficiency. One area where the common law has developed rules that take into account the cost of litigating tort claims involves the use of class actions to settle similarly situated claims in a single proceeding. According to COOTER and ULEN, “class actions ideally consolidate litigation to achieve economies of scale and provide a legal remedy for small injuries that are large in aggregate”.<sup>74</sup> Mass torts may be appropriate for a class action; however, it is important to consider how “[m]ass torts are related to but distinct from class actions, which may be an administratively tractable method of dealing with mass torts”.<sup>75</sup> A single proceeding can limit the judicial resources necessary to adjudicate the whole class of claims.

In other respects, the class action may prevent similarly situated claimants from receiving different awards and may solve the problem which occurs when the tortfeasor becomes bankrupt after the initial claims were individually adjudicated. This is because early losses by a defendant may leave those claimants who were not first to file having little incentive to file because of the tortfeasor becoming judgment proof due to the awards given to the initial claimants in what RUBENSTEIN describes as a “race to the courtroom” problem.<sup>76</sup> The use of class action is one way to solve a coordination problem between similarly situated claimants by providing a mechanism to collectivize a common claim. A class action can also solve a problem of scattered losses, where the harm caused is widespread and significant when taken as a whole, but on average, the damages

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<sup>74</sup> COOTER and ULEN 2016, p. 426.

<sup>75</sup> COOTER and ULEN 2016, p. 268.

<sup>76</sup> RUBENSTEIN 2006, p. 727.

suffered by the individual are so small that it would make filing suit individually inefficient because the litigation cost would far outweigh the potential to recover; thus, the case has a negative value to the individual claimant. According to COOTER and ULEN, “[w]hen the cost of trial for each victim exceeds his damages, making liability law work requires aggregating claims, as in a class action suit”.<sup>77</sup>

RUBENSTEIN has argued that using class action for small claims produces positive externalities by turning individual claims which would not in themselves ever be litigated due to their low expected value into a high expected value single claim. This single claim is then capable of producing public goods in the form of positive externalities in the form of "1) decree effects; 2) settlement effects; 3) threat effects; and 4) institutional effects".<sup>78</sup> According to RUBENSTEIN, the positive externalities of small claims class actions makes the class action preferable “not just in terms of the benefits to the litigants themselves, but also in terms of the spillover effects small claims cases will have for society more generally”.<sup>79</sup> While previous comparative analyses of collective actions in the US and the EU have been characterized as divergent, the recent enactment of a representative action mechanism within the EU may change how future comparative analyses of collective actions between the US and the EU are characterized.<sup>80</sup> While chapter four specifically addresses the use of arbitration for mass tort claims from a public welfare perspective and was published in 2018 through the University of Ljubljana, the research did not fully consider more recent developments in EU law for a procedure based on the use of representative actions.<sup>81</sup>

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<sup>77</sup> COOTER and ULEN 2016, p. 236.

<sup>78</sup> RUBENSTEIN 2005, p. 723.

<sup>79</sup> RUBENSTEIN 2005, p. 725.

<sup>80</sup> Importantly, some EU member states, notably the Netherlands, have some forms of collective action procedures at the national level. See: DUTCH COLLECTIVE ACTION PROCEDURE. DCC art 3:305(a)- 305(d). ALSO SEE: TZANKOVA et. al 2022.

<sup>81</sup> REPRESENTATIVE ACTION DIRECTIVE 2020.

Although this new representative action procedure is not addressed thoroughly in this research, the theoretical framework used concerning the arbitration of mass torts from a public welfare perspective may still provide some basis for a law and economics analysis of the Representative Action Directive.<sup>82</sup> When considering the welfare implications of using the representative action procedure, the sum of the social costs and private costs of using the representative action procedure should be removed from the sum of the social and private benefits of using the representative action procedure. There is certainly the potential for further research into the impact of the Representative Action Directive; however, the implementation of this Directive is beyond the scope of this research.

#### 6. Historical and Modern Developments in Arbitration Law.

Disputes are not new, and the law has developed numerous systems and models to settle disputes. The modern traditional public forum for settling legal disputes is a court presided over by a professional judge. Informal forms of mediation and arbitration have existed for millennia. EMERSON wrote in 1970, "[l]ong before laws were established, or courts were organized, or judges formulated principles of law, men had resorted to arbitration for the resolving of discord, the adjustment of differences, and the settlement of disputes".<sup>83</sup> Arbitration is also a widely used institution, and "[i]f the course of arbitration is traced through the centuries, it will be found in the most primitive society, as well as in modern civilization".<sup>84</sup> While the historical use of arbitration

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<sup>82</sup> REPRESENTATIVE ACTION DIRECTIVE 2020. For a law and economics analysis of the Representative Action Directive, see: VISSCHER and FAURE 2021. The new Directive may face an ongoing issue related to funding. According to VISSCHER and FAURE, "it is very doubtful whether the Directive provides a good solution for the funding problem" and "The Directive suggests that MS have to solve the funding problem (undoubtedly the result of a political compromise), but at the same time, it rejects all the market-based solutions which could provide adequate funding or representative actions." VISSCHER and FAURE 2021, p. 475.

<sup>83</sup> EMERSON 1970, p. 155.

<sup>84</sup> EMERSON 1970, p. 156.

started at the local level, international trade stimulated the growth of extraterritorial arbitration courts.

The deference to the arbitration of international commercial disputes was codified across the globe with the adoption of the New York Convention.<sup>85</sup> The NY Convention is evidence of international preference towards adopting a common framework for recognizing international commercial arbitration judgments. Out of this framework, a number of international arbitration courts have grown or emerged, which deal, to a vast extent exclusively, in international commercial disputes between private parties. The United Nations Commission on International Trade Law (UNCITRAL) has published the “Model Law on the International Commercial Arbitration” since 1985.<sup>86</sup> Even if international arbitration law has largely become *jus cogens*, VADI comments on how there are limits to its application since the UNCITRAL model law on international commercial arbitration (UNCITRAL model law), which "has formed the basis for arbitration laws adopted by many countries throughout the world, provides that a court shall refuse recognition or enforcement of an award if it finds that the award is in conflict with the public policy of its state".<sup>87</sup> VADI further comments how “[t]he emergence of individual-oriented public order norms is particularly evident in the interplay between *jus cogens* and international public order in investment treaty arbitration”.<sup>88</sup> The adoption of international legal norms in commercial arbitration and foreign investment practices leaves a large gap between how these types of claims are treated, how the arbitration of tort claims in purely domestic claims are treated, and what is considered *jus cogens*. In general, we do not see the emergence of any legal norm related to the

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<sup>85</sup> NEW YORK CONVENTION 1958.

<sup>86</sup> UNCITRAL MODEL LAW 2006.

<sup>87</sup> VADI 2016, p. 368. UNCITRAL MODEL LAW 2006.

<sup>88</sup> VADI 2016, p. 385.

use of arbitration for tort claims in a domestic setting, and it is unlikely that any convergence of legal norms across states will lead to an international legal norm on the subject in the foreseeable future. Still, to a more limited extent in Europe, we can see that there is some convergence of norms related to the arbitration of consumer related tort claims, which can be attributed to European Community law, which is itself a type of international legal norm that is recognized within the EU economic area. In the EU, community law, specifically those legal provisions designed to protect consumers in the single market found within the Unfair Terms Directive, has been in direct opposition to legal developments found in the US.<sup>89</sup>

The arbitrability of tort claims raises numerous questions which are unique from commercial disputes. There remains a significant variation between states and their willingness to accept the arbitration process for determining questions of tort claims. Only in recent history has the US begun to expand the scope of arbitration to the subject of all types of tort claims. The SCOTUS has found that the Federal Arbitration Act (FAA) is to be broadly applied to contracts in which parties have agreed to arbitrate tort claims, including tort claims for non-economic torts.<sup>90</sup> Extending the scope of arbitration to cover tort claims has been less extensive in other jurisdictions. Some countries have allowed contracts to arbitrate some, but not all, tort claims.<sup>91</sup> The treatment of conspiracies to use arbitration has also changed significantly in the US since the SCOTUS 1930 ruling in *Paramount Famous Corp. v. US*, where a conspiracy to use arbitration in vendor contracts within the film industry was ruled *per se* illegal.<sup>92</sup>

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<sup>89</sup> UNFAIR TERMS DIRECTIVE 1993. Also, see: ORTOLANI et al. 2014, on the use of arbitration for consumer claims in the EU.

<sup>90</sup> *Marmet Health Care Center, Inc. v. Brown*, (2012).

<sup>91</sup> In Chapter two, a comparative analysis of the laws concerning arbitration is presented.

<sup>92</sup> *Paramount Famous Corp. v. US*, (1930).

The extent to which arbitration impacted tort claims has taken some very troubling developments in the US. In the US during the late 2010s, negative press exposure concerning the use of forced arbitration for sexual assault claims by Uber and Lyft passengers against Uber and Lyft drivers and the companies placed public pressure on the "ride share" providers to end the practice of forced arbitration for sexual assault claims.<sup>93</sup> In the US, the issue of sexual assault claims being forced into arbitration gained increasing public scrutiny in the first two decades of the 21<sup>st</sup> century, as a multitude of sexual assault claims forced into arbitration were publicly discussed by victims in the media. In response to the increasingly negative publicity, Uber and Lyft discontinued the practice of enforcing arbitration on their customers for claims related to sexual assault in 2018.<sup>94</sup> The public outrage at the scope of sexual assault claims being forced into arbitration brought about a rare showing of bipartisan support for limiting the practice in Washington, DC.

The Covid-19 pandemic provided an interruption to the research of this dissertation, and while most legal developments since the spring of 2020 are not incorporated into these chapters, as they were substantially finished, there is one particular piece of legislation, H.R. 4445, the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021, was enacted in March of 2022 and highlights some of the underlying issues which concern the arbitration of tort claims.<sup>95</sup> In the US, there has been an ever-growing use of forced arbitration in every type of contract, and arbitration clauses are now prominently used in business to consumer (B2C) contracts and employment contracts. The use of arbitration in everyday contracts has expanded in the US along

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<sup>93</sup> CHATTERJEE 2018. For context, according to the MALOS et al. review of the 2019 safety report which Uber released covering the years 2017 to 2018, "there were 97 fatal Uber-related crashes over the two years surveyed, 19 fatal physical assaults, and — the most striking statistic — almost 6000 incidences of sexual assault. The sexual assault figures reflect both Uber riders and Uber drivers as victims." MALOS et al. 2018, p. 279

<sup>94</sup> CHATTERJEE 2018.

<sup>95</sup> ENDING FORCED ARBITRATION ACT 2022.

with the judicially expanded scope of the FAA.<sup>96</sup> Up until this action by the US Congress, which has put a stop to one of the most controversial uses of arbitration for sexual assault and harassment claims, the instances of arbitration being forced on sexual assault and harassment victims had been increasingly discussed in the US society and exposed in the media and online social networks, while not in open court. When commenting about the scope of tort claims related to sexual assault in the US, BUBLICK remarks, "[i]n terms of gender roles, increased assertion of tort claims may reflect women's greater economic and political power."<sup>97</sup> The signing of H.R. 4445 into law is a clear departure from the expanded view of the FAA, which the SCOTUS has developed, and provides a real life example of how the use of arbitration for tort claims can affect incentives to take care. While the example of the arbitration of sexual assault claims is limited in its application in that it specifically prohibits the use of *ex ante* arbitration agreements in sexual assault and harassment claims, the legislative record shows there was a concern among members of the US Congress that "forced arbitration has transferred the rights of workers and consumers to a secretive, closed, and private system designed by corporate interests to evade oversight and accountability."<sup>98</sup>

Essentially, the expanded scope of the FAA had allowed all types of companies to hide bad acts committed by their employees against other employees and customers. In the US, there are viable civil claims in tort against not only the perpetrators of sexual assault and harassment but also third parties, which may have a separate duty under tort law to victims of sexual assault.<sup>99</sup> In the recent

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<sup>96</sup> For a historical legal review of the FAA, see: SZALAI 2016.

<sup>97</sup> BUBLICK 2006, p. 62.

<sup>98</sup> U.S. H. REPT. 2022.

<sup>99</sup> According to BUBLICK, "In many if not most tort cases, the assailant is sued alongside other third-party defendants." BUBLICK 2006 p. 65. According to SACKS, "Intentional sex tort law should be reformed so that it is consistent with prevailing sexual norms and principles of intentional tort doctrine. Allegations of tortious interference with sexual autonomy should be analyzed consistent with traditional battery jurisprudence bearing on the issues of intent to offend and offensive contact." SACKS 2008, p. 1051.

past, US courts have been unwilling to allow nearly any civil tort claims covered by an arbitration agreement to go to court, including tort claims related to sexual assault and sexual harassment. The SCOTUS occasionally makes controversial rulings reliant on poorly developed or misapplied legal doctrine. The expansion of the scope of the FAA by the SCOTUS to include any contract to arbitrate is one such instance of a judicial error in statutory interpretation, which has recently led to a partial rebuttal by the US Congress through an explicit limiting of the expansive view of the FAA which the SCOTUS developed using questionable legal reasoning.<sup>100</sup> The doctrine of *stare decisis* relies on common law judges making efficient and workable laws, or in other words, "good law". The doctrine of *jurisprudence constante* used in civil law jurisdictions is also dependent, though to a different extent, on judges making "good" law. When the SCOTUS hands down decisions that are not the result of thoughtful, established legal doctrine and the correct application of rules of statutory interpretation, this places the burden on the US Congress to enact legislation in response to the court's clearly erroneous view of the law.<sup>101</sup> The distrust of the judiciary is more

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<sup>100</sup> See: SZALAI 2016.

<sup>101</sup> The role of the SCOTUS in reversing erroneous rulings has long been a point of contention within the US federal judiciary and the American public. An interesting ruling by the SCOTUS, which relates to the functioning of the SCOTUS in refusing to overturn poorly developed SCOTUS precedent, concerns the legal fiction that organized exhibitions of baseball games do not constitute interstate commerce and thus are not subject to antitrust law. This legal fiction, incorporated into SCOTUS precedent until today, originated in the *Federal Baseball Club v. National League* (1922). In the case *Flood v. Kuhn* (1972), a challenge to Major League Baseball's antitrust exemptions by baseball player Kurt Flood, Justice Blackmun explained that even though the legal reasoning behind the antitrust exemption given by the SCOTUS in the 1922 Federal Baseball Club case to Major League Baseball was incorrect in that it said baseball was not interstate commerce, that "[t]he Court, accordingly, has concluded that Congress as yet has had no intention to subject baseball's reserve system to the reach of the antitrust statutes. This, obviously, has been deemed to be something other than mere congressional silence and passivity." *Flood v. Kuhn*, (1972), p. 283. This legal doctrine of placing the burden on congress in such instances of something more than "silence and passivity" by congress, where actual inaction by congress is given weight by the court, is best described as a "punting" of the issue by the SCOTUS and has the social effect of eroding confidence in the SCOTUS and other public institutions. At other times the SCOTUS has reversed long standing precedents with questionable legal reasoning. A recent ruling by the SCOTUS in *Dobbs v. Jackson Women's Health Organization* (2022), in which the SCOTUS reversed the *Roe v. Wade* and *Planned Parenthood v. Casey*, decisions legalizing and affirming the constitutional right to an abortion and which had been in place for decades, was done using what many legal scholars considered questionable legal reasoning. In the majority opinion, Justice Alito writes "*Stare decisis*, the doctrine on which *Casey's* controlling opinion was based, does not compel unending adherence to *Roe's* abuse of judicial authority." *Dobbs et al. v. Jackson Women's Health Organization et al.* (Slip Opinion) Decided June 24, 2022. In Chief Justice Roberts concurring in judgment only decision, he comments on how the court has failed to show "judicial restraint" and failed to conform with the doctrine

institutionalized in the civil law tradition than in the common law tradition, which may help explain part of why judges in common law legal tradition may be more prone to making “bad law” which proves to be enduring, precisely because of the inability of the legislative process to find consensus in correcting the “bad law”.<sup>102</sup> The main goal of the Ending forced Arbitration for Sexual Assault legislation is to remove these types of claims from a veil of secrecy that the use of arbitration creates, and which the SCOTUS had previously ruled applies to nearly all types of contracts under the FAA, including sexual assault claims. President Joe Biden made the following remarks before the signing of H.R. 4445 into law.

"Forced arbitration isn't court. In fact, forced arbitration prevents survivors from going to court. And under forced arbitration, proceedings are conducted in secret, often by arbitrators selected and paid for by the employer. And the outcomes of the arbitration are usually hidden from the public and the employees and coworkers, and they usually can't even — and they can't be appealed or can't be overturned.

In some arbitration clauses, you can't even acknowledge that you're bringing the claim. And parenthetically, employees can still forbid — can still forbid — employers can still forbid people from talking about what happened to them

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of *stare decisis*. According to Chief Justice Roberts, "we should adhere closely to principles of judicial restraint here, where the broader path the Court chooses entails repudiating a constitutional right we have not only previously recognized, but also expressly reaffirmed applying the doctrine of *stare decisis*." (Roberts, concurring in decision only). *Dobbs et al. v. Jackson Women's Health Organization et al.* (Slip Opinion) Decided June 24, 2022. Unpopular rulings from the SCOTUS have a negative impact on public approval of the SCOTUS. According to the late SCOTUS Justice WILLIAM O. DOUGLAS, "[i]t is, I think, a healthy practice (too infrequently followed) for a court to reexamine its own doctrine" as "[l]egislative correction of judicial errors is often difficult to effect". DOUGLAS pp. 746-747. Additionally, DOUGLAS comments that "[t]he place of *stare decisis* in constitutional law is even more tenuous. A judge looking at a constitutional decision may have compulsions to revere past history and accept what was once written. But he remembers above all else that it is the Constitution which he swore to support and defend, not the gloss which his predecessors may have put on it." DOUGLAS 1949 p. 736. The late SCOTUS Justice SANDRA DAY O'CONNOR has commented on the court, that, "I am sure we do not always succeed in striking precisely the right balance among the competing ideals of law, freedom, and justice". O'CONNOR 2003, p. 15. This implies that there will always be room for the SCOTUS to improve. According to a July 2021 Gallup poll, "[f]orty-nine percent of Americans approve of the job the U.S. Supreme Court is doing, its first approval rating below the majority since 2017." JONES 2021. Public perceptions of the SCOTUS are also affected by court errors. Given the current makeup of the SCOTUS, the SCOTUS will likely continue to deal with challenges relating to balancing adherence to judicial doctrine and making "good" law. It is yet to be seen how the ruling in *Dobbs* will impact future cases which challenge other claimed instances of "abuse of judicial authority" by claimants challenging the use of the doctrine of *stare decisis*, as well as the status of other cases unrelated to abortion which incorporated the *Roe* and *Casey* precedent into their decisions.

<sup>102</sup> PARISI and FON 2009. According to PARISI and FON, in Europe during the 19<sup>th</sup> century, a "strict historical conception of separation of powers was due to general distrust of courts that were manipulated by the king before the French revolution." PARISI and FON 2009, p 80.

through nondisclosure clauses. And I think that should be changed as well, but that's another day.

And when it comes to sexual harassment and assault, forced arbitration shielded perpetrators, silenced survivors, and enabled employers to sweep episodes of sexual assault and harassment under the rug. And it kept survivors from knowing if others have experienced the same thing, in the same workplace, at the hands of the same person.

And, yes, there will be cases where victims want their claims resolved in private. But some survivors will want their day in court. And that should be their choice and nobody else's choice."<sup>103</sup>

Still, the scope of the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021 is limited. As it stands under the law, the vast majority of potential tort claims which could fall under an arbitration contract in the US are still subject to forced arbitration.

This new legislation from the US which limits the use of arbitration for the specific subset of tort claims related to sexual assault and sexual harassment highlights some fundamental issues related to how tort claims are adjudicated. It also raises questions surrounding the economic incentives and motivations which parties to an arbitration contract have to take precautions or due care which would prevent an accidental or intentional tort claim from developing between the parties to the contract to arbitrate.

#### 6.1 Foundation of the Law and Economics of Arbitration.

Free parties' ability to contract over their agreements' terms is generally seen as a beneficial process. However, the ability to contract over the adjudication process is not severable from public courts. If there is a private adjudication agreement, it is meaningless without the support of the public courts. Private courts rely on the rules produced by public courts in adjudicating disputes

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<sup>103</sup> BIDEN 2022.

which they consider. These various characteristics change the private incentive to use various forms of adjudication and the public incentive to allow for private adjudication.

LANDES and POSNER considered if adjudication should be considered a private good and what implication the use of private courts has for the public.<sup>104</sup> In their 1979 article, LANDES and POSNER look at how “[a] court system (public or private) produces two types of services” the first being “dispute resolution” and the second being “rule formation”.<sup>105</sup> They find a problem in private dispute resolution concerning “submission,” which involves the determination of the judge to oversee the adjudication.<sup>106</sup> With regards to the rule formulation aspect of adjudication, they find two problems with private adjudication, 1) the private judge has “little incentives to produce precedents” and; 2) the possibility of “inconsistent precedents which could destroy the value of a precedent system”.<sup>107</sup> They find a stronger case for public adjudication when the production of rules is concerned. According to LANDES and POSNER, “the precedent-creating function of adjudication, more than the dispute-resolving function, may invite public intervention in the judicial-services market”.<sup>108</sup> Arbitrators may be “taking a “free ride” on the precedent-creating activities of the public courts”.<sup>109</sup> This free riding may also influence public courts in supporting private adjudication.

Competition between public and private adjudication may develop where private adjudication depends on public acceptance. According to LANDES and POSNER, “[i]f one assumes that an effective system of arbitration requires judicial enforcement both of agreements to submit to

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<sup>104</sup> LANDES and POSNER 1979, pp. 235-284.

<sup>105</sup> LANDES and POSNER 1979, p. 236.

<sup>106</sup> LANDES and POSNER 1979, p. 248.

<sup>107</sup> LANDES and POSNER 1979, p. 238, p. 239.

<sup>108</sup> LANDES and POSNER 1979, p. 242.

<sup>109</sup> LANDES and POSNER 1979, p. 249.

arbitration and of arbitration awards, then the judges stand in two relations to arbitrators: as suppliers of an essential input into arbitration services—namely public enforcement of the agreement to arbitrate and of the award—and as competitors for cases and fees”.<sup>110</sup> With regards to the types of cases in which public and private adjudicators will compete, “[t]he general conclusion is that we can expect more efficient rules of contract and commercial law... than of tort or criminal law, because parties to contracts face a competitive supply of court systems”.<sup>111</sup>

Presumably, the efficiency of tort law could be manipulated in the market by changing the “competitive supply of court systems”. The issue becomes more complicated when there is a contract to arbitrate a tort claim, and even more so if there is collusion within an industry to mandate arbitration in their standard form contracts. From an efficiency perspective, there may be a need for a “smart mix” of public and private adjudication forums to help alleviate potentially destructive competition in the market for third party adjudication.

Parties to a dispute may have asymmetric economic interests in any given claim. For some parties, “precedential effect is an important dimension in deciding whether to litigate the present case because they do anticipate future similar disputes” and thus have “future stakes” in the precedent.<sup>112</sup> However, a party that benefits from an inefficient rule may be incentivized to keep the dispute from court. According to LANDES and POSNER, “[i]f... the dispute arises in an area where the likeliest outcome is a precedent that will strengthen an existing inefficient rule, litigation will be avoided because its expected yield is negative” and “if the parties have asymmetrical stakes, the conclusion that there will be little litigation in areas dominated by inefficient rules is

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<sup>110</sup> LANDES and POSNER 1979, p. 255.

<sup>111</sup> LANDES and POSNER 1979, p. 258.

<sup>112</sup> LANDES and POSNER 1979, p. 260.

weakened”.<sup>113</sup> The party which will benefit from an efficient rule is incentivized to litigate. This asymmetrical stake also incentivizes the party which benefits from the inefficient rule to keep the dispute out of court. However, "if neither party has any future stake...then neither party has an interest in precedent".<sup>114</sup> Thus only claims involving parties who have a future stake in the law are potentially subject to engaging in efforts to prevent or accelerate rule change.

There are public good characteristics to precedent that may influence public policy and private decisions. According to LANDES and POSNER, “[p]recedent has “public good” aspects that may result in underproduction in a private market” yet “to the extent that the costs and benefits of precedent will be borne (in the future) entirely by the parties to the suit in which the precedent is created, precedent is a private rather than public good”.<sup>115</sup> While the private good aspect of precedent may be felt individually, the public good aspects of precedent are not diminishing merely because it is also a private good to some, so long as there are others who may be affected from the precedent or resulting externalities.

As stated earlier, this research is limited to instances in which there is an *ex ante* contract to arbitrate tort claims, and this is because only *ex ante* contracts to arbitrate tort claims have the ability to influence the party's incentives to take care. SHAVELL finds that *ex ante* agreements to use an ADR, such as arbitration, can be mutually beneficial to parties, provided some conditions are met and that the “general policy of the law should be to enforce *ex ante* ADR agreements”.<sup>116</sup> However, SHAVELL finds two instances when this should not be the case. “first, it may be that party to an agreement was not properly informed about relevant information—in the present

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<sup>113</sup> LANDES and POSNER 1979, p. 261.

<sup>114</sup> LANDES and POSNER 1979, p. 261.

<sup>115</sup> LANDES and POSNER 1979, p. 261.

<sup>116</sup> SHAVELL 1995, p. 8.

context, information about the legal process or the character of ADR.”<sup>117</sup> The second exception is “it may be that an agreement to use ADR would negatively affect third parties”.<sup>118</sup> SHAVELL finds that “although the state should enforce private ADR agreements, this does not imply that it should subsidize or otherwise actively encourage ADR agreements”.<sup>119</sup>

Arbitration has generally become accepted as a more efficient forum for resolving commercial disputes than public judicial systems. According to FAURE and MA "a large part of the law and economics literature points to the advantages of arbitration," which "to a large extent relate to commercial arbitration".<sup>120</sup> In general, the benefits of arbitration include: decreasing time costs, avoiding litigation delay and appeals process, decreased cost of litigation, limited legal fees and discovery, expertise in the subject from specialized arbitrators, increased control of process and remedies, *ex ante* ADR agreements by knowledgeable parties raises their wellbeing, confidentiality, the increased ability to continue relationships, particularly commercial relationships, solving choice of law problems, preservation of public resources through court docket relief and decreased system costs.<sup>121</sup> This list is not exhaustive, and there may be other potential costs and benefits for parties from using arbitration, which must be considered in analyzing the costs and benefits of using arbitration for tort claims. While there is a general attitude of acceptance in the law and economics literature of arbitration as a welfare enhancing option for parties involved in commercial disputes, the use of arbitration in non-commercial contracts does not necessarily provide the same advantages when compared with commercial arbitration,

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<sup>117</sup> SHAVELL 1995, p. 8.

<sup>118</sup> SHAVELL 1995, p. 8.

<sup>119</sup> SHAVELL 1995, p. 8.

<sup>120</sup> FAURE and MA 2019, p. 127.

<sup>121</sup> For an analysis of the benefits of arbitration in commercial disputes, see: VAN AAKEN and BROUDE 2016.

particularly when looking at *ex ante* contracts to arbitrate between unsophisticated parties and sophisticated firms.

## 6.2 *ex ante* Contracts to Arbitrate Tort Claims.

If the parties who agree to the contract containing the arbitration agreement for tort claims are acting as utility maximizers, then the contract should be enforced on the parties, assuming there is not some other market failure justifying legal intervention or some other formation deficiency that would make the contract unenforceable. Contracts should reflect the preference of the parties. The law is thus willing to sacrifice accuracy in adjudication to persons' self-interested choices.<sup>122</sup> However, as much of the research in law and economics concerns, parties to contracts are often making a decision with asymmetric information. Another problem that parties to contracts face concerns their private interests. One unique situation that has been increasing in prevalence is when parties sign contracts without reading them.<sup>123</sup> According to SCHWARTZ, "[t]he assumption that each party to a contract wants to maximize its own profit does not itself imply that parties also want to maximize joint gains" since "a party may prefer a larger share of a smaller pie" and "parties will behave strategically at the expense of joint welfare maximization".<sup>124</sup> COOTER and ULEN identify "two fundamental questions in contract law," the first being "[w]hat promises should be enforced?" and the second "[w]hat should be the remedy for breaking enforceable promises?".<sup>125</sup> Within the analysis of the arbitration of tort claims, the contract to arbitrate needs to be considered within these two fundamental questions. 1) Should contracts to arbitrate tort claims be enforced? 2) What should be the remedy for breaking the contract through committing

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<sup>122</sup> SCHWARTZ and SCOTT 2003, p. 541.

<sup>123</sup> DE GEEST 2002.

<sup>124</sup> SCHWARTZ and SCOTT 2003, p. 552.

<sup>125</sup> COOTER and ULEN 2016, p. 277.

a tort be? These questions highlight a tension between adhesion contracts to arbitrate and public policy, such as those found in criminal statutes and those found within the EU UNFAIR TERMS DIRECTIVE.<sup>126</sup>

### 6.3 Incentives to Take Due Care in Arbitration.

Can arbitration of tort claims provide similar incentives for parties to take care as those incentives found in public tort law? This is one of the main concerns of this research. If arbitration can provide similar incentives to take due care as those found in court, then there is a strong argument in favor of allowing for arbitration of tort claims. If there is an unreasonably lower or higher incentive to take due care, this may be a concern for favoring arbitration of tort claims, as the increased internal or external cost may prove to be welfare reducing. If there is a decrease in the incentive to take due care, this may lead to increased transaction costs related to the resulting increase in accidents and associated increase in negative externalities.

### 6.4 Secondary and System Costs and Arbitration.

If arbitration can provide similar incentives as when tort claims are publicly litigated, then secondary costs and other costs may make arbitration desirable, which may even be true if the incentives are dissimilar. If there is an unreasonably lower or higher incentive to take due care, there may still be other reasons to favor arbitrating tort claims, provided the arbitration process provides a significant enough benefit in some other area. The use of arbitration may decrease transaction costs or system costs. If a reduction in secondary and tertiary system costs outweighs

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<sup>126</sup> UNFAIR TERMS DIRECTIVE. Ex ante contracts to use arbitration in consumer contracts are disfavored in the EU, specifically under the Unfair Terms Directive, if used exclusively to resolve disputes under Annex 1(q) of the Directive.

the increase in due care costs or other primary costs, then there may be an economic justification for continuing to use arbitration.<sup>127</sup>

#### 6.5 The use of Arbitration and Competition Law.

The collusive use of arbitration in an industry may have multiple objectives and effects in highly concentrated markets. If firms within an industry can mandate arbitration that covers tort claims, then it may be possible for those firms to act strategically to subvert due care standards by inhibiting the creative process of courts from adjusting inefficient care standards through the production of public goods from litigation. It may also allow for firms to strategically target some types of public goods from litigation to convert into club goods, which is to say the objective of the conspiracy may be to prevent a class, in this case, anyone with a contract to arbitrate with firms in an industry, from accessing those goods.

#### 6.6 The Costs and Benefits of Using Arbitration.

What does a cost benefit analysis of arbitration tell us when compared to litigation? If the savings to the judicial system costs from arbitrating tort claims proves so high that even the increased cost associated with taking too much or too little care is outweighed, then there may be a strong economic incentive to use arbitration. Under CALABRESI's criteria of accident cost minimization, if the use of arbitration for tort claims leads to an increase of the primary costs of accidents which outweigh savings for the secondary and tertiary costs of accidents, it cannot be justified under economic rationale. When arbitrators have specialized knowledge of the claim subject, they may prove to be more accurate in determining liability than judges. If arbitration results in the correct determination of liability at a higher rate than courts, then this may also be a reason to support

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<sup>127</sup> This is consistent with the economic goals of tort law, which CALABRESI identified, which is the minimization of primary, secondary, and tertiary costs of accidents. See: CALABRESI 1970, CALABRESI 2008.

arbitration of tort claims under an economic rationale. This may be a particularly strong argument for arbitration as opposed to litigation. If the arbitration process limits the procedural rights that parties would be entitled to in public courts, thus limiting the cost of the arbitration yet still producing a more accurate determination of liability than courts, the use of arbitration should be favored on efficiency grounds.

When considering arbitration of tort claims from an economic standpoint, the process that maximizes the sum of social and private benefits minus the sum of social and private costs is the best process to use in any particular case.

#### 7. The Structure of the Research.

Each of the chapters composing this dissertation was written as discrete articles, resulting in some issues being discussed in each chapter. If the chapters had been written as chapters in a book as opposed to discrete articles, the repetition would have to be avoided, but because the chapters are standalone papers and to enable the reader to read the chapters separately, I have not removed the overlap between the chapters. Because of the interrelatedness of each discrete chapter the reader will encounter some repeating and re-introducing issues in subsequent chapters.

This research is structured in the following manner. Chapter 2 is a comparative analysis of arbitration laws and the demand for third party adjudication in six states: England and Wales, France, Germany, Italy, the Netherlands, and the US. The chapter uses a comparative legal analysis to show divergent approaches to the use of arbitration for tort claims across these states. Because of the difficulty in finding data concerning the use of arbitration, proxy measurements are used to identify some information about the demand for legal services in these six states. Chapter 3 concerns the strategic use of arbitration for tort claims using a classic law and economic

methodology, focused on the incentives for parties to behave strategically, the potential impact of strategic behavior given the goals of tort law to minimize the costs of accidents, identifies how parties to a tort claim may behave differently in arbitration, and identifies how the use of arbitration for some types of tort claims may lead to an increase or decrease in the costs of accidents. Chapter 4 uses a law and economics methodology to consider arbitration's potential social welfare implications for mass tort claims. This analysis highlights the potential for different procedural rules to increase or decrease the costs of mass torts depending on the nature of the claim being adjudicated and the potential for the claim to lead to the production of public goods from litigation. Chapter 5 addresses the potential implications for competition law from the use of arbitration for tort claims. This chapter utilizes a comparative law and economic methodology to show that the potential for the collusive use of arbitration for tort claims is higher under the current US legal regime than under EU law. Additionally, chapter 5 uses a game theoretical methodology to explain how focal points facilitate the collusive behavior of firms to use arbitration for tort claims.

The general findings of this research are analogous to what was identified in the early formation of the law and economics academic discipline. The findings of this research readily identify how the use of arbitration for tort claims is both good and bad. The real questions are: To what extent should arbitration be used to adjudicate tort claims?; How can the law limit the strategic use of arbitration for tort claims, leading to decreased social welfare?; and, How can arbitration for tort claims be used to effectuate the minimization of the costs of accidents? Importantly, the presence of transaction costs combined with firms behaving strategically creates the possibility that some firms, particularly RP firms, may use arbitration as a mechanism to obscure the costs of accidents to society, which result from externalities created by their taking less than due care. This may result from efforts to manipulate the production of public goods from litigation by either diverting

inputs necessary for their production into arbitration or strategically waiving arbitration to selectively promote the production of rules.

#### 8. Conclusion.

A critical review of the use of *ex ante* arbitration contracts to settle future tort claims raises numerous questions appropriate for a law and economics analysis. The development of tort law and the increased acceptance of arbitration show how legal systems have taken divergent approaches. A better understanding of the law and economics of the use of arbitration for tort claims provides interested parties, particularly those in positions to influence the law, with a clearer view of the potential for arbitration of tort claims to either increase or decrease the efficiency of the law in incentivizing potential tortfeasors and victims to take care. The articles composing the chapters of this dissertation, although designed to stand alone, develop a reasoned and balanced approach for evaluating the efficiency of the law concerning arbitration and tort claims. By showing the potential costs and benefits of allowing tort claims to be diverted into arbitration, this research is focused on adding to the existing literature concerning arbitration, tort claims, procedural law, competition law, comparative law, and strategic behavior in litigation.

## **Chapter 2. “A Comparative Analysis of the Arbitrability of Tort Claims and the Demand for Adjudication”**

### 1. Introduction.

This chapter is a comparative analysis of several countries' laws covering the arbitration of tort claims and a comparative review of data related to the demand for judicial services in each country. It becomes immediately clear this issue involves contracts, in this case, *ex ante* contracts to arbitrate disputes between the contracting parties. In looking at the use of arbitration for tort claims, one must consider if a claim is contractual or tortious to differentiate when tort due care standards or rules of contractual interpretation are needed, either independently or in combination. Another component in this analysis is the differentiation of public laws concerning arbitration for purely domestic claims and claims that have an international dimension. Additionally, it must be recognized that public disclosures of judicial data from the countries considered here do not differentiate between types of civil claims (tort or contract), and thus available data for all civil claims are considered. Although there is difficulty with several aspects of this analysis, such as differentiating between the third-party adjudication of civil claims and variations in the legal culture of each country, which include tort claims and contract claims, this analysis does provide some descriptive information about how third-party adjudication services, both private and public, are consumed in these countries.

This chapter is a component of a larger dissertation that concerns the use of private arbitration for tort claims. The type of tort claims considered in this analysis are not those between businesses but rather the contracts between individuals and between individuals and businesses. These claims have traditionally been publicly adjudicated, while claims between businesses have a long history of using arbitration. Arbitration removes a claim from publicly administered courts. Arbitration

requires a contract to arbitrate between two parties, in this case, a tortfeasor and a victim. These arbitration contracts are often found in or alongside consumer, employment, and service contracts. The enforcement of a contract to arbitrate tort claims is divergent across countries. Some countries, like the US, allow for the use of arbitration broadly, while other countries have a more limited use, particularly concerning consumer contracts.

Because of the divergent approaches that countries have taken in enforcing contracts to arbitrate tort claims, a comparative approach is used. There are important public policy issues raised by the use of contracts to arbitrate tort claims, as it has the potential to frustrate the development of the law, conceal criminal activity, and harm the public good. There are potential gains from using arbitration for tort claims which may or may not tend to promote public welfare and efficient outcomes. This descriptive chapter is designed to provide a positive evaluation of the source of law concerning arbitration in several countries in the western legal tradition, describe the available data concerning the use of arbitration in these countries for civil claims, which include tort claims and contract claims, and to identify proxy measurements which describe the consumption of third party adjudication services in these countries.

There is a divergence of approaches in enforcing arbitration contracts for determining tort claims. To understand this interaction between public and private law, domestic and international sources of law that may influence the domestic use of arbitration for tort claims are considered. This chapter uses a comparative law methodology to briefly discuss variations in how a claim in tort and a claim in contract are interpreted. The arbitration laws across six countries (nations), England and Wales (UK), France, Germany, Italy, the Netherlands, and the United States (US) are identified. This comparison provides context to the scope of the issue by describing how each

country has developed a unique regulatory approach that may generate a different set of benefits and costs.

This research does not aim to provide any normative analysis of what the law should be, although it does raise some questions which are important in a normative analysis. The research aims to provide a positive analysis of the law and how legal services are consumed in each country.

In addition to identifying the source of law, this chapter attempts to measure the demand for judicial decision-making for tort claims in these countries. The task proves problematic and proxy measurements, including Transnational Legal Indicators (TLI), are considered. Statistical measurements of judicial systems, the use of arbitration, and some proxy measurements for the demand for judicial services can provide information that will be useful in future research related to a comparative law and economics analysis of arbitration of tort claims.

Accordingly, the research questions are: 1) What is the source of laws regulating the use of arbitration, or enforcement of contracts to arbitrate, in England and Wales (UK), France, Germany, Italy, the Netherlands, and the US? 2) Can the use of arbitration for tort claims, or any claims, be quantified? and; 3) Given that only vague and incomplete information about the use of arbitration is available, are there other ways to measure the demand for arbitral services for tort claims in these six countries?

The remainder of the chapter is structured in the following manner: Section 2 addresses the laws governing the use of arbitration and enforcement of arbitration clauses for tort claims in six countries (US, UK (England and Wales), Netherlands, Germany, Italy, and France) and international laws which may influence the use of arbitration for tort claims in these countries; Section 3 addresses the demand for third party adjudication services, including arbitration and

judicial services and proxy measurements for the demand for third party adjudication services in each country; Section 4 is a brief conclusion. An attached appendix addresses the sources used in compiling the descriptive data used in this analysis.

## 2. A Comparison of Sources of Arbitration Laws.

Tort claims have historically been adjudicated in state courts; however, there has been an increased acceptance of using private arbitration tribunals to settle disputes involving tort claims. While “arbitral tribunals and national courts have routinely upheld the arbitrability of tort and other noncontractual claims” and “agreements to arbitrate tort claims are subject to the New York Convention ..and all contemporary national arbitration statutes”, some statutory claims “may exceptionally be subject to national nonarbitrability rules”.<sup>128</sup> The enforcement by courts of *ex ante* contracts to arbitrate all claims, including tort claims, arising out of a contract has led to this increase. The use of arbitration for tort claims is not necessarily dependent only on national law. Within Europe, the laws of the EU are also relevant. International conventions influence the use of arbitration, although to a lesser extent in purely domestic arbitration proceedings. A mix of domestic and international law builds the foundation for each country’s approach to the arbitrability of tort claims.

The acceptance of the use of arbitration clauses that cover tort claims between businesses and consumers has not developed into an international legal norm, while international legal norms have developed in the use of arbitration for commercial disputes and investor state disputes.<sup>129</sup> A review of the use of arbitration for tort claims across borders shows how approaches vary in application,

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<sup>128</sup> BORN 2021, p 368, p.369.

<sup>129</sup> For a discussion about the use of legal norms in international investor arbitration, see: PAULSSON 2006. For a discussion about the role of international legal norms from commercial arbitration, see: DRAHOZAL 2000.

scope, and use. While consumer arbitration is generally accepted in the US, other countries have taken “a wide variety of different approaches to agreements to arbitrate future consumer disputes.”<sup>130</sup> The limits on consumer arbitration can be categorized into “rules of substantive validity” and “nonarbitrability rules”, and generally, “statutory provisions are better regarded as prescribing rules of substantive validity than nonarbitrability”.<sup>131</sup> When comparing common law approaches to the arbitrability of statutory claims with civil law approaches, Born comments that “[b]oth common law and civil law courts have frequently concluded that particular statutory claims are within the scope of the parties’ arbitration agreement” while “some courts and arbitral tribunals have held that various statutory claims were not within the scope of the parties arbitration agreement.”<sup>132</sup>

It is valuable to consider some of the approaches taken in the use of arbitration for tort claims. The laws of six countries: England and Wales (having common arbitration laws), France, Germany, Italy, the Netherlands, and the US, will be compared to show the approaches which have developed. These six countries represent a mix of legal traditions: common law (England and Wales); French civil law (France); Germanic civil law (Germany); a mix of French and German influences (Italy and the Netherlands); and a mix of common law with Spanish and French civil law influences (US). The European countries included in this analysis have been historically influential in developing the western legal tradition.<sup>133</sup> The US can generally be considered a

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<sup>130</sup> BORN 2021, p. 1104.

<sup>131</sup> BORN 2021, p. 1104.

<sup>132</sup> BORN 2021, p. 1472.

<sup>133</sup> The UK is generally considered the birthplace of the common law legal tradition. The French civil code has been widely influential globally, with many countries modeling their legal system on it. The German legal tradition is rooted in Roman law and developed with influences from multiple legal traditions, including canonical law. The horror of WWII and the division of Germany into East and West after WWII also influenced the drafting of the German Basic Law. The concept of "Sonderweg," or the special way, refers to the unique path which Germany took in developing the modern German legal system, which in turn has been influential on other legal systems. The Dutch legal tradition has been widely influential on the law of the sea and international commercial legal norms. The Italian legal culture

common law jurisdiction; however, French civil law and Spanish civil law are also used in some jurisdictions, which can also be described as "mixed jurisdictions".<sup>134</sup> One need only look at the popularity in Europe of ALEXIS DE TOCQUEVILLE'S classic examination of the early American state in "De La Démocratie en Amérique" to see how the democratic ideals of the US influenced European political thought in the 19<sup>th</sup> century.<sup>135</sup> In the 20<sup>th</sup> century, the role of the US in influencing international law increased along with the growing US military and economic power.

Although many countries could also have been included in this list, these six countries were chosen because of the influence of each country on European law, international law, the legal cultures of other countries, or their importance in the practice of arbitration. Another important reason to consider these countries is their relative use of arbitration, as private parties and firms from each country are regularly involved in international arbitration proceedings.<sup>136</sup> From a practical matter, a limited examination demonstrates the divergence of approaches.

The following subsections describe the source of international laws which influence the use of arbitration and the source of domestic arbitration law in each of the six countries.

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is rooted in the Roman tradition, which was subsequently subsumed by the adoption of a French style civil law system which was also influenced by the German legal tradition.

<sup>134</sup> French civil law is the basis for the legal system of Louisiana, and Spanish civil law is the basis for the legal system of Puerto Rico. For a historical review of the French Civil Code's role in Louisiana's laws, see: DART 1929. For a historical review of the role of the Spanish Civil Code in Puerto Rico, see: FIOL-MATTA 1995. PALMER has addressed the unique issue of "mixed jurisdictions," which have multiple legal traditions which influence their legal culture. PALMER 2001.

<sup>135</sup> DE TOCQUEVILLE 1850.

<sup>136</sup> In 2017, the U.S. (8.4%), Germany (5.5%), France (5.4%), Italy (3.2%), the Netherlands (2.5%), and the UK (2.9%) were all within the top ten of the "most frequent nationalities among parties" involved in ICC proceedings. ICC BULLETIN 2018, p. 53.

## 2.1 International Sources of Arbitration Law.

Commercial arbitration has developed on an international scale. Trade between firms in countries and between countries has led to the development of international commercial law, or *lex mercatoria*. The *lex mercatoria* has influenced the development of arbitration as a dispute resolution process in international commercial trade, the development of international legal norms, and the use of arbitration within individual countries.<sup>137</sup>

### 2.1.1 European Union Law.

The EU has enacted a wide range of laws that govern the internal market of the EU. These laws often involve consumer protection. The Unfair Terms Directive is the most striking limit on the use of arbitration in consumer contracts. Some terms are considered unenforceable in European consumer contracts under the directive.<sup>138</sup> According to BORN, “[u]nder the EU’s Unfair Terms in Consumer Contracts Directive, the provisions of standard form consumer contracts are subject to statutory fairness requirements” which “provides that a provision is prima facie unfair, and therefore invalid, if it ‘requir[es] the consumer to take disputes exclusively to arbitration not covered by legal provision’.”<sup>139</sup> In the annex of the UNFAIR TERMS DIRECTIVE, arbitration is explicitly addressed under paragraph (g): “excluding or hindering the consumers right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions” is explicitly prohibited.<sup>140</sup>

The EU has developed rules for determining the jurisdiction of legal disputes and the recognition of member states civil judgments through the Brussels I regulation.<sup>141</sup> The Brussels I regulation

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<sup>137</sup> For a discussion on the role of *lex mercatoria* in international commercial arbitration, see: LANDO 1985.

<sup>138</sup> UNFAIR TERMS DIRECTIVE 1993.

<sup>139</sup> BORN 2021, p. 1109. Citing to UNFAIR TERMS DIRECTIVE 1993, Annex 1(q).

<sup>140</sup> UNFAIR TERMS DIRECTIVE 1993.

<sup>141</sup> BRUSSELS I.

excludes arbitration from its uniform jurisdictional regime for Europe and for the recognition of civil and commercial civil judgments.<sup>142</sup> Despite the exclusion of addressing arbitration, a renegotiated Brussels I regulation does recognize the use of the NY Convention among member states.<sup>143</sup>

### 2.1.2 The New York Convention

The NY Convention of 1958 addresses the recognition and enforcement of foreign arbitral awards and is considered the most significant international agreement on the use of arbitration.<sup>144</sup> The signatory countries include France, Germany, Italy, the Netherlands, the UK, and the US.<sup>145</sup> Three important limitations are found within the NY Convention. Under the NY Convention, there is a distinction between foreign and domestic awards, the recognition may be limited to awards from signatory states, and countries may limit their recognition to awards for commercial disputes.<sup>146</sup> There are several grounds for denying recognition of a foreign arbitral award, including: incapacity, failure to give notice, the award is outside the scope of the agreement, the arbitral tribunal or arbitral procedure was outside the scope of the agreement, or the award has not been recognized as binding by the authorities in the location of the seat of the tribunal.<sup>147</sup> Two significant limits found in the NY Convention concern the inarbitrability of a dispute and when the use of arbitration in a particular dispute is against public policy.<sup>148</sup>

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<sup>142</sup> BRUSSELS I. and ORTOLANI et al. 2014, p. 13.

<sup>143</sup> “Recital 12 of the recast Brussels I Regulation confirms that arbitration falls outside of the scope of the Regulation, and Member States are left free to comply with their international obligations under the New York Convention”. ORTOLANI et al. 2014, p. 14. BRUSSELS I.

<sup>144</sup> NEW YORK CONVENTION 1958.

<sup>145</sup> See the New York Arbitration Convention website for a full list of Contracting States to the New York Convention. NEW YORK CONVENTION 1958.

<sup>146</sup> NEW YORK CONVENTION 1958., ORTOLANI et al. 2014. p. 31-32.

<sup>147</sup> ORTOLANI et al. 2014. p. 32

<sup>148</sup> NEW YORK CONVENTION 1958.

The NY Convention applies to both contractual and non-contractual duties so long as the parties agree upon them. According to BORN, "[t]here is no prohibition in most jurisdictions- either common law or civil law- against the arbitration of non-contractual claims, such as tort, delict, statutory, fiduciary, restitution, unjust enrichment and similar claims not based on contractual provisions" and "Article II(1) of the New York Convention (and many arbitration statutes) defines an arbitration agreement as including differences arising from a relationship 'whether contractual or not'."<sup>149</sup> Furthermore, "[a]lthough the language of Article II(1) of the New York Convention and equivalent provisions of national arbitration legislation acknowledges that noncontractual claims may be the subject of a valid arbitration agreement, these provisions offer no direct guidance in interpreting particular arbitration clauses to determine whether they in fact encompass tort claims."<sup>150</sup> While the NY CONVENTION has been highly influential in the development of international norms concerning commercial arbitration, the scope of domestic sources of law concerning arbitration have not converged around the NY CONVENTION.

### 2.1.3 UNCITRAL Model Law.

UNCITRAL has developed a set of model laws "designed to assist States in reforming and modernizing their laws on arbitral procedure so as to take into account the particular features and needs of international commercial arbitration" which "reflects worldwide consensus on key aspects of international arbitration practice having been accepted by States of all regions and the different legal or economic systems of the world".<sup>151</sup> The UNCITRAL model law of commercial arbitration is influential in the practice of arbitration, and commercial arbitration procedures may be used in arbitration proceedings that concern a tort claim. The UNCITRAL model laws have

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<sup>149</sup> BORN 2021, p. 1465.

<sup>150</sup> BORN 2021, p. 1466.

<sup>151</sup> UNCITRAL MODEL LAW 1985. The UNCITRAL webpage also includes a database of case law which concerns the interpretation and scope of the model laws in national courts.

been widely adopted or used as the basis for public arbitration statutes. The model rules have been "extremely successful, both as the foundation for the national arbitration laws of many states, and more broadly by setting a standard against which arbitration laws are often judged".<sup>152</sup> Some countries have used the model rules extensively in the codification of legal standards for the use of arbitration.<sup>153</sup> UNCITRAL keeps track of the jurisdictions which have adopted "[l]egislation based on the Model Law", which includes "80 States in a total of 111 jurisdictions".<sup>154</sup> Among the jurisdictions being considered here, Germany (1998) and California (1988) are listed by UNCITRAL as having legislation based on the model law.<sup>155</sup>

## 2.2 Domestic Sources of Arbitration Law.

This section identifies domestic sources of arbitration laws in the UK, France, Germany, Italy, the Netherlands, and the US. The identification of the sources of law is focused on the legislative treatment of arbitration and select judicial rulings which concern the interpretation of the relevant country's legislation.

### 2.2.1 England and Wales (UK)

The Arbitration Act of 1996 is the law that governs the use of arbitration in England and Wales.<sup>156</sup> When considering UK law and the law of England and Wales, it is important to recognize how the law of England and Wales is but a part of the UK alongside Scotland and Northern Ireland, with each having certain competencies to enact jurisdiction specific legislation. For this research, the laws of England and Wales are considered UK law. UK Courts have found "that the purpose of

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<sup>152</sup> ORTOLANI et al. 2014. p. 23.

<sup>153</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1985Model\\_arbitration\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html)

<sup>154</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1985Model\\_arbitration\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html)

<sup>155</sup> [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1985Model\\_arbitration\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html)

<sup>156</sup> ARBITRATION ACT OF 1996.

the Arbitration Act is to give effect to the autonomy of the parties to agree to have disputes determined by arbitration rather than by court".<sup>157</sup> The courts in the UK have also been willing to allow for arbitration to cover contractual disputes and non-contractual disputes, such as whether the contract is valid due to fraud.<sup>158</sup> Arbitration may be limited to when the agreement limits a statutory right, involves insolvency, or involves a criminal act.<sup>159</sup> Sex discrimination cases brought under the Equality Act are not limited by an arbitration agreement, and the Employment Rights Act voids any arbitration agreement which would "prevent a person from bringing claims before an Employment Tribunal".<sup>160</sup>

### 2.2.2 France.

In France, the use of arbitration is addressed in the French Code of Civil Procedure (FCCP) under art. 1442 to 1527.<sup>161</sup> The FCCP also differentiates between the use of arbitration in domestic and international matters.<sup>162</sup> Several types of disputes are not arbitrable in France, including: status and capacity of individuals, divorce, disputes involving public institutions, and public policy related issues.<sup>163</sup> According to Born, "French Courts have consistently held employment disputes nonarbitrable on the basis of Article L1411-4 of the French Employment Code".<sup>164</sup> Within France, "parties can conclude an arbitration agreement after termination of employment, but cannot conclude a binding arbitration agreement relating to future disputes".<sup>165</sup> French Courts have found "an arbitration clause contained in an international employment contract was not null and void, but was not binding ("*inopposable*") on the employee who had seized the competent French court

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<sup>157</sup> WILLIAMS et al. 2022.

<sup>158</sup> *Fiona Trust & Holding Corporation v. Privalov* (2007).

<sup>159</sup> *Clyde & Co LLP v Bates van Winkelhof*, (2014). INSOLVENCY ACT 1986. WILLIAMS et al. 2022.

<sup>160</sup> *Clyde & Co LLP v Bates van Winkelhof*, (2014). EQUALITY ACT 2010. EMPLOYMENT RIGHTS ACT 1996.

<sup>161</sup> FCCP. Art. 1442 to 1527.

<sup>162</sup> FCCP. Art. 1442 et seq- Domestic. FCCP. Art. 1504 et. Seq.- International.

<sup>163</sup> BAILEY et al. 2020.

<sup>164</sup> BORN 2021, p 1098. See FN 392. FRENCH EMPLOYMENT CODE 1910.

<sup>165</sup> POUURET et al. 2007, p. 313.

under the applicable rules of jurisdiction”.<sup>166</sup> An arbitration agreement between a football club and the Federation Internationale de Football Association (FIFA) is considered valid, including for tort claims.<sup>167</sup> Some statutory rights have been held to be arbitral in France.<sup>168</sup> Under French law, a non-professional party in a dispute with a professional party can choose to use either arbitration or litigation when there is a dispute; however, between two professional parties and between two non-professional parties, a contract to arbitrate is enforceable.<sup>169</sup> In international disputes, claims in tort are generally considered arbitrable.<sup>170</sup>

### 2.2.3 Germany.

The German Code of Civil Procedure (*Zivilprozessordnung: ZPO*) art. 1025 to 1066 address the use of arbitration in Germany.<sup>171</sup> Parties are free to arbitrate claims which involve an economic interest (*vermögensrechtlicher Anspruch*), and if the parties are free to resolve the dispute through settlement, then the dispute is also arbitrable.<sup>172</sup> The code prohibits the use of arbitration in disputes arising from landlord tenant relationships.<sup>173</sup> A special arbitration tribunal has been established to arbitrate disputes arising from medical treatment, but the arbitral award is non-binding, and the agreement to arbitrate is entered into *ex post*.<sup>174</sup> There is a requirement for arbitration agreements to be in a separate contract that specifically concerns arbitration.<sup>175</sup> There are also limits on the use

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<sup>166</sup> POUURET et al. 2007, p. 313.

<sup>167</sup> *FC Sochaux v. FIFA* (2016).

<sup>168</sup> See: Born 2021, p 1472, FN 253. Citing to: *Zanzi v. de Coninck* 1999.

<sup>169</sup> FCCP. Art. 2061.

<sup>170</sup> BAILEY et al. 2020.

<sup>171</sup> ZPO art. 1025 to 1066

<sup>172</sup> BÜCHELER and FLECKE-GIAMMARCO 2021.

<sup>173</sup> ZPO 1030(2).

<sup>174</sup> For a review of Germany's medical malpractice arbitration system, see: STAUCH 2011.

<sup>175</sup> ZPO 1032(5).

of arbitration in family law and labor law.<sup>176</sup> Some labor disputes in Germany may be arbitrated in accordance with the Labor Court Act.<sup>177</sup>

#### 2.2.4 Italy.

In Italy, the rules governing arbitration are found in Title VIII of Book IV of the Italian Code of Civil Procedure (ICCP) under art. 806 to 840.<sup>178</sup> Parties are free to arbitrate any dispute which does not involve a “non-disposable” right.<sup>179</sup> This allows for the use of arbitration over a wide range of contracts. Under ICCP 2006, Art. 806(2), “disputes referred to in Art. 409 (*controversie individuali di lavoro*) may be decided by arbitrators only if so provided by collective labor contracts”.<sup>180</sup> The Italian Supreme Court (*Corte di Cassazione*) ruled in 2016 that a contract to arbitrate non-contractual disputes must specifically state so in the contract.<sup>181</sup> Labor disputes in Italy are limited in arbitration as they “may be submitted to arbitration only to the extent that is allowed by statute or by individually or collective contracts of employment”.<sup>182</sup>

#### 2.2.5 The Netherlands.

The Netherlands has devoted a section of the Dutch Code of Civil Procedure (*Wetboek van Burgerlijke Rechtsvordering*) (DCCP) to the use of arbitration under art. 1020 to 1077, also known as the Dutch Arbitration Act of 1986.<sup>183</sup> Under the Act, parties are free to enter into agreements to arbitrate both contractual and non-contractual disputes.<sup>184</sup> The Act limits the use of arbitration “to

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<sup>176</sup> BÜCHELER and FLECKE-GIAMMARCO 2021. ZPO 1030(2).

<sup>177</sup> According to BORN, “the German Labor Court Act, §101” provides “as a statutory exception to arbitrability pursuant to ZPO, §1030(3), for a detailed system for arbitration regarding collective wage agreements.” BORN 2021, p. 1103. GERMAN LABOR COURT ACT 1953, § 101. ZPO §1030(3).

<sup>178</sup> ICCP art. 806 to 840. English translation <https://www.jus.uio.no/lm/italy.arbitration/portrait.pdf>

<sup>179</sup> CARRARA et al. 2021.

<sup>180</sup> POUDRET et al. 2007, p. 313.

<sup>181</sup> *Wind Jet SPA v Compagnia Aerea Italiana SPA*, (2016).

<sup>182</sup> BORN 2021, p. 1098. Citing to: EMMANUELE and MOLFA 2014, and ICCP art. 806.

<sup>183</sup> DUTCH ARBITRATION ACT 1986, Articles 1022-1073 CCP. As Amended 2015.

<sup>184</sup> DUTCH ARBITRATION ACT 1986, Art. 1020(1).

determine legal consequences that may not be freely determined by the parties”<sup>185</sup> and extends to any dispute which is a “matter of public order”, including family law matters and issues involving bankruptcy.<sup>186</sup> According to MEIJER and LAZIC, in the Netherlands “claims based on a tortious legal basis may fall within the arbitral tribunal’s jurisdiction” and “claims arising in connection with an agreement submitted to arbitration will generally fall within the arbitral jurisdiction even if they are based on a tort” including “claims for damages not based on the violation of the contract.”<sup>187</sup> The Netherlands permits “arbitration of at least some types of labor disputes”.<sup>188</sup>

#### 2.2.6 The United States.

The US Arbitration Act, or as it is more commonly known and referred to, the Federal Arbitration Act (FAA), is the federal law that governs the use of arbitration in the U.S.<sup>189</sup> Through a series of SCOTUS rulings, the FAA is now broadly applied and has been determined to supersede any state laws on arbitration.<sup>190</sup> The FAA today is an “expansive system” which involves “both state and federal courts and covering virtually all types of non-criminal disputes”.<sup>191</sup> BORN comments that “the ‘pro-arbitration’ presumption under the FAA is generally-applicable to tort claims.”<sup>192</sup>

The FAA was passed in 1925. For the next five decades, the FAA was applied mainly to commercial disputes. According to SZALAI, “the history of the FAA’s enactment helps demonstrate that the FAA was originally intended to provide a framework for federal courts to support a limited, modest system of private dispute resolution for commercial disputes”.<sup>193</sup> Starting

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<sup>185</sup> DUTCH ARBITRATION ACT 1986. Art. 1020(3).

<sup>186</sup> MARGETSON and MARGETSON 2022.

<sup>187</sup> MEIJER and LAZIC 2009, pp. 623-624.

<sup>188</sup> BORN 2021, p. 1103. Reference to: MEIJER and LAZIC 2009.

<sup>189</sup> FAA.

<sup>190</sup> For a comprehensive study of the historical development of the FAA, see: SZALAI 2016.

<sup>191</sup> SZALAI 2016, p. 117.

<sup>192</sup> BORN 2021, p 1466.

<sup>193</sup> SZALAI 2016, p. 117.

in the 1980s, the Supreme Court of the U.S. has extended the scope of the FAA. Beginning with the *Southland Corp. v. Keating* case in 1984, the Supreme Court of the U.S. has been applying the FAA to state courts.<sup>194</sup> The Supreme Court of the U.S. subsequently expanded the scope of the FAA to labor agreements (*Preston v. Ferrer*), employment disputes (*Circuit City Stores, Inc. v. Adams*), personal injury claims (*Marmet Health Care Center, Inc. v. Brown*), and statutory claims (*Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.*).<sup>195</sup> In March of 2022, the Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act was signed into law, which prohibits the forced arbitration of sexual assault and harassment claims.<sup>196</sup> Under § 402(a) of the Ending Forced Arbitration Act of 2022, “no predispute arbitration agreement or predispute joint-action waiver shall be valid or enforceable with respect to a case which is filed under Federal, Tribal, or State law and relates to the sexual assault dispute or the sexual harassment dispute”.<sup>197</sup>

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<sup>194</sup> *Southland Corp. v. Keating*, (1984).

<sup>195</sup> *Preston v. Ferrer* (2008); *Circuit City Stores, Inc. v. Adams* (2001); *Marmet Health Care Ctr, Inc. v. Brown* (2012); and *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.* (1985).

<sup>196</sup> ENDING FORCED ARBITRATION ACT 2022.

<sup>197</sup> ENDING FORCED ARBITRATION ACT 2022.

FIGURE 1. SOURCE OF DOMESTIC ARBITRATION IN SIX STATES

State	Domestic Source of Law	Selected Judicial Decisions
France	French Civil Code Art. 2059 to 2061 (Scope of Arbitration); Code of Civil Procedure Art 1442 et seq.; and 1504 et seq. (Distinction between foreign and domestic).	<i>FC Sochaux v. FIFA</i>
Germany	Code of Civil Procedure (ZPO) 1025 et seq.	
Italy	Italian Code of Civil Procedure Art. 806 to 840; Legislative Decree No. 5/2003 (Corporate Matters); Italian Public Procurement Code of 2016 (Public Works).	<i>Wind Jet SPA v Compagnia Aerea Italiana SPA</i>
Netherlands	Code of Civil Procedure (DCCP) 1020 to 1077.	
England and Wales	Arbitration Act of 1996.	<i>Fiona Trust &amp; Holding Corp v. Privalov,</i>
United States	United States Arbitration Act (Federal Arbitration Act) 9. U.S.C. 1, (1925); Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2021. Pub. L. No. 117-90, 136 Stat. 26.	<i>Southland Corp. v. Keating,</i> <i>Circuit City Stores, Inc. v. Adams,</i> <i>Preston v. Ferrer,</i> <i>Marmet Health Care Center, Inc. v. Brown,</i> <i>Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.,</i>

### 3. The Demand for Dispute Resolution

There is no readily available data about the specific outcomes when tort claims are arbitrated. Since the use of arbitration in adjudicating tort claims is difficult to measure, it is useful to think of the overall demand for dispute resolution for tort claims. This is because contracts to arbitrate almost inevitably include a confidentiality clause. It is also difficult to measure the number of contracts that contain arbitration clauses. Arbitration effectively shields nearly all information from the arbitration proceeding from becoming publicly available. There is some information about arbitration tribunals when arbitration claims or awards are challenged in court. Additionally, some arbitral tribunals publish limited case rulings, which often do not identify the parties involved. The International Council for Commercial Arbitration (ICCA) regularly publishes a yearbook of commercial arbitration, which includes cases concerning arbitration and limited ruling published by the ICC.<sup>198</sup>

The demand for dispute resolution encompasses several processes.<sup>199</sup> The most visible process is the use of open and public courts. When an arbitration clause is challenged in courts, it creates a public record, and in a largely administrative role, courts are used to enforce arbitration awards, although the awards themselves often remain private information. A less visible process is arbitration itself. Negotiation and mediation, which are less structured dispute resolution processes, often lead to a privately agreed upon solution between disputing parties without a need for a third party to adjudicate. A claim in a court or arbitration is adversarial, while the use of negotiation and mediation may be less so. Depending on the dispute, the parties' positions and interests may lead to an adversarial dynamic that may prevent a private solution (settlement

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<sup>198</sup> ICCA 2022.

<sup>199</sup> For an analysis of the competition between dispute resolution services, including arbitration and public judicial services, see: WAGNER 2015.

through negotiation or mediation), creating a need for third party adjudication of the dispute. The measurement of the demand for dispute resolution is broader than the demand for judicial services. The demand for dispute resolution can be broken down to understand better the data which may be available. Statistics on settlement are practically impossible to measure, while information about litigated claims can be easily identifiable through public records. Arbitration falls in the middle in terms of available information about dispute resolution. Some data about the arbitration may become publicly available; however, this information generally does not include any details about the claim in dispute.

While there has been an increase in data gathering related to the functioning of countries' court systems over the last decades, arbitration is a secretive process and produces limited publicly available information. The instances of negotiation and mediation are even harder to quantify, as these processes are often informal and would leave little to no public records and perhaps some private records. The demand for arbitration is part of the demand for judicial services for tort claims. This statistic would be most helpful in an empirical study of the use of arbitration for tort claims. However, from a practical matter, it is nearly impossible to gauge accurately. Proxy measures are the next best option to consider. Looking at proxy measurements concerning a country's legal system may help gather information about the demand for judicial services.

Legal scholars have recognized the difficulty in gathering information about the use of arbitration. According to ESTLUND, "the lack of regulation and transparency has made it very difficult for scholars to assemble data about the aggregate dimensions or consequences of arbitration in employment (or consumer) cases".<sup>200</sup> Some limited statistical data about arbitration is available

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<sup>200</sup> ESTLUND, 2018, p. 684.

and discussed below, but this information is not particularly helpful. Public arbitration statistics provided by arbitration associations provide little information about the specifics of each case, as the parties involved in the dispute normally have a contract that also compels non-disclosure of the process and award. Information provided by courts is generally public knowledge, and therefore the information about the use of a country's courts in resolving disputes is more complete and detailed than the information about arbitration.

Several law and economics papers have aimed to categorize or measure the demand for, or use of, public judicial services, usually by studying the country's courts. POSNER compared civil litigation rates in the US and England and Wales while looking at "differences in ... volume across jurisdictions" of tort litigation.<sup>201</sup> POSNER considered a number of proxy measurements, including: The rate of accidental deaths in a state; The degree to which the state is urbanized; Population Density; Average years of education; Average household income; Liability insurance coverage; Number of lawyers per capita; Alcohol consumption; Ration of male to female; Percentage age under 25; and the Percentage age over 64.<sup>202</sup> RAMSEYER and RASMUSEN measured "plausible proxies" in considering the use of court systems in six developed countries.<sup>203</sup> Similarly to POSNER, RAMSEYER and RASMUSEN looked at proxy measures such as: Number of suits filed per capita; Judges per capita; Lawyers per capita; Cost of prosecuting a contract claim; and Motor insurance premia.<sup>204</sup> The OECD has also conducted studies on public judicial services that examine how judicial indicators and proxy measurements can help compare a

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<sup>201</sup> POSNER 1997, p. 478.

<sup>202</sup> POSNER 1997, p. 478.

<sup>203</sup> RAMSEYER and RASMUSEN 2010.

<sup>204</sup> RAMSEYER and RASMUSEN 2010.

country's judiciaries.<sup>205</sup> Each of these studies looked at numerous different statistics to make proxy measurements of the quality and demand for public judicial services.

The demand for judicial services includes not only the demand for services from state operated courts but also the demand for services from private courts, and the two systems of adjudication can be considered competitors in the market for providing judicial services. The demand for adjudication from multiple producers of adjudication services means there is competition in-between private courts, in-between state courts, and in between private and state courts. LANDES and POSNER address the issue of "Competition in the Judicial Services Market" in their 1979 article on the use of arbitration.<sup>206</sup> According to LANDES and POSNER, "[n]ot only does the public court system face potential competition both from private methods of dispute resolution and from substitution away from activities that lead to judicially cognizable disputes; there is also the possibility of competition between public court systems".<sup>207</sup> The same applies to private courts, as private arbitration tribunals compete with them to provide judicial services. Measuring the demand for private judicial services is even more elusive than the demand for public judicial services.

This analysis considers several statistics that can help understand each country's system for adjudicating tort claims. For instance, measuring judicial resources, the population of lawyers, and civil litigation rates, identify some of the resources and demands a judicial system has. This data provides some important information about trends in the use of judicial services in these countries. A perfect proxy measurement for the demand for arbitration for tort claims in these countries cannot be identified. In comparing the demand for judicial services and arbitration services, the

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<sup>205</sup> PALUMBO et al. 2013.

<sup>206</sup> LANDES and POSNER 1979, p. 253.

<sup>207</sup> LANDES and POSNER 1979, pp. 253-254.

line remains blurred and obscured. However, the two adjudication processes are related to each other. Thus, it is still useful to consider how public judicial services are consumed and produced.

A review of proxy measures may be most helpful when a clear line is drawn or a shock, for instance, when laws have changed. If enough information about the demand for public judicial services before and after a change in the law which either enables or prohibits the use of arbitration for tort claims can be gathered and the demand for public judicial services can be measured by looking at the demand for public judicial services before and after the change, then other information about the use of arbitration might also be produced. This may indirectly be a measurement of what the demand for private judicial services is. Such a study is beyond the scope of this paper.

Some of the data concerning the US focuses exclusively on California. California has developed a mandatory system of annually reporting on the status of the country's judiciary. This California data set includes information about judges, court types, litigation rates, and government expenditures.<sup>208</sup>

Most publicly available information describes the demand for services from, and supply of resources for, a country's courts. Measurements of court budgets may be misleading in that there is a potential problem of administrative agencies seeking rent in the form of public expenditures.<sup>209</sup> Notwithstanding this caveat, other measurements of a judiciary, such as international legal indicators, can help to compare the relative strengths and weaknesses of a nation's judicial system across borders. A less abundant data source is the arbitration associations within each country. The various arbitration associations only release a limited number of vague statistics about the cases

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<sup>208</sup> CALIFORNIA COURT STATISTICS 2017.

<sup>209</sup> For an analysis of administrative rent seeking, see: CONGLETON 1984; and PELTZMAN 1976.

they arbitrate. The following subsections address the public information available from arbitration associations and potential proxy measurements, which could provide some information about the demand for legal services for tort claims.

### 3.1 Data Available for Arbitration.

The source of information about arbitration proceedings is related to the information which arbitration associations voluntarily disclose or are required to disclose under domestic law. Importantly, this section is designed to highlight a need for more information available from arbitration associations. While each of the countries considered here hosts multiple arbitration tribunals, from a practical standpoint, it is useful to show how the information which tribunals disclose is of limited use. The following selected information provided by arbitration tribunals demonstrates that the information that arbitration tribunals are willing to provide to the public is the most limited of data concerning their business.

#### 3.1.1 Reporting from Arbitration Associations.

Information provided by the most prominent arbitration associations in each country is useful when considering the scope of the use of arbitration in a country. These larger arbitration associations are used extensively to settle commercial disputes. The extent to which these associations arbitrate tort claims, or claims involving consumer claims, is difficult to determine from the public reports, but some tribunals can be expected to specialize in international claims. Because of the secretive nature of arbitration, there is a need to take any information provided by arbitration tribunals as incomplete, at best.

### 3.1.2 California's Statutory Reporting Requirement.

California requires arbitration tribunals operating in California to report certain information about the cases they arbitrate. The mandate for this reporting requirement is found in the California Code of Civil Procedure (CCCP) § 1281.96.<sup>210</sup> Under the CCCP reporting provisions, private arbitration services must publish quarterly a public report which contains information about whether there was a pre dispute contract to arbitrate, "the name of the non-consumer party", the type of dispute, the prevailing party (consumer names not disclosed), and a number of other information disclosure requirements.<sup>211</sup>

A study conducted by the University of California Hastings (UC Hastings) in 2013 examined the data made publicly available from private arbitration associations under the CCCP reporting requirement.<sup>212</sup> The report identifies some of the rationales for the mandatory reporting requirement.

“With complete, accurate information, particularly about the outcome and speed of arbitrations, consumers and policy-makers could assess the arbitration system’s fairness, detect repeat player bias, and impose greater accountability upon arbitration providers. Without complete and accurate information, policy makers and the public cannot assess whether the process is fair, cannot compare arbitration’s operation to other forms of dispute resolution, and cannot detect bias in the system or on the part of particular arbitration companies.”<sup>213</sup>

The study identified a serious lag in compliance with the reporting requirements. According to the study, "even companies publishing some of the required disclosures often omitted information the statute requires to be disclosed, or reported information too inconsistently to permit analysis".<sup>214</sup>

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<sup>210</sup> CCCP § 1281.96 et seq. AMERICAN ARBITRATION ASSOCIATION STATISTICS 2017. The excel report of the AAA can be found at <https://www.adr.org/consumer>.

<sup>211</sup> CCCP § 1281.96.

<sup>212</sup> JUNG 2013.

<sup>213</sup> JUNG 2013, p. 2.

<sup>214</sup> JUNG 2013, p. 6

The report also found that the information disclosed under the CCCP reporting provisions was presented in multiple formats, with no common methodology being used across the industry to comply with the reporting requirement.<sup>215</sup> The following table was presented in the report and includes a tally of the total cases reported by private arbitration associations operating in California through 2013.<sup>216</sup>

FIGURE 2. FINDINGS OF UC HASTING REPORT.

QUARTERLY REPORTS / FIVE YEARS TOTAL (✓ = Yes) (✗ = No)				
	Current through Fourth Quarter 2012?	Most recent update	Covering 5 Years?	Total cases
AAA	✗	Second Quarter 2012	✓ (10 years)	51,718
ADR Services Inc.	✗	Third Quarter 2012 10/1/2012	✓ (10)	1,922
ARC Consumer Arbitrations	✗	First Quarter 2012 5/1/2012	✓ (5)	215
BBB (Los Angeles)	✗	10/1/2012	✓ (6)	345
BBB (NE CA)	✓	2/14/2013	✗ (2)	52
JAMS	✓	1/16/2013	✓ (5)	2,500
Judicate West	✓	12/31/2012	✓ (13)	8,701
NAF	✗	Fourth Quarter 2011	✓ (9)	79,829
NAM	✓	1/18/2013	✓ (4)	8
Office of the Independent Administrator	✓	Fourth Quarter 2012 12/31/2012	✓ (10)	7,836
Resolution Remedies	✓	1/2013	✓ (10)	112

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<sup>215</sup> JUNG 2013, p. 6.

<sup>216</sup> JUNG 2013, p. 13.

<sup>217</sup> JUNG 2013, p. 13.

The report suggests further requirements to increase the consistency of the reporting in a “uniform” manner are necessary “for the statute’s goals to be more fully realized”.<sup>218</sup>

### 3.1.3 American Arbitration Association.

The American Arbitration Association (AAA) releases an annual report and financial statement about their work. The International Center for Dispute Resolution, the part of the AAA which focuses on international arbitration, arbitrated 1026 cases in 2017. According to the report, "The largest claims by industry were (in descending order) in technology, commercial insurance, energy, aviation/aerospace/national security, pharmaceuticals, financial services and commercial construction".<sup>219</sup> The AAA also oversees a large number, 290,486 in 2017 to be exact, of New York “No Fault” insurance claims through a special No Fault Arbitration process.<sup>220</sup>

### 3.1.4 International Chamber of Commerce.

The International Chamber of Commerce (ICC), headquartered in Paris, with offices around the globe, is one of the world's most influential international arbitration tribunals. Recently, the ICC "became the first business organisation to be admitted as Observer to the United Nations General Assembly".<sup>221</sup> According to the ICC, "[a]s of end 2017, 1,578 pending cases were being administered by the Court and over 23,300 cases had been registered since its creation in 1923". The ICC keeps track of the nationality of parties involved in ICC arbitration. In 2017 the U.S. (8.4%), Germany (5.5%), France (5.4%), Italy (3.2%), the Netherlands (2.5%), and the UK (2.9%) were all within the top ten of the "most frequent nationalities among parties" involved in ICC

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<sup>218</sup> JUNG 2013, p. 39.

<sup>219</sup> AMERICAN ARBITRATION ASSOCIATION STATISTICS 2017, p. 20.

<sup>220</sup> AMERICAN ARBITRATION ASSOCIATION STATISTICS 2017, p. 22.

<sup>221</sup> ICC BULLETIN 2018, p. 51.

proceedings.<sup>222</sup> Some commercial arbitral decisions held before the ICC are published with redacted confidential information in the ICCA.<sup>223</sup>

### 3.1.5 Netherlands Arbitration Institute

The Netherlands Arbitration Institute (NAI) is the main arbitration association in the Netherlands. According to the NAI website, "The NAI was established as a foundation in 1949 in order to promote arbitration, binding advice and mediation as a means of resolving and settling disputes".<sup>224</sup> The NAI publishes annual reports, which include statistics about the number of arbitration proceedings overseen by the NAI. According to the 2016 report, the total number of notified arbitrations (*Totaal aantal aangemelde arbitrages*) for 2016 was 81, and between 2010 and 2016, the NAI oversaw a total of 787 cases.<sup>225</sup>

### 3.1.6 German Institute for Arbitration

The goals of the German Institute for Arbitration (DIS, short for *Deutsches Institut für Schiedsgerichtswesen*) are to promote and provide "essential support for the conduct of arbitration related tasks in Germany".<sup>226</sup> The DIS published some statistics for 2017 via their webpage.<sup>227</sup> DIS had 166 arbitration proceedings in 2016 and 152 in 2017.<sup>228</sup> This included 19 sport arbitration proceedings in 2016 and 27 in 2017.<sup>229</sup>

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<sup>222</sup> ICC BULLETIN 2018, p. 53.

<sup>223</sup> ICCA 2022.

<sup>224</sup> NAI ANNUAL REPORT 2016.

<sup>225</sup> NAI ANNUAL REPORT 2016.

<sup>226</sup> NAI ANNUAL REPORT 2016.

<sup>227</sup> DIS 2017.

<sup>228</sup> DIS 2017.

<sup>229</sup> DIS 2017.

### 3.1.7 The Milan Chamber of Arbitration.

The Milan Chamber of Arbitration (CAM) is an agency under the *Camera di Commercio di Milano Monza Brianza Lodi*.<sup>230</sup> The CAM is unique from other arbitration courts because it is a "professional public entity" operating under Italian Law No. 580 of 1993.<sup>231</sup> The CAM specializes in commercial disputes and provides reports on the number of proceedings it oversees.<sup>232</sup> In 2017 there were 131 new requests for arbitration with the CAM.<sup>233</sup>

### 3.1.8 London Court of International Arbitration.

The London Court of International Arbitration (LCIA) brands itself as "one of the world's leading international institutions for commercial dispute resolution".<sup>234</sup> According to their 2017 Casework Report, "the LCIA received 285 arbitration referrals" during 2017.<sup>235</sup> The LCIA report maps the nationality of parties that appear in arbitration cases before the LCIA.<sup>236</sup> In 2017, parties to LCIA arbitration included 10.1% from the US, 19.3% from the UK, 3.4% from the Netherlands, and 2.5% from Italy.<sup>237</sup>

### 3.2 Proxy measurements for the Demand for Adjudication.

Due to the lack of available information from arbitration tribunals and from public reporting requirements, the data concerning the use of arbitration for tort claims could be of better quality. Because of this poor quality, proxy measurements, which consider various related information about the consumption of legal services for third party adjudication, are considered. These proxy measurements are imperfect, and there remains a large gap in the available information about

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<sup>230</sup> CAMERA ARBITRALE DI MILANO STATISTICS 2017.

<sup>231</sup> CAMERA ARBITRALE DI MILANO STATISTICS 2017. ITALIAN LAW No. 580, 1993.

<sup>232</sup> CAMERA ARBITRALE DI MILANO STATISTICS 2017.

<sup>233</sup> CAMERA ARBITRALE DI MILANO STATISTICS 2017.

<sup>234</sup> LCIA FACTS & FIGURES 2017, p. 2.

<sup>235</sup> LCIA FACTS & FIGURES 2017, p. 3.

<sup>236</sup> LCIA FACTS & FIGURES 2017, p. 7.

<sup>237</sup> LCIA FACTS & FIGURES 2017, p. 7.

arbitration for tort claims which cannot be adequately overcome by looking at proxies. Still, this analysis sheds light on the legal services market, of which arbitration is such a service.

### 3.2.1 Comparison of Civil Cases.

Civil case data from EUROSTAT, California courts annual reports, U.S. Federal Court statistical reports, and data from the UK Ministry of Justice, is used to make a comparison of the civil cases filed in England and Wales, France, Germany, Italy, the Netherlands, and the U.S., including California.<sup>238</sup> Figure 3 shows statistics on the number of civil cases from 2011 to 2015 which were filed in the country's courts, the population of each jurisdiction in 2016, the per capita rate for filing civil claims, and the number of civil claims filed per 100,000 inhabitants. It is important to note that not every civil claim is a tort claim, and the civil claims statistics will include any civil claim filed in court. Only some of these civil claims go through the entire litigation process, as many claims settle, and no trial is needed. The statistics from California only represent the number of civil cases filed in California state courts, and not the number of civil cases filed in federal courts seated in California, which are a fraction of the number of cases filed in state courts. This trend is true across the US, with only a fraction of all civil claims being filed in Federal courts. The types of civil claims available, and variation in the categorization of claims across borders, means that one should be cautious when considering civil litigation rates. For instance, the minimum value of a claim to be filed in court may vary across jurisdictions, and how claims are categorized may vary depending on which criteria are being used. The following data should be viewed with some skepticism because variations in the classification standards used across jurisdictions can distort a cross border comparison.

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<sup>238</sup> CALIFORNIA COURT STATISTICS 2017.

FIGURE 3. COMPARATIVE CIVIL CLAIMS OVER FIVE YEARS.<sup>239</sup>

State	Civil Claims	Population 2016	Average Claims per person	Average Claims per 100000
France	1698704	66724104	0.025	2545.863
Germany	1308135	82348669	0.016	1588.532
Italy	1938087	60627498	0.032	3196.713
Netherlands	161171	17030314	0.009	946.377
England and Wales	1802286	58381300	0.031	3087.095
California	712299	39103587	0.018	1821.569
US Federal District (2015)	292076	323071755	0.001	90.406

Based on the comparison of civil claims in these six countries, there are three groupings of countries in terms of their average claims per 100,000. Italy (3196.7) and the England and Wales (3087.0) have a high number of claims filed in the group, France (2545.8) takes up a middle-high part of the group, and California (1821.6) Germany (1588.5), the Netherlands (946.4) and take up the middle-lower and lowest part of the group. Noticeably, there is a very low number of civil claims filed in federal court in the US (90.4), and when combining the average federal claim per 100,000 with the average California claims, we see the combined filed claims per 100,000 are (1911.975), which keeps the US average in the middle-lower part the group.

<sup>239</sup> Chart compiled using data from the following sources: CALIFORNIA COURT STATISTICS 2017. EU JUSTICE SCOREBOARD 2017. UK JUDICIAL STATISTICS 2017. US COURTS STATISTICS 2017. US COURT MANAGEMENT STATISTICS 2016. UK SOLICITORS REGULATORY AUTHORITY 2023. AMERICAN BAR ASSOCIATION 2017. COUNCIL OF BARS AND LAW SOCIETIES EUROPE 2016. WORLD GOVERNANCE INDICATOR 2016. CEPEJ 2016. UK MINISTRY OF JUSTICE 2016. CEPEJ Data for Resolved Civil Claims- 1<sup>st</sup> inst court\_Resolved cases\_Civil (and commercial), France, Germany, Italy, and the Netherlands. Judicial data for England and Wales from the UK Ministry of Justice. California and US Federal court statistics for Fiscal Year 2015-2016.

### 3.2.2 Structure of the Judiciary and Related Judicial Statistics.

The number of judges working in a judicial system should reflect a combination of legal norms and the demand for adjudication. Some judicial positions can be considered essential to the functioning of a democratic government. As each of the countries considered are democracies, there has been a separation of the government's executive, legislative and judicial branches. The judiciary in these countries can be generally considered a hierarchy, with the most powerful courts having the fewest judicial positions and the least powerful courts holding the greatest number of seats. Depending on the structure of the judiciary, there may be specialized courts, or there may be courts of general jurisdiction. The use of nonprofessional or lay judges and how judges are categorized may cause frustration when comparing these countries. According to FABRI, who addressed problems in using a comparative analysis for the number of judges across European countries, “there are still some significant problems in the collection of data about the number of judges and court personnel and, more in general, about the functioning of justice systems finalized to a comparative analysis across countries”.<sup>240</sup> A comparative analysis of the number of judges in each country must be approached cautiously because of the different classifications of judges and their competencies.

### 3.2.3 The Number of Attorneys.

Each of the countries considered has a highly regulated system for the practice of law. Each US state sets requirements and administers exams as prerequisites for being admitted to practice law.<sup>241</sup> In the US, each state has the competency to regulate the practice of law within the state courts.<sup>242</sup> The American Bar Association, a private and voluntary association of lawyers, keeps records of

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<sup>240</sup> FABRI 2017, p. 634.

<sup>241</sup> For an overview of the practice of law in the US, see: JOHNSTONE 2007.

<sup>242</sup> Under the Inherent powers doctrine, individual states in the U.S. have the right to regulate the practice of law before state courts. For a further explanation of the inherent powers doctrine, see: THILL 1994.

the number of admitted attorneys in all U.S. jurisdictions.<sup>243</sup> The EU Justice Scoreboard reports the number of practicing attorneys in EU member states based on data provided by each country's bar associations and state courts.<sup>244</sup> The CCBE also provides data on the number of registered attorneys in each EU country and some additional European countries that are not members of the EU.<sup>245</sup> Populations from 2020 are identified by use of data from the World Bank, US Census, and UK Office of National Statistics are used.<sup>246</sup>

How each country determines who an attorney is and what that entails is also important to consider. According to BOWLES, "[t]he work done by lawyers is, of course, sensitive to the constitutional and administrative structure of countries, and tasks done by a lawyer in one country may be done by non-lawyers elsewhere".<sup>247</sup> As each country has a unique requirement for the practice of law, and a unique definition of what the practice of law is, there will be differences across borders. For instance, in England and Wales, the Legal Service act of 2007 delineates which activities are considered "reserved legal activities"<sup>248</sup> which must be carried out by "entitled"<sup>249</sup> persons who have met the regulatory requirements to provide legal services.<sup>250</sup> In Germany, the Federal Lawyer's Act (*Bundesrechtsanwaltsordnung*)<sup>251</sup> and the Rules of Professional Practice for lawyers (*Berufsordnung für Rechtsanwälte*)<sup>252</sup> govern the practice of law.<sup>253</sup> Each country has its own

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<sup>243</sup> AMERICAN BAR ASSOCIATION 2017.

<sup>244</sup> EU JUSTICE SCOREBOARD 2017.

<sup>245</sup> CCBE.

<sup>246</sup> EU JUSTICE SCOREBOARD 2017. CCBE 2020. AMERICAN BAR ASSOCIATION 2017.

<sup>247</sup> BOWLES 1994, p. 18.

<sup>248</sup> LEGAL SERVICES ACT 2007. C. 29 Pt 3

<sup>249</sup> LEGAL SERVICES ACT 2007. C. 29 Pt 3 s 13

<sup>250</sup> According to BOWLES, "The legal profession in England and Wales is split into two main branches," Solicitors and barristers. "There are other practitioners who are allowed to offer certain kinds of legal service but are not qualified" such as "[l]egal executives and licensed conveyancers." BOWLES 1994, p.23.

<sup>251</sup> GERMAN FEDERAL LAWYERS' ACT 1959.

<sup>252</sup> GERMAN PROFESSIONAL CODE OF CONDUCT FOR LAWYERS 1959.

<sup>253</sup> According TO GEROLD, "there is no distinction between different legal services provided by a lawyer (Rechtsanwalt) in the German system today. Every legal professional, who has joined the chamber of lawyers, can practice all kind of legal services for their clients. The German system does not have any distinction as in the common

standard, which has been codified in some manner, and the differences between the countries in regulating attorneys will influence how the population of attorneys is calculated in each country. When considering the statistics on attorneys, it is important to remember that there may be legal jobs limited to attorneys in one country but not in another.

FIGURE 4. 2016 POPULATION OF JUDGES AND ATTORNEYS.<sup>254</sup>

State	Population 2016	Attorneys 2016	Judges 2016	Attorneys per 100000	Judges per 100000
France	66,724,104	65,480	6,995	98.1	10.48
Germany	82,348,669	164,393	19,867	199.6	24.13
Italy	60,627,498	229,292	6,395	378.2	10.55
Netherlands	17,030,314	17,498	2,331	102.7	13.69
England and Wales	58,381,300	136,068	4,681	233.1	8.02
California	39,103,587	167,690	2,125	428.8	5.43
US (Federal)	323,071,755	1,315,561	843	407.2	0.26

Based on this analysis, within these time frames, there are three similar groups of populations among judges and separately among attorneys. In France and the Netherlands, the average number of attorneys in the population seems to be rather low compared to the other groups, with 98.1 and 102.7 attorneys per one hundred thousand people, with Germany and England and Wales nearly twice as large, with 199.6 and 233.1, respectively, while California and Italy are nearly four times

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law countries between a barrister, who is allowed to appear in court and to present the case and solicitor, who prepares the statements and consults the client<sup>25</sup>. GEROLD 2008, p. 2.

<sup>254</sup> The 2016 data used in this chart was recovered from CEPEJ, The World Bank, The Judicial branch of the State of California, US Federal Courts, The American Bar Association, The US Census Bureau, the CCBE and The UK Office of National Statistics. WORLD BANK POPULATION STATISTICS 2016. CEPEJ 2016. CALIFORNIA COURT STATISTICS 2017. US COURTS STATISTICS 2017. AMERICAN BAR ASSOCIATION 2017. COUNCIL OF BARS AND LAW SOCIETIES EUROPE 2020. UK JUDICIAL STATISTICS 2017. An examination of the population of all judges sitting in courts in the US is complicated by how judges are designated in state and local jurisdictions, as there is a need to differentiate between judges with specific jurisdiction over only certain types of claims, and judges sitting in courts of general jurisdiction. According to STATISTA 2022, there were 48,500 “judges, magistrates, and other judicial workers” in the US in 2016.

as large with 428.8 and 378.2. The figures from California are in the range of the US as a whole, which has 407.2.

When it comes to Judges, Germany has the most with 24.13, with a group of the Netherlands (13.69), Italy (10.55), and France (10.48) taking the middle cluster, with England and Wales (8.02) and California (5.43) in the lower end. It should be noted that in the US, there is an average of (0.26) federal judges per one hundred thousand, some of which hold benches in California. The Federal judge population (0.26) when compared to the state of California (5.43) shows there is a limited role of US Federal Courts in administering justice, where state and local courts represent the vast majority of judicial seats in the US. To put the US numbers into perspective, in 2016 there were 48,050 “judges, magistrates, and other judicial workers” in the US.<sup>255</sup>

This information about each country's judicial services shows a divergence in how judicial services are consumed in these countries, with some having relatively high numbers of attorneys or judges.

### 3.3 Publicly Available Transnational Legal Indicators (TLI)

The use of TLIs has been a growing trend in international business law, as firms look to quantify the quality of a country's legal system and its protections. According to AMARILES and MCLACHLAN, “TLIs provide proxy measures about the quality of legal rules, institutions and processes across countries” using “large sample quantitative research methods on a periodic and systemic basis”.<sup>256</sup> The quality of a country's legal system should influence firms' and individuals' willingness to settle a claim, litigate a claim, or arbitrate a claim. A common argument in favor of arbitration is that arbitration is cheaper and takes less time than litigation. If a country has an

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<sup>255</sup> Statista 2022. “Number of judges, magistrates, and other judicial workers in the United States from 2013 to 2021”, (2022) Statista Research Department. <https://www.statista.com/statistics/1087407/number-judges-magistrates-judicial-workers-united-states/>

<sup>256</sup> AMARILES and MCLACHLAN 2018, p. 167, 168.

overburdened court system or charges large filing fees for litigants, arbitration may be cheaper and faster. When a country has a cost and time efficient court system, the argument that arbitration is the better choice for settling disputes becomes less clear. Comparing the TLI scores for these countries shows some information about how these countries' legal systems function, and this provides some information about how legal services, which include the use of private arbitration, are consumed in these countries.

AMARILES and MCLACHLAN identify a number of TLIs and discuss the methodology that these TLIs use.<sup>257</sup> Based on the discussion of the use of TLIs by AMARILES and MCLACHLAN, twelve publicly available TLIs are considered for the six countries in this analysis. The relevant TLI which are considered are: The World Governance Indicators (WGI) Rule of Law Indicators issued by the World Bank; the Doing Business Index (DB) issued by the World Bank; the Investments Across Borders (IAB) indicator issued by the World Bank, (the arbitrating commercial disputes/strength of law score is reported here); the FDI Regulatory Restrictiveness Index (FDI) issued by the OECD; the Service Trade Restrictiveness Index (STRI) issued by the OECD (the insurance score is reported here); the Index of Economic Freedom (IEF) issued by the Heritage foundation; the Global Competitiveness Index (GCI) issues by the World Economic Forum; the Rule of Law Index (WJP) issued by the World Justice Project; the Global Business Rule of Law Dashboard (BROLD) issued by the US Chamber of Commerce (USCC); the Financial Secrecy Index (FSI) issued by the Tax Justice Network; the Global Rights Index (GRI) issued by the International Trade Union Confederation (ITUC); and the Index of Legal Certainty (ILC) issued by the Foundation for Continental Law.

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<sup>257</sup> AMMARIELS and MCLACHLAN 2018.

### 3.3.1 World Governance Indicators (WGI): Rule of Law Indicator.

The WGI Rule of Law Indicator measures the “perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence.”<sup>258</sup> The WGI publishes six indicators, including: Voice and Accountability (VA), Political Stability and Absence of Violence/Terrorism (NPV), Government Effectiveness (GE), Regulatory Quality (RQ), Rule of Law (RL), and Control of Corruption (CC). The RL indicator is the WGI indicator that most closely addresses judicial service quality. This indicator relies “exclusively on perceptions-based governance data sources,” which include “surveys of firms and households, as well as the subjective assessments of a variety of commercial business information providers, non-governmental organizations, and a number of multilateral organizations and other public sector bodies.”<sup>259</sup> The WGI provides access to all data sources used to compile the indicators. Using these data sources, the WGI uses an unobserved components model (UCM) to construct the aggregate WGI measurements for the RL indicator, among the other WGI indicators. The authors of the WGI find the UCM approach has three advantages over other methodologies, including that a UCM maintains “some of the cardinal information in the underlying data” by using common units, a UCM “provides a natural framework for weighting the rescaled indicators by their relative precision” which “has the advantage of improving the precision of the overall aggregate indicators”, and the UCM “naturally emphasized the uncertainty associated with aggregate indicators of governance.”<sup>260</sup> The WGI indicators are reported using two methods. First, aggregate data used for the WGI is measured “in the standard normal units of the governance

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<sup>258</sup> KAUFMANN et al. 2010, p. 4.

<sup>259</sup> KAUFMANN et al. 2010, p. 5, 4.

<sup>260</sup> KAUFMANN et al. 2010, p. 16.

indicator, ranging from around -2.5 to 2.5”.<sup>261</sup> Second, the WGI is measured using “percentile rank terms ranging from 0 (lowest) to 100 (highest) among all countries worldwide”.<sup>262</sup>

### 3.3.2 Doing Business Index (DB).

The DB indicator measures the ease of doing business across borders.<sup>263</sup> The DB indicator includes measurements on starting a business, obtaining construction permitting, obtaining electricity, registering property rights, obtaining credit, protections for minority investors, paying taxes, enforcing contracts, trading across borders, resolving insolvency, and labor market regulations. In terms of what this indicator tells us about the use of arbitration for tort claims, it relates to how contracts are enforced. The DB indicators “measure business regulation and the protection of property rights—and their effect on business.”<sup>264</sup> The DB indicator is compiled using questionnaires which “are administered to more than 13,000 local experts, including lawyers, business consultants, accountants, freight forwarders, government officials and other professionals routinely administering or advising on legal and regulatory requirements.”<sup>265</sup> Data from questionnaires is run through “numerous rounds of verification” and cross referenced with “relevant laws and regulations”.<sup>266</sup> This methodology is designed to “document the complexity of regulation”, “gauge the time and cost to achieve a regulatory goal or comply with regulations, such as the time and cost to enforce a contract, go through bankruptcy or trade across borders”, and to measure the extent of legal protections of property”.<sup>267</sup>

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<sup>261</sup> KAUFMANN et al. 2010, p. 12.

<sup>262</sup> KAUFMANN et al. 2010, p. 12.

<sup>263</sup> DOING BUSINESS 2018.

<sup>264</sup> DOING BUSINESS 2018, p. 67.

<sup>265</sup> DOING BUSINESS 2018, p. 67.

<sup>266</sup> DOING BUSINESS 2018, p. 67.

<sup>267</sup> DOING BUSINESS 2018, p. 67.

### 3.3.3 The Investments Across Borders (IAB) indicator.

The IAB indicators, which include numerous evaluations involving foreign direct investment (FDI) beyond those pertaining to arbitration which are identified here, are designed to “highlight the differences among countries in their regulatory treatment of FDI to identify good practices, facilitate learning opportunities, stimulate reforms, and provide cross-country data for research and analysis”.<sup>268</sup> The arbitrating commercial disputes indicators are a subset of the IAB indicators and are designed to “assess the strength of legal frameworks for ADR, rules for arbitration, and the extent to which the judiciary supports and facilitates arbitration.”<sup>269</sup> The methodology of the IAB “is based on the World Bank Group's Doing Business initiative,” which uses “data collected through a survey of lawyers, other professional service providers (mainly accounting and consulting firms), investment promotion institutions, chambers of commerce.”<sup>270</sup> The focus of the IAB indicators is set “on national laws and, in some cases, on countries' ratifications of international conventions governing selected aspects of FDI” but does not consider “bilateral and regional investment treaties and free trade agreements”.<sup>271</sup> The IAB indicators do not account for “perceptions of investors or companies”; rather, they “are based on legal facts and expert responses collected through a standardized set of questionnaires”.<sup>272</sup> According to the IAB report, “a stable and predictable arbitration regime, as part of the broader legal framework, is another factor that can affect conditions for FDI.”<sup>273</sup> A key issue which drives the necessity to evaluate countries

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<sup>268</sup> INVESTING ACROSS BORDERS 2010, p. 68.

<sup>269</sup> INVESTING ACROSS BORDERS 2010, p. 3.

<sup>270</sup> INVESTING ACROSS BORDERS 2010, p. 4.

<sup>271</sup> INVESTING ACROSS BORDERS 2010, p. 71.

<sup>272</sup> INVESTING ACROSS BORDERS 2010, p. 72.

<sup>273</sup> INVESTING ACROSS BORDERS 2010, p. 3.

based on their arbitration laws is because “[p]arty autonomy levels and enforcement mechanism for arbitration awards vary” across borders.<sup>274</sup>

#### 3.3.4 FDI Regulatory Restrictiveness Index (FDI).

The “FDI restrictiveness is an OECD index gauging the restrictiveness of a country’s foreign direct investment (FDI) rules by looking at four main types of restrictions: foreign equity restrictions; discriminatory screening or approval mechanisms; restrictions on key foreign personnel and operational restrictions.”<sup>275</sup> The methodology used to compile the FDI Restrictiveness Index is intended “to capture regulatory restrictiveness” and expressly not intended “to appraise the overall restrictiveness of the regulatory regime as it is actually implemented”.<sup>276</sup> The FDI Restrictiveness Index looks at four distinct areas to develop a score, including “(i) foreign equity restrictions, (ii) screening and prior approval requirements, (iii) rules for key personnel, and (iv) other restrictions on the operation of foreign enterprises”.<sup>277</sup>

#### 3.3.5 Service Trade Restrictiveness Index (STRI).

The STRI provides a “snapshot of trade restrictiveness in a country and sector at a particular point in time”.<sup>278</sup> The STRI is designed to account for variation in policy concerning “MFN restrictions” independent of “regional trade agreements or mutual recognition agreements”.<sup>279</sup> Within the STRI measurements, “policy measures are grouped under the same five policy areas in all sectors,” which include “restrictions on foreign entry”, “restrictions on the movement of people”, “other discriminatory measures”, “barriers to competition”, and “regulatory transparency”.<sup>280</sup> STRI scores

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<sup>274</sup> INVESTING ACROSS BORDERS 2010, p. 3.

<sup>275</sup> FDI RESTRICTIVNESS 2017.

<sup>276</sup> FDI RESTRICTIVNESS 2017, p. 9.

<sup>277</sup> FDI RESTRICTIVNESS 2017, p. 9.

<sup>278</sup> STRI 2017, p. 6.

<sup>279</sup> STRI 2017, p. 5.

<sup>280</sup> STRI 2017, p. 5.

are broken down under these five areas to compile a score for each country. Each policy area is given a score of either 0 or 1, where a 0 indicates that the policy area is "not restrictive", while a score of 1 indicating the policy area is "restrictive".<sup>281</sup> The scores for each of the five policy areas are then "weighted according to relative importance," based on experts' allocation of 100 points between the five areas.<sup>282</sup>

### 3.3.6 Index of Economic Freedom (IEF).

The Index of Economic Freedom (IEF) compiled by the Heritage Foundation, a conservative think tank from Washington D.C., has "documented since 1995, the positive connection between economic freedom and long term improvements in economic performance and overall development is unambiguous and robust."<sup>283</sup> The IEF is based on evaluations of four specific aspects of a country's economy, "rule of law, government size, regulatory efficiency, and market openness".<sup>284</sup> Within these aspects are twelve subcategories, "graded on a scale from 0 to 100" and "equally weighted and averaged to produce overall economic freedom score for each economy".<sup>285</sup> Each of "the 12 components of economic freedom are weighted equally so that the overall score will not be biased toward any one component or policy direction".<sup>286</sup> Each of these subcategories has a unique methodology. For instance, in the Judicial Effectiveness subcategory under the Rule of Law, the Heritage Foundation uses data from the World Competitiveness Report, the DB, and the Country Risk Assessment TLIs, to make their assessment of property rights in each country concerning "physical property rights, intellectual property rights, strength of investor protection,

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<sup>281</sup> STRI 2017, p. 6.

<sup>282</sup> STRI 2017, p. 6.

<sup>283</sup> IEF 2018.

<sup>284</sup> IEF 2018, p. 453.

<sup>285</sup> IEF 2018, p. 453.

<sup>286</sup> IEF 2018, p. 463.

risk of expropriation, and quality of land administration."<sup>287</sup> The score of each sub-factor used to compile the Property Rights score is "derived from numerical data sets that are normalized for comparative purposes".<sup>288</sup> Within the Judicial Effectiveness subcategory, sub-factors are also considered, including "judicial independence, quality of the judicial process, and likelihood of obtaining favorable judicial decisions."<sup>289</sup> The Judicial Effectiveness score is compiled using data sets from the World Competitiveness Report and the DB, which have been normalized.<sup>290</sup> The twelve components which the IEF uses in compiling each country's score include: 1) property rights, 2) judicial effectiveness, 3) government integrity, 4) tax burden, 5) government spending, 6) fiscal health, 7) business freedom, 8) labor freedom, 9) monetary freedom, 10) trade freedom, 11) investment freedom, and 12) financial freedom.<sup>291</sup>

### 3.3.7 Global Competitiveness Index (GCI).

The GCI measures are compiled by the World Economic Forum and measure national competitiveness, which is defined by the WEF "as the set of institutions, policies and factors that determine the level of productivity of a country."<sup>292</sup> The GCI score is on a scale from 1 to 7, with 7 being the most competitive and 1 being the least.<sup>293</sup> The GCI score for each country is determined using data from numerous sources, including: the World Economic Forum, the International Monetary Fund, the World Bank, and numerous United Nations agencies.<sup>294</sup> The data is used to compile sub scores for: "institutions, infrastructure, macroeconomic, environment, health and primary education, higher education and training, goods market efficiency, labor market

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<sup>287</sup> IEF 2018, p. 453.

<sup>288</sup> IEF 2018, p. 454.

<sup>289</sup> IEF 2018, p. 454.

<sup>290</sup> IEF 2018, p. 454.

<sup>291</sup> IEF 2018.

<sup>292</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 317.

<sup>293</sup> SCHWAB and SALA-I-MARTÍN 2018, p. xi.

<sup>294</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 11.

efficiency, financial market development, technological readiness, market size, business sophistication, and innovation.”<sup>295</sup> Each country receives a score for each of the "pillars," and the overall country score is compiled using sub scores for the country. The sub score for institutions is the most relevant sub score, which concerns the use of arbitration for tort claims. According to the GCI 2017-18 report, "[t]he legal and administrative framework within which individuals, firms, and governments interact determines the quality of the public institutions of a country and has a strong bearing on competitiveness and growth".<sup>296</sup> The GCI is compiled "based on successive aggregations of scores from the indicator level...all the way up to the overall GCI score," and generally, the methodology uses "an arithmetic mean to aggregate individual indicators within a category".<sup>297</sup>

### 3.3.8 World Justice Project Rule of Law Index (WJP).

The World Justice Project Rule of Law Index (WJP) is a “quantitative tool that measures the rule of law in practice.”<sup>298</sup> The WJP methodology “relies on more than 110,000 household and expert surveys to measure how the rule of law is experienced and perceived in practical, everyday situations by the general public around the world”.<sup>299</sup> According to the published indicator from 2011, “the Index’s rankings and scores are the product of a very rigorous data collection and aggregation methodology”.<sup>300</sup> The WJP uses polling to develop their index score where “three

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<sup>295</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 11.

<sup>296</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 317.

<sup>297</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 321.

<sup>298</sup> RULE OF LAW INDEX 2018.

<sup>299</sup> RULE OF LAW INDEX 2018.

<sup>300</sup> BOTERO and PONCE 2011, p. 27.

different polling methodologies were used: CATI, face-to-face, or an online methodology based on panels from non-internet methods to ensure random selection.”<sup>301</sup>

### 3.3.9 Global Business Rule of Law Dashboard (BROLD).

The US Chamber of Commerce (USCC) publishes the BROLD indicator, known as the dashboard.<sup>302</sup> The methodology used by the USCC to compile the dashboard is a “meta-measure that amalgamates existing indicators from published, high quality international indices and surveys”.<sup>303</sup> The USCC uses a two-pronged approach of indices and surveys. According to the USCC, “the Dashboard is simply a sum and reflection of the constituent parts extracted and amalgamated from existing rule of law measures.”<sup>304</sup> The BROLD dashboard “[i]ndices try to have a consistent measurement of predefined criteria, while surveys try to gauge perceptions.”<sup>305</sup> The dashboard uses other indicators in which measurements are deconstructed and analyzed “to identify the relevant rule of law indicators that relate to business”, then “all scores from existing indices and surveys” are “standardized into a percentage” and “combined and treated on a “like-for-like” basis”.<sup>306</sup> Finally, the dashboard uses the “overall percentage obtained for each individual parent measure,” which is then “combined into an average score for each surveyed country, which provides the Dashboard score or percentage for a given country”.<sup>307</sup>

### 3.3.10 Financial Secrecy Index (FSI).

The FSI Secrecy score “is a ranking of jurisdictions most complicit in helping individuals to hide their finances from the rule of law.”<sup>308</sup> The FSI score thoroughly evaluates “each jurisdiction's

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<sup>301</sup> BOTERO and PONCE 2011, p. 19.

<sup>302</sup> US CHAMBER OF COMMERCE 2017.

<sup>303</sup> US CHAMBER OF COMMERCE 2017, p. 43.

<sup>304</sup> US CHAMBER OF COMMERCE 2017, p. 44.

<sup>305</sup> US CHAMBER OF COMMERCE 2017, p. 44.

<sup>306</sup> US CHAMBER OF COMMERCE 2017, p. 45.

<sup>307</sup> US CHAMBER OF COMMERCE 2017, p. 45.

<sup>308</sup> TAX JUSTICE NETWORK: FAQ 2018. Tax

financial and legal systems to identify the world's biggest suppliers of financial secrecy."<sup>309</sup> The FSI "spotlights the laws and policies that governments can change to reduce their contribution to financial secrecy."<sup>310</sup> The FSI score does not give a positive or negative connotation to the score, as "A high or low Global Scale Weight is neither good nor bad, but the higher a jurisdiction's Global Scale Weight is, the greater the responsibility the jurisdiction has to guard against financial secrecy – and conversely, the greater the risk for financial secrecy when the jurisdiction fails to uphold that responsibility."<sup>311</sup> For the purposes of this analysis, the FSI score is considered to be ranked higher when compared to the other countries by having a lower secrecy score. This assumes that the lower level of financial secrecy, the more likely legal institutions are used in financial disputes, i.e., the more secrecy, the more likely private legal forums will be used to maintain secrecy.

#### 3.3.11 Global Right Index (GRI).

The Global Rights Index (GRI) is published by the ITUC and focuses on workers' legal rights across the globe. "The ITUC documents violations of internationally recognised collective labour rights by governments and employers" that uses a methodology that "is grounded in standards of fundamental rights at work, in particular the right to freedom of association, the right to collective bargaining and the right to strike" in compiling the GRI.<sup>312</sup> After the ITUC compiles their documentation of violations and summarizes them within a survey, the data is coded, and then "[c]ountries are rated in clusters from 1-5 depending on their compliance with collective labour rights."<sup>313</sup>

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<sup>309</sup> TAX JUSTICE NETWORK: FAQ 2018.

<sup>310</sup> TAX JUSTICE NETWORK: FAQ 2018.

<sup>311</sup> TAX JUSTICE NETWORK: MEASUREMENTS 2018.

<sup>312</sup> GLOBAL RIGHTS INDEX 2018, p. 48.

<sup>313</sup> GLOBAL RIGHTS INDEX 2018, p. 48.

### 3.3.12 Index of Legal Certainty (ILC).

The Index of Legal Certainty (ILC) is published by the Foundation for Continental Law (Foundation pour le droit continental) under their Civil Law Initiative.<sup>314</sup> According to the 2015 ILC report, "The aim of the Index is to help...to establish what system offers the most guarantees regarding legal certainty" and, more specifically, "to evaluate legal certainty for a foreign investor wishing to start a business in the country observed."<sup>315</sup> The ILC methodology is based on seven specific factors, which in descending order are: the nature of the phenomenon measured, type of result, type of measurement, the scale of measurement, type of indicator, methods, and sources, and actionability.<sup>316</sup> The ILC is developed using primary and secondary sources. Specifically, the ILC identifies primary sources as "[e]ssentially methods of social science research, i.e. surveys of experts or the general population, focus groups, analysis of documents and interviews", which "also included internal and external expertise as a primary data source."<sup>317</sup> Secondary sources are used by the ILC as "Data taken from other indicators, reports or institutions to produce the legal indicator."<sup>318</sup> According to the 2015 report, "the principle of the index is that well thought-out legal certainty is not synonymous with immobility or the equivalent of either total lack of legislative or regulatory constraint or even minimal constraint", rather "it presupposes the accessibility of applicable law, its predictability, achieved through the ranking of the norms and the predefined roles of lawmakers and judges, reasonable stability over time and lastly, a balance between economic interests and the parties concerned."<sup>319</sup>

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<sup>314</sup> INDEX OF LEGAL CERTAINTY 2015.

<sup>315</sup> INDEX OF LEGAL CERTAINTY 2015, p. 83.

<sup>316</sup> INDEX OF LEGAL CERTAINTY 2015, pp. 51-54.

<sup>317</sup> INDEX OF LEGAL CERTAINTY 2015, p. 54.

<sup>318</sup> INDEX OF LEGAL CERTAINTY 2015, p. 54.

<sup>319</sup> INDEX OF LEGAL CERTAINTY 2015, p. 75.

### 3.4 Ranking Methodology.

Since specific scores for England and Wales were generally unavailable, the TLI scores for the UK were used in their place. These publicly available indexes provide information about how each country's judiciary functions and how they compare to other countries. Some of these TLIs do not include every country. For instance, the IAB arbitration indicators, perhaps the most relevant TLI when considering the arbitration of tort claims, did not provide a score for Germany, Italy, or the Netherlands. The Netherlands was also not included in the BOLD and LCI indexes. Each one of these indicators provides a different piece of information that is relevant to determining the demand for adjudication. While these TLIs do not ultimately provide specific information about the prevalence of the use of arbitration for tort claims in any given country, they do shed light on how the functioning of the judicial system and the rule of law in each country. The efficiency of a country's judicial system is one of the main indicators related to the consumption of a country's judicial system and is indicative of the demand from individuals and firms to seek out alternative private adjudication forums for their disputes. This assumes that the more efficient the country's judicial system is, the more likely private adjudication forums will not be used by parties, i.e., the potential benefits from using arbitration are lower the more efficient public judicial forums function.

To compare these TLIs, the ranking of each country is compared to the others. For instance, in the WGI indicator, the Netherlands would be ranked 1 out of 6 with a WGI score of 97, and Italy would be ranked 6 out of 6 with a WGI score of 63. Some other TLIs scores flow the other way, where a GRI score of 1 is ranked higher than a GRI score of 4. Each TLI provides a unique set of information based on the methodology used to give scores to these countries. The TLIs which did not score each country are disregarded from this comparison. The ranking of the ten remaining

indicators (WGI, DB, FDI, STRI Insurance, STRI Legal, IEF, GCI, WJP FSI, and GRI), which scored every one of the six countries, was compiled and ranked from highest to lowest, relatively. The results show that when these six countries are compared using ten TLIs, the UK and the Netherlands were the highest ranked countries on average, followed by Germany, the U.S., France, and Italy.

**FIGURE 5. COMPARISON OF 10 COMMON TLI RANKINGS AMONG SIX COUNTRIES.**

Transnational Legal Indicator Scores, Rankings, and Average Ranking for Six Countries						
	US	France	Germany	Italy	Netherlands	UK (England and Wales)
1. (WGI) 2017	91.35 (4 <sup>th</sup> )	88.46 (5 <sup>th</sup> )	91.83 (3 <sup>rd</sup> )	63.94 (6 <sup>th</sup> )	97.12 (1 <sup>st</sup> )	92.31 (2 <sup>nd</sup> )
2. (DB) 2018	82.54 (1 <sup>st</sup> )	76.13 (4 <sup>th</sup> )	79.00 (3 <sup>rd</sup> )	72.70 (6 <sup>th</sup> )	76.03 (5 <sup>th</sup> )	82.22 (2 <sup>nd</sup> )
3. (FDI) RR 2017	.089 (6 <sup>th</sup> )	.045 (4 <sup>th</sup> )	.023 (2 <sup>nd</sup> )	.052 (5 <sup>th</sup> )	.015 (1 <sup>st</sup> )	.040 (3 <sup>rd</sup> )
4 (STRI) 2017 A. Insurance	.29 (6 <sup>th</sup> )	.13 (1 <sup>st</sup> )	.13 (1 <sup>st</sup> )	.24 (5 <sup>th</sup> )	.15 (3 <sup>rd</sup> )	.16 (4 <sup>th</sup> )
4 (STRI) 2017 B. Legal	.20 (2 <sup>nd</sup> )	.61 (6 <sup>th</sup> )	.24 (4 <sup>th</sup> )	.20 (2 <sup>nd</sup> )	.24 (4 <sup>th</sup> )	.18 (1 <sup>st</sup> )
5. (IEF) 2018	75.7 (3 <sup>rd</sup> )	63.9 (5 <sup>th</sup> )	74.2 (4 <sup>th</sup> )	62.5 (6 <sup>th</sup> )	76.2 (2 <sup>nd</sup> )	78.0 (1 <sup>st</sup> )
6. (GCI) 2017/18	5.85 (1 <sup>st</sup> )	5.18 (5 <sup>th</sup> )	5.65 (3 <sup>rd</sup> )	4.54 (6 <sup>th</sup> )	5.66 (2 <sup>nd</sup> )	5.51 (4 <sup>th</sup> )
7. (WJP) 2017/18	.73 (5 <sup>th</sup> )	.74 (4 <sup>th</sup> )	.83 (2 <sup>nd</sup> )	.65 (6 <sup>th</sup> )	.85 (1 <sup>st</sup> )	.81 (3 <sup>rd</sup> )
8. (FSI) 2018	60 (5 <sup>th</sup> )	52 (3 <sup>rd</sup> )	59 (4 <sup>th</sup> )	49 (2 <sup>nd</sup> )	66 (6 <sup>th</sup> )	42 (1 <sup>st</sup> )
9. (GRI) 2018	4 (6 <sup>th</sup> )	2 (4 <sup>th</sup> )	1 (1 <sup>st</sup> )	1 (1 <sup>st</sup> )	1 (1 <sup>st</sup> )	3 (5 <sup>th</sup> )
Ranked Average	3.9 (4 <sup>th</sup> )	4.6 (6 <sup>th</sup> )	2.7 (3 <sup>rd</sup> )	4.5 (5 <sup>th</sup> )	2.6 (1 <sup>st</sup> -T)	2.6 (1 <sup>st</sup> -T)

#### 4. Conclusion.

This chapter addresses the use of arbitration for tort claims across six countries by comparing sources of law and other related data. The findings of this research are limited due to (1) a lack of relevant data; (2) inconsistency in the data concerning civil claims, attorney populations, and judge populations; and (3) the limited applicability of proxy measurements to provide information about outcomes in arbitration or the consumption of arbitration services in these countries. This issue involves both tort and contract law, and from a comparative perspective, there are difficulties in

separating tort and contract claims, as they vary across countries. The source of domestic arbitration laws is identified, along with international sources of law which are applicable. This positive analysis shows both the similarities and differences between each country regarding the source of law, how the arbitration laws are applied, and how arbitration can be used for tort claims. It demonstrates there is a lack of convergence on norms concerning the use of arbitration for domestic tort claims. Legal norms in the use of arbitration for international arbitration exist, and all examined countries are members of the New York Convention, while legal norms in the use of domestic arbitration do not exist or exist only within EU member states to a limited degree. Data concerning the use of arbitration for tort claims are difficult to obtain, mainly due to the secret nature of arbitration. The limited available data is problematic and lacks specific data concerning the types of claims being arbitrated.

In order to understand the demand for third party adjudication of tort claims, including both arbitration and litigation, proxy measurements are considered. These proxy measurements include a comparison of data concerning the civil litigation rates in each country, and available information from arbitration associations are discussed. Related data about the quality of each country's judiciary and the population of judges and attorneys in these six countries are also identified. This analysis shows that there are groupings of countries with higher numbers of attorney populations in the US, specifically California, Italy, and to a lower extent, England and Wales. The Common Law jurisdictions of England and Wales, and California showed to have a much lower judge population than in the countries with more influential civil law legal tradition, where Germany was the outlier with a markedly higher population of judges than all other countries considered. Multiple TLI proxy measurements related to the functioning of the judiciary of each country are compared. Using ten TLIs that scored all six countries, a comparative ranking of these countries

is made, which shows that on average, the Netherlands and the UK ranked highest with a (2.6) average, with Germany (2.7) closely following, with the US (3.4), France (3.7) and Italy (4.4) rounding out the bottom half of rankings.

A comprehensive understanding of the scope of arbitration for adjudicating tort claims is obscured by the clouds of secrecy that remain over arbitration proceedings. Proxy measurements that describe the demand for dispute resolution and legal services are poor second best measurement option. TLI proxy measurements also prove to be poor at identifying the scope of the use of arbitration for tort claims. Further research which seeks to quantify the use of arbitration for tort claims in these countries is warranted, given the lack of meaningful data which is available. Any future analysis of the use of arbitration for tort claims may need to incorporate innovative methodologies to overcome the "black box" that the arbitration process places over information about arbitrated claims.

APPENDIX A. DESCRIPTION OF TLI USED IN RANKING ANALYSIS.

1. World Governance Indicators, Rule of Law Indicators (WGI)<sup>320</sup>

Issued by the World Bank.

Year: 2016

Objectives of Score: “The six composite WGI measures are useful as a tool for broad cross-country comparisons and for evaluating broad trends over time. However, they are often too blunt a tool to be useful in formulating specific governance reforms in particular country contexts. Such reforms, and evaluation of their progress, need to be informed by much more detailed and country-specific diagnostic data that can identify the relevant constraints on governance in particular country circumstances. The WGI are complementary to a large number of other efforts to construct more detailed measures of governance, often just for a single country. Users are also encouraged to consult the disaggregated individual indicators underlying the composite WGI scores to gain more insights into the particular areas of strengths and weaknesses identified by the data.”<sup>321</sup>

Scoring Methodology: “WGI measures are constructed by averaging together data from the underlying sources that correspond to the concept of governance being measured”.<sup>322</sup>

It is a three step methodology, which includes “[a]ssigning data from individual sources to the six aggregate indicators”, “[r]escalating of the individual source data to run from 0 to 1”, and “[u]sing an Unobserved Components Model (UCM) to construct a weighted average of the individual indicators for each source.”<sup>323</sup>

Score:

WGI Rule of Law Indicators (WGI)					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
91.35 (4 <sup>th</sup> )	88.46 (5 <sup>th</sup> )	91.83 (3 <sup>rd</sup> )	63.94 (6 <sup>th</sup> )	97.12 (1 <sup>st</sup> )	92.31 (2 <sup>nd</sup> )

2. Doing Business Index (DB)<sup>324</sup>

Issued by the World Bank.

Year: 2018

Objectives of Score: “[T]o inform the design of reforms and motivate these reforms through country benchmarking.”<sup>325</sup> “The goal of the Doing Business series is to provide objective data for use by governments in designing sound business regulatory policies and to encourage research on the important dimensions of the regulatory environment for firms.”<sup>326</sup>

Scoring Methodology: Questionnaires.<sup>327</sup>

<sup>320</sup> WORLD GOVERNANCE INDICATOR 2016.

<sup>321</sup> WORLD GOVERNANCE INDICATOR 2016.

<sup>322</sup> WORLD GOVERNANCE INDICATOR 2016.

<sup>323</sup> WORLD GOVERNANCE INDICATOR 2016.

<sup>324</sup> DOING BUSINESS 2018.

<sup>325</sup> DOING BUSINESS 2018, p. iv.

<sup>326</sup> DOING BUSINESS 2018.

<sup>327</sup> DOING BUSINESS 2018.

Score:

Doing Business Index (DB) (score, world rank, rank)						
US	France	Germany	Italy	Netherlands	England and Wales (UK)	
82.54, 6 <sup>th</sup> , (1 <sup>st</sup> )	76.13, 31 <sup>st</sup> , (4 <sup>th</sup> )	79.00, 20 <sup>th</sup> , (3 <sup>rd</sup> )	72.70, 46 <sup>th</sup> , (6 <sup>th</sup> )	76.03, 32 <sup>nd</sup> , (5 <sup>th</sup> )	82.22, 7 <sup>th</sup> , (2 <sup>nd</sup> )	

3. Investments Across Borders (IAB)<sup>328</sup>

Issued by the World Bank,

Note: The arbitrating commercial disputes/strength of law score is reported here.

Year: 2010

Objectives of Score: “The IAB indicators aspire to meet different stakeholders’ needs for information, analysis, and policy action.”<sup>329</sup>

Scoring Methodology: “The indicators are based on a survey of lawyers, other professional service providers (mainly accounting and consulting firms), investment promotion institutions, chambers of commerce, law professors, and other expert respondents in the countries covered.”<sup>330</sup>

Score:

	Investments Across Borders Indicator (IAB)					
	US	France	Germany	Italy	Netherlands	England and Wales (UK)
Strength of Laws	85.0	90.0	N/A	N/A	N/A	99.9
Ease of Process	81.8	86.6	N/A	N/A	N/A	87.5
Extent of Judicial Assistance	75.3	94.0	N/A	N/A	N/A	94.5

4. FDI Regulatory Restrictiveness Index (FDI)<sup>331</sup>

Issued by the OECD.

Year: 2017

Objectives of Score: “[G]auging the restrictiveness of a country’s foreign direct investment (FDI) rules.”<sup>332</sup>

Scoring Methodology: The FDI Restrictiveness Index methodology is intended “to capture regulatory restrictiveness” using data concerning “(i) foreign equity restrictions, (ii) screening and prior approval requirements, (iii) rules for key personnel, and (iv) other restrictions on the operation of foreign enterprises”.<sup>333</sup>

<sup>328</sup> INVESTING ACROSS BORDERS 2010.

<sup>329</sup> INVESTING ACROSS BORDERS 2010, p. 3.

<sup>330</sup> INVESTING ACROSS BORDERS 2010, p. 68.

<sup>331</sup> FDI RESTRICTIVNESS 2017.

<sup>332</sup> FDI RESTRICTIVNESS 2017.

<sup>333</sup> FDI RESTRICTIVNESS 2017, p. 9.

Score:

Regulatory Restrictiveness Index (FDI)					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
.089 (6 <sup>th</sup> )	.045 (4 <sup>th</sup> )	.023 (2 <sup>nd</sup> )	.052 (5 <sup>th</sup> )	.015 (1 <sup>st</sup> )	.040 (3 <sup>rd</sup> )

5. Service Trade Restrictiveness Index (STRI)<sup>334</sup>

Issued by the OECD.

Note: The insurance score is found here.

Year: 2017

Objectives of Score: To highlight a country's industry specific trade restrictiveness.

Scoring Methodology: "The scoring methodology should account for the hierarchy of and the joint effect of regulation. For instance, if no foreign equity is allowed, measures related to foreign firms such as restrictions on the board of directors become irrelevant. Other examples are nationality requirements for local licences, which render residency requirements and restrictions regarding the recognition of foreign qualifications irrelevant. In such cases where a measure of higher hierarchy is binding, the related measures of lower hierarchy are scored as restrictive."<sup>335</sup>

Score:

Service Trade Restrictiveness Index (STRI) Insurance					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
.29 (6 <sup>th</sup> )	.13 (1 <sup>st</sup> )	.13 (1 <sup>st</sup> )	.24 (5 <sup>th</sup> )	.15 (3 <sup>rd</sup> )	.16 (4 <sup>th</sup> )

Service Trade Restrictiveness Index (STRI) Legal					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
.20 (2 <sup>nd</sup> )	.61 (6 <sup>th</sup> )	.24 (4 <sup>th</sup> )	.20 (2 <sup>nd</sup> )	.24 (4 <sup>th</sup> )	.18 (1 <sup>st</sup> )

6. Index of Economic Freedom (IEF)<sup>336</sup>

Issued by the Heritage Foundation.

Year: 2018

Objectives of Score: "The purpose of the Index is to reflect the economic and entrepreneurial environment in every country studied in as balanced a way as possible. The Index has never been designed specifically to explain economic growth or any other dependent variable; that is ably done by researchers elsewhere. The raw data for each component are provided so that others can study, weight, and integrate as they see fit."<sup>337</sup>

Scoring Methodology: "The Index of Economic Freedom focuses on four key aspects of the economic environment over which governments typically exercise policy control: Rule of law, Government size, Regulatory efficiency, and Market openness. In assessing conditions in these four categories, the Index measures 12 specific components of economic freedom, each of which is graded on a scale from 0 to 100. Scores on these 12

<sup>334</sup> STRI 2017.

<sup>335</sup> GROSSO et al. 2015, p. 12.

<sup>336</sup> MILLER et al. 2018. INDEX OF ECONOMIC FREEDOM 2018.

<sup>337</sup> INDEX OF ECONOMIC FREEDOM 2018, p. 465.

components of economic freedom, which are calculated from a number of sub-variables, are equally weighted and averaged to produce an overall economic freedom score for each economy.”<sup>338</sup>

Score:

Index of Economic Freedom (IEF) Score, World Rank, Comparative Ranking					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
75.7 (3 <sup>rd</sup> )	63.9, (5 <sup>th</sup> )	74.2, (4 <sup>th</sup> )	62.5, (6 <sup>th</sup> )	76.2, (2 <sup>nd</sup> )	78.0, (1 <sup>st</sup> )

7. Global Competitiveness Index (GCI)<sup>339</sup>

Issued by the World Economic Forum.

Year: 2017-18

Objectives of Score: “[T]o measure the determinants of competitiveness, defined as the set of institutions, policies, and factors that determine an economy’s level of productivity.”<sup>340</sup>

Scoring Methodology: “The GCI includes statistical data from internationally recognized organizations, notably the International Monetary Fund (IMF); the World Bank; and various United Nations’ specialized agencies, including the International Telecommunication Union, UNESCO, and the World Health Organization. The Index also includes indicators derived from the World Economic Forum’s Executive Opinion Survey that reflect qualitative aspects of competitiveness, or for which comprehensive and comparable statistical data are not available for a sufficiently large number of economies.”<sup>341</sup>

Score:

Global Competitiveness Index (GCI) Score, World Rank, Comparative Ranking					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
5.85, (1 <sup>st</sup> )	5.18, (5 <sup>th</sup> )	5.65, (3 <sup>rd</sup> )	4.54, (6 <sup>th</sup> )	5.66, (2 <sup>nd</sup> )	5.51, (4 <sup>th</sup> )

8. Rule of Law Index (WJP)<sup>342</sup>

Issued by the World Justice Project.

Year: 2017-2018

Objectives of Score: To measure “the rule of law based on the experiences and perceptions of the general public and in-country experts worldwide. Strengthening the rule of law is a major goal of citizens, governments, donors, businesses, and civil society organizations around the world. To be effective, rule of law development requires clarity about the fundamental features that define the rule of law, as well as an adequate basis for its evaluation and measurement. The WJP Rule of Law Index 2017–2018 presents a portrait of the rule of law in 113 countries by providing scores and rankings based on eight factors: constraints on government powers, absence of corruption, open government, fundamental rights, order and security, regulatory enforcement, civil justice, and criminal justice.”<sup>343</sup>

<sup>338</sup> INDEX OF ECONOMIC FREEDOM 2018, p. 453.

<sup>339</sup> SCHWAB and SALA-I-MARTÍN 2018.

<sup>340</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 353.

<sup>341</sup> SCHWAB and SALA-I-MARTÍN 2018, p. 11.

<sup>342</sup> RULE OF LAW INDEX 2018.

<sup>343</sup> RULE OF LAW INDEX 2018, p. 5.

Scoring Methodology: “The WJP Rule of Law Index 2017-2018 report presents information on eight composite factors that are further disaggregated into 44 specific sub-factors (see pages 12-13). Factor 9, Informal Justice, is included in the conceptual framework, but has been excluded from the aggregated scores and rankings in order to provide meaningful cross-country comparisons. To present an image that accurately portrays the rule of law as experienced by ordinary people, each score of the Index is calculated using a large number of questions drawn from two original data sources collected by the World Justice Project in each country: a General Population Poll (GPP) and a series of Qualified Respondents’ Questionnaires (QRQs).”<sup>344</sup>

Score:

Rule of Law Index (WJP)					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
.73 (5 <sup>th</sup> )	.74 (4 <sup>th</sup> )	.83 (2 <sup>nd</sup> )	.65 (6 <sup>th</sup> )	.85 (1 <sup>st</sup> )	.81 (3 <sup>rd</sup> )

9. Global Business Rule of Law Dashboard (BROLD)<sup>345</sup>

Issued by the US Chamber of Commerce.

Year: 2017

Objectives of Score: “The ultimate purpose of the Dashboard is to provide users with an easy-to-understand yet statistically credible meta-measure of the rule of law environment as it relates to business. The Dashboard relies on and uses information and research contained in seven internationally accepted and established indices and surveys of the rule of law. It is a compilation and reflection of these existing measures and it relies on the methodological strengths and weaknesses of those underlying indices and surveys.”<sup>346</sup>

Scoring Methodology: “The dashboard is a meta-measure that amalgamates existing indicators from published, high quality international indices and surveys.”<sup>347</sup>

Score:

Global Business Rule of Law Dashboard (BROLD)					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
71.71	73.6	83.29	59.34	N/A	79.93

10. Financial Secrecy Index (FSI)<sup>348</sup>

Issued by the Tax Justice Network.

Year: 2018

Objectives of Score: “The Financial Secrecy Index thoroughly evaluates each jurisdiction’s financial and legal systems to identify the world’s biggest suppliers of financial secrecy. The index spotlights the laws and policies that governments can change to reduce their contribution to financial secrecy.”<sup>349</sup>

<sup>344</sup> RULE OF LAW INDEX 2018, p. 162.

<sup>345</sup> US CHAMBER OF COMMERCE 2017.

<sup>346</sup> US CHAMBER OF COMMERCE 2017, p. 43.

<sup>347</sup> US CHAMBER OF COMMERCE 2017, p. 5.

<sup>348</sup> TAX JUSTICE NETWORK: MEASUREMENTS 2018.

<sup>349</sup> TAX JUSTICE NETWORK: MEASUREMENTS 2018.

Scoring Methodology: “A jurisdiction’s FSI Value is calculated by combining its Secrecy Score and Global Scale Weight. A jurisdiction’s Secrecy Score is a measure of how much scope for financial secrecy its financial and legal systems enable, where a score of zero means the jurisdiction’s laws allow no scope for financial secrecy and a score of 100 means the jurisdiction allows unrestrained scope. A jurisdiction’s Global Scale Weight is a measure of how much in financial services the jurisdiction provides to residents of other countries, like opening a bank account or setting up a company. This is presented as a percentage of all financial services globally provided by all jurisdictions to non-residents.”<sup>350</sup>

Score:

Financial Secrecy Index (FSI)					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
60 (5 <sup>th</sup> )	52 (3 <sup>rd</sup> )	59 (4 <sup>th</sup> )	49 (2 <sup>nd</sup> )	66 (6 <sup>th</sup> )	42 (1 <sup>st</sup> )

11. Global Rights Index (GRI)<sup>351</sup>

Issued by the International Trade Union Confederation.

Year: 2018.

Objectives of Score: To document “violations of internationally recognised collective labour rights by governments and employers.”<sup>352</sup>

Scoring Methodology: “The methodology is grounded in standards of fundamental rights at work, based on international human rights law, and in particular ILO Conventions Nos. 87 and 98, as well as the jurisprudence developed by the ILO supervisory mechanisms.”<sup>353</sup>

Score:

Global Rights Index (GRI)					
US	France	Germany	Italy	Netherlands	England and Wales (UK)
4 (6 <sup>th</sup> )	2 (4 <sup>th</sup> )	1 (1 <sup>st</sup> )	1 (1 <sup>st</sup> )	1 (1 <sup>st</sup> )	3 (5 <sup>th</sup> )

12. Index of Legal Certainty (ILC)<sup>354</sup>

Issued by the Civil Law Foundation.

Year: 2015

Objectives of Score: “The Index of Legal Certainty focuses on legal and arbitration procedures, but does not directly aim to assess how well justice is administered (even though this is an essential component of legal certainty). It should also be noted that a possible extension of the Index should deal with the prevention of conflicts and their amicable settlement, particularly through mediation. But it is not the mechanisms by which disputes are settled that are being assessed, but legal certainty in the light of the settling of disputes. The aim is not to measure the degree of separation of the powers or the independence of the judge or the corruption of the judicial system.”<sup>355</sup>

<sup>350</sup> TAX JUSTICE NETWORK: MEASUREMENTS 2018.

<sup>351</sup> GLOBAL RIGHTS INDEX 2018.

<sup>352</sup> GLOBAL RIGHTS INDEX 2018, p. 4.

<sup>353</sup> GLOBAL RIGHTS INDEX 2018, p. 53.

<sup>354</sup> INDEX OF LEGAL CERTAINTY 2015.

<sup>355</sup> INDEX OF LEGAL CERTAINTY 2015, p. 12-13.

Scoring Methodology: The ILC score considers “seven (7) methodological factors in order of their practical utility, i.e. by what they contribute to the indicator as an instrument of information about the conditions, performance or quality of a State legal system.”<sup>356</sup>

Score:

Legal Certainty Index (ILC)						
US	France	Germany	Italy	Netherlands	England and Wales (UK)	
5.75	6.82	6.93	6.19	N/A	6.56	

**FIGURE 6. TRANSNATIONAL LEGAL INDICATOR SCORES, RANKINGS, AND AVERAGE RANKING FOR SIX COUNTRIES**

Transnational Legal Indicator Scores, Rankings, and Average Ranking for Six Countries ( <b>RED/BOLD scores excluded due to incomplete scoring for all countries</b> )						
	US	France	Germany	Italy	Netherlands	England and Wales
1. WGI 2017	91.35 (4 <sup>th</sup> )	88.46 (5 <sup>th</sup> )	91.83 (3 <sup>rd</sup> )	63.94 (6 <sup>th</sup> )	97.12 (1 <sup>st</sup> )	92.31 (2 <sup>nd</sup> )
2. DB 2018	82.54 (1 <sup>st</sup> )	76.13 (4 <sup>th</sup> )	79.00 (3 <sup>rd</sup> )	72.70 (6 <sup>th</sup> )	76.03 (5 <sup>th</sup> )	82.22 (2 <sup>nd</sup> )
<b>3. IAB 2010</b>	-	-	-	-	-	-
<b>3.A-Strength</b>	<b>85</b>	<b>90</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>99.9</b>
<b>3.B-Ease</b>	<b>81.8</b>	<b>86.6</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>87.5</b>
<b>3.C-Judicial</b>	<b>75.3</b>	<b>94.0</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>	<b>94.5</b>
4. FDI-RR 2017	.089 (6 <sup>th</sup> )	.045 (4 <sup>th</sup> )	.023 (2 <sup>nd</sup> )	.052 (5 <sup>th</sup> )	.015 (1 <sup>st</sup> )	.040 (3 <sup>rd</sup> )
5. STRI 2017	-	-	-	-	-	-
5 A. Insurance	.29 (6 <sup>th</sup> )	.13 (1 <sup>st</sup> )	.13 (1 <sup>st</sup> )	.24 (5 <sup>th</sup> )	.15 (3 <sup>rd</sup> )	.16 (4 <sup>th</sup> )
5 B. Legal	.20 (2 <sup>nd</sup> )	.61 (6 <sup>th</sup> )	.24 (4 <sup>th</sup> )	.20 (2 <sup>nd</sup> )	.24 (4 <sup>th</sup> )	.18 (1 <sup>st</sup> )
6. IEF 2018	75.7 (3 <sup>rd</sup> )	63.9 (5 <sup>th</sup> )	74.2 (4 <sup>th</sup> )	62.5 (6 <sup>th</sup> )	76.2 (2 <sup>nd</sup> )	78.0 (1 <sup>st</sup> )
7. GCI 2017-2018	5.85 (1 <sup>st</sup> )	5.18 (5 <sup>th</sup> )	5.65 (3 <sup>rd</sup> )	4.54 (6 <sup>th</sup> )	5.66 (2 <sup>nd</sup> )	5.51 (4 <sup>th</sup> )
8. WJP 2017-2018	.73 (5 <sup>th</sup> )	.74 (4 <sup>th</sup> )	.83 (2 <sup>nd</sup> )	.65 (6 <sup>th</sup> )	.85 (1 <sup>st</sup> )	.81 (3 <sup>rd</sup> )
<b>9. BROAD 2017</b>	<b>71.71</b>	<b>73.6</b>	<b>83.29</b>	<b>59.34</b>	<b>N/A</b>	<b>79.93</b>
10. FSI 2018	60 (5 <sup>th</sup> )	52 (3 <sup>rd</sup> )	59 (4 <sup>th</sup> )	49 (2 <sup>nd</sup> )	66 (6 <sup>th</sup> )	42 (1 <sup>st</sup> )
11. GRI 2018	4 (6 <sup>th</sup> )	2 (4 <sup>th</sup> )	1 (1 <sup>st</sup> )	1 (1 <sup>st</sup> )	1 (1 <sup>st</sup> )	3 (5 <sup>th</sup> )
<b>12. ILC 2015</b>	<b>5.75</b>	<b>6.82</b>	<b>6.93</b>	<b>6.19</b>	<b>N/A</b>	<b>6.56</b>
Ranked Average	3.9 (4 <sup>th</sup> )	4.6 (6 <sup>th</sup> )	2.7 (3 <sup>rd</sup> )	4.5 (5 <sup>th</sup> )	2.6 (1 <sup>st</sup> -T)	2.6 (1 <sup>st</sup> -T)

<sup>356</sup> INDEX OF LEGAL CERTAINTY 2015, p. 51.



### **Chapter 3. "Marching Without Memory: *ex ante* contracts to arbitrate tort claims and strategic behavior."**

#### 1. Introduction.

*"The genius of our judicial process is that it makes possible "creative continuity." As Learned Hand once said, 'We march but we remember'."*<sup>357</sup> Page Keeton, 1968.

Tort law is imperfect. The ability of the law to solve market failures involving accidents or torts is constantly tested. It is not uncommon for the law to fail in this task. Parties who create negative externalities are not always forced to fully internalize the harm they cause. However, the law is not blind to its failures or this imperfection, at least not completely. The failures of tort law to perfectly incentivize parties to take due care are not necessarily lasting. The law changes, or rather, is designed to change and keeps an institutional memory of how it changes. Robert and Page Keeton refer to this when they speak of "creative continuity".<sup>358</sup> However, using private arbitration tribunals to adjudicate tort claims stresses the ability of the law to change adequately in the face of its failures and provides a persistent opportunity for strategic behavior that would not be available, or which is limited by rules and procedures in a public judicial system. Arbitration prevents the law from making new institutional memories. According to Carl Sagan, "writing is perhaps the greatest of human inventions, binding together people, citizens of distant epochs who never knew one another" allowing us to "break the shackles of time, proof that humans can work magic."<sup>359</sup> One of the inputs courts uses are the institutional memories the law creates when courts write down their judicial opinions. The use of arbitration may preclude the law from creating some

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<sup>357</sup> P. KEETON 1968, p. 559. Quoting his brother, Judge Robert Keeton, who wrote on creative continuity. Quoting Judge Learned Hand from an unspecified source.

<sup>358</sup> According to R. KEETON, "any legal system, to remain viable over a span of time, must have the flexibility to admit change. To find solutions for a succession of differing problems in a continuously changing context, it must be creative". R. KEETON 1962, p. 463.

<sup>359</sup> SAGAN 1980.

memories. If the law is marching without memory or with constrained memory, where will it lead, and how can anyone follow it?

This chapter addresses the use of arbitration in tort claims under the standard economic model of due care, given the imperfections of tort law. This chapter is focused on a narrow issue, which takes up a niche area among other research involving arbitration. It does not address the overall use of contracts to arbitrate but rather the use of arbitration specifically for claims originating in tort. More generally, this chapter focuses on those tort claims in which the calculus of negligence could be used to reach an economically efficient outcome by the court. While it may be useful to consider how different liability standards give different combinations of incentives to take care, the strict liability standard is less likely to be continually adjusted by courts as it has been narrowly applied when compared to the scope of negligence rules. Additionally, even with a strict liability rule, the defense of contributory negligence means the calculus of negligence is still relevant. The negligence standard is thus appropriate to consider within the use of arbitration for tort claims. Furthermore, this analysis looks specifically at those types of claims capable of leading to the production of public goods from litigation that has a nexus of facts wholly contained within a state. Claims which have an international nature that contains choice of law questions are not considered here, as there has been a convergence of international norms for the use of arbitration for commercial disputes which cross borders under the New York Convention.<sup>360</sup> This limited scope is appropriate given that only a portion of the arbitrated claims involve tort claims, and many *ex ante* contracts to arbitrate tort claims do not fall under the New York Convention. Despite the narrow scope of this analysis, this research aims to argue that the adjudication in private arbitral tribunals of tort claims may influence social welfare. Specifically, this research focuses on the

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<sup>360</sup> NEW YORK CONVENTION 1958.

incentives of potential tortfeasor firms to take care, which directly impacts social welfare, given that accidents are costly and produce negative externalities for individuals and society. Importantly, this analysis is attentive to the social welfare implications of using arbitration for tort claims and how these claims interact with the law and the litigation process, given that the law is not static and functions as a type of feedback loop in reviewing and adjusting standards of care involving tort claims.

The impact of the strategic use of arbitration on incentives to take care can be best understood under the standard model of due care found in the law and economics literature, specifically with regard to how the minimization of accident costs may be frustrated by the strategic behavior of firms. Arbitration impacts the costs and benefits of adjudicating tort claims, which, as the standard model explains, are an integral part of setting efficient due care standards. If we further consider the social costs and benefits of using arbitration for tort claims, we can see there is a need to weigh these costs and benefits in order to determine what the optimal use of arbitration for tort claims is.<sup>361</sup> The consequence of using arbitration for tort claims may lead to an increase in problems which have developed in the adjudication of tort claims, or it may provide a benefit which outweighs the cost of these problems.<sup>362</sup>

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<sup>361</sup> In the seminal article “The Problem of Social Cost”, COASE identified how the perfect world is perhaps unattainable, so much so that it is not necessarily helpful to consider how policy can be designed to reach perfection. Rather, Coase argues that “[a] better approach would seem to be to start our analysis with a situation approximating that which actually exists, to examine the effect of proposed policy changes and to attempt to decide whether the situation would be, in total, better or worse than the original one” The example of pollution is brought up by COASE, who identified how problems, such as pollution causing a fish kill, “has to be looked at in total and at the margin”. As the use of arbitration for tort claims and pollution both come with costs and benefits, it is appropriate to look at the total costs of using arbitration for tort claims. According to COASE “if we assume that the harmful effect of the pollution is that it kills the fish, the question to be decided is: is the value of the fish lost greater or less than the value of the product which the contamination of the stream makes possible”. COASE 1960, p. 43, 2, 2.

<sup>362</sup> Coase argued that attention should be paid to how “corrective measures” change how the system works, as “changes in the system may well produce more harm than the original deficiency”. COASE 1960, p. 43.

There are problems associated with the private enforcement of tort claims. Courts and legal systems have developed various rules designed to solve the problems of court error, information asymmetry, scattered losses, meritorious negative value claims, RP advantages, and strategic behavior. These problems highlight how due care rules may not always provide the right incentives, *ex ante*, for injurers to take due care. Corrective rules and procedures may not be available in arbitration or may be contracted away in combination with an *ex ante* arbitration clause in the underlying contract.

There are clear benefits of using arbitration for some claims.<sup>363</sup> These benefits may not always outweigh the full costs of using arbitration. Benefits may flow to one party at the expense of the other party, or the cost and benefits of using arbitration may change asymmetrically between the injurer and victim.

The public adjudication of tort claims has the potential to produce public goods in the form of precedent, rule interpretation, gap filling, and information production. In both common law and civil law legal traditions disputes serve the role of inputs which courts need to produce specific types of public goods from litigation. While arbitration may have the immediate impact of lowering the cost of administering public court systems, arbitration does not produce any of these public goods. Rather arbitration is designed to produce a privately adjudicated decision. The use of arbitration for tort claims should not be seen as either good or bad but both good and bad. As with other activities, like pollution, arbitration can be seen as both capable of producing a good at a lower cost while also producing a byproduct that can be harmful and has costs.<sup>364</sup> Some parties

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<sup>363</sup> Arbitration is seen to produce some efficiencies and transaction costs savings, particularly in the context of commercial arbitration. For a law and economics perspective on arbitration, including a discussion about the potential benefits of using commercial arbitration, see: VAN AAKEN and BROUDE 2016.

<sup>364</sup> Like many legal dilemmas, this is analogous to the pollution causing a fish kill, which Coase identified. COASE 1960.

may benefit privately from the underproduction of public goods resulting from the adjudication of claims, even if there is a decrease in public welfare because of the underproduction. This can be considered in terms of asymmetric stakes in the law. Public goods are often underproduced, and the production of public goods from adjudication are also susceptible to underproduction.

The standard economic model of due care may be frustrated by the use of arbitration for tort claims due to the strategic behavior of parties involved in the claims. Due care standards impose costs on parties to take care. Some care costs may be minimal, while other care costs may be substantial. By using the calculus of negligence, some of the care costs may be identified. Parties looking to avoid care costs may act strategically to frustrate the enforcement of due care standards, thus avoiding liability for the externalities they have created or enabling shirking from taking due care to avoid care costs. The ability to behave strategically can be further developed by a RP, who may continually gain efficiencies and expertise in a common claim which is arbitrated many times over.

The problem of using arbitration for consumer contracts has been discussed using various methodologies, as has the topic of commercial arbitration. However, this research looks to explain the problems of using arbitration specifically for tort claims within the framework of the standard economic model used in law and economics.<sup>365</sup> Appendix C further explains how strategic behavior related to using arbitration for tort claims may impact the incentive to take due care using the standard economic model of care.

This chapter is structured in the following manner: Section 2 addresses some examples of the use of arbitration for tort claims. Section 3 concerns the goals of tort law. Section 4 addresses the tension between contract law and tort law. Section 5, the most comprehensive portion of the

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<sup>365</sup> The author has found no similar study specifically addressing the use of arbitration for tort claims and the impact this has on due care standards.

research, concerns failures in tort law and related opportunities to behave strategically by RPs given these failures in tort law and how the use of arbitration provides increased opportunities to behave strategically. Appendix B provides examples of contracts to arbitrate found in the US cellular phone service market. Appendix C concerns how the incentives to take care, which is the basis of the standard economic model of care found in the marginal Hand formula, may be stressed by the strategic use of arbitration for tort claims.

## 2. US Examples of Arbitrating Tort Claims.

Before starting the discussion of how arbitration may affect due care standards, it may be useful to look at some industries that commonly use mandatory arbitration clauses in their consumer or service contracts. Some real samples of arbitration clauses from the US cell phone service industry, from or prior to 2018, are included in Appendix A. There is a lack of public information about arbitration decisions due to their confidential nature. However, we can readily observe the presence of arbitration clauses in various contracts, particularly consumer contracts in the US.<sup>366</sup>

In principle, tort claims can be arbitrated in both the US and the EU, although in practice, the US and the EU are distinctively different, and aside from EU community laws, there are divergent approaches within EU member states.<sup>367</sup> Generally, any contract can include an arbitration clause in the US, and US courts have shown an increasing willingness to enforce arbitration agreements in the past three decades, starting with the 1984 *Southland* holding.<sup>368</sup> However, in the EU, there

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<sup>366</sup> While information about arbitration decisions is difficult to gather, some US states have mandated the disclosure of information from arbitration associations, notably California. For a review of the substance of the CA mandatory reporting statute, see: JUNG 2013.

<sup>367</sup> See chapter 2, section 2, regarding a comparison of arbitration law arbitration in the US, UK, Netherlands, Germany, France, and Italy.

<sup>368</sup> The SCOTUS has determined that the FAA “rests on the authority of Congress to enact substantive rules under the Commerce Clause” and applies to states under the supremacy clause, meaning that “the substantive law the Act created” is to be “applicable in state and federal courts.” *Southland Corp. v. Keating*, (1984), p. 11, p. 12. For a legal history of the FAA, see: SZALAI 2016.

are two general approaches that are distinct from the US, specifically concerning consumer contracts. First, EU states may "prevent consumer arbitration agreements in the form of arbitration clauses" with the possibility "to reach an arbitration agreement after the dispute has arisen" and; second, "consumers are free to conclude an arbitration agreement before the dispute has arisen, but the arbitration clause is deemed abusive unless it has been individually negotiated and subscribed".<sup>369</sup> A 2019 study from SZALAI found that of the "top 100 largest domestic United States Companies," which hold "\$21.6 trillion in market value", that eighty-one "used arbitration agreement in connection with consumer transactions," of which "seventy-eight companies include class waivers in their arbitration agreement".<sup>370</sup> The scope of the issue is significant in the US, where contracts to arbitrate are broadly interpreted under the FAA, while in the EU, the scope of the issue is narrower due to limits on contracts to arbitrate consumer claims found in community law. Only recently has the US Congress acted to limit the expansive interpretation of the FAA developed by the SCOTUS by limiting the use of forced arbitration in claims involving sexual assault and sexual harassment.<sup>371</sup>

From a practical standpoint, the expansive use of arbitration in the US provides numerous examples of how arbitration is used for tort claims. There are divergent approaches to the use of arbitration for tort claims, and it is not as simple as labeling a state as allowing the arbitration of tort claims or not, but rather a matter of when and under what conditions will an *ex ante* contract to arbitrate tort claims be enforced. The various possible uses of arbitration for tort claims show a need to weigh the costs and benefits of using arbitration for a multitude of tort claims.

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<sup>369</sup> ORTOLANI et al. 2015, p. 51.

<sup>370</sup> SZALAI 2019, pp. 233-234.

<sup>371</sup> ENDING FORCED ARBITRATION ACT 2022

## 2.1 US Industries Mandating Arbitration.

There is widespread use of arbitration in the US in the consumer products and services market due to the SCOTUS's expansive view of the FAA. The use of mandatory arbitration can be found across all sectors of the US economy. Arbitration clauses can be found in conjunction with cell phone service, software, and phone apps, attached to warranties for consumer goods, included in a contract to open a saving account at a bank, in sales contracts for food and beverage products, within service contracts which cover a wide range of services and related goods, and in nearly every type of contract.<sup>372</sup> Because of the widespread use of arbitration, it may be useful to look at a few specific industries in the US that use arbitration clauses in their standard contracts.

### 2.1.1 Telecom.

If we look at the use of arbitration in the cell phone service market in the US, we can readily see a lack of options for consumers. A merger between Sprint and T-Mobile in 2019 further concentrated the US cell phone service market.<sup>373</sup> A 2008 empirical study by EISENBERG et al. found that among several US industries, including the telecom industry, firms "view consumer arbitration as a way to save money by avoiding aggregate dispute resolution".<sup>374</sup> A short survey of the top five US cellphone service providers prior to the T-Mobile Sprint merger found that each firm used arbitration clauses in their user agreement.<sup>375</sup> In the contracts used in 2018 in the US cell service

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<sup>372</sup> See: CENTER FOR JUSTICE AND DEMOCRACY 2019.

<sup>373</sup> FCC 2019.

<sup>374</sup> EISENBERG et. al. 2007, pp. 894-895. Also, according to Eisenberg et al., "cell phone and credit card companies face a substantial economic threat due to their millions of customers. Intentional or intentional acts that deprive millions of customers of small amounts threaten financial and telecommunications firms only if customers can aggregate their claims. Industrial concentration and the varied risks of aggregate litigation thus suggest an explanation for the pattern of consumer contract mandatory arbitration" clauses. EISENBERG et. Al. 2007, p. 892.

<sup>375</sup> See: Appendix B.

industry, all had an arbitration clause, four of the five major cell providers had a mandatory arbitration clause, with one providing a 30 day opt out option.<sup>376</sup>

### 2.1.2 Medical Services.

The use of mandatory arbitration agreements for medical services in the US has rapidly grown in the past two decades. The 2012 *Marmet Health Care* ruling by the SCOTUS allowed for arbitration agreements in nursing care contracts.<sup>377</sup> Tripp examined the use of arbitration agreements in nursing home care contracts in North Carolina using a survey of nursing home admissions packets, finding that “[f]orty percent (n=82) of those packets contained arbitration agreements” and “[t]he vast majority of the packets containing arbitration agreements came from facilities that were part of large for-profit chains of nursing homes” while “[o]f the 82 facilities that had arbitration agreements in their admission packets, 75% (n=62) of them came from facilities in large chains”.<sup>378</sup> Several years ago, the Obama administration sought to limit the use of arbitration agreements in nursing care contracts. However, the rule was never implemented as it faced legal challenges in court, and the Trump administration reversed the rule, clearing the way for the continued use of arbitration in nursing care contracts.<sup>379</sup> In the US, there have been multiple instances in which tort claims alleged against nursing care facilities, including wrongful death claims and malpractice, have been diverted to arbitration.<sup>380</sup>

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<sup>376</sup> Appendix B details each arbitration agreement with VERIZON, AT&T, T-MOBILE, SPRINT, and US CELLULAR used in 2018.

<sup>377</sup> According to SZALAI, “in *Marmet Health Care Center, Inc. v. Brown*, the Supreme Court applied the FAA in another state proceeding and held that the FAA preempts state law guaranteeing a state judicial forum for personal injury claims against nursing homes,” which in his view, involved “an unconstitutional displacement of state law resulting from the flawed *Southland* holding.” SZALAI 2016, p. 121. *Marmet Health Care Center, Inc. v. Brown*, (2012). *Southland Corp. v. Keating*, (1984).

<sup>378</sup> TRIPP 2011, p. 95.

<sup>379</sup> JAFFE 2017.

<sup>380</sup> See: CENTER FOR JUSTICE AND DEMOCRACY 2019.

### 2.1.3 Employment Contracts.

The relationship between employees and employers is a contractual relationship which may include an agreement to arbitrate any disputes related to the relationship. There are numerous examples of torts occurring within the context of an employment agreement, including: wage theft, on the job sexual harassment and assault, negligent hiring, and safety standards, dangerous working conditions causing long term medical problems, and on the job accidents.

In the US, the use of arbitration in employment contracts has significantly increased since the SCOTUS began expanding the scope of the FAA. A recent study by the Economic Policy Institute found that “since the 2000s, the share of workers subject to mandatory arbitration has more than doubled and now exceeds 55 percent”.<sup>381</sup> The use of arbitration in employment contracts may not necessarily impact the firm's incentives to take due care when a collective contract is negotiated.<sup>382</sup> If, for instance, the arbitration clause was collectively bargained over and includes the availability of labor union assistance in the arbitration proceeding for the employee, incentives for the firm to take due care might be higher than between a firm and a single none union employee or contractor. In essence, the labor union can act as a RP and has bargaining power, while the single non-unionized worker or contractor acting alone has neither advantage. The level of experience and information that the labor union has is higher than the inexperienced, un-unionized individual worker or contractor. Using workers' insurance and regulatory oversight in some industries may also give firms and individuals the proper incentives to take due care. POSNER has discussed how

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<sup>381</sup> COLVIN 2018, p. 1.

<sup>382</sup> According to HYLTON, “In the union context many commentators have argued that the bargaining process creates its own special form of institutional common law, and the arbitrators enjoy an advantage over judges in understanding and applying that law. In this case, the deterrence benefits probably are larger and dispute resolution costs smaller under the arbitration regime than in court. If this is true, then arbitration agreements in the union setting may often be “win-win” arrangements that require no side payment among the parties in order to secure the agreement.” HYLTON 2000, p. 233.

a bilateral monopoly may exist between labor and industry.<sup>383</sup> This bilateral monopoly could force the two sides to bargain with each other at arm's length, meaning one side could not impose their will on the other party, and the two sides could only reach an agreement that would provide benefits for both sides. Still, there remain questions concerning whether unions can represent all union members equally. Despite the difference in bargaining power, both unionized and non-unionized laborers face the possibility of having a claim in tort against their employer. The key distinction is whether the unionized or non-unionized worker is able to be adequately represented in negotiating agreements to arbitrate in their labor contracts.

### 3. The Goals of Tort Law.

While providing compensation to tort victims is often considered a goal of tort law, it is not necessarily the only or best way to understand the goals of tort law.<sup>384</sup> The goals of tort law are generally seen by law and economics scholars as minimizing the cost of accidents.<sup>385</sup> As famously laid out by CALABRESI IN 1970, the goals of tort law should be to minimize the primary, secondary, and tertiary costs of accidents.<sup>386</sup> While issues of fairness and just compensation are not completely void from a legal evaluation of tort law, for determining the "economic optimization of tort law," we should consider compensation "merely as a means, an instrument to force the potential injurer toward efficient prevention".<sup>387</sup> According to SHAVELL, the social goal of tort law should "be the minimization of the sum of the cost of care and of expected accident

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<sup>383</sup> POSNER 2011, p. 426.

<sup>384</sup> According to MICELI, "The primary social functions of tort law are twofold: to compensate victims for their injuries and to deter "unreasonably" risky behavior. Although the economic approach to tort law is not unconcerned with the goal of compensation, its primary goal is optimal deterrence. To this end, tort rules are viewed, first and foremost, as providing monetary incentives for individuals engaged in risky activities to take all reasonable (cost-justified) steps to minimize overall accident costs." MICELI 2017, p. 39.

<sup>385</sup> According to DARI-MATTIACCI and PARISI, "economic analysis suggests that the primary reason for utilizing the tort system is to allow risk-creating activities to be carried out only if the social value of the activity justifies the risk created." DARI-MATTIACCI and PARISI 2003, Section 1.

<sup>386</sup> See: CALABRESI 1970.

<sup>387</sup> FAURE 2017, p. 80.

losses," and the "socially optimal level of care will clearly reflect both the cost of exercising care and the reduction in accident risks that care would accomplish".<sup>388</sup> From looking at law and economics scholars, it becomes clear that tort law should be designed to balance the costs and benefits of activities which could lead to a tort to provide incentives to take care. If the goal of tort law was merely to provide compensation to victims, this can be done through other policies.<sup>389</sup> If the goal is to prohibit an activity, criminal law coupled with strict liability for harm caused by criminal acts may be a better legal approach. If not, then balancing the costs and benefits of taking care is more appropriate.

A major contribution to the economic analysis of tort law is from Judge Learned Hand, who developed what is known as the Hand formula. In a now famous case from the US, *United States v. Carroll Towing Co.*, Judge Learned Hand formulated a standard of considering the probability of loss to a burden of care, where " $B < PL$ ".<sup>390</sup> The reasoning by Judge Hand has become emblematic of how a standard of care is calculated within the context of a negligence tort claim and is known under several names, including the Hand rule, the Hand test, and the calculus of negligence and is graphed in Figure 7.

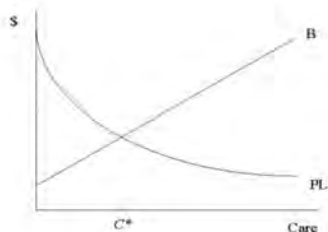
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<sup>388</sup> SHAVELL 2009, p. 178.

<sup>389</sup> According to SHAVELL "in the absence of a the liability system, compensation of victims would probably be about as well accomplished through private and social accident insurance as it is today," rather, "[t]he main difference that the liability system can make to outcomes is the creation of incentives toward safety". SHAVELL 2004, p. 268.

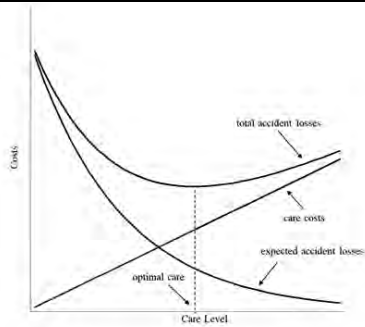
<sup>390</sup> The Hand rule was identified in the context of an accident involving the mooring of a barge being leased by the US government in New York City, which broke away and sunk in the process of it being moved to another location by the Carroll Towing Company. According to Judge Hand, "the owner's duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i. e., whether  $B < PL$ ." *United States v. Carroll Towing Co.*, (1947), p. 173.

FIGURE 7. THE HAND RULE.<sup>391</sup>



The marginal Hand rule identified by BROWN, adjusts the Hand rule slightly, so the care which should be taken corresponds to when the marginal costs of care are equal to the marginal benefits of care instead of simply using the costs and benefits, as shown in Figure 8.<sup>392</sup> The marginal Hand rule is formulated to fully capture the potential benefits of taking care and minimizes the costs associated with accidents when set correctly.

FIGURE 8. THE MARGINAL HAND RULE.<sup>393</sup>



There are many activities which, if completely banned, would lead to fewer accidents, such as prohibiting the driving of cars or the use of trains in order to prevent car and train accidents, but

<sup>391</sup> THE BRIDGE.

<sup>392</sup> BROWN 1973, p. 332.

<sup>393</sup> Based on the graph from SHAVELL 1987.

society benefits from these technologies, and those benefits must also be accounted for as they can be considered positive externalities.<sup>394</sup> The law looks to limit losses from accidents while maximizing the benefits of the underlying activity, which has value.<sup>395</sup> For instance, if an activity were inherently dangerous, the law could hold a party responsible for any damages caused by the activity under a strict liability standard.<sup>396</sup> For less dangerous activities which lead to welfare benefits, the law may use another standard. The analysis here will focus on the due care standards, traditionally used in negligence, not activity standards.<sup>397</sup>

Identifying a due care standard for a given tort claim is the first step when pursuing a claim. A plaintiff must establish a duty which the injurer is responsible for. Under the common law rules for establishing a tort, once a duty has been established, it must also be shown that a breach of the duty occurred and that there was indeed a causal link between the breach of duty and the harm which the victim suffered, in addition to a determination of what harm occurred.<sup>398</sup> In this sense, the economic analysis of due care standards focuses on what duty exists and what the duty entails. While the use of arbitration for tort claims may impact the breach, causation, and harm steps of proving a tort claim, the impact on incentives to take due care *ex ante*, before any harm has materialized, is the focus of this analysis.

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<sup>394</sup> According to SHAVELL, "If the social goal were simply to minimize the number of automobile accidents, the best rule might well involve severe punishment for causing an accident, whereas if the social goal were also to involve the benefits people obtain from driving, the best rule would be unlikely to involve very rigorous punishment for causing an accident." SHAVELL 2004, p. 2.

<sup>395</sup> See COASE 1960.

<sup>396</sup> According to SHAVELL "Under the rule of *strict liability*, injurers must, by definition, pay for all accident losses that they cause. Hence, injurers' total costs will equal total social costs; and because injurers will seek to minimize their own total costs, injurers' goal will be identical to the social goal of minimizing total social costs. Consequently, strict liability induces injurers to choose the socially optimal level of care." SHAVELL 2004, pp. 179-180.

<sup>397</sup> According to SHAVELL, since "benefits that parties derive from their activities" ... "seem practically unknowable, attempts by courts to determine appropriate levels of activity would probably land them in a speculative realm". SHAVELL 2004, p. 198.

<sup>398</sup> The elements of a tort claim vary from state to state; for instance, in the Netherlands, a civil law jurisdiction, a tort includes "unlawfulness, attributability, loss, causality and relativity" found in Burgerlijk Wetboek Art. 6:162 and 163 DCC. DCC art. 6.

#### 4. Tension Between Tort and Contract Law.

Arbitration involves private judges, or arbitrators, adjudicating a legal claim or dispute.<sup>399</sup> In order to use arbitration, all parties must consent to its use. This usually occurs when a contract is agreed upon *ex ante* before any injury has occurred. Arbitration can be contracted for between parties *ex post* as well, but this type of arbitration is much different because parties will not have the same incentives *ex ante* and *ex post*.<sup>400</sup> Generally, the contracts to arbitrate tort claims discussed here are *ex ante* contracts. In the US, contracts to arbitrate are usually found within a clause in the underlying contract. In the EU, contracts to arbitrate may require a separate bargained over arbitration contract or may be prohibited *ex ante* but allowed *ex post*.

In the US, a contract to arbitrate is often used alongside contracts to prohibit collective actions and contracts which limit the liability of one of the parties to the counterparty.<sup>401</sup> Arbitration may be favored when there is a question about the ability of juries or judges to make reliable decisions.<sup>402</sup> Arbitration generally produces no precedent.<sup>403</sup>, particularly when it is between business and consumers, and an arbitration agreement is often combined with other clauses to further limit the choices of the parties in a dispute.<sup>404</sup> The use of arbitration may provide cost savings compared to

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<sup>399</sup> According to VAN AAKEN and BROUDE, “[a]rbitration is an agreed, (usually) binding, third-party form of resolving disputes, akin to adjudication (or litigation), but with a private dimension”. VAN AAKEN and BROUDE 2016, p. 5.

<sup>400</sup> According to SHAVELL, *ex post*, and *ex ante* agreements to arbitrate will affect behavior differently. "Ex post ADR agreements are somewhat different, in part because parties do not take into account how such agreements will affect their prior behavior" and the "benefits of *ex ante* ADR agreements cannot generally be obtained by means of *ex post* agreements to use ADR". SHAVELL 1995, p. 1 and p. 3.

<sup>401</sup> For a detailed discussion on Class Waivers, see: STERNLIGHT and JENSEN 2004.; and for exculpatory clauses, see: BURNHAM 2014.

<sup>402</sup> According to POSNER, "[a] common reason for including an arbitration clause in a contract is to avoid vagaries of determinations made by jurors, who rarely have commercial experience". POSNER 2011, p. 803.

<sup>403</sup> For a discussion on the potential for arbitration to produce precedent, see: WEIDEMAIER 2010.

<sup>404</sup> According to LANDES and POSNER "Precedent has 'public good' aspects that may result in underproduction in a private market. However, to the extent that the costs and benefits of precedent will be borne (in the future) entirely by the parties to the suit in which the precedent is created, precedent is a private rather than public good." LANDES and POSNER 1979, p. 261.

a state court, benefit parties wishing to continue relationships, and reduce the time needed to resolve the dispute.<sup>405</sup> However, these assumptions may not hold depending on the nature of the dispute, the relative advantages of the parties involved, and the parties' ability to act strategically. Within the context of arbitration of tort claims, there is tension between the goals of tort law and contract law.<sup>406</sup> Some contracts to arbitrate may be welfare reducing.<sup>407</sup>

Arbitration, confidentiality, class waiver, and limiting liability clauses may be used together in a contract. Often, these clauses are contained in what has been labeled an “adhesion” contract which is nonnegotiable.<sup>408</sup> According to GILO and PORAT, “transaction costs generated through boilerplate language or in other artificial means could have different impacts on different types of consumers, enabling, inter alia, the screening out of unwanted consumers, price discrimination, cartel stabilization, and the studying of consumer preferences”.<sup>409</sup> These types of clauses, when combined into a contract, may provide parties with an opportunity to avoid fully internalizing the

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<sup>405</sup> According to LANDES and POSNER “even If the precedents or procedures used in the public court system were as or more efficient than those of arbitration, the existence of a long court queue—which is equivalent to a price for judicial services—might reduce the net value of the judicial services provided by the public system to the point where arbitration, though socially less efficient, was an attractive substitute”. LANDES and POSNER 1979, p. 250.

<sup>406</sup> See the discussion in the introductory chapter section 3 concerning the interaction between tort and contract law.

<sup>407</sup> According to SHAVELL, “The parties to a dispute may mutually desire to choose a private system of adjudication over the public system. Notably, they may want to do this to lower the costs of dispute resolution and to reduce risk. However, allowing them to choose a private system does not necessarily raise social welfare. Consider an accident between an individual and a firm. They may decide that it is in their joint interests to elect arbitration for its simplicity and speed, but that may mean that the firm escapes with inadequate liability or that the firm's fault is never properly investigated and made known to the public. And if firms anticipate often being able to reach such agreements to arbitrate, they may not be properly deterred. In other words, because the ex post incentives of parties to use private adjudication are naturally divorced from considerations of deterrence, their use of private systems may be undesirable. By contrast, when parties make agreements ex ante, and all potentially affected parties are involved in the agreements, deterrence is not overlooked.” SHAVELL 2004, pp. 447-448.

<sup>408</sup> In 1943 KESSLER wrote that “the development of large scale enterprises with its mass production and mass distribution made a new type of contract inevitable- the standardized mass contract” to be “used in every bargain dealing with the same product or service.” KESSLER 1943, p. 631.

<sup>409</sup> GILO and PORAT Add that “on other occasions, the transaction costs are imposed in order to hide benefits granted to certain consumers. On yet other occasions the transaction costs are self-imposed by the supplier in order to signal to buyers or competitors that negotiation of the contract would be very costly. There are other cases in which boilerplate language and the artificial imposition of transaction costs do create asymmetry of information between the supplier and its consumers, as in the classic discussions of boilerplate language, but the asymmetry is used as a cartel facilitation tool, an anticompetitive signal device, or a tool for creating the appearance of a fair contract, rather than to merely extract surplus from uninformed consumers.” GILO and PORAT 2005, p. 1030.

costs of accidents they cause or contribute to, or provide an opportunity to avoid transaction costs, including costs related to taking care.<sup>410</sup> According to THORNBURG, “arbitration clauses that provide slanted processes or limited remedies undermine the efficiency goal of personal injury law”.<sup>411</sup> The liability avoidance and the avoidance of transaction costs may not always be to the detriment of the counterparty if, for instance, the cost savings of using these contractual terms are passed onto the counterparty in the contract or if there are other considerations which the parties value, such as confidentiality and the speed of resolving a dispute.<sup>412</sup> BEN-SHAHAR identifies how the “weakest subgroups of consumers” may find “potentially favorable” implications from agreeing to arbitration clauses, as “[a]ccess to courts is ...disproportionally utilized by the sophisticated elite, and these benefits are partially paid for by all consumers, including less sophisticated consumers, through higher prices”.<sup>413</sup> The argument that cost savings from arbitration are passed onto consumers implies there are options for the purchaser or laborer and that there is competition within the market.<sup>414</sup> In a perfectly competitive market, there would be a number of differentiated goods that fully capture the needs of each consumer.<sup>415</sup> If the arbitration

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<sup>410</sup> According to GUPTA and KHAN “The cost of bilking consumers-be it by design or through negligence- will drop, given that consumers pursue claims through arbitration at far lower rates than they do through litigation, and those who do file arbitration claims seem to be less successful”. GUPTA and KHAN 2016, p. 515.

<sup>411</sup> THORNBURG 2004, p. 271.

<sup>412</sup> According to HYLTON, “In settings where parties are repeat dealers, or involved in longterm contracts, they are in a position to compare the governance benefits and enforcement costs of the rules governing their conduct. They can decide whether a certain rule is too expensive, because the governance benefit associated with that rule is less than its enforcement cost. If they decide that a particular rule is too expensive, they may agree among themselves to waive the rule. If parties are rational and well-informed, they will waive a legal rule whenever the governance benefit from the rule is less than the enforcement cost.” HYLTON 2004, pp. 491-492.

<sup>413</sup> BEN-SHAHAR 2016, p. 1798.

<sup>414</sup> DRAHOZAL and WARE comment, when responding to Eisenberg 2008, that “we do not think there is any doubt that businesses using arbitration clauses in their consumer contracts do so because they are pursuing their own interests. The important question is whether they are also (even if indirectly and unintentionally) advancing the interests of their customers...[t]he important question – the question that divides scholars studying consumer arbitration- is not the corporation's motivation for putting the arbitration clause in the cell-phone or credit card form contract but whether that clause benefits or harms the customers who assent to that contract”. DRAHOZAL and WARE 2010, pp. 469-470.

<sup>415</sup> According to COOTER and ULEN, “Competitive markets contain enough buyers and sellers that each person

clauses are being used by a firm with a monopoly position, the firm could, in effect, use the arbitration clauses to perpetuate the monopoly.<sup>416</sup>

Some of the types of contracts which may have an arbitration clause include consumer sales and service contracts, medical service contracts, and labor contracts.<sup>417</sup> Each of these contracts has a unique set of regulatory rules associated with them, and the standards of care will vary depending on the activity taken. For instance, doctors are often monitored by medical boards overseen by a public regulatory body.<sup>418</sup> When a regulatory body is tasked with reviewing the due care standards of a regulated party after an accident, this can be considered as a shift in the tertiary costs of accidents from one part of the government to another. This also highlights the differences between public and private enforcement of regulation. A state policy may allow individuals to bring legal claims for harm caused by activities which the state regulates. In this way, the state encourages the private enforcement of a public regulation as a complement to the public enforcement efforts of the state.<sup>419</sup> In the US, for instance, the Department of Justice (DOJ) has adopted a policy of relying

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has many alternative trading partners. In contrast, oligopoly limits the available trading partners to a small number, and monopoly limits the available trading partners to a single seller. When trading partners are limited, bargains can be very one-sided." COOTER and ULEN p. 298.

<sup>416</sup> According to GUPTA and KHAN, "firms that possess monopoly power can enact a sort of "double punch" by imposing arbitration terms that insulate the abuse of that same power. As Justice Kagan warned in her dissent in that case, '[t]he monopolist gets to use its monopoly power to insist on a contract effectively depriving its victims of all legal recourse.' In this way, 'a company could use its monopoly power to protect its monopoly power, by coercing agreement to contractual terms eliminating its antitrust liability." GUPTA and KHAN 2016, p. 516. Citing to: *Am. Express Co. v. Italian Colors Restaurant*. (2013), (Kagan, J., dissenting).

<sup>417</sup> This is a non-exhaustive list, but in these types of contracts, the use of arbitration clauses has increased in the US since the SCOTUS started a line of rulings in the 1980s which give an expansive view of the FAA. See: SZALAI 2016, p. 121.

<sup>418</sup> Consider Medical boards which oversee and regulate the practice of medicine, regulatory bodies such as attorney ethics panels which review ethics complaints against attorneys, and regulatory agencies which oversee dangerous industries such as coal mining or oil and gas extraction. For a discussion of the comparative uses of liability and regulation, See: SHAVELL 1984. In Colorado, "The Colorado Medical Board (CMB) was instituted as part of the Medical Practice Act for the purpose of regulating and controlling the practice of healing arts, which include establishing and enforcing the licensing standards for Medical Doctors (M.D.s), Doctors of Osteopathy (D.O.s), Physician Assistants (P.A.s), and Anesthesiology Assistants (A.A.s)." "The Division of Professions and Occupations provides consumer protection through its regulation of more than 500,000 licensees within more than 50 professions, occupations and businesses in the State of Colorado." CDRA. CRS, COLORADO MEDICAL PRACTICE ACT 2020.

<sup>419</sup> According to THORNBURG, "A decrease in the deterrent effect of the law is especially problematic in the United States, where tort duties are a major component of how social policy is enforced. The United States depends in large

on the private enforcement of antitrust laws to support the DOJ's public efforts.<sup>420</sup> Provided there is a difference between the state and private parties in their abilities to identify when harm has occurred due to a failure to take due care by a regulated party, there should be a mixed equilibrium of private and public enforcement of regulation. Therefore, contracts to arbitrate tort claims may lead to frustration of a public policy which relies on the private enforcement of regulation.

#### 4.1 Goals of Contract Law.

Well informed parties should enter into contracts which make them better off. SCHWARTZ and SCOTT argue that "contract law should facilitate the efforts of contracting parties to maximize the joint gains (the "contractual surplus") from transactions" and "contract law should do nothing else".<sup>421</sup> According to CRASWELL, the economic theory of contracts is concerned with utility "since voluntary transactions generally increase the welfare of the parties to the transaction, whenever a promise is voluntary it could be argued that welfare will usually be increased if the promise is carried out".<sup>422</sup> Under this reasoning, as individuals are in the best position to know what contracts will increase their utility, they should be allowed to contract with others. The state can support the ability of parties to commit to contracts through the enforcement of contracts. However, states have developed mandatory rules that cannot be contracted over. States have also developed default rules that can fill in the gaps of privately entered into contracts that are incomplete. SCHWARTZ identifies how the law should serve "five regulatory functions for inter-firm contracts" including "enforcing a contract's verifiable terms", "supplying vocabularies",

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part on private lawsuits, including suits seeking compensation for personal injuries, for the enforcement of these policies. Despite this private enforcement mechanism, the goals remain public, and public interest in the enforcement of the law remains". THORNBURG 2004, p. 271.

<sup>420</sup> According to the DOJ handbook, an investigation by the DOJ may arise from the "monitoring of private antitrust litigation to determine whether the Division should investigate the matter." DOJ 2015, p. 6.

<sup>421</sup> SCHWARTZ and SCOTT 2003, p. 544.

<sup>422</sup> CRASWELL 2000, p. 18.

"interpreting agreements", "supplying default rules" which includes a problem solving, informational, and fairness function, and "regulating the contracting process".<sup>423</sup> These functions may not necessarily be applicable when one of the parties is an individual rather than a firm. The goals of contract law can be severely frustrated when assumptions of rational behavior are relaxed or when parties are unable to gather or understand information necessary to fully enter into contracts, and likewise, the goals of tort law may be frustrated because of behavior that deviates from the rational actor model.<sup>424</sup> If parties are incapable of entering into welfare increasing contracts, then the law may intervene to prevent these contracts from being enforced, such as when one party lacks mental capacity or is improperly induced into signing.

#### 4.2 Contracting Away Liability.

Lowering due care responsibilities may seem an odd subject to contract over. Essentially, one party, the potential victim, agrees when entering into a contract to give up the right to pursue a future claim or limit the damages available in any future claim against the counterparty. Contracting away damages may be in the form of a waiver of liability or a clause that limits potential damages to the value of the contract.<sup>425</sup> The contracted damages may be well below the actual damages that the dangerous activity, harmful service, or negligently produced product causes. A contract might be entered into because of some behavioral bias which one of the

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<sup>423</sup> SCHWARTZ 2000, pp. 103-104.

<sup>424</sup> Behavioral law and economics research has shown that individuals do not always behave rationally and rather make biased choices based on heuristics. For a discussion of some of the behavioral law and economics as applied to the standard tort model, see: LUPPI and PARISI 2012.

<sup>425</sup> For a discussion on the economics of waiver of liabilities as compared to the agreement to use arbitration, see: HYLTON 2000.

contracting parties has, such as an irrational discounting of the probability of future harm manifesting or due to a signing without reading problem.<sup>426</sup>

Torts may involve parties with a contractual relationship, and it is from this contractual relationship that an arbitration agreement has been entered into. In consumer products and service contracts which give rise to a tort claim, we should consider how the product or service being sold is priced. In labor contracts, the remuneration of the firm's employees may reflect dangerous work activities.<sup>427</sup> The price of a contract should account for the expected liability costs from the performance of the contract. For instance, in consumer contracts which may give rise to product liability claims, it is generally a given that "the victim has to pay the expected liability costs as part of the product price".<sup>428</sup> Some have framed tort causes of action for consumer contracts as a form of insurance.<sup>429</sup> The expected liability costs of any service or product are likely priced into the contract terms by the party providing the goods or services, which may act as a form of self-insurance by the potential injurer.<sup>430</sup> If arbitration produces cost savings, then these savings should also be priced into the contract to reflect the lower self-insurance costs. If there are no cost savings

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<sup>426</sup> According to BURNHAM, contracting over liability raises an ethical dilemma. BURNHAM comments, "The moral problems that are often the hardest to solve are not those that involve the conflict between good and evil, but the conflict between two goods. Freedom of contract is generally believed to be a good thing. And so is the concept that one who acts negligently should be held responsible for the injury caused by his or her act. The conflict between these two concepts arises when one party to a contract agrees to give up his or her right to sue the other party for negligence." BURNHAM 2014, p. 379. DE GEEST has addressed the widespread problem of signing without reading. See: DE GEEST 2015. It is also possible that people are making their decisions based on heuristics. See: LUPPI and PARISI 2012.

<sup>427</sup> According to SHAVELL "In much the same way that customers, if informed, can decide not to purchase unsafe products or can insist on lower prices as compensation for bearing extra risk, employees, if informed, can decide not to work at firms with unsafe working conditions or can demand higher wages as compensation for bearing added risk". SHAVELL 2004, p. 212.

<sup>428</sup> SCHÄFER 1998, p. 572.

<sup>429</sup> According to GRAHAM and PIERCE, "There is some tradition for labeling payments made by producers to consumers in the event of an accident 'insurance'." Additionally, "The role of the producer in sharing the risk of accident losses is not to provide full insurance for the perhaps infinite personal value of potential losses but to provide precisely the same coverage that the buyer would have chosen for himself at an actuarially fair price". GRAHAM and PEIRCE 1984, p. 464, p. 468.

<sup>430</sup> For a discussion of the analogy between liability and insurance in products liability cases, see: GRAHAM and PEIRCE 1984; and EPSTEIN 1985.

from using arbitration for a tort claim, then the economic rationale for using arbitration for the specific dispute erodes. The continued use of arbitration by industry in their standard form contracts suggests that cost savings are realized. However, the share of cost savings passed on to counterparties is less clear.

Exculpatory clauses are used as a total waiver of rights to pursue a claim against the counterparty. This may not necessarily diminish the incentives for parties to take due care. For example, the use of exculpatory clauses in medical service contracts has been addressed by POSNER as well as SUNSTEIN and THALER as a contract which may be efficient given that doctors will have other incentives to take due care.<sup>431</sup> BURNHAM briefly addresses how POSNER suggested it may be rational for patients to agree to an exculpatory clause in exchange for a lower medical bill, while SUNSTEIN and THALER extended this to argue it is a type of self-insurance which could lead to lower medical costs.<sup>432</sup> As patients are less capable of understanding the potential harms of a medical procedure or evaluating a doctor's skills, it may be hard for the patient to value such a waiver of rights accurately. Still, there is the potential for lowering costs when there is no problem with the treatment. According to BURNHAM, "it is possible that the medical provider would have it both ways—accept the surrender of the right to sue but not reduce the cost" while "[s]upposedly the market would take care of that problem".<sup>433</sup>

If the contract between the parties also includes a limitation of liability in another form, such as a contract to truncate the applicable statute of limitations, these cost savings should be reflected in the value of the contract. The contracting away liability raises questions, including: To what extent

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<sup>431</sup> See the discussion about exculpatory clauses from BURNHAM concerning the views of POSNER 1977 and THALER and SUNSTEIN 2008. BURNHAM 2014, p. 379. Citing to: THALER and SUNSTEIN 2008, pp. 207-14; and POSNER 1977, p. 87.

<sup>432</sup> BURNHAM 2014, p.380; THALER and SUNSTEIN 2008; and POSNER 1977.

<sup>433</sup> BURNHAM 2014, pp. 380-381.

are the cost savings from contracting away liability passed onto consumers? and; How does the contracting over liability impact incentives to take due care?

#### 4.3 Issues of Privity.

When privity is an issue, potential tortfeasors may look beyond the liability they have contracted over.<sup>434</sup> A home may be sold or used by parties not privy to the building contract, just as a product may be sold or used by a third party. Service contracts are more personal, and it may be more difficult to transfer the benefits of the contract to another party. We can see the development of some tort norms in response to claims against firms by an injured party who was not privy to the contract for the sale of a good involved in an accident and thus could not seek compensation for damages under a contractual claim. Many courts have imposed a duty on product manufacturers to third parties by finding an implied warranty of merchantability which provides standing for anyone who suffers harm from using a product, enabling them to bring a claim against the manufacturer for negligently manufacturing the good.<sup>435</sup> Firms facing this type of liability that cannot be contracted over still have some incentive to take care, which is not diluted by using *ex ante* arbitration clauses and liability waivers. We should expect arbitration of tort claims to have the most impact on the production of public goods from litigation in those disputes where questions of privity are clear, and no third parties have been injured.

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<sup>434</sup> According to the Cornell Legal Information Institute, privity is defined as “A legal relationship between two parties based on contract, estate, or other lawful status, that confers certain rights or remedies. For example, parties that are in privity of contract can enforce the contract or obtain remedies based on it.” CLII.

<sup>435</sup> P. KEETON has addressed the development of concepts of privity in products liability. See: P. KEETON 1968, p. 560.

#### 4.4 The Goals of Tort and Contract Law.

The goals of contract law and tort law do not necessarily line up under every circumstance. While tort law looks to provide incentives for taking due care, contract law looks to provide certainty in contracting, though each can be seen as promoting welfare, albeit with different legal tools. When there is contracting over tort claims, the question which must be asked is: what standards and rules should be used in order to maximize welfare? From a law and economics perspective, weighing the costs and benefits of using a particular legal doctrine for a given claim is essential. In the context of contracts to arbitrate tort claims, one potential for a market failure resulting from favoring contract rather than tort standards is found in the possibility of RPs avoiding taking due care through structuring their contracts strategically. When contractual enforcement is continually favored over due care standard enforcement, the logical outcome is one in which the legal system has systemically made tort due care standards secondary to contractual enforcement. Such deference means there is no weighing of the costs and benefits of using either source of law to solve a given problem. This type of deference to contract law may be designed by the legislator to limit the role of discretion in the judiciary, or the judiciary may develop such a deference in order to maximize the individual judges' welfare.<sup>436</sup> There is little doubt that such a system, which does not seek to weigh the benefits of using either contract or tort law, will provide potential tortfeasors an incentive to use contracts to avoid tort liability whenever possible, and this holds open the possibility that such an approach is welfare reducing.

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<sup>436</sup> For a law and economics analysis of judicial production and utility, see: POSNER 1993.

## 5. Failures of Tort Law and the Opportunities for Strategic Behavior.

It is not unrealistic to assume tort law is imperfect; indeed, all forms of law are subject to imperfections.<sup>437</sup> Some situations may cause tort law to fail, and the law has some reactions to these failures. The use of strategic behavior may allow some injurers to avoid remedial rules and procedures developed to address failures in tort law. According to Sugarman, tort law may be imperfect due to an individual's characteristics, including: ignorance, incompetence, their discounting of danger, the potentially high stakes from behaving dangerously, and from small penalties.<sup>438</sup> Tort systems may also be imperfect due to wealth constraints, vicarious liability rules, the inadequacy of damage awards, market imperfections, and the use of liability insurance.<sup>439</sup> It is important to recognize that an imperfectly set or implemented due care standard may find its imperfection in any one of these failures or all of them.<sup>440</sup>

There are numerous examples of how mistakes can lead to tort law failing to provide proper due care incentives.<sup>441</sup> Much of this imperfection leads to victims internalizing the negative externalities caused by injurers. Third parties, including social benefit systems, insurance, family, and social networks, may also end up covering the costs of accidents when tortfeasors are able to avoid liability. Some of the failures of tort law are due to injurers' ability to act strategically to avoid liability for externalities they have created. When injurers do not internalize the negative externalities they create, it will force victims or third parties into covering the costs of accidents.

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<sup>437</sup> According to COOTER and ULEN, it is a "realistic assumption that the tort liability system works imperfectly". COOTER and ULEN 2016, p. 260.

<sup>438</sup> SUGARMAN 1985, p. 586.

<sup>439</sup> SUGARMAN 1985, pp. 571-573.

<sup>440</sup> This discussion about the failures of tort law is not intended to be an exhaustive list.

<sup>441</sup> According to COOTER and ULEN "In tort disputes, mistakes are often made concerning the extent of harm, the cause of the accident, and the actor's fault. Such mistakes are unavoidable by courts and lawmakers because accidents are shrouded in a fog of uncertainty, interested parties such as the plaintiff and defendant provide biased information, and few people have expert information about risks and precaution". COOTER and ULEN 2016, pp. 217-218.

Arbitration of tort claims may tend to make some harm "sticky" because the losses in certain types of accidents will tend to sit where they fall.

### 5.1 Strategic Behavior by Litigants.

Firms or individuals can act strategically to avoid taking due care or to avoid internalizing the negative externalities they create. GRADY has identified how the time period in which a tort occurs impacts the ability of parties involved in the tort to act strategically.<sup>442</sup> While the time period can be useful to consider within a broader discussion of strategic behavior, the nature of due care standards are likely to be considered by the parties *ex ante*, before any harm has occurred.<sup>443</sup> Potential repeat injurers should evaluate how they can lower their due care cost in the future. If lower care costs result in no harm to potential victims, then the lower costs could benefit both the potential injurer and potential victims who have contracted with each other. One benefit of competition is that firms will seek out cheaper and safer practices in order to lower the marginal costs of their goods in order to seek a gain in business. However, these potential benefits for victims depend on the competitive market, the savings being passed onto customers, and firms being willing to adopt safer and more efficient practices.

Firms' use of strategic behavior in litigation needs to be considered separately from other types of behaviors that lead to market failures in tort law. When firms have limited liability protection, liability avoidance may occur with or without planning. For instance, "[a] manufacturer that is simply inept at managing safety issues, or indifferent to them, may fail to solve the social efficiency calculus and thus end up marketing a product that is priced too low to cover the accident costs that

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<sup>442</sup> GRADY 1988.

<sup>443</sup> SHAVELL has commented on how ex post contracts to arbitrate can, by definition, have no impact on incentives to take care, as the agreements to arbitrate are only entered into after the accident. According to SHAVELL, "because the ex post incentives of parties to use private adjudication are naturally divorced from considerations of deterrence, their use of private systems may be undesirable." SHAVELL 2004, p. 448.

will ultimately occur."<sup>444</sup> Some inept tortfeasors will avoid liability because they are judgment proof, unable to cover the costs of the accident and face insolvency due to liability. Firms with subsidiaries can strategically undercapitalize the subsidiary when there is a possibility of facing a large amount of liability in order to keep the subsidiary judgment proof while diverting revenue from the subsidiary to shareholders or the parent company, which can be seen as socially inefficient because it forces victims into covering the costs of the accidents the firm has caused.<sup>445</sup> While both intentional and unintentional harm may occur due to the tortfeasor's fault, the strategic lowering of liability would only be done by a firm looking to avoid their liability as a way to gain financially from care cost avoidance.<sup>446</sup> Thus, the strategic taking of low care by a RP tortfeasor is done with the goal of minimizing total care costs and expected liability over time. According to SILICIANO, "liability-limiting strategies represent both a planning technique for firms actively seeking to ignore the directives of tort law and a partial, post facto absolution for those that unintentionally do so".<sup>447</sup> Liability limiting strategic behavior creates an opportunity for firms to ignore the full cost of the good or service they are providing by failing to price in the expected cost of accidents into the prices they set.<sup>448</sup> This type of strategic planning can be taken regardless of the use of

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<sup>444</sup> SILICIANO 1987, p. 1838.

<sup>445</sup> According to SILICIANO, "The doctrine of limited liability directly encourages adopting this strategy of ignoring delayed liability costs. If the law enforced a regime of unlimited liability – pursuing the producer, and its owners if necessary, until all liabilities were satisfied – a liability avoidance strategy of this type would make little sense. The inflated initial profits would eventually be absorbed by the onset of liabilities, and the firm would ultimately suffer a competitive disadvantage because it marketed the product in a socially inefficient form. But limited liability prevents this day of reckoning from occurring by immunizing the firm's owners from liability once the claims exceed the value of the firm. To be sure, the crushing onset of tort liability will eventually compel liquidation of the firm, but prior to its elimination from the market it will have produced excess risk from a social efficiency perspective." SILICIANO 1987, pp. 1836-1837.

<sup>446</sup> COOTER has identified how the use of punitive damages to incentivize potential tortfeasors to take due care does not work unless the harmful conduct is intentional. According to COOTER, "If fault is unintentional, then imposing punitive damages in addition to compensatory damages is both unnecessary for deterrence and undeserved as punishment." COOTER 1982, p. 79.

<sup>447</sup> SILICIANO 1987, p. 1838.

<sup>448</sup> According to SILICIANO, "the doctrine of limited liability poses special problems for an incentive system, such as tort law, that relies on the full incorporation of expected accident costs into product prices as a means of signaling consumers about relative product risks." SILICIANO 1987, p. 1836.

arbitration, and it may show a state of mind or intent. If regulation also includes criminal sanctions related to the intentional committing of torts or in calculating punitive damages, an intent element may be considered as a factor when determining guilt or responsibility.

Strategic behavior can occur during both litigation and arbitration. Strategic behavior may increase the financial benefit the RP firm gains at the expense of OS, who are harmed due to the firm's low care, or OS fail to receive any of the financial benefits of arbitration because they are captured by the RP. The strategic lowering of due care can be combined with other strategies to avoid liability. Both lowering liability and lowering care costs can have a social welfare reducing effect. Arbitration provides additional opportunities to behave strategically or perpetuates options to behave strategically, options which could be limited by courts. The persistence of strategic avoidance of liability may be protected by arbitration's secrecy.

### 5.2 Strategic Behavior and the Avoidance of Care Costs.

It is useful to consider how parties, or potential parties, to a lawsuit may have a different perspective on the importance of a given claim. A well-known article about strategic behavior by RPs in litigation, "Why the haves come out ahead" was published by GALANTER in 1974. The insights from GALANTER are also useful when considering how RPs behave in arbitration. Galanter, while examining the limits of legal change to have redistributive effects, distinguished between two types of parties to litigation.<sup>449</sup> The first is the parties who "have only occasional recourse to the courts" and are labeled as "one-shotters" or (OS).<sup>450</sup> The second is "repeat players...who are engaged in many similar litigations over time" or (RP).<sup>451</sup> GALANTER identifies some advantages an RP has.<sup>452</sup> These advantages can generally be categorized under

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<sup>449</sup> GALANTER 1974, p. 95.

<sup>450</sup> GALANTER 1974, p. 97.

<sup>451</sup> GALANTER 1974, p. 97.

<sup>452</sup> GALANTER 1974, throughout

three types of advantages: intelligence or information advantage, resource advantage, and opportunity advantage.

#### 5.2.1 Repeat Players (RP).

The RP has a memory that it can use in its repeated interactions with individual OS, such as repeated litigation or arbitration over a similar claim. RP have experience and "advanced intelligence" in the claim and structures their future transactions based on the information they have already acquired.<sup>453</sup> RPs have "expertise" in the claim and "access to specialists," which provide them with "economies of scale" that translates into a "low startup cost" in each given claim.<sup>454</sup>

RPs can seek to gain influence over those they do business with, those who will be involved in regulating them, or parties involved in adjudicating claims against them. Galanter identifies how "RPs have opportunities to develop facilitative informal relations with institutional incumbents".<sup>455</sup> RPs have a bargaining reputation, which allows the RP to appear committed to their "bargaining position".<sup>456</sup> RPs have many chances to be involved in litigation, so "RPs can play the odds" as their stakes in any given claim are likely to be comparatively lower than any individual OS.<sup>457</sup> This allows the RP to "adopt strategies calculated to maximize gain over a long series of cases, even when this involves the risk of maximum loss in some cases".<sup>458</sup>

The rules are important for the long-term outlook of the RP. RPs not only play for the stakes of each claim but also "play for rules", as it "pays an RP to expend resources in influencing the

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<sup>453</sup> GALANTER 1974, p. 98.

<sup>454</sup> GALANTER 1974, p. 98.

<sup>455</sup> GALANTER 1974, p. 99.

<sup>456</sup> GALANTER 1974, p. 99.

<sup>457</sup> GALANTER 1974, p. 98.

<sup>458</sup> GALANTER 1974, p. 100.

making of the relevant rules" through lobbying.<sup>459</sup> RPs also have an interest in playing "for rules in litigation".<sup>460</sup> As the stakes of any single claim increase and the likelihood of being an RP decreases, the lower the concern for rules "which govern future cases of the same kind".<sup>461</sup> An RP facing multiple claims "may be willing to trade off tangible gain in any one case for rule gain" and likewise may also look to "minimize rule loss".<sup>462</sup> An extension of this may be that RP seek to maximize rule loss when it benefits them. As RP face a positive flow of litigation, they "can select to adjudicate (or appeal) those cases which they regard as most likely to produce favorable rules", while the OS will "trade off the possibility of making 'good law' for tangible gain" which should lead to "cases capable of influencing the outcome of future cases" being "relatively skewed towards those favorable to RP".<sup>463</sup> RPs are more capable than any individual OS of distinguishing between rules which are meaningful from those which are symbolic.<sup>464</sup> This allows the RP to "trade off symbolic defeats for tangible gains" through concentrating "their resources on rule-changes" which have an increased probability of resulting in "a tangible difference".<sup>465</sup>

Because RPs have these advantages, they are "more likely to be able to invest the matching resources necessary to secure the penetration of the rules".<sup>466</sup> These advantages are not limited to litigation, and the use of private contracting may create persistent opportunities to behave strategically.

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<sup>459</sup> GALANTER 1974, p. 100.

<sup>460</sup> GALANTER 1974, p. 100.

<sup>461</sup> GALANTER 1974, p. 100.

<sup>462</sup> GALANTER 1974, p. 101.

<sup>463</sup> GALANTER 1974, p. 102.

<sup>464</sup> GALANTER 1974, p. 103.

<sup>465</sup> GALANTER 1974, p. 103.

<sup>466</sup> GALANTER 1974, p. 103. According to GALANTER, penetration is "effectiveness at the field level" GALANTER 1974, p. 97. Or "the number of actors and spheres of action that a particular rule... actually reaches." Quoting: FRIEDMAN 1969.

### 5.2.2 RP in Litigation and Arbitration.

The advantages of the RP may lead to failures in tort law. Some remedies which seek to level the playing field include facilitative procedural rules such as the collectivization of claims, summary judgment, legal aid, punitive damages, fee shifting, the production of public information, regulatory oversight, and the production of public goods from litigation.<sup>467</sup> These remedies may not be able to overcome the RP advantage or prevent RP from behaving strategically, as tort law may fail to address the use of new practices or technologies which facilitate strategic behavior.<sup>468</sup> Remedial procedures or rules may be either unavailable or limited in arbitration.<sup>469</sup>

The advantages RPs have in litigation are also advantages for the RP in arbitration. RPs can use their resource, information, and opportunity advantages in arbitration in a similar way as they would in litigation to engage in strategic behavior, allowing them to escape being held responsible for the externalities they create. This availability of strategies which enable RPs to avoid liability undermines the incentives of using due care standards. When firms can use arbitration to divert claims away from courts and to prevent the use of collective claims, additional opportunities to act strategically may also materialize.

By looking at how the resource, intelligence/information, and opportunity advantages of the RP in arbitration may result in different incentives for the RP to take due care as compared to the

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<sup>467</sup> This is a partial list. However, it may be useful to look at some of the possible solutions which Faure and Weber identify as solving the problem of scattered losses. See: FAURE and WEBER 2015 throughout.

<sup>468</sup> Recall R. KEETON'S comments on the creativity of the law to solve such problems, which he termed "Creative Continuity" R. KEETON 1962.

<sup>469</sup> According to ALDERMAN, "consumers have been able to interact successfully with the repeat-player in the judicial system, due at least in part to their ability to maintain class actions, to establish legal precedent through appellate decisions, and to use liberal discovery rules and shared expertise to establish their own repeat-player strengths. Mandatory arbitration, however, usually imposed through a non-negotiated contract of adhesion, thwarts these advantages by eliminating the ability to use a class action, precluding the establishment of any precedent or an appeal, and reducing the ability to use discovery. The repeat player's ability to designate the forum clearly has substantive ramifications." ALDERMAN 2001, pp. 1255-1256.

incentives to take due care when arbitration is not available, some important additions to the ability to act strategically can be identified. Importantly, these relative advantages work best for the RP when used in unison with other firms in the industry. Having a resource advantage assists the RP in developing an information and opportunity advantage, while having an opportunity and information advantage may lead to the accumulation of resources. As these advantages work best when used together, distinguishing these advantages becomes difficult as they become intertwined with each other.

### 5.2.3 Resource Advantages.

RP have resources to invest in fighting claims against them. The ability of the RP to invest is likely higher than the OS. The resource advantage of the RP can also be viewed as a wealth constraint on the OS relative to the RP. Since litigation or arbitration involves transaction costs, in this case, the cost of filing fees, legal services, waiting times, and other related dispute resolution costs, the ability to pay for these transaction costs matters to both RP and OS. RPs have an interest in investing in legal services, which enable them to develop expertise in the claims they are involved in. The RP can more easily invest in litigation or arbitration than the OS because of a resource advantage. OS have no interest in developing extensive expertise. Rather their interest is in developing only enough expertise to succeed in the single claim they are involved in. OS also have the incentive to free ride on other OS litigation efforts, meaning the first OS to file faces the largest transaction costs from litigation among OS.<sup>470</sup> When RP can strategically waive arbitration to challenge a high care standard, they can potentially pick among many similar claims. The RP could

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<sup>470</sup> According to HYLTON, "suppose plaintiffs do not all sue immediately when they are injured, but rather wait for someone else to sue first. Given an individual plaintiff's incentive under these conditions to free-ride on the litigation efforts of others or insist on the defendant's compensating him for forgoing the right to sue, the public benefit connected to a single plaintiff's retaining his right to sue is probably negligible." HYLTON 2000, p. 246.

then enforce arbitration for those claims which they find to be the least likely to lead to a rule change and selectively waive arbitration only for those claims which they find to be more than likely to lead to a rule change, thus allowing for continued options to behave strategically.

The RP can invest resources in facilitating and organizing information gathering to a greater extent than the OS. Since arbitration keeps the information about claims from becoming public through the extensive use of confidentiality clauses, the OS cannot benefit from information produced in previous arbitration proceedings, while the RP can. The RP uses its position to gather information from each claim and develop an informational advantage in arbitration that it did not have in litigation or which is greater than the informational advantage it has in litigation. Lawyers or associations opposing firms repeatedly in arbitration may specialize in a common claim, but this specialization is likely less developed than the RP due to the relatively higher transaction costs OS faces when compared to RP. It is also likely that the RP is the least cost information producer, so even if the same information could be produced by the OS or the representatives of the OS who are RP victims, they can never produce the same information at the same cost as the RP injurer. The association or lawyer representing many OSs faces opportunity costs that do not match the RP or the coordinating efficiencies of the RP. Hence, there remains the opportunity for the RP to gain an additional information advantage in arbitration, even if there are specializing opposition lawyers or an association representing the OS. The transaction costs of the OS gaining an equal foot with the RP are relatively high and will lead to an underinvestment in the production of information about the claim in arbitration by OS. Underinvestment will lead to an underproduction of information by the OS, which would not occur or would be smaller in litigation, as litigation leads to the production of publicly available information which does not require large resources to access.

The resource advantage of the RP allows them to invest in early claims to develop an information advantage that increases their ability to find an early win in court, thus discouraging subsequent claims. This also allows RP to test strategies for subsequent claims. The cost of litigation or arbitration changes asymmetrically for RP injurers and OS victims. An RP injurer facing multiple similar claims, potentially gains marginal benefits from each similarly situated claim it defends itself against, gaining more information and further developing expertise in defending against the common claim.<sup>471</sup> The potential OS victims cannot realize any benefit from repeated interactions. Even when there is a legal firm or association specializing in pursuing the claim, which may allow the OS to act more as an RP, the marginal cost of the RP victim for each claim is likely still higher than the RP injurer, as the injurer is likely the least cost information gatherer and RP victim likely still faces more resource constraints than the RP injurer.

The benefit of having an early win in litigation is higher than in arbitration. Since the litigation could lead to a precedent related to the claim or could be considered by other courts as persuasive, the RP will invest more in early litigated cases.<sup>472</sup> If RP are not certain they can find an early victory in court, they can mitigate the costs of future claims against them by keeping the claim in arbitration, where a ruling would have no precedential authority and little or no persuasive authority. Using arbitration thus limits the costs of RP having an early loss.

Being an RP may allow firms to gain efficiencies in defending a claim. For instance, as the firm becomes specialized in a common claim, the cost of fighting each subsequent claim decreases. The

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<sup>471</sup> In theory, at some point, the RP may have developed such extensive expertise that the marginal benefit of additional information accumulated in arbitration is lower than the marginal cost of incorporating the information into their knowledge stock.

<sup>472</sup> According to NAGY, when a defendant faces multiple claims, "the defendant may find it rational to invest much more in winning early cases, because winning in these proceedings may discourage later law-enforcement". NAGY 2012, pp. 477-478.

RP has a good memory, while the OS does not. The difference in memory creates an increased gap between the cost of an RP defending a claim and the cost of the OS pursuing a claim. This can be seen in terms of cost shifting. Over time, as the information asymmetry increases between the RP and the OS, the transaction costs for the OS to acquire the same information as the RP increase with each new claim the RP faces. This results in an asymmetric change in the cost of litigation over time between RP and OS. Consider how the first OS to bring an arbitration claim will have a lower cost of obtaining the same information available to the RP at that time than the 100<sup>th</sup> OS, which brings an arbitration claim against the same RP. This is because the 100<sup>th</sup> OS to bring a claim would face the costs of gathering information about the 99 previous similar claims against the RP. This is likely impossible for the 100<sup>th</sup> OS or any OS after the first claim due to the secretive nature of arbitration. In arbitration, the RP gains marginal information benefits from each additional claim they face, while the OS does not. The informational advantage for the RP in arbitration leads to an increase in costs for the OS looking to get on an equal informational footing. Moreover, due to the secretive nature of arbitration, it may be impossible for the OS to gain an equal footing. Arbitration makes information for OS more expensive, and the resulting information asymmetry can only be overcome through the investment of resources to gather information, if at all. Still, a plaintiff firm specializing in a single common claim against a specific RP may have an opportunity to gain marginal information from each additional claim in which they represent a similarly situated OS.

The information advantage of using arbitration over litigation means the RP can be more accurate in investing resources where they will be most beneficial. This is more likely to happen when costs are more certain than not, such as when the RP is more certain they will be found liable given a claim. Any willingness of the RP to settle would depend on the ability of the OS to challenge the

RP. Some OS may be unwilling to pursue a claim because of litigation costs, that can also be thought of in terms of transaction costs related to bringing a claim, which may or may not include non-monetary costs, such as transaction costs involving time or taking into account the reputation of the RP to fight claims. Even if the expected outcome is negative for the RP, the OS's resource constraints may change the RP's calculus concerning which claims they will fight, possibly leading to a lower willingness to settle by the RP.

#### 5.2.4 Opportunity Advantages.

Having good information can make identifying advantageous opportunities easier for the RP. RPs have private information about the rules they benefit from and those they are disadvantaged by. The RP can actively seek to settle or divert claims to arbitration which could challenge rules the RP benefits from, if, for instance, the due care standard is inefficiently low and the injurer benefits from the rule by having lower due care costs. If an inefficient high care standard harms the RP, they could selectively decline to use arbitration and seek to challenge the standard in court repeatedly, if necessary, until the rule is changed to the efficient due care standard.<sup>473</sup> This same incentive for the RP to challenge an inefficiently high due care standard may lead RP to refrain from offering settlements in litigation, even when the expected value of the claim is negative.<sup>474</sup> These opportunities to selectively litigate could lead to the selective development or hindrance of due care standards through the decision to either enforce arbitration or opt out of arbitration.<sup>475</sup> The OS often has no *ex ante* opportunity to choose which claims to arbitrate or litigate. When OS

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<sup>473</sup> A party interested in future legal disputes is incentivized to litigate an inefficiently high due care standard, and this reasoning can be found in the efficiency of the common law theory. See: RUBIN 1977, PRIEST 1999, LANDES and POSNER 1979.

<sup>474</sup> CROSS 2000, p. 13.

<sup>475</sup> According to EISENBERG et al., "corporations' selective use of arbitration clauses against consumers, but not against each other, suggests that their use of mandatory arbitration clauses may be based more on strategic advantage than on a belief that corporations are better serving their customers". EISENBERG et al. 2008, p. 895.

do agree to an *ex ante* contract to arbitrate, it is likely the result of unequal bargaining power with the RP and the inability of OS to dictate any terms of the *ex ante* contract to arbitrate. Rather the OS often take their claims as they find them.

RP has an opportunity to engage in many transactions. This allows the RP an opportunity to try to develop a bargaining or litigious reputation. A reputation for fighting all claims may benefit a firm, as the perception of being a highly litigious party may change the estimation of litigation or arbitration costs for the OS pursuing a claim. The reputation of the RP can be spread even when confidentiality is contracted over, as informal means of communication between individual OS may occur.<sup>476</sup> Having a reputation for fighting all claims, whether in litigation or arbitration, may be a disincentive to OS with a meritorious claim from pursuing the claim, as the reputation for fighting may signal that pursuing a claim will be more costly. The valuation by the OS of the additional cost of filing a claim against an RP with a reputation for fighting all claims may be the difference between a claim being negative in value or positive in value, which a rational plaintiff will account for.

When an RP has the same arbitration contract with many inexperienced OS, then the RP may become involved in the same underlying dispute with multiple OS. The RPs will have increased exposure to arbitrators from repeated appearances in arbitration. The strategic behavior of the RP in choosing an arbitrator may influence the outcome of the arbitration. This may be due to the capture of the arbitrator by RPs or the potential for an RP bias in arbitration.<sup>477</sup> The use of three

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<sup>476</sup> According to PARISI, informational cascades "occur when individuals make a decision on the basis of the observation of others disregarding their own private information." In a reputational cascade, "individuals who acted later in a sequence tend to adopt the same decisions as those who acted earlier, in order to avoid dissenting from the previous actors" PARISI, 2013, pp. 152-153.

<sup>477</sup> GUPTA and KHAN identify how "arbitration seems to favor businesses over consumers not just relative to litigation, but in an absolute sense too: the CFPB found that, within arbitration, companies are far more successful than consumers. According to the Report, businesses won relief in 93% of the business-initiated cases in which

arbitrator panels may limit the impact of capture. However, the RP can maintain better information about the arbitrators than OS through repeated opportunities to interact with arbitrators, which may allow RP to take other steps to screen arbitrators.

In litigation, forum shopping may occur, depending on the jurisdictional dynamics of the state.<sup>478</sup> Some jurisdictions and judges develop reputations, and parties may consider these reputations when deciding where to file if multiple forums are available. This may also reflect the relative expertise of courts. The filing party has control when forum shopping is available in litigation. This may lead OS to selectively litigate in favorable jurisdictions, leaving less room for the RP to influence the presiding judge in the case. Contracting may enable RP to *ex ante* reverse the traditional demand side role of plaintiffs, allowing RP to determine the forum through the use of forum selection clauses in their underlying contracts. In arbitration, the demand side roles of legal disputes are reversed through contracting, as the RP is now capable of forum shopping *ex ante* among arbitration associations.<sup>479</sup> If the RP continually goes to arbitration due to a common harm alleged by multiple OS, the RP risks being labeled with a bad reputation among arbitrators. This may cause some arbitrators to be harsher with the RP because of the reputation. However, since there is a role the parties play in selecting the arbitrators, the RP can continue to seek information about the potential arbitrators and screen those who have given them harsh treatment in previous proceedings, and allow RP to select arbitrators they know ruled favorably toward them in

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arbitrators reached a decision on the merits". GUPTA and KHAN 2016, p. 515. Citing to CONSUMER PROTECTION BUREAU 2015.

For empirical studies on Arbitration which address issues of bias, see: BINGHAM 1997; EISENBERG and HILL 2003; and EISENBERG et al. 2008.

<sup>478</sup> For an in-depth discussion on forum shopping, see: JUENGER 1988.

<sup>479</sup> For a discussion of forum shopping issues within the context of arbitration, see: STERNLIGHT 1998.

previously arbitrated disputes. To a certain extent, arbitration allows RP to "shop around" for the arbitrators which they believe will give the RP an advantage.

The RP likely has better information about the arbitrators than the OS, and thus the RP will benefit if they select arbitrators and arbitration associations that favor them more predictably. Some arbitrators may end up with a reputation for favoring one party over another. If the RP has a positive flow of cases in arbitration, they can choose the arbitrators they know are more likely to be favorable. However, if we consider the criticism of POSNER, arbitrators have an incentive to be middle of the road, as "otherwise they are unlikely to be selected for future arbitrations" while the "party who expects to be sued rather than to be suing if the contractual relationship breaks down may want an arbitration clause in the expectation that the middle-of-the-road propensity of arbitrators will reduce the party's expected liability".<sup>480</sup> If the arbitrators are able to easily throw out claims that are "clearly without merit", then "their middle of the road propensity will operate only in the meritorious cases and the effect will be to truncate the defendant's liability."<sup>481</sup> Any individual OS only has a demand for a single arbitration. As RPs demand more from arbitration, the likelihood of arbitrators trying to attract the demand of RPs may frustrate the advantage of arbitration being "middle of the road," and arbitrators may look to be selected by RPs by having a reputation for not being "middle of the road".

Assuming the demand for arbitrators depends on the choices of parties needing arbitrators, arbitrators are more likely to be influenced or seek selections by an RP than an OS, if only because the RP has sustained exposure to the arbitrators. Consider four possible scenarios where an RP is both the victim and injurer, the RP is the victim and the OS the injurer, the RP is the injurer and

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<sup>480</sup> POSNER 2011 p. 803.

<sup>481</sup> POSNER 2011 p. 803.

the OS the victim, and where both injurer and victim are OS. When both parties are the same type of party, then they have a similar demand for arbitrator's services over time, but when the parties are different, then the demand from arbitrators by any one party will be different at any given time. The situation where the RP is the victim is less likely than the situation where the RP is the injurer. It is safe to argue that the demand for arbitrators will be more competitive from RP injurers than from any single OS victim. It is less likely for the injurer to be an OS, as the RP injurer is more likely to have the resource, intelligence, and opportunity advantages needed to act strategically in litigation or arbitration. Thus, OS injurers will not be able to behave strategically in the same way an RP injurer could. In the case where both injurer and victim are RPs, the victim is likely an association, which may have a resource disadvantage to the RP firm. The resource disadvantage may lead the RP association to be more selective about the claims they bring. If a claim is fully collectivized, it may have the impact of changing the RP firm into an OS firm, as all of the claims the firm faces are combined into a single action. The association could remain an RP so long as they continue to collectivize claims against other OS injurers fully. We can thus safely assume that in most scenarios, the OS victim, or RP association representing victims, will not be able to collectivize the claim fully and will not have a greater demand from arbitrators than the RP injurer.

**FIGURE 9. THE DEMAND FOR ARBITRATORS FROM RP AND OS.**

Injurer and victim demand for arbitrators		Injurer	
		Repeat Player (Firm)	One Shotter (individual)
Victim	Repeat Player (Association)	RP= RP (Similar Demand)	RP> OS (Victim Demand, dependent on full collectivization of claims)
	One Shotter (individual)	OS< RP (Injurer Demand, most likely outcome)	OS=OS (Similar Demand)

### 5.2.5 Information and Intelligence Advantage.

One of the main draws to arbitration is the confidential nature of arbitration when compared to litigation in court. Arbitration remains a private remedy, and most contracts to arbitrate include a confidentiality clause. A confidentiality clause keeps any information revealed in the arbitration procedure private, and often documents held by the arbitration tribunal are destroyed after a prescribed period of time. This is in contrast to a court proceeding that could lead to the production of public information, a public record maintained by the state, the dissemination and discussion of the case in legal journals and reports, and as a source for academic research.

As discussed, the RP has a resource and opportunity advantage in gathering information about the underlying claim. Thus, the information advantage the RP has is related to the resource and opportunity advantages that the RP can exploit. The ability of RPs to gather information is generally greater than the OS's ability to gather information, which may lead to information asymmetry between RP and OS. Open courts produce public information, which can help to lower this information asymmetry, as public court proceedings and publication of court decisions may lead to the production of information about the claim as well as precedents, gap filling, and rule interpretation about the due care standards which apply to the claim.<sup>482</sup> These products can be considered types of public goods.<sup>483</sup> There is no production of public goods in arbitration.<sup>484</sup> The confidential nature of arbitration may increase the information asymmetry between the RP and the OS, and this helps the RP to develop a specialization in the claim. This is a classic case of

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<sup>482</sup> According to KAPLOW and SHAVELL, "There is no reason to suppose that the private incentive to produce information systematically equals its social value. Private parties are motivated by the desire to improve the ex post result, whereas society is concerned with the resulting incentives for ex ante behavior, enforcement costs, and sanction costs. Thus, the problem of designing an efficient dispute resolution system involves the added complication of creating appropriate incentives for parties." KAPLOW and SHAVELL 1994, p. 13.

<sup>483</sup> See: LANDES and POSNER 1979; and SAMUELSON 1954.

<sup>484</sup> See: LANDES and POSNER 1979.

information asymmetry because the ability of OS claimants to gather information is lower than the RP injurer.<sup>485</sup>

If both potential future injurers and victims can access relevant information, both sides can use it to avoid future accidents and losses. It may be possible for information to be kept private in arbitration, which, if made public, would lead to victims being able to avoid injury by taking additional care. This can flow both ways. If an inefficient rule makes potential victims take too much care, full information may identify how it is more efficient for potential victims to take a lower level of care. If an RP uses arbitration to adjudicate all the claims related to the agreements it has with OS, then the information from all claims remains private, and the RP can more easily maintain the status quo of an inefficient rule which benefits the RP while taking less than efficient due care, which enables the RP to avoid care costs. When a due care level is set below the optimal level, as shown in Figure 10, the RP injurer is incentivized to keep all challenges that could lead to a change in the care level out of court. RP can do this either by settling all claims against them or by forcing all claims against them into a private arbitration forum to prevent a change in the due care standard.<sup>486</sup> The waiver of arbitration may be analogous to a "zero offer" settlement intended

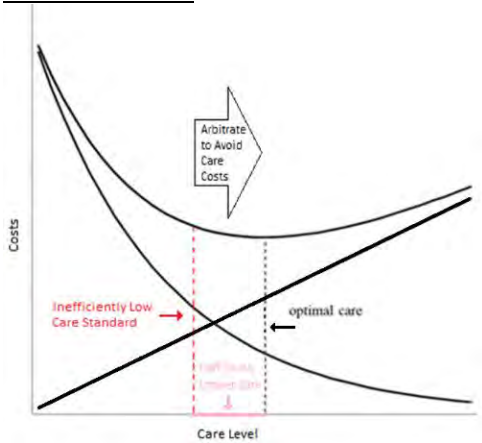
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<sup>485</sup> Consider the role of the least cost information producer (CALABRESI 1970), cheapest cost avoider, cheapest precaution taker, cheapest risk avoider, best risk bearer, and most effective precaution taker (PARISI 2013, p. 42). Also, there is a likelihood that the least cost information gatherer is also the least cost avoider. According to THORNBURG, "If mandatory arbitration predictably results in the wrongfully injured party's receiving little or no compensation (when the court system would have provided greater compensation), arbitration also undermines efficiency in another way: It places the risk of loss on the party with limited ability to take precautions that would avoid the harm. A system that provides inadequate remedies in effect shifts the risk of loss to the patient, the employee, or the consumer. ... Ineffective arbitration thus shifts the risk of loss to the least effective loss-avoider, under mining once again the deterrent function of tort law." THORNBURG 2004, pp. 271-272.

<sup>486</sup> According to CROSS, "cases are not so easy to value, and a significant number of cases may arise in which the valuation disparity is so wide that the parties perceive no mutual beneficial settlement zone." In addition to the possibility of there being no zone of mutual agreement, some defendants "might sometimes make zero offers" as part of an effort of "strategic precedent-setting". Furthermore, "tort defendants are more likely to be repeat players who see precedential value to litigation and thus are likely to settle cases before judges that appear to be pro-plaintiff". CROSS 2000, p. 4, 13, 12.

to show a willingness to engage in litigating a claim, as the RP is waiving arbitration in a strategy to challenge the inefficiently high rule.

**FIGURE 10. INEFFICIENTLY LOW CARE STANDARDS WITH STRATEGIC BEHAVIOR TO ARBITRATE.** <sup>487</sup>



### 5.2.6 Information on the Value of Claims.

Knowing a claim's value is important since victims will not be incentivized to bring negative value claims.<sup>488</sup> However, SHAVELL has identified how some rational victims may bring negative value claims if, for instance, defendants do not know if the victim will bring the suit once filed all the way to litigation or if a plaintiff can "win a judgment if the defendant does not spend an amount on defense".<sup>489</sup> When an RP can behave strategically, both these exceptions seem unlikely. If RP know the value of claims against them, they can use this information to guide their strategies. Relatively, the value of any one claim for the RP is small compared to the value of a claim for the OS, making it easier for the RP to trade short term losses for long term gains.<sup>490</sup> According to

<sup>487</sup> Adjusted from graph based on SHAVELL 1987. See Appendix C for further discussion.

<sup>488</sup> COOTER and ULEN identify how a rational victim will only bring suit when the "expected net payoff is positive" or "EVC  $\geq$  FC d file legal complaint; EVC < FC do not file legal complaint". COOTER and ULEN 2016, p 389.

<sup>489</sup> SHAVELL 2004, p. 421.

<sup>490</sup> GALANTER 1974 p. 101.

CROSS, “[t]he economically strategic defendant will examine its portfolio of cases, and potential future cases, and identify the one that offers the best prospects for success, thereby strategically setting a favorable precedent”.<sup>491</sup>

Courts make mistakes, and parties know this.<sup>492</sup> RP Injurers may thus factor court errors into their choice for taking due care.<sup>493</sup> If the court error rate is high, then RPs may not be fully held to account for the negative externalities they produce. Errors can be further distinguished between an error in setting the care standard and an error in determining damages.

A claim should be fully pursued only when both potential litigants, the RP injurer and the OS victim, are optimistic about the outcome of the litigation or arbitration.<sup>494</sup> The same may not be true when there has been an *ex ante* contract to limit the liability of the injurer, as the combination with contracting away of damages may change the cost of defending against a meritorious claim in which the injurer is not optimistic about the outcome.<sup>495</sup> According to COOTER, raising the costs of a trial and the stakes at play in the dispute will make the parties more eager to settle the dispute before adjudication.<sup>496</sup> Arbitration may keep information private, which, if known by OS victims, would lead them to reevaluate the value of their claim. Even when both the RP and the

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<sup>491</sup> CROSS 2000, p. 7. Furthermore, CROSS opines that “[p]articularly in product liability actions...the repeat player defendant has a much larger stakes in ensuring that it avoids an adverse precedent”. CROSS 2000, p. 9.

<sup>492</sup> For a discussion on court error in tort claims, see: COOTER and ULEN 2016, pp. 208-220. For a discussion on Court error, POSNER 2011 p. 758.

<sup>493</sup> According to COOTER and ULEN, "with a rule of negligence, consistent errors by the court in setting standards distort precaution more than consistent errors in computing damages; so the court should concentrate on avoiding errors in setting the standard of care." COOTER and ULEN 2016, p. 222.

<sup>494</sup> Optimism in the outcome of the claim by both parties leads to litigation. See: PRIEST and KLEIN 1984.

<sup>495</sup> PRIEST and KLEIN 1984.

<sup>496</sup> According to COOTER, “Raising the costs of trial and the stakes at risk make the disputant more eager to settle. The greater the uncertainty created by the institution of punitive damages, however, makes settlement bargaining more difficult.” COOTER 1988, p. 1167.

OS are optimistic, transaction costs may constrain their choices.<sup>497</sup> HYLTON identifies how information asymmetry between RP and OS may make OS less optimistic about their claims than they should be.<sup>498</sup> If OS consistently make errors in underestimating the likelihood of successfully bringing a claim, then there should be an inefficiently low number of claims brought against RP injurers, and an enforcement error should increase.

Some legitimate claims may not be pursued because the cost of pursuing the claim is more than the claim is worth.<sup>499</sup> This type of claim is considered a negative value claim since it would not be capable of providing a positive economic outcome for the claimant, even if they were to win on the merits of the claim. In the best-case scenario, an informed OS who has an arbitration agreement with an RP and seeks to arbitrate a tort claim may find cost savings from moving a claim from litigation to arbitration, and this cost saving moves the claim from being a negative value claim to a positive value claim.<sup>500</sup> It is important to differentiate between negative value meritorious claims, which are unlikely to be filed due to high litigation costs or other transaction costs associated with bringing a claim, and negative value claims which will have a negative value regardless of high claim related transaction costs because the probability of winning on the merits of the claim are low. The rational OS will not bring a claim in which they are optimistic about the outcome if

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<sup>497</sup> According to HYLTON, “If the cost of enforcing is too high relative to the private benefit a litigant gets from bringing suit, he will drop his claim. But that means rule violators whose victims fall within this group are effectively shielded from the law”. HYLTON 2004, p. 494.

<sup>498</sup> See: HYLTON 1993.

<sup>499</sup> For a discussion of negative value claims, see: SHAVELL 2004, pp. 419-423.

<sup>500</sup> It may be interesting to consider an amicus brief submitted by the Wireless Association (CTIA), a telecom trade group, in the *Pendegast v Sprint* case, which was sent to the Florida Supreme Court on certification from the 11<sup>th</sup> circuit concerning the interpretation of unconscionability under Florida law. The Wireless Association argued that “[b]ecause arbitration is quicker and cheaper than litigation, a bilateral arbitration agreement often allows for greater consumer recovery. Without arbitration, “the typical consumer who has only a small damages claim” might not recover because “the costs and delays of [court] could eat up the value of an eventual small recovery”.” CTIA 2012, p. 5. Citing to: *Allied-Bruce Terminix Cos. V. Dobson*, (1995). This could arguably be the best-case scenario which the CTIA is putting forth. The remainder of the Brief is interesting in laying out the arguments for enforcing arbitration agreements in wireless phone contracts.

transaction costs from litigating are higher than the potential payout from being successful in the underlying claim.<sup>501</sup> On average, the RP can assume that OS are rational.<sup>502</sup> Even if the actions of the RP cause harm to the OS, so long as the harm caused is lower than the transaction costs the OS faces from bringing a claim, the OS will rationally not pursue the claim. This holds true for either litigation or arbitration. However, some remedial rules may solve this problem in litigation, while in arbitration, they might not. The RP can gather information about the claim's value, including at what value a claim moves from being a negative value claim to a positive value claim. With the right information, the RP can pinpoint, or at least approximate, the transaction costs associated with litigating or arbitrating a claim for potential OS, potentially even before any harm has occurred. If a fee shifting scheme is used, RPs can gain reliable information about the transaction costs the OS incurs from pursuing a claim against them. The RP can then strategically take only the amount of care needed to keep the claim from becoming a positive value claim, not the full due care standard prescribed by law. This lowers the firm's potential claims, as no rational claimant will be incentivized to pursue a negative value claim. This can be thought of as the negative/positive value horizon or the point at which a claim goes from being negative in value to being positive. Because there are transaction costs to pursuing a claim (i.e., filing fees, attorney

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<sup>501</sup> SHAVELL discusses how there may be instances when a rational victim will bring a negative value claim. SHAVELL 2004, p. 420.

<sup>502</sup> According to CROSS, the classic model of the rational plaintiff may be frustrated when one considers a behavioral economics model in which "[n]oneconomic factors predominated among explanations of failure to settle" civil tort claims. While under the classic model, "if parties could easily calculate the value of cases accurately, one might expect few, if any, trials, because settlement would always appear beneficial". Cross finds that the "irrational" plaintiff may actually benefit the production of public goods from litigation and "that economically irrational decision making by litigants has a positive effect on justness and efficiency in the law". This irrational behavior by the plaintiff, rejecting a settlement offer that may be efficient only within the context of the specific litigation, may be "some rent-seeking manipulation of precedent," which is sought by RP firms. CROSS argues that "decisions to eschew settlement and proceed with litigation are desirable at the margin" by some plaintiffs, and these claims by irrational plaintiffs have the effect of limiting efforts by repeat player "strategic, rational litigants" who "use the litigation process to obtain externalities (precedents) that favor their own private situation ... at the expense of the public good". CROSS 2000, p. 4, p. 24, p. 27, p. 32, and p. 2.

fees, time costs, etc.), the RP tortfeasor can gain information about what transaction costs potential victims will incur in pursuing a claim and take these transaction costs into account when behaving strategically.

The RP tortfeasor firm may be intentionally committing torts to gain some cost savings. According to COOTER, "there may be a small group of unusual persons who derive illicit pleasure from noncompliance or incur exceptional costs from compliance" and "[s]uch people may cross the threshold of fault intentionally and, once crossed, it usually pays them to cross it a long way".<sup>503</sup> It is unlikely the RP tortfeasor firm is gaining pleasure; rather, they increase their welfare by avoiding care costs, either by taking strategically low care given an efficient standard or by taking the efficient level of care given an inefficiently high standard. By taking into account the estimated transaction cost of litigating or arbitrating, the firm can act strategically to make sure that the level of care they take is enough to keep potential claims unworthwhile to pursue, which has the effect of lowering the care cost of the RP below the level prescribed by law. This requires the RP to accurately estimate the transaction costs of litigation relative to the amount of care taken and assumes the amount of care taken is related to the amount of harm suffered by victims. When more care is taken, there are fewer accidents and lower harm, and when less care is taken, there are more accidents and more harm. To maximize care cost avoidance, the RP should go as far as they can to avoid taking due care without making it worthwhile for the rational plaintiff to file. Figure 11 identifies a claims positive/negative value horizon, where the claim changes from being positive in value to negative in value due to the presence of transaction costs in pursuing legal claims. Additionally, Figure 12 identifies how RP tortfeasors may take into account the positive/negative

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<sup>503</sup> COOTER 1982, p. 79.

horizon which victims encounter when determining their care level to ensure they do not face positive value claims from victims.

FIGURE 11. MODIFIED HAND RULE WITH POSITIVE/NEGATIVE VALUE HORIZON.<sup>504</sup>

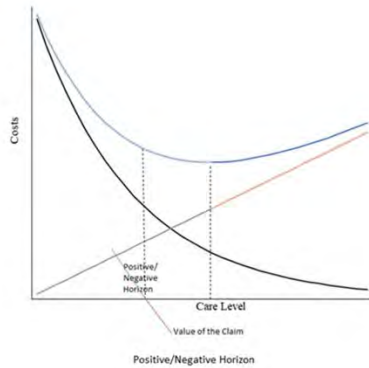
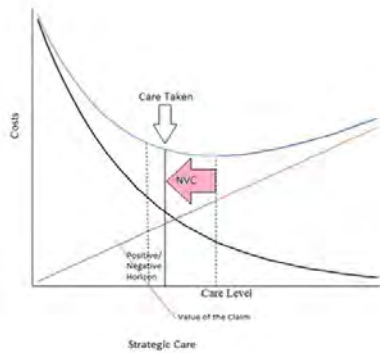


FIGURE 12. MODIFIED HAND RULE WITH POSITIVE/NEGATIVE VALUE HORIZON AND STRATEGIC CARE TAKING.<sup>505</sup>



If potential OS victims know about a deficient level of care being taken by RP injurers, they can adjust the level of care. For instance, when it was discovered that the Samsung Galaxy Note 7 had a design defect that led to some cell phones catching on fire, a public recall was eventually

<sup>504</sup> Adjusted from graph based on SHAVELL 1987.

<sup>505</sup> Adjusted from graph based on SHAVELL 1987.

announced, but not before news of the explosive problems were disseminated in the media. Many potential victims avoided injury by discontinuing their use of the Galaxy Note 7 phone before an official recall was announced.<sup>506</sup> In this and other ways, OS victims can respond to information about RPs taking deficient care by taking more care. This can be seen as a form of cost shifting in that the actions of one party taking less than due care may induce counterparties to increase their care, which results in a change in care costs.<sup>507</sup> Presumably, some individuals who owned a Galaxy Note 7 purchased new phones that were safer in response to knowledge of the dangers of using the faulty Samsung device they already had. If the arbitration about a dangerous product is confidential, the OS may lack the needed information to react to the RP's deficient care. It may be hard to keep the problem of exploding phones under wraps, but rumors of less alarming types of harm may be brushed aside. A lack of claims concerning a dangerous product being litigated in a court should decrease the salience of the product's dangers to the public. This lack of information concerning dangerous products would also likely result in additional harm falling on those who continue to use the product, unaware of the potential danger they face. Informal cascades of information may lead to some potential victims hearing about the need to take additional care.

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<sup>506</sup> The Galaxy Note 7 phones were famously prohibited from being brought on airplanes due to the risk of them catching on fire during flight. The US Department of Transportation banned all Samsung Galaxy Note 7 phones from air transportation in October 2016, and then a recall of the phone was announced in September 2016. Samsung faced multiple suits over injuries from the exploding Galaxy Note 7 phones, including in *Taylor v. Samsung Electronics America* (2018). In the Taylor case, a negligence claim was brought by a victim of an exploding phone against Samsung. A motion to compel arbitration by Samsung was granted, resulting in the tort claim against Samsung for negligence causing bodily harm being dismissed from court and forced into arbitration. In the ruling, the arbitration clause found within a "Health, Safety & Warranty Guide" that accompanied the phone when purchased was determined to be valid. According to the court, "[w]hether plaintiff took advantage of the opportunity to read the terms and conditions does not affect the contract's enforceability; as long as there was a reasonable opportunity for plaintiff to read the terms and reject them, he is bound by them." *Taylor v. Samsung Electronics America*, (2018), section B.

<sup>507</sup> Also, consider the impact of the care taken on the cost of bringing a claim. The care costs impact fees, as the decreased cost of taking due care by the RP, leads to the OS incurring potential transaction costs to pursue the claim against the RP. If the RP knows the impact which taking a certain level of care will have on the OS's litigation costs, the RP can adjust their care in order to keep transaction costs higher than any potential gain from litigation or arbitration while still avoiding optimal care costs. Fee shifting may enable the OS to bring a suit even when they face high legal fees from litigation or arbitration if the fee shifting rule is properly set. For a discussion of fee shifting, see: SHAVELL 2004, pp. 428-432.

These informal information cascades about RP taking deficient care may be drowned out with noise, some of which could be created by the RP injurer saying they are taking care.

The waiver of claims or contracting over damages also impacts the value of claims, as shown in Figure 13.<sup>508</sup> RPs consider this value and other contract terms that limit damages when determining the care taken. If the RP and OS have a contract to arbitrate combined with contracting away damages, then the RP has a nearly perfect amount of information about the value of potential claims against them. In addition to RP facing lower valued claims, the contracting away of damages makes it easier for RP to determine the level of care needed to keep claims from being positive in value, which enables RP to take less than due care without recourse from courts, thus further lowering their care costs.

There are several ways in which the law has responded to the problem of meritorious negative value claims, including: making punitive damages available, providing legal aid, using claimant friendly fee shifting schemes, and allowing for collective actions.<sup>509</sup> When there are many similar negative value meritorious claims by OS against an RP, the losses are often referred to as a problem of scattered losses.<sup>510</sup>

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<sup>508</sup> For a further discussion on the use of waiver and arbitration, see: HYLTON 2000.

<sup>509</sup> According to FAURE and WEBER, “While the deterrence approach is said to work for a variety of torts... for a number of reasons, this ideal model concerning the preventive effect of tort law is challenged in the case of large and widespread harm. The core reason is a potential enforcement failure. When harm is spread over a large number of individuals, the harm suffered by each individual separately may be relatively small, although the total harm could, from a societal perspective, be substantial. However, precisely because the harm suffered by the individual may be relatively small, that individual may not be willing to take action against the tortfeasor. The simple reason is that the individual victim would have to invest substantial amounts of time and money in carrying out a lawsuit against the tortfeasor, whereas his individual loss may be relatively limited. Moreover, the problem may be that if he were to bring such a lawsuit aiming, for instance, at preventing further harm being caused by the tortfeasor, the benefits could be for all persons who were affected by the wrong, whereas only the one bringing the lawsuit would bear the costs.” FAURE and WEBER 2015, p. 164.

<sup>510</sup> FAURE and WEBER 2015.



the use of corrective procedural measures incentivizes RP tortfeasors to consider the full extent of the externalities they create and incentivize rational OS victims to file meritorious claims.

#### 5.2.8 Punitive Damages.

Punitive damages change the expected values of tort claims the OS may have against the RP by creating the possibility for victims to receive damages beyond those directly caused by torts committed by RP. Punitive damages are specifically considered here concerning negative value claims. According to COOTER and ULEN, punitive damages "are money damages over and above compensatory damages assessed against the defendant," the purpose of which "is to punish the defendant, not to compensate the plaintiff".<sup>514</sup> The availability of punitive damages changes the value of the OS claim against the RP. If punitive damages have been contracted away, then there is no possibility for the RP to face being punished through damages.<sup>515</sup>

The availability of punitive damages may shift the negative value OSs claim from negative to positive in value. The change in the claim's value due to the availability of punitive damages may make OS victims more willing to pursue the claim. Punitive damages can be set in such a way as to solve the problem of injurers not being held liable for the full cost of their negative externalities.<sup>516</sup> Punitive damages may also induce a potential tortfeasor to avoid committing

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perpetrator knows that their action may have certain consequences (awareness of the possibilities), but is willing to accept them. They are able to reduce the chances to zero, but refrain from doing so because they want to engage in the behaviour. Conditional intent is the lower limit of intent. Other forms of intent are awareness of necessity (noodzakelijkheidbewustzijn) and pure intent (zuivere opzet)." VAN DER GRAAF 2018, p. 12.

<sup>514</sup> COOTER and ULEN 2016, p. 95.

<sup>515</sup> The availability of punitive damages is jurisdiction specific. There is a much wider use of punitive damages in the US, while in the EU, punitive damages are less common, specifically in civil law jurisdictions. According to Ware, "whether an arbitrator of a given dispute has the power to award punitive damages depends on the agreement by which the parties submitted the dispute to arbitration. If the arbitration agreement expressly confers on the arbitrator the power to award punitive damages, courts must enforce that agreement. Likewise, if the arbitration agreement expressly denies the arbitrator the power to award punitive damages, courts must enforce that agreement." WARE 1994, p. 531.

<sup>516</sup> According to VISSCHER, "If not all victims bring a suit, or if they sue but fail because they cannot prove all the required elements, the probability of the tortfeasor being held liable falls below 100%. Hence, the tortfeasor no longer correctly weighs the costs of precautionary measures against the decrease they cause in the total losses, but only the decrease they cause in his expected liability. Given that the losses exceed the expected liability, the tortfeasor does

torts.<sup>517</sup> Punitive damages can also be seen as a mechanism which solves a court error problem which results in firms avoiding fully internalizing the negative externalities they contribute to. According to COOTER, “in the absence of punitive damages, enforcement errors enable injurers to externalize a portion of the expected social costs that they cause”.<sup>518</sup>

Defendants face a potentially large value claim when claims are collectivized, and punitive damages are available. The availability of punitive damages may make a collectivized claim so large that it would force the defendant into financial ruin. In the US, the certification of a class action may make the defendant firm more willing to settle a claim, potentially at a price that is more than the value of the claim. This situation has been labeled as a "blackmail settlement".<sup>519</sup> In his decision from *in re Rhone*, Judge POSNER commented that a firm that faces a class action claim being certified also faces liability, which would force the firm into bankruptcy if they lose, and “[t]hey may not wish to roll these dice” and instead settle.<sup>520</sup> KANNER and NAGY have labeled Judge POSNER’s ruling in *Rhone* as “both legally and factually erroneous” and driven by “judicial activism” and view the problem of blackmail settlements as overstated.<sup>521</sup> KANNER and

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not take adequate precautions and/or engages in the activity too often. Punitive Damages can ameliorate this situation". VISSCHER 2009 (Punitive Damages), p. 223.

<sup>517</sup> VISSCHER addresses how “Punitive damages may induce a potential injurer to seek a voluntary transfer rather than to commit the tort, if liability including punitive damages is more costly than seeking the voluntary transfer.” VISSCHER 2009 (Punitive Damages), p. 228.

<sup>518</sup> COOTER 1988, p. 1148.

<sup>519</sup> When discussing the economics of collective actions in the US, PRIEST comments that “If the economic power of the certification of the class is such that, if certified, the defendant will settle on some terms, then it seems to me that it’s necessary in order to achieve the goals of justice in our society, to evaluate the merits of the claims as to whether the claims have sufficient merit on their face without a lot of discovery and to examine whether the claims have sufficient potential merit to justify the creation of great economic power through class certification.” PRIEST 1999, p. 483.

<sup>520</sup> Judge POSNER lays out the following scenario resulting in a “Blackmail Settlement”: “Suppose that 5,000 of the potential class members are not yet barred by the statute of limitations. And suppose the named plaintiffs in *Wadleigh* win the class portion of this case to the extent of establishing the defendants’ liability under either of the two negligence theories. It is true that this would only be prima facie liability, that the defendants would have various defenses. But they could not be confident that the defenses would prevail. They might, therefore, easily be facing \$25 billion in potential liability (conceivably more), and with it bankruptcy. They may not wish to roll these dice. That is putting it mildly. They will be under intense pressure to settle.” *Matter of Rhone-Poulenc Rorer Inc.*, (1995), p. 1298.

<sup>521</sup> KANNER and NAGY 2005, p. 686

NAGY find that the “available empirical evidence and a consideration of how federal judges typically manage class actions each suggest that the alleged ‘hydraulic pressure on defendants to settle’ is itself a myth more than a reality”.<sup>522</sup> Even with this empirical evidence, if we assume that some “blackmail” settlements do occur and are not efficient, then the contracting away of punitive damages may have some benefits if it leads to the preclusion of “blackmail” settlements. If “blackmail” settlements are more a myth, this makes a stronger case for using punitive damages in collective actions in order to ensure effective deterrence through the pricing of damages, which more accurately reflect the full social costs of accidents. PARISI and CENINI have addressed how there are “negative collateral effects of punitive damages”.<sup>523</sup> When punitive damages are “applied to the widespread harm characterizing class action lawsuits”, it “presents the possibility of a moral hazard problem”.<sup>524</sup> However, PARISI and CENINI also identify how “there could be a mixed equilibrium where the two remedies are combined and punitive damages are awarded within a class action”.<sup>525</sup> Punitive damages can cause asymmetric effects on different types of claims and court errors; thus, determining damages in any given claim should depend on their potential to solve an enforcement error or induce a deterrence for some types of tortfeasors.

Punitive damages may help solve problems associated with a high court error rate.<sup>526</sup> Punitive damages may incentivize victims to file meritorious claims that would have been negative in value without the availability of punitive damages, particularly when an intentional tort is alleged.<sup>527</sup>

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<sup>522</sup> KANNER and NAGY 2005, p. 693. Quoting: *Newton v. Merrill Lynch, Pierce, Fenner & Smith*.

<sup>523</sup> PARISI and CENINI 2012, p. 13

<sup>524</sup> PARISI and CENINI 2012, p. 6.

<sup>525</sup> PARISI and CENINI 2012. P. 13.

<sup>526</sup> According to COOTER and ULEN, "The efficiency loss due to enforcement error can be offset by augmenting compensatory damages with punitive damages." COOTER and ULEN 2016, p. 260.

<sup>527</sup> When considering how some states have formulated how punitive damages after that found in the common law, COOTER and ULEN comment that “According to the usual formulation, punitive damages can be awarded when the defendant’s behavior is malicious, oppressive, gross, willful and wanton, or fraudulent.” COOTER and ULEN 2016, p. 258.

Punitive damages can provide tortfeasors with the right incentives to take due care. However, COOTER argues that punitive damages are only necessary for willful and wanton behavior, as the incentive inducing effects of punitive damages do not apply to unintentional torts.<sup>528</sup> Punitive damages may deter injurers from intentionally committing torts in a similar way which BECKER described how increased sanctions for crimes change the utility curve of rational criminals.<sup>529</sup> If the probability of the intentional tort being discovered is small, then there may be a need to increase the punitive damages to account for the low probability of detection. Ideally, this will occur when a tortfeasor has "intentionally violated the standard of negligence defined by the hand rule".<sup>530</sup> This can be "accomplished by imposing punitive damages equal to the illicit benefits of noncompliance," which, if exactly offsetting "the injurer's illicit benefits, then his cost function will look just like that of an ordinary injurer in the zone of liability".<sup>531</sup> As the rational victim will not bring a negative value claim, courts can change the calculus of the rational victim by making punitive damages available.<sup>532</sup> Punitive damages are not universally used, and there is a clear divide between the use of punitive damages in continental Europe and common law jurisdiction.<sup>533</sup> When punitive damages are available, there is a potential for private contracting to preclude a punitive award.<sup>534</sup>

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<sup>528</sup> COOTER identifies "three broad characteristics of an economic view of punitive damages: (1) punitive damages should be restricted to intentional faults; (2) these faults will usually violate the legal standard of care by a wide margin; and (3) the awards for punitive damages should be large." These "three characteristics of punitive damages are consistent with the purposes of punishment and deterrence of exceptional injurers, but inconsistent with the purposes of rewarding plaintiffs for suing or fully compensating victims." COOTER 1982, p. 89, p. 90.

Also consider GRADY's comments that "[f]rom an economic point of view, willful and wanton negligence is highly correlated with strategic behavior and inadvertent negligence with its opposite". GRADY 1988, p. 23.

<sup>529</sup> BECKER 1968.

<sup>530</sup> COOTER 1988, p. 1143.

<sup>531</sup> COOTER 1982, p. 89.

<sup>532</sup> According to COOTER and ULEN, "To file a complaint, the plaintiff must usually hire a lawyer and pay filing fees to the court. Filing a complaint creates a legal claim. To decide whether to initiate a suit, a rational plaintiff compares the cost of the complaint and the expected value of the legal claim." COOTER and ULEN 2016, p. 388.

<sup>533</sup> For a discussion of different approaches to using punitive damages, See: VISSCHER 2009 (Punitive Damages).

<sup>534</sup> For some additional analysis on contracting away punitive damages, see: WARE 1994.

Punitive damages can be calculated to account for the court error rate and set so that successful claims include a punitive damage award which makes up for the court error so that the tortfeasor is responsible for the full value, or approximately so, of the negative externalities they produce.<sup>535</sup> To do this, the court must calculate what level of punitive damages are necessary to induce the parties to take due care. The incentive for, and ability of, arbitrators to calculate the efficient amount of punitive damages may be limited, as the arbitration panel may or may not be as competent to accurately calculate the efficient amount of damages as a court. As the use of strategic behavior to subvert due care standards is a willful and wanton act, the use of punitive damages may be an appropriate response to strategic behavior by RP, which results in a tort claim. When the RP intentionally prevents the availability of punitive damages through contracting, then any benefit punitive damages have in incentivizing meritorious negative value claims to be filed, evaporates. When the contracting away of damages is combined with arbitration, any real possibility of RP tortfeasors being forced to fully internalize the negative externalities caused by their tortious acts evaporates, leading to an additional under-deterrence for tortfeasors and a persistent enforcement error.

#### 5.2.9 Collective Actions.

Collectivization may solve the problem of scattered losses, as many similar negative value claims are positive in value once collectivized.<sup>536</sup> Collectivizing claims is also a way to balance information asymmetry between RP and OS.<sup>537</sup> If an RP has committed many similar torts, but

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<sup>535</sup> For a discussion on how to find the efficient punitive damages calculation, See: COOTER and ULEN, 2016, pp. 260-261.

<sup>536</sup> According to HYLTON, "For negative expected value claims, aggregation within the class action is necessary to create a suit with a positive expected value. This has been the fundamental justification for class actions. For positive expected value claims, the social desirability of the class action is less clear because every claimant can profitably bring his own lawsuit." HYLTON 2018, p. 1.

<sup>537</sup> According to VAN DEN BERGH and VISSCHER, "There are several ways in which collective actions can solve, or at least diminish, information deficiencies. In this respect, we must distinguish between collective actions sensu

the value of these individual claims is negative, the RP will not face claims from individual rational OS victims and thus not face liability for the negative externalities they produce. The law can allow similarly situated OS to collectivize their numerous negative value claims into a single positive value claim.<sup>538</sup> The collective claim can be litigated in a single court proceeding, which lowers the cost of litigation per victim and creates other efficiencies for courts.<sup>539</sup> For instance, a collectivized claim centralizes the information gathering of all potential victims. Although there are benefits of using collective actions, they are not absolute, as moral dilemmas may develop, detracting from the efficiencies.<sup>540</sup> There are several types of efficiency gains from using collective actions, but for the sake of incentives for the tortfeasor to take due care, the main efficiency gain comes from providing a legal procedure by which many victims of small harms can gain access to the legal system.<sup>541</sup> If available in arbitration, some of the efficiencies of using a collective action rule may also be realized.

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stricto and representative actions. Under opt-in collective actions, consumers must be appropriately notified about the occurrence of any infringement that has caused them harm. Economically speaking, the value of the information provided is higher than the costs of the notification if it incites consumers to initiate a group action to recover damages. Benefits resulting from the reduction of information asymmetries may be particularly large in the case of representative actions." VAN DEN BERGH and VISSCHER 2007, p. 17.

<sup>538</sup> Examples of collective action procedures include FRCP Rule 23 and the Dutch collective action procedure DCC art 3, and the German MUSTERFESTSTELLUNGSKLAGE. Also, FAURE and WEBER identify potential legal procedures in court and private solutions outside of court, which seek to solve the problem of scattered losses, including: expense insurance, legal aid, transferring of claims to third parties, third party funding, contingency or conditional fees for lawyers, ADR, class actions, representative actions, punitive damages, administrative legal enforcement, and criminal sanctions, with each solution involving a unique set of costs and benefits. FAURE and WEBER 2015, throughout.

<sup>539</sup> PRIEST identifies some benefits of using collective actions. According to PRIEST, "class actions serve the purpose of aggregating common claims. This creates something of an economy of scale, hopefully, whereby a large number of claims can be resolved with, supposedly, greater efficiency and greater dispatch than resolving each of the claims individually. This would be especially true and it has been true with class actions which involve claims that are small on their face and that might not justify individual litigation but which, when joined as a class, become worthwhile to litigate. Although this point is often made, the economy of scale argument does not apply only to small claims. There is no reason not to realize economies of scale of large claims just as of small claims." PRIEST 1999, p. 481.

<sup>540</sup> According to VAN DEN BERGH and VISSCHER, "On the positive side, collective actions generate information about the violation of consumer law, mitigate the rational apathy problem and may cure the free-rider problem. On the negative side, collective actions may exacerbate principal agent problems between lawyers and clients and create scope for frivolous suits." VAN DEN BERGH and VISSCHER 2007, p. 29.

<sup>541</sup> See: PRIEST 1999.

The collectivization of tort claims also has a potential downside. When claims are collectivized, and punitive damages are available, the potential for firms, even those facing marginal legal claims, to be induced into agreeing to a "blackmail" settlement instead of facing crippling liability. There is also a possibility of a "blackmail" settlement occurring in a class arbitration setting. However, contracts to arbitrate are often tied to a class waiver clause, which prevents the realization of efficiencies created through the collectivization of the claims.<sup>542</sup> The preclusion of collective actions may contribute to court error and thus may influence deterrence. According to STERNLIGHT and JENSEN, "by precluding class actions, companies are engaging in 'do-it-yourself tort reform,' freeing themselves from liability without having to convince legislatures to change the substantive law".<sup>543</sup>

Avoiding liability is not the only benefit the RP can realize by precluding class actions. The use of collective actions may change the costs of pursuing or defending a claim. On one side, the use of arbitration and class waivers can lead to an increased cost of litigation through having many claims instead of one. The RP is more likely to bear these increased costs than the OS. On the other side, the use of arbitration and class waiver can decrease the instances of inefficient "blackmail" settlements for firms. Suppose there is no threat of facing a collective claim. In that case, RP can strategically take care below the efficient due care standard without facing positive value claims, so long as the harm caused by the decreased care is not greater than the transaction costs an individual plaintiff would incur from pursuing a claim. By preventing collective actions through

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<sup>542</sup> The waiver of collective actions in arbitration is widespread in the US, and according to STERNLIGHT and JENSEN, "If one looks at the form contracts she receives regarding her credit card, cellular phone, land phone, insurance policies, mortgage, and so forth, most likely, the majority of those contracts include arbitration clauses, and many of those include prohibitions on class actions." Furthermore, STERNLIGHT and JENSEN point to the 2004 study by DEMANIE and HENSLER which found that "thirty percent of the arbitration clauses examined contained explicit class action prohibitions". STERNLIGHT and JENSEN 2004, p. 75. Citing to: DEMANIE and HENSLER 2004.

<sup>543</sup> STERNLIGHT and JENSEN 2004, p. 103.

arbitration, the RP can avoid liability, including potentially firm crushing punitive damages, and avoid the care costs of complying with the prescribed due care standard.

#### 5.2.10 Strategic Behavior to Waive Arbitration.

A rational RP injurer will not use arbitration clauses when the standard of care is above the efficient standard. If an injury occurs, RPs held to an inefficiently high care standard should challenge the inefficient standard and continue to challenge so long as the inefficiently high standard is in place because they face the continued cost of taking inefficiently high care.<sup>544</sup>

Even when it makes sense for the RP injurer to waive arbitration when there is an inefficiently high due care standard, there is still an incentive for the RP injurer to use class waivers to contract away liability even when there is an inefficiently high standard. Class waiver ensures the RP does not face a collective action that could lead to either a blackmail settlement or a legitimately large claim. In an opt out collective action rule, a collective action may also lead to a reinforcement of the inefficiently high due care standard without a possibility to challenge the claim in the future. The use of collective actions can limit the possibility of divergent case law developing, especially when there is an opt out rule which collectivizes all possible claims unless the individual OS victims take an extra step to opt out of the class. In an opt in collective action system, there may be a possibility to litigate the claim again, as fewer OS victims will join the claim.

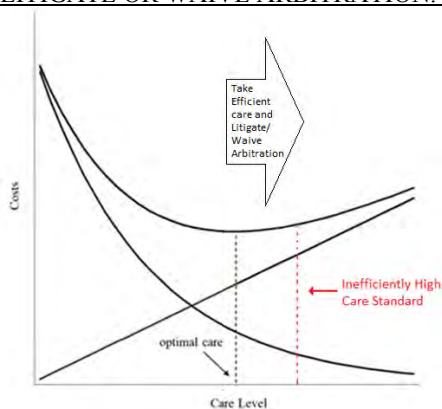
When an RP waives the right to arbitration, the RP decides to take short terms costs in the hopes of avoiding long term care costs. If the inefficiently high standard is adjusted to the efficient standard, the RP will avoid excessive care costs. The incentives for RP to challenge an inefficiently

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<sup>544</sup> This is consistent with the model of the efficiency of the common law, where RP have an incentive to continually challenge an inefficient rule which costs them utility. See: PARISI and FON 2009, Chapter Five: Lawmaking through Adjudication.

high care standard is shown in Figure 14. To challenge an inefficiently high care standard, it requires the RP to be able to identify the excessive standard and take active steps to challenge the standard. This could include a strategic choice not to include an arbitration clause to cover the excessive standard or waiving arbitration when an arbitration contract exists, and the claim relates to the excessive standard. Waiver of liability and collective redress can lower the total expected liability of the RP.<sup>545</sup> RP should not be willing to give up the use of liability waivers and class waivers because they may still provide opportunities to behave strategically, or they may limit their expected liability. In general, we should not expect there to be arbitration of tort claims for which an excessive due care standard is in place because RP will have continued demand for standards that are inefficiently high to be adjusted to the efficient standard. Figure 7 shows how there is an incentive for RP to maintain class waivers to lower expected liability from collectivized claims while still waiving arbitration to create opportunities to challenge an inefficiently high rule.

**FIGURE 14. INEFFICIENTLY HIGH DUE CARE STANDARDS AND THE INCENTIVE TO LITIGATE OR WAIVE ARBITRATION.**<sup>546</sup>



<sup>545</sup> For a further discussion on the role of liability waiver and arbitration, see: HYLTON 2000.

<sup>546</sup> Adjusted from graph based on SHAVELL 1987.

## 6. Regulatory Arbitrage and Coordination among RP.

There are benefits for RPs to use arbitration other than the benefit of preventing a challenge in court to an inefficiently set rule. Recall that arbitration may allow the RP to gain an information advantage it could not gain in a court. This information advantage may perpetuate the RPs' ability to keep an inefficient rule in place or enable the RP to avoid regulatory oversight. The ability to act strategically in arbitration can thus be seen as an alternative to the ability to act strategically in litigation. In essence, multiple judicial forums are available where regulations or standards may be interpreted differently, or a different regulation or standard is being used.

It may be useful to think of the RP's strategic behavior in terms of judicial arbitrage.<sup>547</sup> It is well known that customary law and alternative procedural rules are often used in arbitration. Litigation concerning the terms of a contract can also be considered a form of private regulation.<sup>548</sup> The relationship between litigation and regulation is not merely a choice of one over the other. Rather regulation should complement litigation when litigation fails and *vice versa*.<sup>549</sup>

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<sup>547</sup> SHILL has coined a similar term, "judgment arbitrage". Shill has addressed the situation where "creditors can exploit differences among state recognition standards to maximize the expected recovery" regarding enforcing foreign judgments. According to SHILL, "the procedure consists of two formally and conceptually distinct stages: foreign judgments must first be recognized and then enforced." SHILL 2013, p. 463, p. 459.

This author would define judicial arbitrage differently. Judicial arbitrage is the selection among adjudication forums (both private and public judicial forums) to strategically prevent jurisdiction or avail jurisdiction within a regulatory regime which provides an opportunity for one or both contracting parties to behave strategically in an effort to maximize private welfare through, among other things, a reduction in transaction costs, regulatory oversight or liability. Pre-Dispute Domestic Forum Arbitrage can be considered as a subtype of judicial arbitrage, where there is no choice of law issues as the claim is completely within the scope of a specific jurisdiction, where the choice is only between a single public domestic adjudication forum and private domestic adjudication forums, and where there is the option to choose *ex ante* the forum between the parties involved in the dispute.

<sup>548</sup> According to SCHWARTZSTEIN and SHLEIFER, "government can lay down the regulations, such as disclosure rules and procedures for dealing with conflicts of interest, but then leave the enforcement to private action in court". SCHWARTZSTEIN and SHLEIFER 2009, p. 39. SHAVELL has also identified how "neither tort liability nor regulation could uniformly dominate the other as a solution to the problem of controlling risks, but also that they should not be viewed as mutually exclusive solutions to it. A complete solution to the problem of the control of risk evidently should involve the joint use of liability and regulation, with the balance between them reflecting the importance of the determinants." SHAVELL 1984, p. 365.

<sup>549</sup> According to SCHWARTZSTEIN and SHLEIFER, "In Coase's view, contracts are a substitute for regulation. If potential externalities can be contracted Around, no regulation is necessary. Yet, contrary to this prediction, we see extensive government regulation of contracts themselves." Furthermore, they argue that "The case against regulation

When parties have a choice over the adjudication forum, they have a choice of regulation to a certain degree. Since the use of private arbitration provides individuals with competing forms of regulation enforcement, the availability of arbitration may provide an opportunity for regulatory arbitrage.<sup>550</sup> Given that RP have resource, opportunity, and intelligence advantages over the OS, the threat of litigation against the RP may not necessarily provide the correct incentives to take due care, and regulation may prove more capable of providing the right incentives.<sup>551</sup>

If there is a widespread practice of regulatory arbitrage within a market, a welfare lowering situation may occur, which has been described as a race to the bottom.<sup>552</sup> It has been described in these terms because there are potential welfare reducing implications of lowering regulation in order to attract business, as the lower regulation may contribute to other market failures, such as an inefficient investment in public goods. In the US Supreme Court case *Louis K. Liggett Co. v.*

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relies on well- functioning courts. Courts are needed both to enforce contracts and to provide remedy for torts, and hence are central to the basic private mechanisms for curing market failures.” Additionally, “Contracts accomplish less when their interpretation is unpredictable and their enforcement is expensive. Liability rules would not cure market failures if compensation of the victims is vulnerable to the vagaries of courts. In short, the case for efficient regulation rests on the failures of courts.” SCHWARTZSTEIN and SHLEIFER 2009, p. 28.

<sup>550</sup> Regulatory arbitrage is defined by Fleischer as “a perfectly legal planning technique used to avoid taxes, accounting rules, securities disclosure, and other regulatory costs. Regulatory arbitrage exploits the gap between the economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system’s intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision.” FLEISCHER 2010, p. 229. In contrast, according to POSNER, “Regulatory arbitrage’ refers to the practice of firms’ configuring their business in such a way as to bring them within the regulatory jurisdiction of an agency likely to favor the firm, perhaps because the agency is supported by fees of the firms it regulates and therefore, to increase its budget, seeks to entice firms by an implicit promise of lighter regulation.” POSNER 2011, p. 856.

<sup>551</sup> According to SCHLEIFER, “Because the rich and the politically connected have more resources to influence the path of justice, private litigation cannot be always counted on as an effective mechanism of enforcing socially desirable conduct.” SHLEIFER 2005, p. 445.

<sup>552</sup> According to FLEISCHER, “The literature on regulatory competition routinely assumes that parties choose regulatory regimes in order to minimize transaction costs, which, in turn, is sometimes said to create a “race to the top” as regulators adopt more efficient laws. But the presence of regulatory arbitrage distorts the process, leading to results that are inefficient in the short run and indeterminate in the long run. Because parties may choose to adopt a legal form either because it minimizes transaction costs or because it minimizes regulatory costs, or some combination of both, it’s difficult to know whether new legal forms increase or decrease the overall efficiency of the system. When new forms are chosen because they reduce transaction costs, legal innovation presumptively increases efficiency. But when new forms are chosen because they reduce regulatory costs and increase transaction costs compared to the old structure, we lose twice: efficiency is reduced by the increase in transaction costs, and the regulatory burden is shifted onto those who cannot engage in arbitrage.” FLEISCHER 2010, pp. 274-275.

*Lee*, Justice Brandeis described in his dissenting opinion how “in states where the cost was lowest and the laws least restrictive” due to removing limitations on firms, those states induced firms to incorporate in those states.<sup>553</sup> When arbitration is available for tort claims, firms may look to mandate arbitration with an arbitration association which is the least expensive and least restrictive for the firm, even if this results in the total accident costs increasing as a result of a shift of regulatory burdens on parties who are not behaving strategically.

In so far as courts adhere to a set of procedural rules, they can be considered a type of legal regulation of the litigation process. To a certain extent, both arbitration and litigation are regulatory regimes for a dispute resolution process. If there are different regulatory regimes which firms can choose to operate under, in this case, public or private regulatory regimes for dispute resolution, then these regulatory regimes can act to induce firms to choose their regime by providing favorable regulation for the firms. Since arbitration associations are providing a good, dispute resolution, and are competing with each other for customers of that good, these associations may interact with each other by responding to the actions of the other associations. If one association lowers the price charged for dispute resolution or changes the rules of procedure to be favorable to an industry, the other associations will notice and may choose to change or not to change their prices or procedures in response. This interaction can be considered a ‘strategic interaction’, which has often been applied in the political economy literature on state actions. According to Costa-Font et al., when “policies in one jurisdiction that are correlated with those from neighboring or benchmark jurisdictions,” then “[i]nteractions can take the form of competition or cooperation

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<sup>553</sup> Dissenting opinion of Justice Brandeis *Louis K. Liggett Co. v. Lee* (1933). According to Justice Brandeis, “The race was one not of diligence but of laxity. Incorporation under such laws was possible; and the great industrial States yielded in order not to lose wholly the prospect of the revenue and the control incident to domestic incorporation.” *Louis K. Liggett Co. v. Lee*, (1933), pp. 559-560.

between rival jurisdictions in the provision of publicly provided goods and services”.<sup>554</sup> The main difference in the case of strategic interaction between arbitration associations is that the arbitration associations are incapable of producing a public good even though their actions influence the production of public goods from courts, they rely on the production of public goods from courts, they rely on courts to enforce private arbitral awards, which means arbitration associations are simultaneously competing with public judicial forums, but also relying on public judicial forums to function.

Regulation can be seen as centralized lawmaking by non-judges, be it by bureaucrats or elected officials. However, “as the economy grows in complexity, central officials cannot get the information that they need to make precise regulations”.<sup>555</sup> If we consider that lawmaking is a type of market, one size may not fit all. Judicial rulemaking can play an important role which regulation cannot in administering tort law. According to COOTER and ULEN,

“Tort liability removes many decisions about accidents from bureaucrats and politicians and allows judges to make laws, plaintiffs to decide when to prosecute violators, and courts to determine how much the violators must pay. Thus, the liability system decentralizes much of the task of internalizing externalities.”<sup>556</sup>

Using arbitration as part of a tort liability system removes judges from making decisions and limits plaintiffs’ options. The use of arbitration for tort claims can thus be considered as both decentralizing and privatizing a liability system. Regulatory arbitrage may be one of the goals of the RP, who acts strategically by using mandatory arbitration clauses in their business dealings by taking advantage of variations across decentralized public and private liability systems.

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<sup>554</sup> COSTA-FONT et al. 2015, p. 489.

<sup>555</sup> COOTER and ULEN 2016 p. 227.

<sup>556</sup> COOTER and ULEN 2016, p. 227.

The RP can use arbitration to avoid not only regulation but in order to avoid the cost of compliance with regulation. As regulators use the production of public information from courts as a complement to their own information gathering, the lack of public information production in arbitration may also restrict the ability of regulators to function properly. The impact of this type of regulation avoidance may be compounded when states rely on the private enforcement of law or a mix of private and public regulatory enforcement schemes.<sup>557</sup> In the context of using arbitration for tort claims, the RP who mandates the use of arbitration in all their transactions with OS can not only subvert a private enforcement mechanism in some public regulations by keeping the information about their violation private, but the RP can also lower their regulatory compliance costs by making sure the harms they cause from deviating from the care standard are diffused and incapable of leading to any individual claim which is worth pursuing.<sup>558</sup>

There are potential private benefits for firms to act in unison to avoid judicial review. If there is a concentration of market power within a few firms in a market, and each firm benefits from an inefficiently low due care standard which is susceptible to a more efficient interpretation by courts, the firms can strategically use arbitration to keep the rule from being adjusted to the correct care standard. If this occurs, the whole industry benefits from lower care costs. This may create a risk that public due care standards are being converted from public goods into club goods due to the

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<sup>557</sup> According to POSNER, "Often more than one agency regulates the same activity. Both the Justice Department and the Federal Trade Commission enforce the federal antitrust laws, and in addition state attorneys general enforce state antitrust laws modeled on the federal laws and applicable to many of the same enterprises. Private suits can also be brought to enforce both the federal and the state antitrust laws." POSNER 2011, p. 856.

<sup>558</sup> Consider this in light of the incentive not to litigate inefficient rules which LANDES and POSNER identified. According to LANDES and POSNER, "If, however, the dispute arises in an area where the likeliest outcome is a precedent that will strengthen an existing inefficient rule, litigation will be avoided because its expected yield is negative. Therefore, we expect litigation to arise mainly in areas where there is already a tendency toward efficiency, and this tendency will be further strengthened by litigation that creates additional precedents. Areas dominated by inefficient rules will tend to become dormant in terms of litigation activity". LANDES and POSNER 1979, p. 261.

strategic creation of barriers to access judicially created public goods.<sup>559</sup> The use of boilerplate, or adhesion contracts, may enable RPs to collude to prevent an inefficiently low due care standard from being challenged, essentially limiting public access to the development of public goods from adjudication.<sup>560</sup>

Coordination between firms in the industry could occur by either explicit or implicit means. For example, one firm may publish their standard contract making it available to other firms in the industry, implicitly signaling their preference for the use of arbitration across the market. If there is a concerted effort among firms to engage in judicial arbitrage in order to avoid due care costs and judicial review for the whole industry, then other areas of law may also become involved, including competition and criminal legal regimes. If coordination to manipulate the production of public goods from litigation were to occur, then there would be a deficient development of efficient due care standards affecting the coordinating industry, which may lead to additional market failures. This type of collusion thus has implications beyond what are considered traditional abuses of market power by cartels, i.e., horizontal price fixing, predatory pricing, bid rigging, and setting territories for distribution and production limits, among others.<sup>561</sup> The manipulation of the

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<sup>559</sup> According to LANDES and POSNER, "to the extent that the costs and benefits of precedent will be borne (in the future) entirely by the parties to the suit in which the precedent is created, precedent is a private rather than public good." LANDES and POSNER 1979, p. 261.

According to MANZI and SMITH-BOWERS, "there is a type of good (the club good), which like private goods had excludable benefits but was allocated through groups. This allowed the club members the enjoyment of the benefit but was unlike the private good which is limited to the individual or shared by all in the case of the public good. The club good is neither a 'private' nor 'public' good in the traditional economic sense." MANZI and SMITH-BOWERS 2005, p. 347. Citing to: BUCHANAN 1965.

<sup>560</sup> According to GILO and PORAT, "[t]here are... cases in which boilerplate language and the artificial imposition of transaction costs do create asymmetry of information between the supplier and its consumers, as in the classic discussions of boilerplate language, but the asymmetry is used as a cartel facilitation tool, an anticompetitive signal device, or a tool for creating the appearance of a fair contract, rather than to merely extract surplus from uninformed consumers." GILO and PORAT 2005, p.1030.

<sup>561</sup> LANDE and MARVEL identify type I, type II, and type III categories of collusion. According to LANDE and MARVEL, "Type I or classic collusion include price fixing, bid rigging, assignment of customers, and division of territories", Type II collusion involves "practices which can disadvantage rivals", including "practices that raise rivals costs" and practices which "deprive their rivals of revenue", while Type III collusion "can be characterized as

production of public goods from litigation is also beyond the fixing of conditional terms or standardization of terms in the underlying contracts, although these practices may be considered as facilitating the objective of manipulating the production of public goods from litigation.

It is also possible that firms in an industry seek to create the same welfare reducing effect of collusion through tacit collusion. According to IVALDI et al., “[t]acit collusion’ need not involve any ‘collusion’ in the legal sense, and in particular need involve no communication between the parties”, rather “it is referred to as tacit collusion only because the outcome (in terms of prices set or quantities produced, for example) may well resemble that of explicit collusion or even of an official cartel.”<sup>562</sup> Suppose a state liability system, systematically and without regard to welfare effects, defers to using a private liability system. In that case, the possibility for tacit collusion occurring without recourse could increase, which would, in turn, lead to a decrease in public welfare as it relates to the liability system, representing a type of market failure unique from the market failures involving torts, yet still related to those market failures.

## 7. Conclusion.

The use of arbitration can affect the incentives of parties to take due care. When arbitration allows parties to take less than due care without court oversight, it can frustrate the law’s ability to be creative when new problems in tort law develop. This problem can also be seen as a tension between enforcing contracts and supporting efficient due care standards in tort law. In the best-case scenario, arbitration can be as effective or more effective than litigation in incentivizing injurers to take due care and further provide docket relief for courts, thus lowering the tertiary

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collusion to fix the rules of competition” which are designed to “isolate and exploit consumers”. LANDE and MARVEL 2002, p. 83-84.

<sup>562</sup> IVALDI 2003, p. 4.

costs of accidents. This, however, is not inherent to the arbitration process. The use of arbitration may also allow the parties involved in a dispute to realize some other savings due to lower transaction costs from litigation. However, even without the use of arbitration, tort law is frustrated when there are no proper incentives for parties to take due care or when injurers act strategically to avoid taking due care. The failure of tort law to optimally incentivize parties to take due care is a failure of the law, which perpetuates the market failures associated with externalities resulting from tortious acts. The law's reaction to this market failure has led to the creation of legal rules and procedures which are intended to provide the right incentives for injurers to take due care as well as the production of public goods from litigation such as precedent, rule interpretation, gap filling, and information production. The arbitration of some tort claims may lead to a lack of creative efforts from the judiciary and frustrate the production of public goods from litigation.

Privately contracting to use arbitration, contracting away liability, and contracting over a waiver of class actions, can be used by the strategic RP injurer to avoid corrective rules and procedures as well as to avoid taking due care and the cost associated with taking due care, thus perpetuating market failures related to torts. A strategic waiver of arbitration by RPs should occur when due care standards are excessively high, as RPs will seek to use judicial intervention to lower the standard to the efficient level, thus lowering their future care costs. Injurers, especially RP injurers, can increase their options to behave strategically by unilaterally demanding *ex ante* that arbitration be used to adjudicate tort claims against them. The additional options to behave strategically allow RP injurers to take less than due care without facing legal recourse in court, allows RP injurers to prevent a court challenge from victims to an inefficient rule which the injurer benefits from, and allow injurers to strategically develop the law through the selective litigation of claims in court which challenge an inefficiently high rule. At the extreme, the use of arbitration for tort claims

allows RPs to increase information, intelligence, resource, and opportunity advantages over individual OS litigants, all of which enable RP to behave strategically. Firms in an industry may act in coordination to prevent a challenge to an inefficient rule which they collectively benefit from by using arbitration agreements across the industry.

Efforts to avoid judicial oversight through the use of arbitration can also be seen as a form of regulatory arbitrage. This form of regulatory arbitrage can contribute to an underproduction of public goods from litigation. In such a situation, the fruits of the creative processes found in the law will not grow. The strategic use of arbitration, liability waivers, and class action waivers frustrates the goals of tort law to incentivize injurers and victims to take due care and leads to an increase in the costs of accidents for individuals and society while lowering the costs of accidents for tortfeasors. This frustration of the creative process of the law has implications not only for the parties involved in a given dispute but also impacts the total welfare of society.

## **APPENDIX B: ARBITRATION CONTRACTS FROM US CELLULAR SERVICE PROVIDERS**

### Largest US Cell Phone Service Providers.<sup>563</sup>

Rank	Provider Name	Subscribers (Millions)
1	Verizon Wireless	146
2	AT&T Mobility	134.2
3	T-Mobile US	72.6
4	Sprint Corporation	59.7
5	U.S. Cellular	5

### AT&T Arbitration Agreement.<sup>564</sup>

#### **2.2 Arbitration Agreement**

1. AT&T and you agree to arbitrate **all disputes and claims** between us. This agreement to arbitrate is intended to be broadly interpreted. It includes, but is not limited to:
- claims arising out of or relating to any aspect of the relationship between us, whether based in contract, tort, statute, fraud, misrepresentation or any other legal theory;
  - claims that arose before this or any prior Agreement (including, but not limited to, claims relating to advertising);
  - claims that are currently the subject of purported class action litigation in which you are not a member of a certified class; and
  - claims that may arise after the termination of this Agreement.

References to "AT&T," "you," and "us" include our respective subsidiaries, affiliates, agents, employees, predecessors in interest, successors, and assigns, as well as all authorized or unauthorized users or beneficiaries of services or Devices under this or prior Agreements between us. Notwithstanding the foregoing, either party may bring an individual action in small claims court. This arbitration agreement does not preclude you from bringing issues to the attention of federal, state, or local agencies, including, for example, the Federal Communications Commission. Such agencies can, if the law allows, seek relief against us on your behalf. **You agree that, by entering into this Agreement, you and AT&T are each waiving the right to a trial by jury or to participate in a class action.** This Agreement evidences a transaction in interstate commerce, and thus the Federal Arbitration Act governs the interpretation and enforcement of this provision. This arbitration provision shall survive termination of this Agreement.

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<sup>563</sup> ROTICH 2017.

<sup>564</sup> AT & T 2018.

## T-Mobile Arbitration Agreement.<sup>565</sup>

**Dispute Resolution and Arbitration.** YOU AND WE EACH AGREE THAT, EXCEPT AS PROVIDED BELOW, ANY AND ALL CLAIMS OR DISPUTES IN ANY WAY RELATED TO OR CONCERNING THE AGREEMENT, OUR PRIVACY POLICY, OUR SERVICES, DEVICES OR PRODUCTS, INCLUDING ANY BILLING DISPUTES, WILL BE RESOLVED BY BINDING ARBITRATION OR IN SMALL CLAIMS COURT. This includes any claims against other parties relating to Services or Devices provided or billed to you (such as our suppliers, dealers, authorized retailers, or third party vendors) whenever you also assert claims against us in the same proceeding. You and we each also agree that the Agreement affects interstate commerce so that the Federal Arbitration Act and federal arbitration law, not state law, apply and govern the enforceability of this dispute resolution provision (despite the general choice of law provision set forth below). THERE IS NO JUDGE OR JURY IN ARBITRATION, AND COURT REVIEW OF AN ARBITRATION AWARD IS LIMITED. THE ARBITRATOR MUST FOLLOW THIS AGREEMENT AND CAN AWARD THE SAME DAMAGES AND RELIEF AS A COURT (INCLUDING ATTORNEYS' FEES).

**For Puerto Rico customers,** references to "small claims court" should be understood to mean the Puerto Rico Telecommunications Regulatory Board ("TRB") for matters within the jurisdiction of said agency. See **OTHER TERMS REGARDING DISPUTE RESOLUTION** for details on the billing dispute process in Puerto Rico.

Notwithstanding the above, **YOU MAY CHOOSE TO PURSUE YOUR CLAIM IN COURT AND NOT BY ARBITRATION IF YOU OPT OUT OF THESE ARBITRATION PROCEDURES WITHIN 30 DAYS FROM THE EARLIER OF THE DATE YOU PURCHASED A DEVICE FROM US OR THE DATE YOU ACTIVATED A NEW LINE OF SERVICE (the "Opt Out Deadline").** You must opt out by the Opt Out Deadline for each line of Service. You may opt out of these arbitration procedures by calling 1-866-323-1405 or online at [www.T-Mobile.com/disputeresolution.com](http://www.T-Mobile.com/disputeresolution). **Any opt-out received after the Opt Out Deadline will not be valid and you will be required to pursue your claim in arbitration or small claims court.**

## Verizon Arbitration Agreement.<sup>566</sup>

**YOU AND VERIZON BOTH AGREE TO RESOLVE DISPUTES ONLY BY ARBITRATION OR IN SMALL CLAIMS COURT. YOU UNDERSTAND THAT BY THIS AGREEMENT YOU ARE GIVING UP THE RIGHT TO BRING A CLAIM IN COURT OR IN FRONT OF A JURY. WHILE THE PROCEDURES MAY BE DIFFERENT, AN ARBITRATOR CAN AWARD YOU THE SAME DAMAGES AND RELIEF, AND MUST HONOR THE SAME TERMS IN THIS AGREEMENT, AS A COURT WOULD. IF THE LAW ALLOWS FOR AN AWARD OF ATTORNEYS' FEES, AN ARBITRATOR CAN AWARD THEM TOO. WE ALSO BOTH AGREE THAT:**

(i) THE FEDERAL ARBITRATION ACT APPLIES TO THIS AGREEMENT, EXCEPT FOR SMALL CLAIMS COURT CASES, ANY DISPUTE THAT IN ANY WAY RELATES TO OR ARISES OUT OF THIS AGREEMENT OR FROM ANY EQUIPMENT, PRODUCTS AND SERVICES YOU RECEIVE FROM US (OR FROM ANY ADVERTISING FOR ANY SUCH PRODUCTS OR SERVICES), INCLUDING ANY DISPUTES YOU HAVE WITH OUR EMPLOYEES OR AGENTS, WILL BE RESOLVED BY ONE OR MORE NEUTRAL ARBITRATORS BEFORE THE AMERICAN ARBITRATION ASSOCIATION ("AAA") OR BETTER BUSINESS BUREAU ("BBB"). YOU CAN ALSO BRING ANY ISSUES YOU MAY HAVE TO THE ATTENTION OF FEDERAL, STATE, OR LOCAL GOVERNMENT AGENCIES, AND IF THE LAW ALLOWS, THEY CAN SEEK RELIEF AGAINST US FOR YOU. THIS AGREEMENT TO ARBITRATE CONTINUES TO APPLY EVEN AFTER YOU HAVE STOPPED RECEIVING SERVICE FROM US.

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<sup>565</sup> T-Mobile 2018.

<sup>566</sup> VERIZON 2018.

### Sprint Arbitration Agreement.<sup>567</sup>

**14.2. Arbitration.** The parties agree that all billing disputes related to Sprint's provision of Products or Services provided under the Agreement that do not get resolved through the negotiation process outlined above will be finally settled through bi-lateral arbitration as follows: for billing disputes related to Products or Services provided (A) in the United States, the arbitration will be administered by AAA in accordance with its Commercial Arbitration Rules, governed by the United States Arbitration Act, 9 U.S.C. Sec. 1, et seq., and (B) outside of the United States, the arbitration will be conducted pursuant to the Rules of Conciliation and Arbitration of the International Chamber of Commerce. The parties agree that (1) all arbitration proceedings will be conducted in the English language, (2) each party waives any right to seek, participate in or file a claim as a class action, or proceed as lead claimant or in a representative capacity and will not join additional parties, (3) the arbitrator will have no authority to award damages beyond actual damages as agreed to in Section 9, (4) the arbitration will be conducted by a single attorney arbitrator who has substantial experience and knowledge in telecommunications and commercial contracts, (5) discovery will be limited to the reasonable exchange of relevant documents and will not include other forms of discovery requests or electronic collection protocols or depositions, with the exception that if the arbitrator determines that depositions are appropriate, the number will not exceed three per party, including a corporate representative deposition, and each deposition is limited to five hours, (6) any award rendered by the arbitrator will be accompanied by a reasoned opinion and entered in any court having jurisdiction, and (7) the parties will allocate all arbitration costs equally although each party will be responsible for its own attorney fees and costs.

**14.3. Waivers.** The parties mutually, expressly, irrevocably and unconditionally waive trial by jury. Neither party will make any claim under any consumer protection statute, or in any manner participate in any class action proceeding in a representative capacity against the other party.

### US Cellular Arbitration Agreement.<sup>568</sup>

Arbitration. ANY CONTROVERSY OR CLAIM ARISING OUT OF OR RELATING TO THIS AGREEMENT SHALL BE RESOLVED BY BINDING ARBITRATION AT THE REQUEST OF EITHER PARTY PURSUANT TO THE WIRELESS INDUSTRY ARBITRATION RULES AS MODIFIED BY THIS AGREEMENT AND AS ADMINISTERED BY THE AMERICAN ARBITRATION ASSOCIATION ("AAA"). WE SHALL BE FULLY RESPONSIBLE FOR FILING, ADMINISTRATION AND ARBITRATOR FEES AND WE WILL ADVANCE, OR REIMBURSE YOU FOR, ANY REASONABLE FILING, ADMINISTRATION AND ARBITRATOR FEES FOR ANY ARBITRATION INITIATED IN ACCORDANCE WITH THIS PARAGRAPH. WE WILL REIMBURSE YOU FOR YOUR REASONABLE ATTORNEYS' FEES AND COSTS IF THE ARBITRATOR AWARDS YOU AN AMOUNT EQUAL TO OR GREATER THAN THE AMOUNT YOU HAVE DEMANDED IN SUCH ARBITRATION. THE AMERICAN ARBITRATION ASSOCIATION SHALL ADMINISTER THE ARBITRATION AND JUDGMENT ON THE AWARD RENDERED BY THE ARBITRATOR MAY BE ENTERED IN ANY COURT HAVING JURISDICTION. BOTH PARTIES ACKNOWLEDGE THAT THIS AGREEMENT IS A TRANSACTION INVOLVING INTERSTATE COMMERCE, AND IS THEREFORE GOVERNED BY THE FEDERAL ARBITRATION ACT. BY AGREEING TO ARBITRATION, BOTH PARTIES ARE WAIVING THEIR RIGHT TO LITIGATE IN COURT INCLUDING ANY RIGHT TO A JURY TRIAL. UNLESS YOU AND WE OTHERWISE MUTUALLY AGREE, ALL HEARINGS UNDER SUCH ARBITRATION SHALL TAKE PLACE IN THE COUNTY OF YOUR BILLING ADDRESS. AT YOUR OPTION, YOU MAY BRING AN ACTION AGAINST US IN SMALL CLAIMS COURT, NOTWITHSTANDING THIS AGREEMENT. THE PARTIES AGREE THAT ALL CLAIMS, WHETHER IN ARBITRATION OR IN SMALL CLAIMS COURT, SHALL BE TREATED INDIVIDUALLY AND THERE SHALL BE NO CONSOLIDATION OF CLAIMS, CLASS ACTIONS, REPRESENTATIVE ACTIONS OR PRIVATE ATTORNEY GENERAL ACTIONS. U.S. CELLULAR EXPRESSLY REJECTS AND DOES NOT CONSENT TO ANY CONSOLIDATION OF CLAIMS OR CLASS ACTION IN THE ARBITRATION. THIS ARBITRATION AGREEMENT SURVIVES THE TERMINATION OF THIS SERVICE AGREEMENT. FOR ADDITIONAL INFORMATION ON COMMENCING ARBITRATION AND HOW THE ARBITRATION PROCESS WORKS, YOU MAY CALL THE AMERICAN ARBITRATION ASSOCIATION AT 800-778-7879 OR VISIT THEIR WEBSITE AT WWW.ADR.ORG.

Dispute Information

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<sup>567</sup> SPRINT 2018.

<sup>568</sup> US CELLULAR 2019.

## APPENDIX C: ECONOMIC MODELS OF DUE CARE

### 1. MODELING DUE CARE

It is not a far-reaching assumption to suppose that arbitration for tort claims supports efficient due care standards in some cases and undermines them in others. It may seem obvious that it would be this way since some claims lead to the development of new due care standards, and some claims, perhaps most, will not. The law could react to this divergence by declaring that some cases cannot be arbitrated because they undermine due care standards, and other cases can be arbitrated because they do not undermine due care standards. This may be a potentially powerful public policy argument against allowing the use of arbitration for specific types of tort claims. It is also not so far reaching to think that different states may weigh enforcing contracts to arbitrate and enforcing due care standards differently. Some states may be deferential to tort or contract rules. This appendix provides an additional layer to the models introduced earlier in this chapter to explain further how due care standards may be stressed when tort claims are arbitrated.

As not every claim is capable of leading to the production of public goods, the law could prevent some claims from being arbitrated because they are more likely to lead to the production of public goods from litigation, while claims which are unlikely to lead to the production of these public goods may be arbitrated. It may be that the majority of tort claims in arbitration have no hope of leading to the production of public goods. However, this is an empirical question beyond the scope of this research. With such a designation, there would have to be a different treatment for different types of claims. This may be difficult for judges and legislators to undertake *ex ante*. It may be that *ex post* this is considered through the formulation of corrective rules or procedures, but the use of arbitration may keep some of the information which the rule makers would need to be fully informed about their decisions private. When a claim has the potential to lead to the development

of public goods in the form of due care standards, rule interpretation, or gap filling, then it may incentivize the RP, who will face additional costs because of the production of these public goods, to act strategically to prevent the law from producing them.

The history of tort law shows a clear tendency for the law to critically consider certain types of activities, especially those involving a new technology or new practice, which lead to accidents, legal conflict, or legal tension. This reactionary process may lead to the development of efficient due care standards when the ones in place are inadequate.<sup>569</sup> There seems to be a bend towards accepting arbitration in the US, even when it may undermine due care standards and inhibit courts' production of public goods. This has been reflected in a growing number of cases from the US Supreme Court, which have upheld the use of arbitration for any number of claims, including tort claims.<sup>570</sup> In the EU, the bend towards supporting arbitration is not so distinct, where there is an increased burden in contract formation related to arbitration in consumer contracts, and individual states have placed other procedural and legal limits on the use of arbitration for some other types of claims.<sup>571</sup>

If it is unreasonable for courts to consider the potential of claims to produce precedent, it may not be so difficult for courts to see how the use of arbitration for some tort claims may lead to the inefficient level of care being taken by injurers. Modeling how arbitration can change the incentives to take due care may thus be useful for courts and rule makers to consider.

Due care is centrally important to tort law. Law and economics scholars generally look to Judge Learned Hand and his now well-known decision from the *Carroll Towing* cases in which he

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<sup>569</sup> SCHÄFER 1998, p. 570.

<sup>570</sup> For a history of the development of the FAA in the US, see: SZALAI 2016.

<sup>571</sup> See: ORTOLANI et al. 2015, on the use of consumer arbitration in the EU.

identified the standard of care to be taken as when the cost of taking care is equal to the benefit which the care provides. The “Hand Rule” is not exactly where the level of care should be since it is the marginal benefits and cost of care which should be used.<sup>572</sup> Nevertheless, the error of the original standard, the cost benefit analysis from the Hand formula, has significantly influenced the economic examination of tort law.

Contracting enables the parties to determine where the costs of care will fall. Contracting also enables parties to change the cost of taking due care. This may be through the addition of a clause within a contract that addresses how the cost of care is allocated *ex ante* between the contracting parties. Arbitration may also enable parties to change the cost of not taking due care. This may have implications for third parties and society. Parties may not be fully internalizing the harm they cause, or they may be making a positive externality for which they are not fully compensated. Society may end up covering the costs of these externalities.

The following models and explanations attempt to identify some of the effects on due care which may develop when arbitration is used to adjudicate tort claims. In order to help understand how the RP will behave when facing liability for the torts they commit, it may be useful to make a few assumptions, which are supported by the discussion above about the incentives of RPs to behave strategically. Figure 16 provides a brief overview of some of the assumptions made here. Here it is assumed that the tortfeasor and victim are both rational, that there are litigation costs, and that the RP tortfeasor has the attributes that Galanter identifies, including resource, information, and opportunity advantages.<sup>573</sup> It is also assumed that the amount of care taken by tortfeasors is related to the amount of harm they can be expected to cause, such that if the tortfeasor takes a small

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<sup>572</sup> BROWN 1973.

<sup>573</sup> GALANTER 1974, throughout.

amount of care less than the due care standard that there will be only a small increase in both expected harm and actual losses and if the tortfeasor takes a much lower amount of care than the due care standard that the expected and actual harm will increase in relation to the care taken. It can also be assumed that care taken is related to the probability of an accident occurring, meaning that taking low care will increase the probability of an accident occurring alongside the increase in both expected losses and actual losses. This assumes the strategic taking of low care will influence the size of the actual losses for individual claims and that the RP will take the size of actual losses, which it observes *ex post*, into account when calculating future expected losses and the probability of future losses occurring. A descriptive explanation of assumptions made for this analysis are identified in Figure 16. The RP may take low care, which results in either an increased probability of losses due to low caretaking or an increased occurrence of losses caused by the low care taking. This assumes that the RP has enough information to reasonably estimate the relationship between the care that is avoided and the harm caused by the avoided care taking or the expected harm resulting from taking low care. It is important to differentiate between actual losses which occur and expected losses. Expected losses need to be estimated by the RP, *ex ante*, before low care taking can occur. Actual losses can only be determined *ex post* after harm occurs. Because the RP has a long time to gather information to adjust their care taking information about *ex post* harm which has already occurred, it is assumed that “an excessive legal standard causes excessive precaution, and a deficient legal standard causes deficient precaution”.<sup>574</sup> It is assumed that the RP considers long term gains against short terms costs, and the RP may decide not to take excessive precautions because of an excessive standard. This also assumes the RP has a long-term

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<sup>574</sup> COOTER and ULEN 2016, pp. 219-220. Also, COOTER and ULEN find that “[i]n general, injurers precaution responds exactly to court error in setting the legal standard under a negligence rule”. COOTER and ULEN 2016, p. 220.

time frame to gather information and repeatedly adjust its care level. The RP can develop information about how its care taking was related to actual losses *ex post*. RP can use this information on actual losses and other relevant information to estimate how its care taking is related to future harm. In this way, the RP is not only considering the past harm caused by low care taking but also the future harm expected to occur due to low care taking. It is thus assumed that strategic behavior by the RP is affected by both information about losses which have already occurred and information about future expected losses which the RP has developed.

The time period is important to recognize for the RP. Because the RP has repeated interactions, repeated opportunities to decide on care level, and repeated opportunities to get information about how the care level affects the harm caused. Figure 15 shows how a repeat tortfeasor can change the care they take over time while considering how a change in care will affect expected harm, and the transaction costs, or litigation costs, which a victim would incur from pursuing a claim. Here, assume that there are 11 time periods for RP to set the care level and gather information *ex post* about the harm it is legally responsible for related to its care level *ex ante*. In each time period, the RP (1) sets its *ex ante* care level, (2) observes its care cost, (3) observes the harm it is legally liable for *ex post*, (4) observes the transaction costs which victims incur from bringing claims, (4) Observes the value of the claims it faces, (5) observes if the claim is positive or negative in value, (6) Observes the change in probability of an accident occurring related to care taken, and (7) observes the expected harm which occurs per interaction. The next time period begins with the RP setting its care level *ex ante* and repeats through each time period. Here it is assumed that there are always transaction costs victims incur from filling any claim, legitimate or not, against the RP, in this scenario, the base transaction costs are 10. It is also assumed that as the claim value increases by 10, the transaction costs for victims increase by 5. In this scenario, the RP has 11 time frames

to determine *ex ante* the care taken, to observe *ex post* the legally responsible harm it faces being held liable for, the transaction costs which victims incur in bringing claims, the value of the claims, the probability of injury occurring given care taken, and if the claims are negative or positive in value. From looking at this hypothetical scenario, the RP has been able to gather enough information to determine that when it takes 90% care, it causes 10 in damages to victims, and victims face 10 in transaction costs to bring a claim, meaning that the value of the claim is 0 given the transaction costs. Thus, the RP has gained enough information to know that it can take any level of care above 90% and only face claims with a negative value. What is also clear from this hypothetical scenario is that the RP will not need to keep pushing down its care level after it has identified the transaction costs the OS will face and the care level, which keeps cases negative in value for the OS.

**FIGURE 15. SETTING OF CARE LEVEL BY REPEAT PLAYER TORTFEASOR IN SUCCESSIVE TIME PERIODS.**

Time period	1	2	3	4	5	6	7	9	9	10	11
Care taken <i>ex ante</i>	100	90	80	70	60	50	40	30	20	10	0
Care costs avoided	0	10	20	30	40	50	60	70	80	90	100
Harm <i>ex post</i>	0	10	20	30	40	50	60	70	80	90	100
Transaction Costs	10	10	15	20	25	30	35	40	45	50	55
Value	-10	0	5	10	15	20	25	30	35	40	45
+/-	-	=	+	+	+	+	+	+	+	+	+
Probability of losses %	0	5	10	15	20	25	30	35	40	45	50
Expected Harm per 100 interactions	0	50	200	450	800	1250	1800	2450	3200	4050	5000

FIGURE 16. ASSUMPTIONS ABOUT HOW THE REPEAT TORTFEASOR WILL BEHAVE GIVEN DIFFERENTIATED STANDARDS OF CARE AND THE AVAILABILITY OF ARBITRATION.

<u>Due Care Standard</u>	<u>Strategic Reaction by RP</u>
Inefficiently high	Waive arbitration in order to act strategically through the continued use of the court system to challenge the inefficient rule until the efficient standard is used. The due care cost of the efficient standard will be lower than the inefficiently high standard. If the difference in care costs is larger than the expected liability from taking less than the high care standard, take less than the high care standard. Enforce class waivers to decollectivize claims.
Efficient	Enforce arbitration in order to save litigation costs and time or to keep options to gather private information and behave strategically without court intervention. Enforce collective action waivers to avoid an aggregate claim. Taking less than due care will enable the RP to avoid some care costs. If these costs are not reabsorbed through liability, then the RP will benefit from taking less than due care.
Inefficiently low	Enforce arbitration to maintain lower due care costs, save litigation costs, time, and keep options to gather private information and behave strategically without court intervention. Enforce collective action waivers to avoid an aggregate claim. Enforce liability waiver to lower expected liability costs. RP can avoid the additional care costs which the efficient standard would require by protecting an inefficiently low due care standard. By keeping the standard low, the RP can also avoid the liability it would incur under the efficient standard.

### 1.1 EFFICIENT DUE CARE.

What happens with the standard model for due care when we apply the various factors that come into play with arbitration for tort claims? We look again at the standard model that law and economics uses, the marginal Hand Rule, as shown below in Figure 17 which is a reintroduction of Figure 8, where the marginal cost of care is equal to the marginal benefit of care.<sup>575</sup> We will

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<sup>575</sup> According to BROWN, "Although it is better to provide full protection than none at all, the optimal amount of protection from an overall point of view is  $\Omega$ , where the marginal cost of protection is equal to the marginal expected benefit from the protection". BROWN 1973, p. 332.

consider other situations where through strategic behavior, the due care level can be avoided by injurers without increasing their liability costs. The avoidance of due care standards results in a shifting of care costs if the transaction cost avoidance from arbitration is not passed onto consumers. Arbitration may allow for the continued avoidance of care costs by RPs, even when the efficient due care standard is in place. The use of arbitration, combined with a waiver of collective actions and contracting away damages, may lead to further incentives for RPs to avoid taking due care.

Consider the following situation, which could also be described as the best-case scenario. There is a tort claim in which there are no questions of law to be decided. Only determinations of questions of facts are necessary. If this claim were to remain in litigation, it would only require a judge to apply the already known due care standards, determine if the standard was met or not, establish a causal relationship between the failure to take due care and the harm suffered, and award the appropriate damages. The nature of judicial production of precedent, gap filling, and rule interpretation requires questions of law for a judge to consider, not merely questions of fact. Now assume the parties to the tort claim have a contract to arbitrate. Further, assume the value of the claim is positive, so the victim has the incentive to file a claim against the injurer in arbitration, given the existence of transaction costs. A claim may be positive in value precisely because of the use of arbitration if, for example, the transaction costs savings from using arbitration over courts change a previously negative value claim into a positive value claim. The tort claims then go to arbitration for the questions of facts to be decided. We will further assume the arbitration panel is, for the sake of determining the question of fact, on average reaching the same result as in a court

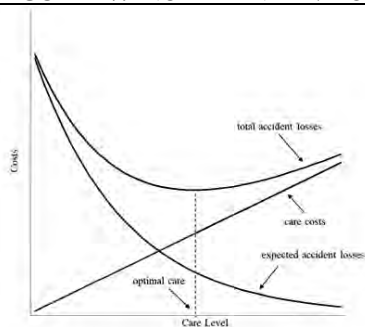
or that arbitrators make errors at the same rate as a court which would have jurisdiction over the claim if not for the arbitration contract.<sup>576</sup>

Everything in this scenario suggests that this would be an efficient way to use arbitration. The public standard for what due care is has been settled, there is no dispute over it, and it is the efficient level where the marginal cost of care is the same as the marginal benefit of taking care. The victim has the incentive to bring their claim to arbitration, and the injurer has an incentive to take due care because they face having to compensate victims for the harm caused by the injurer taking less than due care. Additionally, the arbitration of the claim lowers the tertiary costs of administering the state courts, and there is no forgone benefit from an underproduction of public goods from litigation as the claim is incapable of producing them or because the benefit from having additional public goods is lower than the tertiary costs avoided. This scenario is easy to explain, as due care standards are set correctly, the claim is decided by the arbitrator or arbitration panel based on whether the injurer met this standard or not, and there are no negative externalities created from adjudicating the particular claim in arbitration which are greater than the tertiary costs savings.

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<sup>576</sup> This is an assumption which is not necessarily always the case.

FIGURE 17. INCREMENTAL/MODIFIED/MARGINAL HAND RULE.<sup>577</sup>



### 1.2 STRATEGIC BEHAVIOR WITH THE EFFICIENT RULE.

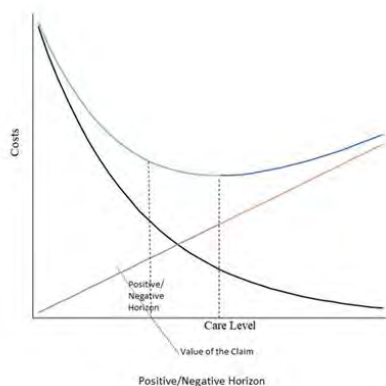
As discussed earlier, RP can behave strategically over time in order to minimize their care costs, litigation costs, and liability costs. In this scenario, the RP injurer has been able to use their resource and information advantages to pinpoint what care level they should take to keep a potential future claim from becoming positive in value. Here, it is assumed that pursuing a claim is costly because it creates transaction costs for plaintiffs involved in pursuing a claim and that the rational plaintiff will consider these transaction costs. The injurer can assume the victim is rational and will not bring a negative value claim. So as long as the cost of harm the victim suffers is lower than the transaction costs of pursuing the claim, the claim can be assumed to be negative in value. As earlier described in Figure 11 and reintroduced below in Figure 18, the value of a claim can be thought of in terms of a positive/negative value horizon for claims, The RP injurer can take less than due care but still take enough care to keep the individual claims from being positive in value, provided they have the right information. This should hold true if care level does affect the size of the losses suffered by victims, while the relationship between care and probability of an accident occurring is less important so long as the size of losses does not change. The taking of strategically

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<sup>577</sup> Adjusted from graph based on SHAVELL 1987.

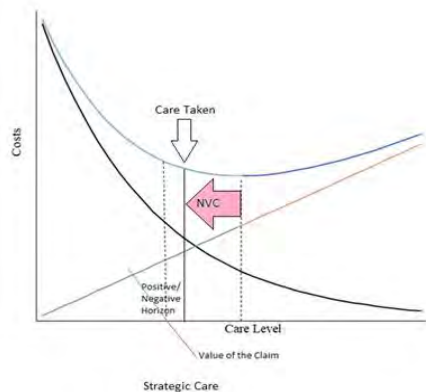
low care means the RP injurer will not face claims from the individual rational victim, as described in Figure 19. While taking strategically low care may be an option, it is not rational when there are rules such as punitive damages, fee shifting, or collective actions available for plaintiffs, which may change the calculus of the rational victim. In arbitration, the waiver of punitive damages, the waiver of class actions, and the waiver of fee shifting may be available, and the RP should demand such waiver alongside arbitration to limit their expected liability.

FIGURE 18. MODIFIED HAND RULE WITH POSITIVE/NEGATIVE CLAIM HORIZON.<sup>578</sup>



<sup>578</sup> Adjusted from graph based on SHAVELL 1987.

**FIGURE 19. MODIFIED HAND RULE WITH POSITIVE/NEGATIVE CLAIM HORIZON WITH STRATEGIC BEHAVIOR<sup>579</sup>**



By using their information advantage, the RP injurer can determine approximately the transaction costs a plaintiff will face in bringing a claim against them. There is an incentive for the RP injurer to take less than due care but still enough care to avoid the claims against them from becoming positive in value. In a way, the RP imposes a transaction cost on the plaintiff by taking less than due care. The law has seen how the RP injurer has this incentive and has developed several ways to correct for this perverse incentive, with regard to the available damages, the shifting of fees, and the collectivization of claims.

If punitive damages are available, the calculus of the rational plaintiff changes. Victims may be incentivized to file because their claims may shift from being negative in value without punitive damages to being positive in value with punitive damages. If the claim becomes positive in value, then the victim has the incentive to pursue the claim in either arbitration or litigation. While the goal of punitive damages may not be to compensate victims but rather to deter injurers, the availability of punitive damages when there is a negative value claim may also help compensate

<sup>579</sup> Adjusted from graph based on SHAVELL 1987.

victims and provide an incentive for RP injurers to take due care. This additional compensation should incentivize plaintiffs to file claims, perhaps even claims with a low prospect of winning but are nevertheless positive in value because of the possibility for additional compensation. It could also be argued that some form of fee shifting scheme may also provide the right incentives for victims with a negative value claim to file, provided that the fee shifting is set so that the transaction costs the victim would incur from pursuing the claim, costs which make a claim negative in value, are fully accounted for. However, fee shifting also provides the RP injurer with information about the claim's value and the transaction costs of pursuing a claim. If set correctly, either mechanism incentivizes victims to file meritorious negative value claims and incentivizes the tortfeasor to take due care, returns in litigation, and arbitration. If, however, the use of arbitration allows the RP to avoid corrective rules and procedures which tend to increase costs for the RP, particularly those corrective rules which are designed to change the expected value of claims by rational plaintiffs, then arbitration should be insisted upon by RP in order to avoid those costs associated with the corrective rules which the RP will incur.

### 1.3 THE EFFICIENT DUE CARE STANDARD IN A CLAIM BETWEEN RP AND MANY OS.

In some claims, a single tortfeasor has caused similar harm to many victims individually, but because of the transaction costs of litigation, no individual claim is positive in value. If collective actions are available, the numerous victims with negative value claims can tie their cases together so that the claims become positive in value, partly because the sharing of the transaction costs of litigation makes it less costly for any individual to pursue litigation. The rational RP injurer facing the possibility of a collective action if they take less than due care, could decide to take the correct standard of care to avoid facing an aggregated claim from the many victims. However, the rational injurer will also look to the available options to act strategically, which they have.

RP can use private contracting to avoid facing a collectivized claim by insisting on class waivers. If mandatory arbitration is contracted for and collective actions are waived, the tortfeasor may act strategically to avoid taking due care and avoid facing claims from those injured due to their taking less than due care. The combination of contracting over arbitration and waiver of collective action may enable an RP or an industry to engage in a form of regulatory arbitrage, where they can take advantage of differences in the law and differences in forums to avoid not only regulation, in this case, a due care standard, but also avoid the cost of taking due care which the regulation requires.

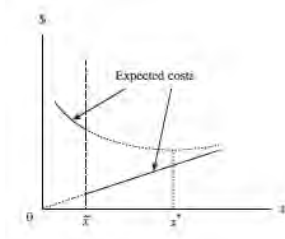
#### 1.4 STRATEGIC BEHAVIOR TO USE ARBITRATION TO KEEP AN INEFFICIENTLY LOW CARE RULE.

If an inefficient rule is in place, then there may be an opportunity for strategic behavior to be taken by RP in order to avoid the inefficient rule from being changed if, for instance, the RP benefits from the inefficient rule because the rule used to determine care levels is inefficiently low which results in lower care costs for the RP. RPs want to keep the status quo if it benefits them or provides opportunities to behave strategically. If RP can use private information to calculate the negative/positive horizon (the point where the claim goes from being negative in value to positive in value, given transaction costs in litigation), they can calculate how much untaken care they can afford to avoid for the claim to remain negative. This allows the RP to take less than due care but enough care to make any resulting harm less valuable than what it would cost to pursue the claim. The firm can be assured that the rational victim will not challenge the inefficient rule in court because the rational victim has no incentive to file. If the firm is worried that the availability of collective actions or punitive damages makes a claims value switch from negative to positive, the firm can demand *ex ante* that the contract contain an arbitration clause and a class waiver. This will keep the inefficient rule from which the RP benefits from, from being challenged by victims.

The RP injurer can avoid the cost of the harm they have caused by taking less than due care because the individual claim of any OS victim is still negative in value.

Now suppose that the RP identifies an inefficient rule which is in place which benefits the RP. Knowing what the inefficient rule is and how they benefit from it, the RP will continue to work to keep the inefficient rule in place because it allows the RP to gain a higher profit or share of the surplus created by trade than under an efficient rule. The RP will not want to risk not gaining these extra benefits, and using arbitration is the perfect fit for making sure a court does not change the care level. Consider the following figure from Cooter and Ulen and how an inefficient care standard will be less costly for firms.

**FIGURE 20. COOTER AND ULEN'S MODEL OF EXPECTED COSTS WHEN THE LEGAL STANDARD IS LESS THAN THE SOCIAL OPTIMUM.**<sup>580</sup>



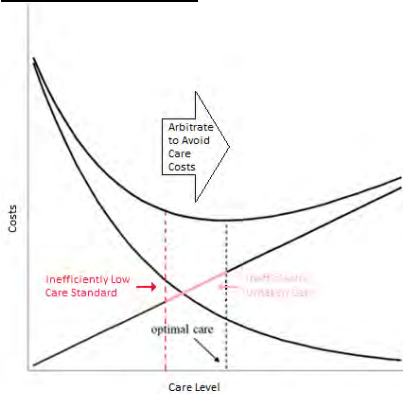
To illustrate, Figure 6.6 depicts the injurer's expected costs under a negligence rule when the legal standard is less than the efficient level of precaution:  $\bar{x} < x^*$ . The solid curves in Figure 6.6 indicate the injurer's costs as a function of the level of precaution. The injurer minimizes costs by setting precaution equal to the legal standard:  $x = \bar{x}$ . His or her precaution is less than the efficient level:  $x < x^*$ . Consequently, too many accidents occur, and the harms they inflict are too severe.

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<sup>580</sup> COOTER and ULEN 2016, p. 220, Figure 6.6.

<sup>581</sup> COOTER and ULEN 2016, p. 220.

FIGURE 21. INEFFICIENTLY LOW CARE STANDARDS WITH STRATEGIC BEHAVIOR TO ARBITRATE.<sup>582</sup>



If we compare the graph of COOTER and ULEN in figure 12 with figure 13, we can see a similarity and identify the economic incentive for the RP to take steps by enforcing arbitration for claims, in order to keep the inefficiently low care standards in place.

1.5 COORDINATION TO KEEP INEFFICIENTLY LOW DUE CARE.

Suppose there is a due care standard that is in place which affects an entire industry. If the due care standard is inefficient and the firms in the industry benefit from the inefficient rule, they will have the incentive to keep the inefficient rule in place. To do so, the firms must act strategically and in coordination, as described in Figure 22. If the firms agree, either tacitly or otherwise, they can take steps to prevent claims that they all could face from being brought before a court. If claims have a quality that could lead to the inefficient rule being changed by a court, then the industry could ensure the inefficient rule is not changed through the courts. Mandatory arbitration clauses are one method by which these firms could achieve this. It is necessary for each of the firms that conduct activities subject to the inefficiently low due care standard to all act in unison. This is because if

<sup>582</sup> Adjusted from graph based on SHAVELL 1987.

one firm allows litigation to go forward and the litigation results in a change in the due care standard to the efficient level, then all the firms in the industry may be subject to the increased care costs which the efficient standard requires, even in arbitration settings.

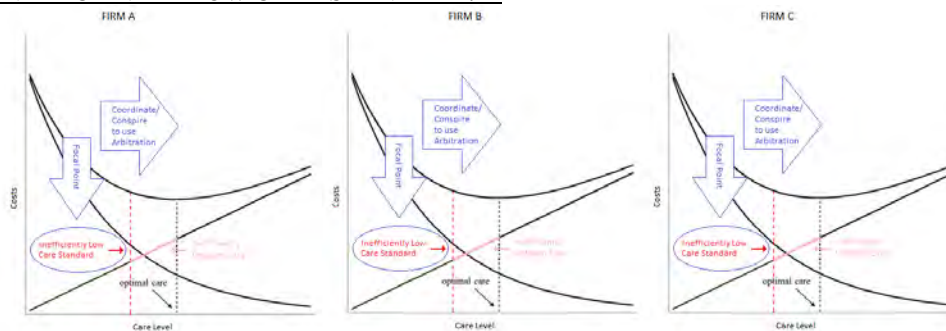
When a party who benefits from an inefficient rule is in a position where claims against them would challenge the inefficient rule, the party is incentivized to keep the claim from going to court when the inefficiently low due care stand can be adjusted. If the RP controls a major share of the market, or if the industry has only a few firms, then using arbitration to keep the claim out of court may benefit not on the individual RP but the industry as a whole. To do so, the RP would have to have good information about what rules it benefits from and which are costly. The RP is more capable of accurately assessing the value of rules than the OS because of the information/intelligence advantage RP has over OS. If the RP demands arbitration by only offering an adhesion contract, which contains an arbitration clause, then the firm can ensure that all disputes, including tort claims arising from that contract, are never considered in front of a court. If all the RP firms in an industry who benefit from the inefficient rule coordinate to include arbitration clauses in their contracts, then the industry may be able to prolong the use of the inefficient rule in the arbitration proceedings and insulate the inefficiently low care standard from court adjustment. This may represent a significant economic benefit to the firms in an industry. The inability of arbitration to produce public goods such as precedent, rule interpretation, or gap filling further incentivizes the use of arbitration for claims over which an inefficient rule is in place.<sup>583</sup> If courts lack the inputs needed to identify the efficient due care standard, then courts are incapable of producing the efficient due care standard.

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<sup>583</sup> According to ALDERMAN, "imposition of mandatory arbitration generally precludes the consumer's freedom to choose to litigate in a class action and eliminates any favorable precedent or law reform that could arise through litigation". ALDERMAN 2001, p. 1242.

The widespread use of arbitration in an industry may indicate a lack of market competition. It may also suggest there is coordination to keep claims in arbitration in order to prevent the development of efficient due care standards, which would lead to the firms incurring additional care costs.<sup>584</sup> Even without explicit collusion, firms may converge on a strategy to use arbitration, given that a particular strategy to use arbitration may be a focal point that firms can easily identify. When an industry widely uses arbitration clauses, a natural result will be that incidents of judicial rulemaking covering the industry will decrease. If all the firms in the industry act the same way it may be because of either explicit collusion or tacit collusion.

**FIGURE 22. COLLUSION IN A CONCENTRATED MARKET TO PROTECT AN INEFFICIENTLY LOW CARE STANDARD.<sup>585</sup>**



<sup>584</sup> According to ORTOLANI 2015, “when any industry adopts adhesion contracts as a standard means of doing business, and where those contracts contain identical or near-identical provisions on important points, consumer choice becomes illusory” and “the effective elimination of the consumer’s ability to alter the terms of a contract containing an arbitration agreement means that the consumer ultimately has no control over the procedures to be used in any resulting arbitration”. ORTOLANI et al. 2015, p. 204.

Also consider STERNLIGHT and JENSEN’S argument that “economic theory alone raises significant doubts that companies pass on to consumers the entire cost-savings from using arbitration clauses to eliminate class actions”, while “[t]he extent to which cost-savings by a monopoly will be transferred to consumers depends heavily on the elasticity of the market demand curve and on the shape of the firm’s marginal cost curve”. STERNLIGHT and JENSEN 2004, p. 95.

<sup>585</sup> Adjusted from graph based on SHAVELL 1987.

### 1.6 STRATEGIC BEHAVIOR TO WAIVE ARBITRATION.

A rational RP injurer will not use arbitration clauses when the standard of care is above the efficient standard. RP should challenge the inefficient due care standard in court if an injury occurs and continue to challenge it so long as the inefficiently high standard is in place because the RP faces the continued cost of taking inefficiently high due care costs over time.<sup>586</sup> There is still an incentive for RP to use class waivers and to contract away liability to make sure that they do not face a collective action (which could lead to a blackmail settlement) or a large potential claim. Enforcing class waiver creates opportunities to continue challenging the inefficiently high rule through individual claim waiver in the cases the RP estimates to be more likely to lead to a change in the due care standard to the efficient level. In an opt out collective action rule, a collective action may also lead to a reinforcement of the inefficiently high due care standard without a possibility to challenge the claim in the future. Still, even in an opt in collective action system, there may be a possibility to litigate the claim again since not every claimant (i.e., those who opted out) will be tied to the collective action.

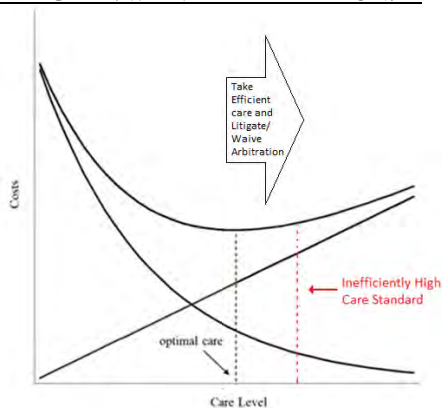
When an RP waives the right to arbitration in order to challenge an inefficiently high care standard, as described in Figure 23, this is an example of the RP choosing short terms costs in order to avoid long term costs. If the inefficiently excessive standard is adjusted to the efficient standard, then the RP can avoid future excessive care costs. This requires the RP to be able to identify the excessive standard and have the ability to take active steps to challenge the standard. This planning may result in a strategic choice not to include an arbitration clause to cover the excessive standard or waiving arbitration only when an arbitration contract exists and a claim relates to the excessive

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<sup>586</sup> This is consistent with the Model of the efficiency of the common law, where RP have an incentive to continually challenge an inefficient rule which costs them utility. See: PRIEST 1977; RUBIN 1977: and PARISI and FON 209.

standard. In general, we should not expect there to be arbitration of tort claims for which an excessive due care standard is in place. Because the RP injurer has no economic incentive to use arbitration for an excessively high due care standard, it should offer a waiver of arbitration in order to challenge the high standard in court. A single OS should accept a waiver of arbitration if the expected value of its claim increases, perhaps because the expected cost of adjudicating the claim decreases and the claim is positive in value. The single OS will only be concerned about its individual claim and make decisions without regard to other OS claims against the RP. Respectively, under the excessively high due care standard, the OS will also have a higher expected value of its claim in both arbitration and in court than under an efficiently set standard applied in arbitration or court. The RP injurer will only waive arbitration to challenge the inefficient rule if the RP knows it will have to continually face claims in arbitration where the same inefficiently high standard is applied over and over. Because of the potential for large future liability costs related to the inefficiently high due care standard, the RP may find it more valuable to invest in challenging the rule in an effort to have the rule adjusted to become more efficient, even if it means the RP will incur short term costs, so long as they expect the long-term costs of excessive care to be high.

FIGURE 23. INEFFICIENTLY HIGH DUE CARE STANDARDS AND INCENTIVE TO LITIGATE/WAIVE ARBITRATION.<sup>587</sup>



### 1.7 CONTRACTING AWAY LIABILITY.

The contracting away of liability will lower the RP injurer's potential costs for committing a tort. If damages are contracted away, punitive damages or fee shifting might not necessarily switch a claim from being negative to positive. These additional rules may not be able to overcome the incentive not to file a negative value claim. Cooter has described how injurers may face incomplete liability when "damages only cover a fraction of the harm" or "only a fraction of victims actually bring suit".<sup>588</sup> Injurers facing incomplete liability will only be incentivized to take an amount of care that keeps them from being held liable under the due care standard which is set. Contracting away liability may have the same result as an "imperfection in the law," which results in the injurer not being liable for the full harm they cause. This description of contracting away liability found in Figure 24 is an extension of COOTER's take on injurers facing incomplete liability under the assumption that "imperfections in the law prevent complete internalization of social costs" which was graphed by Cooter in Figure 25.<sup>589</sup> Here, the contracting away of liability might not necessarily

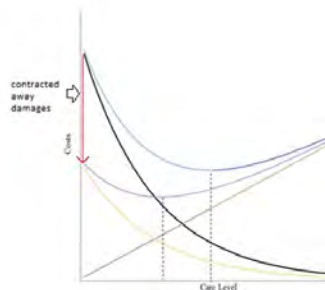
<sup>587</sup> Adjusted from graph based on SHAVELL 1987.

<sup>588</sup> COOTER 1982, p. 85.

<sup>589</sup> COOTER 1982, p. 85.

be considered an "imperfection in the law" (notwithstanding a doctrine of judicial interpretation or public policy which prohibits the contracting over liability) but rather a result of private contracting. Still, the contracting away of liability has the same effect as there being imperfections in the law, mainly that when liability falls "short of the harm" caused by the injurer, they have an incentive to "reduce... precaution below the legal standard of care".<sup>590</sup> The contracting away of liability may have the same or similar impact on incentives to take care, which imperfections in the law have on incentives to take care. While this may also occur outside of the arbitration process, there remains a possibility that arbitrators will have to adjudicate a claim concerning the contracted away damages. Importantly, the contracting away of damages is often used in combination with contracts to arbitrate and class waivers.

FIGURE 24. CONTRACTING AWAY LIABILITY.<sup>591</sup>



If we compare the contracting away of liability graph in Figure 24 with the graph by COOTER in Figure 25 which describes incomplete liability due to imperfections in the law, we can see a similar change in the cost curve and incentives for potential injurers to take care. While the lowering of liability in Figure 24, may be agreed upon by the party's *ex ante*, the lowering of liability in which COOTER describes in Figure 25 is due to some imperfection in the law, which leads to a

<sup>590</sup> COOTER 1982, p. 85.

<sup>591</sup> Adjusted from graph based on SHAVELL 1987.

discounted amount of potential liability the injurer faces. The lowering of liability through contracting can be another way potential tortfeasors look to lower their care costs.

FIGURE 25. COOTER'S GRAPH ON INCOMPLETE LIABILITY.<sup>592</sup>

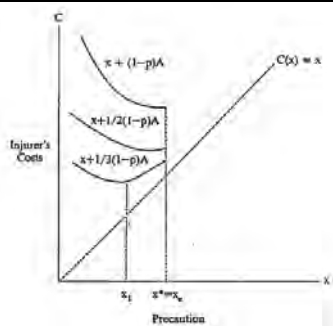


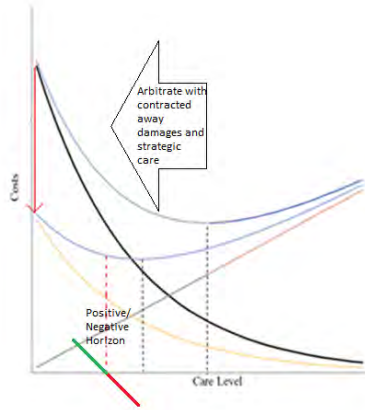
FIGURE 3: INCOMPLETE LIABILITY

### 1.8 CONTRACTING AWAY LIABILITY WITH STRATEGIC BEHAVIOR.

Now consider what happens when the injurer can identify the point at which the potential claims against it move from being positive in value to negative in value, and there has been a contracting away of liability, which is described in Figure 26. Looking back at the assumption made here that the lower the amount of care taken below the due care standard, the more harm there will be, then we can identify how the potential tortfeasor will still have the incentive to take some care in order not to be liable for a higher amount of damages which would cause a claim to be positive in value. This would also assume that either the courts or arbitrators will consider how far the RP tortfeasor deviated from the due care standard and how that relates causally to the harm the victim suffers. Arbitration keeps the claim from being seen by a court and shields the strategic behavior from remedial court measures.

<sup>592</sup> COOTER 1982, p. 84. Figure 3.

FIGURE 26. EFFICIENT DUE CARE STANDARD WITH CONTRACTED AWAY LIABILITY & STRATEGIC CARE.<sup>593</sup>



RP tortfeasor firms in an industry have the incentive to cooperate to protect an inefficiently low due care standard which they mutually benefit from, and to waiver arbitration only if there is an inefficiently high due care standard. There is a dominant strategy for the RP tortfeasors in a concentrated industry to coordinate when the option to take strategic care is introduced. Importantly, there is no potential incentive to defect from this collusive behavior in order to gain extraordinary profit, as the use of arbitration, in this case, represents an indirect price coordination rather than direct price fixing, as the payoff from direct and indirect price fixing are divergent and may face different legal treatments in a given regulatory regime.

<sup>593</sup> Adjusted from graph based on SHAVELL 1987.



## **Chapter 4. The Arbitration of Class Action Tort Claims and the Public Good: A law and Economics Perspective.**

### 1. Introduction.

There is a unique convergence of problems emanating from the use of arbitration for mass tort claims. These problems can be considered using law and economics methods to show how different processes and rules can be stressed by the lack of claims adjudicated in public courts and how a divergence of policies affects public welfare. Tort claims are used to incentivize parties to help solve a market failure that occurs when tortfeasors are not forced to internalize the negative externalities they create.<sup>594</sup> Claims can be collectivized to create efficiencies when the value of each individual claim is low. The use of new technologies and practices may become a source of tension for courts applying due care standards, as new risks may materialize that care standards are incapable of addressing. A fundamental question of legal systems concerns how a changing world creates a change in legal duties and standards of care. Contracts to arbitrate tort claims and contracts to preclude class wide claims complicate how the law determines due care standards, especially when the contract concerns a claim arising from a new practice or new technology which the law has yet to address. Due care standards can be considered a type of public good. There is a need to weigh the cost and benefits of using different adjudication procedures and collective claims rules when considering the economics of mass torts, as an underdevelopment of due care standards or underproduction of information from public adjudication of these claims will be welfare reducing. The following chapter considers several essential factors in determining the forum,

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<sup>594</sup> According to VISSCHER, “In the economic analysis of tort law, minimization of primary accident costs, (deterrence, secondary accident costs (optimal risk spreading and risk bearing) and tertiary accident costs (administrative costs) is regarded as the central objective (Calabresi, 1977, pp 24 ff). The prospect of being held liable and having to pay damages provides potential tortfeasors with behavioral incentives.” Furthermore, “[i]n engaging in activities, people create externalities, *i.e.* a probability for others to suffer losses as a result of this activity. Tort law is regarded as an instrument that can provide behavioral incentives to the actors, so that they internalize these externalities.” VISSCHER 2009 (Tort Damages), p. 219. With reference to: CALABRESI 1977.

standard of care, and collectivization process, which maximizes the welfare benefits of adjudicating mass tort claims.

## 2. Divergent and Similar Characteristics of the Common Law and Civil Law.

*\*\*\*This topic is also discussed in Chapter 1, section 4.1 concerning, concerning common law and civil law legal traditions \*\*\**

There is a divergence in approaches to the use of arbitrating tort claims between the US and Europe. Some of this is due to the differences between the common law and civil law. Another divergence involves the use of punitive damages. While there are numerous differences between the two systems, one of the most significant distinctions, for the purposes of negligence, is the source of law.<sup>595</sup> In civil jurisdictions, laws are found nearly exclusively within codified laws, although judges play an important role in rule interpretation and gap filling, which have varying degrees of precedential value.<sup>596</sup> The common law, in contrast, is based not only on written law or statutes but also on legal precedents created by judicial rulings, which are given weight under the doctrine of *stare decisis*. The role of the judge is different in the two systems. Judges in civil law jurisdictions interpret the law, while judges in common law jurisdictions both interpret the law and produce law through precedent.<sup>597</sup> The differences in the two systems have not led to vastly different outcomes. Even if the results of the two systems are “so close to each other, the methods used to reach them are nevertheless extremely divergent, and the matter is not that simple”.<sup>598</sup>

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<sup>595</sup> For a historical comparison between common law and civil law jurisdictions, see: DAINOW 1966, p. 419.

<sup>596</sup> According to DAINOW 1966, "Generally, in civil law jurisdictions the main source of basis of the law is legislation, and large areas are codified in a systematic matter" and "Although in the form of statutes duly enacted by the proper legislative procedure, these codes are quite different from ordinary statutes." DAINOW 1966, p. 424.

<sup>597</sup> In the civil law, "when a court applies a law, it has to interpret that law; in the process of interpretation the court may well extend the scope of the law considerably beyond that originally contemplated. By this method of interpretation and by filling in gaps where the written law is silent or insufficient, the civil law court can be considered as “making” law, interstitially. In this manner, the utilization of prior decisions is mainly on points of interpretation of written text, whereas in the common law, the decisions are themselves the source of the law and “make” law “from the whole cloth,” as it were”. DAINOW 1966, p. 426. Civil Law traditions may also use precedent under the doctrine of *jurisprudence constate*, which is a less strict doctrine of precedent than *stare decisis*. See: PARISI and FON 2009.

<sup>598</sup> DAINOW 1966, p. 434.

## 2.1 The Common Law, the Civil Law, and Due Care Standards.

The common law is unique from the civil law in the use of precedent to create due care standards, while the interpretation of laws by judges in the civil law may fill in gaps in the code. The efficiency of the common law theory is dependent on the ability of judicial systems to adjudicate claims and formulate new rules.<sup>599</sup> Although “[p]recedent has ‘public good’ aspects that may result in underproduction in a private market”, it must also be considered how “to the extent that the costs and benefits of precedent will be borne (in the future) entirely by the parties to the suit in which the precedent is created, precedent is a private rather than public good”.<sup>600</sup> Code interpretation in civil law jurisdiction can also be considered as a type of public good, and the legal doctrine of *jurisprudence constante* or *arret de principe* (a “doctrine under which a court is required to take past decisions into account only if there is sufficient uniformity in previous case law”), which is used in some civil law jurisdictions, can be seen as a similar but distinct legal doctrine from *stare decisis*.<sup>601</sup> While *jurisprudence constante* influences how code interpretation and gap filling are produced by courts in civil law jurisdictions, both the *stare decisis* and *jurisprudence constante* doctrines play an important role in how public goods from litigation are produced by courts in common law and civil law legal traditions.<sup>602</sup> While the private good aspect

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<sup>599</sup> According to LANDES and POSNER 1979, “the common law system of rule creation is biased in favor of efficiency not necessarily because of any systematic judicial preference for efficient outcomes but as a function of the sample of cases that are likely to be litigated in a system where the decision to sue or litigate and the investment in litigation are private”. LANDES and POSNER 1979, p. 273. Several other authors have addressed the efficiency of the common law theory, including PRIEST 1977 and RUBIN 1977. For a review of the literature concerning the efficiency of the common law theory, see: PARISI and FON 2009.

<sup>600</sup> LANDES and POSNER 1979, p. 261. It is also important to consider the following “Both judicial services-dispute resolution and rule creation-are more accurately described as intermediate goods (inputs) than as final goods. Dispute resolution is not a good in itself but an input into compliance with socially desired standards of behavior. Rule creation is not desired in itself either but is a means of particularizing the standards of socially desired behavior in order to promote compliance with them. For the present, however, it will be more convenient to regard dispute resolution and rule formation as the final products of a judicial system rather than as an input into the real final product-which is right behavior”. LANDES and POSNER 1979, p. 236.

<sup>601</sup> PARISI and FON 2009, p. 80.

<sup>602</sup> According to PARISI and FON 2009, when considering the legal doctrines of *stare decisis* and *jurisprudence constante*, that “[i]t is important to note that these doctrines are not discrete, but rather should be thought of as points

of precedent may be felt individually, the public good aspects of precedent are not necessarily diminished because it is also a private good to some. This is particularly true when the underproduction of public goods creates costs to consumers, third parties, or the public. The adjudication of a claim produces information which is a type of public good unique from but related to precedent or interpretation. Information produced from public courts can be used by private individuals, firms, in the legislative process, and by regulatory authorities which enforce public laws. The difference between the common law and civil law may show how balancing efficiency and flexibility influences legal outcomes.<sup>603</sup>

## 2.2 Tort Law.

*\*\*\*This topic was discussed in Chapter 3, section 5 concerning the strategic behavior in arbitration\*\*\**

A tort is defined as an “act or omission that gives rise to injury or harm to another and amounts to a civil wrong for which courts impose liability”.<sup>604</sup> In the civil law, the concept of negligence is similar to the concept found in the common law, although all torts do not necessarily involve negligence. Tort law has changed much over the past half-century and "generates complicated legal and economic issues-of industrywide apportionment of liability, probabilistic causation, and retroactive liability- that would have appeared bizarre to a lawyer dealing with defective products in the 1950s whose practice was one of warranty interpretation and routine negligence".<sup>605</sup> The

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on the spectrum of possible doctrines of precedent, at one side of which a single earlier decision would be fully binding on a judge, and at the other side of which earlier decisions would not be binding at all. Despite their varying dependence on judge-made law, doctrines of precedent are present in both civil law and common law systems.” PARISI and FON 2009, p. 79.

<sup>603</sup> According to KERKMEESTER and VISSCHER 2003, "differences between judge made law and statute law have to be taken seriously and they might have an influence on the efficiency of the produced legal rules. Also, mainly because of the commitment to precedents, one should be cautious regarding possible differences between judge made law in common law and on the continent. Common law judge made law might be more efficient yet less flexible than civil law judge made law, but on the other hand the (largely codified) civil law statute law might be more efficient yet less flexible than the common law statute law". KERKMEESTER, and VISSCHER 2003, p. 4.

<sup>604</sup> CLII, *Definition of Tort*.

<sup>605</sup> PRIEST 1985, p. 462.

use of new technologies and practices is one of the driving forces in developing tort laws.<sup>606</sup> Tort law in Europe varies from state to state. The European Group on Tort Law has proposed a ‘common framework both for the further development of national laws and for uniform European legislation’ in order to “avoid further divergence of piece-meal rule-making on the national as well as the European level”.<sup>607</sup> The different approaches in how due care standards have developed, both within Europe and globally, are due in part to a divergence in legal cultures.

Proper due care standards are essential for a tort system to function effectively, as due care standards should be set to minimize the primary, secondary, and tertiary costs of torts.<sup>608</sup> Simultaneously, it should be considered how accidents may lead to the creation of benefits, in this case, the production of a public good, which the law should aim to maximize given the costs of accidents. Laws do not always examine, *ex ante*, the potential harms created by new technologies and practices. It is only after the new technology or practice has emerged that the law reacts as a result of claims brought and comes to regulate the technology and externalities caused by the new technology.<sup>609</sup> Recall the previous discussion in the introductory chapter about the emergence of new technologies and how they relate to the development of tort law. When addressing the relationship between tort law and new technology, SCHÄFER comments, “[b]efore the industrial revolution tort law was a rather unimportant field” however, “[w]ith steam engines, modern traffic (locomotive, motor vehicles) and hazardous products the number and severity of accidents rose dramatically” and “[t]his gave rise to the development of modern tort law, especially the

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<sup>606</sup> BARTLETT 1981, p. 337.

<sup>607</sup> KOCH 2005, p. 191.

<sup>608</sup> When considering the work of CALABRESI, FAURE comments, “In order for liability law to be efficient, total accident costs (Primary, secondary and tertiary) should be minimized”. FAURE 2017, p. 82. See CALABRESI 1970, p. 27, p. 28.

<sup>609</sup> According to BARTLETT, “[t]he law regulates social relations and, because science and technology frequently alter the pattern of such interaction, the evolution of the law results, in part, from social changes which have been precipitated by technological advances”. BARTLETT 1981, p. 337.

negligence doctrine and the slow expansion of strict liability for risks caused by very dangerous activities".<sup>610</sup> New technologies and practices often give rise to new consumer products, and tort law has developed, in part, to impose due care standards for consumer products, as well as medical services based on new technology. A socially welfare optimum of care "will clearly reflect both the costs of exercising care and the reduction in accident risks that care would accomplish".<sup>611</sup> According to SHAVELL, "the social goal will be taken to be minimization of the sum of the costs of care and of the expected accident losses".<sup>612</sup> The need for the court to determine the optimal rule means courts must spend judicial resources to determine what the optimal care level is for both parties. If the court is not involved in determining due care standards, then legislative resources need to be used. Determining "the standard of due care often requires some sort of weighing of the magnitude of risk against the disutility or cost of more careful conduct," which "suggests that due care is in fact found by a process that operates as if it were designed to identify behavior that minimizes total social costs, or at least approximately so".<sup>613</sup>

### 2.3 Adjudication: Public v. Private.

*\*\*\*This topic is also discussed in Chapter 1, section 6.1 concerning the law and economics of arbitration.\*\*\**

Adjudication can be considered as a type of production process. LANDES and POSNER identify how "[a] court system (public or private) produces two types of services" the first being "dispute resolution" and the second being "rule formation".<sup>614</sup> With regards to the rule formulation aspect of adjudication, LANDES and POSNER identify two problems with private adjudication, 1) the

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<sup>610</sup> SCHÄFER 1998, p. 570. The role technology plays in driving the development of the law is also addressed in the Introduction and Chapter 4, section 5. See: FN 47.

<sup>611</sup> SHAVELL 2004, p. 178.

<sup>612</sup> SHAVELL 2004, p. 178.

<sup>613</sup> SHAVELL 2004, p. 190, p. 191.

<sup>614</sup> LANDES and POSNER 1979, p. 236.

private judge has “little incentives to produce precedents” and; 2) the possibility of “inconsistent precedents which could destroy the value of a precedent system”.<sup>615</sup> Judges in civil jurisdiction are generally not burdened with producing rules but rather interpreting rules and producing dispute resolutions.<sup>616</sup> According to LANDES and POSNER, “the precedent-creating function of adjudication, more than the dispute-resolving function, may invite public intervention in the judicial-services market”.<sup>617</sup> Considering the types of cases which public and private adjudicators will compete for, “[t]he general conclusion is that we can expect more efficient rules of contract and commercial law... than of tort or criminal law, because parties to contracts face a competitive supply of court systems”.<sup>618</sup>

The value of the precedent influences who will bring a claim because "where the likeliest outcome is a precedent that will strengthen an existing inefficient rule, litigation will be avoided because its expected yield is negative" and "if the parties have asymmetrical stakes, the conclusion that there will be little litigation in areas dominated by inefficient rules is weakened".<sup>619</sup> The party which benefits from an efficient rule is incentivized to litigate, while a party which benefits from an inefficient rule has an incentive to use arbitration to preclude the possibility of the inefficient rule being changed.<sup>620</sup> Due care standards for new technologies and practices are underdeveloped when the supply of cases which could lead to the production of precedent in a common law jurisdiction is diverted from public courts into private arbitration by a party which benefits from an inefficient

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<sup>615</sup> LANDES and POSNER 1979, p. 238, p.239.

<sup>616</sup> DAINOW 1966. See the discussion on the difference between rules of precedent in common law and civil law jurisdictions in the introductory chapter, section 4.

<sup>617</sup> LANDES and POSNER 1979, p. 242.

<sup>618</sup> LANDES and POSNER 1979, p. 258.

<sup>619</sup> LANDES and POSNER 1979, p. 261.

<sup>620</sup> Please see the discussion on the strategic use of arbitration in the chapter 3.

rule. This may also lead to an underproduction of rule interpretation or gap filling in civil law jurisdictions.

#### 2.4 Arbitration Today.

Informal forms of mediation and arbitration have existed for millennia in both “primitive society, as well as in modern civilization”.<sup>621</sup> The arbitration of international commercial disputes was codified across the globe with the adoption of the New York Convention.<sup>622</sup> Even if international arbitration law has largely become *jus cogens*, there are limits to its application, since “a court shall refuse recognition or enforcement of an award if it finds that the award is in conflict with the public policy of its state”.<sup>623</sup> The adoption of international legal norms in commercial arbitration leaves a large gap between what is considered *jus cogens* and the multiple approaches used in the arbitration of tort claims. Modern consumer contracts, medical service contracts, and employment contracts, particularly in the US, often include arbitration clauses to settle disputes arising from the contract. The arbitrability of tort claims raises numerous questions which are unique from commercial disputes creating a need to consider separately from commercial disputes the cost and benefits of arbitrating tort claims.

The ability of free parties to contract over the terms of their agreements is generally seen as beneficial to society. The SCOTUS has found the FAA is to be broadly applied to contracts in which parties have agreed to arbitrate tort claims.<sup>624</sup> The trend in the US is that tort claims are increasingly being diverted to arbitration.<sup>625</sup> Only recently has there been a response from

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<sup>621</sup> EMERSON 1970, p. 156.

<sup>622</sup> NEW YORK CONVENTION 1958.

<sup>623</sup> VADI 2015, p. 368.

<sup>624</sup> *Marmet Health Care Ctr., Inc. v. Brown*, (2012). Also, see FAA.

<sup>625</sup> One example of how arbitration is used for tort claims involves the car service UBER. UBER’s US terms of service include an arbitration clause, which had been used to divert tort claims for sexual assault by UBER drivers into arbitration. Bad media attention raised by a CNN report on the use of arbitration for tort claims related to the sexual assaults caused UBER to change their arbitration clause to exclude claims for sexual assault by UBER drivers. This change was part of a public relations effort by UBER. O’BREIN 2018.

Congress to explicitly limit the scope of FAA for sexual harassment and sexual assault claims.<sup>626</sup> Extending the scope of arbitration to cover tort claims has been less extensive in other jurisdictions. States in the EU have taken a much different approach to the use of arbitration for tort claims, specifically when considering the use of directives which limit the use of arbitration clauses in consumer contracts.<sup>627</sup>

Arbitration can benefit parties to a dispute, but it may also cost parties not involved in the dispute. According to SHAVELL, the "general policy of the law should be to enforce *ex ante* ADR agreements".<sup>628</sup> However, SHAVELL identifies two instances when this general policy should not apply.<sup>629</sup> One exception occurs when "a party to an agreement was not properly informed about relevant information" such as "information about the legal process or the character of ADR".<sup>630</sup> This exception should be particularly acute when there is a widespread signing without reading problem concerning consumer contracts to arbitrate.<sup>631</sup> Another exception SHAVELL identifies is when an "agreement to use ADR would negatively affect third parties".<sup>632</sup> When the parties are informed, and their contract to arbitrate does not negatively impact third parties, the law should respect the preferences of the parties found in the contract.<sup>633</sup>

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<sup>626</sup> This legislation was passed after the publication of this article in its original form. See the discussion on the ENDING FORCED ARBITRATION FOR SEXUAL HARRASSMENT ACT in the Introductory chapter.

<sup>627</sup> According to the 2014 study for the JURI Committee of the European Parliament, "In contrast to the approach adopted in the USA, the EU has taken a more restrictive approach to consumer arbitration, although policies on the admissibility of pre-dispute arbitration clauses vary from one Member State to another. The fairness of consumer arbitration clauses within European Union Member States is controlled by domestic legislation that derives from each State's implementation of the Unfair Terms Directive (Directive 93/13/EC)". ORTOLANI et. al 2014. P. 207.

<sup>628</sup> SHAVELL 1995, p. 8.

<sup>629</sup> SHAVELL 1995, p. 8.

<sup>630</sup> SHAVELL 1995, p. 8.

<sup>631</sup> According to DE GEEST, "Most People sign standard term contracts without reading them. This gives drafters an incentive to insert one-sided, inefficient terms". DE GEEST 2015, p. 1.

<sup>632</sup> SHAVELL 1995, p. 8.

<sup>633</sup> SHAVELL 1995.

### 3. Collective Actions.

In the US, class actions are available in federal cases under the Federal Rules of Civil Procedure (FRCP) rule 23, which requires, among other things, a representative class, class certification, and a number of procedural requirements before the claim will be adjudicated in the federal court.<sup>634</sup>

Some of the benefits of the US class action system may include “a reduction in legal costs, faster progress through the judicial system, increased consumer protection (as the strength in numbers means less of an individual burden, a complaint is more likely to be pursued), which provides for a stronger claim, which, in turn, forces businesses to take such claims more seriously”.<sup>635</sup> Some of the negative aspects of US style class action may include an overly extensive opt-out system which can lead to free riding and claim preclusion, forced settlement, excessively punitive damages, and scrupulous behavior by attorneys.<sup>636</sup>

There are significant differences between mass claims in the US and Europe. According to VALGUAMERA, there are distinct characteristics of the two approaches which differentiate who can bring claims and how it is adjudicated:

“While the American class actions can be brought by any given class member, the European group action models usually restrict this power to selected subjects, such as associations. While the American class action uses an opt-out/mandatory mechanism to determine who will be bound by the judgement, the European models prefer the opposite opt-in solution. While the American class action can be used to litigate, in principle, all subject-matters, the Europeans have preferred piecemeal regulation, restricting the application of the group action devices to a few selected legal fields”.<sup>637</sup>

The REPRESENTATIVE ACTIONS DIRECTIVE leaves the choice of opt in or opt out to the member states, which can be considered an institutionalized form of decentralized federalism

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<sup>634</sup> FRCP 23.

<sup>635</sup> O’SULLIVAN 2010, p.129.

<sup>636</sup> O’SULLIVAN 2010, p. 129.

<sup>637</sup> VALGUARNERA 2010, p. 2. It is important to note that this was written before the 2020 Directive, which enables a representative action procedure in EU member states.

found in the principle of subsidiarity.<sup>638</sup> Another important difference between the US and the EU is the use of punitive damages in collective actions. While punitive damages are generally available in the US, there are generally not available in European jurisdictions.<sup>639</sup> The limitation of punitive damages may increase what COOTER and ULEN describe as an “enforcement error”, which can be understood as the “ratio of compensated victims to total victims”.<sup>640</sup> Since not all victims will join a collective action when there is an opt-in requirement, the likelihood of an enforcement error increases under an opt-in rule, as more claims are litigated individually or not litigated at all by the “rational plaintiff” if the claim is individually negative in value.<sup>641</sup> Similarly, under an opt-out rule, each potential claimant who opts out may lead to an enforcement error due to the claim being less than 100% collectivized. A welfare reducing situation occurs if a tortfeasor can minimize their liability costs when punitive damages and collective actions are not available since the law is unable to make the tortfeasor fully internalize the damages their torts have caused. COOTER and ULEN comment that “the efficiency loss due to enforcement error can be offset by augmenting compensatory damages with punitive damages”.<sup>642</sup> In Europe, the combination of opt-in requirements and the lack of punitive damages may lead to an increase in the rate of enforcement errors in mass tort or negligence claims.

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<sup>638</sup> REPRESENTATIVE ACTION DIRECTIVE 2020. Under the Treaty on European Union (TEU) article 5(3), “Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States”. TEU 5(3).

<sup>639</sup> According to KOZIOL, “Regarding European law, it is true that, in principle, the continental civil law systems disapprove of punitive damages (although one has to confess that there are some departures from this idea). Furthermore, one has to remember that England and Ireland are part of Europe and the European Union (although England sometimes gives the impression that it prefers to forget this). The English and Irish common law system is, of course, familiar with punitive damages, although not to the same extent as the U.S.”. KOZIOL 2007. p. 748.

<sup>640</sup> COOTER, and ULEN 2016, p. 260.

<sup>641</sup> The ‘rational plaintiff’ concept used by COOTER and ULEN is discussed in sec. 4.6.

<sup>642</sup> COOTER and ULEN 2016, p. 260.

#### 4. Adjudicating Mass Tort Claims: the Cart Before the Horse.

Adjudication can lead to costs and benefits for the parties involved, as well as externalities for third parties.<sup>643</sup> According to RUBENSTEIN, “the positive externalities of individual lawsuits can be grouped into four sets of effects: 1) decree effects; 2) settlement effects; 3) threat effects; and 4) institutional effects”.<sup>644</sup> Collective lawsuits and claims diverted into arbitration have decree, settlement, threat, and institutional effects as well, although they are not necessarily all positive. For instance, the decree effects of arbitration may be negative, as the use of arbitration produces no decree effects, and arbitration constrains the volume of input cases from which courts ultimately produce public decrees. The use of arbitration for cases which have no potential to produce decree effects, or precedent, can create positive institutional effects if private courts are as capable of adjudicating the claim as are public courts. The externalities created by any given adjudication

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<sup>643</sup> It may also be useful to consider this in terms of the primary, secondary, and tertiary costs of accidents which were addressed initially by CALABRESI 1970, 2008.

<sup>644</sup> RUBENSTEIN 2006, p. 723. RUBENSTEIN describes these various effects: “Individual lawsuits resulting in judicial decisions produce external *decree effects*. The legal principle developed in the case will create more certainty in structuring social behavior and lower the need for future adjudication concerning the decided issue. If future litigation does arise, the decree from the initial case will serve as *stare decisis*, hence making resolution of later cases more efficient.” “Individual lawsuits resulting in settlements, not judicial decisions, may nonetheless have similar positive externalities as *settlement effects*. To pick up where the last list left off: if one litigant successfully challenges a policy that affects many persons, a defendant may agree to change its behavior as to the entire class. Even if a defendant does not agree as a formal matter to change its general policy as a consequence of the initial case, it may nonetheless do so informally lest it be faced with repeated lawsuits.” “The very threat of individual litigation, absent settlement or decree, may also produce positive social benefits. The risk of litigation is a cost that parties must factor into decision-making in any sphere. The most familiar example is that of tort law, where it is said that the costs of accidents, including the litigation costs and legal remedies, structure social decision-making. The same could be said of the contracting and property realms as well. In undertaking a cost-benefit analysis, a party would logically consider both the risk of losing litigation and the risk that such litigation will actually be filed. If the latter factor is small, it will increase the likelihood a party will engage in the behavior. The small claims case presents a perfect example. A large corporation can bilk many individuals a very small amount, realizing significant gains without fearing that litigation will follow. The very possibility of litigation would change this analysis significantly. Therefore, litigation’s *threat effects* produce positive externalities.” “[T]he institutional result of the class action mechanism and related fee provisions is the development of a private group of law enforcers. By enabling litigation, the class action has the structural consequence of dividing law enforcement among public agencies and private attorneys general and of shifting a significant amount of that enforcement to the private sector. This is an important benefit if in fact private enforcement is, as often argued, more efficient than public enforcement. Even if private enforcement generates its own problems (such as the agency costs that inhere in class actions), nonetheless “the sheer diversity of enforcers should generate more innovations than a monopolistic government enforcer would produce.” These structural effects are not the immediate purpose of any particular piece of class action litigation, yet they are critical externalities of class suits.” RUBENSTEIN 2006, pp. 723-724. Citing to B. H. THOMPSON 2000, p. 206.

forum and procedure rules might be hard to identify with certainty when looking at a class of tort claims *ex ante*; however, when considering the *ex post* effects of any forum or rule, some insights can be made about the costs and benefits of each.

Although this type of analysis may be backward looking in some respects (as in assigning a qualitative value to a claim concerning its likelihood of leading to a precedent), it can still be useful to consider how characteristics of claims may make the use of arbitration or collective actions more likely or not to maximize public welfare. If the efficient forum and rule can be properly determined for similar claims which use similar due care standards, then this type of analysis might help to decrease the transaction costs in future similar claims and promote the maximization of public welfare.

#### 4.1 Mass Torts and Welfare Maximization.

Considering the welfare implications of using a particular adjudication process and a particular rule, the cost and benefits of each combination of adjudication and claim collectivization rule should be compared. The input/costs and output/benefits of such claims need to be differentiated between public and private: *Output: Social Benefit (SB), Private Benefit (PB); Input: Social Costs (SC), and Private Costs (PC)*. The socially optimal goal is to maximize the sum of the social benefits and private benefits minus the sum of social costs and private costs.<sup>645</sup> Four possible scenarios are considered: 1) Litigation of collective actions; 2) Litigation without collective action; 3) Arbitration with collective action; and 4) Arbitration without collective action. Additionally, there is a need to consider the value of the claim, as positive and negative value cases lead to different welfare levels.

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<sup>645</sup> It is important to make sure the costs and benefits are not double counted for third parties, as some third parties are private, and some are public.

The utility from the use of public adjudication with class action will be the sum of the Social Benefits (SB) of the litigation with class action ( $c$ ) and the Private Benefits (PB) of  $c$ , minus the sum of the Social Costs (SC) of  $c$  and the Public Costs (PC) of  $c$ :  $\Sigma(SB_c + PB_c) - \Sigma(SC_c + PC_c)$ ; for litigation without class action ( $w$ ):  $\Sigma(SB_w + PB_w) - \Sigma(SC_w + PC_w)$ ; for arbitration with class action ( $a$ ):  $\Sigma(SB_a + PB_a) - \Sigma(SC_a + PC_a)$ ; for arbitration without class action ( $n$ ):  $\Sigma(SB_n + PB_n) - \Sigma(SC_n + PC_n)$ . For any given set of common claims, these four possibilities can be considered to determine which combination of rule and process is welfare maximizing. For the purposes of comparing the four possible combinations, some of the primary, secondary, and tertiary costs and benefits are considered.<sup>646</sup>

#### 4.2 The Costs and Benefits of Arbitrating.

*\*\*\*This topic was discussed in Chapter 1, section 6.6 concerning the costs and benefits of arbitration.\*\*\**

It is generally believed that arbitration limits both system costs for the public judiciary and private costs for the individual litigants. A case diverted into arbitration immediately lowers the public costs of administering courts and, in some cases, if not most, lowers the private costs of pursuing or defending an individual claim. When the second and third order effects of arbitration are considered, arbitration's ability to limit public and private costs becomes less clear. Depending on the claim's potential to produce a precedent and the potential for a claim diverted into arbitration to dilute due care incentives for tortfeasors, the arbitration of mass tort claims may lead to increased public and private costs.

#### 4.3 The Economics of Mass Torts and Collective Procedures.

Class actions can be used in some circumstances to reduce the costs of litigation. According to COOTER and ULEN, "class actions ideally consolidate litigation to achieve economies of scale

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<sup>646</sup> This is not an exhaustive analysis.

and provide a legal remedy for small injuries that are large in aggregate" and "are sometimes used to reduce total litigation costs in mass torts".<sup>647</sup> PRIEST comments how "[t]here is no reason not to realize economies of scale of large claims just as of small claims".<sup>648</sup> There is a potential to create economic efficiencies which can benefit both public and private interests. A conservative line of thought argues that arbitration with class waiver should not be permitted due to "arbitration clauses" which "are not freely agreed to", to deter "contracts procured by fraud and contracts to engage in price fixing", the presence of "negative externalities", and "states rights".<sup>649</sup> The combination of contracts to arbitrate and class action preclusion dilute the economic efficiencies of using class actions for common claims. If private contracting reduces the public welfare benefits of public adjudication and the efficiencies of using collective actions, then any resulting increase in private benefits must be higher than the loss of those public benefits for arbitration with class waivers to be economically efficient.

#### 4.4 Contracting to Preclude Collective Actions.

Many types of contracts which give rise to a tort claim include a waiver clause which precludes collective actions for common claims.<sup>650</sup> HYLTON identifies several "factors driving class litigation waivers," including "low productivity of precaution, high cost of taking care, and high expected litigation costs".<sup>651</sup> In light of these 'factors', contracts that preclude collective actions may signal that the drafting party is taking less than due care but enough care to prevent the case

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<sup>647</sup> COOTER and ULEN 2016, p. 426.

<sup>648</sup> PRIEST 1999, p. 481. PRIEST adds that there are often "grounds which may caution aggregating large claims in a class", specifically with reference to what are considered "blackmail settlements".

<sup>649</sup> Fitzpatrick 2019, p. 126, p. 127.

<sup>650</sup> A recent case from the US, *Meyer v. UBER Technologies, Inc.* (2017), upheld an arbitration agreement found within the electronic terms of service agreement for using the UBER telephone app, which also included a class waiver.

<sup>651</sup> HYLTON 2016, p. 329.

from becoming a positive value case.<sup>652</sup> It may also be a sign that the product or service has a quality which may lead to a common claim among its users or purchasers, and the drafter is trying to avoid the high litigation costs they anticipate. The value of these clauses in a contract should be taken into account when parties enter into an agreement.

Contracting parties should consider what happens with the cost savings from the use of a class waiver clause. Is the cost savings passed onto potential victims, or does it fully benefit the potential mass tortfeasor? If firms seize the entire economic benefit of using a preclusion clause, then the value of the contract decreases for the consumer and increases for the producer, which may act as a form of redistribution between the contracting parties of the benefits of the contract and may indicate there is a lack of competition in the market.<sup>653</sup> If the savings are passed on, then the contract may reflect the value of the bargain.<sup>654</sup> What if an industry colluded to preclude collective actions across the industry through arbitration clauses and collectivization waivers? If an entire industry colludes to prevent litigation concerning new technologies or practices used across the industry, then the ability of legal institutions to create efficient due care standards for these new technologies and practices is hampered, while competition should lead to a differentiation in the market for the use of arbitration and waiver clauses.<sup>655</sup> A differentiation of contract terms for

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<sup>652</sup> The existence of an arbitration clause can be a source of information. According to CHAPPE, "*Ex ante* arbitration is viewed as a mean of signaling some aspects of the product quality". CHAPPE 2002, p. 27.

<sup>653</sup> WARE has argued that "[a]ssuming that consumer arbitration agreements lower the dispute-resolution costs of businesses that use them, competition will (over time) force these businesses to pass their cost-savings to consumers". WARE 2001, p. 91.

<sup>654</sup> HYLTON considers how a class waiver may be efficient if the value of the waiver is conferred on the contracting parties upfront. "The deterrence benefit of actual class litigation is not sufficiently large for some class members to justify the litigation cost, and for those individuals, it would be socially (and privately) efficient if they executed a class action waiver, thereby saving the litigation costs". HYLTON 2016, p. 317.

<sup>655</sup> According to HYLTON, "Any degree of competition should generate diversity in the set of contracts offered to potential victims. Contractual diversity should lead to efforts to sort potential victims into classes within which waivers may or may not be efficient". HYLTON 2016, p. 318.

arbitration or class waiver among firms in an industry may indicate market competition that reflects consumer preferences.

Parties must have the information necessary to understand the value of the preclusion. Uniformed parties may not have the ability to understand the value of agreeing to the preclusion. HYLTON has found that "[i]n the standard litigation scenario, waivers between informed agents enhance society's welfare, because they are exchanged when and only when the deterrence value of litigation is less than its cost" while "[i]n the class litigation scenario...waivers between informed agents might be exchanged even though they reduce society's wealth".<sup>656</sup>

The use of 'class action preclusion' can only be effective for the tortfeasor if there are enough victims precluded from the class. The potential for the waiver being effective may depend on what HYLTON calls the "pivotal prospective victim" who has the potential to waive the rights of the whole class because their agreement to waive can determine the "class viability threshold", making the class claim either viable or not.<sup>657</sup> An individual may exploit this position and "hold up the injurer for the entire value of the benefit the injurer would receive from the preempting of the class action".<sup>658</sup>

Due care levels taken by tortfeasors can be influenced by the preclusion of class action claims, but the value of the claim matters.<sup>659</sup> If claims are positive in value, preclusion likely leads to increased litigation costs for both parties, costs which are more likely to be bearable by tortfeasors who commit the mass tort than for victims of mass torts. If claims are negative, preclusion may lead to

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<sup>656</sup> HYLTON 2016, p. 337.

<sup>657</sup> HYLTON 2016, p. 337.

<sup>658</sup> HYLTON 2016, p. 322.

<sup>659</sup> HYLTON comments that "it is incorrect as a general matter to suggest that an optimal litigation system would funnel all low-level injuries through the class action mechanism. If the deterrence benefit is low relative to the cost of litigation, waiver is appropriate, even for those low-level injuries that could be taken to court only through class action device. Moreover, because of the option to waive, made possible by the threat of class action, the victims of low-level injuries receive superior compensation than they would have obtained through litigation." HYLTON 2016, p. 319-320.

lower litigation costs due to claims not being filed under the reasoning a “rational plaintiff” would have.<sup>660</sup> The firm which can force a class waiver is in a position to become a RP in arbitration, which allows the firm to gather information from multiple claims and develop expertise in defending the claim in arbitration.<sup>661</sup>

#### 4.5 Settlement Effects and Collective Actions.

Despite the economic benefits of class action, there are potential costs of class action, which are welfare reducing. "Blackmail settlements" occur when "the mere act of certifying a class may be enough to convert low-merit claims into such a high risk of catastrophic failure that the defendant will be impelled to settle" with the class "even though it might have won each individual contest with members of the class".<sup>662</sup> Facing a large judgment increases a defendant's willingness to settle, and PRIEST finds that “where damages are a substantial issue, the combination of the expansion of liability, the uncertainty of the process, and the way our class action procedures are devised, almost always leads to automatic settlement or guaranteed settlement once a class action is certified”.<sup>663</sup> In the case, *In the Matter of Rhone-Poulenc Rorer, Inc.*, Judge POSNER considered the possibility of a blackmail settlement, the likelihood of success of a class action, and other factors concerning a class certification, given that multiple individual cases had already been adjudicated concerning the underlying common claim in the defendant's favor.<sup>664</sup> According to Judge POSNER, when the potential for blackmail settlements is high because of the aggregate value of the potential claim is high, "it is not a waste of judicial resources to conduct more than

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<sup>660</sup> See the cost benefit analysis of the “rational plaintiff” used by COOTER and ULEN 2016.

<sup>661</sup> According to HORTON and CHANDRASEKHER, “[E]xtreme repeat players may be more dexterous within the arbitral forum than other companies. This could stem from top-flight legal services, superior information, or the ability to pool resources.” HORTON and CHANDRASEKHER 2015, p. 123.

<sup>662</sup> COOTER and ULEN 2016, p. 426.

<sup>663</sup> PRIEST 1999, p. 482.

<sup>664</sup> *In the Matter of Rhone-Poulenc Rorer, Inc.*, (1995), p. 1298.

one trial".<sup>665</sup> "Blackmail settlements" seem more likely to occur when a class size is large and when punitive damages are available. If the combination of a large class of claimants and the availability of punitive damages leads to blackmail settlements, there may be a need to limit or lower the availability of punitive damages in collective actions.<sup>666</sup>

Benefits from using class action remain for claims which individually have a negative value but, when collectivized, have a positive value. The preclusion of collective actions for claims which will not lead to blackmail settlements may lead to firms being under deterred from committing torts. An underuse of preclusion of collective actions, which results in a blackmail settlement, may lead to over deterrence. The key is identifying when the cost of potential for blackmail settlements overtakes the efficiencies gained from collectivizing claims.

#### 4.6 Valuation of Claims by Rational Plaintiffs.

The value which rational parties give to a case prior to adjudication influences how and if claims are filed. In the situation of negative value cases for small claims, there will be no economic incentive for victims to pursue claims.<sup>667</sup> When there is no incentive for the victims to pursue a claim, tortfeasors will have a lower incentive to take due care to prevent the harm occurring, as private claims are unable to make the tortfeasor internalize the harms they cause. For positive value cases, claims should be filed. The collectivization of claims makes the issue more complicated.

A critical point for the tortfeasor to keep in mind is the point at which the individual claim will become a positive value case. According to COOTER and ULEN, "[t]he rational plaintiff files a complaint if its expected net payoff is positive:  $EVC \geq FC \rightarrow$  file legal complaint;  $EVC < FC \rightarrow$

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<sup>665</sup> *In the Matter of Rhone-Poulenc Rorer, Inc.*, (1995), p. 1300.

<sup>666</sup> See: PRIEST 1999.

<sup>667</sup> This section relies heavily on the methods used by COOTER and ULEN to calculate when a rational plaintiff will file a claim. There is an additional need to consider how plaintiffs may not be rational in valuing their claims, but for the purposes of this analysis, only the rational plaintiff is considered. There is a need to research further how irrational plaintiffs in mass tort claims may over or under value their claims.

do not file legal complaint".<sup>668</sup> A utility maximizing tortfeasor will consider the incentives of potential claimants to file a suit.

Provided there is class preclusion, the damage a tortfeasor can cause to the victim without having to defend a claim is damage up to the point where the individual claim becomes positive in value since once the value of the claim is positive, a case should be filed. If the tortfeasor knows what this point is, then they should take only enough care to prevent the expected value of the claim from becoming positive, even if the legal standard of care is higher. By acting below the legal standard of care, the tortfeasor can decrease their care costs. By acting above the level of care, which would lead to a positive value claim, the tortfeasor can avoid being held liable for the externalities caused by acting below the set standard of care. If there is class preclusion and tortfeasors can calculate the point where damage levels make a claim a positive value, a tortfeasor can continue to take less than due care so long as they take enough care to make sure the claim remains negative in value.

By precluding collective actions for positive value cases, the value of the case may decrease for the individual claimants as the transaction costs incurred by individuals increase, but so long as the case remains positive in value, the claim should be filed. For positive value cases filed individually, the increased transaction costs for litigation can be considered in terms of the cost of litigating all the claims in one collective action to the number of total claimants. The larger the size of the class, the more transaction costs savings collective actions have. The cost savings need to be discounted because the litigation cost of a class action case is higher than any one individually litigated case, and some parties may opt-out or not opt-in.

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<sup>668</sup> COOTER and ULEN 2016, p. 389.

The increase in litigation transaction costs from using class waivers is not proportional for claimants and defendants. A single defendant facing multiple claims can develop a specialization in the case from being a RP, which may result in lowering their per-case transaction costs.<sup>669</sup> Multiple single plaintiffs cannot coordinate to the same degree as a single defendant can. Claim preclusion can be seen by defendants as means of increasing costs, asymmetrically, for the claimant class, making a case more likely to be negative in value.

#### 4.7 Punitive Damages.

Punitive damages may be used to force potential tortfeasors to take due care when courts are unable to ensure that all victims are compensated. According to CENINI et al., “[p]unitive damages should be awarded within a class action if and only if there are frictions that could prevent the injured party from taking legal action even on a class action basis” as “a mixed equilibrium—where the two remedies are combined and punitive damages are awarded within a class action—may be optimal to create optimal deterrence”.<sup>670</sup> According to COOTER and ULEN, “[a] legal system can save administrative costs by reducing the probability of liability and offsetting this fall with an increase in damages”.<sup>671</sup> Punitive damages can be used to correct “enforcement errors,” which lead to decreased deterrence. The problem of “blackmail settlements” may be compounded when punitive damages are available. Punitive damages combined with a higher filing standard which accounts for the possibility of ‘blackmail settlements’ for collective actions, maybe one way in which courts can decrease the number of claims they administer while still incentivizing potential tortfeasors to take due care.<sup>672</sup>

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<sup>669</sup> HORTON and CHANDRASEKHER 2015, p. 123.

<sup>670</sup> CENINI et al., 2011, p. 230.

<sup>671</sup> COOTER and ULEN, 2016 p. 243

<sup>672</sup> Some have argued for increased standards for class certification under FRCP 23. According to PRIEST, “[I]t’s absolutely crucial that there be some review of the ultimate substantive merit of the claim in the class certification

As a positive value case should be filed by rational victims, the additional availability of punitive damages will not change their decision to file, but it may incentivize victims to invest more in litigation in the hopes of obtaining additional punitive damages. If the availability of punitive damages adds more to the value of the claim than the difference between the value of the claim and the value at which the claim would be positive, then a negative value case may become positive with punitive damages. If the availability of punitive damages does not make the negative value case positive, then the claim should not be filed by a rational victim. Punitive damages cannot correct the “enforcement error” if they do not lead to any otherwise negative value claims becoming positive value claims worth filing. Given that tort liability systems are administered imperfectly, it is unrealistic to collect full damages from tortfeasors for each person who is harmed.<sup>673</sup> If full damages are not assessed to tortfeasors, they will not have the correct incentives to take due care so long as the damages which they are assessed are lower than the precautionary costs they avoid by taking less than due care.<sup>674</sup>

#### 4.8 Free Riding by Claimants and Arbitrators.

There is a potential for free riding among the victims when there is no possibility for collective actions as those victims who do bring a suit to produce positive externalities for the other victims who have not yet filed.<sup>675</sup> For collective actions for small claims, the “expected cost – expected value” balance of the of the law enforcement may be negative on the individual level but positive on the group level”.<sup>676</sup> There will be a “positive external effect conferred on other group members”

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hearing, especially if there are substantial stakes at issue,” especially considering how “a court should not review the claims in a case on their substantive merit for the purpose of certification”. PRIEST 1999, p. 486, p. 482.

<sup>673</sup> COOTER and ULEN 2016, p. 260.

<sup>674</sup> For a comparative law and economics analysis of the Learned Hand Formula, see: KERKMEESTER and VISSCHER 2003.

<sup>675</sup> NAGY 2012, p. 477.

<sup>676</sup> NAGY 2012, p. 477.

which, when "not internalized by the individual law enforcer...may lead to suboptimal law-enforcement".<sup>677</sup> There is a positive external effect created by the individual for the class when a claim is brought by the individual that serves as a test case which "involves a legal question (or more legal questions) relevant for all group members".<sup>678</sup> This may lead to a situation where "non-active group members free-ride on the efforts of the member initiating the test case".<sup>679</sup> However, this potentially positive externality is counterbalanced by the potential for the defendant to invest in litigation expenditures to counter the benefit since "if group members sue on an individual basis and the defendant wins against the first plaintiff, this may have a negative impact on subsequent plaintiffs" and the test case "may have precedential value or at least persuasive authority" over the claims of the other group members.<sup>680</sup> This incentivizes the defendant to "invest much more in winning early cases, because winning in these early proceedings may discourage later law-enforcement," lowering their overall expected liabilities.<sup>681</sup> The investment by defendants in early cases may increase the probability of the defendant winning the early case, or it may lead to a response of the victim who files early to invest more in their case, either decreasing the estimated value of their claim.

There is also free riding which arbitrators and parties to arbitration take from public laws. As laws can be considered a public good, arbitrators use public laws in their arbitration process and gain private financial benefits by providing private adjudication. According to LANDES and POSNER, parties to arbitration "may be said to be taking a "free-ride" on the public legislative-judicial system," although it is not in the traditional sense because "they actually receive less benefit

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<sup>677</sup> NAGY 2012, p. 477.

<sup>678</sup> NAGY 2012, p. 477.

<sup>679</sup> NAGY 2012, p. 469.

<sup>680</sup> NAGY 2012, p. 469.

<sup>681</sup> NAGY 2012, p. 478.

because they have to pay for the arbitrator whereas the state pays for his counterpart in public court systems".<sup>682</sup> Free riding on public law is higher when parties who have no standing to bring a claim in a given state use that state's laws in their arbitration. The arbitration process itself is "taking a "free ride" on the precedent-creating activities of the public courts," although it may not necessarily be inefficient.<sup>683</sup> The dependence of the arbitrators on precedent created by public courts may not be privately inefficient for claimants even if socially inefficient, if the other factors, such as "a long court queue," make gains from arbitration an "attractive substitute".<sup>684</sup> If the claim being considered in arbitration has no ability to lead to the production of precedent, the "free ride" may actually benefit the judicial system by diverting cases which only need to have settled rules applied to the facts of the dispute.

#### 4.9 Judges, Arbitrators, and Private Incentives.

A utility maximizing judge will want to impose rules which make their job less burdensome so that their individual efforts are minimized.<sup>685</sup> According to POSNER, "[j]udges are rational, and they pursue instrumental and consumption goals of the same general kind and in the same general way that private persons do."<sup>686</sup> It is possible that a judge may not want to spend time overseeing litigation of the same claim between a defendant or similarly situated defendants, and a class of plaintiffs over and over, as they find such endeavors decrease their personal utility. Legal certainty can help to prevent these types of claims from being brought before the courts repeatedly.

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<sup>682</sup> LANDES and POSNER 1979, p. 249.

<sup>683</sup> LANDES and POSNER 1979, p. 249.

<sup>684</sup> LANDES and POSNER 1979, p. 250. LANDES and POSNER also make a detailed analysis of the private costs and benefits of using arbitration between two parties; however, their analysis does not go into great depth concerning the use of collective actions for arbitration.

<sup>685</sup> According to LANDES and POSNER, "[M]onetary compensation may not be necessary in order to induce judges to produce precedents. The production of precedents may yield substantial nonpecuniary rewards to judges—especially where they are paid salaries unrelated to the number of disputes resolved". LANDES and POSNER 1979, p. 242.

<sup>686</sup> POSNER 1993, p. 39.

Precedent is used by judges to prevent claims which will be more certainly ruled one way from going through the courts. Procedural rules may be used, such as requesting summary judgment or a ruling by the judge when there is no dispute over facts, and there is only a question of law to be answered.<sup>687</sup> There may be a risk of a perverse incentive for judges to overuse the collective action procedure to limit their own efforts regardless of the merits of the claims.<sup>688</sup> The value of the case means this perverse incentive runs both ways. When the individual claim is negative but the collective claim is positive, the collective claim will lead to an increased caseload for the court. Other procedural rules which scrutinize the certification of a class may alleviate this perverse incentive.<sup>689</sup>

The arbitrator has a different set of incentives than a judge. Arbitrators receive their compensation based on the number of cases they arbitrate. If an arbitrator can prevent collective actions from taking place, they may consider the effect of preclusion on their future work. If arbitration is allowed on a collective scale, then the arbitrator will have a smaller pool of cases from which they may be chosen to serve as an arbitrator. The arbitrator may consider how an increased number of cases benefits their fellow arbitrators. The decision may also be signaling a preference in an industry which is challenging the availability of collective actions, or at the least industry may take their decision as a factor which makes them believe the arbitrator is more favorable to industry. This could be interpreted by victims as a disposition which is unfavorable to claimants. As arbitrators are dependent on gaining work by being chosen by the parties, their impartiality

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<sup>687</sup> Summary Judgment is defined as “In civil actions in federal court, either party may make a pre-trial motion for summary judgment. To succeed in a motion for summary judgment, a movant must show 1) that there are no disputed material issues of fact, and 2) that the movant is entitled to judgment as a matter of law.” CLII.

<sup>688</sup> This perverse incentive can be seen as the other side of why judges are not paid by their output. According to LANDES and POSNER, “The judge who is not paid proportionately to either his final output or his precedent production, but solely according to the number of cases he decides, will have an incentive to overproduce that input”. LANDES and POSNER 1979. p. 241.

<sup>689</sup> This is from the same line of criticism which was addressed by PRIEST 1999.

becomes a serious issue. The arbitrator faces a risk that judges do not. Since arbitration is a private adjudication process, the parties involved in the dispute have a great deal of influence on the arbitrators who serve on the panel.<sup>690</sup> The arbitrator has a financial interest in there being more arbitration cases. Suppose the following: an arbitrator is faced with a case which is at the margins of falling either way in terms of allowing a collective arbitration or precluding it. There is no overwhelming support of either decision. What will the arbitrator do? This type of scenario creates a conflict of interest for the arbitrator. Even if the arbitrator is not chosen to oversee any of the many cases which would result from precluding a collective arbitration, the increased demand for arbitration would still impact the number of cases for which they may be chosen, as other arbitrators take on the cases resulting from the preclusion decision which in turn may preclude those arbitrators from serving as an arbitrator for other cases if those arbitrators face individual capacity constraints. According to FAURE and MA, “arbitrators and potential arbitrators have incentives to behave in ways that correlate to a large extent with the preferences of the disputants—or at least of their legal counsel—in relation to, among other things, the application of law.”<sup>691</sup> This divergence in interest between judges and arbitrators highlights how outcomes in arbitration and litigation are potentially influenced by the private incentives of the third party adjudicator, be it a judge or an arbitrator. The situation where arbitrators must decide if collectivization of claims is precluded may create a prisoner's dilemma between arbitrators competing against each other in the market for arbitration of claims. The payment to the arbitrator may be higher for a collectivized

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<sup>690</sup> LANDES and POSNER address the issue of choice of an impartial arbitrator by the parties. LANDES and POSNER 1979, pp. 237-239, pp. 245-246.

<sup>691</sup> FAURE and MA 2020, p. 5. Furthermore, FAURE and MA find that “A common party appointment model may lead to so-called “affiliation effects,” meaning that a party-appointed arbitrator will have an unavoidable tendency to favor the party which appointed him. In light of the goal of an independent and neutral adjudicatory mechanism, the predisposition toward a party resulting from the party appointment model poses significant challenges to the legitimacy of arbitration.” FAURE and MA 2020, pp. 6-7. Referencing: PUIG and STREZHNEV 2017, and: VAN AAKEN & BROUDE 2016.

claim than the payment for arbitrating the individual claims. While the arbitration of many individual claims would increase the pool of potential cases to be seated as an arbitrator, the individual arbitrator may gain a higher payment while the total payment for all arbitrators decreases. Given that parties to arbitration have the power to pick the arbitrators, often unilaterally when there is a three-arbiter panel, the potential for the individual arbitrator to gain from being repeatedly selected by a party to numerous similar arbitration hearings may outweigh any potential gain from a single higher paying collectivized claim.

#### 4.10 The Impact on Third Parties.

Arbitration or class waivers of mass tort claims may impact third parties. A decrease in due care incentives from the use of arbitration may impose costs on third parties. Suppose a victim or class of victims suffer damages, but the value of filing a claim is negative. The damage falls to the victims to cover. However, these damages do not necessarily fall completely with the victims; rather, the damages may be scattered around the victim. Insurance companies, the state, and other parties may be forced into covering the loss. Suppose a victim is insured and their insurance company covers the loss. This cost may be spread among all policyholders. State social insurance and welfare programs may also be forced to cover the loss, spreading the cost across society. The ability of one party to avoid public sanctions may signal to others a strategy for legal avoidance and lead other potential tortfeasors to act with less than due care, driving the cost to third parties up indirectly.<sup>692</sup>

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<sup>692</sup> The issue of regulatory arbitrage is discussed in the chapter “Marching Without Memory” section 5.

##### 5. The Impact on the Production of Public Goods from Litigation.

Precedent, interpretation, and information produced by courts can be considered public goods since they are nonexclusive and non-rival.<sup>693</sup> According to LANDES and POSNER, "[t]he social benefits of precedent are not limited to the parties to the case—indeed, if those parties have no interest in future disputes for which the decision in their case might constitute a precedent, they derive zero private benefits from helping to create a precedent", while if there is "such a future interest, or if others who do are somehow represented in the litigation, that the social benefits of precedent can be privately appropriated".<sup>694</sup>

A paradoxical relationship develops between private and public courts. This paradox derives from the fact that "[a]rbitrators typically apply the same rules as courts deciding similar questions, often because the arbitration contract will specify that the arbitrator is to apply the contract law of a particular jurisdiction".<sup>695</sup> As arbitration produces no public good from precedent, nor public interpretation or public information, the arbitrator's reliance on public courts means that the arbitrators are constricting the production of rules they use to adjudicate claims.

Prior public adjudications may help parties in a dispute determine a settlement value based on similar claims which have already been determined. Precedent and interpretation inform potential tortfeasors and victims of due care standards and creates legal certainty, which may also lead to

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<sup>693</sup> According to COOTER and ULEN, "A public good is a commodity with two very closely related characteristics: 1. Nonrivalrous consumption: consumption of a public good by one person does not leave less for any other consumer. 2. Nonexcludability: the costs of excluding nonpaying beneficiaries who consume the good are so high that no private profit-maximizing firm is willing to supply the good." COOTER and ULEN 2016, p. 40. Also see RUBENSTEIN 2006. According to RUBENSTEIN, "When the legal system is conceptualized as a market for legal claims, it becomes apparent that the product of the individual lawsuit has the characteristics attributed to public goods: all members of society share the good without depleting it and none can be excluded from doing so. Tragically, therefore, no class member has any incentive to bring the case. This is the collective action dilemma which results in the underproduction of the positive externality. Small claims situations at once pose a collective action problem and a problem of the underproduction of positive externalities". RUBENSTEIN 2006, p. 725.

<sup>694</sup> LANDES and POSNER 1979, p. 274.

<sup>695</sup> LANDES and POSNER 1979, p. 249.

the prevention of harm and avoidance of conflicts.<sup>696</sup> This effect will be greater the more uniform the courts are, and lesser the more divergent courts are. If precedents are contradictory, there will be a need for continued litigation. So long as there are multiple contradictory precedents, legal uncertainty remains.

The production of precedent, interpretation, and information can be differentiated based on the value of the claims.<sup>697</sup> Negative value cases may not be brought before courts as there is no economic incentive for potential plaintiffs to file, so there will be fewer system inputs in the form of cases which are negative in value, even if they are meritorious. Without a collective action process, no precedent or interpretation will be produced for most negative value claims, as no case would be worth filing. There will be less development of legal certainty when collective actions are prohibited for negative value claims and less production of public information by courts about negative value claims. Positive value cases should be filed and may produce precedent, interpretation, or information. Positive value cases may increase system costs when there are appeals from the rulings of the court of first instance. Appeal court system costs increase without the collective procedure for positive value cases as more individual litigants can use the appeal process. This also increases the opportunities for different courts to develop conflicting precedents for the same problem. The collectivization of positive value cases limits the input necessary for precedent while also limiting the opportunities for conflicting precedents to develop. This also limits the production of precedent for positive value cases but decreases appeals court costs.

#### 5.1 Novel Technologies, Products, or Practices and Regulation Avoidance.

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<sup>696</sup> According to LANDES and POSNER, "Precedents provide information not only on the expected outcome of the current dispute between A and B but also on the likely outcome of similar disputes in the future. This information will in turn affect the allocation of resources across activities". LANDES and POSNER 1979, p. 264.

<sup>697</sup> This analysis of the value of a claim and the production of precedent is also heavily reliant on the "rational plaintiff" model. See COOTER and ULEN 2016.

When there is a novel, or new type of harm being alleged in a claim, the preclusion of public courts from adjudicating the claim limits the production of precedent for both public courts and private arbitrators to use in future cases. According to ALDERMAN, “[t]he development of the common law and the courts ability to continually establish and refine legal rights depends on litigants” which is frustrated by the use of arbitration as “[a]rbitration eliminates litigation in a public forum, precedent-establishing decisions, and stare decisis”.<sup>698</sup> The elimination of a class of claims which have not been previously considered for review before public courts may be part of a larger scheme of regulatory arbitrage by an industry.<sup>699</sup> Firms can use arbitration with class preclusion to limit their potential liabilities and avoid regulation through due care standards. FLEISCHER comments that “arbitrage only works if the lawyers involved can successfully navigate a series of planning constraints: (1) legal constraints, (2) Coasean transaction costs, (3) professional constraints, (4) ethical constraints, and (5) political constraints”.<sup>700</sup> The use of arbitration and class waivers likely fall under the first two of these constraints. Judicial review is avoided through arbitration, and legal constraints are loosened. Transaction costs associated with litigation for firms can be avoided when class waivers result in claims against the firm being of negative value. The last three constraints listed likely fall within the efforts of firms to keep the option for arbitration and class waivers available. The use of arbitration and class waivers by firms can be a critical part of a scheme to avoid regulation, and the liability regulation could impose on firms.

New technologies and practices may lead to novel questions of law when existing law is incapable of addressing the type of harm created; however, the value of the claim may influence if a public

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<sup>698</sup> ALDERMAN 2003, p. 11.

<sup>699</sup> According to FLEISCHER, regulatory arbitrage is “the manipulation of the structure of a deal to take advantage of a gap between the economic substance of a transaction and its regulatory treatment”. FLEISCHER 2010, p. 230.

<sup>700</sup> FLEISCHER 2010, p. 230.

court will ever review the issue.<sup>701</sup> If the case value is negative for a claim concerning new technologies and practices, there will be no development of law concerning the new technology or practice unless claims can be collectivized, so the combined value is positive.<sup>702</sup> When the case is of positive value, there should be a production of precedent as multiple cases will be litigated concerning the new technology or practice, and a new legal standard concerning due care levels with regard to the new technology or practice should be produced if they are necessary. When the adjudication process contracted for prevents the production of precedent, which concerns the new technology, there will be an underproduction of the precedent. This is welfare reducing if the private benefits created from private adjudication do not outweigh the decrease in value of precedent from underproduction.

The quality of the claim matters for the judicial production of public goods. The production of precedent is not just dependent on the volume of cases but also the quality of claims. Cases which are incapable of producing a precedent cannot frustrate the common law by being diverted into arbitration. Some disputes concern legal questions which involve well settled precedent, which simply needs to be applied to the facts of the case.<sup>703</sup> The production of precedent is a function of the number of adjudicated cases and the quality of those cases. When it comes to the production of precedent, a thousand cases which concern a settled legal question which will never lead to precedent are not as valuable as one case with a novel legal question for which no precedent exists. Precluding cases which are capable of producing a precedent from judicial review frustrates the common law, while cases incapable of producing precedent being kept from judicial review do

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<sup>701</sup> An earlier discussion of how advances in technology lead to the development of tort law can be found in the introductory chapter. For an analysis of the role of technology in prompting development in tort law. See: BARTLETT 1981 and SCHÄFER 1998.

<sup>702</sup> See the analysis of the "rational plaintiff" based on the model of COOTER and ULEN in Chapter 4 sec. 4.6.

<sup>703</sup> According to LANDES and POSNER, "arbitration is generally limited to disputes where the rules are perfectly clear and the only issue is their application to the facts". LANDES and POSNER 1979, p. 249. It should be noted that LANDES and POSNER wrote this before the SCOTUS began to broadly apply the FAA in the 1980s.

not. In civil law jurisdictions, precluding a claim which could lead to a new rule interpretation or fill a new gap should lead to a similar result. Tort law found in civil law jurisdiction can be considered to a large extent to be judge made law. Because the role of judges in civil law jurisdiction can be rather influential in determining what care is considered reasonable to take within the context of tort claims (not including strict liability), the role of judges in civil law jurisdictions may be similarly powerful in setting due care standards as are judges in common law jurisdictions. A claim involving a new technology or practice is more likely to have qualities which courts have not yet developed precedent for. When judges, in both common law and civil law jurisdictions, are precluded from looking at tort claims involving a new technology or practice due to the use of arbitration, there is a possibility the claim is precluding the development of care standards.

The parties involved in a dispute may have an idea of which disputes may be capable of leading to a precedent. ALDERMAN comments that “[t]hrough the sophisticated use of mandatory arbitration provisions, the business sector may engage in a form of selective creation of the common law- selecting which disputes, if any, our courts will be allowed to deal with” which could “stall the development of the common law, or even worse, it may control common law development to accommodate the needs of business”.<sup>704</sup> This strategic use of arbitration requires foresight and coordination among potential tortfeasors.<sup>705</sup> Within civil law jurisdictions, there is a similar potential for the use of arbitration for tort claims to frustrate the development of the law through the strategic manipulation of rule loss or rule gain (in terms of rule interpretation and gap filling) by firms.

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<sup>704</sup> ALDERMAN 2003, p. 14.

<sup>705</sup> See chapter 3” for a more detailed analysis of the strategic use of arbitration for tort claims.

Some claims are more susceptible to arbitration. In a 2008 empirical study concerning the use of arbitration, EISENBERG found that “[t]he consumer contracts and employment contracts arbitration clause rates are strikingly different from the rates in nonconsumer material contracts” and “[t]he difference between the nonconsumer contract rate and the rate for consumer and employment contracts is highly statistically significant”.<sup>706</sup> The findings of EISENBERG “support the inference that the companies” they sampled “view consumer arbitration as a way to save money by avoiding aggregate dispute resolution”.<sup>707</sup> EISENBERG concludes that “[t]he growth of mandatory consumer arbitration clauses appears to be part of a broader initiative by corporations to preclude or limit aggregate litigation” and “completely preclude aggregation of small plaintiff claims into economically viable actions”.<sup>708</sup> Since “consumer law is a newer body of law and is consequently evolving more rapidly than the law in other areas” the use of arbitration in consumer contracts can be seen as a “threat to” the “common law tradition”.<sup>709</sup> A similar potential frustration of the efficiency of the law to address tort claims applies to civil law jurisdictions, as the possibility of arbitration precluding the production of rule interpretation and gap filling remains regardless of the differences with common law legal traditions. This potential frustration of tort law is particularly important when consumer contracts give rise to a mass tort claim.

When questions of law concerning consumer rights, technology, and innovative practices are kept out of public courts, legal precedents in these areas are underproduced. This underproduction is welfare reducing. Another paradoxical situation exists. The quality of a claim being capable of producing precedent is more likely to be present when the claim is novel, involves a new

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<sup>706</sup> EISENBERG et. al 2007, p. 883.

<sup>707</sup> EISENBERG et. al 2007, pp. 894-895.

<sup>708</sup> EISENBERG et. al 2007, p. 895, 896.

<sup>709</sup> ALDERMAN 2003, p. 15.

technology, or new practice, while a claim being subject to arbitration is also more likely when it has these characteristics.

6. Conclusion.

The arbitration of mass tort claims which could lead to the production of precedent restricts the input which courts need to produce precedent. Precedent production is dependent on not just the quantity of cases, but, more importantly, the quality of the cases being considered. Tort law has developed in the past two centuries largely in response to developments in technologies and reactions from legal institutions to develop new legal norms concerning their use. In common law jurisdictions, the preclusion of claims involving new technologies and practices from public adjudication has the potential to frustrate the production of precedent and harm public welfare, while in civil law jurisdiction, the production of public goods from court decisions and the associated public information production will be frustrated. The use of arbitration and preclusion of collective actions for a claim, one which has no possibility of leading to the production of precedent, may benefit the public welfare by decreasing the cost to public courts. Conversely, the use of arbitration and class preclusion for claims which are capable of leading to the production of public goods from litigation may lead to an increase in the costs of accidents. A weighing of the social cost and private costs against the social benefits and private benefits can show how a combination of rules and procedures can be used to maximize welfare given a particular class of mass tort claims. There is a continued need to weigh these costs and benefits, as the creation of new technologies and the use of new practices has the potential to frustrate existing legal standards of care.

## **Chapter 5. “Since it costs a lot to win, and even more to lose”: Competition Law and the Arbitration of Tort Claims.** <sup>710</sup>

### 1. Introduction.

The use of mandatory arbitration clauses in consumer, service, or employment contracts may result in tort claims being arbitrated in a private tribunal. The arbitration of tort claims has implications for competition law, as firms use *ex ante* arbitration clauses in their standard contracts may undermine free markets. Particularly, the private arbitration of tort claims may enable or facilitate firms to *1) collude in setting market conditions and prices both directly and indirectly; 2) collude to avoid state regulatory or judicial oversight of all forms of collusive behavior, anticompetitive practices in an industry, or the strategic taking of less than due care; and 3) collude, either explicitly or tacitly, within an industry over the development of law, including efforts to selectively litigate claims which would benefit the colluding firms or prevent claims in litigation which could lead to increased care or liability costs for firms in an industry.*

The secretive nature of arbitration makes it impossible to know exactly which disputes have been arbitrated, the outcome of the claims, the economic impact arbitration has on prices in consumer, service, and employment contracts, and how arbitration of tort claims interferes with the production of public goods. This analysis will explore some theoretical aspects of collusive behavior in the use of arbitration for domestic tort claims from a law and economics perspective, specifically how the use of arbitration for tort claims may create opportunities for firms to behave strategically as a consequence of deference towards arbitration.<sup>711</sup> The contracts to arbitrate

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<sup>710</sup> The title is a lyric from the song Deal: GARCIA and HUNTER 1972.

<sup>711</sup> Many law and economics scholars point to COASE's 1960 article "The Problem of Social Cost" as signaling a modern turn in legal analysis toward a "new law and economics" approach focused on transaction costs and efficiency in legal research. According to COASE, "Once the costs of carrying out market transactions are taken into account it is clear that such a rearrangement of rights will only be undertaken when the increase in the value of production consequent upon the rearrangement is greater than the costs which would be involved in bringing it about."

considered here can be further differentiated as only those purely domestic contracts to arbitrate which have not been individually bargained over; rather, they are found within a standardized contract or contract of adhesion, where no choice of law issues are present. A positive analysis concerning some aspects of collusion to use arbitration will also be discussed; however, much of this discussion focuses on how legal deference towards arbitration has shifted, specifically in the US, while in the EU, this has not been the case. This chapter is not all encompassing, although it does demonstrate a need for further research concerning the use of arbitration of tort claims, and it identifies several potential issues which are particularly deserving of further research. Another topic this chapter does not examine is the use of arbitration by firms in a dominant position; rather, the focus is on collusive efforts to use arbitration across firms in an industry in which there is an option for collusive behavior.<sup>712</sup> This paper does not address the use of arbitration for anticompetitive claims concerning anticompetitive behavior unrelated to the use of arbitration, i.e., traditional antitrust claims such as abuse of dominant position, direct price fixing, and collusion on other terms of business.

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Furthermore, COASE comments "the initial delimitation of legal rights does have an effect on the efficiency with which the economic system operates. One arrangement of rights may bring about a greater value of production than any other. But unless this is the arrangement of rights established by the legal system, the costs of reaching the same result by altering and combining rights through the market may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved." COASE 1960. P. 10.

According to POSNER, "Coase's article introduced the Coase Theorem...and more broadly, established a framework for analyzing the assignment of property rights and liability in economic terms. This opened a vast field of legal doctrine to fruitful economic analysis. An important, though for a time neglected feature of Coase's article was its implications for the positive economic analysis of legal doctrine. Coase intimated that the English law of nuisance had an implicit economic logic. Later writers have generalized this insight and argued that many of the doctrines and institutions of the legal system are best understood and explained as efforts to promote the efficient allocation of resources." POSNER 2014, p. 30.

<sup>712</sup> It may be reasonable to assume that a single firm in a monopoly position using a similar arbitration strategy would reach a similar outcome as a cartel acting in unison.

There are problems associated with firms acting in unison or collusively to include mandatory arbitration clauses in their consumer, service, or employment contracts.<sup>713</sup> While much of this collusion results in typical antitrust injuries, some of the harms caused by the collusive use of arbitration for tort claims are not typical of antitrust claims. Arbitration clauses generally cover all claims between the contracting parties, including tort claims.<sup>714</sup> As discussed in chapter 3, the collusive efforts to use arbitration for tort claims creates an opportunity for strategic behavior by firms seeking to gain private utility through the imposition of transaction costs on counterparties or barriers to the use of public goods on counterparties, which creates pressure to push tort due care standards toward being inefficient, which may lead to negative externalities for both individuals and society.<sup>715</sup>

Fixing market conditions and prices is one of the hardcore competition infringements that the EU and the US actively enforce.<sup>716</sup> Collusion to use arbitration across an industry has price effects.

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<sup>713</sup> This paper focuses on the use of mandatory arbitration terms in contracts; however, there are many settings where arbitration may be agreed upon through bargaining, and “mandatory” may have different meanings attached. According to HYLTON, “it is important to distinguish voluntary and mandatory (i.e., state-imposed) arbitration. Informed contracting parties will voluntarily enter into arbitration agreements only when the agreements increase the difference between deterrence benefits and expected litigation costs. However, a law mandating arbitration may impose arbitration even when this condition does not hold. Mandatory arbitration also may have the effect of *increasing* litigation cost by requiring victims to go through an initial stage of pre-trial arbitration or mediation. Mandatory arbitration therefore may reduce overall deterrence benefits.” HYLTON 2000, p. 230. While HYLTON includes state-imposed arbitration as falling under mandatory arbitration, mandatory arbitration may also refer to mandatory terms which a firm has placed in their standard boilerplate contracts, which may not be bargained over; rather, they are a mandatory contract term for a mandatory process of dispute resolution for any party contracting with the firm. This may also be referred to as forced arbitration.

<sup>714</sup> For a list of cases which have been forced into arbitration in the US after judicial challenge to the arbitration clause, including tort claims for wrongful death, assault, negligence, fraud, invasion of privacy, racial and gender discrimination, and wage theft, among others, See: CENTER FOR JUSTICE AND DEMOCRACY 2019.

<sup>715</sup> The strategic behavior of firms in arbitration is discussed in Chapter 3.

<sup>716</sup> Under US Antitrust Law, “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal.” SHERMAN ANTITRUST ACT.

Under EU competition law, “The following shall be prohibited as incompatible with the internal market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular those which:

- (a) directly or indirectly fix purchase or selling prices or any other trading conditions;
- (b) limit or control production, markets, technical development, or investment;

The right to arbitrate has a value, as does the right to litigate in court, as do all the other rights in a contract. The value of the right to arbitrate is thus different from the value of the right to litigate. Despite price fixing being such a hardcore infringement, when price fixing is accomplished through tacit collusion rather than explicit collusion, the firms involved in the price fixing may be able to avoid sanctions while continuing their collusive behavior.<sup>717</sup>

There may be objectives in collusions to use arbitration for tort claims which would benefit firms beyond the initial pricing effects of using arbitration.<sup>718</sup> There are potential competition law infringements beyond price fixing in collusion to use arbitration which are related to the arbitration of tort claims involving agreements: to restrict trade, to manipulate the rules of competition in the market, and to subvert the power of the judiciary to produce public goods which specifically related to the regulation of firms in an industry.<sup>719</sup> In addition to the possibility of collusion enabling indirect price fixing and the distortion of free markets (each contributing to a welfare inefficiency), the arbitration of tort claims combined with collusive behavior by firms seeking to avoid judicial oversight of their tortious acts may contribute to an underproduction of, or under investment in, public goods from adjudication.<sup>720</sup> Firms may use market power and coordination to mandate

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(c) share markets or sources of supply;

(d) apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;

(e) make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts."

TFEU 101.

<sup>717</sup> For a more detailed discussion on the judicial review of tacit collusion, see the discussion below in section 4.4.

<sup>718</sup> When considering the benefits to firms in light of the SCOTUS decisions which favor the use of arbitration, WARDABAUGH found: "The examination of these benefits is primarily an economic task, the results of which suggest that the industries involved in recent Supreme Court consumer arbitration matters have a structure that facilitates collusion and cartel formation. As cartels not only fix prices, but also collude on terms of service, I suggest that a consequence of the use of such exclusions is not to benefit consumers. Rather, the use of arbitration may have the very opposite effect, namely the facilitation of appropriation of consumer surplus." WARDHAUGH 2013. P. 430.

<sup>719</sup> See LANDE and MARVEL for a discussion of type I collusion (price fixing), type II collusion (attack and disadvantage rival firms), and type III collusion (fixing the rules of competition). LANDE and MARVEL 2002, pp. 183-185.

<sup>720</sup> According to LANDES and POSNER, when considering the optimal production of precedent, "an optimal investment would be one that maximized the present value... of the difference between the value of the flow of

private contractual terms, which enable this type of collusive behavior, resulting in a distortion of the market in which they conduct business and a distortion in the market for adjudication.<sup>721</sup> Effects on the market for adjudication also include potential effects on third parties, which may contribute to a market failure if, for instance, these are negative externalities. There is also the potential that these effects represent positive externalities; for instance, if there is no potential for a given claim to lead to the production of public goods and the use of arbitration indirectly provides increased opportunities to adjudicate claims in court which could lead to the production of public goods. In such a scenario, the docket relief from the diversion of claims with no characteristics needed to produce precedent allows for courts to function more efficiently, which may result in lower transaction costs from litigation for claimants and may lead to an increase of positive value claims which could lead to the production of precedent being brought before courts. The selective litigation of claims within an industry may provide benefits for private interests which are not in line with public interests and may undermine the legitimacy of the law and legal institutions. The potential for market restraints from the use of arbitration for tort claims is thus very dependent on the judicial enforcement of contracts to arbitrate tort claims and the nature of the claim.

An efficient due care standard should give parties the right incentives to take care, given that their activities may produce negative externalities.<sup>722</sup> Due care standards are public goods, which limit the costs of accidents across society.<sup>723</sup> The use of courts to adjudicate tort claims leads to the

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services and the costs of investment with respect to investment in each period” provided it meets some criteria. LANDES and POSNER 1976, pp. 264-265. The topic of care avoidance is addressed in chapter 3.

<sup>721</sup> For a discussion about the arbitration and judicial services market, see: WAGNER 2014.

<sup>722</sup> According to the Hand formula, which identifies the calculus of negligence, “if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B less than PL.” *United States v. Carroll Towing Co.*, (1947). BROWN further identified how the marginal cost of care should equal the marginal benefits of care. BROWN 1973. According to SHAVELL, in unilateral accidents, “[t]his socially optimal level of care will clearly reflect both the costs of exercising care and the reduction in accident risks that care would accomplish.” SHAVELL 2009, p. 178.

<sup>723</sup> According to COOTER AND ULEN, “A public good is a commodity with two very closely related characteristics: 1. *Nonrivalrous consumption*: consumption of a public good by one person does not leave less for any other consumer.

production of public goods, including rulemaking and information production, while the adjudication of tort claims in a private arbitral tribunal generally does not lead to the production of these goods.<sup>724</sup> Arbitration produces a private dispute resolution of a claim and does not directly contribute to the development of efficient due care standards.<sup>725</sup> Arbitrating tort claims limits the inputs necessary for courts to produce public goods because it limits their role in developing and maintaining efficient due care standards.<sup>726</sup>

When arbitration is used to adjudicate tort claims unilaterally, it may restrict the use of public goods and production of public goods.<sup>727</sup> Court fees can also be seen as restricting access to public goods. However, as public funds subsidize courts, the restriction on the use of the public good is lower than if users paid the full price of the good. In arbitration, the use of public goods is incidental to the payment for a private good (a decision rendered by the arbitrators). The input of rules from public courts is only partially paid for by the parties to the dispute. Rather the parties in a dispute

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2. *Nonexcludability*: the costs of excluding nonpaying beneficiaries who consume the good are so high that no private profit-maximizing firm is willing to supply the good." COOTER AND ULEN 2016, p. 40.

<sup>724</sup> According to LANDES and POSNER, "Precedent has "public-good" aspects that may result in underproduction in a private market." LANDES and POSNER 1979, p. 261. HYLTON has described precaution as a type of public good "in the sense that the potential defendant's investment in precaution...reduces the probability of harm to all potential plaintiffs simultaneously." HYLTON 2000, p. 238.

<sup>725</sup> LANDES and POSNER comment, "arbitration awards are not a source of rules or precedents." Which "is understandable in the case of general commercial arbitration because of the public-good character of precedent." Furthermore, "[a] system in which arbitrators wrote opinions would be at a competitive disadvantage vis-h-vis one in which they did not write opinions; the former would cost more but would yield no greater private benefits and, being private, could not coerce the necessary financial support by invoking the state's taxing powers." LANDES and POSNER 1979, p. 248. There may be benefits from the production of public goods from litigation when a claim being arbitrated lacks a quality which could result in the production of public goods, as this represents a relief on judicial dockets from claims which lack the ability to induce public good production from the court.

<sup>726</sup> HYLTON has argued that "if a waiver would inhibit the development of new law in a manner that is detrimental to plaintiffs, then a potential plaintiff presumably would take this into account in setting the terms of the agreement. The existence of spillover benefits to other plaintiffs, leading to a divergence between private and social incentives to waive, is an insufficient argument against enforcement because such spillovers are likely to be negligible." HYLTON 2000, p. 214.

<sup>727</sup> According to DRAHOS, "Public goods have specific regulatory contexts that affect their provision as well as their distribution and uptake. The benefits of some public goods (for example, cleaner air) flow automatically while the benefits of other (for example, technical knowledge) do not. One consequence of this is that even if the problem of provision is solved for a given public good, the problem of distribution may not be. Restricting access to a public good is sometimes a deliberate choice. Moreover, such restrictions can be done by regulating the movement of private goods." DRAHOS 2004, p. 322.

in arbitration are free riding to a certain extent off of the public good, which is the law, while also inhibiting the ability of courts to create these public goods.<sup>728</sup>

Collusive behavior in the use of arbitration may divert an entire class of claims away from courts and may lead to persistent market failures, including failures within the market for adjudication of disputes. For instance, if a certain class of claims tends to lead to the production of public goods from litigation, then removing these claims from public adjudication forums will lead to an underproduction of public goods from courts related to the class of claims.<sup>729</sup> On the other hand, the arbitration of tort claims incapable of producing public goods from litigation may lead to lower accident costs and enhance welfare when arbitrators reach similar outcomes as courts. It thus seems a possibility that for some types of tort claims, the collusive use of arbitration may lead to welfare improvements so long as the claims being diverted from courts are wholly incapable of leading to the production of public goods from adjudication and the parties share in the benefits of using arbitration. If the gains from diverting tort claims to private adjudication forums do not outweigh

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<sup>728</sup> See: LANDES and POSNER 1979.

<sup>729</sup> The collusive use of arbitration for tort claims should be seen as creating a different economic effect than settlement. HYLTON has commented that the effects of settlement and arbitration on limiting the development of the law are similar and exaggerated. According to HYLTON, "The capital-stock erosion argument suggests that the law should discourage settlement and pre-dispute arbitration agreements because the private value of such agreements to the parties exceeds their social value", however, "the argument exaggerates the capital erosion effects of settlement, waiver, and arbitration agreements, ignores the potential for capital improvement from such agreements, and underestimates the parties' incentives to take capital-stock erosion into account." HYLTON 2000, p. 243. HYLTON, in this context, was responding directly to the work of FISS. According to FISS, "I do not believe settlement as a generic practice is preferable to judgment or should be institutionalized on a wholesale and indiscriminate basis. It should be treated instead as a highly problematic technique for streamlining dockets. Settlement is for me the civil analogue of plea bargaining: Consent is often coerced; the bargain may be struck by someone without authority; the absence of a trial and judgment renders subsequent judicial involvement troublesome; and although dockets are trimmed, justice may not be done. Like plea bargaining, settlement is a capitulation to the conditions of mass society and should be neither encouraged nor praised." FISS 1983, p. 1075. Furthermore, FISS finds that in settlement, "imbalances of power can distort judgment as well: Resources influence the quality of presentation, which in turn has an important bearing on who wins and the terms of victory". FISS 1983, p. 1077. The collusive abuse of market power to limit access to courts may preclude an entire class of claims with industry specific implications on precedent imposed by potential defendants, can be seen as a strategic decision directly taking into account potential "capital stock erosion". Importantly, settling disputes based on economic interests alone cannot reasonably preclude an entire class of claims, as some potential plaintiffs may not be acting under a rational actor model or making decisions to settle/litigate or not, which are based on heuristics or bias.

the lost benefits from the production of public goods resulting from the adjudication of tort claims in a public forum, or if the benefits from using arbitration are captured entirely by one party, then the use of arbitration cannot be said to be either efficient or welfare maximizing.<sup>730</sup>

In domestic settings where the choice of law is not an issue that arbitration could resolve, if the law allows firms to act in unison to mandate arbitration clauses which cover tort claims, then it may prevent the development of efficient due care standards in tort law, it may allow firms to avoid care cost and liability for tortious behavior, it may distort the market the firms operate in as well as the market for adjudication, and it may act as a private method to coopt the government into restricting the use and availability of public goods.

This chapter looks at the issue of arbitration and competition law from a unique perspective, specifically regarding the adjudication of domestic tort claims in arbitration and the potential anticompetitive effects the use of arbitration for tort claims may produce. There is a dedicated line of literature addressing the competence of arbitration tribunals to adjudicate antitrust claims and the validity of contracts to arbitrate antitrust claims.<sup>731</sup> This chapter is distinguishable from the literature concerning the arbitrability of antitrust claims because of the focus on the arbitration of tort claims and the implications of the use of arbitration for tort claims. Furthermore, this chapter adds to the literature concerning the collusive use of arbitration and the literature concerning the

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<sup>730</sup> One limiting issue in this analysis is that placing a monetary value on precedent is difficult. According to LANDES and POSNER, "Even though... the number of citations in subsequent judicial opinions may be a tolerably accurate proxy for the precedential value of a decision, it would be difficult to attach dollar values to citations so as to weight them against the number of disputes resolved." LANDES and POSNER 1979, p. 242.

<sup>731</sup> There is extensive literature addressing the arbitrability of antitrust claims, including: LOEVINGER 1969. VON ZUMBUSCH 1987. BAKER and STABILE 1993. BREWER 1997. BLANKE and LANDOLT 2011. This is only a small sample of literature addressing the arbitrability of antitrust claims, which can be differentiated from the types of claims considered here. Consider how various types of collusion can be differentiated. According to LANDE and MARVEL, type I collusion includes "price fixing, bid rigging, assignment of customers, and the division of territories", type II collusion includes "cooperating firms" attacking "and disadvantaging rivals in a manner that later allows the colluding firms to raise prices", while type III "can be characterized as collusion to fix the rules of competition". LANDE and MARVEL 2002, p. 183, p. 184.

use of arbitration for tort claims specifically. To a large extent, this analysis is limited in scope to domestic arbitration contracts, which may include arbitration between employers and employees as well as arbitration contracts between product and service providers and consumers. Additionally, this analysis may be of limited use for considering arbitration between employees and employers when the relationship results from collectively bargained labor agreements. Business to business (B2B) contracts to arbitrate are also not included in this analysis because these parties can be considered to be on more equal bargaining grounds and can be thought of as more sophisticated than consumers and the average employee. While some of the issues discussed here may also have implications for the arbitration of non-tort claims between businesses and consumers, the scope of the chapter is narrow, and the focus is purely on the use of arbitration for tort claims, with a specific focus on the efficient use of arbitration for tort claims, the impact of the use of arbitration in setting due care standards, and how firms may behave collusively in order to strategically influence the setting of due care standards through the use of arbitration.

The chapter is structured as follows: Section 2 introduces conspiracies to use arbitration, specifically with examples from the US. Section 3 concerns the Goals of Law, specifically contract, tort, competition, and judicial institutions, as well as the production of public goods from litigation and the efficient use of arbitration for tort claims. Section 4 addresses how a conspiracy to use arbitration for tort claims may function, specifically regarding: court error, the market for adjudication, strategic behavior, bias in adjudication, tacit and explicit collusion, and focal point theory. Section 5 addresses the difference in the legal restraints on conspiracies to arbitrate in the US and EU. Section 6 addresses the strategic use of arbitration and conspiracies to use arbitration for tort claims, including the conspiracy's objectives. Section 7 contains brief concluding remarks.

## 2. Conspiracies to use Arbitration in the US: Motives and Methods.

A conspiracy to use arbitration may seem an odd topic, especially when considering the implications for tort law.<sup>732</sup> Efforts to arbitrate tort claims are not purely hypothetical. Numerous examples of tort claims being arbitrated can be found in the US, while a more limited set of examples can be found in the EU. It is also evident that the use of arbitration for tort claims may be due to the use of standardized contracts, which may apply to an entire class of consumers or laborers and may even be spread across an entire industry.<sup>733</sup>

Two important pieces of legislation need to be identified as central to the development of the Supreme Court of the United States (SCOTUS) approach to antitrust and arbitration, The Federal Arbitration Act (FAA) and the Sherman Antitrust Act (Sherman Act). Under the FAA, passed in 1925, "[a] written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to

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<sup>732</sup> The only similar article the author has found is one that directly addresses the use of conspiracies to arbitrate by LESLIE; however, LESLIE neglects to address several potential objectives of conspiracies to arbitrate. Specifically, LESLIE does not address conspiracies to arbitrate tort claims identified here. See: LESLIE 2017. In this article, LESLIE identifies primary and secondary conspiracies to arbitrate.

<sup>733</sup> In the US, contracts to arbitrate can be embedded within much larger consumer, service, medical, or employment contracts, and parties only need to agree to a single contract for the arbitration clause to be valid. In the EU, contracts to arbitrate consumer, sales, and service contracts are limited compared with the US. According to ORTOLANI et al., "The fairness of consumer arbitration clauses within European Union Member States is controlled by domestic legislation that derives from each State's implementation of the Unfair Terms Directive (Directive 93/13/EC)." Furthermore, "European legal systems usually take into consideration the concerns expressed by the Court of Justice of the European Union as to the conscionable choice of consumers to submit to arbitration and thus set forth some special provisions in this regard. Two approaches are mainly followed: the first possible solution is to prevent consumer arbitration agreements in the form of arbitration clauses. In jurisdictions falling under this model, consumers cannot submit to arbitration before a dispute has arisen: as a result, arbitration clauses included in consumer contracts are null and void. . . . In other legal systems, consumers are free to conclude an arbitration agreement before the dispute has arisen, but the arbitration clause is deemed abusive unless it has been individually negotiated and subscribed. In other words, the arbitration agreement is valid only where it has been subscribed separately from the rest of the contract it is attached to, thus demonstrating a specific will to submit to arbitration. The rationale of these provisions is to separate the consent to the main contract from the consent to arbitration, thus ensuring that consumers are not forced to waive their right to access State courts in order to conclude the main contract." ORTOLANI et al. 2015, p. 207, p. 53. For a comparison of US and EU consumer arbitration, see: DRAHOZAL and FRIEL 2002. MANIA has also made a comparison of US and EU online arbitration contracts. MANIA 2019.

submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>734</sup> The scope of the FAA has steadily expanded under a series of rulings from the SCOTUS, which have found that the FAA preempts state law.<sup>735</sup> The preemption of the FAA over state laws has, arguably, enabled firms to protect otherwise impermissible contract terms through the inclusion of arbitration clauses. The Sherman Act, enacted in 1890, provides both civil and criminal penalties for “[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations”.<sup>736</sup> Each piece of legislation has been the subject of numerous judicial interpretations, and each has been amended over the years.<sup>737</sup>

It may be helpful to look at two examples of legal cases involving allegations of conspiracies to arbitrate from the US to help understand what collusions to arbitrate might look like and how US courts have addressed this specific type of collusive behavior over time. Two cases, the 1930 SCOTUS case, *Paramount Famous Lasky Corp. v. US. (Lasky)* and the 2003 Case from the Federal District Court D, of Kansas, *In re: Universal Service Fund Telephone Billing Practices Litigation (Universal Service Fund)*, highlight the interaction between the use of arbitration and its potential to be anticompetitive and how US courts have treated this interaction between arbitration and antitrust law.<sup>738</sup> While the underlying claims in each case were not necessarily in tort, the cases

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<sup>734</sup> FAA §2.

<sup>735</sup> See: SZALAI 2016.

<sup>736</sup> SHERMAN ANTITRUST ACT § 1.

<sup>737</sup> See: SZALAI 2016.

<sup>738</sup> LESLIE identifies these two cases to highlight the changing approach of courts in examining allegations of conspiracies to arbitrate. *Paramount Famous Lasky Corp. v. US.* (1930), and *In re: Universal Service Fund Telephone Billing Practices Litigation*, (2003). The *Universal Service Fund* litigation encompassed numerous cases.

are still useful to consider when examining conspiracies to use arbitration for tort claims because they demonstrate the motives and methods such a conspiracy would use.

The 1930 *Lasky* case involved a conspiracy among film producers and distributors to mandate arbitration on film exhibitors in a “block booking” scheme using standardized arbitration clauses, apparently as part of a larger scheme to vertically integrate the film industry.<sup>739</sup> According to the SCOTUS ruling in *Lasky*, “the arrangements existing between the parties cannot be classed among ‘those normal and usual agreements in aid of trade or commerce’.”<sup>740</sup> This case can be considered a classic example of how the SCOTUS once applied a *per se* rule to the use of conspiracies to use arbitration.<sup>741</sup> According to LESLIE, “[i]n condemning” the arbitration clause in “the standardized contracts, the Supreme Court in *Lasky* appeared to hold that conspiracies to arbitrate are *per se* illegal.”<sup>742</sup> Furthermore, “the court both conceded and rejected the possibility that the conspiracy to arbitrate improved the efficiency of the motion picture industry” and dismissed any “good motives” which the film industry brought before the court.<sup>743</sup> Even though the court found that “[i]t may be that arbitration is well adapted to the needs of the motion picture industry”, the court also found that “when under the guise of arbitration parties enter into unusual arrangements which unreasonably suppress normal competition, their action becomes illegal” under the Sherman Act.<sup>744</sup> The SCOTUS further found that “[i]n order to establish violation of the Sherman Anti-Trust Act, it is not necessary to show that the challenged arrangement suppresses all competition

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<sup>739</sup> *Paramount Famous Corp. v. US*, (1930). According to GIL, “The sentence was never enforced due to the Great Depression and in 1933 the distributors looked for protection under the National Industry Recovery Act. The government nullified the decree and suspended the antitrust case. As a result, the studios and distributors were allowed to remain vertically integrated and to use temporarily block booking while they recovered financially from the Great Depression.” GIL 2010, p. 173.

<sup>740</sup> *Paramount Famous Corp. v. US*, (1930), p. 43, Quoting to *Eastern States Lumber Ass’n v. US*.

<sup>741</sup> LESLIE 2017, p. 402.

<sup>742</sup> LESLIE 2017, p. 402.

<sup>743</sup> LESLIE 2017, p. 403.

<sup>744</sup> *Paramount Famous Corp. v. US*, (1930), p. 43.

between the parties or that the parties themselves are disconnected with the arrangement”.<sup>745</sup> However, the film studios continued to take steps to keep the production and distribution of film vertically integrated until a court mandated divestiture in 1948.<sup>746</sup> The issue of conspiracies to arbitrate “essentially went dormant for several decades” following the *Lasky* case.<sup>747</sup>

More than seven decades after the *Lasky* case, the issue of conspiracies to arbitrate was looked at by the US District Court of Kansas in the *Universal Service Fund* case concerning an alleged conspiracy between telephone operators AT&T and Sprint “to raise, fix, or maintain the charge they asses their long distance customers” under a “Universal Service Fund” and “to implement similar dispute resolution clauses requiring their customers arbitrate all disputes”.<sup>748</sup> The plaintiffs alleged the phone companies “violated Section 1 of the Sherman Act, 15 U.S.C. §1, by colluding to implement similar arbitration clauses to shield themselves from liability and to eliminate potential competition among themselves with respect to the imposition of those agreements”.<sup>749</sup> The court took into account years of precedent since *Lasky*, which represented a significant change in judicial acceptance of arbitration clauses in consumer contracts. While the case came out of a district court, it highlights how the federal courts' attitude toward the FAA shifted from a *per se* approach in *Lasky* toward a position that “[t]he FAA requires that courts enforce arbitration clauses in contracts the same way they would enforce any other contractual clause” as part of the effort to “achieve the policy goal of eliminating prior hostility to arbitration” from the judiciary.<sup>750</sup> The expansion of the FAA to cover all types of contracts occurred over a series of SCOTUS rulings.

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<sup>745</sup> *Paramount Famous Corp. v. US*, (1930), p. 44.

<sup>746</sup> See: GIL 2010.

<sup>747</sup> LESLIE 2017, p. 405.

<sup>748</sup> *In re: Universal Service Fund Telephone Billing Practices Litigation.*, (2003), p. 1, p. 2.

<sup>749</sup> *In re: Universal Service Fund Telephone Billing Practices Litigation.*, (2003), p. 1, p. 2.

<sup>750</sup> *In re: Universal Service Fund Telephone Billing Practices Litigation.*, (2003), p. 2, p. 3. FAA.

The district court in the *Universal Service Fund* claim did “not believe that the arbitration clauses in question... are intrinsically illegal on the face such that enforcement of the clauses would make this court party to the precise conduct forbidden by the Sherman Act” and that even if “an anti-competitive conspiracy existed” which gave rise to damages, “[i]nvalidating the arbitration clauses...is not an appropriate remedy because the terms of the arbitration clauses are not themselves anti-competitive”.<sup>751</sup> The court noted how the case was different from the *Lasky* case in several respects, including that the state pursued *Lasky*, arbitration was viewed "less favorably" at the time, and the terms of the arbitration clause being used were, according to the court, "significantly...distinct" from *Lasky* on their face.<sup>752</sup> Importantly, this comparison demonstrates the tension between contract and antitrust law and shows how the district court was unwilling to use the *per se* approach from *Lasky* and was deferential to the use of arbitration under the preemption of the FAA.<sup>753</sup>

The different treatments of conspiracies to use arbitration in the *Paramount Famous Corp. v. US* and *In re: Universal Service Fund Telephone Billing Practices Litigation* cases reflect what LESLIE describes as a "reimagining" of the FAA by the SCOTUS.<sup>754</sup> SZALAI comments

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<sup>751</sup> *In re: Universal Service Fund Telephone Billing Practices Litigation.*, (2003), p. 3, 6.

<sup>752</sup> *In re: Universal Service Fund Telephone Billing Practices Litigation.*, (2003), p. 6.

<sup>753</sup> LESLIE also points to a similar case involving conspiracies to mandate arbitration in consumer credit card contracts, *Ross v. Citigroup, Inc.* (2015), as an example of a recent case which also refused to extend the *per se* approach. However, the court in *Ross* did not consider *Lasky* (*Paramount Famous Corp. v. US*, (1930)) in its analysis of the FAA. See: LESLIE 2017. Pp. 441-451.

<sup>754</sup> This change in attitude by the court has been criticized for being an overreaching interpretation of the FAA. LESLIE opines that “courts have misapplied arbitration law in ways that make conspiracies to arbitrate profitable and perhaps inevitable in some markets. Prior to the Supreme Court’s pro arbitration decisions, firms had little reason to conspire to impose arbitration clauses on their consumers. Now, relying on the false premise that Congress created a federal policy favoring arbitration, federal courts have employed seemingly neutral doctrines in ways that actively enforce conspiracies to arbitrate.” According to LESLIE, “In the 1980s, the Supreme Court reimagined a different legislative intent behind the FAA, which the Court claimed had created an “emphatic federal policy in favor of arbitral dispute resolution,” pursuant to which “questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration.” LESLIE 2017, p. 386, 390. Citing to *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, (1985) and *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, (1983).

extensively on how the SCOTUS has “erroneously interpreted” the FAA.<sup>755</sup> SZALAI traces the expansion of the FAA to a “manufactured” ruling that the FAA was applicable to state courts under the *Southland Corp. v. Keating* case.<sup>756</sup> One recognizable result of these changing attitudes toward the FAA from the federal judiciary is that the use of mandatory arbitration clauses in standard form contracts in the US has grown rapidly over the past three decades.<sup>757</sup> Notwithstanding questions concerning the legitimacy of the SCOTUS’s reasoning in the *Southland* case, it is clear that the change in interpretation of the FAA has implications for conspiracies to mandate arbitration.

### 3. Contracts to Arbitrate and the Goals of Law.

\*\*\*This topic was also discussed in Chapter 1 section 5, and chapter 3, sections 4 concerning the goals of contract law.\*\*\*

A contract to arbitrate tort claims is likely to be agreed upon *ex ante*, before harm has occurred.<sup>758</sup> These *ex ante* contracts are particularly relevant to conspiracies to arbitrate tort claims since an *ex post* contract to arbitrate does not have any impact on incentives to take care.<sup>759</sup> In the US, a

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<sup>755</sup> According to SZALAI, “the Supreme Court has grossly erred in interpreting the statute. The history of the FAA’s enactment helps demonstrate that the FAA was originally intended to provide a framework for federal courts to support a limited, modest system of private dispute resolution for commercial disputes, not the expansive system that exists today involving both state and federal courts and covering virtually all types of non-criminal disputes. When one examines the FAA through the lens of history, the Supreme Court’s modest, expansive view of the FAA collapses. As former Justice Sandra Day O’Connor lamented, “the [Supreme] Court has abandoned all pretense of ascertaining congressional intent with respect to the [FAA], building instead, case by case, an edifice of its own creation.” The Supreme Court, through erroneous interpretations of the FAA, has created an expansive, relatively unsupervised system of dispute resolution touching almost every aspect of American life. Current and former Justices have admitted that the Court’s flawed interpretations of the FAA are overly expansive and are causing ongoing constitutional problems. Yet, the Supreme Court has continued to expand its erroneous interpretations of the FAA.” SZALAI 2016. P. 117-118. Quoting *Allied-Bruce Terminix Cos. V. Dobson*, (1995). (O’Connor, J., concurring).

<sup>756</sup> SZALAI further finds that “in *Southland Corp. v. Keating*, the Supreme Court unequivocally held that the FAA is a “substantive rule applicable in state as well as federal courts.” The *Southland* Court found, in connection with a state court proceeding, that the FAA preempted a state law banning the arbitration of franchise disputes. The *Southland* ruling relied on a manufactured “federal policy favoring arbitration” to hold that the FAA “withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.” SZALAI 2016. P. 118. Citing to *Southland Corp. v. Keating*, (1984).

<sup>757</sup> See: SZALAI 2018.

<sup>758</sup> SHAVELL discusses how only *ex ante* contracts to arbitrate have the potential to influence the incentive to take due care, as *ex post* contracts to arbitrate will have no impact on the accident occurring or not, only on where the costs of the harm will fall. See: SHAVELL 2004, pp. 447-448

<sup>759</sup> SHAVELL 2004, pp. 447-448.

contract to arbitrate is generally embedded within a sales, service, medical treatment, or employment contract, which covers all claims arising from the contractual relationship. In the EU, the use of arbitration for tort claims arising from consumer contracts may be limited by either being forbidden or through formation requirements which demand a separate contract to arbitrate be signed simultaneously with the underlying contract, and many EU member states have further limited the applicability of arbitration clauses to certain claims, some of which are tort claims.<sup>760</sup> Contracts to arbitrate tort claims involve different areas of law. The claims considered here are torts claims, which emanate from underlying contracts between a firm and multiple parties, when the firm's rivals have also agreed, either explicitly or tacitly, to standardize and use *ex ante* arbitration clauses in their contracts. In this sense, we need to consider the goals of not only tort law but also contract law, competition law, and the judiciary's role in creating public goods related to these underlying goals.

Under the traditional law and economics methodological framework, which focuses on efficiency, the goal of law should be to maximize societal welfare by having efficient laws in place.<sup>761</sup> The law, tort, contract, competition, and the structure of judicial systems seek to further this goal through sometimes complementary and sometimes contradicting methods. In general, rule makers need to consider how there may be unintended consequences from implementing laws which may create externalities.<sup>762</sup> These externalities may affect jurisdictions from within a state and may also cross borders. Additional solutions for negative externalities emanating from these unintended

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<sup>760</sup> For a discussion of arbitration in consumer contracts in the EU, see: ORTOLANI et al. 2015.

<sup>761</sup> According to PARISI, “much research in law and economics is concerned with either determining whether a law (or set of laws) is efficient or, alternatively, with designing laws that effect efficient results. In such cases, “efficiency” denotes maximal social welfare.” PARISI 2013. P. 319.

<sup>762</sup> German economist SIEBERT coined the term “cobra effect” to describe how laws may produce unintended consequences, such as when a British law in colonial India designed to eradicate cobras had the unintended consequence of increasing the cobra population. See: SIEBERT 2001.

consequences may be necessary.<sup>763</sup> Rule makers must also consider the problems or market failures the rules they produce address and the potential for spillover effects on rules designed to address related market failures found in other areas of law. The compartmentalization of the law into separate issues may only be useful to a certain extent, beyond which a holistic view is best used to promote efficiency. Within the EU there has been criticism that the numerous goals set out in EU community law may at times lead to conflicts with each other, for instance, the goals of harmonization within the EU market and goals of ensuring that member states have the competency to individually enforce EU law under the principle of subsidiarity. According to VAN DEN BERGH, "economic analysis is very helpful in illuminating why the harmonisation process has stalled: divergent preferences as to the goals to be achieved seem to constitute the major cause of this delay".<sup>764</sup> This implies that legal rules are best, i.e., more efficient, when they complement each other rather than when they compete with each other, or as VAN DEN BERGH describes in his critique of federalism in the EU, rules may need to be designed with a "smart mix" or centralized and decentralized characteristics or implementation schemes.<sup>765</sup>

### 3.1 Tort Law and Limiting the Costs of Accidents.

*\*\*\*This topic was also discussed in Chapter 3, section 3 concerning the goals of tort law. \*\*\**

According to the law and economics view, tort law should be designed to minimize the primary, secondary, and tertiary costs of accidents.<sup>766</sup> We can also think of minimizing the costs of accidents

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<sup>763</sup> According to R. KEETON, a "legal system, to remain viable over a span of time, must have the flexibility to admit change. To find solutions for a succession of differing problems in a continuously changing context, it must be creative. On the other hand, a group of institutions and their methods of operation cannot constitute a system in the absence of strong elements of stability and predictability. Creativity must build upon a solid foundation of continuity. Modern developments in tort law present acutely the problems of accommodation of these competing demands for change and stability." R. KEETON 1962, p. 463.

<sup>764</sup> VAN DEN BERGH 2000, p. 451.

<sup>765</sup> See: VAN DEN BERGH 2016.

<sup>766</sup> CALABRESI 2008.

in terms of maximizing the benefits of tort law to some extent. When considering the potential costs of accidents, the standard law and economics theory points to the Hand formula, or more specifically, the marginal Hand formula, where the marginal benefits of care equal the marginal costs of care, which results in the minimization of the costs of accidents, and the taking of less than this amount of care is indicative of a breach of a duty to take care.<sup>767</sup> When considering bilateral accidents in which both victims and injurers can take precautions, SHAVELL comments that "[t]he optimal levels of care of injurers and of victims will reflect their joint possibilities for reducing accident risks and their costs of care".<sup>768</sup> Although many legal scholars also find that there is a corrective justice rationale for tort law, this can be explained as part of the deterrence function of tort law, in that being held liable for the harm one causes is a deterrent.<sup>769</sup> According to FAURE and WEBER, "[f]rom a law and economics perspective tort law is to serve two important functions: deterrence of wrongdoers and victim compensation".<sup>770</sup> Because there are both benefits and costs of using the law to determine due care, there is a need to weigh the costs and benefits of using either arbitration or courts to adjudicate tort claims with consideration of the

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<sup>767</sup> See: *United States v. Carroll Towing Co.*, (1947) and BROWN 1973.

<sup>768</sup> SHAVELL 2004, p. 182.

<sup>769</sup> According to THORNBURG, "Modern tort law performs multiple functions, and it has achieved its current balance through centuries of development. These functions include achieving corrective justice in individual cases, promoting optimal deterrence for would-be tortfeasors and narrating the values of society at large. All three, as well as the courts' ability to shape their relative importance to fit an evolving culture, could be threatened by mandatory arbitration of personal injury claims." THORNBURG 2004, p. 270. From a law and economics perspective, deterrence may occur through the tort liability system. According to COOTER AND ULEN "tort law often aims to internalize costs, such as the risk of accidents. Once costs are internalized, actors are free to do as they please, provided that they pay the price. Internalization, however, is not the proper goal when perfect compensation is impossible in principle or in practice, or when people want law to protect their rights instead of their interests, or when enforcement errors systematically undermine liability. In these circumstances, law's proper goal is deterrence. When deterrence is the goal, actors are not free to pay the price and do as they please. Instead, punishments are calibrated to deter those actors who prefer to do the act in spite of its price." COOTER AND ULEN 2016, p. 462.

<sup>770</sup> FAURE and WEBER 2015, p. 163. FAURE and WEBER identify potential legal procedures in court and private solutions outside of court, which seek to solve the problem of scattered losses, including expense insurance, legal aid, transferring of claims to third parties, third party funding, contingency or conditional fees for lawyers, ADR, class actions, representative actions, punitive damages, administrative legal enforcement, and criminal sanctions, with each solution involving a unique set of costs and benefits. FAURE and WEBER 2015 throughout.

claims' impact on due care standards. An efficient liability rule creates the right incentives for potential injurers and victims to take care.<sup>771</sup>

The use of a private arbitration tribunal to adjudicate tort claims can have the immediate effect of lowering the tertiary costs the public incurs from adjudicating tort claims, in that public subsidies are not used or are decreased to provide the administrative needs of adjudicating a particular tort claim in arbitration as they become private tertiary costs. However, the use of arbitration for tort claims is not costless to states. Domestic arbitration tribunals often rely on the state's laws to adjudicate tort claims. States spend resources to develop and enforce laws, but at the same time, courts require an input of disputes in order to develop undeveloped areas of law, particularly concerning technological advances. Arbitration tribunals rely on courts to enforce arbitral awards; thus, states still incur costs by enforcing arbitral awards. Beyond arbitration resulting in the shifting of tertiary costs from public to private, there is a need to consider all the costs of accidents.<sup>772</sup>

There are not only costs of accidents but also benefits. Accidents may result in harm, but knowledge of accidents helps society to identify where private actors create negative externalities and knowledge of methods to avoid known risks.<sup>773</sup> Accidents may inspire the development of

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<sup>771</sup> While much of this discussion is focused on unilateral accidents, there are also implications from the use of arbitration for bilateral accidents as well. Tort claims related to an accident may include several claims related to a single underlying accident depending on the claims available in the specific jurisdiction. These may include strict liability, strict liability with the defense of contributory negligence, and negligence. It is not uncommon for numerous theories of liability to be claimed. With a strict liability rule, there may be the potential for courts to create public goods related to a due care standard if there is an option for the defense of contributory negligence when there is a bilateral accident being considered. If repeat player firms do use arbitration in their underlying contracts and there is a strict liability rule with a defense of contributory negligence, then firms have the incentive to seek an adjustment of victim care standards when they are inefficiently low, as an inefficiently low victim's due care standard will lead to increased liability for the firm. This incentive may lead to the waiver of arbitration by firms seeking to adjust the victims' due care standards for a rule of strict liability with a contributory negligence defense. For a discussion on the comparison of strict liability and negligence rules and the impact a rule has on incentives to take care, see: SHAVELL 1980, and COOTER and ULEN 2016.

<sup>772</sup> See: CALABRESI 2008.

<sup>773</sup> According to SHAVELL, customers' knowledge of the risk associated with the products they buy is imperfect, and if "customers do not have enough information to determine product risks at the level of individual firms... [t]hen firms will not take care in the absence of liability." SHAVELL 2004, p. 214.

safer and more cost-effective production methods, technologies, and safety precautions.<sup>774</sup> Disputes concerning accidents may lead to the development of new laws and regulations designed to limit the costs of future similar accidents. State courts produce public goods from litigation concerning accidents in order to lower the cost of future accidents. A known and efficient due care standard which is consistently enforced should provide the right incentives for parties to take due care. In this way, the law also looks to decrease future accident costs by prescribing a known and public standard. An efficient due care standard should also consider the foreseeable future accident cost avoidance associated with rulemaking and the possible effects it may have on subsequent legal doctrine.<sup>775</sup> Judge made law may be prospective in that it is not only considering the case at hand but other potential cases with a similar nexus of facts in the future.<sup>776</sup> By having more certainty in due care standards, parties are enabled to make more efficient decisions about their behavior, given the expectation of how a court will review a due care standard. By opening up the possibility of liability for taking less than due care, tort law also serves as a source of continued deterrence to potential tortfeasors through private legal actions rather than state intervention.<sup>777</sup> Limiting the costs of accidents is thus not merely an exercise of limiting the cost of accidents now but also the

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<sup>774</sup> DARI-MATTIACCI and FRANZONI considered "how due-care standards should be conditioned on the technology adopted by the parties in order to improve adoption decisions", arguing that "standards should be biased upwards or downwards, depending on whether the new technology reduces or increases expected harm." DARI-MATTIACCI and FRANZONI 2014, p. 333.

<sup>775</sup> When examining the relative advantages and disadvantages of legal change, KEETON found that when considering the "magnitude of the change", it "may be viewed not only in terms of the immediate impact of the proposed change upon particular decisions and thus upon future legal relations, but also in terms of its relation to the larger doctrinal context, its consistency with major currents of doctrine, and its potential impact upon future doctrinal developments." KEETON 1962, p. 476.

According to POSNER, "Precedent projects a judge's influence more effectively than a decision that will have no effect in guiding future behavior" POSNER 2014. p. 745. It may be argued that the SCOTUS has discounted these future effects when expanding the scope of the FAA.

<sup>776</sup> KEETON 1962, p. 476.

<sup>777</sup> According to POSNER, "[m]aintaining the credibility of the tort system requires that a defendant who is found liable must pay damages at least as great as L in the Hand Formula...for otherwise the victim will have no incentive to sue, and that incentive is essential to the maintenance of the tort system as an effective credible deterrent to negligence." POSNER 2014, p. 223.

costs of accidents in the future. The benefits of judicial review of tort claims must also be taken into account when considering the costs of administering courts, which includes the impact judicial review has on the primary and secondary costs of torts.

Maximizing the expected benefits of public good creation from courts may promote the mitigation of accident costs. In other words, if courts are efficient at setting due care standards, then the primary and secondary costs of accidents should decrease. If an increase in tertiary costs related to the courts' production of public goods is more than offset by lower primary and secondary costs, then the increased tertiary costs can be viewed as having the effect of tending to minimize the costs of torts and thus can be considered as welfare maximizing. We can consider the production of public goods from litigation the same way we think about care. Here we can think of tertiary costs as "care costs" which the state can undertake and primary and secondary costs as "externalities" which fall on different parties. The public goods from litigation should be produced at the efficient level, where the marginal benefits of having an efficient rule in place are equal to the marginal costs of developing the efficient rule. This may mean that some rule production is inefficient, given the cost of producing the rule and the benefits resulting from the rule.

If state courts lack the necessary input of disputes which allow the opportunity for the judiciary to set efficient due care standards, then state courts are incapable of setting efficient due care standards given a changing world. If state courts only see selected types of cases because of the strategic shielding of claims from review in court, then there is also an increased possibility that due care standards are inefficient or that efficient due care standards become inefficient more quickly over time as the world changes. In a sense, due care standards may become "stale" and

should be replaced when, due to changed circumstances, the existing standard becomes inefficient for present-day claims.<sup>778</sup>

### 3.2 Contract Law, Certainty, and Contracts to Arbitrate.

*\*\*\*This topic was discussed in Chapter 1 section 3 and Chapter 3, section 4.1 concerning the goals of contract law.\*\*\**

Contract law should increase certainty in entering into agreements. Parties can rely on the promises made in a contract, and in relying on these promises, they can seek to maximize their welfare. According to POSNER, "the basic aim of contract law (as recognized since Hobbes day) is, by deterring people from behaving opportunistically toward their contracting parties, to encourage the optimal timing of economic activity and (the same point) obviate costly self-protective measures".<sup>779</sup> According to SCHWARTZ and SCOTT, "efficiency is the only institutionally feasible and normatively attractive goal for a contract law that regulates deals between firms."<sup>780</sup> SHAVELL identifies how contracts should not be enforced under some circumstances due to the existence of externalities.<sup>781</sup> A standard economic rationale for enforcing contracts is that it promotes efficiency by providing parties with more certainty when they make promises.<sup>782</sup>

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<sup>778</sup> For a discussion about the relevance of precedent, see LANDES and POSNER 1976.

<sup>779</sup> POSNER 2014, p. 97. Additionally, POSNER identifies how "contract law has five distinct economic functions: (1) to prevent opportunism, (2) to interpolate efficient terms either on a wholesale or a retail basis (gap filling versus ad hoc interpretation), (3) to punish avoidable mistakes in the contracting process, (4) to allocate risk to the superior risk bearer, and (5) to reduce the cost of resolving contract disputes." POSNER 2014, p. 102. Referencing HOBBS 1651.

<sup>780</sup> SCHWARTZ and SCOTT 2003, p. 546.

<sup>781</sup> SHAVELL comments, "A basic rationale for legislative or judicial overriding of contracts is the existence of harmful externalities. Contracts that are likely to harm third parties are often not enforced, for example, agreements to commit crimes, price-fixing compacts, liability insurance policies against fines, and sales contracts for certain goods (such as for machine guns). In such cases, the harm to third parties must tend to exceed the benefits of a contract to the parties themselves for it to be socially desirable not to enforce a contract." SHAVELL 2004, p. 320.

<sup>782</sup> According to SCHWARTZ, "the state should enforce promises in two cases: (1) when enforcement encourages parties to make investments whose value is highest in the particular relationship at issue; and (2) when enforcement permits parties to allocate the risk of changing economic circumstances." Additionally, "the state should supply parties with efficient rules to flesh out incomplete contracts. An efficient rule either maximizes the parties' joint gains under the contract or encourages the better informed party to reveal information that facilitates the maximization of joint gains." SCHWARTZ 2003, p. 142.

Contracts to use arbitration in the case of disputes between the contracting parties can provide benefits to the parties, and the goals of laws concerning arbitration should be considered as a subcategory of the goals of contract law.<sup>783</sup> However, arbitration may also allow RPs to act strategically in order to avoid judicial oversight, care costs, and liability.<sup>784</sup> It is often argued that arbitration allows parties to choose experts in the dispute, saves time from waiting for a long court cue, is “less adversarial”, is private and confidential, the parties can choose the substantive law which will govern the contract, and it may “denationalize” a dispute when parties are contracting across international borders.<sup>785</sup> Important differences between international commercial arbitration and purely domestic arbitration impact these benefits. There is no benefit from denationalizing a claim or facilitating the collection of a foreign award in domestic disputes. In the ideal situation, the benefits from the use of arbitration can be realized, yet there remains the possibility these benefits are, in fact, costly, or these perceived benefits create additional opportunities for a RP involved in disputes to behave strategically.

A contract to use arbitration for tort claims can be seen as a part of the bundle of rights the contract signer holds, including a right to a remedy upon the good or service causing some harm to the user or purchaser for which a remedy is only available in tort.<sup>786</sup> The right to arbitrate in a contract may be a sort of transitory stick which may be beneficial in some instances and may be costly in

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<sup>783</sup> HYLTON has argued that notwithstanding “substantial harm” to uninformed parties resulting from agreements to arbitrate, “ordinary contract law should suffice” in interpreting arbitration contracts. HYLTON 2000, p. 252.

<sup>784</sup> According to CHE and YI, “[f]or a repeat player... going to trial means not only facing a particular court decision, but also setting a good or bad precedent for future cases”, and by “[r]ecognizing this, the players will alter their strategies in pretrial bargaining, based on their expectation of the precedent.” CHE and YI 1993, p. 400. The repeat player advantage in litigation is also present in arbitration, although, in arbitration, it is potentially less restrained. It can be argued that firms using arbitration for tort claims agreed upon *ex ante* take into account long periods of time in which they may face claims and will alter their strategies in pre accident bargaining as well. This means that the nuances of arbitration contribute to the repeat player advantage.

<sup>785</sup> VAN AAKEN and BROUDE 2016, pp. 7-8. There is no issue of “denationalization” for the domestic tort claims considered here.

<sup>786</sup> See: OSTROM 2008.

others.<sup>787</sup> Disavowing the right to use the public judiciary to adjudicate tort claims or any dispute has value and thus a price. The collusive use of mandatory arbitration in consumer, service, medical, and employment contracts may be a form of indirect price fixing. Contracts to arbitrate result in the stick representing the right to use courts to adjudicate potential claims being removed from the bundle and replaced with a stick representing the right to use arbitration in the courts' place as adjudicator. If, for instance, the use of arbitration was value creating, then an arbitration agreement adds a more valuable stick to the bundle of rights than the one it replaced. The instance in which arbitration would be value creating in the context of tort claims is likely limited to circumstances where using arbitration lowers transaction costs from bringing a claim in arbitration when compared to litigation and leads to an increase of claims from plaintiffs because the change in claim related transaction costs moves individual claims from being negative in value to being positive in value.<sup>788</sup> This may lead to a decrease in enforcement errors if arbitration produces accurate results, which makes the underlying contract more valuable. Over time the increased value of the contract should be reflected by a higher price for the good or service, which takes into account the increased value. The possibility of liability under a right to remedy is analogous to an insurance policy included in the contract over a good or service.<sup>789</sup> The price of this "insurance

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<sup>787</sup> It may be useful to think of an analogy found in computer software markets, where firms have often bundled different products into a software package which are then sold as a whole to consumers. While the software package represents the whole right purchased, each of the individual pieces of software represents an individual product which was purchased.

<sup>788</sup> According to HYLTON, "in many settings one potential defendant (e.g., employer) will enter into arbitration agreements with several potential plaintiffs (e.g., employees). In these cases, overall deterrence benefits are often linked with litigation costs in that the plaintiff's litigation cost has the effect of barring claims where the expected judgment falls below the cost of litigation. If arbitration reduces this bar by lowering litigation costs then it will lead to an increase in the number of victims who will litigate their claims, which in turn enhances the potential defendant's incentive to take care. Put another way, in many settings arbitration will increase deterrence benefits *because* it reduces litigation costs." HYLTON 2000, p. 229.

<sup>789</sup> According to EPSTEIN, "the existence of the *direct* contract between the parties allows the warranty provisions to exhibit all the complex characteristics found in pure insurance contracts." Furthermore, "[t]he current doctrines of products liability law can be understood as a form of mandatory insurance that is tied to the sale of" goods, such as "an automobile". EPSTEIN 1985, p. 656, 668.

policy" should be reflected in the underlying contract price. Contracting over rights that have value, such as a dispute resolution process, may be welfare enhancing if parties are well informed and have equal bargaining power.<sup>790</sup>

In any specific context, it should be considered whether the stick representing the right to use arbitration is more valuable for one party than the other or, conversely, more costly. If arbitration does not lead to an increased number of legitimate claims being filed, then the lower associated transaction costs from bringing the claim are insufficient to make negative value claims worth pursuing. If firms know the use of contracts to arbitrate will, in a certain context, tend not to reduce the transaction costs of filing a claim or only slightly reduce them, then firms can shirk from taking efficient care so long as the inefficiently low care taken does not result in claims the firms face becoming positive in value given the transaction costs of pursuing a claim.<sup>791</sup>

The SCOTUS has found that the goal of the FAA is to put arbitration on equal footing with other contract terms.<sup>792</sup> In the EU and individual EU member states, contracts to arbitrate are often treated differently than other contracts, especially when the contract is not international, involves no choice of law issues, and involves the sale of goods or services to consumers.<sup>793</sup>

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<sup>790</sup> See SCHWARTZ 2003, about efficiency in contracting.

<sup>791</sup> See the chapter "Marching Without Memory" for a detailed analysis of how transaction costs influence the strategic behavior of repeat player firms in arbitration.

<sup>792</sup> See: SZALAI 2016.

<sup>793</sup> EU limits on arbitration in consumer contracts can be found in the Unfair Terms in Consumer Contracts Directive. Included in the Directive is a list of terms which are prohibited, including "excluding or hindering the consumer's right to take legal action or exercise any other legal remedy, particularly by requiring the consumer to take disputes exclusively to arbitration not covered by legal provisions, unduly restricting the evidence available to him or imposing on him a burden of proof which, according to the applicable law, should lie with another party to the contract." Unfair Terms in Consumer Contracts Directive. Article 3. 1.(q). Additionally, although all EU member states are party to the New York Convention on the enforcement of foreign arbitration awards, European community law is broadly applied within the EU borders and essentially limits the application of the NEW YORK CONVENTION to consumer contracts in practice. NEW YORK CONVENTION. See the introductory chapter for a discussion on international legal norms for the use of arbitration.

The unilateral choice to use arbitration by industry should be considered detrimental to public welfare if it enables firms to take advantage of the difference between the public and private legal systems in a way which is “socially undesirable”.<sup>794</sup> The possibility that contracts to arbitrate tort claims will be welfare reducing is more likely to occur if consumers are uninformed, such as when there is a high degree of information asymmetry between parties. According to HYLTON, “one of the biggest criticism of arbitration is that firms that are repeat-players take advantage of inexperienced...one shot players” who have an “informational deficit” in that they have either “incomplete or asymmetric information” or that there is the presence of “misperception or misinformation”.<sup>795</sup> This implies that “if the parties are informed, they will enter into waiver agreements when and only when the option to litigate reduces wealth”, such “as when the deterrence benefits provided by the threat of litigation are less than expected litigation costs” and they should “enter into arbitration agreements when and only when the margin between deterrence benefits and dispute resolution costs is larger under the arbitration regime”.<sup>796</sup> It may also be that parties are uninformed because of rational apathy, especially when parties already have little to no

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<sup>794</sup> According to SHAVELL, “We can first dispense with the possibility that unilateral choice of a private legal system by a party to a dispute would tend to be socially desirable. It would not, for the party would select a system that favored him, reducing or eliminating the capacity of the law to channel behavior or to remedy loss desirably. For example, a rule of tort law requiring injurers to pay for harm, which could be beneficial due to the incentives it provides to take care, would be robbed of force if defendants could select their own legal system. They would choose a different rule that allowed them to escape responsibility, or if they were permitted only to elect the method of adjudication, they would select a tribunal that watered down the ability of plaintiffs to collect. Converse problems, involving excessive liability, would arise if plaintiffs could unilaterally choose liability rules or methods of adjudication. It is plain, therefore, that permitting unilateral modification of the public system of law is socially undesirable.” SHAVELL 2009, p. 446.

<sup>795</sup> HYLTON 2000, p. 250, 251. Additionally, HYLTON finds that “the implications for the informational asymmetry problem are not as serious as legal commentators suggest because the uninformed party enters into a pre-dispute arbitration contract only when the expected value of the deal is positive” and “informational asymmetry, standing alone, does not present a compelling case for a general policy of non-enforcement, or for applying selective non-enforcement rules that differ from those already embodied in contract law”. Rather, “[t]o justify extraordinary regulation, there must be some evidence that the agreements that turn out bad ex post for the uninformed party cause substantial harm, and that the regulatory authority has sufficient information to target its corrective instruments to contracts that are ex post bad deals”. HYLTON further finds “that non-enforcement of pre-dispute agreements should be limited to instances in which potential claimants are unlikely to get information to correct their prior beliefs regarding the likelihood of harm.” HYLTON 2000, pp. 251-252, 254.

<sup>796</sup> HYLTON 2000, p. 263.

chance to enforce legal rights against the counterparty due to high transaction costs from bringing a claim.<sup>797</sup> A lack of salience over the terms of a contract may also contribute to a problem of inefficient contracting.<sup>798</sup>

Ideally, a mix of private and public legal systems will allow firms and individuals to best contract over how to resolve their disputes and maximize the gains from trade. If parties can mutually agree, *ex ante*, on the forum in which future disputes will be adjudicated and this *ex ante* contracting makes the parties better off, and no third parties are worse off, then the use of arbitration should be considered socially desirable.<sup>799</sup> The law should encourage beneficial types of contracts to arbitrate while limiting contracts to arbitrate which are welfare reducing. The difference in approaches to the use of arbitration between the US and EU highlights how different legal systems weigh the costs and benefits of using arbitration. Each approach has its own unique consequences for the enforcement of competition law relating to the collusive use of arbitration for tort claims.

### 3.3 Goals of Antitrust Law and Meaningful Competition in the Market.

The goals of competition law can be seen as complementary and in competition with the goals of tort law and contract law. In the US, the goal of competition law has been seen by the SCOTUS, at times, to prevent the harms from the "destruction of competition" in the free market.<sup>800</sup> The

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<sup>797</sup> For a discussion of rational apathy, see: DE GEEST 2015.

<sup>798</sup> For an analysis of the issue of signing without reading contracts, see: DE GEEST 2015.

<sup>799</sup> According to SHAVELL, "it will be socially desirable to allow modification of the public legal system in many circumstances where the decision is made by the parties who are affected by the legal system. An important example is where the parties to a contract stipulate that they want a private system to govern contractual problems that may arise. The reasons that allowing them to choose a private system is socially desirable are twofold. First, if each of the contracting parties agrees to the private system, it must make each of them better off. Second, no one else will be made worse off, presuming that the parties to the contract are the only people affected by it." SHAVELL 2009, pp. 446-447.

<sup>800</sup> The Sherman antitrust act "seeks to protect the public against evils commonly incident to the unreasonable destruction of competition". *Paramount Famous Corp. v. US.* (1930), p. 43.

Chicago School played a significant role in shaping the debate over the goals of competition law.<sup>801</sup> According to VAN DEN BERGH and CAMESASCA, "[s]cholars working in the Chicago School tradition have rejected the propriety of any other goals than allocative and productive efficiency for competition policy", and "this may explain why economic considerations in recent decades have played a more important role in the United States than in Europe".<sup>802</sup> The difference in goals across the Atlantic can be attributed to the uniqueness of the EU.<sup>803</sup> In Europe, "competition policy embraces a multitude of political goals", including "market integration...consumer welfare...freedom of action and fairness", which "must be understood in the context of the need to break down the national boundaries between member states and the Community".<sup>804</sup> The community goals of the EU are not completely in line with the goals of US law and vice versa. Because of this divergence, we should expect to see state action which is biased toward promoting community integration in the EU, while across the Atlantic, we should expect to see state action which promotes economic efficiency in the US. In so far as state action in the EU promotes economic efficiency, the goals of community integration may actually be seen as part of an effort to promote economic efficiency within the EU single market. VAN DEN BERGH has been skeptical of the overemphasis on market integration in the EU at the expense of economic efficiencies. According to VAN DEN BERGH, "when formulated as a goal in itself, the market integration argument too easily lends itself to excessive centralization, because it neglects the potential benefits of decentralization."<sup>805</sup>

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<sup>801</sup> According to PARISI, "one of the characteristics often attributed to the Chicago methodology is the use of economics as a tool of positive analysis." PARISI 2013, pp. 43-44.

<sup>802</sup> VAN DEN BERGH and CAMESASCA 2001, p. 1.

<sup>803</sup> For a comprehensive analysis of the functioning of the EU Government, see: NUGENT 2017.

<sup>804</sup> VAN DEN BERGH and CAMESASCA 2001, pp. 1-2.

<sup>805</sup> VAN DEN BERGH 2016, p. 947.

Because the public enforcement of competition law comes at a cost to society, regulatory agencies tasked with prosecuting anticompetitive behavior face budget constraints which limit their prosecutorial prerogative. Public enforcement of competition law is thus selective and targeted when public competition authorities face budget constraints, while private enforcement of competition law may be available for those individuals who suffer damages, even indirectly, due to a violation of competition laws.<sup>806</sup> Private individuals may have more information and a greater incentive to pursue a claim against a firm or firms for competition law violations than the state in some circumstances, and vice versa.<sup>807</sup> Private enforcement of anticompetitive behavior only occurs when the private costs of the rational victim bringing a claim are outweighed by the private benefits of filing and are described in terms of positive value claims or negative value claims.<sup>808</sup> When a type of harm affects a class of claimants, and the individual damages are low but the aggregate damages high, a claim may only be economically feasible if there is a collective action procedure available or some other rule such as punitive damages or fee shifting, which change the value of the claim or limit the transaction costs of pursuing a claim, which results in making a claim worth pursuing for the rational victim.<sup>809</sup> Claims in the US alleging violations of competition law are often collectivized under the FRCP rule 23.<sup>810</sup> According to VAN DEN BERGH, “[i]n marked contrast with the United States of America... where the vast majority of cases under

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<sup>806</sup> According to VAN DEN BERGH, “Criteria for making a choice between public and private enforcement include the type of sanction that is deemed appropriate, the existence of information advantages and the difference between the private and social motive to sue. Also, the focus on the compensation goal rather than the deterrence goal will have an impact on the design of the optimal enforcement system. A preliminary requirement to achieve optimal deterrence and/or compensation is that indirect buyers are given the right to claim damages.” VAN DEN BERGH 2013, p. 15.

<sup>807</sup> According to PARISI, asymmetric information is “a form of market failure in which one party has access to more relevant information than the other”, which has “undesirable consequences”, including “adverse selection and moral hazard”. PARISI 2013, p. 15.

<sup>808</sup> According to COOTER AND ULEN, “the rational plaintiff files a complaint if its expected net payoff is positive:  $EVC \geq FC$   file legal complaint;  $EVC < FC$   do not file the complaint.” COOTER AND ULEN 2016, p. 390.

<sup>809</sup> According to COOTER and ULEN, “The efficiency loss due to enforcement error can be offset by augmenting compensatory damages with punitive damages.” COOTER AND ULEN 2016, p. 260.

<sup>810</sup> FRCP 23.

antitrust law are brought by private parties, European competition law has been enforced mainly by public bodies.<sup>811</sup> In the EU, efforts to provide a collective action procedure for some private antitrust claims are now enabled by the REPRESENTATIVE ACTION DIRECTIVE.<sup>812</sup> A representative case procedure was enacted at the EU level in 2020.<sup>813</sup> In addition to the collective action procedure available in the US under FRCP 23, the Sherman Antitrust Act also incentivizes victims to file meritorious claims by providing for treble damages.<sup>814</sup> When treble damages and claim collectivization are combined, it creates a significant deterrent to firms seeking to engage in anticompetitive behavior. Some scholars have argued that firms facing a firm bankrupting claim have been induced into entering into so called "blackmail settlements", where firms facing civil antitrust claims settle rather than risking liability which is higher than the value of the firm.<sup>815</sup> Because of the lack of plaintiff friendly rules for collectivizing competition claims in the EU when compared to the US, we should expect to see firms seeking to avoid private claims against them through arbitration and class waivers more often in the US than in the EU.<sup>816</sup> However, the new

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<sup>811</sup> VAN DEN BERGH 2013, p. 13.

<sup>812</sup> In November 2020, the European Parliament voted in favor of the representative action directive, with member states having a two-year window to enact enabling legislation for the directive. DENTONS has published a report on the Directive which examines the implementation within EU member states. DENTONS 2022. In general, this research does not address the representative action procedure other than in passing. Under the "New Deal for Consumers", which the EC proposed in 2018, a uniquely European Representative Action procedure is being advocated. According to the Commission, "Under the New Deal for Consumers it will be possible for a qualified entity, such as a consumer organization, to seek redress, such as compensation, replacement or repair, on behalf of a group of consumers that have been harmed by an illegal commercial practice. In some Member States, it is already possible for consumers to launch collective actions in courts, but now this possibility will be available in all EU countries." EC PRESS RELEASE 2018. According to VAN DEN BERGH, there has been a reluctance in the EU to adopt a collective procedure similar to the one found in FRCP 23. VAN DEN BERGH comments, "The dominant scepticism towards US-style class actions is due to alleged abuses and the prevailing image of an attorney acting as a private entrepreneur maximizing personal profits without sufficiently taking care of the interests of the members of the class. The aversion towards American class actions in Europe is so great that it has become politically incorrect to use this term. Instead, policy makers have proposed to rely on 'collective actions' and 'representative actions' brought by consumer associations." VAN DEN BERGH 2013, p. 13.

<sup>813</sup> REPRESENTATIVE ACTION DIRECTIVE 2020.

<sup>814</sup> For a discussion about some of the negative attributes of treble damages, see: EASTERBROOK 1985.

<sup>815</sup> For discussions on the issue of Blackmail settlements, see: PRIEST 1999, p. 483; Judge POSNER's opinion in *Matter of Rhone-Poulenc Rorer Inc.*, (1995), p. 1298; and KANNER and NAGY 2005.

<sup>816</sup> See: *Mostaza Claro v. Centro Móvil Milenium SL*, (2006). We should expect to see that the use of a new representative action procedure in the EU will create new paths of research.

representative case procedure has yet to generate enough information about how it will impact firms' behavior, although recent research has focused on potential problems concerning the representative action procedure in terms of funding litigation falling under the purview of the directive.<sup>817</sup>

Private enforcement of competition law can also be considered a substitute for public enforcement if the public and private interests align.<sup>818</sup> The public costs of enforcing competition laws can be balanced with the private incentives to pursue competition law claims in such a way as to maximize the benefits of having competition laws in place. However, the complementary nature of private and public enforcement of competition law makes it difficult to determine the efficient combination of private and public enforcement of competition law.<sup>819</sup>

We should think of how the goals of certainty found in contract law, the goals of minimizing the cost of accidents, and the goals of having competition in the market or integration in the market, have sometimes similar and sometimes divergent goals. For instance, there is an efficiency argument to be found in each of these goals of the law. Having certainty in transactions tends to promote the efficient allocation of private resources. Having rules which tend to lower the costs of

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<sup>817</sup> See: VISSCHER and FAURE 2021. It may be useful to look at the implementation of other Directives related to the Representative Actions Directive. Some cases have been decided at the ECJ concerning the Damages Directive, Directive 2014/104/EU, which the EU has published in a 2020 report. The report concluded that “the effectiveness of the implementing measures will greatly depend on their actual implementation by the national courts”. EUROPEAN COMMISSION WORKING DOCUMENT 2020, p 15.

<sup>818</sup> SOKOL comments, “If in fact a lawsuit creates the same interests for government as it does for the private plaintiff, then private rights can be seen as the outsourcing of government litigation resulting from budget constraints. In this sense, private rights are a substitute for government enforcement.” SOKOL 2011, pp. 691-692.

<sup>819</sup> According to SOKOL, “The law and economics literature regarding private rights of action in antitrust conceptualizes private rights of action as a binary decision of one of a complement or substitute to government enforcement. Complement in this context is value neutral and may either positively or negatively add to public enforcement. Behind this dichotomy is a broader theoretical discussion about the optimal mix of antitrust enforcement in the U.S. antitrust system. What is optimal antitrust enforcement is not sufficiently clear. Some theoretical work suggests that private antitrust rights have a neutral effect on total antitrust enforcement. In other theoretical models, private rights may lead to a more optimal antitrust system. In contrast, there are those that argue against any private rights within the antitrust system because they negatively affect total antitrust enforcement.” SOKOL 2011, p. 691.

accidents allows parties to more efficiently make choices about what care they need to take given their circumstances. Having effective competition law should incentivize firms to make more efficient choices with how they structure their business, and how they interact with consumers and firms in the market. At the same time, allowing contract law to dominate other areas of law may lead to inefficient outcomes, as broad deference to one branch of legal doctrine may lead to inefficient market outcomes when firms can use contracting to protect illegitimate or illegal business practices.

### 3.4 Public Goods from Litigation.

*\*\*\*This topic was discussed in Chapter 4, section 5 concerning the production of public goods in litigation, and chapter 3, appendix c. \*\*\**

Laws are public goods, including judge made laws through precedent, rule interpretation, and gap filling. Precedent is valuable for individuals and firms since it signals information about the law and how courts interpret and apply it. According to POSNER, "[t]he body of precedents in an area of law can be thought of as a stock of capital goods—specifically, a stock of knowledge that yields services over many years to potential disputants in the form of information about legal obligation", however, "the value of the services that they yield declines over time".<sup>820</sup> As older precedent becomes less valuable, "new ones are added to the stock through litigation".<sup>821</sup> Courts adjust due

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<sup>820</sup> POSNER 2014, p. 759

<sup>821</sup> POSNER 2014, p. 760

POSNER considers the differences between horse drawn buggies and modern automobiles to highlight how precedent may decrease in value over time as technology and practices change. According to POSNER, "accident law that was developed to deal with collisions between horse-drawn wagons will be less valuable when applied to automobile collisions". POSNER 2014, p. 760.

One potential way to measure the effects of collisions to use arbitration for tort claims is to adapt the model which LANDES and POSNER used to analyze the capital stock of precedent by looking at industry specific precedent concerning due care standards both before and after the *Southland* case, which signaled the shifting attitude towards arbitration in the US and can be considered as a type of shock which would affect subsequent precedent production, then compare this information with other industries and other areas of law which are not susceptible to being strategically developed through the use of arbitration. It should be noted that the use of arbitration may have also influenced arbitration for non-tort claims. In LANDES and POSNER's study, they treated "the body of legal precedents created by judicial decisions in prior periods as a capital stock that yields a flow of information services which depreciates over time as new conditions arise that were not foreseen by the framers of the existing precedent.

care standards by producing judicial public goods, including precedent, gap filling, and interpretation. Another public good which courts produce is information about the claim, which becomes publicly available and part of a public record.<sup>822</sup> Arbitration generally does not produce precedent, gap filling, interpretation, or public information, although institutional precedents and norms may develop, particularly when a claim involves international trade.<sup>823</sup> According to HYLTON, "[t]he parties to waiver and arbitration agreements have incentives to take into account potential effects on new law development, to the extent they alter deterrence benefits".<sup>824</sup> However, businesses and consumers have different stakes in the law, and information asymmetry may lead to consumers discounting these "potential effects". One-shot litigants (OS) are litigants involved in claims against RP and are not RPs themselves; rather, they only have a stake in a single claim against an RP. The discounting by OS of the potential stakes in the law may lead to the development of asymmetric laws when RP can accurately account for these "potential effects," and they can allocate resources to amplify those effects, leading to a potentially biased legal

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New (and replacement) capital is created by investment in the production of precedents". LANDES and POSNER 1976, pp. 250-251. LANDES and POSNER used two "techniques for using the age distribution of citation to estimate rates of depreciation or obsolescence of legal capital," first: "exclusive use of the mean of the age distribution," and; second "makes use of the entire frequency distribution of citations to earlier decisions, not just the mean." LANDES and POSNER 1976, p. 275. This may be one way to solve a problem which HYLTON identifies as justifying "the desirability of subsidizing litigation in order to enhance the stock of legal capital" HYLTON 2000, p. 247.

<sup>822</sup> According to THORNBURG, "The public nature of litigation, and its status as a function of government, is a way in which society enunciates its values, and in which it creates and enforces the rules that govern primary behavior." THORNBURG 2004, p. 272.

<sup>823</sup> According to HYLTON, "An arbitral forum may have an advantage in developing and interpreting that institutional common law. The oldest example of this is the "law merchant" (or "lex mercatoria") that Blackstone described in the late 1700s as the law governing commercial transactions." HYLTON 2000, p. 245. In some forms of arbitration, particularly when it involves similarly situated parties, such as the case in commercial arbitration, a written decision is rendered, and some form of institutional precedent may be developed, but the use is limited, as is the precedential value of the written decision on other arbitrators. This type of precedent creation from arbitration tribunals is a characteristic of international commercial arbitration, while the development of institutional precedent in domestic arbitration is arbitral association and state specific. One noteworthy example of private institutional precedent developing is the *lex mercatoria*, which has been substantially incorporated in many states' public laws. Interestingly, the doctrine of *ex aequo et bono* allows an arbitration tribunal only to examine disputes based on fairness and equity provided the parties to the dispute agree. See: TRAKMAN 2008.

<sup>824</sup> HYLTON 2000, P. 263. However, HYLTON also comments that his "analysis largely rejects the claim that waiver and arbitration agreements should not be enforced because of their inhibitory effects on legal evolution." HYLTON 2000, p. 263.

treatment.<sup>825</sup> RP firms should be able to identify when there is a lack of deterrence and act to maximize their welfare, potentially by taking less than efficient care, given that they have contracted to use arbitration.

Maximizing the expected benefits of public good production from courts may promote the mitigation of accident costs. In other words, if courts are efficient at setting due care standards, then the primary and secondary costs of accidents should decrease.<sup>826</sup> Suppose an increase in tertiary costs related to the courts' production of public goods is more than offset by the lower primary and secondary costs. In that case, the increased tertiary costs can be viewed as minimizing the costs of torts and thus are welfare maximizing. As discussed, we can consider the production of public goods from litigation the same way we think about due care standards. The public goods from litigation should be produced efficiently, where the marginal benefits of public goods from litigation equal the marginal costs of developing them.

Questions before third party adjudicators have two dimensions. First, questions of fact (did an event happen or not). Second, questions of law (which rules or standards apply to the legal process). Arbitration is best designed to resolve questions of fact, particularly where arbitrators have relative expertise in a given industry from which questions of fact arise. Judges sitting in courts of general jurisdiction may not necessarily be experts in an industry from which a claim arises and are thus more dependent on the parties and expert witnesses to help determine questions of fact.<sup>827</sup> Questions of law may be better suited for judges with expertise in the law, as questions of law can lead to the production of public goods from litigation which requires expertise in

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<sup>825</sup> See the discussion on one shotters (OS) and repeat players (RP) found in the chapter "Marching Without Memory."

<sup>826</sup> CALABRESI 2008.

<sup>827</sup> However, some courts are known for having specialized knowledge or expertise in specific types of claims, a factor that may contribute to forum shopping in US federal districts or states. One can easily point to Delaware corporate law and the Delaware Court of Chancery as an example in the U.S.

interpreting the law and promulgating the law. Arbitration may still benefit from expertise in questions of law, dependent on the individual arbitrator's background; however, because the selection of arbitrators is a private decision, the composition of the individual arbitral tribunal may have a mixed set of expertise in factual or legal backgrounds. Questions of fact may still lead to the production of public goods in litigation, such as the production of information which would not have otherwise been disseminated publicly and, in a more limited sense, contribute to precedent, gap filling, or interpretation, which may be related to evidentiary rules in the course of interpretation of evidentiary facts. This type of public good production is less open to manipulation from a conspiracy to use arbitration, as rules related to evidence may be less likely to be limited to a specific industry. Generally, appeals courts in a common law jurisdiction will not take into account only questions of fact, but rather questions of law, although there are often mixed questions of fact and law which may also be considered on appeal. The important difference between questions of fact and questions of law is that only questions of law can lead to the adjustment of due care standards.

While the underproduction of public goods discussed here addresses the potential for due care standards found in tort to be frustrated, similar problems concerning the production of public goods from the judiciary related to contracts and competition law should also be considered as factors. However, the production of public goods related to contract claims and traditional competition law claims do not face the same restraints which contracts to arbitrate tort claims may have, as the demand for efficient rules related to contract and competition law involve legal claims which cannot be wholly captured under a conspiracy to use arbitration. For example, contractual disputes with the state will continue to be litigated, as will state initiated competition claims. The significance of tort claims is that some due care standards may be industry specific, and thus,

private claims against a specific industry are susceptible to being entirely captured under an adhesion contract which demands arbitration. Only to the extent that contractual terms are industry specific can a conspiracy to arbitrate preclude the development of public contract laws, although, in such a scenario, there may be some development of private contract laws, which over time may influence public law. Competition law can be seen as more dynamic in its ability to withstand conspiracies to arbitrate than tort or contract law. Competition law is the standard for competition claims, and competition laws are less likely to be seen as developing completely within the vacuum of a specific industry. Rather, competition law is designed to review the actions of all private industries. In sum, we should expect conspiracies to arbitrate to be more effective in limiting the production of public goods from litigation related to tort disputes, while contract law and competition law are less susceptible to conspiracies regarding the production of public goods from litigation. This is one reason why the strategic use of arbitration for tort claims may be more susceptible to collusive efforts within an industry to preclude a class of claims in litigation than for claims involving purely contractual disputes or claims involving the so called "hardcore" infringements of competition law.

### 3.5 Efficient use of Arbitration.

*\*\*\*This topic was also discussed in Chapter 3, appendix B concerning efficient due care standards and the use of arbitration.\*\*\**

Recall that to minimize the costs of accidents, the primary, secondary, and tertiary costs must all be considered. This goal of tort law should apply to all tort claims regardless of the forum in which the claim is adjudicated, as these costs are interrelated. The use of arbitration for tort claims may change the overall costs of accidents and the distribution of the costs of accidents. The potential of the arbitration of tort claims to be welfare enhancing, given the costs of accidents, is largely dependent on several factors: the competency of judges, arbitrators, and legal institutions, the

transaction costs associated with litigating or arbitrating disputes, the characteristics of the tort claims being arbitrated (for example the potential for these claims to lead to the production of public goods from litigation, the value of claims, and the scope of dispersion of losses), the externalities which flow from the claim (both positive and negative), and the level of competition in a given market which would induce firms to pass on potential efficiency benefits of arbitration to consumers or employees.<sup>828</sup> As due care standards also impact third parties to contracts, we should also consider efficiency in terms of limiting the costs of accidents. Potentially, there is a "smart mix" of public and private adjudication forums, where the welfare enhancing benefits of each forum are maximized, and the potential welfare reducing costs of each forum are minimized, leading to further minimization of the costs of accidents.<sup>829</sup> This type of "smart mix" should be designed to "guarantee a minimum level of protection" of legal rights in either adjudication forum and to allow for cooperative forms of competition between public and private adjudication forums.<sup>830</sup>

If due care rules are set efficiently and are easily identifiable, then an efficient situation could develop where arbitral tribunals merely need to apply the facts of the case to well settled and uncontroversial due care standards. Suppose arbitration tribunals reach similar outcomes as courts in adjudicating tort claims or are more accurate in adjudicating claims than courts. In that case, the

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<sup>828</sup> This is a non-exhaustive list.

<sup>829</sup> VAN DEN BERGH 2016. VAN DEN BERGH describes the need for a smart mix of centralization and decentralization in the EU so that the benefits of each approach to federalism can be maximized and the problems associated with each approach can be minimized. According to VAN DEN BERGH, "[i]n many fields of law, arguments favouring decentralization may go hand in hand with arguments supporting centralization" and "[t]his requires a smart mix of regulations at different levels of government, such as minimum harmonization (which still enables competition between legal rules above a guaranteed minimum level of protection) and different forms of cooperation between the Member States and the EU." VAN DEN BERGH 2016, p. 963.

<sup>830</sup> See: VAN DEN BERGH 2016, p. 963.

use of arbitration for tort claims can be welfare enhancing. This is more likely to occur when there is not a significant disparity between the skills of judges and arbitrators.

Suppose the use of arbitration does tend to enforce the existing standard. In that case, the use of arbitration for tort claims is capable of promoting either efficient or inefficient due care standards, depending on the particulars of the claims being arbitrated and the rules in place. If there is a novel legal question concerning a due care standard which courts have not considered or a new practice or technology for which an existing due care standard is being applied inefficiently, then the use of arbitration is more likely to undermine the production of public goods from adjudication as there is little or no stock of precedent, rule interpretation, or gap filling applicable for the new practice or technology which arbitrators have to look for guidance and judges lack cases with a quality which could lead to the production of public goods from litigation.

The use of arbitration for tort claims may be efficient even when there is a future cost created by the lack of development of the law so long as the future losses in welfare are less than the present welfare gains.<sup>831</sup> When these future costs are more than the present welfare gains, then efficiency cannot be a justification for using arbitration. It is necessary to consider the potential lost value from unproduced public goods from litigation and the potential for the value of precedent to depreciate or appreciate over time.<sup>832</sup> While these values may be difficult to quantify monetarily,

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<sup>831</sup> According to HYLTON, “whenever litigation is socially undesirable because the expected benefits from deterrence are less than the expected litigation costs, informed potential litigants have an incentive to sign a waiver agreement” and “[s]imilarly, informed parties have an incentive to enter into an arbitration agreement when and only when the margin between the deterrence benefit and expected total litigation costs is greater under the arbitration regime.” HYLTON 2000, p. 213.

For a discussion on the differences between Pareto and Kaldor-Hicks efficiency, see: COOTER AND ULEN 2016, p. 42.

<sup>832</sup> For a discussion on the capital stock like nature of precedent, see: LANDES and POSNER 1976.

these potential costs and benefits of precedent play an important role in determining if a given rule which shows deference to arbitration is likely to lead to rule loss or creation.

Depending on the circumstances, the purported private benefits of arbitration may be forgone. In a purely domestic dispute, the benefits of arbitration do not include any "denationalization" of disputes. The benefits of arbitration are not guaranteed, as arbitrators may be inexperienced in aspects of a claim, arbitration may be more costly than litigation, and arbitration may take longer to adjudicate than a claim in court. The availability of collective actions also impacts the costs and benefits of arbitration. The secretive nature of arbitration may increase information asymmetry between parties, which impacts how firms and individuals make decisions. The private benefits of arbitration are dependent on the quality of the arbitrators, the type of claim being arbitrated, and the procedural rules to which parties have agreed. If arbitration produces disparate outcomes than in litigation resulting in a higher enforcement error rate in arbitration than would occur in courts, the argument that arbitration is more efficient disappears.

A middle of the road approach by arbitrators may result in a truncation of a firm's liability when arbitrators are very good at quickly filtering out meritorious claims from non-meritorious claims.<sup>833</sup> In a competitive market, the benefits of truncated liability will be passed onto consumers in the form of a lower price tag or otherwise increased value of the contract. The cost reduction for firms may not necessarily lead to a cost reduction for consumers or a wage increase or improved working conditions for employees. The potential benefits of arbitration related to the pricing of goods and services depend on several factors, perhaps most importantly, competition in the market. Consumers and employees benefit from efficient care being taken by firms and employers because

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<sup>833</sup>POSNER 2014, p. 823.

it will help minimize the expected accident costs.<sup>834</sup> The purported benefits of arbitration may come with costs, especially when the subject of the claim involves due care standards, which may have become inefficient over time. Consumers can benefit from reduced liability costs to firms if cost savings are passed onto consumers.<sup>835</sup> Some consumers would never exercise their legal rights if they were to be harmed, and these customers essentially subsidize other consumers who are willing to exercise their legal rights.<sup>836</sup> In a competitive market, cost savings should be passed on to consumers. If a situation develops where "savings are not passed on to the consumer, they represent supra-competitive return", which may be indicative of a lack of competition in the market or some other form of market failure.<sup>837</sup> Suppose, due to the use of arbitration, consumers suffer from having to pay a higher price for a lower quality good and suffer from having to face increased costs from accidents due to the taking of low care. In that case, there is a serious question as to whether the use of arbitration for tort claims is efficient given other potential cost reducing or cost increasing effects that arbitration may have.

Governments facing budget constraints may support the use of arbitration as a cost cutting technique, or at least a technique to shift costs away from the public sector, which may have the

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<sup>834</sup> See: CALABRESI 2008.

<sup>835</sup> See: HYLTON 2000, p. 252.

<sup>836</sup> BEN-SHAHAR has commented on the potential for liability to be subsidized by one class of consumers which benefits another class of consumers. According to BEN-SHAHAR, "[t]he greater the uncertainty about the outcome of litigation, the less beneficial it is for risk-averse plaintiffs, who would prefer lower settlements to the uncertainty of litigating the case fully." and "[i]t is widely accepted that poorer individuals exhibit higher degrees of risk aversion and thus value the prospect of the litigation "damages lottery" less." BEN-SHAHAR further comments that "[m]andated compensation can fail to generate protective benefits to weak consumers because of the utility handicap and the affordability handicap. Consider first the utility handicap. Tort compensation for injuries arising from defective products requires manufacturers to pay for the losses suffered by victims. The cost of this liability regime is spread to all consumers through the increased price of products. How much each victim gets in compensation depends on how large her losses are, and – not surprisingly – the measurable losses to the poor tend to be smaller than those that accrue to the wealthy. Property-rich and high-income consumers receive greater awards, because damages in tort law are correlated with lost income and with consequential harm to property." Furthermore, "if arbitration indeed reduces consumers' access to redress, this effect is potentially favorable not only to firms, but also to the weakest subgroups of consumers." BEN-SHAHAR 2016, p. 1798.

<sup>837</sup> WARDHAUGH 2013, p. 453.

immediate effect of lowering the tertiary costs of accidents which the public must subsidize while increasing private tertiary costs. When a state favors the use of arbitration, the courts and states allow some cases in which jurisdiction could be asserted to be diverted into a competing private forum for adjudication. If cost cutting by courts leads to an underproduction of public goods from adjudication, such as precedent, rule interpretation, and gap filling, then the overall costs of accidents may actually be increasing as the lower court costs are offset by the higher primary and secondary costs of accidents which results from having inefficient due care rules in place. The use of arbitration for tort claims may contribute to the declining value in the stock of precedent.<sup>838</sup> If competition over the adjudication of claims leads to inefficiently lower due care standards which are persistent, then the use of arbitration for tort claims may contribute to lasting inefficiencies in the law. A lasting inefficiency could be due to domestic forum arbitrage and is characteristic of a “race to the bottom” in the market for adjudication.<sup>839</sup> This may further contribute to enforcement errors as the life of inefficient due care standards is prolonged and applied inefficiently to an increasing number of claims in arbitration over time. In the competition between adjudication

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<sup>838</sup> According to LANDES and POSNER, “although a precedent does not “wear out” in a physical sense, it depreciates in an economic sense because the value of its information content declines over time with changing circumstances.” LANDES and POSNER 1976, p. 263.

<sup>839</sup> Domestic Forum Arbitrage is defined in a previous chapter by the author as a subtype of judicial arbitrage, “where there is no choice of law issues as the claim is completely within the scope of a specific jurisdiction, where the choice is only between a single public domestic adjudication forum and private domestic adjudication forums, and where there is the option to choose ex ante the forum between the parties involved in the dispute.” See Chapter “Marching Without Memory” section 5. A race to the bottom has been described as a form of “destructive competition” between governments in an effort to induce firms to relocate, but a race to the bottom can also be thought of in the context of claims adjudication as destructive competition between adjudication forums, which has the effect of increasing error rates in the adjudication of claims. VAN DEN BERGH has described how, in the context of competition between states, fears of a race to the bottom “causing destructive competition between jurisdictions leading to ‘bad’ law” may be “controversial” because 1) firms may move between states for reasons other than lax regulation, such as “the level of taxes, the level of unionization of the labour force or the quality of the infrastructure”, 2) there is a lack of empirical evidence to “support a generalized fear of destructive competition”, and 3) “competition between jurisdictions may cause a race-to-the-top” and “may improve the international competitiveness of nations”. Conversely, if states try “to outbid each other by enacting lax rules or by leniently enforcing laws in order to attract business to locate to their jurisdiction” and “all other states follow”, then it may result in a situation where “jurisdictions compete with each other in a prisoners’ dilemma setting”. VAN DEN BERGH 2016, p. 943

forums, there may be a need to adopt “smart mixes” of centralized adjudication forums, i.e., state operated courts, and decentralized adjudication forums, i.e., arbitration tribunals, in order to maximize the potential benefits of each adjudication forum and to minimize the potential costs of destructive competition in which private and public adjudication forums are caught in a prisoners dilemma which results in inefficiently low public welfare.<sup>840</sup>

If there is an efficiency improvement for the private parties involved in a tort claim, it is important to distinguish how efficiency has improved. If there is an overall increase in welfare, but the share of the improvements leads to an increased cost to one party while the counterparty realizes all of the gains, we can consider this a Kaldor Hicks improvement in efficiency.<sup>841</sup> If parties are able to redistribute the efficiency gains from using arbitration and no party is worse off, it may be a Pareto efficient improvement.<sup>842</sup> The willingness of firms to pass on an efficiency improvement to consumers so that the improvement is Pareto cannot be assumed. Only if market forces are efficiently competitive will one sided benefits of arbitration be passed on to the counterparty.<sup>843</sup> Beyond the primary cost of the accident, these efficiency improvement criteria must also account for costs to third parties and the state.

#### 4. Collusion to use Arbitration for Tort Claims.

RP firms have numerous opportunities to act strategically to achieve long-term goals. This strategic behavior may lead similarly situated RP firms in an industry to collude in mandating arbitration across an industry. As mentioned, RP litigants behave strategically in numerous,

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<sup>840</sup> This is consistent with VAN DEN BERGH’s analysis of federalism in the EU. VAN DEN BERGH 2016

<sup>841</sup> See: COOTER and ULEN 2016, p. 45.

<sup>842</sup> See: COOTER and ULEN 2016, p. 45.

<sup>843</sup> See: HYLTON 200, p. 252.

repeated similar litigation claims to maximize their private utility.<sup>844</sup> GALANTER addressed how RP in litigation have several advantages over OS, including resource, information, and opportunity advantages.<sup>845</sup> CHE and YI found that in repeated litigation: 1) a “defendant is more willing to settle when an unfavorable precedent is more likely to be set, resulting in a higher settlement rate”; 2) “the parties will engage in preemptive campaigns to turn the precedent in their favor, which could be socially wasteful”; 3) “the existence of precedents tends to penalize plaintiffs with low winning probabilities and discourage nuisance suits” and; 4) “correlated damage awards provide a valuable learning opportunity to the defendant, allowing him to make a more tailored offer after experiencing an initial trial”.<sup>846</sup> Firms may behave strategically in additional ways when options to use arbitration for tort claims are available.<sup>847</sup> Some options to behave strategically in litigation are limited by remedial rules and procedures.<sup>848</sup> For instance, there may be fee shifting rules, collective action procedures, punitive damages, and a number of other tools which states can use to prevent or mitigate strategic behavior.<sup>849</sup> Private contracting may allow firms to circumvent these remedial rules and procedures. Private contracting over the use of arbitration for tort claims may provide firms with persistent opportunities to behave strategically in ways which are unavailable in litigation. If firms have market power or collude with other firms, they may be able to impose arbitration in their contracts across an industry.

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<sup>844</sup> For a discussion on how repeat players (RP) have an advantage over one shot players (OS) in litigation, see: GALANTER 1974.

<sup>845</sup> See: GALANTER 1974.

<sup>846</sup> CHE and YI 1993, pp. 417-418.

<sup>847</sup> In a previous chapter, the author addressed how the strategic use of arbitration may allow repeat players to use mandatory arbitration terms to avoid care costs and liabilities by making use of information, opportunity, and resource advantages over one shot players. See Chapter "Marching Without Memory: How the use of arbitration in tort claims may complicate incentives to take due care."

<sup>848</sup> According to FAURE and WEBER, there are “a variety of solutions to remedy the (rational) cost aversion of the individual, which could thereby potentially increase access to justice and cure the market failure” when a problem is associated with under enforcement due to scattered losses. FAURE and WEBER 2015, p. 168.

<sup>849</sup> It may be useful to examine some remedial rules that limit the problem of scattered losses. See: FAURE and WEBER 2015.

Unilaterally mandated arbitration by industry is less likely to occur when buyers have market power. According to STIGLER, “oligopolistic collusion will often be effective against small buyers even when it is ineffective against large buyers”.<sup>850</sup> If efficient outcomes are related to bargaining power, we should expect more inefficient contracts between parties with divergent bargaining power.<sup>851</sup> This may be one reason why *ex ante* arbitration contracts may lead to efficient outcomes between parties with equal bargaining power. We should expect B2B contracts, including *ex ante* arbitration contracts, to be more efficient than B2C contracts.<sup>852</sup> Conspiracies to use arbitration for tort claims may be successful precisely because potential victims are small buyers.

#### 4.1 Market for Adjudication and Court Error.

The market for dispute resolution includes state courts, private courts, and informal means of dispute resolution.<sup>853</sup> The market for judicial services includes public and private courts.<sup>854</sup> Arbitration, as a type of ADR, shows how public judges and private judges (arbitrators) compete to provide third party adjudication of disputes. Courts may have the authority to take steps to ensure that disputes are diverted to an ADR process, such as arbitration, mediation, or conciliation. In some instances, courts may require parties to engage in facilitative ADR procedures as a prerequisite to the commencement of some official judicial procedures, such as a trial. ADR

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<sup>850</sup> STIGLER 1964, p. 47.

<sup>851</sup> For a discussion on how bargaining power may lead to inefficient contract terms, see: CHOI AND TRIANTIS 2012.

<sup>852</sup> According to SCHMITZ, B2C contracts to arbitrate may be less efficient than Business to Business (B2B) contracts to arbitrate, and many states have limited B2C contracts to arbitrate over “concerns regarding asymmetry of power, enforcement of public rights, and competence of private arbitrators and arbitral institutions.” SCHMITZ 2012, p. 83.

<sup>853</sup> See: WAGNER 2014.

<sup>854</sup> LANDES and POSNER 1979, p. 236

proceedings can be either entirely private or used by a state's judiciary to alleviate the courts' docket by encouraging parties to settle on their own terms.

Competition between courts and arbitration may lead to some benefits. According to SZALAI, “[l]itigation and commercial arbitration are intertwined” where “[c]ross-pollination can easily occur, and procedural developments in one system can influence the other and lead to innovations and improvements in dispute resolution”.<sup>855</sup> The market for dispute resolution may be distorted when firms collude, either explicitly or tacitly, in using arbitration for tort claims. If arbitration and litigation “cross pollinate”, is it also possible that the strategic use of arbitration and litigation may inhibit cross pollination. The market for adjudication may lead to the underproduction of public goods from litigation and the underproduction of regulations when strategic behavior and collusion distort market mechanisms.

In the market for rulemaking, elected officials, judges, and private parties each play a role.<sup>856</sup> Judges interpret and add to legislative decrees. Regulators and elected officials use information as an important input in rulemaking.<sup>857</sup> Private parties use public information to help estimate the costs and benefits of contracting specific terms and to make decisions concerning the care they take. A judge not only plays a role in the rulemaking process, but the judge also serves in the role of third party adjudicator in disputes before state administered courts, thus a judge has influence

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<sup>855</sup> SZALAI 2016, p. 134.

<sup>856</sup> See: WAGNER 2014.

<sup>857</sup> Legislators rely on a number of sources for information, including other branches of government, such as the judiciary. According to MOONEY, “Legislative information sources can be classified into three categories according to how similar their professional experience is to the legislator’s. “Insiders” are a legislator’s colleagues and staff members. These people are in daily contact with legislators and have many of the same pressures and experiences. “Outsiders” are those whose professional experience is least like that of a legislator, those who know little about legislative life and have little on-going contact with legislators, including constituents, officials of other units of government, the mass media, and academics. In between these two extremes lay “middle range” sources-interest groups and representatives of executive agencies. These people regularly interact with lawmakers and strive to understand them but operate under different constraints and have different experiences in the legislative process than do legislators.” MOONEY 1991, p. 447.

on both the rule making process and in the dispute resolution process. Arbitration is the only ADR procedure which leads to a third party adjudication, while other ADR procedures, like mediation or conciliation, are designed to facilitate an agreement between the disputants. In the market for third party adjudication, parties have litigation and arbitration to choose from. Other forms of ADR may be facilitative in nature. If we further look at how public rulemaking can occur through administrative, executive, legislative, and judicial processes, we also see that judicial rulemaking is the only mechanism which is inherently adversarial.<sup>858</sup> POSNER has identified how the judge and the judge's output are not free from the pressure of the judge's own values. According to POSNER, "[w]hen a really new case arises, the rules of the judicial game require the judge to act the part of a legislator and therefore vote his values, although the rules do not require and may even forbid him to acknowledge that this is what he is doing."<sup>859</sup> This highlights how parties to a dispute have a private demand for rules which may be asymmetrical between defendants and plaintiffs.<sup>860</sup> Disputes over the law can only lead to rulemaking through the judiciary, while efforts to pressure the executive, legislative, and administrative rule makers often take place outside the adversarial process found in litigation.<sup>861</sup> However, it is not uncommon for a state to be a party to a civil suit or for the state to seek a rule change through the courts.

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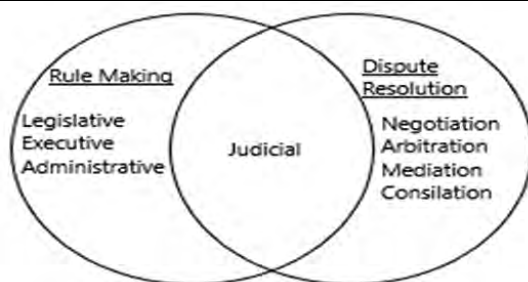
<sup>858</sup> Often, administrative adjudication generally does not include an opportunity for rulemaking or has limited rulemaking authority and can be considered a quasi-judicial procedure as far as the administrative court is considered to be exercising delegated judicial and legislative authority.

<sup>859</sup> POSNER 1993, p.40

<sup>860</sup> According to PRIEST and KLEIN, "It is not implausible in product liability actions, for example, that the stakes are greater, in general, to manufacturer-defendants than to victim-plaintiffs. A product liability judgment, of course, may lead to an appeal establishing an adverse precedent. A trial court judgment may serve to support an estoppel. An adverse judgment might influence subsequent product sales. It might inform other injured parties that a case is worth bringing or increase their estimates of success and thus their settlement demands. Furthermore, it is often alleged that firms that deal over time with a substantial number of claimants invest to establish and preserve a reputation for tough bargaining to reduce further settlement demands." PRIEST and KLEIN 1984. P. 40.

<sup>861</sup> According to GALANTER, in his analysis of repeat player advantages in litigation, "breaking the interlocked advantages of the "haves" requires attention not only to the level of rules, but also to the institutional facilities, legal services and organization of parties", which "suggests that litigating and lobbying have to be complemented by interest organizing, provisions of services and invention of new forms of institutional facilities". GALANTER 1974. P. 150.

FIGURE 27. RULE MAKING AND DISPUTE RESOLUTION.



#### 4.2 Enforcement Errors.

*\*\*\*This topic was also discussed in Chapter 3, section 5.7 concerning enforcement errors. \*\*\**

The use of arbitration for tort claims may lead to a lower enforcement rate of legal rights when there is a decrease in individuals seeking redress for the harms they have suffered.<sup>862</sup> An enforcement error occurs when tortfeasors are not forced into fully internalizing the costs of their tortious acts.<sup>863</sup> Enforcement errors of under enforcement benefit the economic interests of tortfeasors because they are not forced into internalizing the negative externalities they create, which could, in turn, benefits consumers through lower prices if the lower expected liability of firms is reflected in the price. However, the enforcement error itself is detrimental to consumers. Still, there is the possibility that some underenforcement resulting in enforcement errors may

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<sup>862</sup> Consumers and employees may be misinformed or uninformed about the probability of harm arising out of the contractual relationship. According to HYLTON, “One explanation for misperception is that it is costly to discover information about the probability of loss, and the expected rewards for discovering such information are too low to justify the research costs. The expected rewards may be too low because either the probability or the severity of harm, even after the lawsuit threat is removed, is extremely low. In other words, this is a case of *rational apathy*. If consumers and employees suffer from an informational deficit because of rational apathy, there is no justification for prohibition or regulation of pre-dispute arbitration agreements beyond what inheres in contract law. Rational apathy exists because, in equilibrium, consumers or employees rationally discount the deterrence benefits connected to their right to sue. In other words, they do not expect a significant change in the firm’s conduct if the parties agree to resolve their disputes in the arbitration regime.” HYLTON 2000, p. 252.

<sup>863</sup> According to COOTER AND ULEN, “the ratio of compensated victims to total victims” is the “enforcement error.” COOTER AND ULEN 2016, p. 260.

benefit some consumers in the form of a lower price tag.<sup>864</sup> However, the consumer class as a whole should be considered when analyzing due care standards, as the efficient standard will minimize the costs of accidents for the whole group of consumers, although there may be different types of consumers in terms of the benefits of litigation. Enforcement errors of over enforcement will not benefit either tortfeasors or consumers of their products, as the price for the underlying good will be higher than under optimal enforcement as the price of the good reflects the cost of over enforcement.

Some tortfeasors intentionally commit acts which lead to accidents. Thus, for some types of intentional torts, an overenforcement error may be justified under a deterrence model similar to how Becker analyzed criminal deterrence.<sup>865</sup> It can also be argued that intentional torts are always undesirable, and thus overenforcement errors for intentional tort may not be much of a problem and that it is more a matter of balancing enforcement costs for these intentional torts with the deterrence effect. In the context of intentional torts, it could be argued that an "overenforcement error" may be desirable, as it is intended to prevent behavior that is always undesirable. However, given the costs of enforcement, under deterrence may be persistent. For those rational tortfeasors to be efficiently deterred from committing intentional torts, there may need to be sanctions that change the utility the tortfeasor expects to gain from committing the intentional tort. According to Cooter.

“Potential injurers usually find that liability for compensatory damages makes conforming to the legal standard cheaper than violating it. However, in those circumstances where the usual cost relationship is reversed and the decision is made to violate the standard, a large change in behavior is needed to offset the jump in liability costs that goes with falling below the legal standard. That is why

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<sup>864</sup> This is similar to BEN-SHAHAR's argument about how some victims will never bring a claim no matter the circumstances, which essentially results in a subsidy to those customers who will bring claims. BEN-SHAHAR 2016.

<sup>865</sup> BECKER 1968.

intentional violation of a legal standard to save costs tends to be gross. The behavioral criterion for awarding punitive damages in suits against businesses should usually be a gross shortfall from the legal standard. Violation of the legal standard is profitable in the absence of punitive damages because enforcement errors reduce the injurer's expected liability below the social cost of the harm caused by violating the legal standard. To align expected liability and social costs, and to make conforming to the legal standard the least-cost alternative, the punitive multiple should be set equal to the reciprocal of the enforcement error.<sup>866</sup>

Both Becker and Cooter identify how a change in the sanction, either criminal or civil, for those rational actors who act intentionally can result in a change in the behavior of the actor. When internationally harmful behavior by tortfeasors is left without additional civil liability found when punitive damages are available, the rational tortfeasor has a "least cost alternative", which is socially undesirable. By setting punitive damages and criminal liability correctly, the law can incentivize both the rational criminal and the rational tortfeasor into complying with the law because they will both seek to maximize their own utility, which is achieved by complying with legal standards if it is their "least cost alternative" among their options to comply with or violate the legal standard.

The use of arbitration may be contributing to enforcement errors. An error may be due to a problem of scattered losses, the prevalence of negative value claims, errors in calculating damages, or errors in applying the correct legal rules or standards, among others.<sup>867</sup> However, an enforcement error may also be due to the strategic behavior of RPs or the collusive efforts of RPs to influence the error rate. The lower the enforcement of legitimate claims, the larger the enforcement error is likely to be, unless another mechanism forces tortfeasors to fully internalize the harm they create. A problem of scattered losses, information asymmetry, or rational apathy may aggravate an

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<sup>866</sup> COOTER 1989, pp. 1192-93.

<sup>867</sup> For a discussion on enforcement errors, see: COOTER AND ULEN 2016, pp. 260-261.

enforcement error.<sup>868</sup> Potential tortfeasors may take steps to decrease the salience of contract terms which increases the search costs for their customers. The increased search cost for information may also contribute to rational apathy. Efforts to increase search costs on consumers may also include the dissemination of misinformation about the values of claims and the transaction costs associated with pursuing those claims. Industry trade groups often provide a counter narrative to consumer rights groups.<sup>869</sup> If the losses caused by torts are widespread and diffused, once collectivized into a positive value claim, they may increase deterrence by creating incentives for injurers to take care.<sup>870</sup> Antitrust claims can be substantially more complex than other types of claims, and this may contribute to sentiments of rational apathy in victims who suffer diffused harm from anticompetitive practices.<sup>871</sup> This may be particularly true when an individual considers the cost associated with pursuing a competition law infringement claim on their own.<sup>872</sup>

Some states have recognized the problem of scattered losses in mass torts and have provided procedural rules which enable a class of claimants to collectivize their claims, which provides

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<sup>868</sup> According to VAN DEN BERGH and VISSCHER, "[f]rom a deterrence perspective, private enforcement of consumer law can be insufficient for several reasons. Individual consumers may find it too costly to start a lawsuit ('rational apathy') or they may not even know that an infringement has occurred ('information asymmetry'). If public enforcement is not available, or if the budget of public authorities is limited and used for other purposes, the problem of under-enforcement will persist." Furthermore, "In diffuse interest cases, where the expected utility is too low to start an individual claim, the possibility of collective actions could make a claim feasible. After all, the costs per person are lower with a collective action, so that the net expected benefits (the expected benefits minus the costs) might turn out positive. In some cases, however, the diffuse interests are so immaterial to the injured parties involved that even the possibility of collective actions does not lead to a lawsuit." VAN DEN BERGH and VISSCHER 2007, p. 5, p. 19.

<sup>869</sup> See: CTIA LETTER TO COLORADO HOUSE JUDICIARY COMMITTEE 2019.  
CTIA LETTER TO NJ CONSUMER AFFAIRS COMMITTEE 2019.

<sup>870</sup> According to VAN DEN BERGH and VISSCHER, "Besides the high litigation costs, the rational apathy may also be due to the fact that the size of the expected damages is low. Collective actions not only decrease litigation costs in the way described above but also increase the prospective damages awards. Every collective action that is initiated in cases where no individual suits would have been brought increases the total sanction faced by a potential law infringer." VAN DEN BERGH and VISSCHER 2007, p. 5, 19.

<sup>871</sup> VAN DEN BERGH and VISSCHER 2007.

<sup>872</sup> According to VAN DEN BERGH, "Victims of competition law infringements, such as consumers who paid excessively high cartel prices, may not bring an action in court because the costs of doing so are higher than the expected benefits. This is called rational apathy; it would be irrational to bear the high costs of legal proceedings if no offsetting benefits can be expected." VAN DEN BERGH 2013, p. 14.

efficiencies of scale which lower the cost of administering litigated claims.<sup>873</sup> In the US, it is not uncommon for private antitrust suits to be collectivized into a single claim under FRCP 23.<sup>874</sup> In the EU, there have been increased efforts to provide a collective action mechanism for some types of claims, and a representative action procedure was enacted in 2020.<sup>875</sup> When a collective action is available in a state, and firms mandate not only arbitration of tort claims in their contracts but also a waiver of any right to a collective action, the firms can skirt procedural rules, such as a collective action procedure designed to lower an enforcement error. If there is a consistent error of arbitration tribunals either providing deficient damages or making deficient legal standard errors, it should result in injurers taking deficient precautions.<sup>876</sup>

#### 4.3 Judicial and Arbitrator Bias.

Parties may take into account the reputation of the forums from which they can choose to direct the adjudication of their disputes. Parties should prefer to be in a favorable forum where they perceive they may be advantaged by judicial bias. Judicial bias may mean a court is a somewhat favorable forum for plaintiffs.<sup>877</sup> There have been some studies concerning bias in arbitration, which tend to suggest some bias toward defendants.<sup>878</sup> The bias of judges or arbitrators likely has

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<sup>873</sup> For discussions on blackmail settlements, see: KANNER and NAGY 2005 and PRIEST 1999.

<sup>874</sup> When considering federal antitrust filings from 2009 to 2018, DAVIS finds, “Compared to other years in the last decade, filings of antitrust class action complaints were down in 2017 and 2018 (307 and 318, respectively), and were well below the mean (420) during the last 10 years. Over the decade, two years fall outside of one standard deviation from the mean: in 2011, 233 complaints were filed, and in 2015, 660 complaints were filed.” DAVIS and KOHLES 2019, p. 6.

<sup>875</sup> EC PRESS RELEASE 2018. According to a release from Linklaters, “The draft directive was adopted by the Parliament in March 2019 and by the Council in November 2019”, and the legal formalities formalizing the directive are expected to be “completed by June 2020” and “member states will have a set period of time, typically 18-24 months, in which to give effect to the new measures.” STRIK et al. 2020. REPRESENTATIVE ACTIONS DIRECTIVE 2020. VISSCHER and FAURE have recently written on the potential problems with funding representative cases brought under the Directive. VISSCHER and FAURE 2021.

<sup>876</sup> COOTER AND ULEN 2016, p. 221. This may also be seen as analogous to the Becker model of criminal deterrence, where sanctions can be adjusted to change the payoffs of rational criminals. BECKER 1968.

<sup>877</sup> For an analysis of judicial bias toward plaintiffs, see: RUIZ 2014.

<sup>878</sup> For empirical Studies on Arbitration which address issues of bias, see: BINGHAM 1997; EISENBERG et. Al. 2007; and EISENBERG and HILL 2003.

an impact on enforcement errors. When firms mandate arbitration on consumers, an existing bias towards defendant firms in arbitration should lead to either an error of deficient damages or an error of deficient legal standards being applied or both, and these errors could induce deficient precautions being taken by injurers.<sup>879</sup> Conversely, if bias in arbitration leads to overcompensation or over deterrence on average, we should expect to see firms opting out of arbitration and favoring litigation in public courts so long as the perceived bias in court is lower than in arbitration.

Some critiques of the tort system claim it is only in place to serve as a wealth transfer or that it is a "zero sum game" which does not transfer any gain to society; rather, private lawyers gain from imposing transaction costs on the parties.<sup>880</sup> Much of the effort to reform tort law in the US has been advocated "on behalf of business and professional interests...claiming that American tort law is out of control, imposing unjustified costs on defendants amounting to billions and billions of dollars annually", which undermines "US business efforts to compete in the global marketplace" and discourages "technological innovation on the ground that enterprises find it foolhardy to risk introducing new products for fear of potential tort law-induced bankruptcy".<sup>881</sup> Others have framed

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<sup>879</sup> For a discussion on court error, see: COOTER and ULEN 2016, p. 221. For a discussion on how biases exists in arbitration and litigation due to asymmetric stakes in claims, see: KORN and ROSENBERG 2012, p. 1159.

<sup>880</sup> HYLTON has identified this as the "*Bleak House* view of litigation, paying respect to Charles Dickens." HYLTON further adds, "The *Bleak House* view ignores litigation's role in deterring socially harmful conduct, which is the key social benefit from litigation. For example, consider torts. Prohibiting tort litigation would put an end to much of the work of retail-level trial lawyers. However, preventing tort litigation (e.g., through tort reform legislation) can weaken the enforcement of tort law by removing an important deterrent to potential tortfeasors. In theory, this could increase the number and cost of tortious injuries." HYLTON 2000, p. 218. With reference to DICKENS 1853.

<sup>881</sup> SUGARMAN 2002, p. 849. According to SUGARMAN, "Defence-oriented tort reform efforts have been prompted, at least in part, by earlier plaintiff gains. Throughout the 1960s and into the 1970s tort law became increasingly pro-victim. First, the reach of negligence law was much broadened. Not only were many rules that previously strictly limited a defendant's 'duty' overturned, but also commercial actors were given new duties to take affirmative steps to protect their customers from harms caused by third parties. Second, the acceptance of 'enterprise liability' thinking meant that liability without fault was imposed on the makers of defective products and on an increasing number of behaviors labelled 'abnormally dangerous' activities. Third, an increasingly talented plaintiffs' bar proved itself capable of winning larger and larger damage awards from juries. Finally, victim groups achieved success on the legislative front. Most important there was the overturn in nearly all States of the old rule that contributory negligence was a complete defence, and its replacement with comparative negligence law. This new regime, at a minimum, assures substantial compensation to a victim whose minor fault combined with the greater fault of the defendant to bring about the victim's injury. Upset by these trends, defence interests began pushing back, and

the use of arbitration in consumer contracts as waiver of liability.<sup>882</sup> It may also be considered a form of private tort reform initiated by defendants or a way to avoid a pro plaintiff bias in courts.<sup>883</sup> However, it may be that the pro plaintiff bias in court is the result of efforts to correct for an error of underenforcement. The purpose for including pro plaintiff procedures, such as the collectivization of claims or the use of punitive damages, is to help correct for enforcement errors, which may be due to the presence of claims, which are also meritorious, which are never brought to court.<sup>884</sup>

Arbitration should have a propensity to be middle of the road, meaning the arbitrators should not show a bias toward one party or the other.<sup>885</sup> Parties who expect to be sued may mandate arbitration since having "middle of the road" arbitrators appointed may "reduce the party's expected liability" if the arbitrators can dismiss meritless claims easily, as the "middle of the road propensity" will "truncate the defendants liability" for meritorious claims.<sup>886</sup> This "middle of the road" approach should lead to an increase in enforcement errors if it does result in a truncation of defendants' liabilities. Since there is a demand for arbitration by firms who are more often defendants, we can infer that arbitration is not biased towards plaintiffs. If arbitration were biased toward plaintiffs, there would be little reason for firms acting as potential RP defendants to mandate arbitration.

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tort reform quickly became a largely politically partisan matter. Republicans lined up with the business community on the defence side, and Democrats lined up with plaintiffs, especially as plaintiff lawyers became among the most generous contributors to Democrats' political campaigns nationwide." SUGARMAN 2002, p. 850.

<sup>882</sup> See: HYLTON 2000.

<sup>883</sup> For a discussion on how arbitration may lead to a form of private tort reform, see: THORNBURG 2004.

<sup>884</sup> For an analysis of how pro plaintiff procedures can address enforcement errors, see: COOTER AND ULEN 2016, p. 255. Also see: POLINSKY and SHAVELL 1998.

<sup>885</sup> See: POSNER 2014, p. 803.

<sup>886</sup> According to POSNER, "the contract party who expects to be sued rather than be suing if the contractual relationship breaks down may want an arbitration clause in the expectation that the middle-of-the-road propensity of arbitrators will reduce the party's expected liability" POSNER 2014, p. 803.

From deduction, we can assume that arbitration is either unbiased with a middle of the road propensity or biased towards defendant firms.<sup>887</sup>

The possibility of arbitrators considering whether their involvement in the arbitration of legitimate tort claims, which are the result of the collusive use of arbitration in an industry, is itself an infringement of antitrust law and places the arbitrator in a precarious position, one in which their own self-interests may impact their decision making. In such a situation, the arbitrator must determine if their very presence as an adjudicator is anticompetitive or not, placing the arbitrator in a situation in which their interests may conflict with the interests of the parties involved in a dispute, making the arbitration tribunal into a tool of a conspiracy to arbitrate which brings into question the legitimacy of the procedure.<sup>888</sup> Judges are not free from this dilemma either. If a conspiracy to arbitrate does exist, and courts knowingly enforce the anti competitive behavior of firms, then courts risk becoming a mere "instrument" of the conspiracy.<sup>889</sup>

The perception of bias or corruption in public and private adjudication forums may lead defendants or plaintiffs to favor one forum over the other. The demand for adjudication should reflect perceptions of bias, where the party demanding a forum for adjudication will seek to maximize their chances of winning on a given claim or multiple similar claims by choosing the forum in which bias is perceived to favor them. If RP defendant firms have demanded a forum pre dispute, then it can be assumed that the choice is made to minimize their expected total liability. Thus, they act as utility maximizers. If, on the other hand, potential individual plaintiffs demand the use of arbitration, *ex ante*, then it could be assumed that the use of arbitration is perceived to be done to

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<sup>887</sup> Some studies have shown a bias toward defendants in arbitration. See: BINGHAM 1997.

<sup>888</sup> See: LESLIE 2017.

<sup>889</sup> LESLIE has commented that when courts enforce arbitration when there is a conspiracy to arbitrate, the court acts as an instrument of conspiracy. LESLIE 2017. P. 427.

maximize their potential payoff if an accident were to occur, thus also making them utility maximizers. It does not appear that individual plaintiffs have been driving the use of arbitration. Firms with market power are more capable of demanding specific contract terms, and individuals bargaining with the firms are usually faced with take it or leave it terms. Thus, it can be assumed that the inclusion of *ex ante* arbitration clauses in contracts between firms and unsophisticated individuals is driven by firms and not the individuals contracting with firms. Corruption may also play a role in the desire to use arbitration, as the presence or perception of corruption in the courts may be a factor which parties consider when entering into arbitration contracts.<sup>890</sup> There is also the possibility that arbitrators in a given case may be corrupt, and parties may also take this into account.

#### 4.4 Tacit and Explicit Collusion.

Firms can act in unison to dictate the terms of accessing or entering the market they operate in. Often, this form of collusive behavior takes the shape of a cartel which agrees to restrict production in the market and charge monopoly prices to consumers, thus creating a deadweight loss, decreasing consumer surplus, and increasing producer surplus. When firms agree to charge minimum prices for their products, it facilitates the earning of monopoly profits.<sup>891</sup> Firms can also agree on non-price terms, and these non-price terms may have pricing effects or contribute to barriers to entry into a market.<sup>892</sup>

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<sup>890</sup> TLIs may be useful when considering the prevalence of corruption in a given state's legal system. The Rule of Law Index published by the WORLD JUSTICE PROJECT is one such indicator and includes data on corruption. RULE OF LAW INDEX 2018. BOTERO AND PONCE 2011.

<sup>891</sup> For a discussion on tacit collusion and price fixing, see: POSNER 2014, pp. 378-380.

<sup>892</sup> See: STIGLER 1968.

Explicit collusion occurs when firms communicate with each other in order to facilitate their coordinated behavior in the market.<sup>893</sup> Tacit collusion does not involve direct communication between firms to enter into a conspiracy.<sup>894</sup> Tacit collusion can be further distinguished between "conscious parallelism and concerted action", where conscious parallelism may lead to an "equilibrium with higher market prices" without direct communication, while concerted actions fall "between explicit collusion and conscious parallelism" as "these actions involve some form of direct communication" without the "firms expressing their intent to reach a collusive agreement".<sup>895</sup> Both tacit collusion and explicit collusion can lead to market failures which may be indistinguishable.<sup>896</sup> While explicit collusion is considered one of the "hardcore" violations of competition law in both the US and the EU, tacit collusion has been treated differently across the

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<sup>893</sup> According to REES, "The word collusion describes a type of conduct or form of behaviour whereby decision-takers agree to co-ordinate their actions. This in general would seem to involve two elements: a process of communication, discussion, and exchange of information with the aim of reaching an agreement; and, where there are gains to renegeing on the agreement given that the others comply, some kind of mechanism for punishing such violations and so enforcing the agreement. In the economics of oligopolistic markets the distinction between 'explicit' and 'tacit' collusion turns on the first of these elements. It is possible that firms could agree to co-ordinate their actions in some way without explicit communication and discussion." REES 1993, p. 27.

<sup>894</sup> According to IVALDI et al., " 'Tacit collusion' need not involve any 'collusion' in the legal sense, and in particular need involve no communication between the parties. It is referred to as tacit collusion only because the outcome (in terms of prices set or quantities produced, for example) may well resemble that of explicit collusion or even of an official cartel." IVALDI et al. 2003, pp. 4-5.

<sup>895</sup> BOSHOFF et al. 2018, p. 441. Furthermore, "Conscious parallelism, sometimes called oligopolistic price coordination, is described as the process 'not in itself unlawful, by which firms in a concentrated market might in effect share monopoly power, setting their prices at a prefixed maximizing, supracompetitive level by recognizing their shared economic interests and their interdependence with respect to price and output decisions'." *In re Baby Food Antitrust Litigation*, (1999), p. 121. Citing to *Brooke Group Ltd. V. Brown & Williamson Tobacco Corp.*, (1993).

<sup>896</sup> See: POSNER 2014 on economic effects of tacit and explicit collusion, §10.1-10.2.

Atlantic.<sup>897</sup> One notable issue involving tacit collusion is the treatment of alleged infringements of competition law involving the publication of prices, which may have ambiguous implications.<sup>898</sup>

#### 4.5 Focal Point Theory.

Focal points can be created through public legal decisions from courts and legislation or rules from government bodies. Firms or individuals may use these focal points to help them determine how best to make decisions given the law.<sup>899</sup> It is possible for firms in an industry to act in unison

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<sup>897</sup> According to the SCOTUS, “Tacit collusion, sometimes called oligopolistic price coordination or conscious parallelism, describes the process, not in itself unlawful, by which firms in a concentrated market might in effect share monopoly power, setting their prices at a profit-maximizing, supracompetitive level by recognizing their shared economic interests and their interdependence with respect to price and output decisions.” Furthermore, “Because relying on tacit coordination among oligopolists as a means of recouping losses from predatory pricing is “highly speculative,” ... competent evidence is necessary to allow a reasonable inference that it poses an authentic threat to competition.” Additionally, “Especially in an oligopoly setting, in which price competition is most likely to take place through less observable and less regulable means than list prices, it would be unreasonable to draw conclusions about the existence of tacit coordination or supracompetitive pricing from data that reflect only list prices.” *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, (1993), p. 227, p. 232 & p. 236. According to the ECJ, “tacit coordination is more likely to emerge if competitors can easily arrive at a common perception as to how the coordination should work, and, in particular, of the parameters that lend themselves to being a focal point of the proposed coordination. Unless they can form a shared tacit understanding of the terms of the coordination, competitors might resort to practices that are prohibited by Article 81 EC in order to be able to adopt a common policy on the market. Moreover, having regard to the temptation which may exist for each participant in a tacit coordination to depart from it in order to increase its short-term profit, it is necessary to determine whether such coordination is sustainable. In that regard, the coordinating undertakings must be able to monitor to a sufficient degree whether the terms of the coordination are being adhered to. There must therefore be sufficient market transparency for each undertaking concerned to be aware, sufficiently precisely and quickly, of the way in which the market conduct of each of the other participants in the coordination is evolving.” *P Bertelsmann and Sony Corporation of America v Impala*, (2008), p. 123.

<sup>898</sup> According to BOSHOF et al., “[t]he Horizontal Guidelines of the European Commission (2011) take account of this ambiguity by classifying binding advance price announcements as in accordance with competition law, whereas private non-binding advance price announcements are considered likely to violate competition law and public non-binding advance price announcements constitute a grey area.” BOSHOF et al. 2018, 440.

In reviewing the case law concerning price announcements, the SCOTUS has noted, “in *Sugar Institute v. United States*, 297 U. S. 553, 601-602 (1936), the Court held unlawful an agreement to adhere to previously announced prices and terms of sale, even though advance price announcements are perfectly lawful and even though the particular prices and terms were not themselves fixed by private agreement. Similarly, an agreement among competing firms of professional engineers to refuse to discuss prices with potential customers until after negotiations have resulted in the initial selection of an engineer was held unlawful without requiring further inquiry. *National Society of Professional Engineers v. United States*, *supra*, at 692-693. Indeed, a horizontal agreement among competitors to use a specific method of quoting prices may be unlawful. Cf. *FTC v. Cement Institute*, 333 U. S. 683, 690-693 (1948).” *Catalano, Inc. v. Target Sales, Inc.* (1980), pp. 647-648. Citing to; *National Society of Professional Engineers v. United States*, (1978), *Sugar Institute v. United States*, (1936), pp. 601-602, and Cf. *FTC v. Cement Institute*, (1948). Also see: *Container Shipping Comm’n Decision* and *In re Precision Moulding Co.*, (1996).

<sup>899</sup> According to MCADAMS, “Sanctions can solve coordination problems, but so can clear, well publicized, third-party statements, including the legal pronouncements of judges and legislatures” as “law can make focal one means of coordinating and thereby induce individuals to select that means” which “has the advantage of publicity and

without explicitly agreeing to act collusively.<sup>900</sup> Standard contracts can convey information about a firm's focal point and commitment to cooperate within a cartel. According to SCHERER, "in a wide variety of problems, when behavior must be coordinated tacitly...there is a strong tendency for choices to converge on some such focal point".<sup>901</sup> SCHERER further identifies "[s]everal specific ways by which focal points enter into oligopolistic price determination" including "price lining", such as "[i]n setting one's price at a focal point", where a firm "in effect asks rhetorically, 'If not here, where?'" implicitly warning rivals of the danger of downward spiraling".<sup>902</sup>

Industry trade groups may provide firms with an opportunity to collude, and the actions taken by trade associations may show evidence of a common position within the group. According to VAN DEN BERGH, "[a] general lesson from Public Choice theory is that industry groups will be more powerful lobbyists than consumer groups."<sup>903</sup> The US telecom lobby group, now known as CTIA, originally called the Cellular Telecommunications Industry Association, then Cellular Telecommunications and Internet Association routinely sends out position letters to legislators and submits legal briefs to courts advocating for the use of arbitration in the wireless communications industry with unsubstantiated claims that without arbitration consumers "would be unable to navigate the complex rules of civil litigation and would have no remedy at all".<sup>904</sup> CTIA points to

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uniqueness" over other "third-party pronouncements" MCADAMS 2008, p. 1728. Also see: HART and MOORE 2008.

<sup>900</sup> According to POSNER, "it is entirely possible that some market settings permit collusive pricing with so little actual communication among the sellers as not to expose them to an appreciable danger of being prosecuted for price fixing. Moreover, whether a case involves oligopolistic pricing without explicit collusion, or overt conspiracy under such favorable conditions as to generate no evidence of conspiracy, is a distinction without a policy difference. From the standpoint of the trier of facts, both are cases of oligopolistic pricing, or "tacit collusion," which is my term for any form of collusion not detectable by means of the conventional, noneconomic approach to proving culpable price fixing." POSNER 1975, p. 904.

<sup>901</sup> SCHERER 1967, p. 496.

<sup>902</sup> SCHERER 1967, p. 497, 498.

<sup>903</sup> VAN DEN BERGH 2016, p. 945.

<sup>904</sup> CTIA LETTER TO NJ CONSUMER AFFAIRS COMMITTEE 2019. CTIA LETTER TO COLORADO HOUSE JUDICIARY COMMITTEE 2019.

SCOTUS rulings concerning the FAA which favor the use of arbitration, including *At&t Mobility LLC v. Concepcion*, *American Exp. v. Italian Colors Restaurant.*, *DirecTV, Inc. v. Imburgia*, and *Koontz v. St. Johns River Water Mgmt. Dist.*, some of the cases in which the SCOTUS has expanded the scope of arbitration in the U.S. in recent decades.<sup>905</sup> If a firm provides public or private information they know will reach their competitors about their use of arbitration in their terms, it may signal a strategy to other firms. If each firm in the industry identifies how they benefit from the whole industry using arbitration in their terms and the terms of the individual firm's contracts can be monitored, then the firms can more easily act in unison through conscious parallelism.<sup>906</sup> The letters from CTIA demonstrate that firms in the telecom industry have identified a course of common action to use arbitration, and the firms can also monitor their rivals for their support of pursuing this common course through their use of arbitration and potentially through their involvement with the CTIA.<sup>907</sup>

The actions of a “maverick” firm can serve as a focal point for other firms in the industry. According to GILO and PORAT, “operating with rigid standard-form contracts and raising the transaction costs of negotiating the contract with buyers can serve as a credible commitment by” a firm “not to cut prices, since it makes the price cut more transparent to” the firm’s “rivals”, and

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<sup>905</sup> CTIA LETTER TO NJ CONSUMER AFFAIRS COMMITTEE 2019. CTIA LETTER TO COLORADO HOUSE JUDICIARY COMMITTEE 2019. Both Letters citing to: *At&t Mobility LLC v. Concepcion* (2011); *American Exp. V. Italian Colors Restaurant* (2013); *DirecTV, Inc. v. Imburgia*; and *Koontz v. St. Johns River Water Mgmt. Dist.* (2013).

<sup>906</sup> According to TURNER, “conscious parallelism is never meaningful by itself, but always assumes whatever significance it might have from additional facts. Thus, conscious parallelism is not even evidence of agreement unless there are some other facts indicating that the decisions of the alleged conspirators were *interdependent*, that the decisions were consistent with the individual self-interest of those concerned only if they all decided the same way.” TURNER 1962. P. 658.

<sup>907</sup> According to SCHULDT and TAYLOR, “The presence of a trade association could theoretically impact cartel effectiveness by improving channels of communication and information sharing within the industry.” Furthermore, “[a] trade association could also help with the coordination and monitoring of the cartel.” SCHULDT and TAYLOR 2018, pp. 1-2. It should also be noted that monitoring the use of arbitration by firms can be accomplished indirectly by monitoring other firms’ involvement in claims in the court system.

“[t]his could facilitate tacit collusion” across an industry when the firm “is an industry maverick.”<sup>908</sup> If an “industry maverick” unilaterally adopts the use of arbitration clauses in their contracts, then through tacit collusion, the other firms in the industry could follow suit with the maverick. Even though the firms have not communicated with each other, they have seen what the leader in the industry is doing and mimic that behavior, essentially leading to collusion within the industry.<sup>909</sup>

The SCOTUS trend is toward an expansive view of the FAA, starting with the *Southland Corp. v. Keating* case in 1984.<sup>910</sup> The extension of the scope of the FAA through *Southland* and other cases concerning the scope of the FAA have likely served as focal points for private industry.<sup>911</sup> By expressly stating the contractual elements necessary to include in an arbitration clause for it to fall under the SCOTUS view of the FAA (which includes SCOTUS rulings on class waivers and a number of other pro defendant arbitration terms), firms can readily observe the strategic benefits of using arbitration and how to mandate for arbitration in their standard contracts to fall in line with the court's interpretation.<sup>912</sup> Other third parties, such as industry trade groups, further support the expressive function of the SCOTUS rulings in creating focal points.

The laws in Europe also serve as a focal point for firms. The decrees of EU law through treaties, directives, and court rulings have shown skepticism toward the use of arbitration in Europe,

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<sup>908</sup> GILO and PORAT 2005, p. 1020. Definition of Industry Maverick.

<sup>909</sup> For a discussion on the role of mavericks in creating focal points, see: GILO and PORAT 2005, p. 1020.

<sup>910</sup> The court found “[i]n creating a substantive rule applicable in state as well as federal courts, Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements”, thus state laws which curtail the use of arbitration contrary to the FAA “violates the Supremacy Clause” of the US Constitution. *Southland Corp. v. Keating*, (1984), p. 16. For a more detailed review of the expansion of the FAA, see: SZALAI 2016.

<sup>911</sup> LESLIE 2017, p.381.

<sup>912</sup> According to LESLIE, “the Supreme Court’s pro-arbitration jurisprudence encourages and protects conspiracies to arbitrate.” Furthermore, “The Supreme Court’s incorrect claim of a congressional policy favoring arbitration makes primary conspiracies to arbitrate rational” as “pro-arbitration decisions created the legal environment necessary for arbitration conspiracies to thrive”. LESLIE 2017, pp. 384, 424.

particularly regarding consumer contracts.<sup>913</sup> Individual EU member states also create such focal points through law. Firms operating in the EU can see that trying to enforce *ex ante* contracts to arbitrate could lead to an increase in transaction costs related to claims arising under the agreement, given that the *Mostaza Claro* case leaves open the door for those with disputes against firms being able to challenge the arbitration clause even after the arbitration proceedings have been completed.<sup>914</sup> Thus, the expressive nature of the law in Europe focuses firms on the potential pitfalls and additional costs of including arbitration in their consumer contracts.

##### 5. Conspiracies under EU and US Law.

The ability of the law to address or prevent market failures due to the collusive behavior of firms in using arbitration to settle tort claims is very much questionable. Courts in the US and EU have found that antitrust claims can be arbitrated, provided that the contract to arbitrate sufficiently provides for the claim to be arbitrated.<sup>915</sup> However, a contract to arbitrate antitrust damage claims with a firm does not necessarily cover the firm's coconspirators due to a lack of contract privity, but is rather based on the "scope and construction of arbitration clauses...governed by national law" and "it is ultimately a matter of contractual interpretation" for courts.<sup>916</sup> According to NAZZINI, within the context of cartel damages claims, "[t]he principle of effectiveness of EU law would only require such a disapplication if it were established that pursuing a cartel damages claim

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<sup>913</sup> The two most salient examples of this are the Unfair Terms Directive and the ECJ ruling in the *Mostaza Claro* case, which found that EU member states national courts "seised of an action for annulment of an arbitration award had to determine whether the arbitration agreement was void and annul that award where that agreement contained an unfair term, even though the consumer had not pleaded that invalidity in the course of arbitration proceedings, but only in that of the action for annulment." SEIN 2011, p. 59. *Mostaza Claro v. Centro Móvil Milenium SL*, (2006). Also see: *Eco Swiss China Time Ltd v Benetton International NV.*, and *Asturcom Telecomunicaciones SL v Cristina Rodríguez Nogueira*, (2009). UNFAIR TERMS DIRECTIVE 1993.

<sup>914</sup> *Mostaza Claro v. Centro Móvil Milenium SL*, (2006).

<sup>915</sup> See: NAZZINI 2018, p. 129; and BLANKE and LANDOLT 2011.

Also, see: *American Exp. V. Italian Colors Restaurant* (2013); *Cartel Damage Claims (CDC) Hydrogen Peroxide SA v Akzo Nobel NV et al.* (2015); *The Amsterdam Court of Appeal in Kemira Chemicals Oy v CDC Project 13 SA*, (2015); and, *Microsoft Mobile OY (Ltd) v Sony Europe Limited & Ors*, (2017); and, *Rechtbank Rotterdam* (2019).

<sup>916</sup> NAZZINI 2018, p. 132, 130.

for breach of EU law in arbitration would be impossible or excessively difficult”.<sup>917</sup> This leaves open the possibility of adjudication of antitrust claims against coconspirators in the cartel in a public forum. This option may be eroding. LESLIE identifies how some courts in the US have used the doctrine of equitable estoppel to mandate arbitration on antitrust claims against coconspirators of a cartel when the individual had a contract to arbitrate with only one of the conspiring firms.<sup>918</sup> Others have pointed to the changing attitude of the SCOTUS as a source for relaxing the requirements that “an arbitration agreement to be in writing” since “the Supreme Court's conclusion in *Doctor's Ass'n, Inc. Casarotto v.* that an arbitration clause may not be treated differently from any other contractual language has accelerated the development of legal and equitable principles whereby a nonsignatory to an arbitration agreement can be compelled to arbitrate based upon implied consent to such an agreement.”<sup>919</sup> Implied consent under EU law would be unavailable in consumer contracts which contain arbitration clauses.<sup>920</sup> A comparison of the *per se*, rule of reason, presumption of anti-competitiveness, and the use of effects test, as legal doctrines show how these judicial doctrines result in different deterrent effects on conspiracies to use arbitration, and indeed, these doctrines are designed to have different deterrent effects on anti-competitive behavior. The application of these legal doctrines has resulted in different legal developments involving conspiracies to use arbitration in the EU and US. Although the deference to arbitration in the doctrinal approach now taken by the SCOTUS has made alleging conspiracies to use arbitration more difficult in the US, in the EU, the inclusion of arbitration clauses in consumer contracts is seen as disfavored compared to other contract terms and the doctrinal

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<sup>917</sup> NAZZINI 2018, p.137.

<sup>918</sup> For a discussion on the use of equitable estoppel by US courts, see: LESLIE 2017, pp. 428-432.

<sup>919</sup> ULOTH and RIAL 2002, p. 593. Also see: *Doctor's Associates, Inc. v. Casarotto* and *Continental Television v. GTE Sylvania* (1977).

<sup>920</sup> CONSUMER RIGHTS DIRECTIVE 2011.

approach found in EU law makes it more difficult to engage in conspiracies to use arbitration when compared to the US.<sup>921</sup> In the US, legal claims alleging a conspiracy to use arbitration are more difficult to bring under a progressively heightened pleading standard created by the SCOTUS which has led to a near universal use of arbitration clauses in some highly concentrated industries in the US, particularly the cellular phone service industry, and has made the use of arbitration clauses in standard consumer and service contracts balloon over the past four decades. Because of the divergence in approaches in the US and the EU to the treatment of collusive behavior, a comparison of EU and US competition law is necessary to explore the collusive use of arbitration when examining conspiracies to use arbitration which covers tort claims. These doctrines must be understood as part of the greater goals of the Sherman Act and TFEU 101.

#### 5.1 US Doctrinal Approaches to Collusive Behavior.

Courts in the US consider anti-competitive practices under several standards. In the most hardline of standards, concerted efforts can be considered illegal *per se*, meaning that there is no further need for the court to consider the effects of the concerted effort. Rather the simple fact that a concerted effort exists makes it illegal. A less hardline approach is the rule of reason, which considers the effects of the constraints.

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<sup>921</sup> Although in the EU there has been momentum to expand the use of ADR procedures, including arbitration, in resolving consumer complaints, the ADR DIRECTIVE 2013 explicitly states in its preamble, "ADR procedures should not be designed to replace court procedures and should not deprive consumers or traders of their rights to seek redress before courts." ADR DIRECTIVE 2013, ph. 45. Moreover, under the UNFAIR TERMS DIRECTIVE 1993, all arbitration contracts involving consumer contracts must be "individually negotiated" and are considered unfair. THE UNFAIR TERMS DIRECTIVE 1993, art. 3, ph. 1.

### 5.1.1 Per Se and Rule of Reason Standards in the US.

The US courts have found horizontal restraints unreasonable under one of two categories.<sup>922</sup> First, restraints which "always or almost always tend to decrease competition and reduce output" or are "manifestly anticompetitive" are seen by the courts as unreasonable '*per se*', or on their face, these practices tend to distort the free market.<sup>923</sup> The '*per se*' approach has narrowed since its inception. The SCOTUS has been cautious "to extend *per se* analysis to restraints imposed in the context of business relationships where the economic impact of certain practices is not immediately obvious".<sup>924</sup> The SCOTUS has also found the *per se* standard appropriate when the "surrounding circumstances make the likelihood of anticompetitive conduct so great as to render unjustified further examination of the challenged conduct".<sup>925</sup> Restraints on trade can "only" be considered *per se* illegal when they are "so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality".<sup>926</sup>

Notwithstanding a *per se* violation of the Sherman Act, the second standard which the court uses falls under a rule of reason test. According to the SCOTUS, "[o]rdinarily, whether particular concerted action violates § 1 of the Sherman Act is determined through case-by-case application of the so-called rule of reason".<sup>927</sup> This underscores the court's view that the *per se* standard is no longer the "ordinary" standard. Rather, the rule of reason is the ordinary standard, and the *per se*

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<sup>922</sup> See: *Ohio v. American Express Co.*, (2018), pp. 2283-2284. Also, note that "a vertical restraint is not illegal *per se* unless it includes some agreement on price or price levels." *Business Electronics Corp. v. Sharp Electronics Corp.*, (1988), pp.735-736.

<sup>923</sup> *Business Electronics Corp. v. Sharp Electronics Corp.*, (1988) p. 723. Citing to: *Continental T. V., Inc. v. GTE Sylvania Inc.*, (1997), p. 49, and *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, (1985), pp. 289-290, quoting *Broadcast Music, Inc. v. Columbia Broadcasting System, Inc.* (1979), pp. 19-20.

<sup>924</sup> *FTC v. Indiana Federation of Dentists*, (1986), pp. 458-459.

<sup>925</sup> *National Collegiate Athletic Assn. v. Board of Regents of Univ. of Okla.*, (1984), pp. 103-104.

<sup>926</sup> See: *Business Electronics Corp. v. Sharp Electronics Corp.*, (1988), p. 724; and *National Society of Professional Engineers v. United States*, (1978), p. 692.

<sup>927</sup> *Business Electronics Corp. v. Sharp Electronics Corp.*, (1988), p. 723.

approach is appropriate under the most flagrant of violations. The rule of reason test used by US courts involves "a fact-specific assessment" designed to determine the actual effects of restraint and accounts for both the market structure in question and a determination of market power.<sup>928</sup> Under a rule of reason test, some restraints may be considered reasonable, such as "restraints stimulating competition that are in the consumer's best interests", while only those "restraints with anticompetitive effect that are harmful to the consumer" are considered illegal.<sup>929</sup> This also shows how the SCOTUS consideration is focused on "consumer welfare" as the object which is either being harmed or enhanced by a particular restraint.

US Courts may consider plus factors, which may have probative value to the court in assessing if a restraint resulting from parallel conduct results from an agreement between competitors. This is significant because "the line that distinguishes tacit agreements (which are subject to section 1 scrutiny) from mere tacit coordination stemming from oligopolistic inter dependence (which eludes section 1's reach), is indistinct".<sup>930</sup>

Plaintiffs in US antitrust cases alleging illegal collusion prohibited by section 1 of the Sherman Act bear the burden of proof, and courts will consider both direct and circumstantial evidence of collusion.<sup>931</sup> This approach emerged through a series of antitrust cases in which the SCOTUS developed a "doctrine governing the use of circumstantial evidence to prove an agreement", which includes, (1) "courts would characterize as concerted action interfirm coordination realized by means other than a direct exchange of assurances", (2) "courts would allow agreements to be inferred by circumstantial proof suggesting that the challenged conduct more likely than not

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<sup>928</sup> *Ohio v. American Express Co.*, (2018), pp. 2283-2284

<sup>929</sup> *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, (2007).

<sup>930</sup> KOVACIC et al. 2011, p. 405

<sup>931</sup> KOVACIC et al. 2011, p. 402

resulted from concerted action”, and (3) “courts would not find an agreement where the plaintiff showed only that the defendants recognized their interdependence and simply mimicked their rivals’ pricing decisions”.<sup>932</sup> According to the SCOTUS in the *Monsanto Co v. Spray-Rite Service Corp.* “there must be direct or circumstantial evidence that reasonably tends to prove that (the parties) had a conscious commitment to a common scheme designed to achieve an unlawful objective”.<sup>933</sup> According to KOVACIC et al., “[n]either Monsanto nor any earlier case provides a useful basis for identifying concerted action” as they “offer no useful operational means for determining when the defendants have engaged in something that is more than consciously parallel conduct”.<sup>934</sup> The SCOTUS further distinguished that a plaintiff “must show that the inference of conspiracy is reasonable in light of the competing inferences of independent action or collusive action that could not have harmed” the plaintiff, in what KOVACIC et al. describes as the court seeking “to reduce error costs associated with the excessively broad application of liability standards”.<sup>935</sup> The heightened standard for plausibility was further extended to pleadings alleging conspiracies under § 1 of the Sherman Act, where the “court reiterated the principle that proof of conscious parallelism alone is inadequate to establish conspiracy”<sup>936</sup> The SCOTUS “observed that a more rigorous examination of the plaintiff’s pleadings was necessary to limit the plaintiff (and classes of plaintiffs) from setting in motion the costly process of civil discovery and extracting unjustified settlements from defendants” in the *Twombly* case.<sup>937</sup> According to *Bell Atlantic Corp. v. Twombly* ruling, a claim must state “enough facts to state a claim to relief that is plausible on its

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<sup>932</sup> KOVACIC et al. 2011, p. 401

<sup>933</sup> *Monsanto Co. v. Spray-Rite Service Corp.*, (1984), p. 768.

<sup>934</sup> KOVACIC et al. 2011, p. 401. *Monsanto Co. v. Spray-Rite Service Corp.*, (1984), p. 763.

<sup>935</sup> KOVACIC et al. 2011, p. 402. Citing to *Matsushita Elec. Industrial Co. v. Zenith Radio Corp.*, (1986).

<sup>936</sup> KOVACIC et al. 2011, p. 403.

<sup>937</sup> KOVACIC et al. 2011, p. 404. Referencing *Bell Atlantic Corp. v. Twombly*, (2007).

face", which is more than a claim being merely "conceivable".<sup>938</sup> The SCOTUS has further heightened pleading standards in *Ashcroft v Iqbal*, where it found that "to state a claim based on a violation of a clearly established right, respondent must plead sufficient factual matter" in the complaint.<sup>939</sup> There are "six key elements of a competition law system" in which collusion claims may be shown as "interdependent," according to KOVACIC et al.. These elements include "the substantive scope of the legal command, the volume and quality of evidence required to prove a violation, the means for detecting violations, the prosecution of violations, the adjudication process that determines innocence or guilt, and the sanctions imposed for infringements."<sup>940</sup> KOVACIC et al. point to "[p]erceived excesses with private rights of action (the prosecution element) and the mandatory trebling of damages for victorious plaintiffs (the remedy element)" as issues which have prompted the "Court to engage in 'equilibration' -the adjustment of one element of the antitrust system (namely, the evidentiary standard) to offset imperfections in other elements."<sup>941</sup>

Plus factors which KOVACIC et al. identify as being "chief plus factors" include: "[a]ctions contrary to each defendant's self interests unless pursued as part of a collective plan"; "[p]henomena that can be explained only as the result of concerted action"; "[e]vidence that the defendants created the opportunity for regular communication"; "[i]ndustry performance data... that suggest successful coordination"; and "[t]he absence of a plausible, legitimate business rationale for suspicious conduct (such as certain communications with rivals) or the presentation of contrived rationale for certain conduct".<sup>942</sup> Despite courts identifying these factors, "the absence of a methodology for ranking plus factors according to their likely probative value" is completely

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<sup>938</sup> *Bell Atlantic Corp. v. Twombly*, (2007), p. 1960.

<sup>939</sup> *Ashcroft v. Iqbal*, (2009), p. 1949.

<sup>940</sup> KOVACIC et al. 2011, p. 404

<sup>941</sup> KOVACIC et al. 2011, p. 404, citing to CALKINS 1986.

<sup>942</sup> KOVACIC et al. 2011, pp. 405-406.

absent from judicial doctrine.<sup>943</sup> Another issue which creates a problem for judicial consideration of these plus factors concerns the "economic literature regarding repeated games" which has shown how "market outcomes associated with collusive schemes can result from interdependent, consciously parallel conduct in some industries".<sup>944</sup>

## 5.2 EU Doctrinal Approach to Collusive Behavior.

The doctrinal approach the EU takes towards collusive behavior reflects the goals of EU competition law, which focus on the integration of EU member states into the EU internal market and goals such as "fairness" and the promotion of the "four freedoms", as well as other goals found in the EU's treaties and directives.

### 5.2.1 Presumption of Anticompetitive Effects.

Under the European approach found in TFEU 101, some forms of restraints are "presumed to have anticompetitive effects".<sup>945</sup> According to WITT, "Article 101(1) ... as interpreted by the Court of Justice... contains an inbuilt recognition that certain types of contractual clauses may be presumed to have anticompetitive effects on the basis of their wording, purpose and the broader economic context of the agreement."<sup>946</sup> An agreement may be considered as having the objective of restriction, where "contractual restrictions... are so likely to have negative effects on competition that it would be redundant to prove their actual effects".<sup>947</sup> Those restraints which have been presumed to be anticompetitive include "horizontal price fixing, output reduction, and customer

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<sup>943</sup> KOVACIC et al. 2011, p. 406

<sup>944</sup> KOVACIC et al. 2011, p. 406.

<sup>945</sup> WITT 2018, p. 9.

<sup>946</sup> WITT 2018, p. 9. TFEU 101.

<sup>947</sup> WITT 2018, p. 18.

allocation, but also resale price maintenance, absolute territorial protection and agreements designed to restrict parallel trade between EU Member States".<sup>948</sup>

The "presumption of anti-competitiveness" approach is similar but distinct from the "*per se*" approach the US adheres to; however, the difference has "not been overly significant".<sup>949</sup> Under the *per se* approach, the agreement or conduct is held illegal, and the infringer has no grounds to rebut the holding other than an appeal to a higher court, while under the presumption approach, there may be an exception under TFEU 101(3) which defendants may plead.<sup>950</sup> However, in practice 101(3), defenses do not appear to be a serious factor as there is a "presumption that restrictions that are blacklisted in Block Exemption Regulations are unlikely to fulfill the conditions of Article 101(3)" and the "Commission applies a high standard of proof for the efficiency defence".<sup>951</sup>

#### 5.2.2 Economic Effects Test.

Those restraints which are not found illegal under a presumption of anti-competitiveness standard "need to be assessed as to their actual or likely effects on competition."<sup>952</sup> For this, the EC has published guidelines that concern assessing economic effects on competition.<sup>953</sup> According to WITT, these four guidelines were promulgated in order to create a "coherent theoretical framework for assessing the effects of agreements that do not have an anticompetitive object".<sup>954</sup> The two step process for assessing the effects on competition entails (1) "the enforcing body needs

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<sup>948</sup> WITT 2018, p. 4.

<sup>949</sup> WITT 2018, p. 9.

<sup>950</sup> TFEU 101.

<sup>951</sup> WITT 2018, p. 9. TFEU 101.

<sup>952</sup> WITT 2018, p. 9.

<sup>953</sup> See: WITT 2018, p. 2. Also see: EUROPEAN COMMISSION GUIDELINES, C 101/7 (2004), C 11/1 (2011), C 130/1 (2010), and C 89/3 (2014).

<sup>954</sup> WITT 2018, p. 3.

to demonstrate that the investigated agreement leads to a restriction of competition either through coordination or foreclosure", and (2) the enforcing body "needs to prove on the basis of cogent evidence that this restriction of competition has the effect of reducing consumer welfare, for example in the form of higher prices, reduced output, lower quality or diminished levels of innovation".<sup>955</sup> The economic effects test and the rule of reason test are clearly distinct but still have some similar criteria.

#### 6. Collusion and the Strategic use of Arbitration.

Individuals contracting with firms are often at a bargaining disadvantage, especially when firms have market power. A bargaining disadvantage may reflect other disadvantages individuals have when being involved in disputes with firms with market power who are repeatedly involved in similar disputes. Market power can lead to other bargaining advantages, such as an information advantage. GALANTER has identified how RP firms benefit from several advantages in litigation, including resource, intelligence, and opportunity advantages.<sup>956</sup> RP firms can exploit these advantages to influence the outcomes of disputes. The RP will also have these same advantages in arbitration. However, the structure of arbitration may contribute to these advantages as judicial limits on strategic behavior may not be available in arbitration.

Bargaining asymmetry may lead to an excessive number of inefficient contracts for consumers, especially when there is a rampant problem of signing without reading.<sup>957</sup> According to CHOI and TRIANTIS, there are "ways in which the shift in bargaining power might lead to a deviation from efficient contract design", including: 1) parties "engage in value-claiming rather than value-creating strategies"; 2) "the party with greater bargaining power has better incentives to invest ... in

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<sup>955</sup> WITT 2018, p. 10. TFEU 101.

<sup>956</sup> For a discussion on strategic behavior in litigation, see: GALANTER 1974.

<sup>957</sup> For a discussion on the signing without reading problem and its relation to rational apathy, see: DE GEEST 2015.

innovating and developing contractual opportunities to create value"; 3) the use of "bargaining power" in contracting to "distort the agreement on non-price terms"; and 4) "in negotiations characterized by information asymmetry, unequal bargaining power might encourage excessive signaling or screening activity in the design of nonprice terms".<sup>958</sup> Adhesion boilerplate or standard form contracts give little for the individual bargaining with the firms to bargain over. Widespread use of standardized terms in an industry may leave consumers or employees with little choice over the terms of contracts for potentially necessary goods, services, medical treatments, or employment.

If an entire industry adopts the same nonnegotiable contractual terms, including mandatory arbitration, individuals contracting with the firms have only two options. First, accept the universally used terms, with no choice over arbitration as the forum to enforce their legal rights against the firms in the industry, or, second, reject them and forego accessing the benefits of a market.<sup>959</sup>

Conspiracies to use arbitration may be undertaken in pursuit of a number of goals. LESLIE distinguishes between primary and secondary conspiracies to use arbitration, where the primary conspiracy concerns only the mandated use of arbitration and the standardization of arbitration contracts, while secondary conspiracies include using arbitration to "conceal an underlying conspiracy", "undermining pro-plaintiff aspects of antitrust law" and "alleviating settlement pressure".<sup>960</sup> According to LESLIE, in the US, conspiracies to use arbitration may allow firms to avoid "pro plaintiff" aspects of the antitrust laws "designed to encourage private plaintiffs to

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<sup>958</sup> For a further discussion on how bargaining power influences contract design, see: CHOI and TRIANTIS 2012, pp. 1671-1672

<sup>959</sup> See: LESLIE 2017.

<sup>960</sup> LESLIE 2017. P. 406, pp. 412-423.

pursue antitrust litigation", such as "a means to de-treble antitrust damages", "preclude any injunctions against their interests", "nullify antitrust law's fee-shifting mandate", "truncate statutes of limitations", and use "class action waivers in arbitration clauses" to "immunize themselves from private antitrust liability."<sup>961</sup> In addition to the primary and secondary conspiracies which LESLIE identifies, conspiracies to mandate arbitration of tort claims may allow or enable firms to: strategically choose judicial forums in an effort to benefit from arbitrage strategies, strategically take less than due care, thus avoiding care costs, avoid regulatory compliance costs, indirectly fix prices using nonprice terms (through making contracts less valuable under the same sales price), switching the demand side economics of litigation from being pro plaintiff to pro defendant, and developing future options to behave strategically.<sup>962</sup> It cannot be forestalled that the indirect price fixing is not the actual aim of a primary conspiracy to arbitrate, as the conspiracy may result in increased profits for firms without any further goal. However, there may also be incentives for firms to coordinate on other terms of business in relation to the use of arbitration.

Firms can use the terms of their contracts to enable their collusive behavior and anticompetitive strategic behavior. According to GILO and PORAT, there are situations where "boilerplate language and the artificial imposition of transaction costs do create asymmetry of information between the supplier and its consumers, as in the classic discussions of boilerplate language, but the asymmetry is used as a cartel facilitation tool, an anticompetitive signal device, or a tool for creating the appearance of a fair contract, rather than to merely extract surplus from uninformed consumers."<sup>963</sup> When arbitration clauses are included in these boilerplate contracts, the opportunities to conceal anticompetitive behavior from regulators may be persistent; meaning

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<sup>961</sup> LESLIE 2017, p. 414, p. 415, p.416, p. 417, and p. 418.

<sup>962</sup> LESLIE 2017. The strategic use of arbitration was discussed in the chapter titled "Marching Without Memory".

<sup>963</sup> GILO and PORAT 2005, p. 1030.

firms are enabled to behave strategically due to the terms of the arbitration contract being robust against a challenge for anticompetitive behavior.

The use of boilerplate arbitration clauses in contracts may enable collusion across an industry. If this occurs, the market for dispute resolution may be distorted by a lack of competition and a lack of options for courts to review anticompetitive behavior. Collusion to restrict the market for adjudication may result in a lower amount of consumer welfare, lower production of public goods from courts, and arguably lower social welfare. These losses may be analogous to the deadweight loss associated with monopoly pricing.<sup>964</sup>

#### 6.1 The Private Costs and Benefits of using Arbitration.

*\*\*\*This topic was discussed in introductory chapter, section 6.6 concerning the costs and benefits of arbitration\*\*\**

It is necessary to consider how private parties to a dispute may either incur costs or benefits from the use of arbitration for tort claims. As firms in an industry each have their own unique costs and benefits to consider, they can be considered as individual costs and benefits. The RP and the OS have different costs and benefits. That is to say, the attributes of arbitration that provide benefits to the RP may not result in benefits to the OS. If the benefits or costs of arbitration are disproportionate between RP and OS, then it will be an advantage to one party over the other to have arbitration be mandated to cover their contractual disputes. Interestingly, the advantage to an RP against an OS in an individual claim may not be large; however, when the benefits of that

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<sup>964</sup> In so far as a price fixing scheme or tacit collusion is occurring, there is a deadweight loss. Consumer surplus will decrease when the benefits of using arbitration for tort claims are wholly captured by the firm, as the consumer is now burdened with a less valuable product or service if there is no corresponding change in price. If the cost savings were to be passed on to consumers, then the price point for the product or service would reflect the value more accurately, and additional consumers may be willing to purchase. In terms of quality, the presence of a contract to arbitrate may make the underlying contract less valuable, and any loss in value should be reflected in the price. If there is no change in price alongside the inclusion of mandatory arbitration, *ex ante*, it may be considered an indirect price fix with a deadweight loss.

advantage are considered in aggregate when the RP faces many OS in individual claims, they may be significant.

Disputes can generate transaction costs for the parties of disputes related to the resolution process, which can also be framed in terms of litigation costs. Some forms of dispute resolution are designed to minimize potential transaction costs related to the dispute. For example, mediation can facilitate the resolution of disputes between parties without having to incur costs from a third-party adjudicator (a third party mediator also has costs) but leads to increased transaction costs for the parties if mediation is unsuccessful, and a third party is needed to settle the dispute. The scope of the transaction costs associated with dispute resolution is influenced by the process used. There are transaction costs in litigation, as lawyers, judges, and various legal support services may be used. There are also transaction costs of arbitration and any other form of dispute resolution, for that matter. The degree of the transaction costs depends on the nature of the dispute, the forum in which resolution is sought, and the dispositions of the parties. A few of the potential benefits of using arbitration over litigation in courts may include: lower transaction costs, a shorter time frame for the process to be completed, it may help to enable a continued relationship after the dispute is resolved, and it may allow for the parties to choose arbitrators with expertise relevant to the claim.<sup>965</sup> However, these benefits cannot and should not be assumed or guaranteed.<sup>966</sup> According

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<sup>965</sup> For a lobbyist view about the potential benefits of arbitration, see: CTIA LETTER TO COLORADO HOUSE JUDICIARY COMMITTEE 2019. CTIA LETTER TO NJ CONSUMER AFFAIRS COMMITTEE 2019. VAN AAKEN and BROUDE 2016. Also, See: SHAVELL 2004. P. 323 for an analysis of why arbitration may be used to enforce contracts instead of litigation.

<sup>966</sup> DRAHOZAL found in 2007 that “the available empirical evidence suggests the following tentative conclusions. First, the upfront costs of arbitration will in many cases be higher than, and at best be the same as, the upfront costs in litigation. Whether arbitration is less costly than litigation thus depends on how attorneys’ fees and other costs compare, and the evidence here is inconclusive. Second, for employees and consumers with small and mid-sized claims, the availability of low-cost arbitration makes arbitration an accessible forum, and possibly a more accessible forum than litigation. But for consumers with large claims, and for employees not able to use low-cost arbitration, the evidence is less clear. For such claimants, administrative fees and arbitrators’ fees likely will exceed court filing fees. The question is whether other cost savings in arbitration offset the higher upfront costs. Moreover, even if arbitration is more affordable on net, it still may not be a more accessible forum than litigation.” DRAHOZAL 2007, pp. 816-

to SHAVELL, parties in "an accident between an individual and a firm...may decide that it is in their best interests to elect arbitration for its simplicity and speed, but that may mean the firm escapes with inadequate liability or that the firm's fault is never properly investigated and made known to the public", which may lead to under deterrence "if firms anticipate often being able to reach such agreements to arbitrate".<sup>967</sup>

Only those disputes in which at least one of the parties has wrongly estimated the potential outcome in adjudication will be pursued, as having an accurate estimation of the outcome should lead to settlement in order to minimize the private costs the parties incur due to the dispute.<sup>968</sup> Parties have a zone of possible agreement to use arbitration, given each party's minimum and maximum asking or taking price, and parties should account for litigation costs and deterrence effects when determining pricing.<sup>969</sup> In such a scenario, the *ex post* use of arbitration clauses should lead to more efficient uses of arbitration as the total litigation costs can be more accurately estimated by both parties, while in *ex ante* arbitration contracts, the estimation of expected litigation costs is less clear.<sup>970</sup> However, the RP is more accurate than the OS in estimating both *ex post* and *ex ante* litigation costs due to its informational advantage, created through the accumulation of information in numerous disputes.

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817. Furthermore, a survey study of plaintiffs' attorneys conducted by GOUGH in 2014 found that a review "of approximately 700 contemporary employment discrimination cases shows outcomes in arbitration are starkly inferior to outcomes reported in litigation: employees are nearly forty percent more likely to win and receive average awards nearly twice as large in cases adjudicated in the civil litigation system compared to those that are arbitrated". GOUGH 2014, p. 112.

<sup>967</sup> SHAVELL 2009, p. 448.

<sup>968</sup> PRIEST and KLEIN 1984.

<sup>969</sup> According to HYLTON, "the minimum asking price demanded by the party who will be disadvantaged by committing to the alternate court will be less than the maximum offer price of the party who will be advantaged when, and only when, the difference between the deterrence benefit and the expected total litigation costs is greater in the alternate than in the default court." HYLTON 2000, p. 225.

<sup>970</sup> SHAVELL 1995, p. 3.

As described in the previous Chapters, the use of mandatory arbitration by a firm may reduce the firm's liability costs either through their taking of strategically low care or through the protection of an inefficient rule.<sup>971</sup> The arbitration of tort claims may allow RP firms to protect an inefficient rule from which they benefit from being adjusted by a court to an efficient one. It matters if the inefficient rule is inefficiently high or inefficiently low. When an efficient rule replaces an inefficiently low rule, it will increase care costs for the firms. The increased care costs should be reflected in the service's or product's price, and the increased price should reflect the product's full value, including the costs of taking the efficient level of care and the cost of potential accidents.<sup>972</sup> Under an inefficiently high rule, the increased expected liability costs of the firm should also be reflected in the price of the good, and firms may have the incentive to take steps to adjust the inefficiently high rule to an efficient rule in order to avoid excessive care costs. This potential for firms to seize consumer surplus from their transactions through the use of *ex ante* contracts to arbitrate tort claims is a powerful benefit which firms may focus on, which may further incentivize collusive behavior in a market over the terms of contracts.

Firms may have a private incentive to strategically take low care, which results in no positive value claims given the transaction costs of dispute resolution. There may be remedial rules in litigation that address this type of strategically low care taking, which may be unavailable in arbitration, such as collective actions or punitive damages. The taking of strategic care or use of liability waiver leads to a reduction in transaction costs (as well as expected liability) associated with tort

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<sup>971</sup> These specific issues are discussed at length in Chapter 3.

<sup>972</sup> According to SHAVELL, "a customer will buy a product only if the utility of the product to him exceeds its perceived *full* price – the price actually charged in the market plus the perceived expected accident losses that liability payments would not cover and thus that he would have to bear. The expected accident losses that a customer perceives that he would have to sustain will depend on his information about the product risks." SHAVELL 2009, pp. 212-213.

claims for RP firms, while only the efficient waiver of liability leads to a reduction in transaction costs (or minimization of expected harm) for potential OS plaintiffs.<sup>973</sup>

The efficient use of arbitration for tort claims depends on the adjudicated claim type, the efficient due care rules applied to the claim, and the potential for claims to lead to the production of public goods. If a claim is incapable of leading to the production of public goods from courts, then the use of arbitration may lead to lower tertiary costs, which society subsidizes and may be welfare increasing. If it is inefficient to use arbitration for a tort claim, it may be due to an underproduction of public goods from litigation, an increase in enforcement errors, an increase in accident costs, or because there is no market force in place which forces firms to pass off the potential savings from using arbitration.<sup>974</sup> While there are questions concerning the social desirability of the use of arbitration for any given tort claim, when there is a conspiracy or coordination in the use of arbitration for specific tort claims, there is little room for argument that such coordination to manipulate a market is socially desirable.

Firms will consider the costs and benefits of joining a conspiracy and the cost and benefits of defecting after joining a conspiracy. The use of arbitration to conceal anticompetitive activities

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<sup>973</sup> According to HYLTON, similarly to arbitration, waiver can be used as “the fundamental Coasean result suggests that parties will enter into waiver agreements in settings where litigation reduces wealth in the sense that the deterrence benefits are less than total litigation costs—that is, whenever litigation is likely to be of the rent-seeking variety depicted in *Bleak House*.” HYLTON 2000, p. 222.

<sup>974</sup> HYLTON has made a case that the “general argument against arbitration agreements is that they contribute to the erosion of the publicly accessible stock of common-law rules and hinder the development of new rules” and is dependent “on the desirability of subsidizing litigation in order to enhance the stock of legal capital.” However, a prohibition of “arbitration would have no more effect on the legal capital stock than prohibiting settlement”, and “it is doubtful that either” prohibition or subsidization “will improve the legal capital stock”. Furthermore, “[i]n certain settings, parties may develop an institutional common law through repeated dealings” and “even if capital-erosion did occur...it is still not clear that the private incentive to arbitrate deviates from the social incentive.” HYLTON 2000, p. 244, p. 245. This approach by HYLTON may not be taking into account the potential collusive use of arbitration within an industry, which has the aim of contributing to the erosion of the “stock” of rules already in place. Thus, a specific argument against the use of coordinated arbitration within an industry that contributes to an “erosion” as having a greater impact on the “legal capital stock” than settlement may be appropriate. In such a case, the private incentive to arbitrate deviates from the social incentive.

will lead to a lower deterrence to enter into a conspiracy to arbitrate because the use of arbitration should facilitate the concealment of the conspiracy. A price cut may not necessarily deter all firms in a market from defecting from the strategy of using arbitration to protect an inefficiently low due care standard by using contracts to arbitrate to limit the litigation of a tort claim involving an inefficiently low due care standard. In actuality, the risk that the firm takes by defecting is to create a price increase for every firm in the market, which is caused by increased care costs and liability costs due to an adjustment of due care standards to the efficient rule. Price fixing may also lead to less innovation by firms and may be a form of rent seeking or part of a rent seeking strategy.<sup>975</sup> If the use of arbitration for tort claims leads to diminished investments in innovation by industry, this may negatively inhibit what SCHUMPETER described as a process of “creative destruction” by which capitalist markets evolve.<sup>976</sup> Thus, a conspiracy to use arbitration across an industry may be

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<sup>975</sup> If arbitration is used for tort claims and if firms fully capture the benefits of cost savings without any passing on of benefits, this could be considered rent seeking in the sense that this is a manipulation of the judicial deference to arbitration. It will allow firms to extract value from consumers or employees without contributing to the production of the underlying activity and without compensation to consumers. Firms in a conspiracy may also not have to face the market pressure which prompts the search for new technologies and methods.

According to MCNUTT, “The computation of rent as a geometric measure requires information on two prices, the real competitive price and the monopoly price. The latter would generate the largest geometric measure on the presumption that the monopoly price represents the greatest divergence in price from the real competitive price. If we are to continue with the monopoly premise, then we should refer to the long run prices and the long run costs.” Furthermore, MCNUTT finds that “With more competition, the economy will inevitably witness a greater incidence of rent-seeking games *viz* inefficient firms may opt to become complainants, efficient firms acquire a dominance that they wish to protect, a greater frequency of price games will emerge as potential offenders abandon mergers in favour of price as a strategy to maintain and acquire greater market shares. Such firm-specific activities and strategies will impose higher opportunity costs *viz* the real resources of the economy as individual firms adjust to the new competitive equilibria, arrived at competitively, but with only a few dominant players remaining in the market.” MCNUTT 2002, p. 8, p. 20.

<sup>976</sup> According to SCHUMPETER, “Capitalism, then, is by nature a form or method of economic change and not only never is but never can be stationary. And this evolutionary character of the capitalist process is not merely due to the fact that economic life goes on in a social and natural environment which changes and by its change alters the data of economic action; this fact is important and these changes (wars, revolutions and so on) often condition industrial change, but they are not its prime movers. Nor is this evolutionary character due to a quasiautomatic increase in population and capital or to the vagaries of monetary systems of which exactly the same thing holds true. The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.” SCHUMPETER 1942, p. 82-83.

considered a source of reduction of public welfare through the forgone benefits that a competitive market would produce.

The strategic or collusive use of arbitration may lead to several types of injuries. LESLIE identifies higher prices, lower quality, the deprivation of procedural or substantive due process rights, quantity restraints including fewer options to choose from, and the benefits of competition, as the injuries which occur due to a conspiracy to use arbitration.<sup>977</sup> LESLIE also identifies how injunctive relief from courts may prevent future injuries from illegal conduct by stopping the illegal activity, limiting the private benefits of illegal conduct, and promoting competition.<sup>978</sup> When injunctive relief is unavailable, injuries may mount up while the illegal activity continues.

Besides injunctive relief, there are also the benefits of judicial review, which may be forgone due to the use of arbitration, including the value of appeal and the production of public goods from litigation, such as efficient due care standards, precedent, rule interpretation, and gap filling.<sup>979</sup> These benefits may also be costly due to externalities from litigation.<sup>980</sup> However substantial the benefits may be, it is still difficult to quantify. According to SHAVELL, "if private adjudication is employed where contracts would have harmful external effects... it would obviously not be desirable for courts to enforce the private adjudicative findings."<sup>981</sup> If an underproduction of public goods from litigation results from the use of arbitration, then it may "reduce the deterrence benefits of arbitration over time".<sup>982</sup> The lack of deterrence harms third parties when the externalities of

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<sup>977</sup> LESLIE 2017, p. 410

<sup>978</sup> Additionally, LESLIE explains how "[t]hrough a conspiracy to arbitrate, antitrust violators may draft arbitration clauses that deny arbiters the authority to grant injunctive relief." LESLIE 2017, p. 415

<sup>979</sup> See the discussion on the benefits of judicial review in the chapter: "Marching without Memory".

<sup>980</sup> According to LANDES and POSNER, "Much of the social benefit of litigation, viewed as a rule creating activity, is received by people who may never be involved in litigation" and "[t]he existence of this external benefit may justify externalizing some of the costs of litigation by financing judges' salaries out of general tax revenues and keeping litigation fees low" LANDES and POSNER 1979, p. 241.

<sup>981</sup> SHAVELL 2004, p. 323

<sup>982</sup> HYLTON 2000, p. 246.

accidents fall outside the defendant and plaintiff, such as when insurance companies or state services incur costs from the accidents. Family and social networks of victims may also incur costs from accidents.

One result of having known rules and standards is that parties will more accurately be able to identify the outcome of a dispute in litigation and thus will prefer to settle the dispute and avoid the transaction costs of litigation.<sup>983</sup> This can be extended to argue that parties will be able to estimate the expected litigation costs of their disputes more accurately when rules and standards are well defined. The certainty effects of the law are also related to the extent to which externalities harm third parties. An efficient and certain standard should limit negative externalities for third parties, as limiting the expected costs of accidents should also limit the expected cost of externalities from accidents falling on third parties.

When arbitration becomes a standard practice in an industry through collusive behavior, the likely result is an underproduction of public goods from litigation in that industry.

## 6.2 Arbitrage Strategies and the Stock of Precedents.

*\*\*\*This topic was discussed in Chapter 3, section 5.2.11 concerning regulatory arbitrage. \*\*\**

When firms have a choice over the domestic judicial forum, which will adjudicate claims they are parties to, the firms can choose the forum which provides them with the most benefits, be they legal or economic. Given that courts can adjust due care standards through the production of precedent, gap filling, and interpretation, firms can choose *ex ante* to avoid some jurisdictional

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<sup>983</sup> LANDES and POSNER have addressed how “the parties decision calculus may be affected by the precedential character of their case, if the case is litigated to judgement”. This is because “[a] decision in plaintiff’s favor will increase the probability of the plaintiff’s winning similar cases in the future, and a decision for the defendant will increase the probability of his winning similar cases in the future.” The judgment in the underlying dispute “will alter (though, in an incremental, common law system, we assume slightly) the ration of favorable to unfavorable precedents applicable to the parties’ future activities”. LANDES and POSNER 1979, p. 260.

oversight in court by mandating a strategic choice of law and forum in their contracts. This type of arbitration takes advantage of the difference between public and private adjudication forums and can be considered a type of domestic forum arbitration.

Influencing the stock of precedent may be one of the aims of the arbitration strategies. Firms may be seeking to strategically influence how precedent is developed and the value of existing precedent. Precedent has a value, like stocks, which can increase or decrease over time.<sup>984</sup> The salience and use of the precedent are related to how often the precedent is cited or how often the precedent influences the private settlement of disputes.<sup>985</sup> Rule interpretation and gap filling may have a value similar to precedent in so far as the gap filling and interpretation are considered public goods produced by courts that may have depreciating values.

The competition in the market for adjudication may lead to a unique form of jurisdictional arbitration when firms can dictate contractual terms concerning the choice of adjudication forum. This type of arbitration is a form of regulatory arbitration. Regulatory arbitration is a "planning technique used to avoid" regulation in order to exploit "the gap between the economic substance of a transaction and its legal or regulatory treatment."<sup>986</sup> Jurisdictional arbitration can be seen as a broader form of

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<sup>984</sup> For a discussion on the capital stock nature of precedent, see: LANDES and POSNER 1976.

<sup>985</sup> For a discussion on how precedent influences the behavior of individuals and firms, see: POSNER 2014, p. 59.

<sup>986</sup> FLEISCHER defines regulatory arbitration as "a perfectly legal planning technique used to avoid taxes, accounting rules, securities disclosure, and other regulatory costs. Regulatory arbitration exploits the gap between the economic substance of a transaction and its legal or regulatory treatment, taking advantage of the legal system's intrinsically limited ability to attach formal labels that track the economics of transactions with sufficient precision." FLEISCHER 2010, p. 229.

Similarly, POSNER comments, "'Regulatory arbitration' refers to the practice of firms' configuring their business in such a way as to bring them within the regulatory jurisdiction of an agency likely to favor the firm, perhaps because the agency is supported by fees of the firms it regulates and therefore, to increase its budget, seeks to entice firms by an implicit promise of lighter regulation." POSNER 2014, p. 856.

A type of regulatory arbitration has also been framed in terms of Jurisdictional Arbitration. USLegal.com defines jurisdictional Arbitration as "Jurisdictional arbitration means the act of taking advantage of the disagreements between competing legal jurisdictions. It takes its name from arbitration. For instance, the practice of hiring legal service for a lower value in one jurisdiction and offering it for a higher value in another jurisdiction is a jurisdictional arbitration. Just as in financial arbitration, the attractiveness of jurisdictional arbitration depends largely on its costs of switching legal service providers from one government to another. Jurisdictional arbitration is an important concept in modern free

arbitrage under which a more distinct form of arbitration being discussed here should be considered.<sup>987</sup> An accurate term for this unique type of arbitration is “Domestic Forum Arbitration” because it implies there is no choice over state jurisdictions, but rather the choice is over competing private and public domestic adjudication forums within a state.<sup>988</sup>

Firms will take advantage of differences in regulation in order to avoid costs associated with regulation. All other costs being equal, when there are multiple states in which firms can choose to incorporate, and one has a lower regulatory burden, firms may have a financial incentive to incorporate in the state with a lower regulatory burden.<sup>989</sup> Likewise, if there are competing judicial forums (each with unique burdens for the firm) in which firms can avail itself of jurisdiction, firms can avail itself of the forum with the lower regulatory burden to take advantage of the differences between forums.<sup>990</sup>

There is a market for resolving legal disputes, which includes private and public forums and processes.<sup>991</sup> Courts, arbitration tribunals, mediators, conciliation, and private negotiation are all

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market anarchist schools of thought. Jurisdictional arbitration is often employed by the transnational criminals such as terrorists, money launderers, cyber-attackers to hinder attempts at governmental prosecution include. Jurisdictional arbitration often helps in tax avoidance.” USLEGAL.COM 2020.

<sup>987</sup> According to DINE, Multinational Companies (MNCs) use their market power to make “accountability very difficult especially when they hide their irresponsibility in complex structures in other jurisdictions” through the “use jurisdictional arbitration.” DINE has also found that jurisdictional arbitration and regulatory arbitration are interlinked, where firms seek “out the jurisdiction with the fewest protections in order to maximize profits”. DINE 2012, p. 77, p. 49.

<sup>988</sup> The defining difference between the arbitration strategy discussed here, which I call Domestic Forum Arbitration, and Jurisdictional Arbitration, is that Domestic Forum Arbitration involves taking advantage of differences in third party judicial forums, both public and private. This may or may not involve Jurisdictional Arbitration as part of a strategy to take advantage of the differences between competing jurisdictions within a state. For instance, options for Jurisdictional Arbitration may not exist in a purely domestic dispute. In contrast, options for arbitration strategies concerning the choice of public or private adjudication may exist, or there may be no possibility to take advantage of differences in various jurisdictions’ laws because of convergence across states, yet there remain options to take advantage of the differences between private and public judicial forums.

<sup>989</sup> The motivation for regulatory arbitration was identified in courts as far back as the 1930s by Justice Brandeis. See: Dissenting opinion of Justice Brandeis in *Louis K. Liggett Co. v. Lee*, (1933). Importantly, transaction costs may make the movement of already incorporated firms more costly.

<sup>990</sup> This is analogous to the classic example of regulatory arbitration and the impetus for a race to the bottom.

<sup>991</sup> According to BOOKMAN, “the fundamental distinction between litigation and arbitration is often thought of as the difference between public and private adjudication, or between state-mandated procedures and party-designed or

options for parties looking to resolve a dispute. The only forums where a third party adjudicates disputes are public judiciaries (including quasi-judicial government institutions) and private arbitration. According to Dilanni, “competition between courts has characterized many legal systems throughout history, and has played a significant role in the development of our own modern legal system.”<sup>992</sup> Because there are no complete contracts, parties can try to lower the transaction costs of dispute resolution by *ex ante* determining how future disputes will be resolved, including which forum, rules, and procedures will be used if a dispute develops.<sup>993</sup> Institutions affect the competition for judicial services, which may lead to bias that distorts outcomes.<sup>994</sup> A reputation for bias should influence contracting parties' choice of adjudication forum. In a litigation setting, the plaintiff determines the forum to file in, and the plaintiff drives the demand for adjudication, absent an *ex ante* contract over the choice of forum. When firms have market power, they can mandate *ex ante* the adjudication forum used in the event of a dispute. If firms are more likely to be defendants in such contractual settings, they can choose to mandate arbitration in the boilerplate contracts they use, but they should only do so if arbitration is expected to provide an economic advantage which is higher than alternative forums.<sup>995</sup>

Assuming the demand for litigation and arbitration is influenced by bias or perceived bias, parties can strategically choose a forum they perceive to be pro plaintiff, pro defendant, or neutral, depending on their expected position in future disputes. A party who expects to be involved in

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designated ones, or between confidential proceedings and public ones, or between consent-based jurisdiction and state-power-based ones.” BOOKMAN 2020, p. 277.

<sup>992</sup> DILANNI 2010, p. 206.

<sup>993</sup> DILANNI 2010, p. 206.

<sup>994</sup> According to DILANNI, “The potential for competition in the market for adjudication services is natural and automatic. In theory at least, any third party can adjudicate a dispute. The presence of a public court system does not alter this fact in itself. However, the institutions that guide disputants in the process of choosing whether to adjudicate, and the choice between different venues, can affect the way in which different adjudicators compete with each other. This in turn can affect the outcome of the adjudication process, i.e. whether there will be a pro-plaintiff bias.” DILANNI 2010, p. 211.

<sup>995</sup> See SHAVELL 2004, pp. 447-448.

disputes as both a plaintiff and defendant equally will seek a neutral forum. Arbitration may change neutral or pro plaintiff bias in litigation into a bias towards defendants in arbitration.<sup>996</sup> This may be caused by the timing of the demand as potential defendants' *ex ante* for arbitration, while potential victims only demand litigation *ex post*. This reverses the demand side of litigation, where plaintiffs have the initial choice of potential forums *ex post*, into an *ex ante* demand by firms to choose among arbitral forums of their choice.

### 6.3 Price Fixing Effects and Cartel Enforcement.

Collusion to use arbitration changes the rights and duties associated with the underlying good or service; here, the legal rights related to enforcement of the contract and claims arising out of the contract. The individual rights which make up a contract can be seen as analogous to a stick within the bundle of sticks metaphor used to describe property rights.<sup>997</sup> Although arbitration clauses in a contract can be considered a non-price term, their presence changes the value of the "bundle of sticks" associated with the good or service, so it can also be considered an indirect price term.<sup>998</sup> The price of a product or service should include all the potential costs associated with using the

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<sup>996</sup> See BINGHAM for a discussion of the repeat player effect in employment arbitration and the potential for arbitration bias. BINGHAM 1997, p. 189.

<sup>997</sup> OSTROM framed the property rights related to common pool resources "in terms of bundles of rights rather than a single right". These rights included access, withdrawal, management, exclusion, and alienation. Furthermore, different combinations of these property rights create different incentives to invest in or make use of the property. OSTROM 2008, p. 28.

Contracts can also be thought of in terms of bundles of rights. PENNER has framed both tort and contract law in terms of bundles of rights. According to PENNER, "We tend to study the law of contract not as the "right to make contracts," but the rights and duties which arise under contracts, and the ways contracts are formed. The disintegrative urge applied to contracts is thus likely to appear as a program to divide contract into different kinds of contract, such as sales, employment contracts, credit agreements, etc., rather than to say that the "right to contract" is a bundle of rights to trade goods, to employ, to be employed, to lend money at interest, and so on. Similarly, in the law of torts the general *duty* "not to harm others" appears better placed than a *right* "not to be harmed" to work some unification over the subject as a whole, given the emphasis placed on the nature and scope of the duty in negligence, which occupies a large part of any tort syllabus." PENNER 1995, p. 740.

<sup>998</sup> STIGLER 1968. According to Stigler, "If the increment of output is sold by increasing a non-price variable (advertising, durability, etc.), there is also the cost of the additional amount of the non-price variable." Stigler 1968, p. 152.

product or service, including the costs of accidents.<sup>999</sup> The market for labor should also adjust to working conditions.<sup>1000</sup> If the use of arbitration leads to lower care costs or lower liability costs for firms, the lower costs should be reflected in the price of the product or service being sold or the cost of labor, so long as there is competition in the market.<sup>1001</sup> If there is a lack of competition in the market, firms lack economic pressure to change the costs of goods, services, or labor to reflect the lower care and liability costs realized from the use of arbitration. In an oligopolistic market, no market force pressures firms to pass on the savings from using arbitration to consumers or employees. Rather, these savings can be wholly or substantially captured by firms. According to POSNER, "[e]xclusive sales agencies, revenue pooling, production quotas, customer and territorial allocations, provisions for arbitration of disputes, and fines for violating the cartel agreement are among the mechanisms by which cartels seek to maximize the profits from price fixing."<sup>1002</sup> Indirect price fixing may even be the objective of the coordinated use of arbitration since the cost savings being passed onto consumers is largely dependent on competition in the market when the market has proven to be acting in unison in its use of arbitration.<sup>1003</sup>

The strategic use of arbitration for tort claims across an industry may allow firms to essentially price fix. The presence of an arbitration agreement for tort claims can be seen as an indirect non-price element of the underlying good or service being contracted over, which impacts the price of the underlying good or service. According to STIGLER, a "price cut will often take the indirect

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<sup>999</sup> Tort liability for defective products is sometimes viewed as analogous to accident insurance, as all potential victims pay for the price of potential accidents. See: EPSTEIN 1985.

<sup>1000</sup> Hazardous working conditions often lead to an increased demand for payment from labor in the form of hazard pay. See: COUSINEAU et al. 1992, pp. 166-169.

<sup>1001</sup> See: STIGLER 1968. The cost savings or increase from the use of arbitration can be considered a type of price effect emanating from non-price terms.

<sup>1002</sup> POSNER 1975, p. 903.

<sup>1003</sup> According to HYLTON, "the savings generated by an arbitration clause are passed on to consumers in the form of a lower price" in a competitive market. HYLTON 2000, p. 252.

form of modifying some non-price dimension of the transaction”.<sup>1004</sup> By including an arbitration clause, firms can credibly provide information about continuing with the colluded behavior. The removal of mandatory arbitration clauses can be seen as a price increase because it prevents firms from using arbitration to affect price, and it potentially provides consumers with a more valuable bundle of sticks, all other things being equal, than the products, services, or labor contracts of their industry rivals who use arbitration as an indirect form of price fixing.

Although collusion to prevent litigation of tort disputes to protect an inefficiently low due care standard is not necessarily direct price fixing, it does not mean there is no price fixing due to the collusion. STIGLER found in his analysis that detecting secret price reductions could be "extended to non-price variables, subject to two modifications".<sup>1005</sup> First, there is “a definite joint profit-maximizing policy upon which the rivals can agree,” and second, “the competitive moves of any one firm will differ widely among non-price variables in the detectability by rivals” where “some forms of non-price competition will be easier to detect than price-cutting because they leave visible traces...but some variants will be elusive”.<sup>1006</sup> If there is a primary conspiracy to arbitrate, such as the one identified by LESLIE, then it is possible that firms will still compete or collude over other product variables. STIGLER identified how "non-price variables", such as advertising, may be the topic of collusion within an industry.<sup>1007</sup>

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<sup>1004</sup> STIGLER 1964, p. 47.

<sup>1005</sup> STIGLER 1964, p. 55.

<sup>1006</sup> STIGLER 1964, pp. 55-56.

<sup>1007</sup> STIGLER 1968, pp. 149-154. Additionally, STIGLER comments that “The common belief of economists that price competition is much more effective in increasing output and reducing profits than non-price competition is now seen to rest upon an empirical judgment: Marginal costs of production do not rise so rapidly as marginal costs of advertising, quality competition, and other non-price variables. Perhaps the following reformulation is more suggestive. An increment of output has a given marginal production cost. If the increment of output is sold by a price reduction, there is also the cost of reducing price on the units already being sold. If the increment of output is sold by increasing a non-price variable (advertising, durability, etc.), there is also the cost of the additional amount of the non-price variable. The common view, which is very plausible, is that the marginal non-price variable cost is larger than the marginal price-reduction cost, if one starts from a monopoly position.” STIGLER 1968, pp. 151-152.

The inclusion of an arbitration clause in a boilerplate contract used by firms in an industry is easy to observe by rival firms in the market, especially given the emergence of the online digital marketplace. A claim in state courts is public knowledge, and firms can monitor for claims arising in a public forum, while a claim in arbitration remains private information. Thus, it is easy for firms to monitor the actions of other firms in terms of their standard contracts and their use of the court system.

A waiver of mandatory arbitration may be seen as a sign of an inefficiently high due care standard being targeted or that the firm is price cutting. The inclusion of arbitration in consumer contracts can be easily monitored by co-conspiring firms that could respond to waiver with retaliation. The reaction of other firms to the indirect price cut will be context specific as to why arbitration was waived and the scope of the waiver. For instance, if other firms recognize the waiving firm is challenging an inefficiently high due care standard which causes all firms to incur costs, the firms in the industry may not necessarily view this context specific waiver as defecting. However, if the firms in an industry which are colluding to use arbitration for tort claims expect to be retaliated against for defecting, then, in the long run, the collusive behavior can be sustained.<sup>1008</sup> If firms collude to protect an inefficient due care standard from being changed by courts through the use of arbitration agreements and one of the colluding firms' defects, the remaining firms may try to punish the defector the same way in which they would when the firms were colluding to fix prices, and this potential for punishment may make the agreement stronger.

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<sup>1008</sup> The homogeneity of the market will also impact the formation and stability of a cartel. According to DAVIDSON, "If competitors are few enough, it may be possible to develop a durable price fixing system without either explicit agreement or 'conscious parallelism,'" however "homogeneity may also undermine price fixing schemes" DAVIDSON 1983, p. 452.

This collusive behavior may not only have price effects due to moral hazard, in that a lower value in the good being provided at a certain price which does not change while the quality does change, but it may also have quality effects due to adverse selection, in which a product or service is provided with a lower quality although at the same price as a higher quality good. This may also contribute to a situation where a market for lemons exists, where higher quality goods and lower quality goods cannot be distinguished from each other in the market.<sup>1009</sup> Under competitive conditions, where there is not a prevalence of information asymmetry, firms should differentiate products based on not only the features of the products but also the bundle of rights which are tied to the products, such as warranties, service guarantees, or the use of arbitration, in order to capture the demands of the market more fully and thus potential profit. If firms can perfectly discriminate through product differentiation, other potential issues involving competition law may come into play, although this is beyond the scope of this thesis. Firms may have the power to change the characteristics of a good or service, including the attached rights, unilaterally, and this may be part of a price fixing scheme or other abuse of market power.

An indirect price fixing scheme involving arbitration may also lead to increased secondary costs of torts, as third-party insurers and state social services may be burdened with covering the costs of accidents which firms avoid liability for through their collusive behavior. Because the colluding firms may still have the incentive to use arbitration even when the economic incentive to use arbitration falls below the full benefit of using arbitration across an industry, firms looking to price cut or retaliate may need to do so using other price cutting techniques than abandoning the scheme to use arbitration. This makes the potential negative externalities from the collusive use of

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<sup>1009</sup> In a market for lemons, the quality of the goods traded decreases as the firms or sellers use information asymmetry in order to pass off low quality goods as standard or high-quality goods. See: AKERLOF 1970.

contracts to arbitrate more robust to challenges from market forces, cartel retaliation, and legal intervention.

#### 6.4 Avoiding Liability and Care Costs.

*\*\*\*This topic was discussed in Chapter 3, section 5 concerning the strategic behavior in arbitration\*\*\**

The use of arbitration for tort claims may allow for the avoidance of liability by firms when those with tort claims against the firms are customers of the firms. This may be especially true when individuals contracting with firms are unknowledgeable, uninformed, or unsavvy.<sup>1010</sup> Avoidance of liability through the use of arbitration can be accomplished through a combination of several contractual devices. Contracts to arbitrate are often combined with contractual terms that cap damages, limit punitive damages, limit consumer or labor friendly procedures and rules, limit collective actions, narrow the application of statutes of limitations, and apply these terms retroactively through the adoption of new terms of service in prolonged contractual relationships.<sup>1011</sup> Firms can take these strategic steps to lower the payoff from filing claims against them. Firms may also seek to use an arbitration process that is costly for victims.<sup>1012</sup> This may be the difference between a claim being positive in value and negative in value. It may also allow firms to strategically take less than due care when they can recognize the transaction costs that a potential victim will face when pursuing a tort claim against them.<sup>1013</sup>

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<sup>1010</sup> According to SHAVELL, “customer’s perceptions of product risks... will affect customer’s willingness to make purchases”. SHAVELL 2004, p. 213

<sup>1011</sup> LESLIE identifies breaking collective actions, capped damages, de trebling damages, and truncating the statute of limitations as potential motives to conspire to use arbitration. LESLIE 2017, pp. 407-419.

<sup>1012</sup> According to WARDHAUGH, “[i]mposing an arbitration process which requires consumers to incur costs, whether in the form of filing or other fees or services or cost shifting (i.e. “loser pays”) will deter a significant number of claims.” WARDHAUGH 2013, p. 444.

<sup>1013</sup> This particular type of transaction costs can be considered as the costs which a rational victim will include in their determination if a claim is negative in value and thus not worth pursuing or positive in value and thus worth pursuing, which includes the consideration of transaction costs directly related to the “price of litigation” as well as costs indirectly related to the price of litigation which a victim must also account for. According to VISSCHER, “[e]conomic analysis of civil procedure centers on the issue how different procedures affect the sum of *direct costs* and *error costs*

If firms can identify the transaction costs which are required to bring a claim against them and can identify when a claim moves from being positive in value to negative in value relative to the care being taken and by accounting for the transaction costs a victim will face when bringing a claim, then the firms can take strategic care which is below due care.<sup>1014</sup> Firms can use information, resources, and opportunity advantages in the arbitration process to enable the strategic taking of low care. Firms can decollectivize mass tort claims by including class waivers alongside arbitration clauses. This creates an asymmetric increase in litigation costs for plaintiffs, who can no longer benefit from the transaction costs efficiencies of using a collective action to bring a claim on behalf of an entire class of similarly situated individuals. When a firm is able to identify the cost of individual plaintiffs bringing a single claim, they can take this into account when determining how much care to take. If firms can identify the point where a claim goes from being positive in value to being negative in value relative to the amount of care being taken, the firms can strategically take less than due care without having to worry about facing claims for the accidents resulting from the low care taking. This is because the individual suffering harm has suffered an amount of harm below the amount of harm necessary for a claim to be positive in value, given that the enforcement of legal rights under the contract has costs. If there is also an inefficient due care standard in place, the firms in an industry may be able to identify an even lower amount of care to take than under an efficient rule while keeping individual claims negative in value.

The potential for strategic care taking is not only present in the arbitration setting but also in the litigation setting. However, in a court, the risk of being discovered may be higher as it may influence the adjudication of other similar claims against the tortfeasor. In contrast, in arbitration,

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and how they influence the behaviour of the parties involved in the dispute resolution process” where “[d]irect costs are the costs of adjudication itself, so the time invested by the various actors involved (parties, lawyers, judges, (expert) witnesses), their wages, as well as the material costs (offices, office supplies, et cetera).” VISSCHER 2012, p. 72.

<sup>1014</sup> See the analysis of the strategic taking of less than due care in the chapter “Marching Without Memory”.

the possibility of a single claim influencing other similar claims is lower due to the secretive nature of the arbitration process. By taking strategic care, the firms in an industry can gain from having lower care costs without facing tort claims from rational plaintiffs with only negative value claims.

#### 6.5 To Protect or Defeat an Inefficient Due Care Standard.

*\*\*\*This topic was discussed in Chapter 3, section 5 concerning the strategic behavior in arbitration\*\*\**

Potential injurers, who are RPs and benefit from an inefficiently low due care standard, have the incentive to prevent a challenge in court to the rule in order to limit the opportunities for a court to change the rule to the efficient one. Using arbitration for tort claims can keep firms that benefits from an inefficiently low due care standard from facing a challenge to the rule in a public forum and prevent the court from adjusting the care level to the efficient care standard. When firms in an industry all recognize the shared benefit of the use of arbitration for tort claims, it will enable collusive efforts to limit judicial challenges to a rule which benefits the firms through the inclusion of *ex ante* contracts to arbitrate tort claims, and this is consistent with the focal point theory of the law.

In an industry, firms that have included arbitration clauses in their consumer contracts should demand arbitration when a claim has the potential to lead to an adjustment of an inefficiently low due care standard by a state administered court since an adjustment by the court to an efficient standard will lead to the firms incurring additional care costs. The firms should waive arbitration when a claim could lead to an adjustment of an inefficiently high due care standard by a state administered court which would lead to lower care costs for the firms.

If only a single firm in an industry uses arbitration, claims against the other firms may lead to an adjustment of the care standard, which is common for all the firms in the industry. The protection

of an inefficient rule thus requires some coordination, either explicitly or tacitly, within an industry to prevent claims from going to court. An inefficient due care standard cannot be protected through the use of arbitration unless everyone “plays ball” through coordination among the “players”.

If victim care is a substitute for injurer care, then an inefficiently low due care standard will provide benefits for potential injurers in the form of lower care costs and lower liability for accidents while creating costs to potential victims in the form of increased care costs and an increased burden of covering the costs of accidents. This is because the inefficiently low standard will require less care than is efficient for potential tortfeasors and more care than is efficient for potential victims. Potential victims will either incur costs of taking care to make up for the low level taken by tortfeasors or perhaps incur losses that tortfeasors are not legally liable for, given the inefficiently low due care standard. Either way, the potential victim will pay a higher price for a good or service than under an efficient due care standard so long as no market force makes the potential injurer offer their goods at a competitive price. An inefficiently low due care standard provides a perverse incentive for injurers to take less than efficient care and an inefficient incentive for potential victims to take excessive care. The combination of the two leads to increased accident costs and lowers welfare.

An inefficiently low due care standard allows firms to gain profits by avoiding care costs and liability. If the inefficiently low due care standard could be changed by a court, a change which would impact the industry as a whole, then firms may coordinate to include arbitration clauses in their boilerplate contracts to prevent claims from going to a court, thus preventing a change to the inefficient rule arising out of a claim against the firm. The whole industry has the same economic incentive to include arbitration as the single firm does. When the interests of individual firms align,

each can identify an identical course of action that results in private benefits, including the benefits of coordinated action within an industry.

An inefficiently high due care standard brings additional care costs to potential injurers and may lower the care taken and care costs of potential victims if they know the excessive precaution being taken by potential tortfeasors.<sup>1015</sup> The inefficiently high care standard is more costly for potential injurers than the efficient care standard, and potential victims may react by taking less than due care. The result is inefficient because the total accident costs and care costs are higher than when the rule is set efficiently. Parties in an industry should recognize this and structure their business knowing the inefficiently high due care standard affects their business. Parties will weigh the costs and benefits of going to court, as potential tortfeasors who repeatedly face excessive care costs have an economic incentive to challenge an inefficiently high care standard in a public forum until the rule is changed to the efficient level.<sup>1016</sup> Firms in an industry can recognize the benefits of an inefficiently high due care standard being adjusted. Arbitration does not lead to the adjustment of state mandated due care standards, which may be the objective of engaging in conspiracies to arbitrate.<sup>1017</sup> The legal acceptance of the use of arbitration for tort claims, at the least, provides a focal point around which collusive behavior may materialize.

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<sup>1015</sup> According to COOTER AND ULEN, the consequences of an error of an excessive legal standard by courts under a negligence rule are that injurers will error in overestimating the legal standard and take excessive precautions COOTER AND ULEN 2016. Interpreted from table 6.3 at p. 221.

<sup>1016</sup> This is consistent with the efficiency of the common law theory. However, the "tendency of the common law to generate efficient rules" is "weaker...when parties stakes are asymmetrical." LANDES and POSNER 1979, p. 280. According to the PRIEST KLEIN selection hypothesis, "the determinants of settlement and litigation are solely economic, including the expected costs to parties of favorable or adverse decisions, the information that parties possess about the likelihood of success at trial, and the direct costs of litigation and settlement. The most important assumption of the model is that potential litigants form rational estimates of the likely decision, whether it is based on applicable legal precedent or judicial or jury bias. From this proposition, the model shows that the disputes selected for litigation (as opposed to settlement) will constitute neither a random nor a representative sample of the set of all disputes." PRIEST and KLEIN 1984, p. 4.

<sup>1017</sup> For a discussion on why it is problematic for private judges to produce precedent, see: LANDES and POSNER 1979, p. 238-240.

## 7. Conclusion.

A market failure may occur when the use of private contracts to arbitrate results in a lack of substantive deterrence to the anticompetitive behavior of firms. Private contracting strategies to conceal anticompetitive practices may include contractual terms that make it more difficult and costly for tort victims to enforce their legal rights. If an arbitration agreement is an instrument by which the cartel or monopolist is able to conceal its anticompetitive practices, then the enforcement of such an agreement by state courts will result in a persistent opportunity for firms to behave collusively and insulate themselves from regulatory oversight. The arbitration of tort claims may allow firms to protect an inefficient due care standard or rule which benefits the firms. Firms can avoid care costs by using arbitration strategically to prevent courts from reviewing their behavior and thus from adjusting an inefficiently low due care standard, and firms can strategically waive arbitration when there is an inefficiently high due care standard in order to have their care costs lowered through the adjustment to the efficient standard. Individual OS claimants may be willing to accept the waiver of an RP if they estimate, either rationally or irrationally, that litigation in court will lead to an increased expected value of a claim. When firms have information about the transaction costs which potential victims will incur from pursuing a claim, firms can use arbitration to conceal their taking of strategically low care costs when there is an efficient due care standard in place, which allows them to take only the care necessary to ensure no claim against them will be positive in value. When all firms in an industry recognize the economic advantage of behaving strategically with the use of arbitration for tort claims, then the colluding firms can minimize their expected liability costs and care costs through a combination of taking strategic care and collusively using arbitration as a form of indirect price fixing as well as a method to protect an inefficiently low due care standard which they benefit from and a method to keep courts from having oversight of other forms of collusive behavior.

Since the use of arbitration for tort claims can influence the setting of due care standards and the price of goods, services, and labor, there are clear implications for competition law. EU and US competition authorities have taken different approaches to mix private and public enforcement of competition law and have unique goals which are divergent. These divergent approaches in competition law have made the incentives to conspire to use arbitration for tort claims greater in the US than in the EU. In other words, the likelihood of success of such a conspiracy and the expected payoffs are greater in the US than in Europe. Divergent approaches for statutory limits on arbitration and judicial deference to arbitration have also resulted in greater incentives to conspire to use arbitration for tort claims in the US than in the EU. Despite these divergent approaches and payoffs, firms in an industry should use contracts to arbitrate tort claims when they gain financially. Even without overt collusion, if the potential gains from using arbitration for tort claims are identifiable by all firms in an industry, then we should expect their actions to converge in unison.

Rather than adding to the existing literature regarding the arbitrability of antitrust claims, this chapter examines how firms may collude to mandate the use of arbitration for tort claims in private contracts in order to avoid care costs, avoid liability costs, or reap revenue in excess of what a competitive market would allow. The use of contractual terms which facilitate the avoidance of care and liability costs may have price fixing effects and may hamper the development of efficient due care standards resulting in their underproduction, both of which are welfare reducing for consumers and society. When arbitration is used as a mutually agreed upon method to resolve disputes where the benefits of lower transaction costs are shared, efficiencies may potentially be realized over litigation. When arbitration is used to enable collusive behavior, and other strategic behavior, such as avoidance of care and liability costs, the potential efficiencies of lower

transaction costs from arbitration will be distributed asymmetrically in favor of the colluding firms. Thus, individuals and society will suffer a welfare loss at the expense of the firm gaining utility. When arbitration becomes a standard practice in an industry through collusive behavior, the likely result is an underproduction of public goods from litigation in that industry.

## **Chapter 6. Conclusion.**

### 1. Introduction to Conclusion.

The use of *ex ante* contracts for arbitration of tort claims may lead to unintended consequences, which may impact how legal systems function, how firms structure their business, and how individuals behave. This is a very narrow topic within the subtopics of tort law, contract law, competition law, and legal procedure, and it takes up a niche within the law and economic literature concerning arbitration. Modern tort law has been developed over years of errors and trials. It is easy to see how a changing world leads to changes in the types of accidents which occur. While accidents are costly, developing efficient due care standards by courts is a legal process which helps reduce the cost of future accidents. This process is prospective, as judges look not only at accident claims which appear in their courts but also may consider how their rulings will lower the cost of future accidents which involve similar circumstances. The litigation process and the promulgation of legal precedents from judicial decisions have been a key driving force in the development of tort law in common law jurisdictions. In civil law jurisdictions, the judicial role of interpretation and gap filling has played a similar but distinctly different role. Despite the differences in common law and civil law judicial systems, the results of judicial review have not been vastly different, and tort law has developed in a sometimes-similar way in both legal traditions. The arbitration of tort claims has the potential to change the efficiency of the law. Because arbitration has no role in producing precedent, rule interpretation, gap filling, and public information, arbitration may lead to the diversion of claims incapable of leading to the production of public goods from litigation, and it may lead to the diversion of claims which could lead to the production of public goods from litigation.

Like other dispute resolution processes, arbitration has both advantages and disadvantages. Arbitration and litigation both use a third party to adjudicate legal claims, so they can be considered competitors in the market for dispute resolution. Arbitration may, in some cases, be a more efficient process than litigation in a public judicial forum in that arbitration may potentially lower the overall costs of adjudicating some tort claims. Arbitration may have characteristics that allow parties to a dispute to save on the costs of adjudication when compared to adjudication in a public judicial system. However, the cost savings of using arbitration are not guaranteed, and it cannot always be said to be more efficient in adjudicating tort claims than public judicial systems. One potential impact of the use of arbitration for tort claims is the potential frustration of the setting of efficient due care standards by courts. When tort claims are arbitrated, the advantages of arbitration may become a disadvantage, or the cost benefits of arbitration may be distributed asymmetrically between parties. This is because arbitration may potentially lead to an increased cost of accidents or be part of a strategy that firms use to increase profits without providing an increase in the value of their goods or services. It is also possible that the use of arbitration for some tort claims is inefficient in that it increases enforcement errors which results in tortfeasors avoiding liability for tortious acts they commit. The use of arbitration for tort claims has the potential to be welfare enhancing or welfare reducing.

By comparing how the US and EU approach some aspects of the use of arbitration for tort claims, a clear distinction can be made in the potential for the use of arbitration for tort claims to contribute to or alleviate market failures which are symptomatic of accidents and the economic rationale for having tort law. There is potential for the arbitration of tort claims to lower the costs of some accidents. Those claims which have no potential to lead to the development of efficient due care standards or the production of public goods from litigation are the claims in which arbitration has

the most potential to lower the costs of accidents. This is likely because arbitration may lower the burden on courts to adjudicate these claims or lead to other lower transaction costs. It is important to distinguish between claims which have the potential to lead to the development of public goods from litigation and those which cannot. When tort claims which have the potential to lead to the development of efficient due care standards are diverted from courts into arbitration, this may increase the costs of accidents and create negative externalities from future accidents which could have been avoided. When these negative externalities are present, the arbitration of tort claims cannot be rationalized on efficiency grounds.

The possibility of tort claims leading to efficient developments in tort law is one of the rationales in the "efficiency of the common law" theory developed in the law and economics literature. Some aspects of the theory of efficiency of the common law are also applicable in the civil law legal tradition, as courts in civil law jurisdictions also produce public goods from litigation which contribute to the efficiency of the law. The efficiency of using arbitration of tort claims must be considered under the economic goals of tort law, which CALABRESI has identified as minimizing the primary, secondary, and tertiary costs of accidents.<sup>1018</sup> There is a need to weigh the costs and benefits of using any legal process, in this context, competing dispute resolution processes and procedural rules, to promote legal rules that maximize society's welfare. GALANTER identified how RPs in litigation have distinct advantages over one-shotter litigants. The RP advantage in litigation expands in arbitration. Firms acting in collusion over the use of arbitration for tort claims provide additional strategic advantages for firms in litigation and their respective markets. Because of differences in the legal treatment of arbitration for tort claims and procedural law between the US and Europe, it is possible to identify how these divergent legal treatments affect the efficiency

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<sup>1018</sup> For a description of the economic goals of tort law, see: CALABRESI 1970, p. 26-31.

of the law. This research has demonstrated the theoretical aspects of how RP advantages in the arbitration of tort claims are similar to, but in some ways distinct from, the RP advantage in litigation. Additionally, this research has identified the theoretical distinctions concerning competition law that the collusive use of *ex ante* arbitration contracts for tort claims in an industry may have from other collusive uses of arbitration in an industry.

This research can be considered a niche within the law and economics literature concerning tort law, contract law, competition law, judicial review, and ADR. Thus, the findings of this research are focused and limited to the specific contexts identified. Specifically, this research concerns *ex ante* contracts to arbitrate tort claims within purely domestic settings where no choice of law questions are involved.

Competition law implications from the use of arbitration for tort claims are identified, which describes theoretically how firms may act collusively to strategically influence the adjudication process of tort claims and the development of the legal rules by courts that affect their behavior.

The potential for arbitration to reduce the costs of accidents is real. However, this research also demonstrates how firms involved in repeated tort disputes may take strategic actions in arbitration, which may frustrate the potential for arbitration to be welfare enhancing. The potential for the arbitration of tort claims to be welfare reducing or welfare enhancing is context specific, and it is a question that may fall on the margin. It may be difficult to determine *ex ante* if the use of arbitration is welfare enhancing or welfare reducing, given that some transaction costs are difficult to identify or quantify. Because of the secretive nature of arbitration, it is also difficult *ex post* to identify if the arbitration of tort claims is efficient. These secretive and obscured characteristics of the arbitration of tort claims make a theoretical approach which considers the efficiency of using arbitration for tort claims appropriate. However, there are circumstances when the use of

arbitration for tort claims can be identified clearly as having a cost which is not worth the benefits when compared to adjudication of tort claims in public judicial systems.

This subject crosses several areas of law and highlights some tensions between tort law, contract law, procedural law, and competition law. While each article presented as a chapter is built on some of the same fundamental assumptions, themes, and background, each is unique in its scope, objective, and findings. Importantly, each chapter of this dissertation is designed to stand independently. Furthermore, this critical examination of the arbitration of tort claims has highlighted the need to consider the potential for unintended consequences in implementing laws and the need to consider these potential consequences *ex ante*, before laws are enacted or promulgated. This series of articles add to the law and economics literature concerning the use of arbitration for tort claims, contracts to arbitrate, the use of collective action procedures in civil claims, judicial systems, collusive behavior of firms in an industry, and strategic behavior in legal disputes. The approach taken here to address these similar but discrete sub issues concerning the arbitration of tort claims is designed to show how there is fertile ground within the topic for the law and economics discipline to find new insights which can benefit society. Because this is a niche topic, there is a need to differentiate how *ex ante* contracts to arbitrate tort claims create unique questions from other forms of arbitration for non-tort claims.

#### Chapter 2. A Comparative Analysis of the Arbitrability of Tort Claims and the Demand for Adjudication.

A comparison of US, UK, France, Germany, Italy, and the Netherlands domestic source of arbitration laws shows a divergence in approaches for the use of arbitration for tort claims, although it does demonstrate that each of these states have legal provisions which allow for the

arbitration of tort claims to varying extents.<sup>1019</sup> There is a lack of information available from arbitration forums concerning the claims they adjudicate and it is necessary to consider proxy measurements related to the consumption of dispute resolution services in these six states which shows some important differences in how dispute resolution and legal services are consumed in each state, but little of the specifics of how private arbitral services are consumed.<sup>1020</sup> Proxy measures, including a comparison of population rates, attorney populations, judge populations, litigation rates, and the use of transnational legal indicators, prove to be a poor second-best option. Data concerning the use of arbitration, in general, is difficult to identify or infer from proxy measurements. This chapter demonstrates that a theoretical analysis of the use of arbitration for tort claims is useful given the lack of data on the use of arbitration, generally.

### Chapter 3. Marching Without Memory: How the use of Arbitration in Tort Claims may Complicate Incentive to Take Due Care.

The strategic use of arbitration for tort claims may frustrate the law's ability to use institutional memory and "creative continuity" to lower the costs of future accidents. Firms involved in repeated litigation have options to behave strategically. While GALANTER has identified the advantages of RPs in litigation, options for RPs to act strategically expand under arbitration.<sup>1021</sup> Repeat player defendants can use arbitration to strategically take low care or strategically commit torts without facing recourse from their victims or the courts.<sup>1022</sup> RP firms can do this because they have information, resource, and opportunity advantages over potential OS litigants.<sup>1023</sup> RP firms can

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<sup>1019</sup> See Figure 1 in Chapter 2 in Section 2 for a chart of the relevant domestic sources of law concerning arbitration.

<sup>1020</sup> See Chapter 2 Section 3 for an analysis of data concerning arbitration and the use of proxy measurements to examine the demand for adjudication in these states.

<sup>1021</sup> See chapter 3, Section 5 concerning the use of strategic behavior in arbitration.

<sup>1022</sup> See Chapter 3, Section 5.

<sup>1023</sup> See Chapter 3, Section 5.2.3, Section 5.2.4, 5.2.5 and 5.2.6 for an analysis of resource, opportunity and information advantages of Repeat Players.

strategically use arbitration to circumvent costly rules and protect inefficient rules from which they benefit.<sup>1024</sup>

The strategic uses of arbitration for tort claims and the combination of the use of arbitration for tort claims with class waiver and liability waiver lead to enforcement errors and undermine the use of due care standards in tort law.<sup>1025</sup> By developing a deeper understanding of how the arbitration of tort claims contributes to the RP firms' ability to behave strategically, better practices can be developed which limit the costs of this type of strategic behavior.

#### Chapter 4. The Arbitrability of Class Action Tort Claims and the Public Good: A law and Economic Perspective.

The arbitration of mass tort claims from a comparative law perspective using a law and economics methodology highlights a divergence in procedural law concerning mass tort claims and the laws concerning the use of arbitration for tort claims between US and EU jurisdictions. This chapter analyzed the use arbitration for mass tort claims using a public welfare criterion.<sup>1026</sup>

Four potential procedural scenarios are considered for the adjudication of mass tort claims. Those are options to use litigation with and without a collective procedure and arbitration with and without a collective procedure.<sup>1027</sup> Ultimately, the procedure which has the lowest costs, or highest benefits, is the procedure that is best justified under a welfare rationale. The costs and benefits for each procedure may need to be weighed on a case-by-case basis. Some characteristics of claims may make it more or less likely to lead to the production of public goods from litigation, which is one of the benefits of the public adjudication of tort claims. The emergence of new technologies

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<sup>1024</sup> See Chapter 3, Section 5.2.1 and 5.2.2 for an analysis of Repeat Players in litigation and arbitration.

<sup>1025</sup> See Chapter 3, Appendix C, concerning the use of economic modeling to analyze the use of arbitration for tort claims under the standard “calculus of negligence” which was first identified by Judge Learned Hand.

<sup>1026</sup> See Chapter 4, Section 4 concerning the adjudication of mass tort claims.

<sup>1027</sup> See Chapter 4, Section 4.4 concerning the economics of mass tort claims and collective procedures.

and practices can be seen as one of the driving forces behind the development of tort law, and the diversion of tort claims related to new technologies and practices has a significant potential to frustrate the creativity of the public judiciaries in producing public goods from litigation.<sup>1028</sup>

The future costs of accidents cannot be ignored, as there is a potential for a mass tort claim to lead to the production of public goods if adjudicated in a public judicial system. These public goods from litigation may have the effect of lowering the future costs of accidents. The promulgation of efficient due care standards from judicial adjudication of accident claims is a beneficial product of accidents, which the law should seek to maximize. Judicial efforts to maximize the benefits of accidents can be seen as part of the economic goal of tort law. When a mass tort claim cannot result in the production of public goods from litigation, the claim will have no impact on the future costs of accidents, and the likelihood that using arbitration for that particular claim is welfare enhancing may increase.

This expansion of the use of arbitration for tort claims and the use of class waivers has effectively limited the procedural rules for class action claims in the US. In the EU, the arbitration of mass tort claims has been less of an issue due to the limited use of class action type procedures and arbitration between businesses and consumers. This subject is poised for future evaluation as a new representative action procedure has been implemented in the EU.

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<sup>1028</sup> See Chapter 4, Section 5 on the role which technology plays in tort claims.

Chapter 5. “Since it costs a lot to win, and even more to lose”: Competition Law and the Arbitration of Tort Claims.<sup>1029</sup>

There is a market failure when firms in an industry collude to mandate arbitration for tort claims. The collusive behaviors among firms in an industry to mandate the use of arbitration for tort claims impacts tort law. This type of collusion may manipulate the stock of precedent, judicial gap filling, or rule interpretation in order to gain extraordinary profits through indirect price fixing, to enable other anticompetitive behavior and practices, and to obscure tortious acts from judicial review.<sup>1030</sup>

The collusive use of arbitration for tort claims is an indirect form of price fixing, which allows firms to provide a lower valued good without having to make a corresponding reduction in the good's price.<sup>1031</sup> The arbitration of tort claims can be used as a way for firms in an industry to selectively develop due care standards through the selective use and waiver of arbitration for tort claims, and enforcement of arbitration contracts. This is in addition to the motive firms may have of strategically taking less than due care and using arbitration to hide their shirking of taking due care from courts. Strategically colluding to use arbitration for tort claims enables arbitrage strategies in the third-party adjudication process.<sup>1032</sup>

The potential for firms to use focal points to collude to use arbitration for tort claims is also identified, as is the distinction from other types of collusive behavior, which may result in retaliation against firms who defect from a collusive strategy.<sup>1033</sup> When there is collusion to use arbitration for tort claims in a concentrated market, there is a corresponding loss of consumer

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<sup>1029</sup> The title is a lyric from the song Deal: GARCIA and HUNTER 1972.

<sup>1030</sup> See Chapter 5, Section 4 concerning the collusive use of arbitration for tort claims in an industry.

<sup>1031</sup> See Chapter 5, Section 6.3 concerning price fixing.

<sup>1032</sup> See Chapter 5, Section 6.4 for an analysis of strategic behavior to protect or defeat an inefficient due care standard.

<sup>1033</sup> See Chapter 5, Section 4.5 on the use of focal points in collusive behavior.

welfare and social welfare and may lead to frustration with the purpose of public judicial forums in producing efficient due care standards and other public goods from litigation.<sup>1034</sup>

## 6. Concluding Remarks.

This research takes up a niche area within the topics of tort law, contract law, competition law, procedural law, and judicial systems. It represents a modest but genuine addition to the law and economics literature concerning the arbitration of tort claims. This dissertation identifies how the use of arbitration for tort claims may be theoretically socially welfare enhancing when claims cannot lead to the production of public goods from litigation and when arbitration tribunals have similar or lower error rates than public judicial forums. This research also has demonstrated, theoretically, that there is a motive for firms to use arbitration for tort claims in order to, shirk from taking due care to lower their care costs, strategically take low care in order to keep potential claims against firms from becoming positive value claims, use arbitration to protect an inefficiently low due care standard involved in tort claims, to combine class waiver and liability waiver with contracts to use arbitration for tort claims in combination with the aforementioned strategies in order to maximize the firms welfare potentially at the costs of private and social welfare, to use arbitration to obscure tortious acts from judicial oversight, to collude to mandate the use of arbitration for tort claims across an industry, to collude to indirectly fix prices across an industry using arbitration clauses in contracts, to collude to selectively use public judicial forums to develop due care standards through the waiver or enforcement of arbitration, and to strategically use arbitrage strategies to take advantage of the differences in public and private judicial forums within a state. These theoretical insights are further supported by a comparative analysis of US and EU

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<sup>1034</sup> See Chapter 5, Section 6 concerning the collusive use of arbitration and the related problems associated with cartels and consumer welfare and Chapter 5, Section 6.1 with regards to collusive behavior and the production of public goods from courts.

legal treatments of arbitration for tort claims and the enforcement of competition law, which can be characterized as divergent across jurisdictions. Select legal cases are highlighted in a positive analysis of the laws concerning the arbitration of tort claims. From a normative perspective, this research has identified how the use of arbitration for tort claims can be socially inefficient under certain circumstances and that legal norms may need to be developed in the use of arbitration for tort claims which are designed to lower the costs of accidents. These theoretical insights are important because the secretive nature of arbitration makes any quantitative analysis of the use of arbitration for tort claims difficult. The use of arbitration for tort claims can be considered both good and bad. In order to maximize the benefits of tort law, contract law, competition law, and public and private adjudication systems, the law should aim to create a “smart mix” of centralized public adjudication and decentralized private adjudication of tort claims. The law should seek to maximize the potential benefits of the use of arbitration for tort claims while limiting the potential costs of arbitration for tort claims in order to minimize the costs of accidents.



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## **Acknowledgements**

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## Propositions

1. The use of ex ante contracts to arbitrate tort claims by “repeat player” tortfeasors, allows them to behave strategically in ways which are unavailable outside of the arbitration process or are unavailable in the litigation setting within state operated courts.
2. The use of arbitration tribunals for the adjudication of tort claims may lead to the preclusion of some types of industry specific tort claims from judicial review when firms in the industry have coordinated to include arbitration clauses in their standard form contracts.
3. Because of a divergence between the EU and the US concerning the legal treatment of ex ante contracts to arbitrate claims related to consumer contracts, there are less instances of arbitration being used to adjudicate tort claims within the EU than in the US, although because of the secretive nature of arbitration the number of claims arbitrated is impossible to identify.
4. While international legal norms have developed in the use of arbitration for international commercial transactions, largely under the auspice of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, there is no convergence of legal norms in the use of arbitration for domestic claims.
5. A unique form of regulatory competition may occur when individuals and firms are permitted to contract over private and public adjudication forums for tort claims within a state, which can lead to the arbitrage of tort claims from public forums into private arbitration tribunals, which can be described as a domestic forum arbitrage strategy which is enabled by the strategic contracting of repeat player litigants to tort claims.
6. During parts of the United States Afghanistan War (2001-2021), the United States engaged in the practice of extrajudicially arresting suspected terrorists in European states under a practice known as extraordinary rendition, some of these extrajudicially detained suspects were kept in so called “black sites” within European host states, and the United States also engaged in a practice of labeling some captured combatants in the conflict as “unlawful combatants”, a designation which does not have the same legal protections given to enemies of war under the Geneva Conventions of 1949, with each practice contributing the frustration of international law.
7. In closed professional sports leagues, the competition between cities for the right to host professional sports teams contributes to an increase in public financing for professional sports stadia, which has contributed to a “race to the bottom” in the market to host professional sports teams in the United States.
8. The use of artificial intelligence to make legal determinations in the adjudication of civil and criminal claims is controversial in so far as the decisions rendered by artificial intelligence are contained within a so called “black box” which does not allow for the review and examination of the process by which the artificial intelligence has rendered its decisions.
9. The COVID-19 pandemic highlighted how in federal systems there is a need for a “smart mix” of centralized and decentralized state responses to widespread disasters, which allows federal systems to take advantages of both local expertise and economies of scale.
10. Aleatory contracts, in which risk is an essential part of the underlying contract, should be enforced even when there are unforeseen circumstances which render the performance of the contract onerous to one of the parties.
11. The band Nirvana is a more influential band than Pearl Jam, although Pearl Jam has become a more technically proficient studio and live band than Nirvana was.



ERASMUS UNIVERSITY ROTTERDAM

**PHD PORTFOLIO**

**Paul Daniel Aubrecht**

<b>Description Required</b>	<b>Organizer</b>	<b>EC</b>
Basic Math course for lawyers (2017)		2.00
Advanced Econometrics (2017)	Erasmus Universiteit	2.00
Experimental Law and Economics (Engel) (2017)		2.00
Advanced ELS Research Design - Theory Practice (2017)		2.00
Workshop Crossroads of Law and Economics (2017)		0.00
Academic Writing (2017)		4.00
Law and Economic Development (Guerriero) (2017)		2.00
EDLE - EDLE BOLOGNA European Competition Law and Intellectual Property Rights (2018)		2.00
EDLE - EDLE BOLOGNA Game Theory and the Law (2018)		2.00
EDLE - EDLE BOLOGNA Modelling European Private Law (2018)		4.00
EDLE - EDLE BOLOGNA Law Enforcement and Behavioural Economics (2018)		2.00
EDLE - EDLE BOLOGNA Workshop Presentation Skills (2018)		0.00
EDLE - EDLE BOLOGNA attendance EDLE 3rd year presentations (2018)		0.00
EDLE - EDLE BOLOGNA present final research proposal (2018)		0.00
EDLE - EDLE BOLOGNA Experimental Economics (2018)		2.00
EDLE - EDLE HAMBURG Introduction to Empirical Methods (2018)		0.00
EDLE - EDLE HAMBURG Introductory course on the German Legal system (2018)		2.00
EDLE - EDLE HAMBURG International Summer School (2018)		6.00
EDLE - EDLE HAMBURG presentation introduction chapter (2018)		0.00
EDLE – EDLE EUR ESL Two presentations of a content chapter at EDLE seminars (2019)		0.00
EDLE – EDLE EUR ESL attendance BACT seminar series (2019)		0.00

EDLE – EDLE EUR ESL attendance EDLE seminar series (2019)	0.00
EDLE – EDLE EUR EGSL lunch lectures (2019)	0.00
EDLE – EDLE EUR ESL Written peer feedback on peer content chapter 1 (2019)	0.00
EDLE – EDLE EUR ESL Written peer feedback on peer content chapter 2 (2019)	0.00
EGSL - Academic Integrity (2019)	1.00
EDLE – EDLE BOLOGNA presentation of a content chapter (2019)	0.00
EDLE – EDLE EUR ESL attending Joint Seminar ‘The Future of Law and Economics’ (2020)	0.00
EDLE – EDLE EUR ESL presentation of a content chapter in the Joint Seminar ‘The Future of Law and Economics’ (2020)	0.00
<b>Optional</b>	
EDLE - EDLE BOLOGNA Introductory Course in Statistics (2017)	3.00
	----- +
<b>Total EC</b>	<b>38.00</b>

## **CV- Paul Daniel Aubrecht**

### Professional Qualifications

- Admitted to practice law in Colorado, June 2014 (Current)
- Uniform Bar Exam (UBE) February 2014
- Multistate Professional Responsibility Examination (MPRE) November 2013

### Professional

- Faculty Chair for International Arbitration 2023: ADR Summer School- Humboldt University Berlin & Tulane University, Berlin Germany.
- Attorney 2014-2017, 2018- current: Private Practice, Denver Colorado.
- Associate Attorney 2017-2018: Gordon & Melun PLLC/ Gordon, Melun & Maton LLP, Denver Colorado.
- Faculty 2015-2019, 2022: ADR Summer School- Humboldt University Berlin & Tulane University, Berlin Germany.
- Document Review Attorney 2014: Hudson Legal, Denver Colorado.
- Legal Research Assistant 2013: University of Wyoming College of Law, Laramie Wyoming.
- NCAA Compliance Internship 2012: University of Wyoming Athletic Department, Laramie Wyoming.

### Academic

- European Doctorate in Law and Economics: Joint doctoral program with University of Bologna faculty of economics, University of Hamburg school of law, and Erasmus University Rotterdam school of law.  
Dissertation approved by advisors (June 2023) and committee (September 2023)  
Expected defense in January of 2024.
- European Master in Law and Economics: Erasmus Mundus Joint Degree Program.  
Gent University (magna cum laude) and Erasmus University Rotterdam. 2015.
- Juris Doctor, The University of Wyoming College of Law. 2013. Deans Honor Roll.
- Bachelor of Arts in Political Science Metropolitan State University of Denver. 2008.  
Provost's Honor Roll.
- Bachelor of Arts in History Metropolitan State University of Denver. 2005. Provost's Honor Roll.

### Courses Taught

Intercultural Negotiation, Mediation and Arbitration, ADR Summer School, Berlin Germany  
Humboldt University Berlin and Tulane University  
Arbitration Chair 2023  
Faculty 2015-2019, 2022

## Publications

“Frustration of Purpose, Brexit, the COVID-19 Pandemic and Commercial Contracts” Coauthored with Mitja Kovač. *Nordic Journal of Commercial Law*, No. 1, pp. 3-32, 2022.

“Centralized and Decentralized Responses to COVID-19 in Federal Systems: US and EU Comparisons” Coauthored with Jan Essink, Mitja Kovač, and Ann-Sophie Vandenberghe. *Utrecht Law Review* 18, no. 1 (2022): 93-107.

“Brexit as a frustrating event and the case of *Canary Wharf v. European Medicine Agency*.” Coauthored with Mitja Kovač. 2020. *European Medicine Agency* (April 1, 2020).

“Brexit and the Boilerplate Clauses in Commercial Contracts.” Coauthored with Mitja Kovač. *Business Law Review*, Volume 40, Issue 6, pp. 249-257, 2019.

“The Arbitration of Class Action Tort Claims and the Public Good: The use of Divergent Approaches from a Law and Economics Perspective.” Chapter in “Ljubljana talks in law and economics”, University of Ljubljana Faculty of Economics, pp. 61-89, 2018.

## Conference Presentations

“A Comparative Analysis of the Arbitrability of Tort Claims and the Demand for Adjudication.” 2022 Italian Association of Law & Economics Annual Conference, LUMSA University Palermo.

“‘Since it costs a lot to win, and even more to lose’: Implications for competition law from the use of arbitration for tort claims and the possibility of collusion to subvert due care standards.” 2021 Italian Association of Law & Economics Annual Conference, University of Trento.

“Marching without memory: how the use of arbitration in tort claims may complicate incentives to take due care.” 2019 Italian Association of Law & Economics Annual Conference, University of Milan, and 2020 European Master in Law and Economics Mid Term Conference, Erasmus University Rotterdam.

Poster Presentation: “The Arbitration of Class Action Tort Claims and the Public Good.” Challenge Accepted! Exploring Pathways to Civil Justice in Europe Conference, Erasmus University Rotterdam 2018. Conference Award: Best Poster Presentation.

“The arbitration of class action tort claims and the public good: a law and economics perspective.” 2018 German Law and Economics Association Annual Conference, University of Ljubljana.

“Update 2018, The Brexit: Complications for the AIFMD and macroprudential regulation in AIF markets in Europe.” Presented at the 2018 German Law and Economics Association Annual Conference, University of Ljubljana.

“The Brexit: Complications for the AIFMD and macroprudential regulation in AIF markets in Europe.” Presented at the 2017 European Master in Law and Economics Mid Term Conference, Ghent University.