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"Contractualizing Procedure"

by

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Note: It is expected that you will have reviewed the speaker's paper before the Seminar. This paper is somewhat longer than usual. The author has provided the following guidance if you do not have time to read the entire paper: "The main arguments of the paper are given in the introduction. Reading it should, therefore, suffice to know what the talk will be about. The paper follows with three sections: Why pre-dispute modification of procedural rules is efficient from the contractors' perspective, what are the boundaries of pre-dispute modifications of procedural rules, and how should procedural rules be structured if they may be modified at the time of contracting. Pages 7-14 summarize the efficiency considerations of pre-dispute contractualized procedures. Pages 26-37 are most important in understanding our argument for contractualize procedure, given the availability of arbitration. Pages 52-65 present our analysis of pre-dispute default procedures."

CONTRACTUALIZING PROCEDURE

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ABSTRACT

This paper analyzes the advantages of pre-dispute modifications of procedural rules, the inadequacy of private arbitration in providing similar advantages, and the boundaries that should be set over such modifications. Based on this analysis the paper offers a conceptual framework for designing optimal procedural default rules that may be modified by contracting parties before a dispute arises. By exploring the underlying rationales that should inform the choice of optimal pre-dispute default procedural rules, the article sketches the contours of such defaults from a pre-dispute perspective.

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1. INTRODUCTION

Procedural rules are constructed to provide a comprehensive and efficient framework for conducting judicial proceedings, so as to enable a just, expeditious and efficient resolution of legal disputes.¹ While this objective may often be realized, this is not always the case. In certain cases, litigants may find it more conducive to modify the procedural rules pertaining to their dispute and to adjust them to its specific circumstances.

Acknowledging the need of litigants to adjust procedure to the particular circumstances of their case, the rules of civil procedure feature a flexible framework, and litigants are allowed to contract around these rules through mutually agreeable procedural arrangements.² Since litigants, and not the court, can best represent their interests, courts typically presume such arrangements to be just and efficient, and enforce them,³ provided that they do not disturb fundamental principles of justice.

Mutually agreeable arrangements that modify procedural rules are commonplace between litigants during trial. However, such agreements are much less prevalent between contracting parties *before* the dispute arises. Pre-dispute modification of procedural rules, or, as we call it, *Contractualized Procedure*, is rarely found in practice. Indeed, an examination of a random sample of agreements covering a wide range of commercial and corporate activities shows that most agreements do not include any procedural modification, and when they do, such provisions cover only a limited range of procedural devices.

Contract, so it seems, is commonly perceived as a mechanism that enables contracting parties to design, structure and affect their behavior in the realm of substance, but not in the procedural domain. It should therefore come as no surprise that pre-dispute arrangements modifying the rules of procedure have been

¹ Federal Rules of Civil Procedure, Rule 1.

² See *infra*, section ****.

³ For the analysis of *post-dispute* modification of procedural rules see , for example, Michael L. Moffitt, *Customized Litigation: The Case for Making Civil Procedure Negotiable*, 75 GEO. WASH. L. REV. 461 (2007) (hereinafter ‘Moffitt, *Customized Litigation*’); Judith Resnik, *Procedure as Contract*, 80 NOTRE DAME L. REV. 593 (2005); Sarah Rudolph Cole, *Managerial Litigants? The Overlooked Problem of Party Autonomy in Dispute Resolution*, 51 HASTINGS L.J. 1199 (2000)

essentially overlooked in contract law scholarship so far.⁴ Likewise, procedure scholars have paid little attention to the intriguing concept of pre-dispute contractualized procedure. Since most disputants have no contractual relationship or agreement prior to their dispute, the rules of procedure apply to their case involuntarily. In such cases, neither contract law nor pre-dispute procedural arrangements hold relevance to their controversy. Furthermore, procedural rules are perceived to be trans-substantive,⁵ that is, they apply uniformly to all disputes, irrespective of their substantive characteristics. Hence, little interest has been paid to the implications of pre-dispute contractual relationships over procedural law. While some scholars have recently addressed a number of concerns pertaining to a limited set of pre-dispute procedural arrangements,⁶ no comprehensive analysis of pre-dispute contractualized procedure has been provided.

This article offers a conceptual framework for designing optimal procedural default rules that may be modified by contracting parties before a dispute arises. By exploring the underlying rationales that should inform the choice of optimal pre-dispute default procedural rules, this article sketches the contours of such defaults from a pre-dispute perspective.

The framework we offer is derived from two normative claims. The first claim, which we present in Section 2, is that parties should be allowed to contract around procedural rules before a dispute arises. This claim is based on the various advantages that

⁴ Few notable exceptions are Robert E. Scott & George E. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L. J. 814 (2006); Richard R. Brooks & Warren F. Schwartz, *Legal Uncertainty, Economic Efficiency, and the Preliminary Injunction Doctrine*, 58 STAN. L. REV. 381; Alan Schwartz, *Contracting About Bankruptcy*, 13 J. L. Econ. & Org. 127 (1997).

⁵ On the trans-substantive character of the rules of procedure see, for example, Robert M. Cover, *For James Wm. Moore: Some Reflections on a Reading of the Rules*, 84 YALE L.J. 718 (1975); Carl Tobias, *The Transformation of Trans-Substantivity*, 49 WASH. & LEE L. REV. 1501 (1992); Robert Bone, *Securing the Normative Foundations of A Litigation Reform*, 86 B.U. L. REV. 1155 (2006).

⁶ See David H. Taylor & Sara M. Cliffe, *Civil Procedure by Contract: A Convoluting Confluence of Private Contract and Public Procedure in Need of Congressional Control*, 35 U. RICH. L. REV. 1085 (2002); Elizabeth Thornburg, *Designer Trials*, 2006 J. DISP. RESOL. 181 (2006); Henry S. Noyes, *If You (Re) Build It, They Will Come: Contracts to Remake the Rules of Litigation in Arbitration's Image*, 30 Harv. J. L. & Pub. Pol'y 579 (2007). Several authors have discussed the ex-ante (pre-dispute) incentives effects of the rules of procedure and evidence, but most of them have not considered modification of these rules before the dispute. We discuss this literature *infra* in section ****

contracting parties can obtain by means of pre-dispute procedural arrangements. Unlike the limited benefits that litigants can gain from procedural arrangements made after the dispute arises, namely reduction of litigation costs and risks, pre-dispute modifications of procedural rules can achieve significant benefits not only after the dispute, but also before it.

Specifically, parties can obtain three major advantages by way of pre-dispute contractualized procedure. The first advantage concerns the ability of contracting parties to reduce strategic and opportunistic behavior once a dispute arises. During trial, litigants frequently abuse various procedural mechanisms, such as discovery and provisional remedies, to impose excessive costs on their counterparts. Moreover, litigants tend to find themselves locked in strategic Prisoners' Dilemma situations, where each tries to gain advantage over the other, yet both lose due to their failure to cooperate. We show that pre-dispute procedural arrangements can reduce both manipulation of procedure and strategic behavior.

At the contracting stage, parties are often uncertain about future contingencies and about their respective roles as plaintiff and defendant should a dispute arise. At that early stage they also enjoy a high degree of cooperation. These circumstances enable them to increase their welfare by creating tailored mechanisms that prevent them from acting opportunistically and from abusing procedure.

The second advantage involves the ability of contracting parties to shape their pre-dispute substantive and procedural behavior. Pre-dispute procedural arrangements affect parties' behavior both in the substantive and procedural domains. They impact the parties' incentives to perform their contractual obligations and to comply with substantive law, and they affect the parties' decisions to engage in a dispute, to bring suit, to invest in litigation and to consider the possibility of a settlement.

The third advantage concerns the parties' ability to increase their welfare by creating information revelation mechanisms at the pre-dispute stage. We show how uninformed parties can make use of such arrangements to screen and sort among potential partners based on their private information about their propensity to perform their contractual obligations and on their future litigation behavior. Similarly, we show how informed parties can signal their private information to prospective contractors by way of pre-dispute procedural arrangements.

Neither of these advantages can be realized by post-dispute procedural arrangements. After the dispute arises cooperation

becomes almost impossible, prior behavior is unchangeable, as well as opportunities for information revelation. Therefore, the welfare implications from pre-dispute contractualized procedure are far reaching, and they cannot be obtained by post-dispute modifications.

In Section 3 we make our second normative claim, that pre-dispute procedural arrangements should be allowed *within* the court system, since parties cannot achieve the same advantages by opting out of the public system and agreeing to refer their disputes to private arbitration. We base this claim on the inherent distinction between the incentives of public judges and those of private arbitrators in resolving disputes.

Unlike public judges, private arbitrators have to compete for their cases in the market. When deciding cases, they have to consider the implications of their decisions on their reputation in the arbitration market. Since their awards affect the decision of prospective disputants to appoint them as arbitrators in future disputes, arbitrators often have to compromise disputants' pre-dispute interests for their post dispute satisfaction. Similarly, since arbitrators are affected by market incentives, they cannot guarantee their awards to be identical to court judgments, as these may not maximize disputants' post dispute satisfaction. In particular, arbitrators would fail to provide strict adherence to substantive law, if this would harm their reputation, even though before the dispute the parties would have wanted them to do so. We show how such conflicts might indeed come about.

Consequently, arbitration cannot serve as a perfect substitute for litigation. If contracting parties are to be allowed to maximize their joint contractual surplus, pre-dispute modification of procedural rules is necessary *within* the judicial system. However, allowing parties to contract around procedural rules does not imply that there should be no constraints on pre-dispute arrangements. Litigation creates both positive and negative externalities. Contracting parties should not be allowed to increase their own welfare by externalizing costs over non-parties. Our analysis sketches the boundaries of pre-dispute procedural arrangements that result from various externalities they might create.

Based on these two normative claims, namely, that pre-dispute modification of procedural rules is desirable, and that that it should be allowed *within* the court system, Section 4 then offers a framework for devising public pre-dispute procedural defaults. It examines the various factors and considerations that should inform the choice of such optimal defaults.

We first explore the underlying rationale for procedural rules, when these cannot be contracted around before the dispute since at that time the parties have no contractual relationships. We show that the major consideration that informs devising non-contractible procedural rules is to allow litigants maximum access to procedural mechanisms, subject to court supervision. We call this the *maximalist* approach.

This approach is necessary when litigants have no prior relationships. To allow litigants maximum access to court and to information, they must be allowed all possible means to materialize these rights. This requires allowing them to choose from as broad as possible menu of procedural devices, subject to the court's discretion.

However, since the maximalist approach may induce strategic behavior and impose high litigation costs which courts cannot prevent, it is not necessarily an optimal choice for devising pre-dispute *defaults*. By definition, default procedural rules can be modified, so even if such defaults do not include all possible procedural mechanisms, contracting parties may still incorporate such mechanisms into their contract. Therefore, when procedural rules can be modified before the dispute, other rationales for constructing them should be considered.

Following the literature on substantive default rules we offer two alternatives to the maximalist approach. One is the Majoritarian approach, according to which the default chosen should be the rule that most parties would have contracted for. The majoritarian default would prove optimal if it reduces the parties' costs of having to contract around it. In the case of procedural defaults, there are many procedural devices the parties would prefer to forgo because their costs outweigh their benefits, from a pre-dispute perspective. Liberal pleading rules and broad discovery are representative examples of procedural mechanisms that are currently available under the maximalist approach, yet many contracting parties may prefer to forgo at the time of contract. A majoritarian default approach may thus feature stricter pleading rules and narrower discovery.

Alternatively, a non-majoritarian approach suggests that cost reduction and information revelation considerations may justify setting a default even if only a minority of contracting parties would have contracted for it. According to this approach, a procedural default may prove optimal if, for example, it induces an informed party to reveal her private information to her contracting partner and increase her incentives to perform her contractual obligations.

One important implication of this approach may be to adopt procedural defaults that would penalize parties who are more informed about the possible range of procedural devices, by denying them these devices. They would thus be forced to inform their counterparts of such mechanisms if they wish to incorporate them into their contract. Since many contractors are often unaware of the exact range of procedural mechanisms, such as provisional remedies or rights of discovery, the penalty approach may prove adequate to protect them from unexpected use of these mechanisms.

In addition, the choice of procedural defaults may also impact the extent to which factual information revelation would be exercised. For example, different fee shifting defaults would induce different screening and signaling outcomes. Therefore, their choice should be also informed by their information revelation implications.

Like the considerable literature on default substantive rules, our default approach to procedural rules is also inconclusive. The choice of optimal default procedures often requires further empirical study that would explore contractors' preferences and modification costs.⁷ Yet, we do manage to single out some procedural defaults that are supported by both the majoritarian and the penalty, non-majoritarian, approaches. That is, such defaults should be preferred because it seems that they would have been opted for by most contractors. But even if this turns out not to be the case, their information revelation and post dispute cost reduction strongly support their choice as defaults.

2. WHY CONTRACT FOR PROCEDURE?

The rules of civil procedure aim at striking a balance between the interests of the plaintiff and those of the defendant, in order to provide justice and fairness in the resolution of legal disputes.⁸ While the rules provide a framework for efficient and just judicial process, litigants have wide discretion in conducting trial under the adversarial model of litigation. This model rests on the premise that justice can be best realized by allowing the litigants wide latitude in defining the scope of litigation, in identifying the issues at stake and in gathering and presenting the relevant evidence to bolster their

⁷ As we explain, arbitration rules cannot be a source to study optimal defaults, because of the different incentive structures in the arbitration market as compared to adjudication. See Section *** below.

⁸ ***

claim and defense. Since the litigants, and not the court, can best represent their interests, allowing them control over the development of the trial and the presentation of evidence guarantees them the most just and accurate outcome.⁹

The adversarial model of litigation is characterized by the parties' responsibility for discovering, gathering and presenting the facts of the case to the court and by an essentially passive court, whose role is limited to securing a fair process.¹⁰ Under this model the court usually does not intervene in the process unless requested to do so by the litigants. Liberal pleading rules,¹¹ easy joinder,¹² broad discovery¹³ and lengthy cross examinations,¹⁴ are but few of the many characteristics of an adversary system.

The Federal Rules of rules of Civil Procedure (FRCP) allow parties modification that best serve their interests in resolving their controversies. Being informed about the circumstances that have led to their dispute, the litigants know best whether they wish to apply these rules or to depart from them. Since at the post-dispute stage the litigants are aware of the ramifications of any arrangement that modifies the rules of procedure, they know which set of rules will best suit their interests in resolving their disputes. The FRCP therefore allow them to customize their litigation by making post-dispute procedural arrangements.¹⁵ They allow parties to consent to waiver of service of process,¹⁶ to amend pleadings,¹⁷ to modify

⁹ ***Resnik to the contrary????***

¹⁰ See, e.g., Martin H. Redish, *The Adversary System, Democratic Theory, and the Constitutional Role of Self Interest: The Tobacco Wars, 1953-1971*, 51 DEPAUL L. REV. 359 (2001); David Luban, *LAWYERS AND JUSTICE: AN ETHICAL STUDY*, 149-167 (1988); Neil Andrews, *PRINCIPLES OF CIVIL PROCEDURE* (1994) Ch. 3.

¹¹ *** find some refernce/s on this topic***

¹² *** find some refernce /s on this topic***

¹³ *** find some refernce /s on this topic***

¹⁴ *** find some refernce /s on this topic***

¹⁵ For a through discussion see Moffit, *Customized Litigation*, *supra* note 3, at ***

¹⁶ See Fed. R. Civ. P. 4(d) (allowing parties to waive service of process in order to save money and effort). See also 4A Charles Allen Wright & Arthur Miller, *Federal Practice & Procedure* §1092.1 (3d. ed. current through 2008) (discussing the purpose and procedures for procuring waiver). Some limitations on the ability of parties to agree to waive service also exist. *Id.* For example, waiver cannot be requested of either the federal government, its agencies, corporations, and officers, or of foreign nations, states, local governments, or infants and incompetent persons. *Id.* Interestingly, when it comes to service upon foreign sovereigns, the federal statute on point, the Federal Sovereign Immunities Act ("FISA"), prefers the method of party agreement to all other procedures for

mandatory disclosures, depositions, or interrogatories, and to change any other discovery defaults,¹⁸ to waive the right to a jury trial,¹⁹ to substitute a magistrate judge for an Article III District Judge,²⁰ or to forgo their right of appeal.²¹

The rules of discovery vividly demonstrate this flexible approach.²² Rule 29 expressly grants the parties broad discretion over both the taking of depositions²³ and of any other discovery procedure including mandatory disclosures, save extensions which may require court approval.²⁴ The Advisory Committee's goal in allowing such discretion was explicitly stated - to encourage economic efficiency and reduce wasted time.²⁵

Courts will not honor procedural arrangements only if they are unenforceable under contract law,²⁶ if they modify the courts'

service of process. See 28 U.S.C. §1608; 4B Wright & Miller, *supra*, at §1111 (noting that FISA creates a hierarchy of methods of service of process, the first being party agreement).

¹⁷ Fed. R. Civ. P. 15 (both before and during trial).

¹⁸ Fed. R. Civ. P. 26, 29, & 30, 31, 33-36.

¹⁹ Fed. R. Civ. P. 39.

²⁰ Fed. R. Civ. P. 73.

²¹ See e.g. *United States Consolidated Seeded Raisin Co. v. Chaddock & Co.*, 173 F. 577, 579 (9th Cir. 1909) (dismissing appeal of suit ****more***); See, e.g., *Vargo v. Mangus*, 94 Fed.Appx. 941, 942 (3d Cir. 2004) (**add reference**).

²² See generally Jay E. Grenig, *Stipulations Regarding Discovery Procedure*, 21 AM. J. TRIAL ADVOC. 547 (1998)

²³ Fed. R. Civ. P. 29(a). The rule allows litigants, absent a contrary order from the court, to stipulate that “a deposition may be taken before any person, at any time or place, on any notice, and in the manner specified — in which event it may be used in the same way as any other deposition.” *Id.*

²⁴ See Fed. R. Civ. P. 29(b) (allowing parties to stipulate any “other procedures governing or limiting discovery be modified — but a stipulation extending the time for any form of discovery must have court approval if it would interfere with the time set for completing discovery, for hearing a motion, or for trial”). Rule 26(a)(1) allows the parties to stipulate around its mandatory provisions. Fed. R. Civ. P. 26(a)(1).

²⁵ Fed. R. Civ. P. 29 advisory committee notes. The committee noted:

This rule is revised to give greater opportunity for litigants to agree upon modifications to the procedures governing discovery or to limitations upon discovery. Counsel are encouraged to agree on less expensive and time-consuming methods to obtain information, as through voluntary exchange of documents, use of interviews in lieu of depositions, etc.

Id. See also 8 Charles Alan Wright, Arthur R. Miller & Richard L. Marcus, *Federal Practice & Procedure* §2091 (2d. ed. current through 2008) (noting that the purpose of the flexibility is for party convenience and economy).

²⁶ ***Reference***

subject matter jurisdiction,²⁷ if they contradict basic notions of justice,²⁸ or if they stand in contrary to public policy by burdening the court or the process.²⁹ Enforcement by courts of post-dispute procedural arrangements reflects the adversary system's commitment to party control over trial and manifests the ingrained perception that leaving litigation in the hands of the litigants would best serve justice and efficiency.³⁰ Thus, absent exceptional circumstances, the rules of procedure are considered as default rules that may be altered by litigants after a dispute arises and a lawsuit is filed.

Parties make post-dispute procedural arrangements after having considered their expected litigation costs, their chances of prevailing, their risks, and the effects that these arrangements may have on the trial's outcome. By making such arrangements parties can reduce their litigation expenditures and lower their risks, thereby customizing their litigation more efficiently. However, post-dispute procedural arrangements are limited in their scope and effectiveness to the post-dispute stage. They cannot address inefficient opportunistic behavior; they cannot shape or affect the parties' primary (pre-dispute) behavior; and they cannot assist contracting parties in imparting private information at the pre-dispute stage. These benefits cannot be realized, since by the time

²⁷ ***Reference***

²⁸ Courts will relieve parties from stipulations if they would be "inequitable" or "work injustice." *In re Westinghouse Electric Corp. Uranium Contracts Litigation*, 570 F.2d 899, 902 (10th Cir. 1978). holding that it would be inequitable to enforce an ex post procedural agreement barring depositions). Note that, Fed. R. Civ. P. 29 grants the court power to enter an order contrary to a stipulation of the parties as to the procedures and conditions under which depositions may be taken). See also 8 Wright & Miller, supra note 25 at §2092 (making the same point).

²⁹ See e.g., Fed. R. Civ. P. Rule 29(b) (not allowing for stipulations which extend time for any discovery that would interfere with the timetable set by the court, without the court's permission); *Atlantic Leasing Co. v. General Outdoor Advertising*, 4 F.R.D. 122, 123 (S.D.N.Y. 1943) (excluding stipulation regarding the taking of depositions because it would "more likely . . . complicate than simplify" the proceedings before the court); 8 Wright, Miller, & Marcus, supra note 25, at §2092. Note that Atlantic Leasing took place while Rule 26 still provided that depositions should be taken only in accordance with the FRCP. *Atlantic Leasing*, 4 F.R.D. at 122-23. The reasoning in rejecting the stipulations, however, was not based on the prohibition in 26, but on the theory that the Rules were intended to secure a "just, speedy, and inexpensive determination of every action." *Id.* at 123 (quoting FRCP Rule 1).

³⁰ For a recent demonstration of this approach in the criminal context see *United States v. Mezzanatto*, 513 U.S. 196 (1995).

the dispute has materialized, pre-dispute behavior has already occurred.

In this section we discuss the benefits of *pre-dispute* procedural arrangements - arrangements to modify the rules of procedure made by contracting parties before the dispute arises. Unlike procedural arrangements made after the dispute arises, whose goal is to reduce litigation risks and costs, pre-dispute modifications of procedural rules can also impact behavior before the dispute and thus achieve significant advantages both before and after the dispute occurs.

Pre-dispute procedural arrangements are currently practiced in a limited set of issues, including forum selection,³¹ choice of law,³²

³¹ See e.g., *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 9-10 (1972) (holding that forum selection clauses are prima facie valid and should be enforced unless enforcement is unreasonable under the circumstances, at 10). See also, 14D Charles Alan Wright, Arthur R. Miller & Edward H. Cooper, *Federal Practice & Procedure* §3803.1 (current through 2008). On forum selection clauses in standard form contracts see, *Carnival Cruise Lines, Inc., v. Shute*, 499 U.S. 585, 595 (1991) (noting the salutary effects of such ex ante contracts, including the certainty and avoided expense and hassle of determining the appropriate forum ex post). For a critical view on the court's decision in *The Bremen*, see, e.g., David H. Taylor & Sara M. Cliffe, *Civil Procedure By Contract: A Convuluted Confluence of Private contract and Public Procedure in Need of Congressional Control*, 35 U. RICH. L. REV. 1085, 1096 (2002) (claiming that the court has invaded legislative power by allowing parties by enforcing forum selection clauses which apparently contravene the ouster doctrine, which states that agreements to oust the jurisdiction of the court are illegal and void. The ouster doctrine was first decided in *Home Insurance Co. v. Morse*, 87 U.S. (20 Wall.) 445, 451 (1874).

³² See, *Restatement (Second) of Conflict of Laws* 186-87 (1988); stating that, with few exceptions, the law chosen to govern by the parties is the law that will be applied); *Uniform Commercial Code* §1-301; 8 *Williston on Contracts* §19:5 ("The autonomy doctrine . . . gives effect to the law intended by the parties, as evidenced by their express or implied agreement, provided the transaction has some reasonable relationship with the place where the law functions and will be applied by the courts."); 17A *Am. Jur. 2d Contracts* §261 ("Ordinarily, the parties to a contract may agree as to the law which will govern their transaction, even as to issues going to validity of contract."). See also, *Dykes v. DePuy, Inc.*, 140 F.3d 31, 39 (1st Cir. 1998) ("If two contracting parties express 'a specific intent as to the governing law, Massachusetts courts will uphold the parties' choice as long as the result is not contrary to public policy and as long as the designated state has some substantial relation to the contract.'") (quoting *Steranko v. Inforex, Inc.*, 362 N.E.2d 222, 228 (Mass. App. 1977)). Choice of law provisions differ from procedural arrangements as they seek to establish the substantive rules that will be applied in case a dispute arises. For an empirical study on parties' ex ante use of choice of law and choice of forum clauses in corporate merger agreements see Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 *VAND. L. REV.* 1975

appointment of service agent or waiver of notice altogether,³³ limitation period,³⁴ or waiver of the right to a trial by jury.³⁵ With

(2006) (finding that choice of law and choice of forum provisions appear to be negotiated vigorously in these merger contracts and that there exists a substantial degree of overlap between choice of law and choice of forum designations). For an empirical study of the court's attitude in enforcing choice of law agreements see, Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363, 375 (2003) (claiming that courts enforce approximately 85% of choice of law agreements). There is a controversy among scholars over the enforcement of choice of forum clauses: While some authors defend the use of forum selection clauses, see e.g. Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure*, 25 CORNELL INT'L L.J. 51 (1992), others criticize their use in form contracts, see e.g., Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. Rev. 700 (1992).

³³ Nat'l Equip. Rental v. Szukhent, 375 U.S. 311, 315-16 (1964) (noting also that "it is settled . . . that parties to a contract may agree in advance to submit to the jurisdiction of a given court, to permit notice to be served by the opposing party, or even to waive notice altogether"). See also, Beautytuft, Inc. v. Factory Insurance Association, 48 F.R.D. 15, 26 (E.D. Tenn. 1969) (citing *Szukhent*). See also *Barker v. Greenstreet Financial, L.P.*, 823 So. 2d 195, 196 (Fla. App. 2002) (upholding service by mail and noting that contractual provisions for service were effective and did not violate rules, statutes, or due process). The FRCP provide for waiver of service of process and direct mailing of the complaint. See, Fed. R. Civ. P. 4(d). Further, the rule imposes "a duty to avoid unnecessary expenses of serving the summons" on any party subject to service, and imposes upon them, for refusing waiver without good cause, the costs of the subsequent service and any attorney's fees necessary to recover those costs.

³⁴ In some jurisdictions parties may limit the time in which actions may be brought based on a contract. See e.g. *Gifford v. Travelers Protective Association*, 153 F.2d 209, 211 (9th Cir. 1946) (upholding six month limitation on bringing claims for benefits under insurance contract); *Chilcote v. Blue Cross & Blue Shield United*, 841 F. Supp. 877, 879 (E.D. Wis. 1993) (noting that in both Wisconsin and the Seventh Circuit it is "well established that, in the absence of a controlling statute to the contrary, a provision in a contract may validly limit, between the parties, the time for bringing an action on such a contract" provided that the limitation is reasonable); *Elliot-McGowan Productions v. Republic Productions, Inc.*, 145 F. Supp. 48, 49 (S.D.N.Y. 1956) (upholding two year limitations on actions). See also 31 Williston on Contracts §79:10 (4th ed.) ("A substantial majority of jurisdictions permit the parties to a contract to agree upon and provide for a shorter time period within which an action must be brought than the period provided by the applicable statute of limitations."). Some jurisdictions even recognize the ability to contractually extend the statute of limitations for a reasonable time. See, e.g., *Collins v. Environmental Systems. Co.*, 3 F.3d 238, 242 (8th Cir. 1993) (applying and then predicting Minnesota law). Others, however, do not allow extension at all. For example, the Louisiana Supreme Court held in *E.L. Burns Co., Inc. v. Cashio*, that the one year statute of limitations for bringing claims on a surety bond could not be extended, because release of liability and "the prevention of litigation brought long after memories have dimmed and evidence has been lost have long been considered vital to the

the exception of choice of law arrangements, and to a limited extend forum selection clauses, these arrangements have a limited effect on the parties' behavior prior to the dispute, that is, on their incentives to perform their contractual obligations, to litigate or to settle. Moreover, aside from jury waiver agreements, these arrangements do not impact the litigation procedures, in case a dispute arises and a suit is filed.³⁶

public order..". See, 302 So. 2d 297 (La. 1974) (construing the statute of limitations in that particular statute as prohibiting exceptions, without intimating whether the discussion applied to all statutes of limitations). Courts do not, however, allow parties to extend, or waive the protections, of the statute of limitations indefinitely. See, e.g., 70 Colo. 517, 520 (1922) (concluding that "waiver. . . for an indefinite time [which] permanently removes the statute of limitations from operation . . . is held to be[]void."); *Mutual Life Insurance Co. v. United States Hotel Co.*, 144 N.Y.S. 476, 485 (N.Y. Sup. 1913) (same).

³⁵ U.S. Const., Amend. VII guarantees the right to trial by jury in most civil actions brought in federal courts. The Seventh Amendment provides that "in suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved."

³⁵ Fed. R. Civ. P. 38(a) provides that "[t]he right of trial by jury as declared by the seventh amendment to the Constitution or as given by a statute of the United States shall be preserved to the parties inviolate." Although Rule 38(d) explicitly permits ex post contractual waiver of the right to jury trial ("The failure of a party to serve and file a demand as required by this rule constitutes a waiver by the party of trial by jury."), the courts have enforced ex ante agreements to waive this right. See e.g. *Herman Miller, Inc. v. Thorn Rock Realty Co.*, 46 F.3d 183 (2d Cir. 1995); *Leasing Serv. Corp. v. Crane*, 804 F.2d 828 (4th Cir. 1986); On jury trial waivers see e.g., Stephen J. Ware, *Arbitration Clauses, Jury-Waiver Clauses, and Other Contractual Waivers of Constitutional Rights*, 67 LAW & CONTEMP. PROB. 167, 169-70 (2004); Chester S. Chuang, *Assigning the Burden of Proof in Contractual Jury Waiver Challenges: How Valuable is Your Right to a Jury Trial?*, 10 EMPL. RTS. & EMPLOY. POL'Y J. 205 (2006) (Discussing the use of pre-dispute jury waivers in the employment context and arguing that public policy considerations, and convenience and fairness concerns, call for assigning the burden of proof to the party seeking enforcement of the waiver).

³⁶ An noted exception is the cognovit note "by which the debtor consents in advance to the holder's obtaining a judgment without notice or hearing, and possibly even with the appearance, of the debtor's behalf, of an attorney designated by the holder" in advanced that the creditor may obtain a judgment against him without notice of proceedings or any hearing if the debt is not paid on time. See, *D.H. Overmyer Co. v. Frick Co.*, 405 U.S. 174, 177 (1972). The cognovit note has been described by Yeazell as "the outer limits of the parties' ability to contract out of procedural law." Stephen C. Yeazell, *CIVIL PROCEDURE* 144-45 (6th ed. 2004). On cognovits see Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331, 351; See also, Stephen J. Ware, *Arbitration Clauses, Jury-Waiver Clauses, and Other Contractual Waivers of Constitutional Rights*, 67 LAW & CONTEMP. PROB. 167, 182-88 (2004) (discussing ex ante agreements to waive due process rights).

In this section we focus on less prevalent pre-dispute arrangements that, nonetheless, have greater effects on the parties' primary behavior and on the way trial is to proceed. We discuss pre-dispute modifications of various procedural arrangements, including discovery, provisional measures, cost allocation, and appeal. These arrangements demonstrate the various advantages of contractualized procedures, as they may curtail strategic opportunism, affect the parties' primary behavior and assist the parties in signaling their private information and in sorting between prospective counterparts according to their private information. The following sections elaborate on these advantages.³⁷

We assume throughout this section that the parties to a commercial contract wish to alter the rules of procedure that would otherwise apply to any future dispute between them. They negotiate the procedural modifications in good faith, and then, knowingly and voluntarily, enter procedural arrangements freely, while understanding the effects that these arrangements may yield. We therefore do not discuss procedural arrangements that are unenforceable under contract law and rule out all possible claims of mistake, misrepresentation, fraud, oppression, duress, undue influence, or some other claim of unconscionability. We postpone discussion of contractualized procedures in unequal settings, both due to information and to market imbalance, to Section 4.

A. REDUCING STRATEGIC OPPORTUNISM

Parties make litigation decisions whose expected benefits are higher than their expected costs. After a suit is filed the litigants participate in an adversary game whose outcome depends not only on the merits of the case but also on their respective trial expenditures and procedural maneuvers.

Describing litigation as a game does not imply, however, that it is a zero sum game.³⁸ Litigants' expenditures and strategies may offset

³⁷ Although many of our discussion pertains to pre-dispute modification of evidentiary rules as well, we nevertheless leave the analysis of contractualized evidence for future research. For the analysis of ex-ante implications of evidence rules see for example Scott and Triantis, *supra* note 4; Chris W. Sanchirico, *A Primary Activity Approach to Proof Burdens*, J. LEGAL STUD. (forthcoming 2008)

³⁸ A Zero Sum game, or alternatively, a Strictly Competitive game, is a game in which for any two outcomes, if one player prefers one outcome, the other players

each other, thereby leaving the parties in exactly the same position they would be if they could commit to constrain their strategic behavior. Since the effects of each litigant's decision depend on her adversary's decision, both litigants might try to outspend each other, thus finding themselves locked in a strategic situation similar, in many respects, to a Prisoner's Dilemma.³⁹

While parties can lower their costs and increase their benefits by limiting their investment in trial, refraining from discovery abuse, avoiding unnecessary motions, and negotiating a possible settlement in an open and collaborative manner, each litigant is better off defecting, irrespective of her adversary's strategy. This is exactly what characterizes a Prisoner's Dilemma situation. That is, in equilibrium each litigant plays his dominant strategy – defecting. However, if both players cooperate, they would both be better off. The cooperative outcome is said to *Pareto* dominate the equilibrium, defection, outcome, which is therefore inefficient.⁴⁰

Pareto inefficiencies due to strategic opportunism are part and parcel of an adversary litigation system. These inefficiencies can be contained if litigants cooperate by reciprocally curtailing their choice of procedural strategies. Yet, there are two main reasons why cooperation is difficult to achieve after the parties have embarked on the litigation war-game. First, cooperation requires the litigants to negotiate the terms of any prospective arrangement to restrict their opportunistic behavior. Once a dispute arises and a claim is filed, such cooperation is far from obvious. Second, there is no guarantee that both litigants would equally benefit from such cooperation. If one litigant gains more from cooperating than her adversary, the latter may be unwilling to concede. This would be even more so if a litigant fears he may end up with a net loss from what seems to be mutual concessions and cooperation.

prefers the other. See Martin J. Osborne & Ariel Rubinstein, *A COURSE IN GAME THEORY* (1994, MIT) 21. Put differently, in a two player zero sum game, whatever one player wins the other loses. See Drew Fudenberg & Jean Tirole, *GAME THEORY* (1993, MIT) 4.

³⁹ See Ronald J. Gilson and Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509, 514-522 (1994); Gillian Hadfield, *The Price of Law: How the Market for Lawyers Distorts the Justice System*, 98 MICH. L. REV. 953, 980-982 (2000) (Claiming that litigation is a Sunk Cost Auction, leading to a war of attrition style behavior).

⁴⁰ This is exactly the definition of a Pareto dominated outcome.***reference***

Litigants often behave opportunistically by abusing procedural instruments, such as provisional remedies and discovery measures. They might use them to uncover private, yet irrelevant for the case, information or to impose unnecessary costs on their adversaries. During the early stages of trial, courts cannot discern the true motivation behind each party's actions, and they cannot distinguish procedural measures taken in good faith, from those aimed merely to pressure the other party. As a result, courts cannot entirely avert such strategic behavior.

At the contracting stage, however, the parties may be willing to make procedural arrangements that would prevent them from strategically and opportunistically manipulating procedure. They would do so to save costs and to avoid future abuses of process, as long as such arrangements do not adversely affect their incentives to perform their contractual obligations. Parties who are aware of the Prisoner's Dilemma dynamics and who wish to avoid strategic behavior and to lower their prospective litigation costs can agree *ex ante* to reduce the number of instances where such a dilemma might occur. For example, they can agree to exclude lengthy depositions, to limit the number of witnesses that may be called during trial, to refrain from applying for provisional measures, or to proscribe interlocutory appeals.

Cooperation may be possible ahead of the dispute, since at that stage the parties often act behind a veil of ignorance. They typically do not know which of the many contingencies that may lead to a dispute would actually materialize, and what side they would assume under each contingency – that of a plaintiff or a defendant. This state of uncertainty enables the parties to realize greater benefits, if they contract for procedural arrangements prior to a dispute than if they do so only after one arises. It is often the case that uncertainty enables parties to commit to cooperative behavior, which they would not be able to agree on after they assume the roles of plaintiff and defendant.

To take an example, suppose that an agreement to limit discovery saves each party 5 in litigation costs. Assume also that the defendant's expected liability under limited discovery is lower than the expected outcome under full discovery, and that the difference is 15. After a dispute arises and a lawsuit is filed, the plaintiff will not agree to limit discovery, since he will save 5 but lose 15.

Now, suppose that the parties agree at the time of contracting to limit discovery in case a dispute arises and the parties proceed to trial. Assume further, that being uncertain about future eventualities neither party knows who will assume the role of a plaintiff and who

will be the defendant. The parties' limited information about the future enables them to average over the gains and losses resulting from limited discovery. At this early stage, both parties are as likely to benefit as they are to lose from such discovery. Therefore, they only perceive a net savings of 5 for each, as the possible gain and loss of 15 cancel each other out. Thus, incompleteness of information that the parties possess ahead of the dispute enables them to negotiate and commit to future cooperative discovery.⁴¹

Moreover, at the pre-dispute stage the parties enjoy a high degree of trust and cooperation.⁴² This state of affairs allows them to make asymmetric procedural arrangements as well, whereby, in exchange for a transfer payment or a favorable modification of the contract's substantive conditions, a party agrees to give up future procedural rights to benefit the other party in the event the parties proceed to trial.

To take another example, suppose a start-up company and a large technology firm enter a joint venture agreement for the development of a new software. The companies contemplate the possibility of future disputes. The start-up wishes to avoid attachment of its property if a suit is filed, since this might adversely affect its activity, causing it much more harm than the direct benefit for the technology firm. In order to avoid this possibility, the companies can form a procedural arrangement whereby the large firm undertakes not to seek provisional remedies in exchange for some financial consideration. Since the expected harm to the start-up is higher than the large firm's gain, they would find a mutually beneficial agreement, foreclosing the possibility of future attachment, even if such agreement involves transfer payments between the parties.

⁴¹ Absent any pre-dispute behavioral effects, which we discuss in the next section, this agreement is efficient. It is also efficient ex-post, as the 15 gained by discovery are merely transferred between the litigants and have no efficiency implication. ***Reference to Posner book, intro, on transfer payments.

⁴² See Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S CAL L REV 113 (1996); Russell Korobkin and Chris Guthrie, *Psychology, Economics and Settlement: A New Look at the Role of the Lawyer*, 76 TEX L REV 77 (1997); Linda Babcock, et al, *Forming Beliefs about Adjudicated Outcomes: Perceptions of Risk and Reservation Values*, 15 INTL REV L & ECON 289 (1995); Russell Korobkin and Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH L REV 107, 129-42 (1994); Peter J. van Koppen, *Risk Taking in Civil Law Negotiations*, 14 L & HUMAN BEH 151 (1990).

To summarize, the range and benefits of possible procedural agreements at the pre-dispute stage is much larger than the respective range and benefits of agreements made after the dispute emerges. Uncertainty about future contingencies and about the parties' roles as plaintiff or defendant renders many procedural arrangements possible *ex ante*, whereas certainty at the post-dispute stage prevents these arrangements from materializing. Under pre-dispute state of uncertainty both parties view each other on symmetric grounds. As gains and losses cancel out, the parties can realize net savings in litigation costs.

Furthermore, pre-dispute arrangements can also resolve strategic opportunism in asymmetric situations. Pre-dispute procedural arrangements only require that the parties' *joint* benefits outweigh their *joint* costs and therefore such arrangements may materialize even if they benefit only one party, as long as he is willing to pay for such benefit in advance. This is to be contrasted with the necessary conditions for procedural arrangements made after the dispute arises, which require each litigant's *individual* benefits to outweigh its *individual* costs, since transfer payments are impractical at this stage.

B. SHAPING BEHAVIOR BEFORE THE DISPUTE

When deciding how to act before a dispute arises, parties expect that if their behavior leads to a legal action, their litigation decisions would be privately optimal from a post-dispute, but not necessarily from their pre-dispute perspective. Therefore, the parties' *ex post* optimizing behavior limits their *ex ante* potential actions. Accordingly, the parties are bound to take the optimal actions subject to this post-dispute constraint. This constrained optimization may result in a pre-dispute behavior which is often inefficient for all parties from an *ex ante* perspective – since it allows for less than optimal deterrence and induces opportunistic behavior. This section elaborates on this *ex ante* – *ex post* divergence, and explains how contractualized procedure can resolve it.

The divergence between *ex ante* and *ex post* optimal litigation decisions has been analyzed extensively in the law and economics literature.⁴³ After a dispute arises litigants act to maximize their

⁴³ See Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575 (1997).

post-dispute payoff. That payoff does not include any pre-dispute costs and benefits. In particular, it does not include the deterrent effects of litigation. Thus, for example, under a strict liability rule plaintiffs will bring suits even if there is nothing defendants can do to reduce harm or its probability of incidence. Conversely, under a negligence rule plaintiffs may abstain from bringing suits even if this undermines defendants' incentives to take care and to satisfy their legal duties. Hence, parties' decisions whether to bring suit or defend are not necessarily optimal from a deterrence perspective.

The same is true for other litigation decisions – how to conduct litigation, how much to invest in it, whether to settle and for how much, or what procedural avenues to choose. All such decisions are made from a post-dispute perspective. After the dispute arises, litigation decisions can maximize litigants' payoffs, yet, they often have undesirable effects over the parties' pre-dispute behavior. Indeed, since pre-dispute behavior is past gone by the time of dispute, there is no reason to expect post-dispute behavior to be optimal from a pre-dispute perspective.

Procedural rules direct and shape the parties' behavior during litigation, as well as before a dispute arises and a suit is filed.⁴⁴ Since the parties expect any future dispute to be litigated according to the rules of procedure, these rules affect the probable outcome that litigation would generate, and as a consequence, also the parties' pre-dispute behavior. They affect the parties' incentives to comply with substantive law and to perform in accordance with their contractual obligations. They also affect the parties' incentives to engage in a dispute, to bring a suit or to refrain from doing so, to invest in the litigation and to consider the possibility of a prospective settlement.

Nonetheless, procedural rules cannot fully overcome the ex ante–ex post divergence. Being trans-substantive and applied uniformly to all disputes, the rules cannot address the specific wishes, concerns and characteristics of all contracting parties, nor can they be tailored and adjusted to their particular needs.

⁴⁴ The analysis of procedural rules from an ex ante perspective has been advocated in Bruce L Hay, *Procedural Justice: Ex Ante vs. Ex Post*, 43 UCLA L. REV. 1803 (1997). For a more critical approach see Lawrence B. Solum, *Procedural Justice*, 78 S. CAL. L. REV. 182; Robert G. Bone, *Agreeing to Fair Process: The Problem with Contractarian Theories of Procedural Fairness*, 83 B.U. L. REV. 485 (2003).

Moreover, although contracting parties are often aware of the substantive rules affecting their future conduct and the probability that a dispute would arise, they are much less aware of procedural rules that would apply. In this respect there exists what one scholar called an *acoustic separation* between the two stages – that of substantive (primary) behavior, and that of litigation. Whenever such acoustic separation indeed applies, procedural rules do not affect substantive behavior.⁴⁵

Pre-dispute procedural arrangements can permeate these gaps. First, pre-dispute procedural arrangements can be tailored to suit the parties' needs and to provide them with optimal pre-dispute incentives. Second, contracting parties are much more conscious of procedural arrangements they have mutually adopted in their agreement than of procedural rules in general. Indeed, the assumption that the parties' pre-dispute behavior depends on the expected procedural mechanism used to resolve it seems more plausible if such a mechanism is negotiated and agreed upon before the dispute arises.

An agreement on a procedural mechanism to be used in case a dispute arises ensures that it is adjusted and customized to best accommodate the contracting parties' interests, and that both parties are aware of its terms. It therefore guarantees that the parties would conduct their behavior accordingly.

Ex ante procedural contracting may affect the parties' behavior on two different levels: substantive and procedural. On the substantive (primary behavior) level, such arrangements may engender incentive effects on the parties' behavior in performing their contractual obligations, and as a consequence, on the likelihood that a dispute would arise. On the procedural level, ex ante procedural agreements may influence the parties' decisions to engage in a dispute or to settle.

Suppose that a seller and a buyer sign a contract for the supply of an advanced technological product. The product is technologically complex and its production requires great expertise. The seller's incentives to perform his contractual obligations depend on the substantive terms he has agreed to. These terms would specify the product's quality and price and the time and place of delivery.

⁴⁵ Meir Dan-Cohen, *Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law*, 97 HARV. L. REV. 625 (1984); Lawrence B. Solum, *Procedural Justice*, 78 S. CAL. L. REV. 182, 206–214 (2004)

However, due to the product's technological complexity the parties may expect that the court would be unable to detect the seller's substandard performance, or that the assessment of the seller's performance might be too costly. These constraints would increase the probability of an erroneous judicial determination. Consequently the seller's incentives to perform would be undermined.

The parties may want to induce the seller's willingness to perform his obligations by entering a procedural arrangement that would increase the accuracy of the court's decision, should a dispute arise and the parties go to trial. They can do so by agreeing, for example, that in case a dispute arises and a suit is filed they will appoint a joint expert who will produce a report on all technological issues relating to the product. Under such an agreement the parties renounce their respective right to appoint experts and submit contradicting reports supporting opposite assertions. The quality of performance would thus be appraised by one expert who can discern between good performance and substandard performance. By expecting the joint expert to assess performance accurately, the seller would have greater incentives to perform his contractual obligations. Moreover, by increasing the verifiability of the seller's contractual obligations, the parties also reduce the buyer's incentives to file frivolous lawsuits in hope of an unjustified favorable court outcome. Thus, the procedural arrangement renders both contractual performance and litigation more efficient, increase the accuracy of trial outcome, affect deterrence and generate a higher rate of compliance with substantive law.⁴⁶

The parties may also want to improve their choice between litigation and settlement in case a dispute arises. The higher the costs and risks involved in litigation, the less likely are suits whose probability of success is low. Thus, the parties may enter into a procedural arrangement that will deter them from bringing meritless suits and increase their incentives to settle. They may do so, for example, by changing the allocation of their litigation costs.

Increasing optimal deterrence, yet at the same time decreasing litigation costs, requires optimal cost allocation. While litigation should not be too costly to prevent a party from suing when the contract has been breached, it should be sufficiently costly to deter

⁴⁶ One may claim that the same argument would call for incorporating an arbitration clause into the agreement. We explain in the next chapter why this would not allow the parties to realize the same advantages as the expert clause that would be implemented within public litigation.

filing of low probability of prevailing suits when the contract has not been breached.⁴⁷ In the face of judicial error, cost allocation that satisfies both objectives is not trivial.⁴⁸ Yet, since at the pre-dispute stage contracting parties know what their private goals are as well as what their case specific information is, they may single out a fee shifting rule that best accommodates their goals.

The allocation of private litigation costs between the litigants may be contingent on various variables: on the outcome of litigation, on the divergence between this outcome and the pleadings, on settlement offers made and declined, and on litigants' behavior throughout trial. Each allocation of costs may, for example, affect the parties' incentive to file a lawsuit,⁴⁹ induce optimal contractual behavior with minimum litigation costs when a settlement is possible,⁵⁰ or impact litigation risk and affect the parties' incentives to invest in litigation.⁵¹

The effects of various fee shifting rules over litigation and settlement behavior have been comprehensively analyzed in the literature.⁵² Tailoring the allocation of costs to the parties' needs is contingent on their specific circumstances. These effects are difficult to analyze generally since litigation risks and investments depend on

⁴⁷ See Albert Choi and George Triantis, *Completing Contracts in the Shadow of Costly Verification*, forthcoming J. LEGAL STUD

⁴⁸ Absent judicial error, The English fee shifting rule would induce optimal litigation as well as primary decisions. See Steven Shavell, *Suit, Settlement and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982).

⁴⁹ Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD 55, 59 (1982); David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON 3, 5, (1985); James W. Hughes Edward A. Snyder, *Litigation and Settlement under the English and American Rules: Theory and Evidence*, 38 J. LAW & ECON 225, 249 (1995). For a claim that in an asymmetric-information model of litigation, the English rule may not deter low merit claims, see A Mitchell Polinsky & Daniel L. Rubinfeld, *Does the English Rule Discourage Low-Probability-of Prevailing Plaintiffs?*, 27 J. LEG. STUD 519 (1998).

⁵⁰ Alon Klement and Zvika Neeman, *Against Compromise*, 21 J. L. ECON. & ORG. 285 (2005); Alon Klement and Zvika Neeman, *Civil Justice Reform: A Mechanism Design Framework* 164 J. INST. & THEOR. ECON. 52 (2007). This, however, is true mainly when the parties' private information in any future dispute concerns their liability, and not the level of losses.

⁵¹ See Plott C. R., *Legal Fees: A Comparison of the American and English Rules* 3 J. L. ECON. & ORG. 185 (1987).

⁵² For a comprehensive review of the literature see Avery Katz, *Indemnity of Legal Fees*, in ENCYCLOPEDIA OF LAW AND ECONOMICS, Boudewijn Bouckaert & Gerrit De Geest eds. (Elgar).

the litigants' interactive strategic litigation decisions, as well as on the way they design their attorney fees arrangements. Yet, contracting parties who are aware of their attitudes to risk, their attorney fee arrangements and other characteristics, may bargain for an optimal fee shifting rule.

Pre-dispute modifications of procedural rules may, therefore, help in resolving the tension between pre dispute and post dispute incentives. Being negotiated in advance, such modifications are certain to affect the parties behavior, both in the substantive and in the procedural levels. Having agreed to such modifications, the parties may guarantee more efficient outcomes and better incentives to satisfy their contractual obligations.

C. SIGNALING AND SORTING

A negotiating party may possess two types of private non-verifiable information which his partner cannot acquire directly prior to entering the contract: information pertaining to his prospective performance of the contract (*substantive information*) and information about his future litigation behavior should a dispute arise (*litigation information*).

A party's private substantive information includes all information that may affect the value of his contractual performance. A product's quality, its probability of failure and its inherent risks, as well as the producer's production costs, are but few examples of a producer's private substantive information, which an uninformed buyer does not know at the time of contracting, and cannot verify even after a dispute arises.⁵³

A party's litigation information consists of information about his propensity to use the legal system should a dispute arise, and about the likelihood of using procedural mechanisms to impose costs on the other party. The legal system is but one of various mechanisms that impact the probability that a dispute arises. Other mechanisms include the market (through reputation),⁵⁴ social norms,⁵⁵ and private, cultural and moral norms and ethics.⁵⁶ These alternative mechanisms may serve as substitutes for litigation and as constraints on a party's

⁵³ Thus, the information is non-observable and non-verifiable. See ****

⁵⁴ ***references***

⁵⁵ ***references***

⁵⁶

willingness to strategically abuse available procedural mechanisms in litigation and impose costs on her adversary, in order to extract a larger share in settlement.

This section explains how an uninformed party can make use of pre-dispute procedural contracting to sort and screen between informed parties, based on the private substantive and litigation information they possess, and how informed parties can signal their private information to uninformed parties by way of pre-dispute procedural arrangements. Notably, both types of information revelation require that contracting parties be able to choose between alternative procedural arrangements. Absent such choice, neither sorting nor signaling is possible. They therefore require procedure to be contractualized.

An uninformed party can sort between potential contracting partners based on their private substantive information. One example is a product warranty, which insures buyers against product failure, thus changing the de facto liability regime between sellers and buyers.⁵⁷ The higher the product's quality, the lower is the cost of its warranty. Therefore, the product's price enables a seller to signal the product's quality through the warranty. Alternatively, a buyer can sort among various sellers by requesting a product warranty. In this case, only the high quality product sellers would agree to provide such warranty.

Warranties are substantive mechanisms that help reveal private substantive information.⁵⁸ Procedural mechanism may have similar effect, and may help resolve information asymmetries which substantive mechanisms cannot address.⁵⁹ Similarly, uninformed contracting parties can sort between prospective counterparts according to their private litigation information. Since litigation information pertains only to the post-dispute stage, substantive mechanisms are often at loss in creating incentives to reveal it. By contrast, Pre-dispute procedural arrangements can be used to uncover private litigation information prior to the dispute, thus affecting the price of litigation behavior,

⁵⁷ See for example Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure about Product Quality*, 24 J. L. AND ECON. 461 (1981).

⁵⁸ Some may call warranties evidentiary mechanisms, as they shift the burden of proof as to the cause of failure to the seller. **reference***

⁵⁹ See Scott and Triantis, *supra* note 5.

Take, for example, a pre-dispute procedural arrangement to modify the rules of provisional remedies. Contracting parties may wish to agree prior to the dispute which provisional remedies they may apply for in case a dispute arises, and set the conditions required for applying them. The parties' ability to designate the appropriate arrangement pertaining to the application and use of provisional remedies allows one party to signal his contracting partner both his substantive and litigation information.

A tenant may, for example, wish to signal her reliability in satisfying her financial obligations. Absent any credit history or real guarantees, she might have trouble proving this information to the landlord prior to the dispute. She may, however, do so by making provisional remedies easier for the landlord to obtain, in case she defaults on her rental payment. She may forgo bail requirements or agree that provisional remedies would be issued *ex parte*. Even if such an agreement only shifts the costs of provisional remedies from the landlord to the tenant, it would not only make it less costly for the landlord to collect the rent, but also signal that the tenant is reliable, having agreed to bear the additional costs in case of default.

To take a numerical example, suppose that the probability of default is 0.2 for an average tenant, that the costs of provisional remedies are 200, and that they are equally borne by the tenant and the landlord (100 each). Therefore, the rental price would have to account for the owner's expected costs of collection, 20 ($=0.2*100$).

Now suppose that for some tenant the probability of default is 0.1. He may then offer the landlord to shift part of the costs of provisional remedies, reducing the landlord's costs to 50, and at the same time increasing his costs to 150, if a provisional remedy is indeed imposed. Since the landlord does not know the tenant's probability of default, his expected savings from such a pre-dispute arrangement is 10 ($=0.2*50$). The landlord would, therefore, be willing to reduce the rent by no more than 10. Suppose the landlord offers a rent discount of 8. An average tenant would not benefit from such reduction, as her expected costs would increase by 10 ($=0.2*50$), more than the 8 discount. A low-probability-of-default tenant, however, would opt for such a modification because his cost increase is only 5 ($=0.1*50$). In this case, both landlord and tenant benefit from the new arrangement.⁶⁰

⁶⁰ The owner gets a rent premium of 12, whereas his expected costs are only 5. The low probability tenant bears additional costs of 5, but earns an 8 discount. We

It may seem that a similar separation of reliable tenants can be realized through a substantive arrangement that would penalize the tenant in case of default. Yet, we have assumed that a defaulting tenant does not satisfy her financial obligations, so the incentive effect of any financial sanction would be minimal, at best. Thus, modification and choice of provisional remedies' requirements may provide the only means to induce information revelation.

Similarly, provisional remedies arrangements could be used to reveal litigation information about prospective contractors. In the landlord-tenant example, suppose that some landlords abuse their right for injunctive relief, just to harass tenants and extract additional rental payments from them. Other owners, however, abstain from similar abuse due to reputational and other concerns. By foregoing such remedies, or by making them more costly to apply, the landlord can signal his lower probability of abusing procedural mechanisms, thus rendering the lease more valuable for the tenant. Therefore, a similar mechanism to the one analyzed in the substantive information example could separate between abusive and non-abusive owners. Here, too, substantive mechanisms cannot induce such separation since by their nature the different landlord types relate to their procedural conduct only, and post dispute sanctions would be unlikely to affect such conduct.

To conclude, the opportunity to offer a menu of procedural arrangements, on the one hand, and choose from this menu, on the other hand, allows contractors to separate among themselves according to their private information. Absent such opportunity, private information concerning substantive and litigation characteristics limit contractors' possible gains from trade.

3. THE BOUNDARIES OF CONTRACTUALIZED PROCEDURES

In the previous section we established a case for pre-dispute modification of procedural rules. We showed that allowing contracting parties to modify the rules of procedure before a dispute arises increases their joint contractual surplus, by curbing strategic opportunism, shaping pre-dispute behavior and allowing for information revelation through signaling and sorting.

assume for simplicity that the original rent premium covers the owner's *expected* costs based on his prior beliefs even in this separating equilibrium. ***analyze formally***

Although pre-dispute modifications of procedural mechanisms are rarely agreed upon with respect to future litigation, they are far from being novel as far as private dispute resolution mechanisms are concerned. Indeed, pre-dispute arbitration agreements often include detailed procedural arrangements, specifying various mechanisms and devices that would apply in case a dispute arises and arbitration proceeds. Moreover, arbitration institutions such as the AAA, the NAF and the JAMS, allow parties who incorporate their arbitration rules into their arbitration agreements to contract around these rules and adjust them as they see fit.⁶¹

Since contracting parties can opt for arbitration and agree on the procedure that will apply to their dispute, a question arises as to the necessity of allowing them to modify procedural rules *within* the public court system. If arbitration and adjudication are perfect substitutes, why should be parties allowed to contract around the rules of procedure instead of opting for arbitration?

Another set of questions arises in relationship to the social desirability of enforcing contractualized procedures: Can pre-dispute procedural arrangements frustrate our common understanding of the role of public courts and of the judicial process? Can they impose any undue costs on the public system? Can they obstruct any fundamental notions of justice and due process, which cannot be reconciled within the judicial system? If the answer to any of these questions is positive (as we show them to be), then attention should be given to the proper boundaries of contractualized procedure, even if it is allowed notwithstanding the arbitration alternative.

In this section we address these two questions. We explain why arbitration cannot provide a perfect substitute for adjudication, and as a consequence, why pre-dispute modification of procedural rules is necessary in order to allow contracting parties to realize the joint benefits discussed in Section 2. We then analyze the circumstances under which pre-dispute procedural arrangements should nevertheless not be enforced. The analysis focuses on the negative externalities pre-dispute procedural arrangements may create and sets the limits and boundaries of such arrangements.

Finally, we discuss pre-dispute procedural arrangements within the framework of standard form contracts. We claim that adjudication

⁶¹ See, e.g., R-1 of the AAA Commercial Arbitration Rules; Rule 2 of JAMS Comprehensive Arbitration Rules and Procedures; Rule 1 of the NAF Code of Procedure.

should certainly be preferred to arbitration, as it affords better protection of weak parties than private arbitration.⁶² Moreover, we explain how parties with weak and strong bargaining power can benefit from pre-dispute procedural arrangements, as long as the limits on such arrangements are safeguarded.

A. *WHY NOT ARBITRATION: THE ADVANTAGES OF NON-MARKET ADJUDICATION*

Litigation is generally the default mechanism for resolving disputes between private parties. However, contracting parties can agree, before a dispute arises, to opt out of the public court system and to refer their dispute to arbitration.⁶³ As a flexible alternative to public adjudication, this private mechanism for the resolution of disputes enables the parties to define the scope of the dispute and to specify the form and substance of the proceedings. The parties can agree on a vast array of procedural mechanisms, such as the form of pleadings, the extent of future discovery measures, the conduct of hearings and the rules of evidence that would apply. They can also agree on the substantive norms, either legal or non-legal, that would govern any subsequent dispute.

Unlike in litigation, where a judge is randomly assigned to a case, in arbitration the parties select the arbitrator or agree on the method of her selection. When the resolution of the dispute necessitates special qualifications, or requires technical or scientific expertise, the parties may choose professional experts to serve as arbitrators. Arbitration

⁶² On the quality of bargaining process in contractualized procedure, see generally, Resnik, *supra* note XX, at 598 (stating that questions of legitimacy and fairness “now need to be redirected towards bargaining processes promoted by courts ...”); Thornburg, *supra* XXX at 181 (claiming that if parties with sufficient bargaining leverage could customize litigation the result would be “a designer trial with the procedural deck stacked in favor of the party with the greatest pre-dispute bargaining power”); David H. Taylor & Sara M. Cliffe, *Civil Procedure by Contract: A Convoluted Confluence of Private Contract and Public Procedure in Need of Congressional Control*, 35 U. RICH. L. REV. 1085, 1159-60 (2002) (arguing that Congress should address considerations of the type of party and determine the proper use of pre-dispute agreements); Sarah Rudolph Cole, *Managerial Litigants? The Overlooked Problems of Party Autonomy in Dispute Resolution*, 51 HASTINGS L.J. 1199, 1203 (2007) (“courts need a reliable and consistent framework for evaluating the various requests and determining which they will adopt and which they must deny.”)

⁶³ See Federal Arbitration Act, 9 U.S.C. §§ 1-307 (2000). Bruce Benson, *Arbitration*, in 5 ENCYCLOPEDIA OF LAW AND ECONOMICS 159 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000)

may thus achieve a more accurate outcome than litigation, or one that better aligns the parties' incentives with their preferred contractual norms.⁶⁴

Nevertheless, it is often the case that arbitration is subject to substantive law, and parties appoint prominent attorneys and former judges to serve as arbitrators. In such cases, arbitration appears to provide a perfect substitute for litigation.⁶⁵ If this assumption holds, then pre-dispute procedural arrangements should not be enforced within the public court system, given that contractualized procedure, unlike arbitration, creates public cost externalities.⁶⁶ Contracting parties who wish to modify the rules of procedure and adapt them to their specific needs should do so in the framework of arbitration.

However, as we explain below, arbitration is far from being a perfect substitute for litigation. Therefore, allowing parties to contract around procedural rules prior to the dispute is necessary to increase their joint welfare. We begin by reviewing empirical findings on the choice between arbitration and litigation, and conjecture that in practice, at least, contractors often see significant advantages in litigation. We then explain what we view as an important advantage of public adjudication over private arbitration, namely, the absence of market incentives.⁶⁷ Market incentives, we claim, may lead arbitrators to compromise litigants' pre-dispute interests for their post-dispute satisfaction. Contractors may therefore prefer, *ex ante*, to litigate future disputes in the public court system than to opt for arbitration.

⁶⁴ See generally, Steven Shavell, *Alternative Dispute Resolution: an Economic Analysis*, 24 J. LEGAL STUD. 1 (1995); Bruce Hay, *Procedural Justice: Ex Ante Vs. Ex Post*, 44 UCLA L. REV. 4 (1997)

⁶⁵ Our focus here is on the parties and not on the public in general. We delay discussion of externalities that are generated by the dispute resolution mechanism to the next section. For the present discussion we leave aside the question of whether the difference between judicial review on arbitration awards and on court judgments affects the parties' perception as to the similarity of both processes. Unlike court judgments which are subject to appeal, arbitration awards are subject to vacature on limited grounds. See § 10 of the Federal Arbitration Act. The Supreme court has recently ruled that parties cannot, by their own agreement, expand the scope of judicial review on arbitration awards, *see*, *Hall Street Associates L.L.C. v. Mattel, Inc.*, 552 U.S. (2008). On the effect of appeals process on adjudicators *see* Steven Shavell, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 462 (2004); Steven Shavell, *The Appeals Process and Adjudicator Incentives*, 35 J. LEGAL STUD. 1 (2006); Steven Shavell, *The Appeals Process as a Means of Error Correction*, 24 J. LEG. STUD. 379, 391 (1995).

⁶⁶ See *infra*

⁶⁷ This is no mistake. Unlike many scholars we claim that market competition of arbitrators might create a disadvantage from contractors' *ex ante* point of view.

Allowing parties further leeway in contractualizing the procedures that would apply, is then necessary to increase their joint contractual surplus.

If arbitration and litigation were perfect substitutes, we would expect parties to choose arbitration when the difference between the benefits and the expected dispute resolution costs is larger under arbitration than under litigation. They would opt for arbitration whenever they anticipate the savings from subsidization of public litigation to be more than offset by the private costs and delay it creates. To wit, arbitration should be preferred to litigation even when it does not feature any substantive difference in the standard of decision or in the expertise of the decision-maker. Reduction in cost and delay should suffice.

Recent empirical findings demonstrate, however, that contracting parties often choose litigation over arbitration. Theodore Eisenberg and Geoffrey Miller have recently reviewed over 2800 contracts filed with the Securities Exchange Commission (SEC) in 2002 by public firms. They have found that only 11% of these contracts had an arbitration clause.⁶⁸ In a different study, Eisenberg, Miller and Sherwin have found that less than 10% of a sample of large⁶⁹ public firms' non-consumer and non-employment contracts reported to the SEC in the years 2007-2008 included arbitration clauses.⁷⁰ Low rates of arbitration clauses incorporation were also found in end user online software agreements (6%),⁷¹ health care delivery agreements (9%),⁷² and telecommunication employment agreements (14%-16%).⁷³ Thus,

⁶⁸ Theodore Eisenberg and Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DE PAUL L. REV. 225 (2007).

Make reference here or somewhere else to studies mentioned in pp. 346-348 of the above article

⁶⁹ Listed by *Fortune* magazine among the top 100 of American companies, or close to the top 100.

⁷⁰ Theodore Eisenberg, Geoffrey P. Miller and Emily Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, New York University Working Papers, Paper 136 (2008).

⁷¹ Florencia Marotta-Wurgler, "Unfair" *Dispute Resolution Clauses: Much Ado about Nothing?*, in *BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS* (Omri Ben-Shahar ed., Cambridge) 45 (2007).

⁷² Elizabeth Rolph, Erik Moller and John E. Rolph, *Arbitration Agreements in Health Care: Myths and Reality*, 60 LAW & CONTEMP. PROBS. 153 (Winter 1997).

⁷³ Alexander J.S. Colvin, *From Supreme Court to Shopfloor: Mandatory*

notwithstanding larger percentage of arbitration clauses in some standard form consumer contracts,⁷⁴ it is obvious that many sophisticated market participants demonstrate preference for public adjudication over private arbitration.

One reason for the paucity of arbitration agreements⁷⁵ could be the lower, subsidized, costs of the public court system.⁷⁶ While arbitration is generally considered cheaper than litigation,⁷⁷ this is not necessarily the case. Arbitration costs, which include attorney's fees, arbitrator's fees and various administrative costs, may be significantly higher than litigation costs.⁷⁸ Accordingly, contracting parties may prefer litigation to arbitration because litigation costs and delay are often lower than the fully internalized costs of arbitration.⁷⁹

Arbitration and the Reconfiguration of Workplace Dispute Resolution, 13 CORNELL J. L. & PUB. POL'Y 581, 587 (2004).

⁷⁴ For example, in Eisenberg, Miller and Sherwin's sample, *supra* note 70, 75% of the corporations' consumer agreements have provided for mandatory arbitration.

⁷⁵ See, e.g., Eisenberg and Miller who suggest that parties do not opt for arbitration for three reasons: first, the parties may always agree to opt for arbitration after a dispute arises; second, the parties may encounter difficulty in negotiating the arbitration agreement; third arbitration may not be as efficient as it is commonly assumed. Eisenberg and Miller, *supra* note 68 at 368.

⁷⁶ On the problematics of measuring the process costs of arbitration and litigation, see, Peter B. Rutledge, *Whither Arbitration?* 6 Geo. J.L. & Pub. Pol'y 549, 582. On an empirical research providing for data on the costs of employment arbitration, see, Elizabeth Hill, *Due Process at Low Cost: An Empirical Study of Employment Arbitration Under the Auspices of the American Arbitration Association*, 18 OHIO ST. J. ON DISP. RESOL. 777 (2003)

⁷⁷ A report published by the consumer advocacy group Public Citizen concluded that the overall costs in arbitration are higher than the overall costs in litigation. Public Citizen, *The Costs of Arbitration* (2002): "The cost to a plaintiff of initiating an arbitration is almost always higher than the cost of instituting a lawsuit. Our comparison of court fees to the fees charged by the three primary arbitration provider organizations demonstrates that *forum costs*- the costs charged by the tribunal that will decide the dispute- can be up to five thousand percent higher in arbitration than in court litigation. These costs have a deterrent effect, often preventing a claimant from even filing a case." Available at <http://www.citizen.org/publications/release.cfm?ID=7173>. Some commentators follow this criticism of arbitration, See e.g., Mark E. Budnitz, *The High Cost of Mandatory Consumer Arbitration*, 67 Law & Contemp. Probs. 133, 161 (2004); Reginald Alleyne, *Arbitrators' Fees: The Dagger in the Heart of Mandatory Arbitration for Statutory Discrimination Claims*, 6 U. Pa. J. Lab. & Empl. L. 1, 30 (2003); Noyes, *supra* note **Error! Bookmark not defined.** at XX; Michael L. Moffitt, *Customized Litigation: The Case for Making Civil Procedure Negotiable*, 75 Geo. Wash. L. Rev. 461, 518-19 (2007)

⁷⁹ See Christopher R. Drahozal, *Arbitration Costs and Contingent Fee Contracts*

Notwithstanding the possible cost differential between arbitration and litigation, we suggest a different explanation why contracting parties prefer litigation, based on the inherent distinction between private arbitrators' and public judges' incentives and constraints.⁸⁰ Whereas the cost differential explanation assumes that arbitration can fully substitute litigation, our analysis claims that it necessarily fails to do so.

Following Posner, we suggest that adjudicators' behavior can be best understood as a function of their incentives and constraints.⁸¹ Private arbitrators and public judges share certain functional similarities, which relate to their adjudicative role. However, unlike judges, who are paid fixed salaries, arbitrators are paid only when they hear a case. Whereas judges are effectively shielded from competition, arbitrators act in a competitive market, and are exposed to the same market pressures as any other service provider.⁸² Therefore, arbitrators must always take notice how their decision would affect the parties' choice whether to re-appoint them as arbitrators in future disputes. This renders arbitrators' incentives in deciding disputes different than those of judges.⁸³

Unlike arbitrators, judges are isolated from market pressures, yet they are subject to institutional mandates, either formal or informal, that constrain their decisions. Thus, they maximize their own utility subject to institutional constraints,⁸⁴ independently of litigants'

(Aug. 3, 2005) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=776786 (discussing the excessive upfront costs of arbitration and suggesting that contingent fee mechanism could provide a means for overcoming liquidity and risk aversion barriers to arbitration).

⁸⁰ Although some cases are decided by juries and not professional judges, we limit our discussion to public judges and arbitrators.

⁸¹ Richard Posner, *Judicial Behavior and Performance: An Economic Approach*, 32 FLA. ST. U. L. REV. 1259 (2005).

⁸² Robert D. Cooter, *The Objectives of Private and Public Judges*, 41 PUB. CHOICE 107, 107 (1983) (discussing private judges); See also, Robert D. Cooter & Daniel L. Rubinfeld, *Trial Courts: An Economic Perspective*, 24 L. & SOC'Y REV. 533, 545 (1990)

⁸³ Christopher R. Drahozal, *Privatizing Civil Justice: Commercial Arbitration and the Civil Justice System*, 9 KAN. J.L. & PUB. PL'Y 578 (2000).

⁸⁴ On the agendas of judges, see generally, Richard A. Posner, *What do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1 (1993); Jonathan R. Macey, *Judicial Preferences, Public Choice, and the Rules of Procedure*, 23 J. LEGAL STUD. 627 (1994); Janet Cooter Alexander, *Judges' Self-Interest and Procedural Rules: Comment on Macey*, 23 J. LEGAL STUD. 647 (1994); Judith Resnik, *Mediating Preferences, Litigant*

satisfaction with the decisions they render. While arbitrators have an incentive to maximize the parties' benefits, so as to increase the likelihood to be re-appointed in future disputes, judges have no interest in appeasing the litigants before them.⁸⁵ Moreover, since judges are not hired by parties to a dispute, and their income is unaffected by the number of cases they decide or by the decisions they render, they are not concerned about their reputation or popularity among future litigants as much as private arbitrators are.⁸⁶

True, a distinction should be drawn between elected judges and appointed judges.⁸⁷ Since elected judges are elected for a limited term and have to stand for reelection, they are more sensitive to public opinion than appointed judges, who are appointed for lifetime tenure.⁸⁸ Consequently, elected judges have different incentives than appointed judges, as they would likely tend to satisfy their local voters.⁸⁹ Notwithstanding this difference, elected judges' incentives to appease their voters, who are not necessarily the litigants who appear before them, are different than arbitrators' incentives to maximize the benefits of the disputants whose dispute they decide.

The market incentives that arbitrators must attend to, on the one hand, and the institutional constraints of public judges, on the other hand, must affect their decisions. This institutional approach implies

Preferences for Process and Judicial Preferences for Settlement, J. DISP. RESOL. 155, 167 (2002).

⁸⁵ See, however, Cooter, who argues that generally appointed public judges, who cultivate prestige among lawyers and litigants, have the same incentives as income-maximizing private judges. Yet, he argues that public judges may give some weight to third parties, whereas private judges would not. Robert D. Cooter, *The Objectives of Private and Public Judges*, 41 Pub. Choice 107, 130 (1983)

⁸⁶ Posner, *supra* note **Error! Bookmark not defined.**, 10. Check exact page.

⁸⁷ On their selection, see, Judith Resnik, *Judicial Selection and Democratic Theory: Demand, Supply, and Life Tenure*, 26 CARDOZO L. REV. 579 (2005)

⁸⁸ Posner *supra* note XX at 1267; Paul R. Brace & Melinda Gann Hall, *The Interplay of Preferences, Case Facts, Context, and Rules in the Politics of Judicial Choice*, 59 J. POL. 1206 (1997); F. Andrew Hanssen, *Is There a Politically Optimal Level of Judicial Independence?*, 94 AM. ECON. REV. 712, 717 (2004); Jonathan R. Macey, *Judicial Preferences, Public Choice, and the Rules of Procedure*, 23 J. Legal Stud. 627,631 (1994); Judith Resnik, *Interdependent Federal Judiciaries: Puzzling About Why & How To Value the Independence of Which Judge*, DOEDALUS 1 (2008)

⁸⁹ Therefore, one could expect that the decisions of elected judges would be different than those of appointed judges who are free of political constraints. Empirical research has shown that elected judges tend to favor in-state local litigants than out-of state litigants., See, Alexander Tabarrok & Eric Helland, *Court Politics: The Political Economy of Tort Awards*, 42 J. L.& Econ. 157 (1999)

that even if judges and arbitrators are fully exchangeable, use the same procedures and rules of evidence, and apply the same legal standards, their expected decisions would not be the same.

Some empirical work has been conducted on comparative win rates in arbitration and litigation of employment disputes.⁹⁰ However, no definite conclusions can be drawn on the difference in outcomes between arbitration and litigation. Therefore, we can only speculate how the difference in incentives between judges and arbitrators affects the resolution of disputes under each mechanism. In what follows we offer several hypotheses on the implications of the divergence between market and non-market incentives. Yet, our main argument does not require these hypotheses to be verified unequivocally. It only requires that the difference between market and non-market incentives would prevent arbitration from being a perfect substitute for adjudication, thus rendering pre-dispute modification of procedural rules necessary.

⁹⁰ For example, Eisenberg and Hill studied They studied data from state court trials in 1996, federal court trials in 1999, and 200 AAA arbitrations from 1999 and 2000 and found no material differences in outcomes for higher compensated employees. Yet, the study showed that higher-pay employees (whose gross annual income was of at least \$ 60,000) prevailed in 64.9% of their cases, while lower pay employees prevailed in 39.6% of their cases. *See*, Theodore Eisenberg & Elizabeth Hill, *Arbitration and Litigation of Employment Claims: An Empirical Comparison*, 58 DISP. RES. J. 44, 44 (Nov 2003-Jan 2004). William Howard found that in employment arbitrations employees receive some recovery 68% of the time in arbitration and 71% of the time in litigation and that results in litigation exceeded awards in arbitration. *See*, William Howard, *Arbitrating Claims of Employment Discrimination, What Really Happens?, What Really Should Happen?* DISP. RESOL. J. (Oct.-Dec. 1995) 44. Morris Kleiner and Michael Delikat compared employment discrimination cases in the Southern District of New York federal court and employment arbitrations in the securities industries. They found that claimants prevailed in higher proportions in arbitration (46%) relative to litigation (34%). *See* Michael Delikat & Morris M. Kleiner, *An Empirical Study of Dispute Resolution Mechanisms: Where do Plaintiffs Better Vindicate Their Rights?*, Disp. Resol. J. 56 (Nov. 2003- Jan 2004). *See also*, Richard A. Bales, *Normative Consideration of Employment Arbitration at Gilmer's Quinceanera*, 81 Tul. L. Rev. 331, 342-52 (2006); David Sherwyn, Samuel Estreicher & Michael Heise, *Assessing the Case for Employment Arbitration: A New Path for Empirical Research*, 57 Stan. L. Rev. 1557, 1567-78 (2005).

On the methodological concerns of these research, *see*, Bales, *ibid*, at 347-51; Sherwyn et al., *ibid*, at 1564-66; W. Mark C. Weidemaier, *From Court-Surrogate to Regulatory Tool: Re-Framing the Empirical Study of Employment Arbitration*, 41 U. MICH. J.L. REFORM 843, 847-56 (2008).

One possible implication of market competition is that arbitrators' decisions would tend to have low variance. This is implied by disputants' risk aversion. Since high variability in arbitration outcomes implies higher risk, risk averse disputants would choose an arbitrator whose decisions tend to have lower variance. Low variance is also implied by disputants' loss aversion.⁹¹ Disputants who weigh their losses more than their victories, would prefer arbitrators whose decisions are closer to a 'middle ground' over arbitrators who tend to deliver 'all or nothing' decisions.

For example, the expected value of an arbitrator's decision for a *risk averse* plaintiff if the decision is expected to be 200 with probability 0.5 and 0 with probability 0.5, is lower than its mean value, 100. Therefore, the plaintiff would prefer an arbitrator whose expected judgment is 100 with certainty. If the plaintiff is also *loss averse*, then his value from losing is lower than 0, whereas his value from winning is as high as 200. Again, his expected value is lower than 100, the value of a certain 100 decision.⁹²

Some empirical studies have shown that arbitrators tend to 'split the difference' between the parties.⁹³ That is, given settlement offers by the parties, arbitrators tend to decide the case close to the mean of the two offers. Also, few studies have shown that the variance of arbitrated decisions of wage disputes is larger than negotiated settlements of similar disputes.⁹⁴ Yet, contradictory evidence has also been reported.⁹⁵ Thus, while empirical literature cannot unequivocally corroborate the proposition that arbitrators tend toward finding middle grounds between parties, and that their decision would have low variance,⁹⁶ it does support them.

⁹¹ Reference to Kahneman Tversky + papers in law relating to loss aversion

⁹² This example assumes the mean value serves as a reference point for wins and losses.

⁹³ See e.g., David E. Bloom, *Empirical Models of Arbitrator Behavior under Conventional Arbitration*, 68 REV. ECON. & STAT. 578, 585 (1986)

⁹⁴ Janet Currie, *Arbitrator Behavior and the Variances of Arbitrated and Negotiated Wage Settlements*, 12 J. LABOR ECON. 29 (1994). ***Check references on p. 37***

⁹⁵ Stephanie E. Keer & Richard W. Naimark, *Arbitrators Do Not "Split the Baby" – Empirical Evidence from International Business Arbitration*, 18 J. INT'L ARB. 573 (2001); Henry S. Farber, *Splitting-the-Difference in Interest Arbitration*, 35 INDUSTRIAL & LABOR RELATIONS REV. 70 (1981); Orley Ashenfelter, *Arbitration*, In 1 The New Palgrave Dictionary of Economics and the Law 88, 91 (Peter Newman, ed., 1998) *** Check***

⁹⁶ It should be noted that none of these papers has examined how arbitrators'

Another potential consequence of market incentives is that arbitration awards would display a pattern over time. If an arbitrator is chosen by repeat players, the pattern might feature bias in their favor. That is, arbitrators who act in the market and depend on repeat business, might tend to favor repeat players like employers, franchisors or corporations, because unlike one shot players, they will be in a position to re-appoint them in future disputes.⁹⁷ In other contexts, where either both parties are repeat players or neither of them is, arbitrators may want to avoid a reputation for consistently ruling in favor of one identifiable side. This is a consequence of the unverifiable nature of arbitrators' decisions, on the one hand, and their motivation to disprove any appearance of favoritism to either side, on the other hand.⁹⁸ One way arbitrators may take is to allow each side a partial victory.⁹⁹ Alternatively, arbitrators who do not 'split the difference' would want their decisions to feature a 'balanced' pattern, when considered in aggregate. They would avoid long sequences of successive decisions for one side, since these might be interpreted as a sign of bias.¹⁰⁰

Important for our argument, these (potential) implications of market competition suggest that arbitrators' decisions might compromise contractors' pre-dispute interest in creating optimal incentives to perform their contractual obligations. As we have explained, such incentives require the difference between the liability of liable and non-labile defendants to be maximized.¹⁰¹ Compromise judgments, splitting the difference, low variance decisions, and patterned decision sequences all stand in contrast to this goal.

decisions stand in comparison to the merits of each case, as distinguished from their negotiation offers.

⁹⁷ Peter B. Rutledge, *Whither Arbitration?* 6 GEO. J.L. & PUB. POL'Y 549, 565 (2008). Lisa Bingham reviewed AAA employment arbitration awards and found that in cases where the employer was a repeat player, employees were significantly less successful in arbitration. Lisa B. Bingham, *Employment Arbitration: The Repeat Player Effect*, 1 EMPLOYEE RTS. & EMP. PLO'Y J. 189 (1997); Lisa B. Bingham, *On Repeat Players, Adhesive Contracts, and the Use of Statistics in Judicial Review of Employment Arbitration Awards*, 29 MCGEORGE L. REV. 223 (1998).

⁹⁸ In circumstances where arbitrators are selected by one party, such as in some standard form contracts, arbitrators may tend to rule in favor of that party. In such circumstances the differences between arbitration and adjudication become even more pronounced. We discuss standard form contracts in section *** below.

⁹⁹ See Posner, *id.* At 1261-1262.

¹⁰⁰ Reference to Alon Klement and Zvika Neeman – our work in progress****

¹⁰¹ See supra

Since arbitrators are usually chosen after the dispute arises, their selection demonstrates a divergence between the parties' pre-dispute and their post-dispute interests. This divergence is similar to the divergence we have analyzed with respect to pre-dispute and post-dispute litigation decisions.¹⁰² Moreover, even if contracting parties were to select an arbitrator prior to the dispute, or if they were to choose an arbitration institution whose arbitrators do not feature any of the above tendencies, at the post-dispute stage they would want to renegotiate their pre-contractual selection of arbitrator, and replace it with their post-dispute preferred arbitrator.¹⁰³ Thus, the ex post selection of the arbitrator is likely to undermine the parties' ex ante welfare.

In conclusion, arbitration cannot offer a perfect substitute for public adjudication, since there is an inherent difference between the incentives and constraints of judges and those of arbitrators. This difference may well be one that is cherished by contracting parties who wish legal standards to be strictly applied to the resolution of their dispute, if any of them defaults on her contractual commitments. Pre-dispute modifications of procedural arrangements may be therefore necessary to enable parties to increase their joint welfare, even though similar modifications can be implemented in private arbitration. Since public judges lack market incentives, they can be trusted to strictly enforce legal mandates, even when such enforcement has extreme ex post distributional and efficiency implications for the parties. Arbitrators, in contrast, would be (even somewhat) inclined to decide the dispute in a more flexible manner, due to their ex post market concerns. Thus, since pre-dispute modification of procedural rules can make litigation more efficient both from pre-dispute and post-dispute perspectives, it should be allowed and enforced by courts. In the following section we discuss the necessary limitations over the enforcement of contractualized procedures.

¹⁰² On the method of appointment of arbitrators see Sect. 5 of the Federal Arbitration Act, 9 U.S.C. §§ 1-307 (2000). See also, R-11 (appointment from National Roster) and R-12 (Direct Appointment by Parties) of the AAA Commercial Arbitration Rules; Rule 15 of JAMS Comprehensive Arbitration Rules and Procedures and rule 21 of the NAF Code of Procedure.

¹⁰³ Reference to renegotiation literature****IMPORTANT maybe add something in texts

B. CONTRACTUALIZED PROCEDURE AND LITIGATION EXTERNALITIES

As we explained in the previous section, contracting parties may prefer litigation to arbitration because public judges are not subject to market incentives. The parties may prefer public adjudicators who seek accurate and just resolution of the dispute as part of their judicial ethos and guiding norms, over income-maximizing arbitrators who have one eye turned to their prospects of being re-appointed in future disputes. It is the *public* nature of adjudication¹⁰⁴ which makes it attractive for actual and prospective litigants who wish substantive law to be strictly applied to their disputes. However, this *public* nature of adjudication should not be misused by parties either after a dispute arises, or before it occurs. In this section, we discuss the boundaries of pre-dispute procedural arrangements that result from externalities they might create.

Litigation generates both negative and positive externalities.¹⁰⁵ On the negative side, each party's ex-post litigation decision determines the level of resources expended by her adversary, as well as by the legal system. Litigants impose costs on each other and on the state, including the opportunity cost of judiciary, jury and administrative personnel, and the rent of court rooms and other necessary equipment. Moreover, since litigation uses scarce judicial resources it has an immediate effect over the delay of pending suits. Thus, litigation also imposes congestion costs on non-participating litigants who wait for their turn to litigate.

On the positive side, litigation produces precedents and a body of law for use by society at large. Legal precedents are of social value because they reduce the transaction costs of contracting parties, they engender deterrence effects and they guide future behavior.¹⁰⁶ Furthermore, courts' judgments and precedents demonstrate the judicial system's commitment to just and efficient processes, thus validating public trust in the system's integrity.

¹⁰⁴ On the public character of the adjudicatory process, see e.g. *Press-Enterprise Co. v. Superior Court*, 478 U.S. 1 (1986)

¹⁰⁵ For a general theory of externalities see, for example, Richard Cornes & Todd Sandler, *THE THEORY OF EXTERNALITIES, PUBLIC GOODS AND CLUB GOODS* (2nd. Ed., Cambridge, 1996), 39-65. They define externality as an event which confers an appreciable benefit (or inflicts an appreciable damage) on some person or persons who have not fully consented to it.

¹⁰⁶ William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. Legal Stud. 235, 247 (1979)

When making litigation decisions, parties consider their private expected gains and costs flowing from their actions. However, they do not weigh the possible social costs and benefits of their decisions.¹⁰⁷ Since court services are subsidized, there is a divergence between the private and social costs associated with the use of the legal system. Consequently, the parties' private incentives to use the legal system may be excessive.¹⁰⁸ They may bring suits that are socially undesirable because their social costs exceed their social benefits;¹⁰⁹ they may want to use more judicial resources than the system allocates to their dispute;¹¹⁰ they may use their procedural arsenal in a way that benefits them less than the costs they inflict on each other and on the state; they may settle too early from a social perspective measured by their case's precedential and expressive value;¹¹¹ they may settle for an amount that is inadequate from a social perspective;¹¹² or they may use judicial resources in a way that undermines the courts' institutional integrity.¹¹³

Similar concerns impact pre-dispute procedural arrangements: they may interfere with the public allocation of judicial resources, inefficiently use those resources, or adversely affect the court's institutional integrity. We call these concerns *allocation* concerns,

¹⁰⁷ Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 578 (1997).

¹⁰⁸ Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. LEGAL STUD. 575, 577-78 (1997).

¹⁰⁹ See Steven Shavell, *The Social Versus the Private Incentive to Bring Suit In A Costly Legal System*, 11 J. LEGAL STUD. 333 (1982); Peter Menell, *A Note On Private Versus Social Incentives to Sue In A Costly Legal System*, 12 J. LEGAL STUD. 41 (1983); Louis Kaplow, *Private Versus Social Costs In Bringing Suit*, 15 J. LEGAL STUD. 371 (1986); Susan Rose-Ackerman & Mark Geistfeld, *The Divergence Between Social And Private Incentives To Sue: A Comment On Shavell, Menell, And Kaplow*, 16 J. LEGAL STUD. 483 (1987).

¹¹⁰ Id., 577. Steven Shavell, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 416 (2004)

¹¹¹ On the expressive function of the law see Lawrence Lessig, *Social Meaning and Social Norms*, 144 U. PA. L. REV. 2181 (1996); Cass Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996); Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998).

¹¹² See Steven Shavell, *The Level of Litigation: Private Versus Social Optimality of Suit and of Settlement*, 19 INT. REV. L. & ECON. 99 (1999); Kathryn Spier, *A Note On The Divergence Between the Private and the Social Motive to Settle Under A Negligence Rule*, 26 J. LEGAL STUD. 613 (1997).

¹¹³ For example, litigants may want to lower their litigation investments by increasing the variance of the expected outcome. Reducing the level of accuracy, however, would possibly produce worse precedents and undermine public trust in the judicial system.

efficiency concerns, and *reputational* concerns, respectively. They are all consequences of litigation externalities. In this section we elaborate on each of these concerns and examine to what extent they should implicate enforcement of pre-dispute procedural arrangements.

i. Allocation Concerns

Litigation involves two categories of costs – private and public. Private costs consist of all costs internalized by the litigants, such as attorney fees and the resources expended by the parties for the preparation and conduct of trial. Public costs include the costs necessary for the operation of the judicial system, such as the time and labor resources of judges, administrative personnel and jury, as well as capital resources like court rooms.

The judicial system determines the public costs of operating the legal system and allocates its resources among its various courts and prospective litigants through the rules of procedure. Jurisdiction rules designate the appropriate court or set of courts for resolving disputes, depending on considerations of Federalism, administrative efficiency and specialization, as well as on other public considerations.¹¹⁴ Limitation periods prescribe a fixed time limit within which a plaintiff can use the legal system to pursue his claim. Procedural limitations are imposed to set a limit on the use of judicial resources and time throughout litigation.

Since litigation is subsidized and litigants do not fully internalize the public costs expended by the judicial system on their dispute, they may try to interfere with the public allocation of judicial resources and use more resources than are intended be allocated to their dispute. Such attempts are often curtailed by the court.¹¹⁵

Similar allocation concerns arise at the pre-dispute stage. Contracting parties, who do not fully account for the public litigation and congestion costs, may make procedural arrangements that would affect the use of public resources and time allocated to their dispute. They would make such arrangements if their *ex ante* benefits would

¹¹⁴ ****references****

¹¹⁵ For example, parties cannot create subject matter jurisdiction by consent. See, *Arbaugh v. Y & H Corp.*, 126 S. Ct. 1235, 1237 (2006) (“Courts ... have an independent obligation to determine whether subject-matter jurisdiction exists, even in the absence of a challenge from any party.”) *Commodity Futures Trading Comm’n v. Shcor*, 478 U.S. 833, 851 (1986) (“The parties by consent cannot confer on federal courts subject-matter jurisdiction...”)

outweigh their added ex post costs,¹¹⁶ irrespective of the public costs these arrangements may cause. For example, they may agree to increase the court's level of accuracy in deciding their future dispute; they may wish that if a dispute arises, their litigation will proceed for a larger number of days than allocated by the legal system; or they may design procedures that would impose higher expenditures on the court. Consequently, pre-dispute procedural arrangements could be suspect of causing wasteful increase in public expenses and of interfering with the public allocation of resources.

Similar problem may arise with respect to pre-dispute procedural arrangements that circumvent jurisdiction mandates, thus allocating to their disputes different judicial resources than publicly intended. For example, arrangements that create subject matter jurisdiction in a court that otherwise has none, that provides that a specific forum will hear the case¹¹⁷ or that provides that the case will be heard by three judges instead of one judge. If enforced, such arrangements could have an effect of manipulating the resources allocated to the dispute and of increasing the public costs expended.

However, as a practical matter it seems likely that pre-dispute procedural arrangements would usually *reduce* the public cost and time consumed in litigation, the reason being that there is a correlation between the *public* and the *private* time and costs borne by the legal system and the contracting parties respectively. Whenever parties make a procedural arrangement that would reduce their future investment in a prospective litigation, the arrangement would also reduce the public resources expended on their dispute. The same effect would ensue if the parties make procedural arrangements that reduce the probability of filing a lawsuit or that increases their chances of reaching a settlement. Such arrangements would reduce the public costs expended on litigation since they would lessen the number of suits filed. Thus, since many procedural arrangements are aimed at reducing the parties' private costs, they would consequently decrease the parties' use of public time and resources.

Unlike post-dispute procedural arrangements whose effect on the use of public resources is evident to the court, pre-dispute procedural

¹¹⁶ The optimal level of court accuracy from a social perspective was analyzed in Louis Kaplow, *The Value of Accuracy In Adjudication: An Economic Analysis*, 23 J. LEGAL STUD. 307 (1994).

¹¹⁷ On forum selection clauses, see, David Marcus, *The Perils of Contract Procedure: A Revised History of Forum Selection Clauses in the Federal Courts*, 82 TUL. L. REV. 973 (2008).

arrangements' effect on the utilization of public resources may be less apparent. Since there is an inverse relation between litigation costs and the propensity to sue and litigate instead of settle,¹¹⁸ pre-dispute procedural arrangements that increase litigation time and costs may, in fact, reduce the parties' incentives to file a lawsuit or increase their inclination to settle. The higher are the anticipated post-dispute expenditures, the less likely are lawsuits to be filed, and the more likely are those claims that are filed to be settled. Thus, both effects reduce the parties' utilized share of public resources. An opposite effect might also ensue where an ex ante procedural arrangement, that seemingly reduces litigation time and costs, would actually result in excessive use of public resources.

Since courts may find it difficult to assess the effects of *pre-dispute* procedural arrangements on the allocation of public resources, they may be inclined to focus attention only on these arrangements' *post-dispute* effects. We suggest that in evaluating whether to enforce pre-dispute procedural arrangements that may impact judicial time and costs, courts should be aware of the possible tradeoff between pre-dispute and post-dispute costs and benefits of such arrangements.

ii. Efficiency Concerns

Judicial resources are scarce. Therefore, they must be used efficiently. Efficiency requires all resources to be allocated to their best use. In an economist's jargon, resources should be used where their comparative advantage and specialization in production is greatest.¹¹⁹ Under general conditions, market transactions allocate all resources according to the above principal. The same is not necessarily true for publicly supplied resources.

Judges specialize in deciding disputes based upon the facts adduced on the record and on the law applicable to the case. This is their expertise.¹²⁰ Parties who use the courts for their expertise make

¹¹⁸ See Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 J. Legal Stud. 575 (1997).

¹¹⁹ See e.g. N. Gregory Mankiw, PRINCIPLES OF ECONOMICS, (3rd. ed., 2004) 52-55

¹²⁰ On redefining the role of judges to include management and settlement of civil cases, see, Judith Resnik, *Trial as Error, Jurisdiction as Injury: transforming the Meaning of Article III*, 113 HARV. L. REV. 924; Judith Resnik, *Competing and Complementary Rule Systems: civil Procedure and ADR: Procedure as Contract*, 80 Notre Dame L. Rev. 593 (2005); Marc Galanter & Mia Cahill, "Most Cases Settle": *Judicial Promotion and Regulation of Settlements*, 46 STAN. L. REV.

an efficient use of judicial resources. Any other use of these resources is inefficient.¹²¹ For example, parties who agree that the court will decide the case by flipping a coin or according to non-legal norms use judicial resources inefficiently. If litigants were to bear the full costs of litigation, they would certainly not use the court inefficiently. However, since litigation is subsidized, inefficiency might ensue.

Like misallocation of judicial resources, inefficient use of those resources is possible both under post-dispute and pre-dispute procedural arrangements. However, under post-dispute procedural arrangements inefficient use of public resources would be less prevalent than under pre-dispute arrangements. At the post-dispute stage litigants are aware of the ramifications of any procedural arrangement they make, and can estimate the effects of such arrangement on the outcome of their case. Therefore, it is not likely that they would both agree to a procedural modification that causes inefficient use of judicial resources and expertise. By contrast, at the pre-dispute stage, parties act under incomplete information. Their uncertainty about future contingencies and about their roles as plaintiff and defendant in a prospective litigation makes them more prone to make inefficient use of judicial resources.

Courts, however, should not find it difficult to identify an agreement that inefficiently uses their time and skills, and deny enforcement of any such agreement. Unlike the case of misallocation of resources, where there could be a divergence between ex ante and ex post perspectives on the use of public time and costs, here, what seems to be an inefficient use of judicial resources from a post-dispute perspective would also be inefficient from a pre-dispute perspective. Since inefficient use of judicial resources implies that judges do not have comparative advantage in performing what the parties wish them to do, the same outcome can be obtained more efficiently by contracting out of the public judicial system. Contracting parties might fail to opt out of the public legal system only because they do not fully internalize the public costs of litigation. This, however, cannot render their arrangement efficient.

1339 (1994);

¹²¹ This, indeed, is why managerial judging is inefficient. See Resnik, *Managerial Judges*, 96 HARV. L. REV. 374 (1982); Jeffrey W. Stempel, *New Paradigm, Normal Science, or Crumbling Construct? Trends in Adjudicatory Procedure and litigation Reform*, 59 .

iii. Reputational Concerns

The public court system serves both private and public functions. Through their dual roles, courts provide a private dispute resolution service and produce precedents and legal rules¹²² that are public goods that benefit society at large.¹²³ The nature of courts as public institutions requires them to act within their institutional duties and obligations. By following the rules of civil procedure courts substantiate their judicial integrity and commitment to a fair and efficient process and to the search for a just and accurate judicial resolution of disputes. Precedents, public trust and judicial integrity are all public goods whose benefits are enjoyed by all members of society. Moreover, as we explained above, the most significant advantage of public courts lies in their commitment to deciding cases on the basis of substantive law. Thus, courts enjoy a reputational capital which litigants use and substantiate.

At the post-dispute stage, it would be very rare to have both parties wish the court to decide their case in a way that would adversely affect its reputational capital. The reason for that being simply that any such use would probably change the outcome of litigation in a way that would be unacceptable to one of the parties. This, however, is not the case prior to the dispute.

As we explained above,¹²⁴ after a lawsuit is filed the litigants negotiate procedural arrangements in the shadow of default procedural rules and their effect on the anticipated outcome. At this stage, the litigants, having assumed their respective roles as plaintiff and defendant, can estimate the effect of any procedural arrangement on the proceedings and on the outcome of litigation, both in terms of costs and in terms of the anticipated court decision. A litigant will agree to modify a procedural rule only if his expected benefits from the modification are higher than his expected costs, that is, if his net payoff is positive. This net payoff depends on two factors: the difference in the expected outcome, and the difference between the expected costs with the procedural modification and without it.

¹²² Owen M. Fiss, *The Supreme court 1978 Term – Foreword: The Forms of Justice*, 93 HARV. L. REV. 1, 29 (1979) (“[C]ourts exist to give meaning to our public values, not to resolve disputes.”)

¹²³ See, e.g., David Luban, *Settlements and the Erosion of the Public Realm*, 83 Geo. L.J. 2619, 2623 (1995)

¹²⁴

Since each litigant would agree to modify a procedural rule only if his net payoff from doing so is positive, the difference in the anticipated outcome cannot be significant.¹²⁵ The same cannot be guaranteed in case of pre-dispute modifications of procedural rules. At the pre-dispute stage, the parties act behind a veil of ignorance, not knowing who would benefit from the pre-dispute modification, and who would lose from it. The state of uncertainty shared by the parties enables them to mutually agree to modify procedural rules, even if the effect of their agreement on the expected outcome could be substantial. This is one of the advantages parties can realize through such an agreement.¹²⁶ Enforcement of this agreement might nevertheless impair the reputation of the court.

To take a simple example, suppose that after a dispute arises and a suit is filed the defendant's expected liability in trial is 100 and that each litigant's expected litigation costs are 20. Since the maximum difference in expected liability that both parties would be willing to negotiate is 20, the expected liability in trial pursuant to an ex post procedural arrangement would range between 80 and 120. Suppose, however, that the parties agree on the procedural arrangement before the dispute arises. Since the parties do not know at the pre-dispute stage who will be the plaintiff and who will be the defendant after a dispute arises, their only concern is to decrease their future litigation costs. Therefore, the parties can enter a procedural arrangement even if it modifies the expected outcome of trial by more than 20.

Thus, the parties may agree before the dispute to reduce the level of accuracy of the court's decision if such an agreement reduces their costs in a way that outweighs any advantageous effect of increased level of accuracy.¹²⁷ Since a process lacks legitimacy if it produces bad outcomes,¹²⁸ pre-dispute procedural arrangements might be

¹²⁵ Although in theory a litigant might agree to a large change in the expected judgment, in return for a transfer payment, such a Coasian bargain is practically impossible after the lawsuit is filed. This is due to various heuristics and psychological effects that are broadly discussed in the behavioral economics literature. See also reference in note **Error! Bookmark not defined.** above, for a more concrete application of these cognitive biases and deviations from rationality to litigation and settlement.

¹²⁶ See *supra* discussion on pages ***

¹²⁷ Note on the difference between the internal efficiency of accuracy – which kaplow and shavell talk about, and the externality that inaccuracy might create... ****

¹²⁸ Robert G. Bone, *The Process of Making Process: Court Rulemaking, Democratic Legitimacy, and Procedural Efficacy*, 87 GEO. L.J. 887, 918 (1999)

suspect of undercutting the adversary nature of the judicial process, thus adversely affecting its reputational capital.

Courts must be wary of enforcing pre-dispute procedural arrangements that undermine their institutional integrity. Pre-dispute arrangements that provide that the parties would be allowed to give directions to the court as to the weight and relevance of the evidence presented may undermine the society's sense of courts' legitimacy. In the language of some constitutional acts, such arrangements might *bring the administration of justice into disrepute*.¹²⁹

There are two categories of arrangements that may harm the court's reputation: procedural arrangements that change the mode of judicial decision-making, or impart such decision-making to non-judicial mechanisms, yet require the court to embrace the outcomes of these mechanisms and implement them; and procedural arrangements that create an imbalanced process, adversely affecting the court's accuracy in a biased manner.

Arrangements in the first category are inefficient irrespective of their reputational effect, as explained in the previous section. Their adverse reputational effect only renders them more inefficient. Therefore, the decision not to enforce such arrangements should prove straightforward. The same cannot be said of procedural arrangements in the second category. Such arrangements may very well be efficient, as explained in Section 2, yet it is only their adverse reputational effect on the court, or their *disrepute* effect, which renders them undesirable. It is very difficult to draw a sharp line between arrangements in this category which should, nevertheless, be enforced, and those that should not.

However, it should be noted that most *ex ante* procedural arrangements do not fall into any of these categories. Fee shifting arrangement, discovery constraints and procedural modifications pertaining to provisional remedies, are but few examples. These arrangements do not significantly impact the institutional integrity of the courts and raise no concern in this respect.

One qualification to any possible ban on arrangements that may hinder the court's integrity is due. If courts can distinguish between ordinary decisions and decisions they believe were affected by pre-dispute procedural arrangements, they may dilute their adverse

¹²⁹ Canadian Constitution Act, 1982, s. 24(2). The section deals with different concerns than the ones presented in the text ***

reputational effects. Courts can explicitly identify the modified procedure in their decision, thus reducing the threat to their judicial integrity.¹³⁰ By doing so, courts render the differences between litigation under procedural rules and litigation under pre-dispute modified rules observable, thus avoiding the inferences from biased procedures over the judicial system in general. By singling out these decisions, courts may alleviate the adverse effects of ex ante modified procedures over public trust in the judicial system. Examination of this qualification requires, however, a more elaborate analysis of the reputational capital of the courts. Such analysis goes beyond the scope of this paper.

C. THE CONTRACTUAL LIMITS OF CONTRACTUALIZED PROCEDURES

We have assumed so far that contracting parties who wish to modify the rules of procedure before a dispute arises, negotiate any modifications in good faith, and then, knowingly and voluntarily, enter procedural arrangements, while understanding the effects that these arrangements may yield. When the parties are informed and sophisticated business actors who freely negotiate the terms of their contract, pre-dispute procedural arrangements should be enforced, assuming that no special defense under contract law, such as duress, undue influence or unconscionability, is available.

However, when there is a large disparity in the bargaining power between the contracting parties (such as between an employer and her employee),¹³¹ or when pre-dispute procedural arrangements are not negotiated, but rather are included in standard form contracts, a concern might arise as to the fairness of such arrangements, and moreover, to their efficiency.

Form contracts are offered on a “take it or leave it” basis,¹³² thus denying the offeree any opportunity to consider and negotiate any modifications to the terms contained in the contract.¹³³ It is often the

¹³⁰ Reference to 79A section of the Israeli judicial act, and similar arrangements***

¹³¹ On the development of the legal concept of inequality of bargaining power and the inability of courts to identify standards for assessing power relationships, see, Daniel D. Barnhizer, *Inequality of Bargaining Power*, 76 U. COLO. L. REV. 139 (2005).

¹³² See, e.g., David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS L. REV. 33, 76;

¹³³ See, e.g., Melvin A. Eisenberg, *The Limits of Cognition and the Limits of*

case that offerees have no true opportunity to consider the contract's terms,¹³⁴ nor even to read or understand them.¹³⁵

The concern about unfair or inefficient terms in standardized contracts can be more accentuated when procedural matters are at stake. Procedural rules are in the realm of lawyers. Laymen, lacking any legal education, are not familiar with the rules' implications, advantages and disadvantages. Lawyers drafting form contracts might include provisions that substantially favor their client one-sidedly. For example, they might impose higher costs on prospective claimants, thus discouraging them from filing suits; they might deny the weaker party the possibility of applying for provisional measures, thereby denying procedural rights; or they might allow themselves the possibility of applying for interim measures without the need of posting a bond, thus providing them with unfair advantage.

Concerns over the fairness of pre-dispute arrangements have been raised in the literature with respect to arbitration clauses in form contracts.¹³⁶ Scholars have argued that these clauses are

Contract, 47 STAN. L. REV. 211, 240-3 (1995) This is a good one. See where it was cited. Look also in the book "the limits of freedom of contract" by trebilcock (maybe; Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 688 (1996); Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 600 (1990);

¹³⁴ See, e.g., Ronald J. Mann, *Boilerplate in Consumer Contract: "Contracting" for Credit*, 104 MICH. L. REV. 899, 901, 902-6 (2006)

¹³⁵ On this claim with respect to arbitration clauses in standard contracts, see, e.g., Linda Demaine & Deborah Hensler, "Volunteering" To Arbitrate Through Pre-dispute Arbitration Clauses: The Average Consumer's Experience, 67 LAW & CONTEMP. PROB. 55, 73-74 (2004); Paul Carrington & Paul Castle, *The Revocability of Contract Provisions Controlling Resolution of Future Disputes Between the Parties*, 67 LAW & CONTEMP. PROB. 207, 218-20 (2004). Empirical studies have shown that in consumer contracts only a small percentage of consumers read form contracts, and of these, only a smaller number understand what they read. See, e.g., Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 223 (2002); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1174, 1179 (1983).

¹³⁶ On the debate on pre-dispute arbitration clauses, see, e.g., Paul D. Carrington, *Regulating Dispute Resolution Provisions in Adhesion Contracts*, 35 HARV. J. ON LEGIS. 225 (1998); Paul H. Haagen, *New Wineskins for New Wine: The Need to Encourage Fairness in Mandatory Arbitration*, 40 ARIZ. L. REV. 1039 (1998); Richard E. Speidel, *Consumer Arbitration of Statutory Claims: Has Pre-Dispute [Mandatory] Arbitration Outlived Its Welcome?*, 40 ARIZ. L. REV. 1069 (1998); Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. REV. 81, 105-06 (1992); Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme*

unfair,¹³⁷ that parties do not really have the possibility to choose between litigation and arbitration,¹³⁸ that parties lack consent and the ability to understand the terms of the arbitration clauses,¹³⁹ that these clauses deny access to justice due to the high costs of arbitration,¹⁴⁰ and that drafting parties have unfair control over the design of the dispute resolution system.¹⁴¹

Notwithstanding fairness concerns, form contracts, including contracts containing provisions in fine print, are generally enforceable.¹⁴² Therefore, the fact that the non-drafting party did not

Court's Preference for Binding Arbitration, 74 Wash. U. L.Q. 637 (1996); Michael Z. Green, *Debunking the Myth of Employer Advantage from Using Mandatory Arbitration for Discrimination Claims*, 31 RUTGERS L.J. 399 (2000); Samuel Estreicher, *Predispute Agreements to Arbitrate Statutory Claims*, 72 N.Y.U. L. REV. 1344 (1997); Stephan Landsman, *ADR and the Cost of Compulsion*, 57 STAN. L. REV. 1593 (2005); Jean Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 5 STAN. L. REV. 1631 (2005); Richard C. Reuben, *Democracy and Dispute Resolution: The Problem of Arbitration*, 67 LAW & CONTEMP. PROB. 279 (2004); Erica F. Schon, *The Uncertain Future of Mandatory Arbitration of Statutory Claims in the Unionized Workplace*, 67 LAW & CONTEMP. PROB. 321 (2004); Christopher R. Drahozal, "Unfair" Arbitration Clauses, 67 LAW & CONTEMP. PROB. 695 (2004); Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 10 OHIO ST. J. ON DISP. RESOL. 267 (1995); Thomas J. Stipanowich, *Resolving Consumer Disputes: Due Process Protocol Protects Consumer Rights*, 53 DISP. RESOL. J. 8 (1998);

¹³⁷ See, e.g., Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 Wash. U. L.Q. 637 (1996)

¹³⁸ See, e.g., David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS L. REV. 33, 37.

¹³⁹ See, e.g., Russell D. Feingold, *Mandatory Arbitration: What Process is Due?*, 39 HARV. J. ON LEGIS. 281, 284 (2002);

¹⁴⁰ See, e.g., Mark E. Budnitz, *The High Cost of Mandatory Consumer Arbitration*, 67 LAW & CONTEMP. PROB. 133 (2004)

¹⁴¹ See, e.g., Harry T. Edwards, *Where are We Heading with Mandatory Arbitration of Statutory Claims in Employment?*, 16 GA. ST. U. L. REV. 293 (1999); Michael Z. Green, *Debunking the Myth of Employer Advantage from Using Mandatory Arbitration for Discrimination Claims*, 31 RUTGERS L.J. 399 (2000); Richard E. Speidel, *Consumer Arbitration of Statutory Claims: Has Pre-Dispute Mandatory Arbitration Outlived Its Welcome?*, 40 ARIZ. L. REV. 1069 (1998). For an analysis of dispute system-design, see, Lisa B. Bingham, *Control Over Dispute-System Design And Mandatory Commercial Arbitration*, 67 LAW & CONTEMP. PROB. 221 (2004)

¹⁴² See, e.g., Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1204 (2003); Todd Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1176 (1983)

read the terms of the contract or did not understand them, does not in itself prevent the contract from being enforceable. It is only when the terms are unconscionable that the court will decline to enforce them.¹⁴³ A term is not unconscionable just because there is a disparity in bargaining power. However, a gross inequality of bargaining power with unreasonably favorable terms to the stronger party may indicate that the weaker party had no choice or did not assent to the unfair terms.¹⁴⁴

¹⁴³ On the doctrine of unconscionability in general and with respect to pre-dispute arbitration agreements in particular, *see*, Steven J. Burton, *The New Judicial Hostility to Arbitration: Federal Preemption, Contract Unconscionability, and Agreements to Arbitrate*, 2006 J. DISP. RESOL. 469, 479-80, 490-500 (2006); On the courts' reliance on the unconscionability doctrine to regulate the use of arbitration clauses to preclude class actions, *see, e.g.* Jean Sternlight & Elizabeth Jensen, *Using Arbitration To Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse?*, 67 LAW & CONTEMP. PROB. 75 (2004). *Alexander v. Anthony Int'l, L.P.*, 341 F.3d 256, 265 (3d Cir. 2003) ("Unconscionability requires a two-fold determination: that the contractual terms are unreasonably favorable to the drafter and that there is no meaningful choice on the part of the other party regarding acceptance of the provisions."). Thus, unconscionability consists of substantive and procedural elements. Substantive unconscionability means "gross disparity in the values exchanged". *See*, Restatement (Second) of Contracts Sect. 208 cmt. c (1981). Procedural unconscionability consists of an absence of meaningful choice for the party with weaker bargaining power. *See*, Restatement (Second) of Contracts Sect. 208 cmt. d (1981). On procedural unconscionability, *see*, *Maxwell v. Fidelity Fin. Servs., Inc.*, 9907 P.2d 51, 58 (Ariz. 1995) ("Under the procedural rubric come those factors bearing upon... the real and voluntary meeting of the minds of the contracting party: age, education, intelligence, business acumen and experience, relative bargaining power, who drafted the contract, whether the terms were explained to the weaker party, whether alterations in the printed terms were possible, whether there were alternative sources of supply for the goods in question." (Quoting *Johnson v. Mobil Oil corp.*, 415 F. Supp. 264, 268 (E.D. Mich. 196); *Gillman v. Chase Manhattan Bank*, 537 N.Y.S.2d 787, 791 (N.Y. 1988)). On the knowing consent standard in jury waiver clauses as opposed to the contractual consent standard in arbitration clauses, *see*, Stephen J. Ware, *Arbitration Clauses, Jury Waiver Clauses, and Other Contractual Waivers of Constitutional Rights*, 67 LAW & CONTEMP. PROB. 167, 189 (2004).

¹⁴⁴ *See* U.C.C. 2-302 & cmt. 1 (1952) and subsequent publication of Restatement (Second) of Contracts 208. The commentary accompanying section 208 provides: "Gross inequality of bargaining power, together with terms unreasonably favorable to the stronger party, may confirm indications that the transaction involved elements of deception or compulsion, or may show that the weaker party had no meaningful choice, no real alternative, or did not in fact assent or appear to assent to the unfair terms." Restatement (Second) of Contracts, 208 cmt. d. *See* also *Williams v. Walker -Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965) (the court defined unconscionability as including "an absence of meaningful choice on the part of one of the parties together with contract terms

Since parties drafting form contracts might use them to impose procedural terms that can adversely affect weaker parties' ability to litigate in accordance with the rules of procedures, a question arises as to the desirability of allowing such modifications. It might seem plausible to prohibit procedural modifications in form contracts in order to protect weaker parties from unfair abuse of their procedural rights. We argue, however, that allowing modifications of procedural rules in form contracts could prove advantageous to both parties, for the following reasons.

First, procedural terms in form contracts could be used for sorting and signaling between prospective contractors. We showed in part XX that uninformed parties can sort between potential counterparts based on their private litigation information, and that informed parties can signal their information by way of pre-dispute procedural arrangements. Thus, in case weak parties can choose between potential contracting parties, they can sort between them based on the procedural terms contained in the form contracts they offer. Similarly, drafting parties could signal in their form contracts their probability of abusing procedural mechanisms should a dispute arise.

Second, although standard form contracts are offered to weak parties without giving them any opportunity to challenge or to modify any of their terms, they may nevertheless prove efficient. Standard form contracts benefit both parties as they lower bargaining and drafting costs and can allocate risk efficiently. Since courts can refuse to enforce unconscionable terms, they can constrain strategic opportunism by drafting parties, when they abuse procedural mechanisms in their favor. When faced with a claim of unfair procedural terms, courts should consider, however, the overall efficiency of these terms. That is, even if an asymmetric procedural term in a form contract seems unfair, it may nevertheless benefit both parties. For example, when the seemingly unfair procedural term is exchanged for a favorable term of the contract's substantive conditions this may benefit the 'weaker' party, as well as the drafting 'stronger' party. To take another example, even if the procedural modification reduces future costs of opportunism and strategic behavior by the 'weaker' party, she may still enjoy the cost saving at the time of contracting, through price reduction.

which are unreasonably favorable to the other party.”).

Third, contractualized procedures offer drafting parties a third, middle ground, alternative, in addition to non-contractualized litigation, on the one hand, and private arbitration, on the other hand. It may therefore induce drafting parties to litigate their future disputes in the public court system, rather than opt for private arbitration.¹⁴⁵ In such cases, weak parties, such as employees, consumers and franchisees, would not be forced to bring their cases to private arbitrators, who are not necessarily bound by substantive law and whose decisions are not subject appeal but rather to limited review. Thus, staying within the court system and using contractualized procedure would actually afford weaker parties better protection from strategic opportunism by drafting parties.

Finally, in order to constrain strategic abuse of procedural mechanisms, procedural rules could be drafted in a way that disadvantages the strong drafting parties. We discuss the various possibilities for drafting default procedural rules in section XX below. We show that the choice of an efficient procedural default is informed by various rationales, one of which is information revelation. According to this rationale, a procedural default should be chosen based on the parties' incentives to disclose their private information to their contracting partners. Accordingly, the default rules chosen could be the default which would be worse from the drafting parties' perspective. Setting such defaults would induce that party to include in the form contract procedural terms that modify the default, thereby informing the weak party about the default as well as its modification.

To take just one example, whereas current procedural rules allow drafting parties extensive use of provisional remedies, often to the detriment of their weak counterparts,¹⁴⁶ procedural defaults may deny such remedies. The drafting party would then have to include such remedies explicitly in the contract, thus increasing the weak party's opportunity to become aware of them. We discuss the considerations that should inform pre-dispute procedural defaults next.

4. OPTIMAL PRE-DISPUTE PROCEDURAL DEFAULTS

In the previous sections we answered the first two questions of our inquiry: could contracting parties enhance their welfare by modifying

¹⁴⁵ On empirical findings about arbitration clauses in form contracts, *see, e.g.*,

¹⁴⁶ Reference to *Fuentes v. Shevin* and other cases***

procedural rules ahead of the dispute, and if so, should they be allowed to modify procedural rules within the public court system? After having established our claim that parties should be allowed to contract around procedural rules, we now move to our final question: when procedural rules are understood to be pre-dispute defaults, which default should be chosen?

We claim that optimal procedural rules that cannot be contracted around by prior agreement, since litigants do not have a contractual relationship prior to their dispute, differ from optimal pre-dispute procedural defaults, and that there are different considerations that should be taken into account when devising them. We first present the underlying rationale of non-contractible procedural rules under the Federal Rules of Civil Procedure – to allow parties maximum access to court and to procedural mechanisms. We then suggest alternative considerations that should inform the choice of pre-dispute procedural defaults.

This section makes a first step in exploring the optimal design of pre-dispute default procedural rules. We are unaware of any prior study of this problem in the literature.¹⁴⁷ As a first take on this problem, our query cannot undertake all the possible minutiae that should be addressed if one is to adopt our proposed framework. For example, one question that should be addressed is whether our analysis implies devising a special set of default procedural rules for contract disputes – ‘contract track defaults’, and if so, should contracting parties be allowed to choose between the contract track defaults and the ordinary rules of civil procedure? Another question concerns the level of specificity of defaults – should default procedures be tailored to specific types of contracts? Should the default standard form contract procedures be different than regular

¹⁴⁷ On the notion of default rules from contractual perspective, see generally, Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL’Y 639 (1989); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Randy E. Barnett, *The Sound of Silence: default Rules and Contractual Consent*, 78 VA. . REV. 821 (1992)

contract defaults? These questions, as well as many others, must be left for future research. Here we only draw the basic framework for such research.

A. NON-CONTRACTIBLE PROCEDURES: A MAXIMALIST APPROACH

Most disputants have no contractual relationship prior to their dispute: Injurers do not know their victims before an accident occurs; property owners do not negotiate with all claimants of conflicting rights before claims are asserted; and buyers do not sign contracts for each purchase they make. Lacking the ability to agree on any procedural measure at the pre-dispute stage, litigants are confined to the rules of civil procedure applicable to their case. While these rules can be modified by mutual consent during trial, failing any such modification, they apply involuntarily. In this section we discuss the implications of the non-contractible nature of procedural rules.

Procedural rules must allow litigants an opportunity to advance their claim or defense, in order to persuade the court to accept their allegations; the rules must endow each party with adequate devices to uncover private information held by her adversary; they must allow each litigant to present the relevant evidence to bolster his claim or defense and ensure that due process rights are respected; and they must guarantee effective execution of judgments. Since at the post-dispute stage litigants are unlikely to mutually agree on any such measures, the rules of procedure must provide them with maximum measures that would enable them realize their rights. Any procedural measure absent from the procedural code is unlikely to be agreed upon by the parties after the dispute arises, since one of the parties would probably be adversely affected by such arrangement. Therefore, if maximum procedural rights are to be secured, they must be set in the procedural code.

The Federal Rules of Civil Procedure demonstrate this maximalist approach. Pleadings have been reformed from strict fact pleadings, to liberal, simplified notice pleadings, requiring neither evidentiary support nor consistency, thus allowing broad claims and defenses. Joinder of claims¹⁴⁸ and parties¹⁴⁹ is highly permissive. Discovery rules allow litigants to force the disclosure of evidence, witnesses, and documents before trial, using a wide range of mechanisms, including

¹⁴⁸ Fed. R. Civ. P. R 18.

¹⁴⁹ Fed. R. Civ. P. R 19.

admissions, production of documents, interrogatories, physical and mental examinations, and depositions.¹⁵⁰ Similarly, there is a considerable scope of provisional and interim remedies intended to secure satisfaction of future judgments, including seizure of person or property, injunctions and restraining orders.¹⁵¹ Finally, litigants are allowed an appeal from a judgment as of right.¹⁵²

Clearly, the maximalist approach promotes the above stated goals. However, this approach entails high litigation and administrative costs, since it enables litigants to inflict costs on each other and on the court and to act in a highly strategic and opportunistic manner. These externalities can only be controlled by close judicial supervision and monitoring, which is itself costly. And, in the face of judicial incomplete information and limited judicial resources, monitoring can never be fully realized. Thus, while the rules of procedure feature a permissive and maximalist approach, they are not necessarily optimal.

B. CONTRACTUALIZED PROCEDURES: CHOOSING AN OPTIMAL DEFAULT

Once parties are allowed to contract around procedural defaults prior to the dispute, there is no convincing argument to maintain the maximalist approach. If contracting parties can agree in advance to adopt any procedural measure that will enhance their joint welfare from a pre-dispute perspective, procedural defaults need not necessarily feature the most extensive measures possible. Which pre-dispute defaults should be chosen, and how should they be set, then?

The choice of an efficient procedural default, like the choice of an efficient substantive default, is informed by various (often competing) rationales. One alternative to the maximalist default would be the majoritarian default - designing the set of rules that most parties would have contracted for. This would implement the arrangements that would have been contractualized anyway, and would minimize the number of necessary procedural modifications.¹⁵³

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¹⁵¹ Fed. R. Civ. P. R 64, 65.

¹⁵² Fed. R. App. P. R. 3, 4

¹⁵³ See, for example, Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597 (1990); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Charles Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089

However, there are other considerations besides the majoritarian rationale, and they may justify setting a non-majoritarian default. One consideration is cost reduction - choosing a default that would minimize the costs of contracting around, implementing, and failing to modify the default. Another rationale is information revelation, calling for examination the effect of a chosen default on the parties' incentives to disclose their private information.

Furthermore, the effect of contractors' perception or misperception about the content and the extent of the default should also be considered when choosing the optimal default. If, for example, most parties would not contract around a default, because they would mistakenly believe that it features the same approach adopted in the non-contractible ordinary rules of civil procedure, then policymakers should take this into account when setting the optimal default

Based on the extensive literature on substantive default rules, we now compare the two alternatives for choosing procedural defaults – majoritarian defaults and non-majoritarian defaults, which are often also called *penalty* defaults. The following discussion introduces the various considerations that inform the choice of a default. However, it does not arrive at definite conclusions as to the choice of the optimal default. Concrete recommendations would require further investigation of the different considerations at stake.

i. Majoritarian Defaults

Any choice of a default rule entails three types of costs: modification costs, implementation costs, and the costs of failing to contract around the default.¹⁵⁴ Modification costs include all private costs that the parties have to incur in order to contract around the default – legal fees, negotiation costs, and drafting costs.¹⁵⁵ Implementation costs include all private and public costs that are necessary to interpret a vague default or its modified alternative, to fill gaps in either of them, or to modify them, when necessary. The costs of failing to contract around a default include all welfare and efficiency losses incurred when parties fail to opt for their preferred alternative. In the next section we elaborate on the reasons for failing

(1981); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992).

¹⁵⁴ Ian Ayres & Robert Gertner, *Majoritarian v. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1593 (1999)

¹⁵⁵ Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 92-93 (1989)

to contract around defaults, or, put differently, on the ‘stickiness’ of default rules. Here we assume these costs away. We also assume that implementation costs do not depend on the default chosen. Thus, the analysis in this section focuses on modification costs only.

Assume that contracting parties always opt for their privately preferred procedural arrangement. If they prefer the default, they do not incur any modification costs. If, however, they modify the default, they must incur such costs. They would therefore contract around the default if their net benefits from the modified rule are greater than their modification costs. Since we assume initially that this condition is always satisfied, the costs of any default are only the costs of modifying it.

If modification costs are similar for all alternative defaults, then lawmakers should choose the rule that most parties would have contracted for. The reason is straightforward – if costs of all possible defaults are similar, the aggregate costs of each rule are proportional to the number of contracts that would modify it. The larger this number the more costly is the default. This default rule is often referred to in the literature as a majoritarian default.

A simple example of a majoritarian procedural default is a venue rule requiring the plaintiff to file her lawsuit in the judicial district where the defendant resides. Since at the time of contracting neither party knows who would be the plaintiff in case a dispute occurs, this default would usually limit the plaintiff’s opportunities to impose travel and other costs on the defendant. Such a default would, therefore, restrict plaintiffs’ opportunistic behavior and decrease their incentives to file frivolous suits, just to harass defendants.

Parties may wish to contract around this venue rule and agree instead that any lawsuit would be filed in a pre-specified judicial district, for example, in a district where the contract is to be performed. Assuming, however, that most contracting parties would have preferred the defendant’s residence as venue, since at the time of contracting they do not know who would assume the role of a plaintiff and who would be the defendant, the defendant’s residence default, which is the majoritarian default, would be the most efficient.

To take another example, one where the majoritarian default would prove efficient, yet differ from the maximalist default, consider discovery. The Federal Rules of Civil Procedure adopt a maximalist approach, providing the litigants with a wide range of discovery

measures.¹⁵⁶ Since most tried cases entail limited private information, and as empirical research has found, in most cases the amount of discovery is limited¹⁵⁷ broad discovery measures do not usually affect the parties' incentives to perform their contractual obligations, nor are they required to secure a just and fair resolution of the dispute. On the contrary, extensive discovery measures allow litigants the opportunity to act in a highly opportunistic manner, thus inflicting costs on each other. Therefore, at the pre-dispute stage most contracting parties would prefer to forgo broad discovery, or at least to limit its scope.

Moreover, expecting limited discovery, each party is likely to better preserve (what might turn out to be future) evidence and documentation, since obtaining them during trial through discovery procedures would prove difficult. This would only reinforce the redundancy of extensive discovery. It is as though there are two possible *ex ante* – *ex post* equilibria: one with limited discovery, where costs are shifted to the pre-dispute stage, and another with broad discovery, inducing cost shifting to the litigation stage. We believe that in most cases contracting parties would opt for the former, limited discovery, arrangement.

That a limited discovery rule would have been chosen by most contracting parties does not imply, however, that it is the optimal default. There are other factors that should be considered in choosing the optimal default: modification and implementation costs, as well as the default's 'stickiness' and the costs of failing to contract around it. Assuming, however, that modifying any discovery default is not too costly, that there are no implementation costs or costs for failing to modify it, and that there are no information revelation considerations (on which we elaborate in the following section) to the contrary, a limited discovery rule seems to be the optimal default.

To summarize, majoritarian 'would have wanted' procedural defaults may prove efficient, since they minimize the costs of contracting around them. However, as we show in the section below, modification costs are not the only consideration that should inform the choice of optimal defaults. Other cost and information considerations should be taken into account as well, thereby possibly pointing to alternatives to the majoritarian default.

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¹⁵⁷ See, James S. Kakalik, *Discovery Management: further Analysis of the Civil Justice Reform Act Evaluation Data*, 39 B.C. L. REV. 613, 621-622 (1998) ; Thomas E. Willging, *An Empirical Study of Discovery and Disclosure Practice Under the 1993 Federal Rule Amendments*, 39 B.C. L. REV. 525, 540 (1998).

ii. Non-Majoritarian and Penalty Defaults

As we explained in the previous section, any choice of a default rule involves three types of costs: modification costs, implementation costs and the costs of failing to contract around the rule. These costs may render one default more costly than its alternatives, even if that default would have been chosen by contracting parties more often. Thus, setting a majoritarian default might not always prove efficient. Aside from its comparable costs, one default may be preferable to another if it induces informed contractors to reveal their private information to their counterparts, or if it increases their incentives to perform their contractual obligations. Both costs and information considerations have been extensively analyzed by contract scholars as far as the choice of substantive defaults is concerned. None, however, have applied their insights to procedure. This section makes a first effort in this direction.

Cost reduction and information revelation considerations may justify a default even if only a minority of contractors would have preferred it. However, as some commentators have observed, implementation of these considerations may prove quite complicated. Costs and information may be distributed differently in different cases, mandating a different choice of default. If these circumstances cannot be identified in advance, a non-majoritarian default analysis may prove futile.

This is even more so in the case of procedural defaults. If pre-dispute procedural defaults are to apply to all contract disputes, irrespective of their substantive characteristics setting defaults featuring majoritarian as well as non-majoritarian considerations should depend on the extent to which such considerations can be uniformly applied across substance. Nevertheless, we try to sketch some of the relevant considerations in choosing non-majoritarian procedural defaults.

a. Information about the Default

One consideration that seems to have general application in the choice of procedural defaults, is the parties' awareness and knowledge of the default, or conversely, their misconceptions regarding it.

As we already explained, contracting parties are often unaware of the rules of procedure that would apply to their future disputes. There may be 'acoustic separation' between substantive rules, that apply to primary behavior and of which the parties are essentially aware, and

procedural rules that apply in case of litigation, which are essentially in the realm of lawyers. While this acoustic separation may exist at the time of contracting, it would often not persist as the parties' relationship progresses. Down the road, various procedural rules and devices, such as discovery rules, provisional remedies, appeal, or fee shifting may affect the parties' pre-dispute behavior and contractual performance. It is therefore preferable that parties be aware of these rules at the time of contracting.

Incomplete information about procedural rules may take one of two forms: asymmetric and symmetric. In the first case, one of the parties is uninformed or misinformed about the procedural default, whereas the other is aware of it. In the second case both parties are unaware of the procedural default or misconceive its content.

In the asymmetric information case, one of the parties is informed about the procedural default, whereas the other party is either uninformed about it or worse yet, misconceives its imperatives. Choosing a default which the knowledgeable party is likely to want to contract around would induce him to inform his counterpart about that default. Although such a 'penalty' default might be modified by most contractors, thus generating large modification costs, it might nevertheless prove more efficient from the contractors' ex ante joint welfare perspective than a majoritarian default.

To take an example where a penalty default might prove optimal, consider provisional remedies provisions. While these remedies are necessary to bridge the time gap between commencement of the lawsuit and its conclusion, they also allow one litigant to behave strategically and force his adversary into a weaker bargaining position, by seizing his property, foreclosing his future business and sales, or withholding him access to property and land. Thus, these remedies allow the issuing litigant a bargaining leverage over his adversary, before the case is tried, and until it is decided.

Whenever a party is more likely to be subject to a provisional relief than her adversary, yet at the same time she is unaware or misinformed about it, does not expect the court to issue it, or underestimates its probability, a no-provisional-remedy penalty default may prove justified. The informed party who is more likely to apply for provisional remedies will have an incentive to contract around the default in order to allow for provisional measures in case of a future dispute. In order to do so, he will have to inform his counterpart about the default. This would not only inform her about the possibility of issuing such remedies, but also enable her to price her willingness to agree to contract around the default. Unexpected

harmful contingencies would be prevented, as both parties would be aware of possible provisional measures, their costs and their benefits.

It is possible, of course, that the informed party is not interested in the option of future provisional remedies, whereas his counterpart would have liked to have such option, had he known about it. This, however, is much less likely than the opposite case where informed parties are the ones who would want to utilize provisional remedies. Uninformed contractors are usually those whose financial position is weaker, and therefore they are the ones who are most likely to be subject to future attachment or injunction, in the asymmetric information situations. Most cases would therefore feature the above scenario. Provisional remedies, thus, demonstrate the advantages of a penalty default (in this case - a no-remedy default) in inducing information revelation about contractors' types, future measures and their consequences, and in avoiding costs of unexpected application of such measures, in asymmetric information situations.

In the symmetric incomplete information case, both parties are unaware of the procedural default or misconceive its imperatives. They may, therefore, fail to contract around it even if its modification would enhance their joint welfare. In this case, the optimal default could be a majoritarian default, as it is likely to minimize efficiency losses due to inadequate procedural arrangements, or a penalty default assuming its higher costs would induce contractors' awareness of its content. However, if both parties mistakenly believe that a default is similar to the comparable provision in the ordinary rules of civil procedure (say, the default limits discovery measures, but the parties believe it allows broad discovery), and as a result they refrain from contracting around it, a default featuring the approach of the ordinary rules may prove efficient. Which of these considerations should take precedence depends on comparable costs and benefits of each default in such circumstances.

b. Private Information Revelation

As we explained above, a contractor may possess information about various issues that may be of importance to her counterpart. These include her expected quality of performance; her reputational capital and its effectiveness in constraining her from acting opportunistically; and her propensity to make strategic and opportunistic use of various procedural devices throughout litigation. These factors may mandate both the choice of default rules over immutable rules and the choice among alternative default rules. We now explain the latter.

As an example, consider the choice between the American (each party bears his legal expenses) and the English (the loser bears the winner's attorney's fees) fee allocation rules. As explained above, by opting for the English fee shifting rule, parties are able to screen among counterparts, for example between those who are more likely to file frivolous suits and those who are less inclined to do so, or between those who are more likely to satisfy their contractual obligations and those who are not. We showed that the ability to choose between the two fee shifting rules allows contractors to sort and separate between their counterparts. We assumed, however, that the choice would not be affected by the default. That is, we assumed that the contractors who would opt for one of the fee shifting rules, say the English rule, would do so irrespective of whether that rule is the default or not.

Default rules, however, are 'sticky'.¹⁵⁸ As we already discussed, the costs of modifying default procedural rules might prevent parties from contracting around the rules, even if absent such costs modification could enhance their welfare. Moreover, there are additional behavioral regularities that increase the 'stickyness' of defaults, such as the status quo bias, anchoring, and loss aversion heuristics.¹⁵⁹ Finally, informed parties may be reluctant to contract around the default, because revealing the information about their true type would have significant effect on the price or other contract terms.¹⁶⁰ Thus, the assumption that the parties' choice of a fee shifting rule would not be affected by the default is inaccurate.

Take for example a contract for the sale of a machine. Assume that there is some probability that the machine would fail to operate properly and that this probability depends on the seller's investment in the quality of production. Assume further that even under maximum investment there remains some positive probability of failure. Suppose that although the product's quality is verifiable by both the seller and the buyer, its verification in court might be too costly. Consequently, some buyers would file strike suits, just to extract some nuisance settlement, even when the product's quality is the one agreed.

¹⁵⁸ See, e.g. Cass R. Sunstein, *Switching the Default Rule*, 77, 109 N.Y.U. L. REV. 106 (2002).

¹⁵⁹ See, Russel Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998); Russel Korobkin, *Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms*, 51 VAND. L. REV. 1583 (1998) N.Y.U. L.REV. 106 (2002)

¹⁶⁰ Johnston....

The English fee shifting rule reduces the incentives to file strike suits more efficiently than the American rule, as it increases the legal fees incurred by customers. Similarly, the English rule encourages the filing of justified suits, thus increasing the sellers' incentives to perform his contractual obligations and provide high quality products. The American rule induces opportunistic behavior and frivolous filing of lawsuits, as customers do not bear the sellers' legal costs. Moreover, it reduces the difference between the seller's expected costs if he produces a high quality product and his costs if he underperforms. Therefore, under this rule, the seller would not contract for a lower quality product, yet he would charge customers the price of strike suits.

Suppose that the default rule for allocating costs is the American rule. Customers who are not inclined to file strike suits would prefer to contract around the default and opt for the English fee shifting rule, thus winning a price reduction as well as a better quality contract. Assume further that customers who are inclined to file strike suits value their right to file these suits sufficiently, so that they would prefer keeping the American rule, irrespective of the lower quality product they are bound to accept. In this case, non-strike-suiters would sign a different (high quality product or cheaper) contract than strike-suiters (lower quality product or more expensive). This is an efficient, *separating*, outcome.

Assume, conversely, that the default is the English rule. Now the ones who would prefer to contract around the default and adopt the American rule are the strike-suiters. In order to do so they would have to accept a price increase in exchange for modifying the default. Yet, this price increase might be too high, thus preventing them from modifying the rule. If the rule is not modified, the strike-suiters would continue to file strike suits, although maybe less often. Although this implies that sellers would provide higher quality products than they would have provided under the American rule, the products' quality would be lower than the one that would be provided to non-strike-suiters who would have contacted around the American default and opted for the English one. Thus, an English fee shifting default may prove less efficient than the American one since it may induce an inefficient *pooling* outcome.

The above example demonstrates how a choice of one default may result in different arrangements than its alternative. Information may be revealed only under one default rule, and as a consequence, that default may prove more efficient. As the literature on substantive default rules has recognized, the choice of an optimal default for its informational effects is complicated and often indecisive. Our goal

was only to demonstrate that similar considerations (as well as qualifications) would apply in the procedural realm.

c. Choosing between Rules and Standards

Another application for the analysis of cost and information considerations in choosing optimal procedural defaults is the choice between a rule-type and a standard type formulation of default, that is, the choice between a specific language and vague terms.¹⁶¹ Take for example the case of discovery. One rule-type default could prohibit any discovery measures, unless otherwise agreed to by the parties. Another default could define the exact scope and costs of discovery measures allowed. Yet, a standard-type default would allow discovery as long as it is “reasonably calculated” to lead to the discovery of admissible evidence. To take another example, in the case of provisional remedies, a rule-type default could prohibit any such remedies, whereas a standard-type default would allow the court to take whatever interim measure it “deems necessary”.

Standards impose public costs, since they require the court’s involvement in interpreting and implementing them. This is true of all standards, substantive as well as procedural. However, in the case of procedure, standard-type rules are also prone to strategic abuse by litigants, as the cases of discovery and provisional remedies evidently demonstrate. This might render procedural standard-type defaults substantially more costly than rule-type defaults, from a post-dispute perspective.

In choosing between a standard type and a rule type default, one should also recognize that parties are less likely to contract around standard-type procedures than around rule-type procedures, either because standard formulation seems to attract less attention from uninformed parties, or because bargaining over an alternative and defining it may prove too costly.¹⁶² Therefore, to limit the use of standard-type procedures, and their inherent public costs, rule-type

¹⁶¹ See, Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1 (1993); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992)

¹⁶² Since parties can always contract for a standard type procedure, the only way to limit post-dispute costs would be if courts decline to enforce any standard-type modification for being too vague. Yet, in the face of current procedural standards, voiding similar contractual modifications for vagueness would seem rather artificial.

defaults must be adopted. This would not eliminate all costs of standards, but can surely reduce them.

5. CONCLUSION

In this article we have outlined a framework for exploring and analyzing *contractualized procedures* - pre-dispute modified procedural rules. We demonstrated that ex ante contractual modifications of procedural rules allow contracting parties to increase their joint contractual surplus, enhance contractual performance, expand their contractual set and allow them to sort and signal their pre-dispute and post-dispute litigation behavior. We also demonstrated why such modification is necessary within litigation and cannot be obtained through private substitutes like arbitration. Yet, we showed that the public nature of litigation mandates the limits of contractualized procedure in order to minimize their negative externalities.

In conclusion we sketched the considerations that should be involved in the choice of optimal pre-dispute procedural defaults. As we showed, pre-dispute default procedure analysis requires better knowledge of the various implications of cost and information revelation considerations of alternative defaults. Considering these factors, however, may not point necessarily to one optimal default. Different circumstances, such as the case of symmetric and asymmetric incomplete information, may point to alternative defaults, featuring any of the approaches discussed - the maximalist approach, the majoritarian approach, or the non-majoritarian approach. As the first study on setting and designing pre-dispute procedural defaults, our analysis neither arrives at any definite conclusion regarding the relative weight that should be given to each and every factor, nor does it suggest that any one rationale should always be preferred. Rather, our objective was to demonstrate the various factors that efficiency minded lawmakers should consider in designing an optimal pre-dispute procedural default framework.