Seeking Optimal Dispute Resolution
Clauses in High Stakes Employment Contracts

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I.
INTRODUCTION: THE PROBLEM OF DETERMINING THE OPTIMAL DISPUTE RESOLUTION CLAUSE

At present, many contracts between firms and highly skilled employees contain dispute resolution clauses.¹ The providers of arbitration strongly urge the inclusion and utility of arbitration clauses in employment contracts. The drafters of such contracts often assume that dispute resolution clauses are advantageous. According to this assumption, dispute resolution clauses, which may include two-step² agreements to mediate and arbitrate but are more likely to be limited to contracts to arbitrate disputes, are useful to each party to the transaction and, therefore, advance efficiency by achieving mutual benefits. This thesis assumes that privately provided mediation and arbitration methods result in a dispute resolution process that is less expensive, less risky, more private, more equitable, and quicker than the default alternative, conventional litigation as supplied by government subsidized courts.³ Fear of the jury and of punitive damage awards also may animate the choice to include a pre-dispute ADR clause. This popular mythology assumes that arbitration and mediation will be optimal for each party, the employee and the employer, and therefore, that efficiency will be advanced for both sides by including a pre-dispute ADR clause in the contract.⁴

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¹ See, e.g., Stuart J. Schwab & Randall Thomas, What Do CEOs Bargain For? An Empirical Study of Key Legal Components of CEO Contracts (forthcoming 2002) (finding that a substantial minority, 33 of 93, of CEO contracts studied used arbitration clauses); U.S. GOVERNMENT ACCOUNTING OFFICE, ALTERNATIVE DISPUTE RESOLUTION: EMPLOYERS’ EXPERIENCE WITH ADR IN THE WORKPLACE (Aug. 1997) (10 percent of private sector employers and non-union arbitration systems intend to adopt arbitration in the near future); REPORT AND RECOMMENDATIONS OF THE COMMISSION ON THE FUTURE OF LABOR MANAGEMENT RELATIONS (1995) (endorsing and recommending voluntary ADR processes, including arbitration, to resolve employment disputes). The use of arbitration clauses in employment contracts involving white collar jobs is so common that software is now marketed that includes form arbitration clauses in multi-clause employment contracts. See, e.g., http://www.cpi4hr.com/cpi/ProdServ_EmpDocs.asp (last visited Nov. 1, 2001) (Bay Area software provider to lawyers includes arbitration clause in its employment contract form package).

² See EDWARD BRUNET & CHARLES B. CRAVER, ALTERNATIVE DISPUTE RESOLUTION: THE ADVOCATE’S PERSPECTIVE 287 (2d ed. 2001) (describing “two-step” ADR clause in which parties agree to mediate but, if unsuccessful, also agree to arbitrate their dispute).


⁴ The impact of the Supreme Court’s recent decision in Circuit City v. Adams, 532 U.S. 105 (2001) (holding that the Federal Arbitration Act applies to employment arbitration) is certain to make employment arbitration even more popular. See, e.g., Linda Greenhouse, Court Says Employers Can Require Arbitration of Disputes, N.Y. TIMES, Mar. 22, 2001, at C1 (referring to Circuit City v. Adams as a “major victory” for employers enabling them to “insist that workplace disputes go to arbitration rather than to court” and asserting that “employers are increasingly requiring workers to agree in advance” to arbitrate); Sarah Schafer & Charles Lane, High Court Upholds Forced Arbitration, WASH. POST, Mar. 22, 2001, at A1 (describing Circuit City v. Adams as “a decision that could encourage an increasingly
This Article explores the accuracy of the assumption of efficiency that has caused increased use of pre-dispute arbitration and, to a lesser extent, mediation clauses in employment contracts between the highly skilled employee and their employer. The Article supports use of pre-dispute mediation clauses but challenges whether routine use of standard arbitration clauses in high stakes employment contracts is necessarily optimal for either the employee or the employer. It concludes that employees and employers who want low risk, predictable results may be disappointed in arbitration and attracted to litigation or an increasingly popular type of judicialized arbitration. The Article also explores whether courts will enforce application-of-law arbitration clauses in employment contracts, and whether courts will honor contractual demands that arbitrators and judges apply specified legal principles when reviewing contracts to arbitrate.

As discussed in the following pages, the negotiation of employment contracts between the highly skilled employee and her employer bristles with problems. Multi-part employment contracts typically involve asymmetric information and decisions to invest in differing subjects, including dispute resolution, but also topics such as compensation, benefits, and job description. The incentives for opportunistic behavior in negotiating the entire contractual arrangement are clearly present. These conditions apply as well to the negotiation of the dispute resolution clause in this specific type of contract, a multi-part, high stakes employment contract. This Article is intended to reduce the chances for opportunism when negotiating the dispute resolution clause of a contract involving a highly skilled employee by exposing some of the mythologies surrounding arbitration and mediation clauses.

This topic presents difficulties relating to research methodology. Because contracts between highly skilled workers and their corporate employees are understandably confidential, real world examples of such contracts are rare. Accordingly, the substance of the Article has a theoretical focus. Nonetheless, a few valuable resources do exist to provide concrete examples supporting the theories expressed. In addition to litigated cases and journalistic output, this Article refers to and quotes from actual contracts between CEOs and publicly traded corporations found in the Corporate Library database. These contracts were published by The Corporate Library, which in 1999 collected corporate data by asking S&P 500 companies to contribute their employment contracts with CEOs. The CEO contracts are now available on The Corporate Library website and popular practice among companies trying to hold down their legal costs.

5. See Schwab & Thomas, supra note 1.

6. The Corporate Library, http://www.thecorporatelibrary.com/company_research/companies_ceos/default.asp (last visited Jan. 11, 2002) [hereinafter The Corporate Library]. The Corporate Library "is intended to serve as a central repository for research, study and critical thinking
provide an extremely useful glimpse into the world of agreements between highly skilled employees and their employers.

This Article makes strategic use of the valuable Corporate Library database. Yet, the database possesses its own limitations. It reports only the terms of completed CEO contracts and fails to show the multiphase process of negotiating agreements. The static database thus omits description of the dynamic process of negotiating CEO contracts (e.g., which party insisted on what contract term, what the terms of counteroffers were). While it is helpful to study the terms of these contracts, one cannot tell whether the employee or employer sought or prevented a signed agreement to arbitrate nor can one discuss the motivations for these actions by the potential contractual partners. Because of these limitations, the following Article mixes data from case law and the Corporate Library database with rank speculation and theorizing about the necessarily changing, dynamic contracting process.

II.
EXPLORING THE ASSUMPTIONS SPURRING USE OF ARBITRATION IN DISPUTE RESOLUTION CLAUSES WITH THE HIGHLY SKILLED EMPLOYEE

A. The Questionable Assumption that Equity-Based Final Arbitration Awards Are Superior

One of the major characteristics of arbitration is an adjudicatory result that is premised on facts, not law. Arbitration awards are the product of fact-dominated rough justice. Equity, not law, is the order of the day when

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8. See Karen Eggleston, Eric Posner, & Richard Zeckhouser, The Design and Interpretation of Contracts: Why Complexity Matters, 95 NW. U.L. REV. 91, 104 (2000) [hereinafter The Design and Interpretation of Contracts] (describing contract complexity in terms of “uncertainty about the contractual environment” and explaining that “when parties enter a contract, they allocate obligations across different possible states of the world, and the number of possible states of the world is infinite”).

9. A “dynamic” contracting process involves the process of contracting. This means negotiating terms of a proposed deal with offers and counteroffers traded back and forth between the parties. A study that focused only on the terms of the completed contract between the highly skilled employee and the firm would not accurately describe the problems addressed by this paper.

the arbitrator crafts an award. The use of equity or fairness as a basis of
decision by the arbitrator reflects the history of arbitration. Traditionally,
arbitrators were seldom lawyers but were fellow merchants in the same
business as the disputants and were selected because of the expectation that
they would decide using industry custom and usage norms.

Because courts do not require that arbitrators apply correct substantive
legal rules to a dispute, equity based arbitration results are typical. The
law may not apply in arbitration. Courts have traditionally provided
minimal judicial review of arbitration results. This tendency has led to the
generalization that arbitral results are final. According to Professor
Richard Speidel, finality is a core ingredient of arbitration that supposedly
gives arbitration an advantage over litigation. The supposed rule that

11. See, e.g., Brown v. Coleman Co., 220 F.3d 1180 (10th Cir. 2000) (upholding decision of
arbitrators to award over $2.3 million in stock options to former president of corporate division setting
forth an express arbitrator rationale that award was equitable to prevent unjust enrichment); Lisa
Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry,
21 J. LEGAL STUD. 115, 127 (1992) (diamond merchant arbitrators decided cases “on the basis of custom
and usage, a little common sense, some Jewish law and last, common law legal principles”).

12. See, e.g., LINDA R. SINGER, SETTLING DISPUTES: CONFLICT RESOLUTION IN BUSINESS,
FAMILIES, AND THE LEGAL SYSTEM 5 (1990) (New York Chamber of Commerce forms arbitration
system in 1768 to “settle business disputes according to trade practice rather than legal principles”);
James A. Jaffe, Industrial Arbitration, Equity, and Authority in England, 1800-1850, 18 L. & HIST. REV.
525 (2000) (setting out historical evidence that 19th century arbitrators used equity to secure order
without law in commercial and employment disputes); Katherine Van Wetzel Stone, Rustic Justice:
collecting and describing authority that by the 1920s over 1000 trade associations used arbitration for
intra-industry disputes and that arbitrators were “drawn from the . . . membership” and used their trade
knowledge to reach an equitable result).

arbitrators “cannot be compelled to follow the law and their errors cannot be corrected on appeal”
(Posner, J.); Stroh Container Co. v. Delphi Indus., 783 F.2d 743, 751 (8th Cir. 1986) (“The arbitration
system is an inferior system of justice, structured without due process, rules of evidence, accountability
permitting arbitrators to “disregard strict rules of law or evidence and decide according to their sense of
equity”.

Comercial, 745 F.Supp. 172, 178 (S.D.N.Y. 1990) (the whole point of arbitration is that the merits of
the dispute will not be reviewed in the courts); Mentschikoff, supra note 10.

15. See, e.g., Revere Copper & Brass, Inc. v. Overseas Private Inv. Corp., 628 F.2d 81, 83 (D.C.
Cir. 1980), cert. denied, 446 U.S. 983 (1980) (providing minimal judicial review of arbitral award and
suggesting that “judicial review of an arbitration award has been narrowly limited”); In re Aimcee
Wholesale Corp. v. Tomar Prods., Inc., 237 N.E.2d 223, 225 (1968) (“Arbitrators are not bound by rules
of law and their decisions are essentially final.”).

16. See e.g., Int'l Standard Elec. Corp. v. Bridas Sociedad Anonima Petrolea, Industrial y
Comercial, 745 F.Supp. 172, 178 (S.D.N.Y. 1990) (“The whole point of arbitration is that the merits of
the dispute will not be reviewed in the courts”); In re Aimcee Wholesale Corp. v. Tomar Prods., Inc.,
237 N.E.2d 223, 225 (1968) (“Arbitrators are not bound by rules of law and their decisions are
essentially final.”); Wharton Poor, Arbitration Under the Federal Statute, 36 YALE L.J. 667, 676 (1927)
(arbitration parties prefer a final decision to a court’s second-guess).

courts will set aside arbitration results in manifest disregard of the law\textsuperscript{18} is in tatters. Modern decisions give the old “manifest disregard of the law” approach a severely narrow construction and often even explicitly reject it outright as inconsistent with the nature of arbitration.\textsuperscript{19}

The normative assumption that arbitration decisions can be based upon facts rather than law merits close scrutiny. Judge Posner has concluded that arbitration awards “are more like jury verdicts than the decisions of the courts.”\textsuperscript{20} Arbitration awards based on equity are, in fact, often little more than compromises. The “compromise award”—an award that intentionally prevents either side from prevailing and may involve the arbitrator awarding the claimant one-half the alleged monetary injury—\textsuperscript{21}—is enough to strike terror in the hearts of corporate America.

Many (but certainly not all) major corporations spend huge amounts to obtain and comply with the legal opinions of counsel. Corporations who invest in law by paying for opinion letters should expect a return on this investment. If these firms chose to follow substantive rules, they probably want to have legal rules applied with care to their disputes. The nature of attorney opinion letters and oral advice to business clients is usually to adopt a legal position that is “close to the line”—the optimal business posture for the firm consistent with “the law.” This close to the line advice is premised on an assumption that a court will carefully and accurately apply legal principles to any future dispute.

Compromise arbitration awards, and awards based upon equity, benefit parties who ignore the law and punish firms who seek to comply with

\textsuperscript{18} See Wilko v. Swan, 346 U.S. 427, 436-37 (1953) (“the power to vacate an award is limited... the interpretations of the law by the arbitrators, in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation”) (emphasis added).
\textsuperscript{19} See, e.g., Kanuth v. Prescott, Ball & Turben, Inc., 949 F.2d 1175, 1182 (D.C. Cir. 1991) (“manifest disregard means much more than a failure to apply the correct law”); Sobel v. Hertz, Warner & Co., 469 F.2d 1211 (2nd Cir. 1972) (interpreting manifest disregard to not require arbitrators to explain their awards); Moncharsh v. Heity & Blase, 3 Cal. 4th 1 (1992) (courts should not set aside an arbitration award merely because of erroneous applications of law or erroneous factfinding by the arbitrator); Stephen L. Hayfield, A New Paradigm for Commercial Arbitrations: Rethinking the Relationship Between Reasoned Awards and the Judicial Standard for Vacatur, 66 GEO. WASH. L. REV. 443, 471-74 (1998) (asserting that “no commercial arbitration award has been vacated on this [manifest disregard of the law] ground via application of the current ‘degree of error’ inference-based analysis” and limiting the meaning of manifest disregard of the law to situations where “the arbitrator ignored or refused or failed to comply what she knew to be the correct law”); Comment, Compulsory Arbitration Agreements Worth Saving: Reforming Arbitration to Accommodate Title VII Protections, 47 UCLA L. REV. 1885, 1912 (2000) (characterizing manifest disregard as “a different standard” under which “it is unlikely that an arbitration award will be vacated on this ground”) [hereinafter Compulsory Arbitration]; Note, Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the "Manifest Disregard of the Law" Standard, 27 IND. L. REV. 241 (1993).
\textsuperscript{20} IDS Life Ins. Co. v. Sun America Life Ins. Co., 136 F.3d 537, 543 (7th Cir. 1998).
\textsuperscript{21} See Mentschikoff, supra note 10, at 860 (describing compromise awards as “decisions arrived at by ‘giving a little and taking a little’”).
substantive law. The business investment in legal advice is wasted when arbitrators issue compromise or equitable decisions. An arbitration award that is premised upon the arbitrator's gut level of "fairness," rather than the substantive rule of law, yields a negative return on investment for a business that has paid attorneys for legal advice.

Consider the group of recent, July 2000, arbitration awards granting discretionary bonuses to highly skilled Wall Street traders and investment bankers.\textsuperscript{22} As a legal matter, payments of these bonuses were strictly discretionary with management and were not provided for by contract. However, in these well-publicized set of multimillion dollar equity-based arbitration awards, arbitration panels decided to award bonuses to several traders and investment bankers who were discharged prior to receiving bonuses. The awards may indicate an arbitrator's feeling that dismissal of a trader cannot be used to escape paying a bonus—an equity-based compromise "instinct" of fairness that smacks of a jury award and eschews a legally premised result. Imagine the reaction of a Wall Street firm that had invested in a legal opinion from counsel that bonus payments to traders who were discharged were wholly discretionary and not legally required but that is forced to pay a discretionary bonus based upon the purely equitable instincts of an arbitration panel.

At the critical point at which the arbitrator decides a dispute, fact-based arbitration as a concept lacks substantive integrity. Compromise awards are seldom capable of successful attack in court. They are final and courts are unlikely to set them aside using the largely discredited manifest disregard of the law rationale.\textsuperscript{23}

Employees who think the possibility of compromise awards will be beneficial to them may find arbitration clauses desirable and seek an arbitration clause in their employment contracts. To some extent, the decision to seek an equitable arbitration clause is a question of statistical probability. The high stakes employee, together with experienced counsel,\textsuperscript{24} will assess a proposed arbitration clause and evaluate the probabilities of a helpful arbitral compromise in a prospective dispute with the employer. The employee who is likely to be better off with a fact-based

\textsuperscript{22} Randall Smith, Losing a Job on Wall Street These Days Often Doesn't Mean Losing a Bonus, Too, WALL ST. J., July 19, 2000, at C1 (describing four recent arbitration awards granting bonuses of over $2,000,000 per claimant and attorneys fees to highly paid traders and investment bankers after they were discharged and apparently reaching this result without any contractual authority).

\textsuperscript{23} See, e.g., Merrill, Lynch, Pierce, Finney & Smith, Inc. v. Bobker, 808 F.2d 930, 933 (2nd Cir. 1986) (court of appeals reverses a trial court order vacating an award granting the claimant $11,500 when precisely twice that amount, $23,000, was sought and reasons there must be more than a showing that the result was clearly erroneous because "the error must be obvious and capable of being understood as error by an average person qualified to be an arbitrator").

\textsuperscript{24} Like their prospective employers, highly skilled employees are likely to hire and involve counsel in negotiating an employment contract. This, of course, is an investment decision.
compromise than a rigid application of legal rules will avoid litigation and seek equitable arbitration.

Consider the case of Negotiation Illustration #1, The Enterprising Bond Trader. A highly compensated Wall Street bond trader and her attorney confer regarding exit possibilities in a prospective job change negotiation with a potential new employer. They conclude that issues of overall fairness and good faith are likely to dominate any possible exit dispute. The employee will seek insertion of a boilerplate style arbitration clause into the tendered employment contract.25 The employer, whose first draft employment contract had omitted an arbitration clause, decides to risk the inclusion of arbitration in the contract in the interest of hiring a scarce and talented employee.

At the same time, the employee needs to assess whether she could be injured by a possible equitable award of the arbitrator. By contracting to arbitrate, the employee has essentially voluntarily relinquished legal rights and, instead, opted to transfer equitably based decisional authority to the arbitrator. There are simply no guarantees that legal rights will apply in arbitration.26 This dynamic may harm an employee whose likely claim against his employer is based upon a violation of clear principles of employment or civil rights law. It cannot be ignored that employees have gained considerable new legal rights during the last thirty years.27 The act of opting to arbitrate effectively waives the application of those potentially valuable legal rights for the employee. This conduct represents the taking of a risk that the arbitrator's equitable award will be more valuable than an award premised on legal rules.

The decision of the employee to seek arbitration on the theory that compromise will be preferable to the application of legal rules will be based on imperfect information regarding both the type of dispute which may arise in the future and the potential nature of the arbitrator's decision.28 The

25. For an illustration of a highly paid employee able to profit through an arbitration that led to a multi-million dollar equitable award in his favor, see Brown v. Coleman Co., Inc., 220 F.2d 1180 (10th Cir. 2000) (court of appeals upholds arbitration award of $2.32 million to former division president of major corporation in a case where arbitrators specifically reasoned that the basis of their award was equity to prevent unjust enrichment). The employee in Illustration #1 should avoid seeking or agreeing to a judicial arbitration clause that calls for the arbitrator to apply the law or for a court to review for errors of law. See infra text accompanying notes 47-57.


27. See, e.g., Walter Olson, The Excuse Factory: How Employment Law is Paralyzing the American Workplace 3 (1997) ("since the mid-1960's, the American workplace has been transformed by a series of powerful new laws"); Steven Wellborn et al., Employment Law 3 (2d ed. 1998) ("for the current generation of workers, the law has become an increasingly significant force").

28. See Bert Holmström, Moral Hazard and Observability, 10 Bell J. Econ. 74, 74 (1982)
quantum of information on this issue held by the employee is critical and will heavily influence the employee's uncertain choice. Each party to a negotiation will possess their own hidden and asymmetrical information regarding the value of an asset or proposed contract term. As Brown and Ayres have shown, such hidden information "can give rise to adverse selection."  

This can be demonstrated by Negotiation Illustration #2, The Mistaken CEO. A new start-up firm negotiates an employment contract with its new CEO. The latter, with the advice of counsel, estimates the likelihood that his legal rights will be violated by an opportunistic employer during the period of employment. Not being aware of the tendency of some arbitrators to ignore the law and concentrate upon equity, the mistaken CEO erroneously assumes that an arbitration clause will provide protection for his legal rights during the period of employment. When the employer's draft of the employment contract omits an arbitration clause, the prospective CEO inserts a standard arbitration clause. This is a mistake. A dispute arises upon exit and the arbitrators ignore the CEO’s clear legal rights and give him a minuscule award they deem fair. The application of legal rules in litigation would have been the preferred option for the mistaken CEO.

Asymmetrical information in such bargains between the employee and employer is to be anticipated and may contribute to the possibility of opportunistic behavior. The parties may be expected to consume scarce resources negotiating with no guarantees that their investments are cost effective. One side, for example, may intentionally misrepresent the value

(questioning "when . . . perfect information [can] . . . be used to improve on a contract which initially is based on the payoff alone"). Of course, parties who are fully informed about the relative costs and benefits of litigation and arbitration are likely to make efficient decisions. See Keith N. Hylton, Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis, 8 SUP. CT. ECON. REV. 209, 209 (2000) (Well informed bargainers "will enter into waiver (arbitration) agreements when and only when litigation is socially undesirable in the sense that the deterrence benefits provided by the threat of litigation fall short of litigation costs.").

29. Jennifer Gerada Brown & Ian Ayres, Economic Rationales for Mediation, 80 VA. L. REV. 323, 331 (1994) [hereinafter Economic Rationales]. Adverse selection occurs when an individual bargainer makes a poor quality decision due to the presence of hidden information. See, e.g., John C. Coffee, Jr., The Regulation of Entrepreneurial Litigation: Bargaining Fairness and Efficiency in the Large Class Action, 54 U. CHI. L. REV. 877, 906 (1987) (adverse section presented where "one party to a contract knows something that the other does not").

30. See, e.g., The Corporate Library Website, http://www.thecorporatelibrary.com/companies/u/usw/ceo.usw.htm (last visited Feb. 28, 2001), Venator Group CEO Contract ("Any Controversy or claim arising out of or relating to this Agreement, or this breach thereof, other than injunctive relief . . . shall be settled by arbitration in the City of New York, in accordance with the rules of the American Arbitration Association before three arbitrators. The decision of the arbitrators shall be final and binding on the parties."). This boilerplate form is used frequently.

31. See O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985) ("opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, obfuscate, or otherwise confuse").
of a proposed form of dispute resolution. Alternatively, the other side may lack information that the arbitrators can ignore legal rights and decide disputes based upon pure gut instincts. As aptly said by Brown and Ayres, "Adverse selection can consume a large percentage of the potential gains from trade."32

B. Factoring Risk Assessment and Bargaining Power Into the Proposed Contract

Whether the employee should be deterred from signing a proposed arbitration clause because of fear of waiver of legal rights is also somewhat of an empirical question. The employee and her attorney need to estimate the probabilities that legal rules will benefit the employee. This estimate involves predicting likely breaches of legal rules by the employer and asking whether the arbitrator will be likely to apply the legal rules or, alternatively, craft a fact-based equitable solution to the dispute. Like all choices in the bargaining between the employee and employer, this estimate involves decisional choice made with imperfect information and carries a degree of risk.

Of course, the employer needs to make a similar risk calculation. Consider, for example, the landmark contracts case of Raffles v. Wicklehaus.33 This case involved a dispute regarding an international sale of cotton, a textile dispute historically arbitrated within the industry by fellow cotton merchants to reflect industry customs and achieve an expert result.34 Yet, the Raffles dispute was ostensibly litigated, according to Professor Simpson, out of one firm's fear that the arbitrators would have split the difference.35 A company's preference for litigation based upon a fear of arbitrator compromise is usually based upon a probability estimate. These decisions are likely to be imperfect hunches that are not based upon a firm informational footing. They will be gut instincts or impressionistic guesses, at most.

Moreover, employee or employer objections to the proposed use of arbitration raise the potentially unseemly specter of adding unnecessary squabbling to the contracting process. Neither party may want to hear about potential future disputes at the start of a new business relationship, especially what procedures should be used if the new business relationship fails. At the time of the forthcoming "marriage" between the potential

32. Economic Rationales, supra note 29, at 333.
35. Simpson, supra note 34, at 323.
employee and employer, the mere act of raising the subject of "divorce"—future employer-employee disputes—during an employment contract negotiation has both transaction costs and risks. An employer can be frightened away from a highly skilled employee who seems "too legalistic" when confronted by a proposed arbitration clause. Conversely, the employee who sees a potential employer's demands as rigidly "following the law" may react negatively and terminate contract negotiations. Fears of such contractual legalism may explain why a majority of S&P 500 firms in The Corporate Library database did not report having a written CEO contract. It appears that a handshake deal and a contract at will is more popular in CEO contracts than a formal contract.

This can be demonstrated by Negotiation Illustration #3, The Overly Legalistic Prospective CEO. The would-be CEO of a new high technology start-up refuses to sign an employment contract containing substantial stock options and a boilerplate arbitration clause. He continually brings up the need to retain his legal rights if there is a later exit dispute. The high-tech firm's culture is informal and premised upon concepts of compromise and fairness, not legalities. The potential employer becomes skeptical of a possible CEO who might be too legalistic to fit in. After consuming excessive time attempting to reach an agreement, the high-tech firm decides to walk away from the overly legalistic prospective CEO.

However, the parties to this type of high stakes negotiation are usually repeat players. They are likely to be experienced negotiators. The employer knows that most executives will eventually leave the firm and will likely invest in a well thought-out contracted bargaining position. The prospective employee will also be likely to anticipate the eventual exit from the job. Exit strategy is an essential bargaining topic for each contractual party.

Some discussion of exit strategy may be expected in the case of the high stakes employment contract. Not all employers will break off negotiations over a hard-ball attitude concerning the dispute resolution clause. Highly skilled employees such as the overly legalistic prospective CEO face a risk that insistence on an arbitration clause will endanger a successful contractual negotiation.

The relative degree of bargaining power should be roughly equal in the negotiation of a high stakes employment contract. The assumption that an employer possesses bargaining power in these contractual settings seems clear. The employer's bargaining power stems from its ability to offer an attractive compensation package and information garnered from repeat

36. See Schwab & Thomas, supra note 1. One reason so many highly skilled employees lack a formal contract with their employer is the belief that opportunistic behavior at the time of job exit will be deterred by a fear of damage to reputation. See infra text accompanying notes 63-65.
player experience in negotiating and monitoring prior employment contracts. Similarly, the employee should also have substantial bargaining power. Highly skilled employees are, by definition, scarce. In addition, the highly skilled employee may also be a repeat player when negotiating contracts. She should be well informed and, if not, can become informed through attorney representation. These factors create good conditions for an efficient bargain between parties of roughly equivalent bargaining power.

This does not mean that the final employment agreement will always define precisely the exact conditions for employee exit. Some contracts with highly skilled employees will lack a clause relating to dispute resolution. Many employment contract bargainers "fail to contract around the employment at-will default." Consequently, many employment contracts are silent regarding dispute resolution.

The fact that multi-part contracts negotiated at arms length between two informed and incentivized parties actually lack ADR clauses should come as no surprise. The Corporate Library data on CEO contracts studied by Schwab and Thomas showed that 65% of contracts between CEOs and S&P 500 corporations did not contain an arbitration clause. There are many potential reasons for this result. First, neither party may desire an arbitration option. Second, one party may want arbitration but be willing to give it up in bargaining for other valuable consideration. Third, incomplete contract terms are common and may be explained by the presence of informed, efficient bargainers as well as uninformed contractual participants.

The dynamic nature of the negotiating process leading to these employment contracts affects whether there will be an arbitration clause. Risk assessment and investment will dominate the contracting decisions by employee or employer. Hunches based on probabilities will have to be used to decide multiple issues. Uncertainty prevails, even where one party is a corporation and the other is a highly paid executive or technically trained professional.

37. Ian Ayres & Peter Cramton, Relational Investing and Agency Theory, 15 CARDOZO L. REV. 1033, 1053 (1994) ("reducing an [employee] incentive scheme to written form is extremely costly... while financial carrots are sometimes put in writing, it is extremely rare for terms of dismissal to be explicitly stated.").
38. Id. (citing Richard A. Epstein, In Defense of the Contract at Will, 51 U. CHI. L. REV. 947, 949 (1984) (concluding that contract at will is the default rule)).
39. Schwab & Thomas, supra note 1, at 18.
40. See generally ERNST FEHR ET AL., ENDOGENOUS INCOMPLETE CONTRACTS (forthcoming 2002). For the view that asymmetric information leads to incomplete contracts, see Kathryn E. Spier, Incomplete Contracts and Signaling, 23 RAND J. ECON. 432 (1992).
C. The Perception of Cost Savings and the Problem of Asymmetric Information

To many employers, the primary perceived benefit of arbitration is the avoidance of the jury and the accompanying diminished chance of an aberrant jackpot punitive damage award. While punitive damages are possible in arbitration awards,\(^4\) they are clearly less likely than in conventional litigation. To American businesses, the perceptions or fear of a huge punitive award drives the urge to opt out of the jury system into the “safer” realm of arbitration.\(^4\)

The business attraction to arbitration is thus not primarily based on a reflection that arbitration is faster and cheaper than litigation. Instead, corporate preference for arbitration may be primarily predicated upon a seemingly accurate belief that arbitration possesses a much smaller risk of a giant punitive damage award. Many companies are drawn to arbitration mainly out of the fear of court-based punitive damages. Arbitration, under this reasoning, is less risky than litigation.

The assumptions that have caused business preferences for arbitration merit rethinking. Not every foreseeable high stakes employment dispute holds significant potential for a punitive damage award. The highly skilled (and paid) employee may not seem that attractive to a jury,\(^4\) and thus may not be helped by the average juror. The type of business conduct involved may not trigger the anger that leads to punitive damage awards. The decisional task of the employer, then, is to knowledgeably evaluate whether using the arbitration option with the decreased risk of punitive damages is worth the risk of an injurious compromise award. This is another estimate based on imperfect information that may or may not be accomplished accurately.

This dynamic is shown by Negotiation Illustration #4, The

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41. See, e.g., Baravati v. Josephthal, Lynnon & Ross, Inc., 28 F.3d 704 (7th Cir. 1994) (award of punitive damages in defamation case not in excess of arbitrator’s authority); Lee v. Chica, 983 F.2d 883 (8th Cir. 1993) (upholding arbitrator’s punitive damage awards in fraud and breach of duty case); Raytheon Co. v. Automated Bus. Sys., Inc., 882 F.2d. 6 (1st Cir. 1989) (allowing punitive damages in a tort arbitration). Of course, courts will generally uphold the contractual prohibition of punitive damages in arbitration. See, e.g., IAN MACNEIL ET AL., 3 FEDERAL ARBITRATION LAW § 36.2.4 (1994) (parties may limit discretion of arbitrators to award damages in their agreement); Richard Speidel, Contract Theory and Securities Arbitration: Whither Consent?, 62 BROOK. L. REV. 1335, 1348 (1996) (parties have power to permit arbitrators to award punitive damages or to deny such a power).

42. See, e.g., Compulsory Arbitration, supra note 19, at 1914-15 (describing employers’ fears of “jackpot jury awards” and employers’ preference for arbitration).

43. The reputed jury desire to redistribute wealth may be lacking in a dispute between a firm and a high-end employee. See Dorsey D. Ellis, Jr., Punitive Damages, Due Process, and the Jury, 40 ALA. L. REV. 975, 979 (1989) (confirming jury tendency to assess damages based upon wealth redistribution); Litigation Sciences, Psychological Characteristics of Punitive Damages Jurors, in SEVENTH ANNUAL INSTITUTE ON CORPORATE LAW DEPARTMENT MANAGEMENT 61-65 (1993) (wealth redistribution a factor in jury verdicts).
Unnecessary Contract to Arbitrate. After listening to horror stories of counsel regarding jury awards of punitive damages, a company decides to include an arbitration clause in a first draft contract with a highly paid CFO. The firm has already expended considerable sums on attorney opinion letters and arranged its business conduct to comply with applicable law. Upon exit, a dispute is arbitrated. The arbitrators issue a seven-figure “good faith” style equitable award that punishes the corporate employer and ignores the company’s compliance with law. The employer would have been better off in court where, in all likelihood, a well-paid CFO would not appeal to the typical juror and be unlikely to ever receive punitive damages.

The employee faces a similarly sticky decision regarding arbitration. The decisional task of accurately estimating both the chance of a valuable “compromise” award and the possibility of losing valuable legal rights is daunting. Because neither the employee nor her employer holds perfect information, there is a chance that the decision to select or reject the arbitration option will be flawed. In addition, the quantum of informational expertise possessed by the employee and employer regarding these relevant risks is likely to be asymmetrical.

Brown v. Coleman Co. demonstrates the reality of Negotiation Illustration #4. There Coleman negotiated an employment contract with Gerald E. Brown, the President of the Coleman Powermate Division. The agreement, which contained an arbitration clause, provided that if Brown were terminated for cause he would be entitled to only vested stock options, but if he were terminated without cause he would be allowed to keep all stock options. Following Brown’s termination for alleged misuse of company funds, an American Arbitration Association (AAA) panel found the discharge without cause and awarded Brown an additional $2,322,355 in post dismissal stock options on the basis of equitable unjust enrichment.

44. See Mei L. Bickner et al., Developments in Employment Arbitration, 52 Disp. Resol. J. 8, 78-79 (1997) (describing a survey of employers that systematically used arbitration and specifically quoting survey evidence that employers thought juries presented a risk of “runaway” monetary awards).

45. Negotiation Illustration #4 is illustrated by the July 2000, multimillion dollar arbitration award to Wall Street traders who had no legal right to a bonus but nonetheless received an equitable arbitration award. See Smith, supra note 22, at C1.

46. Id. This does not mean that highly paid or skilled employees will not generally fare well in litigation. There is evidence that highly skilled employees do better in wrongful termination suits than other workers. See, e.g., Margaret A. Jacobs, Executives are Often Successful in Wrongful Termination Suits, WALL ST. J., April 15, 1996, at B5 (citing study by Jury Verdict Research finding that executive managers won 64% of wrongful termination cases, as opposed to 42% for general laborers, 48% for professionals, and 58% for middle managers; these differences were explained due to the greater oral abilities and credibility of highly skilled employees).

47. 220 F.3d 1180 (10th Cir. 2000), cert. denied, 531 U.S. 1192 (2001).

48. Alternatively, the panel’s stock option award was based upon an interpretation that Brown’s dismissal was improper under the employment contract. Id. at 1182.
The court of appeals affirmed the stock options award, reasoning that arbitrators possess broad equitable powers and pointing to the presence of an AAA rule allowing the arbitrators to "grant any remedy or relief that the arbitrator deems just and equitable."\textsuperscript{49}

Each side, employee and employer, should be relatively well informed when negotiating their employment relationship. Employers, as repeat players in hiring highly skilled employees, have reason to invest heavily in valuable information concerning prospective dispute resolution consequences. Highly skilled employees, at least once they self-identify to such status, are similarly likely to be repeat players,\textsuperscript{50} albeit usually ones who will necessarily negotiate employment contracts with less frequency than employers. Employers may well have a slight asymmetrical informational edge in estimating the probabilities because they would appear to negotiate more often than even highly skilled employees. A printed form or boilerplate arbitration clause drafted by a corporation should not be used unless the firm has reached a knowledgeable conclusion that arbitration offers low risks and costs.

\textbf{III. DETERRED OPPORTUNISTIC BEHAVIOR, THE DIFFICULTY OF BILATERAL OPTIMALITY, AND THE INVESTMENT IN PRECONTRACT NEGOTIATION}

It would be advantageous to arrive at one optimal dispute resolution clause in the mutual interest of both the highly skilled employee and the employer firm. An optimal solution\textsuperscript{51} to the problem of negotiating a dispute resolution clause would advance efficiency by reducing transaction costs. A single mutually acceptable dispute resolution clause would simplify the contracting process by removing a major subject matter from potentially lengthy and complex bargaining and post-contract policing and monitoring. It also would reduce the risk of erroneous estimates of application of law and equitable results.

Nonetheless, pervasive opportunistic behavior\textsuperscript{52} by self-interested

\textsuperscript{49} Id. at 1183 (citing and quoting AAA Employment Dispute Rule 34(d)).


\textsuperscript{51} By "optimal solution" I mean a dispute resolution clause that achieves maximum efficiency for both the employer and the highly skilled employee.

\textsuperscript{52} By "opportunistic behavior" in this negotiation context I mean that a party negotiates a contract in its own self-interest to seek a transfer in wealth from the opposing party. See O. WILLIAMSON, MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS 26 (1975); Butler & Baysinger, Vertical Restraints of Trade as Contractual Integration: A Synthesis of Relational
highly skilled employees and employers may frustrate achieving optimality. It will be the goal of each contracting party, the highly skilled employee and the employer, to strike the best bargain possible. For example, the employee is unlikely to want to give up firm legal rights when he or she sees advantages to be gained. Similarly, the employer will want to negotiate the best deal possible regarding application of legal principles or equitable usage of trade norms. Bilateral two-party optimality, then, may be made impossible by realistic and ongoing opportunism. Collective action, while instinctively valuable, may be unable to achieve an optimal dispute resolution clause.

To be sure, there will be individual contractual negotiations during which each side will decide that a particular sort of dispute resolution clause will be mutually advantageous. For example, a business that is “equitably driven” and avoids expending efforts to “follow the law” may be contracting with a highly skilled employee who is similarly indifferent to legal principles and attracted to fact-based industry customs. Here, it is in the self-interest of each contracting party to avoid a legally-based arbitration decision and elect a fact-based equitable style award. Mutual demand for a classical “compromise” style of arbitration can occur. This more equitable type of arbitration may be seen as a type of insurance which lowers the risk of loss for the parties.

This point can be shown by Negotiation Illustration #5, Marketing, Inc. Meets The Marlboro Man. The employer here is a company with a company culture much like that reputed to Proctor and Gamble. It is known for slavish adherence to marketing at the expense of other factors,
including legal rules. It is negotiating the employment contract of the new Vice President of Marketing. The latter is a veteran marketing specialist and is currently in the same position at Nike, another firm with a strong marketing culture. Neither party is legally driven, and each is comfortable with a boilerplate form arbitration clause that leads to equitable and fair results. Mutual interests will lead the parties to execute a contract with a boilerplate arbitration option and at very little negotiation cost.

Similarly, the interests in achieving a private as opposed to public resolution of an exit dispute may also often be mutual and may help to deter opportunistic behavior. An employer and her employee may want to avoid adverse publicity that may derive from a publicly litigated trial and written judicial opinion. The presence of a reputation market will encourage use of a private ADR mechanism from the perspective of both parties. Each party may fear that cheating could be detected and will contribute to a bad reputation. The realistic fear of injury to reputation and "a sense of fair play [are] what [are] likely to make the relationship go forward." The employee and employer may trust one another because of the threat of "bad mouthing the cheater's reputation."

Employers seeking to hire scarce, highly skilled employees in a tight labor market may be particularly interested in achieving a private form of disputing. Employers with a particular desire to quash any "whistle blower" tendencies may also be drawn to the privacy characteristics of arbitration. A highly skilled employee may have numerous job changes on his or her resume and may not want to risk the potential bad publicity that might accompany a public employment squabble.

Each party's incentive to reach a better bargain controls negotiation and is ubiquitous. Although achieving a dispute resolution clause that is mutually or bilaterally optimal—optimal to each bargaining party—is efficient, it is unrealistic to elevate bilateral optimality itself as the ultimate


58. See Epstein, supra note 38, at 967 ("Any party who cheats may obtain a bad reputation that will induce others to avoid dealing with him.").

59. The Design and Interpretation of Contracts, supra note 8, at 116.

60. Id.

61. See, e.g., Compulsory Arbitration, supra note 19, at 1915 (contrasting privacy of arbitration with negative publicity of a public trial); David Sherwyn et al., In Defense of Mandatory Arbitration of Employment Disputes, 2 U. PA. J. LAB. & EMP. L. 73, 138 (1999) (explaining that in certain industries employers cannot afford to risk the adverse publicity of litigation).

62. See, e.g., Margaret A. Jacobs, Arbitration Policies Are Muting Whistle-Blower Claims, WALL ST. J., Aug. 6, 1998, at B1 (detailing "dozens of court decisions [that] have required people who claim to be whistle blowers to take their grievances to arbitration" and describing tendency of employers to use arbitration to prevent managers from whistle blowing).
A transactional goal in negotiation. Market-based incentives held by each side, employee and employer, are likely to dominate and should help to create an efficient dispute resolution clause for each self-interested bargainer.

Much of contemporary negotiation theory urges collaborative behavior between disputants to achieve so called “win-win” results. Parties may bargain fairly and eschew opportunism in the hope and expectation that an opponent will reciprocate. Certainly some bargainers will behave in this manner; the norm of reciprocity is legitimately grounded in reality. Nonetheless, if each party lacks a market incentive to negotiate in their own informed self-interest, efficient bargains will be frustrated. Each contracting party knows its own preferences and understandably is well informed about its own needs and desires. There are information advantages that frustrate a quest for bilateral optimality. Opportunism, ingrained into the contract negotiation process, will prevent bilateral optimality. Yet, such opportunism and strategic use of information can lead to efficient bargains for both individual parties to a contract.

The presence of a market for information regarding the reputation of highly skilled employees and their employers may mitigate against particularly outrageous examples of opportunistic behavior and favor use of confidentiality clauses in employment contracts. In our economy the reputation of highly paid employees and their employers, both repeat players with an incentive to invest in information regarding reputation, is itself a valuable commodity. The growth and effectiveness of executive search “headhunter” firms provide a type of information specialist or broker in the market for highly skilled employees. The reputation market will deter some (but certainly not all) opportunism and cause some careful bargainers to cabin the dissemination of reputational information.

Negotiation Illustration #6, Mutual Privacy, shows this type of bargain. A large soft drink manufacturer and marketer with its corporate headquarters in the South negotiates with a prospective African-American

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64. See generally ERNST FEHR, ALEXANDER KLEIN, & KLAUS M. SCHMIDT, FAIRNESS, INCENTIVES AND CONTRACTUAL INCOMPLETENESS 41 (forthcoming 2002); Ernst Fehr & Klaus M. Schmidt, Theories of Fairness and Reciprocity: Evidence and Economic Applications, in ADVANCES IN ECONOMIC THEORY, EIGHTH WORLD CONGRESS OF ECONOMETRIC SOCIETY (M. Dewatripont et al., forthcoming 2002).
65. See Black & Gilson, supra note 57 (characterizing venture capital providers as repeat players); The Design and Interpretation of Contracts, supra note 8, at 116 (contracts may be simple where the threat of retaliation deters opportunism).
Vice President and General Counsel. The company has pending two class actions brought against it on behalf of African-American employees who allege civil rights violations. The prospective employee, age forty-one, has changed jobs eight times as he has climbed the corporate ladder. Each party perceives a mutual interest in a purely private mode of dispute resolution. Neither party wants any dispute between them to go public. The parties agree to mediate, and, if unsuccessful, to arbitrate any disputes and to bar themselves from discussing the terms of the award or even the nature of the dispute with third parties.67

The arbitrator is not likely to be the source of an informational leak. The typical arbitration ends silently with an inscrutable whimper—a one sentence award will state only who has prevailed and what, if any, damages will be owed. Except in labor grievance, maritime, or international commercial arbitrations, there is normally no discursive opinion.68 Arbitration critics have argued that routine written opinions are beneficial.69 Judge Posner has asserted that courts “should not create disincentives” that prevent arbitrators from writing opinions “because writing disciplines thought.”70 Disputants might desire reasoned opinions to learn the rationale of the arbitrator and make the process seem more rational. Yet, if the parties desire an opinion they need to analyze whether it will be public or private.

The analytical thesis of this paper assumes that the highly skilled employee and her prospective employer will invest resources in pre-contract negotiation71 and argues that each party should pay careful attention to assure a potentially beneficial dispute resolution clause. This

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67. See, e.g., The Corporate Library Website, supra note 30, American General CEO contract ("All proceedings conducted hereunder and the decision of the arbitrators shall be kept confidential by the parties, e.g., the arbitrators’ award shall not be released to the press or published in any of the various arbitration reporters."); The Corporate Library Website, supra note 6, Compaq CEO contract ("All proceedings and documents prepared in connection with any Arbitrable Claim shall be Confidential Information and, unless otherwise required by law, the contents or subject matter thereof shall not be disclosed to any person other than the parties "); The Corporate Library Website, supra note 6, R.R. Donnelley & Sons ("neither a party nor an arbitrator may disclose the existence, content or results of an arbitration hereunder without the prior written consent of the Company and the Executive"); The Corporate Library Website, supra note 6, Tektronix CEO contract ("the parties shall keep all matters relating to any arbitration confidential ... [including] the existence and subject of the arbitration").

68. See BRUNET & CRAVER, supra note 2, at 335-36.


70. Chicago Typographical Union No. 16 v. Chicago Sun-Times, 935 F. 2d 1501, 1506 (7th Cir. 1991).

71. See Shell, supra note 53 (characterizing pre-contractual negotiation as an investment decision).
does not mean that a fully executed and implemented dispute resolution clause will always be advantageous. When such proposed contractual terms regarding exit are suggested, negotiated and finally implemented, each negotiating party is making an investment. Transaction costs of such bargaining behavior exist and should be taken into account by each negotiator. Such investments in a detailed contracting process “expose the investor to opportunistic behavior by the other side.”

As with any investment decision, prospective costs and benefits need to be balanced.

To be sure, the parties to a contract involving a highly skilled employee could decide not to invest in selecting a particular mode of dispute resolution. I term this the “non-investment” option. This decision has risks but low or zero transaction costs. Failure to invest in negotiating and particularizing a type of arbitration or mediation upon exit means that the default form of dispute resolution, conventional litigation, could be used by either party. Litigation, often associated with high attorney fees, delay, and high opportunity costs, may be more or less efficient than an arbitration alternative.

There is reason to think that the litigation default mechanism is not uncommon. The use of pre-dispute arbitration clauses to resolve issues between highly skilled employees and their former employers is by no means universal. Such clauses were used in only a minority of the CEO contracts collected and published by the Corporate Library. While this is hardly a definitive database of contracts between the firm and highly skilled employees, the Corporate Library data shows that arbitration clauses are not routine. The “non-investment” option occurs frequently.

A “non-investment” option need not mean that a highly skilled employee and the firm will never use mediation or arbitration. Upon the occurrence of a dispute, the parties or their attorneys may discuss the advisability of using alternatives to the default mechanism of conventional litigation. For example, the parties may disagree on the utility of arbitration and, consequently, may end up in court. Conversely, the disputants’ interest in arbitration may be mutual, causing them to contract to arbitrate well after their initial bargain and following the outset of a dispute. The post-dispute decision to arbitrate is a real possibility.

Arbitration agreements may be executed at one of two times. The arbitration may be part of a multi-part employment contract or can be agreed to later at the time of an exit dispute. There may be more information available to the disputants about the advisability of arbitration at the latter date. Yet, the presence of the default option of litigation may frustrate mutual selection of arbitration well after the initial contractual

72. Id. at 235.
73. See Schwab & Thomas, supra note 1.
"marriage" of employee and employer. The climate for positive negotiation on topics such as prospective dispute arbitration procedure may be better at the time of the initial negotiation of the employee-employer relationship than at the time of employee exit when the nature of the employee-employer relationship is strained.

Simply deciding not to invest in pre-contract negotiation of dispute resolution may be highly inefficient for the party who may benefit from a lower cost alternative form of dispute resolution. On the other hand, the non-investment option may be efficient for the party who is certain that the default option, litigation, is advantageous. It may be efficient for the bargainers of this contract to leave the exit dispute resolution terms incomplete.\(^7\) For example, a company may be close to certain that it has followed and will adhere to all employment law rules scrupulously and, accordingly, that a court will find for it in any potential suit filed by the highly skilled employee. Under these circumstances, the employer may opt not to even raise the subject matter of dispute resolution during pre-contractual negotiations with the highly skilled employee. This tactic will reduce negotiation costs and, if not opposed by the opposing side, will achieve application of substantive legal principles.

*Negotiation Illustration* #7, The Non-Investment Option, demonstrates this point. A company, Fortune 100, Inc., seeks to follow legal rules fully. Its in-house Vice President "Ethics Officer," now a rising star within the firm, counsels fellow managers to follow the law always. A few years ago, the company lost an arbitration award where the arbitration panel issued an award that amounted to a very expensive compromise. Fortune 100, Inc., will not, as a matter of company policy, contract to arbitrate. It will not negotiate whether to arbitrate. Its negotiation costs are reduced somewhat by this strategy. While it might lose out on hiring a great highly skilled manager who must have an arbitration clause, Fortune 100, Inc., believes that few such employees find the need for arbitration essential and that any employee who must have arbitration is not worth the risk. When a highly skilled prospective employee requests inclusion of an arbitration clause during an employment contract negotiation, Fortune 100, Inc., refuses to consider the matter.

The above illustration is not universal. Although many firms and employees do not invest in dispute resolution clauses, other employers routinely invest in pre-contractual consideration of mediation and arbitration. The remainder of this Article focuses on this investment.

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\(^7\) See Fehr, Klein, & Schmidt, *supra* note 64 (explaining why contract terms are sometimes deliberately left incomplete).
IV.
A PARTIAL SOLUTION? A STRATEGIC USE OF JUDICIALIZED ARBITRATION

It is possible for disputants to guarantee a form of arbitration that will apply legal principles in a manner not unlike litigation. The selection of this type of "judicialized arbitration" offers the parties some of the perceived benefits of arbitration—speed, lesser expense, jury avoidance, privacy—while assuring that "law application," normally only available in litigation, is achieved.

The shift by many arbitration users toward a more judicial model results largely from market demand for law application. Nowhere is this shift clearer than in the advertising of the National Arbitration Forum, a national supplier of arbitration services. The Forum publishes advertisements in publications such as the A.B.A. Journal proclaiming that "[a]ll arbitration is not the same" and "[a]rbitration does not have to be arbitrary." The Forum mandates its arbitrators to base all arbitration awards upon the rule of law. The Forum's choice to ban more subjective equitable awards reflects market acceptance of arbitration outcomes based on the rule of law.

Examination of modern arbitration case law demonstrates that corporations increasingly seek to prevent arbitrators from entering equitable style awards and, instead, contract for results that require application of substantive law. This demand side preference for "legal" as opposed to

75. See generally Brunet, supra note 26, at 39 (describing market based model shift away from "folklore arbitration" to a contract model in which arbitration users may select those procedures desired by contract).


80. See, e.g., Syncor Int'l Corp. v. McLeland, No. 96-2261, 1997 U.S. App. LEXIS 21248 (4th Cir. 1997) (upholding arbitration contract that states "errors of law shall be subject to appeal"); LaPine Tech. Corp. v. Kyocera Corp., 130 F.3d 884 (9th Cir. 1997) (upholding contract that required arbitrators to "issue a written award which shall state the bases of the award and include findings of fact and conclusions of law" and enable a federal court to "vacate, modify or correct" for error of law); Gateway Tech. v. MCI Telecomm. Corp., 64 F.3d 993 (5th Cir. 1995) (upholding claims that "errors of law shall be subject to appeal"); Western Employers Ins. Co. v. Jeffries & Co., 958 F.2d 258 (9th Cir. 1992) (reversing arbitration award where arbitrators had refused to follow the partner's agreement that the panel enter findings of fact and conclusions of law); New England Utilities v. Hydro-Quebec, 10 F. Supp. 2d 53 (D. Mass. 1998) (upholding parties' agreement providing that "any party may utilize a court . . . for review of [an arbitrator's] errors of law.").
“equitable” arbitration can be accomplished in several ways, each by contract. The parties may require arbitrators to apply the law of a particular jurisdiction—this is nothing more than a choice of law clause—and then police this effort by mandating that the arbitrator enter conclusions of law. Alternatively, the parties may create the opportunity to appeal erroneous arbitration awards to an appellate panel of three arbitrators who are awarded the power to review for legal error. In addition, the parties may request that the arbitrator has no power to enter awards inconsistent with a particular substantive law and covenant that the losing arbitration party may seek review of legal error in the courts.

The fact that each of the above examples has occurred repeatedly in the last twenty years shows market dissatisfaction with equitable or arbitrary arbitration and at the same time, reflects the ability of the contract process to shift to a variation on the arbitration model. No firm, rigid definition of arbitration exists. It appears that some courts will uphold such agreements to judicialize the arbitration process and to allow privatized creativity to improve arbitration. A party’s decision to require an arbitration premised upon legal rules creates a context in which the loser can always seek to set aside the arbitration award.

Examination of the set of contracts between CEOs and S&P 500 firms reveals some use of judicialized arbitration. To be sure, many of the CEO contracts calling for arbitration contain simple boilerplate agreements to arbitrate. In contrast, consider the CEO contract between Toys ‘R’ Us and

81. Arbitration is a creature of contract because it is a process that can only be created by agreement of the disputants. SeeVolt Info. Sci., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989) (identifying congressional intent in the Federal Arbitration Act to ensure that “private arbitration agreements are enforced according to their terms”).

82. See, e.g., LaPine Tech. Corp., 130 F.3d 884 (9th Cir. 1997); Western Employers Ins. Co., 958 F.2d 258 (9th Cir. 1992).


84. See Richard Speidel, ICANN Domain Name Dispute Resolution, the Revised Uniform Arbitration Act, and the Limitations of Modern Arbitration Law, 6 J. SMALL & EMERG. BUS. L. (forthcoming 2002) (noting that arbitration legislation fails to formally define the process of arbitration and that “the definition must be teased from the legislation”).


86. See, e.g., The Corporate Library Website, supra note 30, Venator Group CEO contract (“Any controversy or claim arising out of or relating to this Agreement, or the breach thereof, other than injunctive relief . . . , shall be settled by arbitration in the City of New York, in accordance with the rules of the American Arbitration Association (the “AAA”) before three arbitrators. The decision of the arbitrators shall be final and binding on the parties hereto and judgment upon the award rendered by the
its CEO. The agreement illustrates a "legal" framework designed to assure that arbitration results be based upon law rather than equity. It provides that "any award rendered . . . shall specify the findings of fact of the arbitrator or arbitrators and the reasons for such award, with the reference to and reliance on relevant law."87 Similarly, the American General Company CEO contract mandates that "the arbitrator shall apply the substantive laws of the state of Texas" and the GTE CEO contract requires findings "consistent with the arbitrator's understanding of the findings of a court . . . in applying the applicable law to the facts underlying the dispute."88 Several published CEO contracts mandate "judicialized" application of a substantive statute of limitation provision.89

The contracts contained in the Corporate Library Database have other features more common in a court than in arbitration.90 Some CEO contracts create procedural rights not typically found in employment arbitration. Numerous CEO contracts permit the arbitrator to award the payment of attorneys’ fees to the prevailing party.91 In contrast, many CEO contracts call for all costs and fees of arbitration to be borne by the employer company.92

The shift to a judicialized style of arbitration comes at a cost.
Judicialized arbitration makes arbitration results less final and subject to risky and expensive judicial attack. A business that selects judicialized arbitration features in its employment contracts is making a decision to spend more on the dispute resolution process. Yet, the very presence of these characteristics of litigation within custom-crafted arbitration clauses means that litigation-like procedures have value. Arbitration informality and finality are not always virtues, especially where a final arbitration award is erroneous and cannot otherwise be corrected.

Employers who seek to follow substantive rules will want a type of arbitration that guarantees application of such positive law. They will want a return on their opinion letter investment. The normal arbitration award, if erroneous, cannot be corrected by a reviewing court. In contrast, a properly judicialized arbitration clause can trigger enhanced judicial review.

V.
THE EFFICIENCY OF THE MEDIATION ALTERNATIVE: THE MEDIATOR AS A CENTRAL CLEARINGHOUSE OF EFFICIENT INFORMATION

Because the arbitration option is fraught with uncertainty and risk, it is worthwhile to consider whether contracting for mediation improves the optimality of the dispute resolution clause. Stripped to its essentials, mediation is simply assisted negotiation, with the mediator facilitating settlement decisions between disputants.

Mediation is now extremely popular among American businesses. In part, this is because mediation is but a variant on the age-old dispute resolution mechanism of choice, negotiation. As in negotiation, mediation stresses party control or autonomy. Each side wins if mediation terminates a dispute because each side specifically approves of the terms. A party who dislikes the terms proposed by either the mediator or the opponent can refuse to terminate the dispute. In mediation, an informal process characterized by offers and counters presented through the reasonableness


94. A recent survey of litigators and house counsel demonstrates the general popularity of mediation. The survey, conducted by the National Law Journal and the American Arbitration Association, compared the popularity of arbitration and mediation. Survey questionnaires were sent to leading litigators and Fortune 500 house counsel, 69% of litigators and 88% of house counsel preferred mediation to arbitration. Of those preferring mediation, 80% of the litigators and 88% of house counsel preferred mediation because of the perception that it saves time and money. See Lisa Brennan, What Lawyers Like: Mediation, NAT'L L.J., Nov. 9, 1999; accord, John Lande, Getting the Faith: Why Business Lawyers and Executives Believe in Mediation, 5 HARV. L. NEGOT. REV. 137, 215 (2000) (concluding that preserving relationships has “institutionalized” the popularity of mediation among business executives).

95. See BRUNET & CRAVER, supra note 2, at 181 (“mediation is, at its core, a supercharged negotiation”).
filter of the mediator, complete decisional control rests with the disputants. In stark contrast with litigation and arbitration, more costly and formal adjudicatory processes, decisional control is not ceded by the parties to a court or an arbitrator when mediating. Mediation, then, has less risk than arbitration or litigation because the parties should never be forced into a bargain with which they disagree. Certainly some of the recent popularity of mediation stems from repeat player frustration with the inherently risky and unpredictable arbitration process.

Mediation is also characterized by lower transaction costs than litigation or arbitration. There is no trial or evidentiary hearing. Discovery, while becoming more available in mediation in order to inform each disputant, is restricted. Formalism in the form of pleadings is absent in mediation unless the mediation process occurs after a conventional case is filed.

Mediation, however, must also be compared to unmediated negotiation. Mediation has greater transaction costs than negotiation. These include the expenditure of paying a mediator for a process that may be more lengthy than bilateral negotiation, the investment of monitoring mediator conduct, and the costs of informing the mediator through devices such as mediation briefs. Why, then, do parties find it efficient to engage the services of a mediator when they may be able to settle by bilateral negotiation?

Brown and Ayres have effectively set forth the efficiencies of mediation. Despite claims that the mediator must keep all information learned in private caucus sessions confidential, they predict that the critical efficiency of mediation lies in the mediator’s intentionally “noisy disclosure of information”96 gained through alleged confidential caucus comments of the disputants. By leaking this information from one disputant to another, the mediator mitigates the chances of adverse selection.

The information leaks on disclosures of confidential information will typically not be patently obvious. If a mediator learns “in confidence” that a negotiator A will pay B $150,000 to settle, she will not present these exact words to B. Rather, the “noisy” mediator will ask B if he “would settle for $150,000, assuming that I [the mediator] could obtain such an offer.” The mediator will sometimes describe this ploy as an independently derived “mediator assessment,” meaning that she recommends settlement at $150,000. Alternatively, the mediator can ask B if he would settle for $150,000 if the mediator can obtain this amount from A. Party B will listen carefully and translate either question into a conclusion that the mediator has learned that A would pay B $150,000.

These intentional leaks represent the mediator’s transfer of critical

96. Economic Rationales, supra note 29, at 356.
information on highly risky negotiation sticking points. Risk and the cost of negotiation are reduced where the disclosure of such information leads to informed agreements between the parties. Under this theory, optimality would seem to be advanced by using a mediator to help settle a dispute. The mediator becomes a clearinghouse of information with the discretion and ability to transfer selected information to the parties.

This point is shown by Negotiation Illustration #8, the Not-So-Subtle Mediator. X is a software developer at Firm, Inc. The two parties, X and Firm, Inc. are mediating an exit dispute after earlier signing a pre-dispute mediation agreement. X argues that he was discriminated against because of a disability and seeks damages of $4,000,000 in a civil court complaint. At a confidential caucus session the mediator learns that X would settle for a written apology, a favorable letter of recommendation written by his attorney, and $300,000. When he next caucuses with Firm, Inc., the mediator asks if the company would settle for $300,000, a letter of recommendation, and an apology. The case soon settles on the terms outlined.

The theory of "noisy mediation" assumes that the parties will be truthful in communicating their "bottom line" or "resistance points" to the mediator. Some, but certainly not all, parties are willing to play straight with the mediator regarding bottom lines. Other negotiators will engage in outright prevarication when communicating a resistance point to the mediator. Some disputants will communicate only one end of a "range" of an estimated settlement zone. The opportunity for adverse selection haunts interactions between distrustful negotiators and potentially inaccurate mediators. Some parties tend to bargain with the mediator just as they would when negotiating directly against an opponent. In such cases "noisy mediation" may cause inaccurate transmittal of information from the mediator to the parties. These problems stem from the mediator's difficulty in establishing trust with the adversary parties. Trust is a scarce commodity and not automatically generated at the mediator's whim. Despite some clear efficiency advantages, mediation results are not always efficacious.

Negotiation Illustration #9, The Deceived Mediator, demonstrates this problem. New Start-Up, Inc. is mediating a dispute regarding stock options with its former CFO. At the first confidential caucus session, the mediator asks the former CFO's attorney for the lowest dollar amount needed to settle. The attorney knows that his client has told him that $1,500,000 would be needed but tells the mediator "I can get the CFO to take $1,000,000." After the mediator persuades the former employer to offer $1,000,000, the offer is communicated to the former CFO who rejects it and

97. See BRUNET & CRAVER, supra note 2, at 74 ("resistance point" is the minimum set of terms a party will accept after taking into account the alternative to a negotiated settlement).
says that he would not settle for anything near $1,000,000. The mediation ends.

Mediation possesses other potential efficiencies. The presence of a mediator may also aid the parties to cut short a useless negotiation session. Without the ability of a mediator to urge the parties to cease negotiating, hopeful and opportunistic disputants may inefficiently insist on further fruitless negotiation. By using mediation, the parties make the mediator a contractual filter or clearinghouse of important negative information. The mediator who learns that the disputants will not share an overlapping zone of agreement should tell the parties that settlement is fanciful and negotiations should cease. In this way mediation may reduce fruitless negotiation costs.

Mediation holds great potential for efficiency. The mediation option should be considered in the type of high stakes contract between the skilled employee and her employer. While pre-dispute agreements to mediate are increasingly common, such clauses seldom exist in isolation. Because of the highly legitimate fear that a mandatory mediation will not resolve the dispute, it is not uncommon to see a “two-step” dispute resolution clause, mandating that the parties first mediate and, if that is not successful, arbitrate. The fact that mediation may not achieve peace requires further party investment in some other form of dispute resolution, usually arbitration.

VI.
CONCLUSION: THE PLACE OF THE OPTIMAL DISPUTE RESOLUTION CLAUSE IN A DYNAMIC CONTRACT NEGOTIATION

This Article analyzes the process of seeking an optimal dispute resolution clause in a dynamic contract negotiation.
resolution clause containing mediation and arbitration options in contracts between the highly skilled employee and the firm. Its focus is very specific, on just one segment of multiple subjects of bargaining between employee and employer.

This particular and theoretical focus on dispute resolution clauses needs to be placed in the more realistic context of a dynamic and multifaceted negotiation between well-informed contracting partners who negotiate regarding several issues, of which the dispute resolution clause represents merely one part. It may be the fact that one significant issue, such as the compensation package for the highly skilled employee or a covenant not to compete, tends to dominate the negotiation between the highly skilled employee and the firm. In such a situation, many employees will give ground or trade away a highly desirable dispute resolution clause in exchange for the inclusion of an attractive compensation package. The benefits of the optimal arbitration clause for the employee may be of less value than a lucrative stock option or bonus.

There are risks inherent in such a trade-off because the employee may lose deferred compensation in an “equitable” arbitration that was not really bargained for in an earlier contract negotiation. The dispute resolution clause is but one of multiple subjects of bargaining in negotiations between the highly skilled employee and her employer. Dispute resolution may or may not be one the top objectives of the bargainers in a high stakes, multi-part employment contract. Bargainers tend to select one or more subjects as crucial, other subjects as important (but less so) and the remainder as of marginal importance. While a bargainer with perfect information should focus on dispute resolution, some may view the dispute resolution clause as a bargaining chip to be traded off against more valuable consideration when bargaining a multi-issue contract.

However, pre-dispute mediation contracting is often in the mutual interest of each party to the high stakes contract. The retention of control over the mediation result eliminates the risk of errors or compromises by an arbitrator or judge. The information clearinghouse role played by the mediator allows each party to gain strategic information helpful to settle a dispute. The common practice of negotiators not sharing their true bottom lines with the mediator can frustrate efficient results. Yet, the risks and cost of mediation compare favorably with arbitration or litigation.

Arbitration presents greater problems for resolution of disputes between the highly paid employee and the firm. While arbitration possesses advantages of speed, informality, and privacy, it presents risks for employees or employers who think that their legal rights need vindication.

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100. See BRUNET & CRAVER, supra note 2, at 65 (lawyer negotiators “either formally or informally divide client goals into three basic categories: (1) essential; (2) important; and (3) desirable.”).
Consideration should be given either to judicialized arbitration by forcing the arbitrators to apply substantive law or to using the default option of conventional litigation. The non-investment option, choosing not to discuss dispute resolution, may be efficient for some bargainers. The possibility of contracting to arbitrate later, at the time of the dispute, presents a vexing but potentially attractive alternative.

Conditions for opportunism are obviously present in such bargaining contexts. While it is impossible to eliminate totally the possibility of opportunistic behavior, several factors mitigate against recurring examples of outrageous opportunism. The market for reputation should force some disputants to seek mutual gains. Highly paid employees and their employers are repeat players in a focused environment in which reputational information is gathered and sought. The need to preserve a solid reputation should be a significant deterrent force. Some bargainers will seek reciprocal gains instinctively. Opportunism will exist but is unlikely to thrive in this context.