THE RATIONALE BEHIND CHOOSING ARBITRATION OVER LITIGATION: A LAW & ECONOMICS PERSPECTIVE

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ABSTRACT

In the contemporary globalised economy, popularity of arbitration as a dispute resolution method has amplified. It has many advantageous features such as expertise of arbitrator, speedy procedure, party autonomy, confidential proceedings, which lack in litigation, thereby making arbitration the preferred mode of dispute resolution. The growth of arbitration is also credited to its stakeholders, namely the arbitrator(s) and the parties. The stakeholders take part in arbitration to derive maximum utility for themselves. They make decisions in the process which are backed by economic considerations. Cost and incentives become the major determinants, guiding their rationale supporting 'the choice of arbitration'.

This paper studies the mechanism of arbitration through Law and Economics lens. It is divided into five parts. Part I introduces the theme and builds up conceptual framework for the ideas presented. Part II explores the incentives available to the parties to choose arbitration over litigation. Part III discusses the incentives available to arbitrator, which encourages them to constantly work on their skill to remain relevant in the highly competitive market of arbitration. This part also makes comparison between the incentives available to judges of traditional court with that of arbitrators. Part IV examines the social costs of arbitration and determines whether arbitral award is a public good or a private good. Part V concludes the paper by outlining the key findings of this study.

Keywords: Arbitration, Rational Choice Theory, Cost, Incentives

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1. INTRODUCTION

"The concept of man as a rational maximiser of his self-interest implies that people respond to incentives — that if a person's surroundings change in such a way that he could increase his satisfactions by altering his behaviour, he will do so".

\- *Robert A. Posner*[+]

Law and Economics ("L&E") literature, has majorly focussed on judicial adjudication while reviewing legal systems and processes.[1] The economic perspectives into adjudication has given major insights in understanding judicial behaviour and analysing cost of litigation. However, it is pertinent to mention, that there are relatively less economic studies of arbitration, despite the fact, that cost and incentives are major determinants of its popularity.[2] In contemporary times, arbitration (both commercial and investment related) is a preferred mode of resolving disputes between parties. It has many procedural benefits which make it a lucrative method of dispute resolution. Arbitrators are generally experts in their field thereby reducing the cost of judicial errors. It is not procedure laden like litigation hence saves the time costs.[3] Arbitration is non-adversarial and this helps in preserving relations between parties. The proceedings are confidential which helps parties in preserving their trade secrets and other business-related information and also protect their reputation.[4]

The preference for a private adjudication over state sponsored mechanism of adjudication in court, signals toward the act of making 'choice' by the parties. The problem of economics is the problem of choice.[5] Similarly, in determining whether to settle a dispute through arbitration or court litigation, parties do face this problem as they cannot choose both. Though, if either or both the parties are not satisfied with the arbitral award, the option of approaching court with

[+] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 4 (Wolters Kluwer 1997). (hereinafter "BENSON")
[1] BRUCE L. BENSON, ARBITRATION, in B. Bouckaert and G.D. Geest, eds, ENCYCLOPEDIA OF LAW AND ECONOMICS 159 (Edward Elgar 2000).
[2] Michael Faure & Wanli Ma, *Investor-State Arbitration: Economic and Empirical Perspectives*, 41 MICH. J. INT'L L. 1 (2020). (hereinafter "FAURE & MA")
[3] BRUCE L. BENSON, ARBITRATION IN SHADOW OF LAW, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, 93 (Peter Newman eds.1998).
[4] *Id.*
[5] Problem of Choice is a fundamental concern in economics. It refers to allocation of scarce resources which also have alternative uses. Similarly, while deciding method of resolving disputes parties have to make a choice where to allocate their resources of money, time and efforts; whether in litigation or arbitration.

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their dispute is available to them.[6] Usually there is a legislative bar to pursue parallel proceedings in court and through arbitral tribunal/institution.[7] Therefore, the parties must choose and they must choose fast, because pendency of an unresolved dispute will affect them financially and in reputation.[8]

The choice of parties should be rational. In fact, law considers all actors in a legal process to be rational beings.[9] According to economist Gary Becker, rationality promotes human behaviour which is guided by their pursuit of maximising utility, from a stable state of preferences and is based on optimal processing of information and other inputs.[10] As per the Rational Choice theory of economics, individuals make rational choices by making rational calculations to achieve objectives which are in furtherance of their own self-interest. When people exercise their rationale, it is expected that the resultant outcome will provide them with greatest benefit and satisfaction. According to economist, Amartya Sen, one of the dominant approaches to rational choice is constant pursuit of self-interest.[11] Therefore when parties opt for arbitration instead of litigation to resolve their dispute, an analysis of this choice through economic lens will reveal that they are focusing on maximum utilization of the process to serve self-interest. Parties' self-interests in the mechanism of arbitration are, quick disposal of dispute through an expert (arbitrator), within minimum time and cost and least damage to their reputation in business circle.[12]

The rationale behind parties, in making the 'choice of arbitration' is dominated primarily by two economic factors namely, cost and incentives.[13] As per economist, Bruce Benson, arbitration is a joint effort by parties to reduce cost in dispute resolution. Due to high level of

[6] William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD 247 (1979). (hereinafter "LANDES & POSNER")
[7] In India, Section 8 of the Arbitration and Conciliation Act, 1996 makes it compulsory for the judicial authority, before which an action is brought in a matter which is the subject of an arbitration agreement to direct the parties to go for arbitration.
[8] Leon E. Trakman, *Confidentiality in International Commercial Arbitration*, 18 ARB. INT'L 1, 2 (2002).
[9] ANNE VAN AAKEN & TOMER BROUDE, ARBITRATION FROM A LAW AND ECONOMICS PERSPECTIVE, in THE OXFORD HANDBOOK OF INTERNATIONAL ARBITRATION, 876 (Thomas Schultz & Federico Ortino eds. 2020). (hereinafter "TRANKMAN")
[10] GARY S. BECKER, THE ECONOMIC APPROACH TO HUMAN BEHAVIOUR 14 (University of Chicago Press 1976).
[11] Amartya Sen, *Rationality and Uncertainty*, 18 Theory and Decision 109 (1985).
[12] BENSON, *supra* note 1, at 165.
[13] Cost is a concept in economics which means the fiscal value of a product or service. Incentives means a factor that will motivate a person to perform or behave in a particular way.

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expertise of the arbitrators the possibility of occurring error cost is minimised.[14] Arbitration is less formal, therefore procedural cost is less if compared with litigation. Since arbitrator can give decisions relatively quicker with less amount of information transferred to him by parties, it saves time cost. The costly delay that arises when court time is allocated by waiting is also kept under check.[15] Therefore despite judicial mechanism being subsidised by the state, parties in present times are instead opting for arbitration, which is largely self-financed.[16]

It is not just the parties, but also arbitrators, who as the important stakeholders in the system of arbitration, have contributed towards its popularity. However, the incentives they derive are different from those of disputants such as reputation, income, future appointments etc.[17] Incentives are those factors that motivate a person to act in a particular way or behave in a certain manner.[18] Incentives need not be monetary always. Appreciation, reputation, serving social cause, social status, personal satisfaction are certain non-monetary incentives.[19] While arbitrators' incentives for conducting a successful arbitration may purely be personal such as income and reputation, a judge's incentives are service of society through protection of citizen's rights and interpretation of law, prestige and leisure.

2. INCENTIVES FOR PARTIES TO CHOOSE ARBITRATION

The discipline of economics perceives that the participants in legal process are rational maximisers. They participate in the legal system as intelligent maximisers of their satisfactions.[20] Just as ordinary consumers, they will purchase more of a commodity which is priced less and reduce the consumption of a commodity which is priced high. In this context, the cost effectiveness of arbitration process matters to the parties who opt for it instead of litigation. Moreover, these rational participants also respond to incentives.[21] The theory of incentive acknowledges that if there is a change in person's surroundings, he would respond by moulding his behaviour, only if that contributes to maximisation of his satisfaction from the

[14] Error costs is the cost born by the parties at dispute due to an error in judgement.
[15] BENSON, *supra* note 3, at 93.
[16] FAURE & MA, *supra* note 2, at 4.
[17] TRANKMAN, *supra* note 9, at 876.
[18] EDWARD J. LÓPEZ, AN INTRODUCTION TO THE PURSUIT OF JUSTICE, in THE PURSUIT OF JUSTICE 5 (Edward J. López eds. 2010).
[19] *Id.*
[20] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 4 (Wolters Kluwer 1997). (hereinafter "POSNER")
[21] *Id.*

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process.[22] This explains, that apart from cost, there are many other incentives which make arbitration an attractive option for parties.

At present, all international trade contracts at least, have clauses where parties commit to submit their dispute to arbitration and specifically exclude jurisdiction of national courts.[23] What is it about arbitration, that parties opt for this self-financed process over the state subsidised mechanism of adjudication?[24] From a L&E perspective, one possible answer could be that parties before submitting their dispute to arbitration, have already taken a rational account of the effects of arbitration.[25] Arbitration in fact, offers various incentives which make it lucrative.

Arbitration is a specialised process. It is in tune with demands of the modern times where specialisation adds desirable value in production of most goods and services. [26]Today, the virtue of specialisation is expected to be rooted in justice also. Parties appoint arbitrators on the basis of their specialised expertise.[27] Disputants make analysis as to, whether the expertise arbitrators profess to have, is suitable for dealing with their dispute or not. From the perspective of economics, their decision will be based on, whether their rational choice will lead to utility maximisation and therefore serve their self-interest in the process. For example, if the dispute is regarding construction of a building, the disputing parties can appoint a civil engineer as arbitrator. The expertise of civil engineer is specific to the dispute. So, it is expected that his specialisation in the subject matter will result in a refined and technically sound resolution of dispute. If the same dispute is submitted before a judge, there is a possibility that his decision making is based on precedents and he is likely to be more generalist in his approach.

Another advantage of the expertise of arbitrators is, that they tend to render awards in a relatively faster pace than the judges.[28] Since arbitrators require less transfer of information from the parties as compared to judges in traditional court, the decision-making process in arbitration is relatively a speedier process. Traditional judge are generalists in their approach

[22] Richard A. Posner, *The Economic Approach to Law*, 53 TEX. LAW REV. 763 (1975).
[23] Bruce L. Benson, *To Arbitrate or To Litigate: That Is the Question*, 8 EUR. J. L. & ECON. 93 (1999).
[24] FAURE & MA, *supra* note 2, at 4.
[25] Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1 (1995).
[26] BENSON, *supra* note 1, at 187.
[27] FAURE & MA, *supra* note 2, at 4.
[28] BENSON, *supra* note 23, at 94.

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and follow system of precedent and established rules. They require assistance from the advocates in understanding the facts of the case and the applicable law. On the other hand, arbitrators, being specialists in the subject matter, are well acquainted with the technicalities of the dispute. The expertise of arbitrators has another advantageous consequence of minimising cost. In fact, arbitration can be called as a cooperative exercise to minimize the costs of dispute resolution.[29] Error Cost in arbitration is far less as compared to arbitration. Error Cost arises in courts because courts have imperfect information, which leads them to make mistakes when applying law.[30] Due to adversarial nature of court adjudication the parties may not reveal everything and this causes errors in judgement. The unsatisfied party will then move to the appellant authority which adds onto the cost of case disposal. Errors distort incentives and also impose various cost on the society.[31] Due to cooperative nature of arbitration, error cost is minimised. Procedural cost in arbitration is kept under check as arbitration is a flexible process. Since parties can opt for rules which are less technical and facilitate fast disposal of case, arbitration turns out to be a less expensive method of dispute resolution. Arbitration also minimises the time cost, as not only the time spent on procedural formalities is saved but also the costly delay which arises when the court time is allocated by waiting is avoided.[32] For businesses time is money and delays can be devastating.[33]

Another incentive for parties to opt for arbitration is that it gives them the choice to select the substantive law and procedural rules to which they want to bind their contract with.[34] This choice of legal jurisdiction is not available in adjudication in courts, where the judges are bound to apply the law of the land. The international contracts can specify that a dispute in future will be resolved as per the laws of a particular nation. In doing so, one thing is certain that the law of any of the contracting party's nation will not be chosen as that may give rise to biasness. Parties generally, maintain a neutral stand in choice of legal jurisdiction so that no party receives an unfair advantage. In this way, the dispute tends to get denationalised.[35] It has been observed that standards of business practice and usage within trade associations and other

[29] BENSON, *supra* note 1, at 164.
[30] Robert Cooter & Daniel Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J.EL.1067 (1989).
[31] *Id.*
[32] BENSON, *supra* note 3, at 93.
[33] BENSON, *supra* note 1, at 164.
[34] BENSON, *supra* note 23, at 94.
[35] BENSON, *supra* note 1, at 162.

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commercial groups also act as a source of basic rules on which contracts are drawn and later disputes are settled.[36] The parties may also expect the arbitrators to apply such rules of businesses in settlement of disputes.

Arbitration is a party-autonomous process which is a lucrative incentive. Parties exercise a considerable control over the process, in terms of appointment and termination of arbitrator(s), in determining the rules applicable to the process, in deciding the seat and venue of the arbitration.[37] Parties are and feel more in control, in arbitration than litigation. In litigation, once a dispute is submitted it is very much out of the realm of parties and becomes a continuous volley between advocates-judge-law-procedure. Since parties had an important role to play at each stage of arbitral process, it is assumed that the award is more likely to be acceptable to them. Another incentive for choosing arbitration is that it is based on a 'win-win' format unlike litigation which is 'winner takes it all' mechanism. By submitting their dispute to arbitration, the parties are assured that their side of the story will equally be paid attention to and they will walk out of the arbitration with something in their hand and will not lose it all. The cooperative nature of the arbitration proceedings allows for continuation of mutually-beneficial repeated-dealing relationships.[38]

There are other advantages of arbitration that incentivise disputants to participate. Arbitration is less adversarial than litigation. The atmosphere of the court room, the continuing tension between the litigating parties, the aggressive argument style of the advocates, reflect that litigation is indeed a contest between the parties at dispute and therefore they are going to do anything to let the scales of justice bend in their direction. This adversarial nature of litigation sours relationships. On the other hand, arbitration recognises the importance of continuity of relations in business, thereby it is modelled on cooperative value. Therefore, arbitration incentivises continuance of amicable commercial relations between the two parties. Another factor for which the parties prefer arbitration over litigation is confidentiality. The parties by opting for arbitration, do not want that their dispute is discussed in open court which may also lead to reputational damages. By discussing and resolving their dispute in closed chambers,

[36] Lisa Bernstein, *Opting Out of the Legal System: Extra-legal Contractual Relations in the Diamond Industry*, 21 J. OF LEG. STUDIES, 115 (1992).
[37] Stephen E. Blythe, *The Advantages of Investor-State Arbitration as a Dispute Resolution Mechanism in Bilateral Investment Treaties*, The International Lawyer 273 (2010).
[38] BENSON, *supra* note 1, at 163.

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parties are also able to preserve their trade secret and other business issues and thereby maintain good business relations.[39]

However, despite the lucrative incentives that arbitration offers, many scholars have also pointed towards the over-valuation of arbitration as a dispute resolution mechanism. Dr. Robert Kovacs, a renowned lawyer specialising in arbitration, highlighted the challenges to efficiency in arbitration.[40] He mentions the information failures, agency costs and dilatory tactics that may be played by the parties. By suggesting information failure as a disadvantage in arbitration, he is of the view that it is not necessary that the counsels and arbitrators are able to provide best of their service and possess adequate knowledge and experience. Therefore, not always the most accurate advice regarding the dispute can be rendered to the parties. Because of this, the cost of dispute settlement may increase as the unsatisfied party(s) is likely to approach court. With regard to agency costs, Kovacs is of the opinion that an agency relation exists between a party and the counsel which may result in monitoring costs being born by the party.[41] Parties may also use tactics to delay, for example by seeking court intervention, to avoid the adverse effects that an award may have on their financial records.[42] Biasness of arbitrator towards the party who has appointed her has always been there. The 'affiliation effects' signifying that a party appointed arbitrator may have the tendency to render decision in the favour of the party that appointed him may challenge the legitimacy of arbitration as an unbiased mechanism and may render the whole practice, corruptible.[43] However, these shortcomings has not deterred parties at dispute from choosing arbitration over litigation. The usage of blind appointments has also been suggested in which the parties do appoint the arbitrators, however the arbitrators so appointed are unaware bout their appointee parties. This may reduce the scepticism around affiliation bias.[44]

[39] TRAKMAN, *supra* note 8.
[40] Robert B. Kovacs, *Efficiency in International Arbitration: An Economic Approach,* 23 AM. REV. INT'L ARB. 155 (2012). (hereinafter "KOVACS")
[41] *Id* at 162. Monitoring costs are borne by the clients who are not able to put budgetary limits, influence nor monitor the work of advocates due to lack of expertise. Therefore, they emerge to be at the receiving end in an agency relationship in attorney-client relation.
[42] *Id* at 166.
[43] Sergio Puig & Anton Strezhnev, *Affiliation Bias in Arbitration: An Experimental Approach*, 46 J. LEGAL STUD. 371 (2017).
[44] *Id* at 372.

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3. INCENTIVES FOR ARBITRATORS VERSUS JUDGES

The success and popularity of arbitration as the most preferred method of dispute resolution not just belongs to businesses as contracting parties, but also arbitrators. Arbitrators are important stakeholders in the development of arbitration as a practice. The continuous pursuit of arbitrators to deliver high quality decisions have instilled people's faith in the practice. However, according to L&E scholarship, the incentives that arbitrators receive are much different than those of judges, thereby justifying their conduct of continuously working on their skill and reputation to keep themselves relevant in the market.[45]

Judges in the traditional court system are like any other legal actor trying to maximise their utility in the legal process.[46] However, what the judges do as utility maximisers is different from what the other legal players do. Unlike arbitrators, money as an incentive for judges to perform well cannot be over-analysed as judges receive a fixed salary or honorarium, which will not change whether the decisions that they give out are bad or good. Hence, their performance in decision making is not incentivised by monetary factor as there is no change in their renumeration even if they render high quality decisions or receive criticism for some. Therefore, money cannot be the only incentive for judges to perform their best.[47] Judges' self-interest in the process is guided by non-monetary incentives such as leisure and prestige.[48] Generally judges get appointed at the peak of their age and legal career. In later stages of their life, they may tend to value leisure over hard work. Since judges do not receive a pay raise as a reward, if they give out high quality decisions, they may feel less incentivised to put in their best efforts in the legal process. Increased case load will not make a judge work harder to get over with the pendency soon, instead, that will minimise one of the few incentives that a judge receives, that is, leisure. To an increased workload a judge may respond by spending less time on each case so that his leisure is not scarified.[49] In fact the judges of superior judiciary, because they cannot get further promotion, tend to value leisure more in their decision making.[50]

[45] Daphna Kapeliuk, *The Repeat Appointment Factor: Exploring Decision Patterns of Elite Investment Arbitrators*, 96 CORNELL L. REV. 47, (2010).
[46] Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1 (1993).
[47] POSNER, *supra* note 20, at 570.
[48] *Id.*
[49] *Id.*
[50] POSNER, *supra* note 46, at 2.

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Reputation, is another incentive which will motivate a judge to perform better. Judges are aware that the kind of decision making they do will affect their reputation, at least in their legal circles. They may be cautious in their approach while dealing with matters as being a part of the judicial system of the country, they serve the larger purpose. The decisions they render, extracts to them the approval from the public and respect from the legal community.[51] Due to fixed renumeration, reputation is an incentive for which judges may work harder. Unlike arbitrator, a judge does not have to work on securing an appointment as his job security and income are virtues that are embedded in his office. Even, if a party(s) is not satisfied with the decision of a judge, they have the option of approaching appellant authority, but it has no effect on appointment of the judge. Unlike an arbitrator who renders award, keeping in mind that he has to secure future appointments too, he avoids taking extreme positions in a case. A judge on the other hand has no such reservations as he presides over a 'winner-loser' model of decision making and is bound to give decision in favour of one party.

Judges in their decision-making follow what is known as the theory of legal formalism.[52] The core idea of this theory is to apply law to facts. Judges are bound to apply the substantive and procedural laws to the case that are submitted before them. They follow the rules and value precedent in their decision making. The approach of arbitrators is rather flexible, however that is because of the very nature of arbitration. It was developed and promoted to avoid the strict 'law-abiding' procedure in court adjudication. Judges in court tend to be generalists in their approach. As the nature of adjudication does not demand specialisation, there is no motivation rather requirement for a judge to develop his skills on a particular subject matter.

Parties cannot dictate a judge in the court room. Judge does not get his authority from the contract of the parties. He is a constitutional authority deriving his authority from the supreme law of the land. Therefore, when a party submits dispute in a court of law, his own case is very much out of his control as now, it is the advocates-judges-law and procedural rules that take it forward. Judges do not have to mould their conduct in order to pacify the parties, like arbitrators do in order to seek future appointments. A judge in the courtroom serves a larger purpose of service to law of the land and society.

[51] Lawrence Baum, *What Judges Want: Judges' Goals and Judicial Behaviour*, 47 POL. RES. Q. 749 (1994).
[52] THOMAS SCHULTZ, THE ETHOS OF ARBITRATION, in THE OXFORD HANDBOOK OF INTERNATIONAL ARBITRATION, 876 (Thomas Schultz & Federico Ortino eds. 2020).

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Incentives that arbitrators get are much more in comparison to what judges receive by providing high quality decisions. Arbitrators continuously work on their skill to remain relevant in the market. The constant pursuit of upgrading and enhancing their skill and building reputation is due to the fact that arbitration market is very competitive. Arbitrators are paid handsomely for their high quality-specialised decision making. Parties at dispute opt for arbitration, due to the specialised expertise of arbitrators. Hence it is generally the experts of a subject matter that secure appointment as arbitrators, for their skill of specialised decision-making thereby adding value to the award. Incentives for arbitrators are many and they also mould their conduct and performance to derive maximum utility from the process. For instance, there is always the pressure of optimizing performance. Therefore arbitrators, always have to work on their skill. Like judges, arbitrators also have their own interest such as, earning income and also ensuring its continuous flow, establishing and maintaining their reputation in market, advancement of career, contributing in furtherance of justice even though privately and they may also value leisure time.[53]

It is observed that arbitrators' decision making is directed towards the preference of existing or potential parties.[54] 'Arbitrator's exchangeability' explains as to why arbitrators will deter from taking extreme positions. The parties in arbitration are allowed to express their preference in selection of arbitrators.[55] Each party is likely to rule out appointment of an arbitrator who is known for taking extreme positions, and thereby the possibility of each party walking out with good share of the pie is minimised. Parties will expectedly, not allow for appointment of arbitrators whose historical decision are in conflict with the interests of the party.[56] Therefore a pattern in the behaviour of arbitrators has been observed. Arbitrators are likely to give out decisions that other arbitrators will also give out in similar situations. Through this systematic strategy arbitrators protect their decisions from looking unusual.

[53] Kovacs, *supra note* at 40, at 160.
[54] Aaken & Broude, *supra note* 9, at 14.
[55] Orley Ashenfelter, *Arbitration*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 90 (Peter Newman ed., 1998).
[56] *Id.*

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Arbitrators also employ the strategy of 'splitting the difference,' that is, they will give each side a partial victory.[57] Such approach also rules out any allegation of biasness on arbitrator and is also attractive to risk-averse parties at dispute. It also increases the possibility of acceptability of award. Arbitrators also placate both the parties as it is one of the essential determinants in securing them future appointment. By taking extreme stand, they will not diminish the future possibility of their selection. This is what has led arbitration to become a win-win method of dispute resolution since each partly is likely to walk out with something for itself from the award. This also ensures that business relations are maintained.

Arbitrators come armed with expertise. However, to survive in the competitive market of arbitration services, they also have to build their reputation. Reputation in fact will fetch them other incentives attached with the process such as continuity in flow of income, advancement in career and also leisure. For an arbitrator his reputation will matter a lot, as disputants would hardly approach someone less reputed in arbitration as their economic calculations will motivate them to invest in somebody experienced in the field, to lower down the party's cost of decision errors. However, reputation may take years to build.[58]

Thus, arbitrators are better incentivised in comparison to judges which motivates them to refine their skills as arbitrators. Even if judges, render high quality decisions, there is no pecuniary reward they are entitled to, apart from the fixed salary they receive. The competition in the arbitrator market is high, therefore it requires continuous effort on part of the arbitrators to upgrade their skills, establish their reputation, to seek appointments and to ensure regular flow of income. Judges on the other hand are appointed through a fix process varying as per jurisdictions and receive fixed salary/honorarium and therefore lack the motivation in terms of income to work upon their prowess as decision makers. But a judge serves the society at large through his decision making and also contributes to the development of law through its application and interpretation, and that in itself may act as an incentive for many and encourage them to optimise their performance at work.

[57] POSNER, *supra* note 20, at 558.
[58] KOVACS, *supra* note 40, at 170.

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4. SOCIAL COSTS OF ARBITRATION

The role that a judge plays in the society is very different from that of an arbitrator and rather a massive one. When a judge presides over a case, he serves the interest of the society while an arbitration proceeding is limited to utility maximisation of the stakeholders who are part of the process. In other words, arbitration will be sought by the parties to serve their own self-interest and not necessarily society's good. Therefore, one can undertake that, adjudication in court produces public good while arbitration produces private good.[59]

A public good has two characteristics. First, it is non-rivalrous. Meaning, that if one person consumes the good, another person is not excluded from consuming the same good as well. The second characteristic is non-excludability - it is difficult to provide good to one person or a defined set of persons while at the same time not making the good available to others.[60] In the light of this explanation of public good, a precedent created in a courtroom can be described as a public good. Judge while presiding over a case is assumed to offer two kinds of services.[61] One is the dispute resolution where judges determine whether a rule has been violated. Second, is the rule formulation, where a legal point is settled, which provides ratio for future disputes of similar circumstances. This practice creates a rich mine of precedent, something which is absent in practice of arbitration. A precedent which is the by-product of the dispute settlement process provides information regarding the likely outcome of similar dispute in future. Therefore, one can assume that adjudication is a public good. Since court creates large and public positive externalities, courts are subsidised by the government.[62] The whole society, even not being directly involved in the dispute is able to benefit from the increased clarity in the legal norms and their application.

Arbitration on the other hand, is a private good, as the proceedings are exclusive.[63] As a process it only focuses on the parties who have opted for the same or to state more clearly have paid for it. Therefore, it excludes others from the proceedings. Unlike a judge who serves the society

[59] RALF MICHAELS, INTERNATIONAL ARBITRATION AS PRIVATE OR PUBLIC GOOD in THE OXFORD HANDBOOK OF INTERNATIONAL ARBITRATION, 398 (Thomas Schultz & Federico Ortino eds. 2020). (hereinafter "MICHAELS")
[60] *Id.* at 402.
[61] LANDES & POSNER, *supra note* 6, at 236.
[62] Positive externality is when a third-party benefits from another party deciding to consume or produce a product or service.
[63] MICHAELS, *supra* note 59, at 408.

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at large, arbitrators focus exclusively on the parties who have paid to avail their services thus making arbitration rivalrous. Hence arbitration is a private good. Arbitrators are not bound by the precedent nor they are expected to produce any while resolving a dispute. Arbitrators have to only concentrate on resolving disputes by doing justice in the individual case. Their decision making need not have relevance beyond the parties. Therefore, Arbitration is a beneficial process for the parties however it does not serve societal purpose.[64] It is less likely to have any impact on the public at large when compared with adjudication in the court.

Arbitration does not produce public good in the way adjudication does. This is also because, arbitrators lack the incentive to write their opinion as arbitration is privately financed unlike court which is funded through public finance. [65]Moreover arbitrators address each case on exclusive considerations and refrain from establishing a system of arbitral precedents. That will encourage parties to seek settlement instead of opting for arbitration as they can predict response of arbitrator in their case. Parties will settle beforehand to save costs on arbitration. Therefore, to maintain the relevancy of arbitration market, following and setting up of precedent system is not beneficial. Hence, arbitration produces a private good whose consumption is restricted to the parties who pay for it.

Thus, considering the social cost of arbitration, one may say it is not able to produce the public positive externalities like court system does.[66] There is nil incentive for the arbitrator to write opinion or give reasons for their decision. Maintaining uncertainty in the decision-making process in arbitration is rather beneficial for the market of arbitration to survive. Therefore, establishing and following a system of arbitral precedent finds no encouragement. Form a social perspective, arbitration is plagued with a substantial disadvantage, which is absence of public good.[67]

5. CONCLUSION

In the globalised economy of modern times, arbitration with its many advantages has become the preferred way of resolving commercial disputes. The keen inclination of parties to opt for a self-financed method like arbitration instead of state-sponsored adjudication, calls for an

[64] LANDES & POSNER, *supra* note 6, at 236.
[65] *Id.*
[66] Social costs is the sum total of private costs that are borne by individuals who are a part of transaction with external cost borne by third parties who are directly not involved in the transaction.
[67] FAURE & MA, *supra* note 2, at 12.

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analysis of such behaviour through L&E methods. L&E approach enlightens, that while opting for arbitration, parties in advance make calculations regarding the benefits they are likely to derive through their participation in the process. L&E scholarship acknowledges that all legal actors make rational choices which lead to utility maximisation, aiming at their respective satisfaction. Therefore, disputants and arbitrators are expected to take part in arbitration to serve their self-interest.

Apart from minimisation of cost there are other incentives for disputants which make arbitration an attractive option. Autonomy over the process, speedy disposal of dispute under the aegis of a specialised expert, within minimum time and preservation of business relations and reputation are certain non-monetary incentives for parties in dispute. Arbitrators on other hand are focussed on ensuring a regular flow of income, securing future appointments, and building their reputation in the market. They are likely to avoid taking extreme positions and not jeopardise their future appointments and to achieve this, they have a tendency to split the difference. The incentives available to arbitrators are more as compared to judges who might prefer to maximise their utility through, leisure and maintaining prestige in the advance stages of their career.

To conclude, a L&E approach provides us with valuable insights. Ultimately, legal actors are rational human beings. They make rational choices and like many choices they make in their everyday life, ‘the choice of arbitration’ is also guided by economic considerations. Their rationale is guided by economic factors such as cost and incentives and after making considerable calculations about their utility maximisation from the process, they choose arbitration over litigation.

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