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Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis

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Abstract

As arbitration agreements have grown in use, they have become controversial, with many critics describing them as a disguised form of waiver. This paper presents an economic analysis of waiver and arbitration agreements and applies this analysis to the evolving arbitration case law in the Supreme Court and elsewhere. The paper examines the conditions under which parties have an incentive to enter into these types of agreement, and their welfare implications. It shows that, if parties are well informed, they will enter into waiver 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. Under similar conditions, they will enter into arbitration agreements when and only when the margin between deterrence benefits and dispute resolution costs is larger under the arbitral regime. These results suggest a presumption in favor of enforcing these agreements, especially where parties are informed. Exceptions to this presumption largely should be based on informational disparities. The theory developed in the paper is used to critically examine arguments against arbitration contracts, such as the claim that these agreements inhibit the development of new law, and to suggest a positive theory of the case law. Although the focus here is on waiver and arbitration agreements, the analysis has broader implications for the literature on the social desirability of litigation. The key implication is that the answer to socially undesirable litigation is not a wholesale reduction in the amount of litigation or the number of lawyers, but an expansion of markets in waiver and arbitration agreements.

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