

CHAPTER 14

LAW AND ECONOMICS OF ALTERNATIVE DISPUTE RESOLUTION

TALIA FISHER

14.1 INTRODUCTION

ALTERNATIVE dispute resolution (ADR) refers to a variety of private processes for resolving disputes, independent of trial before a court of law. During the past five decades the Anglo-American world witnessed the rapid evolution of ADR in the resolution of civil disputes. The roots of ADR can be traced back to the 1976 Pound Conference, co-sponsored by Chief Justice Warren Burger and the ABA, and dedicated to the litigation explosion. At the conference, leading figures in the legal community expressed concern over the increasing costs and extended delays parties were facing in the over-burdened judicial system. Professor Frank Sander examined means for reducing judicial workload and for dispensing justice in a more efficient and accessible manner. He introduced his vision of a Multi-door Courthouse—whereby litigating parties in civil trials are offered a variety of dispute resolution processes upon entering the court system, in addition to the trial option, and cases are screened to the process most befitting of their characteristics. The Multi-door Courthouse Model was implemented in several sites and was deemed a success. Since then, ADR mechanisms have become an integral part of the legal system, both in the United States and worldwide.

The most prevalent ADR processes currently employed are arbitration and mediation. Arbitration can be conceptualized as a market institution replicating trial. Instead of resorting to the state adjudication system, where public judges decide cases according to prevailing law, in arbitration the disputing parties choose the arbitrator (or private judge) and may supply him or her with different substantive and procedural norms from the ones the court would apply. The basic undertaking, of adjudicating the case according to pre-existing norms, mimics the workings of the public court. In light of the

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adjudicative component, underlying this process, arbitration is considered a binding form of ADR. In contrast, mediation is depicted as a non-binding form of ADR, essentially replacing direct negotiation between the parties. Mediation is a process whereby a neutral third party facilitates negotiations between the disputing parties, aiming for a contractual resolution of the dispute. Mediation is directed at resolving, rather than deciding, the case. In this sense it is not merely a privatized version of trial, but offers a qualitatively different, settlement-based, solution to the dispute. In addition to arbitration and mediation, hybrid proceedings, such as med-arb, mini-trials, and early neutral evaluation (ENE) are also widely employed today, both within the court system as well as in out-of-court settings.

A significant portion of civil disputes are settled through resort to these mechanisms, and ADR proceedings even play a (more modest) role in the criminal realm. In addition to the domestic level, ADR processes are also employed in the international realm. In light of the qualitatively different ADR proceedings, and the numerous legal sites in which they operate, "ADR" may have become too capacious a term to describe all that fits within its boundaries. However, for the purposes of this chapter the term "ADR" will refer to any mode of civil dispute resolution that exists outside the trial arena.

Economists are interested in ADR for two main reasons: first, from an ex post perspective, the manner in which disputes are resolved or decided in society affects the operation of the legal system and its cost-efficiency. Second, from an ex ante perspective, the manner in which rights are vindicated impacts primary behavior and investments in prospective dispute avoidance. The literature relating to the economic analysis of ADR can be roughly divided into two facets: one facet is dedicated to the interests of litigating parties to make use of ADR mechanisms. The second facet is directed at the social interest in ADR. Accordingly, this chapter will commence with identifying the conditions under which parties will be incentivized to enter into ADR proceedings, and then move on to examine the social welfare implications of ADR.¹

14.2 THE PARTIES' INCENTIVES TO TURN TO ADR

The incentives of parties to a civil dispute (or potential dispute) to agree to ADR proceedings stem from the assumption that ADR would increase their welfare by allowing a reduction in the transaction costs of resolving their dispute and/or in paving the way for an improvement in the quality of the outcome. In order to better define the increase in the welfare of the parties one needs, first, to identify the benchmark against which ADR

¹ Another related body of economic literature, which will not be discussed in this chapter, relates to the settlement process, not necessarily in the realm of ADR proceedings. For example, see Mnookin and Kornhauser (1979).

proceedings are assessed. The two primary alternatives to ADR, faced by the parties, are public adjudication in a court of law and direct negotiation. One body of research in the literature on economic analysis of ADR compares ADR with public adjudication. Another branch in the economic literature assesses ADR (specifically, mediation) against the backdrop of un-facilitated, direct, negotiation between the parties.²

Starting with the former: in his article, "Alternative Dispute Resolution: An Economic Analysis"³ Shavell discusses the conditions under which parties may have a heightened interest in ADR as compared to the trial alternative. In depicting these conditions and the private benefits of ADR, he draws a basic distinction between *ex post* ADR agreements (entered into after the rise of the dispute) and *ex ante* ADR agreements (employed before the rise of the dispute, typically at the contracting phase). Since party interests prior to the eruption of the dispute are not identical to post-dispute party interests, the implications of agreements to resort to ADR during these two stages may be fundamentally different. In addition, the range of viable contingencies faced by the parties, during each of these stages, may be different. Shavell demonstrates how the temporal distinctions and the cut-off point of dispute eruption affect the range of benefits that parties can gain from engaging in ADR agreements. Another distinction that needs to be drawn, when evaluating the private incentives to engage in ADR, relates to the distinction between the various types of ADR processes, most notably between binding ADR, such as arbitration, and non-binding ADR, such as mediation. In what follows I will survey the benefits parties can reap from ADR agreements and proceedings, incorporating all of these taxonomies into the discussion.

14.2.1 *Ex Post* ADR Agreements

After a dispute arises parties may agree to engage in an ADR proceeding, such as arbitration. Compared to the alternative of public adjudication, the market-based ADR proceedings may allow parties to economize on the costs and risks of trial. In addition to cutting the costs and risks of trial, ADR may also offer unique benefits to the disputing parties. These advantages are rooted in the fundamental differences between ADR and trial in court.

Thus, with respect to alleviating the risks and costs of trial: in the realm of ADR the parties are able exercise choice as to the identity of the adjudicator of their dispute, while a public judge is typically assigned. This allows them to opt for experts in the field of their dispute, and in doing so to decrease the investment of resources necessary to educate the adjudicator as to the subject matter or as to the norms implemented in the

² As claimed by Mnookin, normally, arbitration is compared with public adjudication while mediation is compared with unfacilitated negotiation. Of course, mediation also serves as an alternative to trial, while arbitration is also an alternative to direct negotiation. See Mnookin (1998). The dichotomy is rooted in the adjudicative nature of arbitration and in the non-binding nature of mediation, discussed in the text above.

³ Shavell (1995).

field. The decision of a higher-skilled arbitrator may also be more predictable, thereby decreasing the risks associated with the resolution of the dispute.

The decrease in costs associated with ADR proceedings stems not only from the control parties can employ over the identity of the adjudicator but also from the fact that in arbitration the parties govern the procedural framework of the proceeding, and can better tailor it to the characteristics of the dispute and to their personal preferences. Likewise with respect to the substantive norms that are applied—these too can assure a less time-consuming and resource-consuming proceeding for adjudicating the dispute.

In mediation the effective control the parties can exercise over the substantial contours of the dispute resolution outcome and the procedural framework is more pronounced—in light of the contractual basis of mediation outcomes and in light of its informal procedural traits. Mediation may, potentially, lower the risks and transaction costs associated with resolving the dispute even more dramatically.

In addition to economizing on the costs and risks of trial, ADR proceedings—whether arbitration or mediation—also offer the parties unique benefits: resorting to ADR proceedings allows parties to preserve confidentiality regarding the dispute and its resolution, widens the zone of possible agreements, allows parties to extract reputational benefits, and may pave the way for heightened *ex post* compliance.⁴

Hereto, I have compared the benefits parties derive from ADR vis-à-vis the trial option. In what follows, I will briefly survey the studies relating to the benefits parties derive from ADR as compared to the option of direct negotiation. Direct negotiation differs from trial and ADR proceedings in that it does not involve a third party. The parties enjoy maximal leeway to shape the outcome of their dispute to meet their mutual preferences, and are under no obligation to reach a principled result, according with pre-existing norms.⁵ In light of this extended ability to craft their own solution to the conflict under direct negotiation, what are the advantages that ADR proceedings offer?

Proponents of ADR claim that these proceedings may prove superior to direct negotiation both in terms of the ability to reach conflict resolution and in terms of the content of the resolution. These claims may seem rather intuitive with respect to arbitration: it is easy to imagine cases in which disputing parties may not be able to reach agreement regarding the ultimate resolution of their dispute, due to divergent expectations and assessments as to the merits of their cases⁶ but in which agreeing on the procedure by which the dispute will be adjudicated—such as the identity of the arbitrator, or the substantive and procedural frameworks of the process—may prove feasible (precisely because of these differences in the parties' subjective assessments).

Even where mediation is concerned the same may hold true: engaging in the process of facilitated negotiation can assist parties to reach a negotiated agreement in cases in which direct negotiations would lead to an impasse (as well as to reach a superior negotiated agreement, compared to the direct negotiation alternative, where the transaction

⁴ Mnookin (1998).
⁵ Mnookin (1998).
⁶ Landes (1971).

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ADR & Negotiation

Meditation
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informal procedural traits
lower the risks
transaction costs
ADR proceedings
unique benefits
confidentiality
widens the zone
reputational benefits
heightened *ex post* compliance
vis-à-vis
direct negotiation
third party
leeway
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pre-existing norms
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costs involved in direct negotiation would not necessarily prevent a negotiated agreement from being formed in the first place). Brown and Ayres⁷ demonstrate that mediators can mitigate adverse selection and moral hazard and create value in negotiations through sequential caucusing—by controlling the flow of private information between the parties (eliminating, translating, and creating it). Thus, adverse selection involves concealed pre-contractual information and moral hazard encompasses hidden post-contractual conduct. Both phenomena result from the parties' ability to hide information about themselves or their conduct, and both result in inefficiency. Adverse selection may lead to suboptimal results in negotiation when parties hide information about their assessments prior to reaching agreement. Moral hazard can create inefficiency when one or both parties engage in concealed post-contractual measures that reduce the joint gains from the interaction and deem coordination less feasible. The authors identify three ways in which sequential caucusing can effectively mitigate these informational problems: (1) by committing parties to end negotiations when private representations to the mediator indicate that there are no gains to be made from trade; (2) by committing parties to equally divide the gains from trade; and (3) by committing to send noisy translations of information disclosed during private caucuses. Moreover, as demonstrated by Mnookin,⁸ agency problems can also act as a barrier to reaching agreement via direct negotiation that mediation may help overcome. A neutral mediator may be able to facilitate settlement and improve negotiation outcome, in these circumstances, by getting the right people to the negotiation table and by exposing the host of underlying interests.⁹

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14.2.2 Ex ante ADR Agreements

Any mutual benefit that parties can reap through ex post ADR agreements can also be obtained through ex ante ADR arrangements. In addition, by contracting to resolve a potential dispute through resort to ADR before such a dispute arises, parties can enhance contingencies and enjoy additional advantages that cannot be obtained by means of post-dispute arrangements. Ex ante ADR agreements motivate changes in pre-dispute conduct, thereby increasing the joint benefits of the parties to the interaction.

First, ADR agreements at the contracting phase can also positively affect parties' primary behavior—inducing them to meet their contractual obligations and to comply with the substantive law through more accurate outcomes or other traits, and this is another source of mutual benefits. For instance, if arbitrators are more qualified to identify substandard performance than are courts, ex ante agreements to turn to arbitration in case a dispute as to performance arises will induce the parties to meet standard performance requirements. Greater accuracy in the resolution of the dispute, under

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⁷ Brown and Ayres (1994).
⁸ Mnookin (1993).
⁹ For discussion of the central (behavioral) barriers to ex post ADR agreements, see Barendrecht and de Vries (2005).

ADR, will create a greater incentive to fulfill the contractual obligations. In addition to these epistemic effects, *ex ante* agreements to engage in ADR can positively affect primary behavior through the prospective imposition of better-tailored substantive norms than are employed by the court.¹⁰ Second, *ex ante* ADR agreements can also positively shape the parties' procedural behavior *ex ante*—allowing them to make more informed decisions regarding investment in evidence gathering and preservation of information throughout the interaction. Third, *ex ante* ADR agreements may allow parties to overcome information or strategic barriers to reaching mutually beneficial ADR agreements post dispute, of the types discussed above.¹¹ Fourth, *ex ante* ADR agreements can also enhance the zone of possible agreements.¹² Fifth, *ex ante* ADR agreements can positively affect the incidence of disputes, inducing parties to refrain or engage in disputes to begin with. Naturally, the above-mentioned benefits can only be enjoyed against the background of pre-existing relationships between the parties, and even in those cases transaction costs may be high. In sum, there are a variety of ways in which ADR proceedings pave the way for more cost-effective and better dispute resolution outcomes for the parties involved.¹³

14.3 THE SOCIAL INTERESTS IN ADR AND IN THE CONTRACTUAL ORDERING OF DISPUTE RESOLUTION

The discussion hereto surveyed the reasons why parties may be incentivized to engage in ADR proceedings, and listed the potential benefits they may reap from resolving their disputes in this manner. Even assuming that ADR agreements accord with the mutual interests of the relevant parties, they may still conflict with the public interest. The following discussion will be dedicated to a normative evaluation of ADR from a social welfare perspective. It will start by examining the social benefits that can be attributed to ADR, and then turn to discuss the social costs entailed in the privatization of dispute resolution by way of resort to these processes.

The normative support for ADR is anchored in considerations of efficiency, underlying the enforcement of contracts, more generally.¹⁴ The efficiency attributed to ADR agreements is premised upon the increase in the welfare of the parties, as can be deduced from their very choice to enter the ADR agreement. In addition to the inherent social value in improving the welfare of the parties, in most cases the common interest of the

¹⁰ See Shavell (1995: 6).

¹¹ Kapeliuk and Klement (2013).

¹² Kapeliuk and Klement (2013).

¹³ Shavell addresses the incentive effects of adding ADR proceedings to the parties' array of choices, using the standard model of civil litigation. See Shavell (1995).

¹⁴ Paulson (2013).

parties also aligns with the social utility function: thus, for example, the common interest of the parties to economize on the costs of deciding their dispute is consistent with the public interest in the cost-effective resolution of conflicts in society.

However, the fact that the social interest and the interests of the parties may, generally, go hand in hand does not imply a perfect alignment between these interests: litigating parties do not fully bear the costs of trial and externalize onto the taxpayer the costs associated with judicial salaries, with juror time, and with infrastructure expenditures. Since the costs of trial are subsidized, the parties save less by resorting to ADR than does society at large, and may therefore face suboptimal incentives to avert trial.¹⁵ The divergence between the social interest and the interest of the parties is rooted not only in the partial externalization of costs of trial, but also in the mirror-image phenomenon of non-internalization by the parties of the social benefits of conducting trials in public courts. The following section will be devoted to further elaboration of this latter concern, regarding the undersupply of the public goods, associated with trials, in the ADR realm.

14.4 THE ADVERSE SOCIAL EFFECTS OF ADR

14.4.1 Undersupply of the Public Goods Associated with Adjudication

Adjudication of civil disputes bears prominent private features in that the resolution of a dispute generates private utility to the litigating parties. But alongside this private utility are also public goods associated with channeling a dispute to court, which may be jeopardized when ADR is employed.

A central public good supplied by the judicial process is the legal precedent.¹⁶ Salient examples of judicial precedents for regulating social behavior include the sexual harassment precedents and the development in courts of the prohibitions in the realm of domestic violence.¹⁷ Legal precedents feature the defining public good characteristic of nonrivalry: from the moment a body of precedents is formed, an unlimited number of individuals can make use of this legal corpus and derive from it the entire diversity of attendant utilities. The marginal cost of supplying the legal precedent to an additional consumer is nearly zero. The fact that one agent shapes her behavior in accordance with a legal precedent does not detract, in itself, from the ability of others to act similarly. In addition to the defining feature of nonrivalry, the public good quality of in-excludability is also present in the legal precedent framework: it is not feasible to grant copyright in

¹⁵ Shavell (1999).

¹⁶ Landes and Posner (1979).

¹⁷ Resnik (2006).

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a legal precedent or to preclude someone without such property rights to act in accordance with its prescriptions.¹⁸

In light of its public good nature, the legal precedent will be undersupplied in the market realm of ADR. Both the parties to the dispute and private arbitrators are not expected to internalize the social benefits resulting from precedent setting in their utility functions, and may thereby refrain from investing the socially optimal level of resources for the development of the law. Instead of making uncompensated contributions to future parties through norm generation, disputing parties will be incentivized to invest in the resolution of their own dispute and to freeride on the lawmaking efforts of others. Similarly, private arbitrators will also lack incentives to produce precedents. As claimed by Landes and Posner in their well-known article "Adjudication as a Private Good,"¹⁹ because it is not feasible to establish property rights in precedents, private arbitrators will not be sufficiently incentivized to explain the results of their cases. Moreover, claim Landes and Posner, private arbitrators may purposely avoid explaining their results because the demand for their services would be reduced by rules that decrease the incidence of disputes, and because maintaining ambiguity would allow them to attract a broader spectrum of future clientele.²⁰ Optimal development of the law will be possible, consequently, only by way of public supply of legal norms, and based on non-market motivations and incentives, which exist in the framework of the public adjudication system.²¹

Even in cases in which the legal issues at stake are negligible, and where the trial essentially revolves around ascertaining the factual claims, adjudication plays a central public role. For, similar to the case of the legal precedent, judicial fact-finding is also a public good, and plays a role in succeeding litigation. The trial serves as a public epistemological sphere—as a means of conveying information to the public. For example, returning to the sexual harassment example, the judicial finding of liability can caution the public against the particular defendant. ADR proceedings tend to restrict access to information: the ability to conceal matters underlying the factual basis for liability in nondisclosure agreements tends to be a significant part of the mutual gains parties associate with arbitration. Non-binding ADR proceedings, such as mediation, are not

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¹⁸ In-excludability manifests in the legal precedent in both its aspects: not only is there no practical way of withholding the fruits of the precedent from someone who did not participate in supplying it, but the economic feasibility of so doing is doubtful. The power of the legal precedent is anchored in its collective application. Any attempt to limit the consumption of the legal precedent solely to those who have participated in its supply process would be directly at odds with the very essence of the legal precedent as a tool for minimizing transaction costs and guiding social behavior.

¹⁹ Landes and Posner (1979).

²⁰ Landes and Posner (1979: 238).

²¹ Note, the delegalization and undersupply of legal norms in ADR is a widespread assumption, shared by both critics and advocates of the ADR movement. One of the most well-known contenders in this regard is Owen Fiss, who claimed in his famous paper "Against Settlement," that as ADR expands to include significant portions of the civil disputes landscape, legal norms will be undersupplied and the adjudicator will have at its disposal an insufficient pool of cases from which to craft rules and guide human behavior. See Fiss (1984).

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typically premised on fact-finding at all, and therefore also compromise the epistemic functions mentioned above. The result of resort to ADR proceedings—binding and non-binding—may, therefore, be the undersupply of information to the public.

To conclude, the formation of legal precedents and the supply of information to the public, along with other public goods underlying adjudication,²² may be undersupplied in the settlement arena: disputing parties and private arbitrators will fail to internalize this range of social utilities in their utility functions. Due to freeriding tendencies, each individual in the market will rely on others to supply rules of conduct and information—and will not be willing to bear the costs of supplying these public components of the judicial process. The outcome will be a suboptimal supply of these public goods in the ADR realm.

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14.4.2 Network Industry Failures

Another set of problems associated with ADR and with the privatization of adjudication is related to network characteristics. The term "network industry" refers to the wide range of industries and goods for which there are demand-side benefits to scale: the utility that the lone consumer derives from consuming a network good positively correlates with the number of additional consumers of the good (and in some instances also the extent of their overall consumption). The demand for a network good is a function both of the price of the good and the size of the network. As a rough generalization, network industries can be categorized as those industries whose goal is to serve as a platform for interaction between consumers and which feature characteristics that enable their consumers to share information, electronic signals, and standards. Legal and adjudicative systems constitute a network industry— they are platforms for coordination and interaction between individuals. The legal system's role of guiding social behavior and deciding disputes is contingent on consumption of these services by others. The greater the scope of the legal network and its number of members, the more far-reaching the potential legal interactions between those members will be.²³

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The competition between networks features characteristics that qualitatively differ from competition in the case of standard goods. These competition characteristics raise two types of difficulties in supplying the network goods, such as adjudication of disputes and legal norms, within the structure of a decentralized market. The first problem touches on over-divergence (under-standardization): each consumer who joins the network increases the utility derived by the rest of the individuals consuming the network good or service, in that he expands its effective size. His actual consumption generates positive utility for the other consumers of the network. This social utility, however, is extrinsic to his own utility function. The ensuing outcome is likely to be the

²² Additional public goods associated with adjudication include enhancement of court legitimacy and deterrence. See Alschuler (1986).

²³ Gillette (1998, 1999).

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establishment of legal and adjudicative networks whose scope is suboptimal. Put differently, privatizing the adjudicative system through ADR paves the way for the emergence of a multitude of dispute resolution systems within a given geopolitical unit, and the accelerated development of differential legal rules—above and beyond the social optimum. In the words of Landes and Posner, a multiplicity of arbitrators are likely to lead to “a bewildering profusion of precedents and no obvious method of harmonizing them. An individual contemplating some activity will have difficulty discovering its legal consequences because they will depend on who decides any dispute arising out of the activity.”²⁴

Produit de precedents a definir will de precedents

The second concern relates to over-convergence (legal lock-in); the efficiency of the private legal system is not a matter only of whether or not it will be possible to standardize and to institute uniform norms, rather, it is a broader issue that relates also to the content of the uniform norms that will be established, if at all. In a decentralized market structure for adjudication, even if the market forces lead to standardization and to the application of uniform norms, there is still a danger of the legal network getting locked into a suboptimal norm or standard. Due to the network characteristics, private arbitrators may refrain from shifting to new and preferable legal regimes, since unilateral detachment from the existing legal network would amount to a forfeiting of the private utility inherent to belonging to the network. In a decentralized structure, the private law suppliers and consumers will likely fail to internalize the social utility entailed in the adoption of efficient legal rules and may prefer instead less efficient rules, so as not to exit the “legal network.” Due to the private utility of belonging to the prevailing legal network and the difficulty in consolidating a critical mass of consumers who will be willing to transfer to an alternative legal regime, a negative incentive arises for legislative enterprise. This faulty incentive system is likely to lead to legal stagnation—to collective adherence to the inferior legal regime and resistance to a coordinated shift from the status quo to the more efficient legal standard. Accordingly, the state system might actually ensure a richer platform for legal development and is likely to generate, at the end of the day, legal rules that do not stagnate, since the centralization inherent to the state law enables a coordinated move to preferable legal standards.

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14.5 CONCLUSION

ADR may result in market failures: undersupply of the public goods associated with trial and network failures. In order to make a definitive statement with regard to the supply of the dispute resolution function in society, however, it is not sufficient to merely point to the existence of such market failures. Rather, it is necessary to compare between the flaws entailed in private supply of these services and the problems that arise in the framework of its public supply, via state courts.

²⁴ Landes and Posner (1979: 239).

It cannot be a priori assumed that public adjudication systems necessarily function more efficiently in situations in which the private ADR market fails, or that the state can fix the failures at zero cost. Thus, inherent to the state adjudicative system are the same failures of under-incentive to become efficient that characterize all public-sector bodies. Under the public adjudication model, the incentive system is not necessarily strong enough to drive judges to adjudicate efficiently or to formulate high-quality rulings, as their salaries and professional advancement are not directly dependent on the degree of utility generated by the adjudicative products they generate. Despite the fact that judges are subject to public and other types of scrutiny, they are not directly subject to market forces, and may be under-motivated to adjudicate efficiently. Non-exposure to market forces impairs not only the incentive structure to adjudicate efficiently but also the effective ability to do so. The mechanism for the transfer of information between public judges and the state's citizenry is immeasurably more ambiguous and limited than the signals provided by market forces and the pricing mechanism in the private sector. The dispersed character of the information, necessary for formulating efficient precedents and adjudicative procedures, may preclude judges from reaching these results outside of the market context. In other words, an evaluation of ADR and of the proper social stance towards it needs to be carried out as a comparison between ADR and the public adjudicative system, after taking into account the potential virtues and vices of both systems.

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