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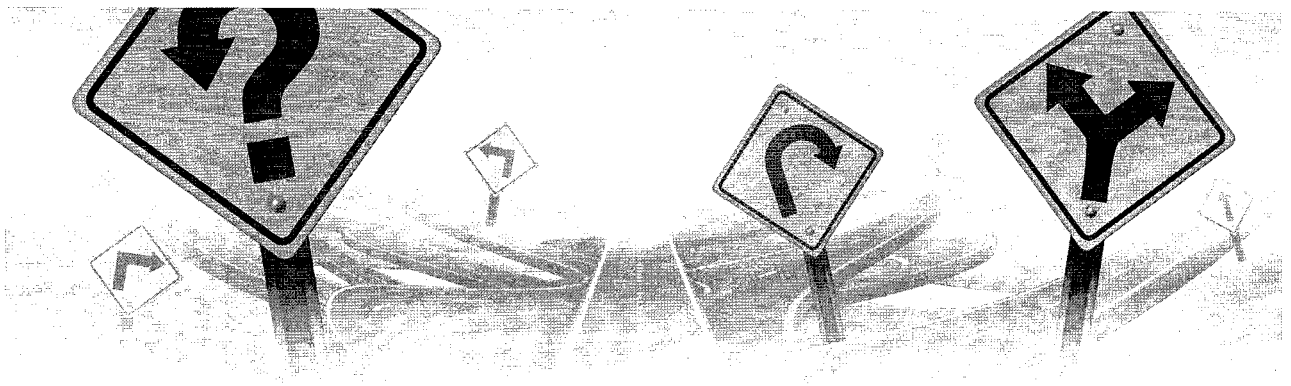
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“Live Free” or Regulate?

Considering A, B and their Dispute Resolution Clause Regarding Blackacre

By Jean R. Sternlight

A and B enter into a dispute resolution agreement pertaining to Blackacre, that parcel of land so often the subject of law school discussions. Should courts or regulators enforce the clause as A and B have written it, void part of their agreement or add more requirements? Absent regulation, is there reason to believe this agreement would be just?

The dispute resolution field is split on these issues. While many of us are attracted to the free-spirit or even libertarian idea that disputants should design processes that best suit their needs, others fear that unregulated dispute resolution processes may lead to unjust results. For example, should A and B be permitted to use any neutral they wish, even if the neutral lacks any commonly accepted credentials or experience with a respected dispute resolution group? (Such lack of credentialing is the norm in many parts of the United States.) Should A and B be permitted to use a process some disapprove of, such as so-called evaluative mediation or party-appointed non-neutral arbitration? Should the neutral A and B selected be required to disclose information not requested by them? Should B be allowed to use a form contract to require A to agree to pre-dispute binding arbitration?

As we consider these issues, we might want to think of the dispute resolution field as a marketplace,¹ one in which A and B may be viewed as shoppers choosing among various dispute resolution products and services. A and B presumably will take into account their own preferences, the costs of the alternative processes (e.g. in money, time and emotion) and the prospective benefits of those processes (e.g. in terms of likely result, money, reputation, emotion, future relationships and furtherance

of justice). In this model, the “sellers” of mediation, arbitration and even perhaps judicial dispute resolution services compete to be selected by disputants.² Although the government does not actually sell dispute resolution services, except through a heavily subsidized filing fee, at least some court administrators and judges aspire to provide services that will be attractive to disputants.

Those who believe strongly in the benefits of free markets may suggest that regulation is not needed, because A and B will knowingly select a particular form of mediation, arbitration or other process that meets their needs and reject those forms of dispute resolution that they perceive to be too costly, slow, biased or unfair. Such free-market advocates claim that competition between sellers of dispute resolution

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services will ensure that prices fall to a minimum and that the interests of A and B are well served.

The marketplace analogy, however, is imperfect. First, one purported “seller,” the government, may actually prefer that disputants resolve their disputes privately so that the government need not subsidize litigation.³ Second, instead of a single buyer choosing a dispute resolution process, this “market” features multiple disputants who may have different preferences but must agree on a common product. Yet despite these limits, the marketplace analogy is still useful as we contemplate whether and when to regulate A’s and B’s choice of dispute resolution processes. While traditional economists are often seen as advocates of limited regulation, relying instead on Adam Smith’s “invisible hand” to ensure fairness and prosperity, the field of economics can also help us understand when regulation is appropriate due to the absence of perfect competition.⁴ Adding psychology to economics, as is done in the new field of behavioral economics,⁵ provides even more helpful insights. We will also see that the need for regulation depends upon the identity and circumstances of the mysterious A and B.

Limitations of Free Markets Justify Regulation

Lack of Perfect Information

Perfect competition exists only when buyers possess perfect or complete information about the available products and services, so they can choose products they want and avoid products they do not. Yet we know that consumers of dispute resolution services may not be so well informed. If A is Archie Homeowner entering into a small-print form contract with Bezillion Bank, we cannot assume that Archie possesses or can acquire anything close to complete information. Archie may not know what mediation and arbitration are nor understand how they relate to litigation. He may not realize that in agreeing to binding arbitration, he is relinquishing any right to a jury trial or, depending on the language of the clause, likely giving up any right he might have had to participate in a class action. He may not know that a dispute resolution provider has an improperly close relationship with some of the disputants for whom the practitioner supposedly provides neutral dispute resolution services. In these kinds of circumstances, we cannot count on perfect competition to protect Archie’s interests and may instead need to prohibit or regulate such clauses.

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On the other hand, if A and B are the Allied Renovation Company and Builder Inc., two large companies, we can reasonably assume they are more knowledgeable about the nature of dispute resolution. We can better trust such parties to knowingly select a particular form of mediation, arbitration or other process that meets their need and to reject those forms of dispute resolution that they perceive to be too costly, slow, biased or unfair. Thus, the case for regulation is weaker.

Yet even sophisticated users of dispute resolution services may not have perfect information. They may not understand how neutrals are selected, how discovery or appeals are handled in arbitration or how confidentiality

plays out in mediation or arbitration. Moreover, even knowledgeable consumers of dispute resolution services are also affected by cognitive frameworks that may discourage them from seeking out all the information they might need. For example, because we tend to be overly optimistic about the future, we will typically discount the

likelihood that a dispute will occur at all, and therefore often pay inadequate attention to the fact that we may end up involved in one.⁶

In sum, the case for regulation is strongest when the parties to a dispute resolution agreement are most likely to lack perfect information. In such cases, we may want to regulate to provide better access to information or, when that is not likely to succeed, to directly regulate the quality of dispute resolution processes.

Impacts of Parties’ Dispute Resolution Clauses on Non-parties

The unregulated market can work perfectly only when the choices of buyers and sellers exclusively impact those buyers and sellers. When, by contrast, A’s and B’s dispute resolution choices may positively or negatively impact other parties indirectly, regulation may be needed. For example, if Archie Homeowner and Builder Inc. choose to litigate the issue of whether the material used in constructing Blackacre causes cancer, their choice to litigate may provide a public good. If the dispute goes to trial,



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and especially if it is appealed, it will create precedent, and the availability of this precedent may help others resolve their similar disputes more efficiently.

Resolutions reached in mediation or arbitration can sometimes also benefit non-parties. For example, Archie Homeowner and Bezillion Bank might settle a dispute over Archie's mortgage in mediation, and this settlement might require or inspire the bank or even other banks to change their loan practices. Or an arbitrator's decision to require Archie Tenant to vacate the premises of Blackacre might greatly improve the morale of neighbors who had been putting up with a prostitution ring Archie had been running out of his home.

Just as private parties' resolution of their disputes can benefit non-parties, so can private parties' use of dispute resolution processes impose burdens on non-parties. If Archie Homeowner is raising pigs on Blackacre, an arbitration clause that results in a decision allowing him to continue that operation will have negative olfactory implications for the entire area. Similarly, if Builder Inc. prevents Archie Homeowner from bringing a class action claim regarding the lead paint used in Blackacre and other properties, this will potentially harm not only Archie but other homeowners and tenants who might have benefitted from that claim. In fact, the Texas Supreme Court found that the adult child of a home purchaser could not bring a personal injury claim against the builder because her father had entered into an arbitration clause with that builder.⁷

Yet the unregulated free market does not take account of additional costs or benefits imposed on non-parties. To the extent we believe that the dispute resolution agreements between A and B pertaining to Blackacre may implicate the interests of non-parties, we have a societal interest in regulating those agreements, and we may want to prohibit parties from entering into dispute resolution agreements that would deprive the public of important precedents. Or we may want to proscribe certain kinds of dispute resolution agreements that we think might be harmful to society – because, for example, they eliminate the option of class actions.

Inequality of Initial Resources

Even a perfectly competitive market cannot ameliorate an initial unequal distribution of resources. If Archie Homeowner believes that Bezillion Bank committed fraud with respect to the mortgage for Blackacre, Archie may not be able to afford to bring

that claim, whether in litigation, arbitration or even in mediation. Should society decide that allowing Archie or others to bring such a claim is desirable, it may need to step in to regulate or subsidize the dispute resolution process. Unregulated, dispute resolution processes will often help the rich get richer while the poor get poorer. Consider for example *Bernal v. Burnett*, in which a number of students in online, for-profit technical schools and colleges sought to litigate fraud and consumer protection claims against those schools, only to be told that an arbitration clause precluded them from joining together in a class action.⁸ As Marc Galanter noted many years ago, the more powerful “repeat players” are well positioned to do better than “single player” disputants in any context.⁹ Thus we may want to prevent wealthy companies or individuals from using dispute resolution clauses to take advantage of less wealthy members of society by eliminating jury trials, class actions, or punitive or compensatory damages. We might even regulate dispute resolution clauses to try to begin to equalize resources by, for example, requiring companies to submit to binding arbitration when consumers select arbitration.¹⁰

Beware the Race to the Bottom

If consumers of dispute resolution services cannot protect themselves, do we necessarily need to turn to government regulation for protection? Some will urge that we should trust dispute resolution providers to do the right thing, because they are good and fair and because they are interested in protecting their own reputations.

Yet economics teaches that profit-driven providers of dispute resolution services will always at least be tempted to cater to powerful repeat players, to the detriment of less knowledgeable consumers. Though some providers may be reputable and ethical, companies may be

tempted to retain other, less reputable ones. If the market cannot be relied upon to regulate itself and if the government does not step in, there is nothing to prevent this race to the bottom. Had the Minnesota attorney general not sued the National Arbitration Forum for fraud and deceptive practices, the NAF would likely still be purporting to provide neutral services to debt collectors with whom it was intertwined.¹¹

When Regulation is Least Needed

An economic and psychological analysis of the market for dispute resolution also provides insights for when

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regulation is *least* needed. Sometimes the features of a particular dispute make it reasonably likely that the market will effectively regulate itself and ensure that any dispute resolution clause entered into will be fair. Specifically, when two or more sophisticated users of dispute resolution services, with fairly equal resources, knowingly want to enter into an agreement that will have little impact on others, there is little need to fear market imperfections and thus little need to prevent them from entering that agreement. Thus, if Allied Renovation Company and Builder Inc. want to enter a dispute resolution agreement regarding problems that might occur during the renovation of Blackacre, we should not worry much about issues such as the credentials of the neutrals they select or the precise form of the dispute resolution process they choose.

Conclusion

Understanding some of the purposes of regulation – to protect people who lack sufficient information to protect themselves; to protect the interests of non-parties; and, at times, to redistribute resources that are distributed inequitably – can help us to work toward better and more just regulation of the dispute resolution field. These same factors can help us decide *what* regulation is needed. Not all regulations are good or sensible, just as not all regulation is bad or unnecessary. Rather, by thinking about the underlying economics and psychology and by considering the nature of the specific parties and issues involved in a likely dispute, we can come up with better solutions for when and how dispute resolution should be regulated. ♦

Endnotes

1 See generally Stephen J. Ware, *Is Adjudication a Public Good?: "Overcrowded Courts" and the Private-Sector Alternative of Arbitration*, 14 CARDOZO J. CONFLICT RESOL. (forthcoming May 2013), available at <http://ssrn.com/abstract=2178166> (exploring extent to which it is appropriate to subsidize use of court system).

2 See William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUDS. 235 (1979).

3 Paul D. Carrington, *Adjudication as a Private Good: A Comment*, 8 J. LEGAL STUDS. 303 (1979).

4 This article does not provide a comprehensive list of all of the conditions for a free market to be effective. Other important limits to perfect competition include market power (one side dictates terms), transaction costs (buyers' and sellers' costs to exchanging goods and services), and non-homogenous products and services (lots of variation among mediation, arbitration and litigation).

5 See, e.g., BEHAVIORAL LAW AND ECONOMICS (Cass R. Sunstein ed., 2000).

6 See Russell Korobkin, *Bounded Rationality, Standard Form Contracts and Unconscionability*, 70 U. CHI. L. REV. 1203 (2003). See generally JENNIFER K. ROBBENOLT & JEAN R. STERNLIGHT, *PSYCHOLOGY FOR LAWYERS: UNDERSTANDING THE HUMAN FACTORS IN NEGOTIATION, LITIGATION, AND DECISION MAKING* 68-71 (2012).

7 *In re Weekley Homes, L.P.*, 180 S.W.3d 127 (Tex. 2005) (applying estoppel principles).

8 *Bernal v. Burnett*, 793 F. Supp. 2d 1280 (D. Colo. 2011).

9 Marc Galanter, *Why the 'Haves' Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 1 (1974).

10 See Jean R. Sternlight, *In Defense of Mandatory Arbitration (if Imposed on the Company)*, 8 NEV. L.J. 82 (2007).

11 See Complaint, *Minnesota v. National Arbitration Forum, Inc.*, (D. Minn. July 14, 2009), available at <http://www.ag.state.mn.us/PDF/PressReleases/SignedFiledComplaintArbitrationCompany.pdf>.

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