

Unbundling Procedure

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Bundling, or the package sale of two or more goods or services, is “ubiquitous.”¹ Consider, for example, gift baskets, cable service packages, and cars sold with standard options.² This widespread bundling suggests that firms and customers both benefit from packaged products and services.³ At the same time, however, recent technological innovation and legal change have resulted in an increasing unbundling of previously packaged products. Phone companies provide long distance calling plans separately from local phone service.⁴ Airlines charge separately for air travel and baggage handling.⁵ Music companies sell songs individually instead of in albums.⁶ Television programs are available a la carte.⁷ Economists and others debate the implications of unbundling for consumers and society,⁸ but that unbundling is occurring is beyond dispute.

Like other sellers, courts and arbitration institutions provide bundles of services to their customers — in this case, bundles of dispute resolution procedures to the parties to a dispute.

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¹ See generally Bruce Kobayashi, *Does Economics Provide a Reliable Guide to Regulating Commodity Bundling by Firms? A Survey on the Economic Literature on Bundling*, 1 J. OF COMPETITION L. & ECON. 707, 707 (Dec. 2005).

² For other examples, see *id.* at 707 n.2.

³ Bruce H. Kobayashi, *Two Tales of Bundling: Implications for the Application of Antitrust Law to Bundled Discounts*, in ANTITRUST POLICY & VERTICAL RESTRAINTS 10, 10-12 (Robert W. Hahn ed. 2006). Kobayashi also describes potential price discrimination and anti-competitive uses of bundling. *Id.* at 13-22.

⁴ Gregory S. Crawford & Ali Yurukoglu, *The Welfare Effects of Bundling in Multichannel Television Markets*, 102 Am. Econ. Rev. 643 (2012).

⁵ Hans O. Schumann & Harmeet Singh, *The De-Bundling of U.S. Airline Bag Fees & Fares: An Exploratory Study*, 13 J. ACAD. OF BUS. & ECON. 91 (2013).

⁶ Anita Elberse, *Bye Bye Bundles: The Unbundling of Music in Digital Channels*, 74 J. MARKETING 107 (2010).

⁷ Gregory S. Crawford & Ali Yurukoglu, *The Welfare Effects of Bundling in Multichannel Television Markets*, 102 AM. ECON. REV. 643 (2012).

⁸ See, e.g., Guy A. Rub, *Contracting around Copyright: The Uneasy Case for Unbundling of Rights in Creative Works*, 78 U. Chi. L. Rev. 257 (2011); Gad Allon et al., *Would the Social Planner Let Bags Fly Free?* (Aug. 30, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1919807; Marty Lariviere, *Are Baggage Fees Good for Society?*, THE OPERATIONS ROOM (Aug. 31, 2011), available at <http://operationsroom.wordpress.com/2011/08/31/are-baggage-fees-good-for-society/>.

Courts provide the default bundle,⁹ but parties can opt instead for arbitral procedural bundles that vary according to the applicable arbitration rules chosen by the parties.¹⁰ The choice between courts and arbitration depends on a number of factors. Courts provide government-appointed decision makers (i.e., judges), typically more discovery than arbitration, and an appeals process.¹¹ In contrast, arbitration provides party-selected decision makers (i.e., arbitrators), less discovery than court, often a more expedited final determination, and only a limited appeals process.¹² Litigation is open to the public (with exceptions) and subsidized by the government; arbitration is typically confidential and is paid for by the parties.¹³ Class actions may be available in court but not arbitration (at least if parties include a class arbitration waiver with their arbitration clause).¹⁴

There is a rich literature on party choice between courts and arbitration.¹⁵ Within this literature, scholars traditionally assume that sophisticated parties make a single choice between court and arbitration based on the bundle of dispute resolution services that seems most appealing *ex ante*.¹⁶ As with the literature on bundling generally, however, legal scholars increasingly are focusing their attention on the unbundling of court and arbitral procedures — that is, the ability of parties to contract for a *la carte* or customized dispute resolution procedures in court and arbitration.¹⁷ While such unbundling is common *ex post*, i.e., after a dispute

⁹ STEPHEN J. WARE, *ALTERNATIVE DISPUTE RESOLUTION* § 1.5 (2d ed. 2007).

¹⁰ For examples of off-the-rack procedural rules, see Am. Arb. Ass'n, *Commercial Arbitration Rules* (Oct. 1, 2013); JAMS *Employment Arbitration Rules & Procedures* (July 15, 2009); Int'l Chamber of Commerce, *Rules of Arbitration* (Jan. 1, 2012).

¹¹ See, e.g., Stephen A. Broome, *An Unconscionable Application of the Unconscionability Doctrine: How the California Courts are Circumventing the Federal Arbitration Act*, 3 HASTINGS BUS. L.J. 39 (2006); Kevin M. Lemley, *I'll Make Him an Offer He Can't Refuse: A Proposed Model for Alternative Dispute Resolution*, 37 AKRON L. REV. 287, 312 (2004).

¹² See, e.g., Christopher R. Drahozal & Quentin R. Wittrock, *Franchising, Arbitration, and the Future of the Class Action*, 3 ENTREPRENEURIAL BUS. L.J. 276, 300 (2009) (explaining that “[a] party including an arbitration clause in its contract is specifying a bundle of characteristics of the dispute resolution process”); Obiajulu Charles Okuh, *Reasons to Arbitrate Disputes Between Multinational Companies and Third-Country National Employees*, DISP. RESOL. J., May-July 2011, at 64.

¹³ Amy J. Schmitz, *Untangling the Privacy Paradox in Arbitration*, 54 U. KAN. L. REV. 1211, 1222-26 (2006); Stephen J. Ware, *The Case for Enforcing Adhesive Arbitration Agreements — with Particular Consideration of Class Actions and Arbitration Fees*, 5 J. AM. ARB. 251 (2006).

¹⁴ Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 377 (2005).

¹⁵ E.g., Bruce L. Benson, *To Arbitrate or To Litigate: That is the Question*, 8 EUR. J.L. & ECON. 91 (1999); Christopher R. Drahozal & Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. LEGAL STUD. 549 (2003); Keith N. Hylton, *Agreements to Waive or to Arbitrate Legal Claims: An Economic Analysis*, 8 SUP. CT. ECON. REV. 209 (2000); William A. Landes & Richard W. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979); Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1 (1995); see also GARY B. BORN, *INTERNATIONAL COMMERCIAL ARBITRATION* 71-90 (2009); CHRISTIAN BÜHRING-UHLE, *ARBITRATION AND MEDIATION IN INTERNATIONAL BUSINESS* 127-156 (1996); Christopher R. Drahozal & Stephen J. Ware, *Why Do Businesses Use (and Not Use) Arbitration Clauses?*, 25 OHIO ST. J. ON DISP. RESOL. 433 (2010).

¹⁶ See *infra* text accompanying note 28.

¹⁷ E.g., Robert G. Bone, *Party Rulemaking: Making Procedural Rules Through Party Choice*, 90 TEX. L. REV. 1328 (2012); Kevin E. Davis & Helen Hershkoff, *Contracting for Procedure*, 53 WM. & MARY L. REV. 507 (2011); Jamie Dodge, *The Limits of Procedural Private Ordering*, 97 VA. L. REV. 723 (2011); Daphna Kapeliuk & Alon Klement, *Changing the Litigation Game: An Ex Ante Perspective on Contractualized Procedures*, 91 TEX. L. REV. 1475 (2013); Michael L. Moffitt, *Customized Litigation: The Case for Making Civil Procedure Negotiable*, 75 GEO.

arises,¹⁸ most of the scholarly attention has focused on ex ante unbundling of procedures. Unfortunately, this burgeoning theoretical literature faces a difficult empirical reality: the available empirical evidence reveals surprisingly little use of customized procedural rules in contracts between sophisticated parties.¹⁹ Parties only rarely agree to unbundle dispute resolution procedures ex ante.

In this article, we argue that ex ante procedural unbundling does occur, but through unbundling by claim and remedy rather than through a la carte choice of individual procedures. Claim and remedy unbundling has been ignored by procedural scholars, but it plays a vital role in contractual customization of dispute resolution. Specifically, parties that agree to arbitration clauses commonly exclude (or carve out) certain claims or remedies from their arbitration clause,²⁰ and parties that plan to take most disputes to court sometimes provide for arbitration to resolve particular matters. In separate studies, we have found considerable evidence that these forms of customization are common. O’Hara O’Connor et al. found “strong evidence” of parties “carving out certain types of litigable claims from otherwise broad agreements to arbitrate” in the CEO employment contracts they studied.²¹ Likewise, Drahozal and Wittrock found frequent use of carve-outs in arbitration clauses in franchise agreements.²² Less commonly according to the CEO employment data, parties will agree to litigate future disputes as a matter of default but then provide that certain specific disputes will be settled through arbitration. In these latter situations, the parties “carve in” particular matters to arbitration.

WASH. L. REV. 461 (2007); Henry Noyes, *If You (Re)Build It, They Will Come: Contracts to Remake the Rules of Litigation in Arbitration’s Image*, 30 HARV. J.L. & PUB. POL’Y 579 (2007); Colter L. Paulson, *Evaluating Contracts for Customized Litigation by the Norms Underlying Civil Procedure*, 45 ARIZ. ST. L.J. 471 (2013); Robert J. Rhee, *Toward Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514 (2009); Robert G. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006); Elizabeth Thornburg, *Designer Trials*, 2006 J. DISP. RESOL. 181.

¹⁸ See, e.g., Judith Resnik, *Procedure as Contract*, 80 NOTRE DAME L. REV. 593 (2003); Moffitt, *supra* note 17, at 495-96. In this paper we focus primarily on ex ante unbundling via the use of carve-outs from arbitration, for two reasons. First, ex ante carve-outs are more easily and more reliably studied than are ex post carve-outs. Second, where drafting costs can be overcome, ex ante customization likely is more frequent than ex post customization, at least in the context of arbitration. As several scholars have noted, ex post the parties’ interests likely diverge in ways that make agreement over large matters difficult. See, e.g., Samuel Estreicher, *Saturns for Rickshaws: The Stakes in the Debate Over Pre-dispute Employment Arbitration Agreements*, 16 OHIO ST. J. ON DISP. RESOL. 559, 567-68 (2001); Christopher R. Drahozal, “Unfair” Arbitration Clauses, 2001 U. ILL. L. REV. 695, 746-78; Scott Baker, *A Risk-Based Approach to Mandatory Arbitration*, 83 OR. L. REV. 861, 895-96 (2004). Although we focus on studies of ex ante customization, the possibility of limited ex post customization could cause parties to avoid the drafting costs of ex ante procedural customization, a topic we take up briefly in Part I. Finally, we focus on carve-outs rather than carve-ins because they appear to be much more commonly incorporated into party agreements. In the contracts we studied, evidence of carve-ins was much more isolated.

¹⁹ David A. Hoffman, *Whither Bespoke Procedure?*, 2014 U. ILL. L. REV. ____ (manuscript at 44) (“There is precious little evidence that parties are routinely, or even rarely, attempting to tailor public procedure [i.e., procedures in court] to their own ends.”); Erin O’Hara O’Connor, Kenneth J. Martin, and Randall S. Thomas, *Customizing Employment Arbitration*, 98 IOWA L. REV. 133, 137 (2012) (“[D]espite the robust academic literature on the subject, real-world customization is largely absent, although we find some evidence that it is slowly increasing over time.”).

²⁰ Even outside the context of customized procedure, carve-outs have received relatively little discussion in the academic literature. For exceptions, see Christopher R. Drahozal, *Nonmutual Agreements to Arbitrate*, 27 J. CORP. L. 537, 552-55 (2002); Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. DISP. RESOL. 89, 98-100.

²¹ O’Hara O’Connor et al., *supra* note 19, at 137.

²² Christopher R. Drahozal & Quentin R. Wittrock, *Is There a Flight from Arbitration?*, 37 HOFSTRA L. REV. 71, 113-15 (2008).

Carve-outs and carve-ins are mechanisms by which parties choose between court and arbitral bundles of procedures on a claim-by-claim or remedy-by-remedy basis. By using carve-outs and carve-ins, parties are able to obtain a more carefully calibrated unbundling of procedure than would be provided by an arbitration clause or forum-selection clause alone, but at a much lower overall cost than they would incur by contracting for individual procedures. What often results is a sort of middle ground for bundling of procedural rules: parties choose among pre-set bundles of dispute resolution services, but unbundle the circumstances where any given dispute resolution bundle will be used. The phenomenon is common and widespread, observed with varying frequency across a number of different contracting contexts, and thus is deserving of more careful consideration.

This article undertakes a comprehensive theoretical and empirical analysis of procedural unbundling by use of carve-ins and carve-outs.²³ Part I provides an informal model of decision making regarding the choice between court and arbitral procedural bundles as well as the unbundling of those procedures by use of carve-outs and individualized customization. Under the model, choices regarding dispute resolution forum and possible unbundling are a function of deterrence benefits, dispute resolution costs, drafting (or specification) costs, and bifurcation costs (which result from the possibility that a dispute between the parties might need to be resolved in two different forums). The model sheds light on why some but not all parties will opt for carve-outs or carve-ins, and why a-la-carte customized procedure could prove too costly for most parties.

Part II provides an empirical overview of procedural unbundling by carve-outs in several contractual settings, including CEO employment contracts, technology agreements, franchise contracts, joint-venture agreements, and cell-phone service contracts. These varied contractual settings enable a comparison of the use of carve-outs across types of relationships; in domestic, foreign and cross-border contracts; as well as in sophisticated party and consumer settings.

Part III explores several implications of procedural unbundling by carve-outs for future scholarship and public policy. First, carve-outs are a form of procedural unbundling that deserves greater emphasis in the literature on contractual procedure, and they shed light on the plausibility of explanations for the dearth of other types of contractual customization.

Second, there is disagreement in the development literature about the extent to which a nation seeking to maximize investment opportunities needs first-rate court systems with highly-developed rule of law principles when it could instead opt for the cheaper route of credibly committing to enforce arbitration clauses and awards. Our study of procedural unbundling by use of carve-outs suggests that arbitration is not always a perfect substitute for well-functioning courts. As such, it suggests that the governing legal principles and court procedures are far more important for the resolution of some types of private disputes than others. Some more general implications can be drawn as well. For example, we suggest that states take a closer look at their rules governing specific performance as a remedy.

²³ Specifically, we treat the two phenomenon theoretically, but report on carve-outs only in our empirical analysis, due to the fact that carve-outs appeared much more frequently than did carve-ins in our studies.

Third, the common use of carve-outs by sophisticated parties provides important context for courts when reviewing the use of carve-outs in contracts with consumers and employees. Courts across the world are currently struggling with whether to enforce contract clauses that give only one party a right to seek relief in courts or in arbitration, and our analysis provides helpful guidance for some of those cases. Courts often see carve-outs as strange contract terms that likely lack legitimate business justification, but this suspicion is unwarranted. Far from shocking the conscience, these provisions are commonplace in contracts between sophisticated parties who are represented by lawyers. Such provisions are not inherently unfair exercises in nonmutuality; instead, at least in sophisticated party contracts, they are wealth-maximizing customizations that provide value to the parties.

Finally, our analysis of procedural unbundling by carve-outs suggests that courts should be more willing to use severability doctrines to preserve the arbitration obligation for remaining claims, even when some claims must proceed in court. Contrary to the assumptions used by most courts, sophisticated parties readily contract for proceedings bifurcated between arbitration and court. Accordingly, when a court invalidates certain provisions in an arbitration clause as unconscionable, the arbitration clause as a whole should be preserved for claims as to which the arbitral procedural bundle is not unconscionable. By this analysis, courts strike the entirety of the arbitration provision far too often. Likewise, when Congress or a court decides that a federal right is not appropriately vindicated in arbitration, the limitation should extend only to the problematic claim and not to the striking of the entire arbitration clause, as sometimes happens. Part III uses treatment of arbitration clauses under the Magnuson Moss Warranty Act²⁴ and the Dodd-Frank Wall Street Reform and Consumer Protection Act²⁵ as examples.

I. Contracting for Procedure

This Part provides a simple informal model of dispute resolution choices to illustrate the tradeoff between differing types of procedural bundles.²⁶ Subpart A considers the situation where *ex ante* parties make a binary choice between courts and arbitration for the resolution of future disputes. In subpart B, parties consider the possibility of unbundling procedure by claim or remedy — that is, by using carve-outs from or carve-ins to arbitration. In subpart C, parties return to the binary choice between courts and arbitration and instead consider the possibility of unbundling procedure by individually customizing the procedures that would apply to resolve their disputes. Subpart C captures party decision making as presumed in the existent literature on procedural unbundling. The framework provides a mechanism for thinking about the tradeoffs involved in the parties' choices.²⁷

²⁴ 15 U.S.C. §§ 2301 et seq. (2012).

²⁵ 12 U.S.C. §§ 5301 et seq. (2012).

²⁶ Our model starts with Keith Hylton's framework for choosing between courts and arbitration. Hylton, *supra* note 15, at 223-26. Like other scholars, Hylton conceived of the parties' choice as binary, without considering the ways parties can choose to unbundle procedures. Because unbundling by claim and remedy consists of a series of choices between courts and arbitration, Hylton's framework provides solid foundation for our general approach. We therefore borrow from and extend upon his analysis.

²⁷ Of course, other contractual choices are possible. For example, parties could opt to attempt to resolve their disputes through mediation. Because mediation does not bind the parties, however, it is different in kind from and

A. Dispute Resolution as Binary Choice of Forum

Scholars analyzing the contractual choice between litigation and arbitration have traditionally treated the decision as a binary one,²⁸ as reflected in Figure 1:

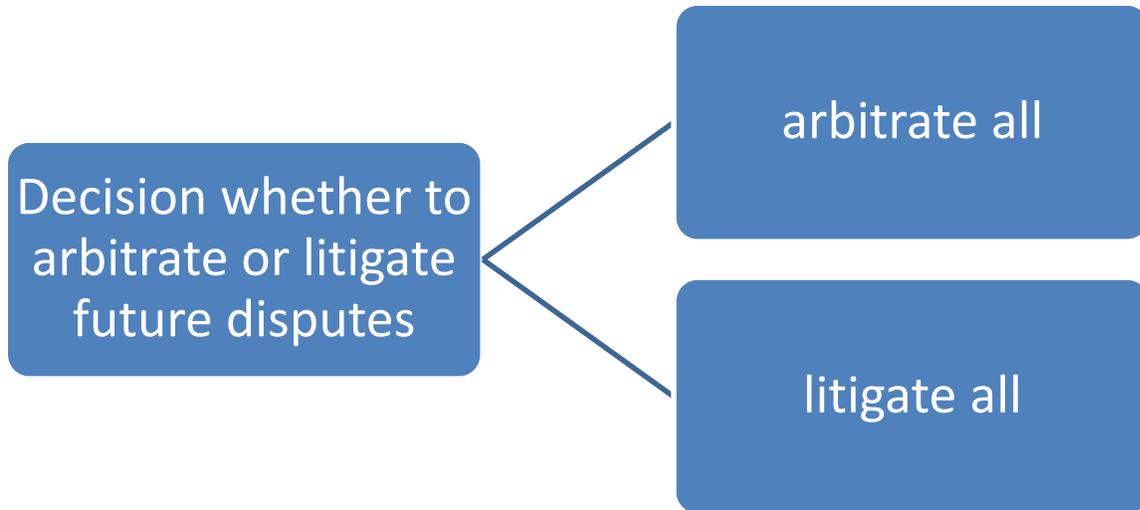


Figure 1—Binary Choice of Forum: Arbitration or Litigation

Although many scholars have analyzed this choice as a straightforward determination based on the relative dispute resolution costs of arbitration and litigation, Keith Hylton famously pointed out that the method of dispute resolution can provide “deterrence benefits” that should be taken into account in a cost-benefit calculus.²⁹ Deterrence benefits are the social benefits associated with having a potential defendant take care to avoid harm to the other party, through breach or otherwise, and the defendant’s incentive to take care can turn on the liability he expects to face, which can in turn depend on the dispute resolution forum chosen by the parties. Specifically, the choice between litigation and arbitration can influence the extent to which parties comply with their contractual obligations, because it can affect the feasibility of vindication as well as the accuracy of liability determinations, and those considerations should be taken into account in assessing the relative virtues of choosing the forum.³⁰

can be used in conjunction with both arbitration and courts. We therefore do not treat contracting for mediation in this article.

²⁸ *E.g.*, *id.* at 223; *see also* Richard R.W. Brooks & Sarath Sanga, *Commercial Arbitration Agreements Between Sophisticated Parties: An Empirical View* 5 (Feb. 25, 2013).

²⁹ Hylton, *supra* note 15, at 218.

³⁰ *Id.*

Consider, for example, two features of the arbitral bundle of procedures that might reduce the costs to the parties of arbitrating their claims relative to litigation: (1) the ability to choose expert decision makers; and (2) limited discovery options available to the parties. Although each of these features of arbitration can reduce the cost of proceeding to arbitration, they can differentially affect the parties' incentives to behave well under the contract. Expert decision makers can decrease the likelihood of an erroneous decision, which would have the effect of enhancing contractual performance, or deterrence benefits.³¹ In contrast, limited discovery might hamper a plaintiff's ability to establish her claims, which could increase the likelihood of an erroneous decision relative to litigation, and therefore decrease deterrence benefits.³² When making a binary determination between courts and arbitration, the overall cost considerations must be weighed together with the overall effect that the procedures will have on the likelihood that the parties will perform carefully as promised.

In Figure 1, parties will choose arbitration over litigation if the net benefits to arbitration exceed the net benefits to litigation, taking all possible claims and disputes into account. The net benefits to arbitration include the deterrence benefits from arbitration minus the costs of proceeding to arbitration; similarly, the net benefits to litigation include the deterrence benefits from litigation minus the costs of proceeding with litigation. Specifically, if we assume that defendant's failure to take care can increase the probability (and perhaps the magnitude) of harm suffered by plaintiff, then the deterrence benefits associated with defendant taking precautions include the marginal decrease in expected loss to plaintiff minus the cost to defendant of taking those precautions.³³

The various features of arbitration and litigation can influence the probability that defendant will take care. In Figure 1, the forum choice is binary so that the net effect on this probability is determined in the aggregate. As a result, expected deterrence benefits are equal to the probability the defendant will take care — given the dispute resolution forum chosen — times the net benefits of taking care. Expected dispute resolution costs are simply the sum of the expected costs to each party of resolving their disputes in a particular forum. When the parties' forum decision is binary, then the parties will choose to arbitrate rather than litigate their claims when the deterrence benefits from arbitration minus the costs of arbitrating exceed the deterrence benefits of litigating in court minus the costs of litigating.³⁴ Using a similar analysis, Hylton concludes that parties will decide to arbitrate whenever the social benefits of arbitration exceed the social costs of doing so.³⁵ However, that conclusion only holds in a world without transactions costs. In reality, the parties must incur costs to negotiate and then draft arbitration clauses if they wish to opt for arbitration. Our analysis here removes the assumption of zero

³¹ Drahozal, *supra* note 18, at 751.

³² *Id.* at 752-53.

³³ Thus, if:

L_L = expected loss to potential plaintiff when defendant does not take precautions,

L_S = expected loss to potential plaintiff when defendant does take precautions, and

X = cost of precautions to defendant,

then, the expected deterrence benefits associated with defendant taking precautions are equal to: $L_L - L_S - X$.

³⁴ Stated otherwise, denoting P as the probability the defendant will take care, if expected deterrence benefits for a particular forum equal $P(L_L - L_S - X)$ and expected dispute resolution costs equal $EC_P + EC_D$, the parties will agree to arbitration when $P_a(L_{La} - L_{Sa} - X_a) - [EC_{Pa} + EC_{Da}] > P_c(L_{Lc} - L_{Sc} - X_c) - [EC_{Pc} + EC_{Dc}]$.

³⁵ Hylton, *supra* note 15, at 263.

transactions costs.³⁶ In particular, parties who opt for litigation need not include any provisions in their contracts,³⁷ but parties opting for arbitration must specify that preference and then ideally further specify information about their preference (or not) for an arbitration provider, an arbitration venue, governing rules, etc.³⁸ We refer to these costs as the specification costs of drafting a generalized arbitration clause.³⁹ Thus, still assuming a binary choice, parties would choose to arbitrate rather than litigate their future disputes if the deterrence benefits to arbitrating minus the expected arbitration costs minus the cost of contract specification exceed the deterrence benefits of litigation minus expected litigation costs.⁴⁰

B. Dispute Resolution with Procedures Unbundled by Claim or Remedy (i.e., with Carve-Outs and Carve-Ins)

In reality, however, the choice between litigation and arbitration is not binary; in many contractual settings parties choose the litigation bundle of procedures for most claims but reserve the right to take particular claims or determinations to arbitration. Alternatively, parties who have chosen an arbitral bundle of procedures for most of their claims regularly reserve a right to litigate certain claims and/or obtain certain remedies in court. We refer to these more specific decisions as carve-ins in the former situation and carve-outs in the latter situation. We present this decision making process as a two-stage decision, with the first stage entailing the decision about whether in general the parties wish to have disputes resolved in court or arbitration and then the second stage treating the question of whether to carve-in or carve-out exceptions. Thus, the parties' decisions are represented by the matrix presented in Figure 2:

³⁶ Hylton also does not consider that parties do not pay the full cost of the court system (court systems are heavily subsidized by tax revenues), and so when parties opt for court resolution of their claims, they do not actually internalize the costs of using court personnel. For simplicity, we ignore here the potential problem of assuming that courts are costless, but we will consider this defect when analyzing the policy implications of our analysis in Part III.

³⁷ If parties wish to agree to litigation in a particular forum, then litigation would have specification costs as well.

³⁸ *E.g.*, GARY B. BORN, INTERNATIONAL ARBITRATION AND FORUM SELECTION AGREEMENTS: DRAFTING AND ENFORCING (3d ed. 2010); PAUL D. FRIEDLAND, ARBITRATION CLAUSES FOR INTERNATIONAL CONTRACTS (2d ed. 2007).

³⁹ We acknowledge that the specification costs here may at times offset savings in specification costs elsewhere in the contract. Thus, arbitration by an expert decision maker might enable the parties to avoid specifying performance duties (although it could also increase other specification costs due to the fact that the focus on dispute resolution makes the parties rethink other contract terms). For simplicity, we hold the other contract specification costs constant in order to focus on these ignored but important costs to choosing arbitration.

⁴⁰ Or when:

Equation 2: $P_a(L_{La} - L_{Sa} - X_a) - [EC_{Pa} + EC_{Da}] - SC(\text{arb})_{P,D} > P_c(L_{Lc} - L_{Sc} - X_c) - [EC_{Pc} + EC_{Dc}]$
 where $SC(\text{arb})_{P,D}$ represents the specification costs incurred by the parties.

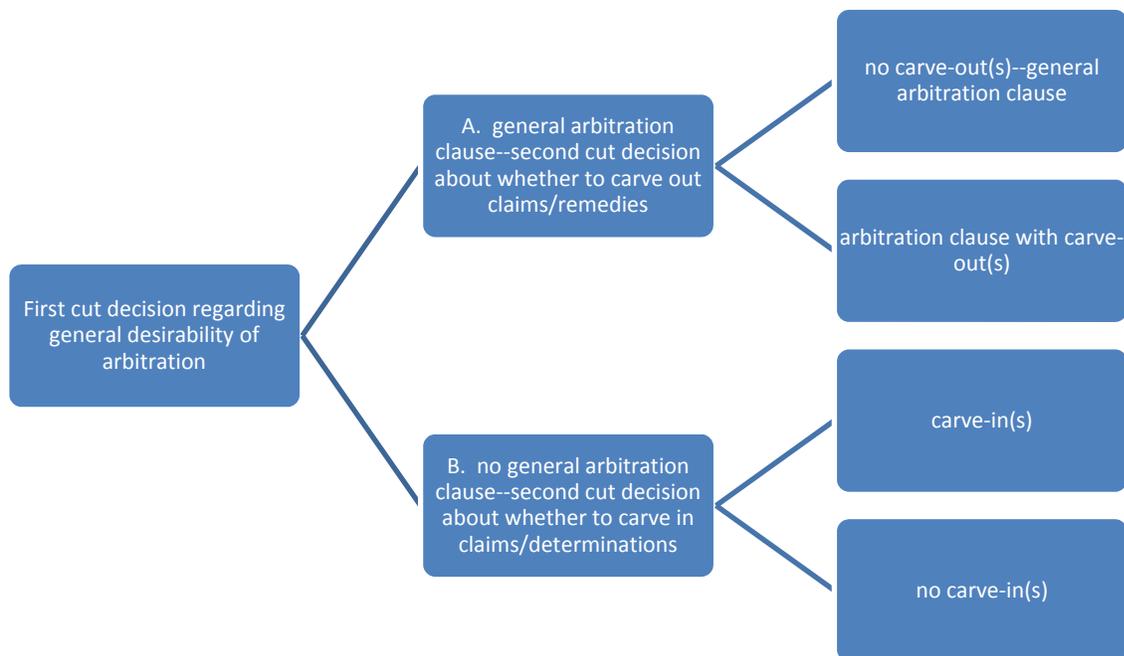


Figure 2--Decision Matrix with Claim/Remedy Specific Determinations

As indicated above, Hylton’s analysis assumes that parties must make an all-or-nothing choice between arbitration and litigation.⁴¹ Under his analysis, the parties will choose the socially optimal result after taking into account the overall costs and benefits of choosing courts versus arbitration.⁴² But with such binary decision making, it remains entirely possible that the parties have chosen a suboptimal method of resolving particular types of claims or disputes under the contract. If parties are able to unbundle the applicable procedures by claim or remedy, they may be able to construct a dispute resolution clause that makes them better off than an all-or-nothing choice of litigation or arbitration. Our analysis here removes the assumption that the parties’ decisions are binary.

The decision process of the parties is represented in Figure 2.⁴³ At the first decision node in Figure 2, the parties must choose whether to start with the background assumption that in general they will arbitrate or litigate their claims. Borrowing our analysis from subsection I(A) above, parties would choose a default rule of arbitration rather than litigation if for a majority of claims the deterrence benefits to arbitrating minus the expected arbitration costs minus the cost of contract specification exceed the deterrence benefits of litigation minus expected litigation costs. This decision reflects the parties’ judgment about the best procedure for resolving a majority of the parties’ disputes, even if a subset of the claims would be better resolved by other procedures.

⁴¹ See *supra* text accompanying notes 28-32.

⁴² Hylton, *supra* note 15, at 223-24.

⁴³ Figure 2 might not accurately represent the decision making process of all parties in that the decision regarding the treatment of particular claims may be part and parcel of the parties’ decision whether to utilize a background choice for courts or arbitration. In particular, for some parties, arbitration is made appealing only after some claims are set aside for courts. We treat the two decisions separately here in order to promote ease of analysis, but nothing turns on the particular presentation.

Once the parties choose arbitration or litigation for most disputes, the parties face a second decision regarding whether to carve-out or carve-in particular claims or remedies for separate treatment. Unbundling procedures by claims and remedies enables the parties to choose dispute resolution mechanisms that further maximize their joint benefits. Consider for example the situation where parties find themselves at decision node A in Figure 2. Although these parties will have chosen to arbitrate most claims, they might reserve a right to go to court for a subset of possible claims. In particular, as explained further below, parties might prefer the court bundle of procedures in a number of circumstances, including where the primary form of relief sought is injunctive (including preliminary injunctions and other provisional remedies), when the merits of the case are likely to be clear, and when the stakes of the dispute are perceived by the parties to be very high.⁴⁴

Conversely, parties located at decision node B in Figure 2 have chosen to take the bulk of their claims to court, but yet some might be better resolved using the arbitral bundle of procedures. For example, industry experts might be better situated to make certain factual determinations such as calculating a bonus provision or other valuation or making substantial performance determinations,⁴⁵ and arbitration will be preferred to litigation in circumstances where cross-border enforcement is contemplated.⁴⁶ And relatively small claims might be more viable in arbitration, where formalized procedures can be relaxed and attorney representation might be unnecessary.⁴⁷

The question of carve-outs (decision node A) involves an initial determination to utilize arbitration as a matter of default. Parties will incorporate carve-outs into their agreement in specific circumstances where the net benefits to litigation exceed the net benefits to arbitration. However, the drafting costs to including carve-outs are incurred when the parties opt for litigation rather than arbitration to treat some individual claims. The drafting costs of specifying courts for a claim or remedy include the costs of negotiating for court resolution of that claim/remedy and the cost of drafting a relevant clause (which could but need not include a provision specifying the court where such claim or relief would be sought). This more fine-tuned calibration could entail significant costs, however, because with carve-outs the parties must contemplate specific types of future disputes and even potential issues that might arise in the course of those disputes and then carefully describe (in a way that prevents courts from intruding into the wrong disputes and/or becoming involved in line-drawing) which disputes fall into the carve-out provision. In addition to these additional drafting costs, parties who choose to carve-out some claims for litigation might incur “bifurcation costs,” which are costs of having a party’s dispute divided between two forums because that dispute involves multiple claims, only

⁴⁴ Drahozal & Ware, *supra* note 15, at 453-57.

⁴⁵ Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts in Corporate Acquisitions*, 81 U. CINN. L. REV. 127, 170 (2013).

⁴⁶ *E.g.*, BÜHRING-UHLE, *supra* note 15, at 136 (citing relative ease of enforcing international arbitration awards as one of most significant advantages of international arbitration).

⁴⁷ *E.g.*, *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 281 (1985) (permitting businesses to avoid pre-dispute arbitration clause might “leav[e] the typical consumer who has only a small damages claim ... without any remedy but a court remedy, the costs and delays of which could eat up the value of an eventual small recovery”); *see also* Theodore Eisenberg & Elizabeth Hill, *Arbitration and Litigation of Employment Claims: An Empirical Comparison*, DISP. RESOL. J., Nov. 2003-Jan. 2004, at 44, 45.

some of which fall within the agreement to arbitrate.⁴⁸ Practitioners cite these drafting and bifurcation costs as reasons not to carve out claims from an arbitration clause⁴⁹ (indeed, the widespread presence of carve-outs has come as a surprise to some practitioners with whom we've talked).

For informed decision makers at node A, then, carve-outs will be included in an agreement only if the net benefits to arbitrating the claims (deterrence benefits to arbitration minus expected arbitration costs) are less than the net benefits to litigating the claims (deterrence benefits to litigation minus expected litigation costs minus the specification costs of including carve-outs minus expected bifurcation costs).⁵⁰ Otherwise, the parties will choose the no-carve-out option.

Informed parties at decision node B have decided to retain the default court bundle of procedures for resolving most claims, and they face the question of whether to carve-in some of their claims or issues for determination in arbitration. In this case, carving in entails specification costs, including both the costs of choosing (or not) an arbitral forum, governing rules, etc., but also the costs of carefully specifying which claims ultimately should proceed to arbitration. In addition, the decision to use carve-ins can entail bifurcation costs.⁵¹ To justify a carve-in, arbitration of the particular matter must add deterrence benefits and/or decrease dispute resolution costs relative to litigation, and those advantages need to be large enough to offset the accompanying specification and bifurcation costs. Conversely, to justify a carve-out, litigation of the particular matter must add deterrence benefits and/or decrease dispute resolution costs relative to arbitration, and those advantages need to be large enough to offset the accompanying specification and bifurcation costs.

Stated otherwise, carve-outs and carve-ins enable parties to unbundle dispute resolution procedures where efficient. To illustrate: According to the arbitration literature (and practitioner

⁴⁸ Whenever parties choose to arbitrate claims, they run the risk of incurring a second type of bifurcation cost, whereby they must proceed in court to determine some matters, including whether the arbitration clause is enforceable and whether the courts should provide preliminary relief, and then they proceed to arbitration to resolve the underlying claim, at which point they might need to turn back to the courts to enforce the arbitration award. Arbitration law serves to minimize much of this bifurcation cost by severely limiting the role of courts in scrutinizing arbitration agreements and awards. Nevertheless, these costs do exist, and they are likely more significant in cases where parties seek temporary and/or permanent injunctive relief. We further explore this second type of bifurcation cost in Part II but leave it out of the textual analysis here so as not to unduly confuse the reader.

⁴⁹ *E.g.*, 1 BORN, *supra* note 15, at 1128 (“The enforceability of [carve-outs for payment obligations] is not subject to serious doubts. In general, however, sophisticated advisers counsel against this approach. The jurisdictional and other uncertainties that result from such a bifurcated dispute resolution scheme usually outweigh any potential benefits.”); Kenneth Mathieu & Vincent P. (Trace) Schmeltz III, *Dispute Resolution as a Part of Your Merger or Your Acquisition Agreement*, 1 MICH. J. PRIVATE EQUITY & VENTURE CAPITAL L.301, 317 (2012).

⁵⁰ Or when:

$$\text{Equation 3: } P_{a(\text{carve-out})}(L_{La} - L_{Sa} - X_a) - [\text{EC}(\text{carve-out})_{Pa} + \text{EC}(\text{carve-out})_{Da}] < P_{c(\text{carve-out})}(L_{Lc} - L_{Sc} - X_c) - [\text{EC}(\text{carve-out})_{Pc} + \text{EC}(\text{carve-out})_{Dc}] - \text{SC}(\text{carve-out})_{P,D} - [\text{EBC}(\text{carve-out})_P + \text{EBC}(\text{carve-out})_D]$$

where $\text{SC}(\text{carve-out})_{P,D}$ represents the specification costs of carving out claims or relief and $[\text{EBC}(\text{carve-out})_P + \text{EBC}(\text{carve-out})_D]$ represents the expected bifurcation costs to each party of possibly having to proceed in two different forums in the event of dispute.

⁵¹ Thus, we can expect parties to use carve-ins only when:

$$\text{Equation 4: } P_{a(\text{carve-in})}(L_{La} - L_{Sa} - X_a) - [\text{EC}(\text{carve-in})_{Pa} + \text{EC}(\text{carve-in})_{Da}] - \text{SC}(\text{carve-in})_{P,D} - [\text{EBC}(\text{carve-in})_P + \text{EBC}(\text{carve-in})_D] > P_{c(\text{carve-in})}(L_{Lc} - L_{Sc} - X_c) - [\text{EC}(\text{carve-in})_{Pc} + \text{EC}(\text{carve-in})_{Dc}]$$

surveys), parties often seek arbitration as a low cost mechanism for resolving disputes.⁵² In order to ensure that arbitration is cheap, however, there can be an inevitable tradeoff between cost and accuracy.⁵³ Parties generally preferring a low-cost arbitration forum (and rules) might instead opt for a more expensive forum to ensure that when accuracy really matters they can obtain a high quality determination. The carve-out can have the effect of enabling the parties to get the benefit of low-cost arbitration while at the same time using courts when the added costs are justified.

The opposite can be true as well. Sophisticated international parties might opt for ICC arbitration, which is expensive but very high quality (higher than for most courts) but carve-out some claims for court resolution when the high costs of arbitration are unjustified. In each case the parties are better off than they would be if they compromised by choosing mid-level cost and accuracy for all of their claims. Sometimes parties can achieve this tailoring without carve-outs or carve-ins, by for example choosing an arbitral forum that offers both types of dispute resolution and allowing the forum (or the parties after the fact) to choose the appropriate dispute resolution mechanism. But carve-ins and carve-outs are justified when the parties are unlikely to agree ex post and the arbitration provider's decision cannot be trusted (incentive incompatible) and/or when other potential benefits are obtainable with carve-outs or carve-ins. When parties opt for high-end or low-end arbitration, then, we would expect a higher incidence of carving out claims, all else equal.

Carve-ins and carve-outs can serve an additional function not reflected in the analysis provided above. Specifically, they can help the parties deal with uncertainty regarding the appropriate treatment of cases within a particular claim category. The analysis above assumed that particular types of claims on net are better suited for arbitration or courts, and, although it might in general be possible to make such conclusions for claims categories, parties might face considerable uncertainty regarding the appropriate treatment of individual claims within a category. Thus, for example, broad discovery rights might not be important for most disputes within a given category of high value claims, but accurate resolution of some disputes might turn on the ability to use broad discovery. Because the claims are presumed to be high value, a party might want the option to proceed to court for those cases even though for other cases likely to come up the costs of litigating the claims (bifurcated proceedings plus additional dispute resolution costs) would not be justified. Consider also the situation where the value of some claims in a category cannot be known unless plaintiff has a right to broad discovery without incurring high up-front costs.⁵⁴ Here too the party might value the option of bringing some claims to court, where filing fees are lower. In these cases, retaining the litigation option can significantly influence deterrence benefits because it helps to ensure that meritorious cases are in

⁵² E.g., Douglas Shontz, Fred Kipperman, & Vanessa Soma, Rand Institute for Civil Justice, Business-to-Business Arbitration in the United States Perceptions of Corporate Counsel 9-10 (2011), *available at* http://www.rand.org/content/dam/rand/pubs/technical_reports/2011/RAND_TR781.pdf (based on survey of 121 corporate counsel). For a summary of other surveys on point, see Christopher R. Drahozal, *Arbitration Costs and Forum Accessibility: Empirical Evidence*, 41 U. MICH. J.L. REF. 813, 826-29 (2008).

⁵³ Drahozal, *supra* note 18, at 752-53.

⁵⁴ In a model presented by Huang and Grundfest, variance in the expected value of a lawsuit can induce litigation even in "negative-value" suit contexts because cheap discovery provides plaintiff with more information about the actual value of the lawsuit which could turn out not to be negative. Peter H. Huang & Joseph A. Grundfest, *The Unexpected Value of Litigation: A Real Options Perspective*, 58 STAN. L. REV. 1267 (2006).

fact brought. Consistent with this analysis, carve-outs and carve-ins can be (and often are) drafted to provide one of the parties with the option, rather than a duty, to proceed in court (or arbitration) for the specified category of matters. Having the option in the face of uncertainty—i.e. where potential suits within a claim category are heterogeneous—enables the parties to further maximize the joint benefits of dispute resolution decisions.

C. Dispute Resolution as a Binary Forum Choice With a la Carte Procedures

Now consider procedural unbundling by use of customized or a la carte procedures. Parties make a binary choice between court and arbitration, but they can customize the specific procedures applied by the forum. As in subsection B, we model the parties’ choice as a two-stage decision. Here, the forum is chosen in stage 1, and then in stage 2, the parties make a decision about whether to customize the procedures. In reality, the customization choice could conceivably influence the forum choice, but here we assume that the parties pick the forum that comes closest to their preferred procedures and then decide whether it is worth the additional effort necessary to further tailor the procedures to their needs. Figure 3 represents the parties’ decision matrix:

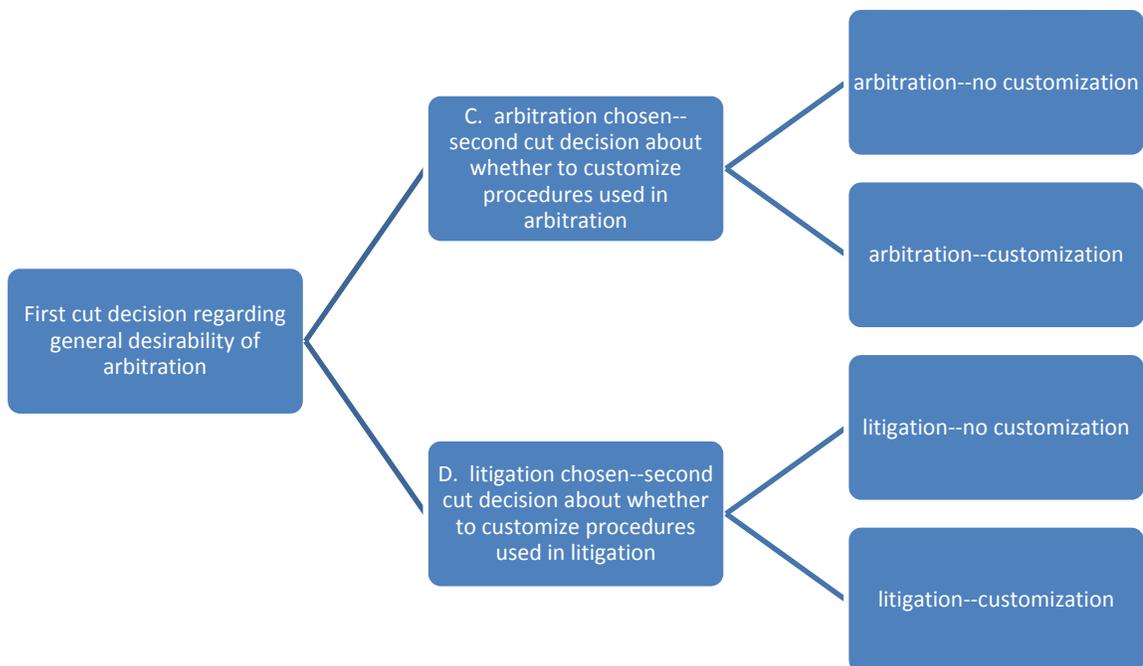


Figure 3--Decision Matrix with Customized Procedure Determinations

The stage 1 decision—the choice between decision nodes C and D—entails the costs and benefits described in subpart A. Specifically, the parties will choose arbitration as their forum if and only if the deterrence benefits to arbitration minus the expected costs of arbitration minus the specification costs of arbitration (without customization) exceed the deterrence benefits to court resolution minus the expected costs of proceeding in court. Costs and benefits here are calculated by aggregating the costs and benefits across contract risks and their accompanying claims.

Once the initial decision to arbitrate or litigate is made, the parties make the customization decision. For parties located at node C, having chosen arbitration, they must decide whether to customize the arbitration procedures. We assume here that the parties have chosen an arbitration provider and an off-the-rack set of rules offered by the provider. The question the parties face is whether to customize the default procedures represented by their choice of forum and rules along one or more dimensions. Parties would choose to customize the arbitration procedures where the added deterrence benefits to customized arbitration minus the incremental costs of the customized arbitration exceed the specification costs associated with the customization.⁵⁵

For many potential customizations, this condition is unlikely to hold. Consider first the marginal benefit of customization for the parties. Without customization, the parties have chosen an arbitration provider that generally operates according to its needs (or at least comes closer than other available options) and off-the-rack rules that further align the parties' preferences with the proceedings. Any specific customization can improve on these off-the-rack rules administered by the chosen provider, but because the parties have already chosen the set of default rules that best suit their needs, presumably the marginal effect will be relatively small. Moreover, that customization will apply to all of the parties' claims, and for many customizations, the net benefits can operate in opposite directions across claims. For example, a customization requiring that the arbitrator be an industry expert will lower the cost of some claims (substituting away from the need to engage in costly proof exercises) and provide greater accuracy (and therefore greater deterrence benefits). For other claims, however, accurate resolution will not require that the arbitrator be an industry expert. In those cases, the expert doesn't add to deterrence benefits and could actually increase the cost of dispute resolution, assuming that experts charge more than non-experts and there is no reduction in party effort to prove the claim.

More generally, because off-the-rack rules tend to provide arbitrators with considerable discretion,⁵⁶ customization can inhibit the flexibility of the arbitrator. Limiting the arbitrator's flexibility can be problematic if that flexibility would otherwise enable her to apply optimal procedures to each claim.⁵⁷ Consider, for example, customization of the parties' rights to discovery or the presentation of evidence in the event of dispute. Narrow discovery rights and/or evidence rules tend to enable the parties to conserve dispute resolution costs at the expense of accuracy, while broader discovery rights and/or evidence rules increase the cost of dispute resolution but can increase accuracy.⁵⁸ Without ex ante specification, arbitrators might find

⁵⁵ Or when:

Equation 5: $P_{a(\text{customize})}(L_{La} - L_{Sa} - X_a) - [EC(\text{customize})_{pa} + EC(\text{customize})_{Da}] > SC(\text{customize})_{p,D}$.

⁵⁶ Rusty Park has lamented the broad procedural discretion given to arbitrators, calling for more specific rules to cabin that discretion. William W. Park, *The 2002 Freshfields Lecture – Arbitration's Protean Nature: The Value of Rules and the Risks of Discretion*, 19 ARB. INT'L 279, 283 (2003). The absence of much if any movement in that direction supports the contrary view stated here.

⁵⁷ Note that the conclusion here is the converse of that found in the development literature, where scholars promote rules rather than standards for use in developing national courts in order to check judicial corruption and incompetence. Jonathan Hay & Andrei Shleifer, *Private Enforcement of Public Laws: A Theory of Legal Reform*, 88 AM. ECON. REV. PAPERS & PROC. 398 (1998). Here party control over the choice of arbitrator should in general protect against corruption and incompetence, although in cases where parties use arbitration for cheap and quick conflict resolution (e.g., Ebay disputes), less discretion might be preferred.

⁵⁸ Drahozal, *supra* note 18, at 752-53.

some leeway in the governing procedural rules to at least partially tailor discovery and evidence to the type of claim at issue.⁵⁹ If so, the arbitrator would be able to use that discretion in order to ensure that additional dispute resolution costs are justified by the marginal benefit of increased accuracy for the dispute. No doubt arbitrators can make errors in judging which available procedures maximize deterrence benefits at lowest cost, but ex ante those errors may appear less costly than the parties' rigid imposition of a procedural rule to be applied to the resolution of all future disputes.

As for the specification costs of customization, these are likely to be large relative to the net benefits. The costs of physically drafting a customization are not likely significant, especially for high-value contracts. However, the cost of anticipating the universe of possible disputes and ensuring that on net the customization provides a net benefit to the parties could be quite significant.⁶⁰ Errors deprive the arbitrator of flexible application of available procedures. Contrast these specification costs to those present in the context of carve-outs and carve-ins. With carve-outs, the parties decide that although in general they prefer to resolve their disputes with arbitration, for one or more claims an option to proceed in courts is preferred. With carve-ins, the parties decide to use courts with the exception of one or more claims. In each context, the exceptions work to increase the expected welfare of the parties because the parties believe that a particular risk should be treated in a different way. Presumably, that increased welfare can be realized without having to think about the universe of possible claims or contexts where disputes might arise. A specific claim or form of remedy can be separated out for particularized negotiation and treatment. In general, then, we would expect the specification costs to customization of specific procedural rules to tend to be greater than the specification costs to including carve-outs or carve-ins.

Parties located at node D, having chosen courts, must also decide whether to customize the procedures applied in court. Similar to the decision faced by parties at node C, these parties should choose to customize when the net deterrence benefits to customization minus any cost increase are greater than the specification costs of customization.⁶¹ The costs and benefits here are presumably similar to those faced by the parties at node C with three possible differences. First, the parties may be less confident that a judge will have procedural discretion or will use it in beneficial ways. Thus, the hampering of deterrence benefits to customization is likely smaller. Second, the cost savings to customization could be larger because unlike arbitration providers, courts are not developing menus of off-the-rack rules that pretend to suit parties well.⁶² Third, the parties might think that they are limited in the extent to which they can customize their

⁵⁹ See, e.g., Am. Arb. Ass'n, International Arbitration Rules, art. 16(1) (June 1, 2010); Int'l Chamber of Commerce, Rules of Arbitration, art. 22(2) (Jan. 1, 2012); Am. Arb. Ass'n, Procedures for Large, Complex Commercial Disputes, rule L-4(c) (June 1, 2009); JAMS Employment Arbitration Rules & Procedures, rule 17(b) (July 15, 2009).

⁶⁰ Park, *supra* note 56, at 296 ("[S]pecific rules might cause lawyers to counsel against arbitration, from fear of losing their margin to manoeuvre once the dispute arises. Prior to the arbitration, parties do not necessarily know what rules will benefit them on matters such as discovery and punitive damages.").

⁶¹ Or when:

Equation 6: $P_{c(customize)}(L_{Lc} - L_{Sc} - X_c) - [EC(customize)_{Pc} + EC(customize)_{Dc}] > SC(customize)$.

⁶² Of course, business courts might provide an exception here, but the point is that arbitration providers typically engage in more menu development than do courts.

procedures.⁶³ Parties might think that they can get away with customizing one or two features of court dispute resolution but limit their provisions out of a fear that judges would balk at numerous specifications that change the judge’s perceived role. If so, then the deterrence benefits and cost savings might be limited, with the specification costs still high. In general, though, although parties have relatively little incentive to specialize procedures in courts or arbitration, it is not clearly the case that the parties’ incentives are lower when they opt for court resolution of their disputes.

In summary, relative to untailored all-or-nothing forum-selection clauses, procedural unbundling through customized procedural rules carries the promise of greater deterrence benefits and lower process costs, but applying those customized procedures to all possible disputes can entail much higher specification costs. Moreover, customized procedural rules can hamper the decision maker’s flexibility in ways that actually reduce deterrence benefits. Arbitration clauses that opt for carve-outs rather than customization can be used to obtain greater deterrence benefits and lower process costs than all-or-nothing forum-selection rules, but they introduce increased specification costs and bifurcation costs. Relative to customized procedural rules, carve-outs could impose higher dispute-resolution costs, but the effect on deterrence benefits is uncertain. At the same time, carve-outs create bifurcation costs, but their ability to align customizations with differing risks suggests that their specification costs would be much lower.⁶⁴

Ultimately, the relative costs and benefits of these differing choices of procedural bundles is an empirical question. As discussed above, the existing empirical studies find little evidence of unbundling through detailed customization of procedures in contracts between sophisticated parties.⁶⁵ In the next part, we examine the extent to which parties contract for procedural unbundling by claim or remedy — i.e., for carve-outs.

II. Unbundling Procedure by Claim and Remedy: Data and Findings

In this Part, we examine empirically the use of procedural unbundling by carve-outs in a wide range of contracts, including CEO employment contracts; domestic, foreign and cross-border agreements entered into by technology firms; domestic and international joint venture agreements; franchise agreements; and mobile wireless service contracts.⁶⁶ At least three of

⁶³ Bone, *supra* note 17, at 1351 (“For without formal assurance of legal enforcement [of party procedural rulemaking], parties would have trouble making credible commitments.”).

⁶⁴ As noted above, *see supra* note 18, our focus here is on ex ante procedural unbundling rather than ex post procedural unbundling. As such, our models simplify reality by assuming away the possibility of ex post customization. To the extent parties can agree to ex post customization at low cost, it would reduce their incentive to agree to ex ante customization as well as, possibly, their incentive to use carve outs. Ultimately, how parties respond to the various alternatives is an empirical question, and our findings suggest that they frequently agree to use carve-outs.

⁶⁵ *See supra* text accompanying note 19.

⁶⁶ Our focus here is on carve-outs rather than carve-ins because the use of carve-outs is much more common, facilitating our empirical analysis. Of course, the apparent rarity of carve-ins itself is a relevant data point.

these categories of contracts involve two sophisticated parties with substantial bargaining power.⁶⁷ Two of the types of contracts enable a comparison of contracting behavior between US firms and others, particularly those located in China. And a comparison across contract types and industries enables a glimpse at the circumstances where carve-outs seem most useful.

The contracts we study nevertheless create inevitable selection bias in that we purposefully sought to focus on contracts where arbitration clauses are commonly used and it hasn't yet been possible for us to study the clauses present in many contractual settings.⁶⁸ Although the findings here therefore can provide only tentative conclusions about party use of carve-outs, much can be said at least initially about their incidence and functions. Our central findings are as follows:

1. Carve-out rates vary across our contract studies. They are present in about 98% of franchise contract arbitration clauses, nearly 2/3 of domestic and cross-border technology contract arbitration clauses, about 1/2 of domestic joint venture agreement arbitration clauses and CEO employment contract arbitration clauses, and, with one exception noted in conclusion 5, in relatively few international and foreign agreements. Specific types of carve-outs are present with varying rates across industries and contract type. This suggests that parties take into account the relative costs and benefits of using such carve-outs.
2. Carve-outs are used more often for claims where the parties will seek primarily property-type protections, or injunctive relief. The carve-outs suggest that injunctive relief is more valuable to the parties when it is backed by state force. Court resolution of these matters likely provides significantly higher deterrence benefits. Parties could, and often do, simply carve out a right to go to court for preliminary and/or permanent injunctive relief. But in many cases parties carve out the whole claim for court resolution. This suggests that parties seek potential cost savings associated with having a court decide the whole matter. Otherwise, the parties must go to court seeking preliminary relief, return to the arbitrator for resolution of the merits of the claim, and then back to court for permanent injunctive relief. Apparently some parties forecast that the cost savings to carving out the claim is greater than the possible bifurcation costs associated with having some claims resolved in courts while others are resolved in arbitration.
3. Carve-outs are broadly used as a tool for parties to protect the value of information, innovation, and reputation in their contracts. The result for information seems counterintuitive at first, because one commonly suggested virtue of arbitration is its ability to enable the parties to maintain confidentiality. However, as explained below, information is often best protected with injunctive relief, a remedy more effectively provided by courts. To the extent that technological advances suggest that larger fractions of the value of contracts derive from information and innovation over time, one can forecast an increasing reliance on the use of carve-outs.

⁶⁷ See *infra* text accompanying notes 69-90.

⁶⁸ For example, the contracts collected from SEC filings are limited to contracts "material" to the corporation and likely do not include many contracts from business's day-to-day operations. Drahozal & Ware, *supra* note 15, at 458-60.

4. For those types of contracts where protection of information and innovation seem more important to the contract's value (i.e., franchise contracts, domestic technology contracts), carve-outs are more prevalent. This is true even in the case of cross-border contracts, where the enhanced cross-border enforceability of arbitration awards should deter parties from using courts to resolve any claims.
5. In the cases of protection of information, innovation, reputation and property, the carve-outs often seem to benefit one party to the agreement. If that party has substantial bargaining power in the drafting of the contract, carve-outs will appear at very high rates as the drafting party directly benefits. Thus, they are found in almost all franchise contracts, for example. Where bargaining power is more equal, carve-outs are still common but appear somewhat less frequently, as is the case for domestic joint venture agreements and CEO employment contracts. The fact that carve-outs are still found in half of the latter arbitration clauses suggests that the increased deterrence benefits of the carve-outs can create mutual benefit to the parties. However, the increased specification costs (including negotiation) and bifurcation costs must be shared jointly and could work to hinder their presence somewhat.
6. Parties also sometimes carve out small claims and claims for moneys owed, suggesting a motivation to reduce dispute resolution costs: arbitration can be more expensive than litigation for debt collection cases because of the need to confirm an arbitration award in court before creditors' remedies can be used.
7. In general, carve-outs are used more often by US contracting parties than by parties located in other countries. This could be a function of the US lawyer culture, or it could be a byproduct of uncertainty in the other countries represented in our data about the reliability of their court systems.
8. Parties can only derive the benefit of carve-outs when (a) they trust courts to better protect their interests than arbitrators; and (b) courts will enforce the arbitration clauses with the carve-outs. The technology contracts and international joint venture agreements provide powerful evidence that the first requirement is not satisfied for parties located in China. Carve-outs are almost never found in these contracts. And the CEO employment contracts provide evidence that California courts' failure to satisfy the second requirement hinders the ability of California contracting parties to reap the benefits of carve-outs in employment contracts. In short, this form of wealth enhancement requires well-functioning and cooperative courts.

A. CEO Employment Contracts

In 2007, Thomas, Martin, and O'Hara O'Connor gathered a sample of CEO employment contracts for companies included in the S&P 1500 during 1995-2005. They coded 915 initial

and restated contracts⁶⁹ filed by those companies with the SEC and available on LiveEdgar.⁷⁰ They then coded the contracts for the presence of a number of provisions, including dispute resolution clauses. The parties agreed to arbitrate all of their disputes (though perhaps with carve-outs) in 458 of these contracts, agreed to arbitrate only some of their disputes (“carve-ins”) in 5 of the contracts, and provided options to arbitrate in another 12 of the contracts. Thus, 475 of the 915 contracts, or 51.9% of them, included an arbitration provision. Of these 475 contracts, the contract filed with the SEC included the text of the arbitration provision in all but 10 of these contracts. They therefore were able to study the details of the arbitration clauses in 465 contracts.⁷¹

Of the arbitration clauses in the sample, 224, or 48.2% included one or more carve-outs — that is, specific provisions within the arbitration section of the agreement that listed one or more exceptions to or exclusions from the arbitration agreement. Table 1 shows a list of the carve-outs found in the arbitration clauses and the frequency with which they were present:

Type of Carve-Out	# of contracts with carve-out	% of arbitration clauses with carve-out
Any carve-out	224	48.2%
Noncompete clause claims	144	31.0%
Confidentiality clause claims	166	35.7%
Client nonsolicitation clause claims	99	21.3%
Employee nonsolicitation clause claims	137	29.5%
Nondisparagement clause claims	30	6.5%
Preliminary relief carve-out	56	12.0%

A noncompete clause carve-out was present in a contract that included (1) a noncompete clause, which is a clause under which the CEO agrees not to work for a competitor and/or to open a business that competes with the company for some period of time after her employment terminates; (2) an arbitration clause; and (3) a clause providing that notwithstanding the arbitration clause, claims based on the noncompete clause could be heard in courts. A confidentiality clause carve-out was present in agreements where (1) the CEO promised to keep certain information pertaining to the company and its activities private; (2) the parties agreed to arbitrate their disputes; and (3) the parties nevertheless reserved the right to bring confidentiality clause claims to court. Client nonsolicitation and employee nonsolicitation clauses contain promises by the CEO not to solicit clients or employees of the company for a certain period of time after leaving the firm. A nondisparagement clause contains a promise by the CEO not to

⁶⁹ Restated contracts are those that are drafted after amendment and/or renewal with the intention of replacing the parties’ initial contract.

⁷⁰ Details of the contract collection and coding are provided in Randall Thomas, Erin O’Hara & Kenneth Martin, *Arbitration Clauses in CEO Employment Contracts: An Empirical and Theoretical Analysis*, 63 VAND. L. REV. 959 (2010). The study started with 1970 CEO employment contracts, but many took the form of contract amendments, which were eliminated from the sample once it became clear that the amendments were short, tended to address only 1 or 2 matters, and tended not to address dispute resolution.

⁷¹ For a description of the details of the arbitration clauses in these contracts, see O’Hara O’Connor, et al., *supra* note 19, at 162-77.

make public comments disparaging the firm during or after termination of the employment relationship. Finally, the preliminary relief carve-out provides a statement that notwithstanding the arbitration clause a party can go to court to seek preliminary relief (such as a preliminary injunction). The preliminary relief carve-out may differ from the other types of carve-outs discussed in this paper in the sense that these carve-outs may be inserted in aid of arbitration rather than as a statement that the parties desire courts instead of arbitration. But regardless of the motive for the carve-out, all carve-outs can tell us something about the circumstances in which contracting parties demand court services.

The carve-out rates listed above do not tell us all we would like to know. Specifically, we don't always know from the data what fraction of the contracts containing both a particular type of clause and an agreement to arbitrate also state that disputes arising under the clause will be carved out for court resolution. For example, in the entire sample of CEO employment contracts, only thirty contained nondisparagement clause carve-outs. That seems like a small number of carve-outs, but it could be that relatively few contracts contain nondisparagement clauses in the first place. Unfortunately, the data was not coded for the presence of all of these clauses, but it was coded for the presence of confidentiality clauses and nonsolicitation clauses. 418 of the contracts calling for arbitration also contained a confidentiality clause. Recall that 166 of these contracts carve-out disputes involving a breach of that clause. Thus, 39.7% of the contracts with both confidentiality clauses and arbitration clauses carve-out these disputes for courts. The data was also coded for the presence of a nonsolicitation clause (in this case the clause could prohibit the solicitation of either employees or clients). 345 contracts with an arbitration clause contained such a contract. 141 of these contracts carved out claims under either the employee or the client nonsolicitation provisions. Thus, 40.9% of the contracts with a nonsolicitation clause and an arbitration agreement carved those issues out for court resolution.

Note that the companies are carving out disputes involving clauses that serve to help the company protect the value of its private information. That information helps to give the company a competitive advantage, through enhanced trademark, effective trade secrets, and otherwise. One stated advantage of arbitration is that it provides the parties with enhanced confidentiality because unlike courts, the arbitral proceedings are not a matter of public record.⁷² When the underlying dispute is itself about the CEO diluting the value of the company's information, however, resort to courts may be necessary in order to protect the information value. Arbitrators have the authority to order injunctive relief,⁷³ but without the contempt powers of the courts, an arbitrator's order may prove ineffective. Moreover, preliminary injunctions may be a necessary adjunct to such a proceeding, and arbitration is not well suited to the award of such emergency relief.⁷⁴ Both arbitrators and courts can award damages for breach of an agreement, but valuing information is difficult and proof problems and limited CEO assets can hinder effective compensation. In these circumstances, the parties seem to prefer courts to arbitration because they prefer more reliable recourse to equitable relief.

⁷² *E.g.*, Schmitz, *supra* note 13, at 1222-26.

⁷³ *E.g.*, I BORN, *supra* note 15, at 2480-81; *see, e.g.*, Am. Arb. Ass'n, Commercial Arbitration Rules, rule R-34(a) (June 1, 2009); *id.* Rule R-43(a).

⁷⁴ Drahozal & Ware, *supra* note 15, at 456-57. Note that we do not code as provisional relief carve-outs arbitration clause incorporating provider rules stating that pursuing provisional relief in court is not a waiver of the right to arbitrate. *E.g.*, Am. Arb. Ass'n, Commercial Arbitration Rules, rule R-34(c). Such rules differ from carve-outs because they do not exclude the arbitrators from jurisdiction over the matter.

Finally, the data showed both a statistically significant increase in the use of arbitration clauses over time as well as a statistically significant increase in the use of carve-outs over time. In addition, the average number of carve-outs found in an arbitration clause increased during the time period studied.⁷⁵

B. Technology Contracts

Technology-related contracts provided a second type of contract from which to study carve-outs from arbitration. We gathered and coded contracts filed with the SEC between July 2007 and July 2011 and available on EDGAR. A search was conducted of the filings of companies classified by four-digit SIC codes (and company names) that indicated the filing company was classified as an IT-related business. Seven SIC codes were selected, producing contracts from companies in radiotelephone communications (including wireless operators), telephone communications (including names like AT&T), data processing services, computer programming services, computer integrated systems design, computer processing and data services, and business services “not elsewhere classified” (including companies such as Yahoo!, Ebay, and Zillow). Company filings were searched for “service agreement” and for “commercial agreement,” and then obviously non-IT documents were filtered out (i.e. share purchase agreements, credit agreements, financial reports, shareholder proxy agreements, and leases). This left 141 contracts that took the form of service agreements, master service agreements, licensing agreements, and other similar agreements. Several contracts were essentially duplicate contracts where the same company had entered into the same agreement with multiple parties. Where the terms looked substantially similar, duplicates were removed from the sample. 120 contracts were then coded.

The coded contracts represent firms listed in all 7 SIC code categories.⁷⁶ Although all contracts were filed between 2007 and 2011, the contracts themselves were executed between 1998 and 2011. However the vast majority (90%) were entered into between 2005 and 2011, and approximately 72% were entered into between 2007 and 2010.

⁷⁵ O’Hara O’Connor et al., *supra* note 19, at 175. Interestingly, contracts involving firms headquartered in California had significantly fewer carve-outs per arbitration clause than did firms located elsewhere, which likely stems from California court hostility to the use of carve-outs in employment contracts. *Id.*

⁷⁶ The frequency of the types of firms in the sample is as follows:

SIC Number	Category	# of contracts
4812	Radiotelephone Communications	10
4813	Other Telephone Communications	21
7370	Computer Programming/Consulting	14
7371	Computer Programming Services	5
7373	Computer Integrated Systems Design	4
7374	Computer & Data Processing	15
7389	Business Services (NEC)	51
	TOTAL	120

Taken as a whole, 57 or 47.5% of the technology contracts contain an arbitration clause. This rate is similar to the CEO employment contracts (51.9%) discussed above.⁷⁷ The technology contracts contain comparatively fewer carve-out provisions, however. In total, 20 or 35.1% of the contracts with arbitration clauses carved out some actions or forms of relief for court resolution, as compared with 48.2% of CEO employment contracts and 97.7% of franchise contracts. Technology contract provisions carved out the types of claims shown in Table 2. The two most common types of carve-outs were for claims for injunctive relief (35.1% of arbitration clauses) and claims for breach of a confidentiality clause (17.5% of arbitration clauses).

Type of Carve-out	# of contracts with carve-out	% of arbitration clauses with carve-out
Any carve-out	20	35.1%
Injunctive relief claims	19	33.3%
Confidentiality clause claims	10	17.5%
Claims for monies owed	3	5.3%
Noncompete clause claims	1	1.8%
Nonsolicitation clause claims	1	1.8%

The rate of incorporation of both arbitration clauses and carve-outs in the technology contracts varies by type of firm, as shown in Table 3. These rates also vary by the type of contract, as shown in Table 4. The variance, especially the large variance across contract type, suggests possible differences in party bargaining power and in the relative value of information, innovation or other assets for which injunctive relief might be necessary, as well as possible differences in the portfolio of risks each type of contract entails. More generally, these differences would reflect differences in deterrence benefits, dispute resolution costs, specification costs, and/or bifurcation costs.

SIC Category	% contracts with arbitration clauses	% of arbitration clauses with carve-out
Radiotelephone Communications	60.0%	33.3%
Other Telephone Communications	43.0%	44.4%
Computer Programming/Consulting	35.7%	40.0%
Computer Programming Services	40.0%	50.0%
Computer Integrated Systems Design	50.0%	50.0%
Computer & Data Processing	53.3%	25.0%
Business Services (NEC)	49.0%	36.0%

⁷⁷ See *supra* text accompanying note 71.

Contract Type	# of contracts	% of contracts with arbitration clauses	% of arbitration clauses with carve-outs
Master Services	22	36.4%	75.0%
Service Agreements	36	44.4%	25.0%
Consulting Agreements	8	87.5%	0.0% ⁷⁸
Licensing Agreements	8	62.5%	60.0%
Communication Contracts	14	28.6%	25.0%
General Business Operations	19	47.4%	44.4%

Importantly, the technology contracts provide an opportunity to observe the contracting behavior of parties outside of the US and those contracting across national borders. Each contract was categorized into one of three groups:⁷⁹ contracts between two American parties; contracts between two non-American parties from the same country; and contracts between companies located in two different countries (cross-border contracts). Most of the contracts involving two companies from the same country that is outside the US are contracts between two companies located in China. Of the 43 contracts in this category, 36 are executed by companies from China, 2 are executed by companies located in Vietnam, 2 by companies located in Mexico, 1 by companies located in the UK, 1 by companies located in Brazil, and 1 by companies located in Taiwan. Of the 21 cross-border contracts, 16 of them involve a contracting party located in the U.S.

Table 5 below reports on the incorporation of arbitration clauses and carve-outs from arbitration in the contracts for each of the three party location categories:

⁷⁸ All of the consulting agreement contracts were entered into between 2 companies located in China. As discussed *infra* text accompanying notes 81-82, none of the contracts entered into between two Chinese companies had any carve-outs.

⁷⁹ The frequency of each of the groups in the sample is as follows:

Location of Parties	# contracts	% of total technology contracts
Both companies US	56	46.7%
Both companies located in same country—non-US	43	35.8%
Companies located in two different countries (cross-border)	21	17.5%

	Both US	Same country – foreign	Cross-border
% of contracts with arbitration clauses	35.7%	65.1%	42.9%
% of arbitration clause with carve-outs	65%	3.6%	66.7%

All but two of the “same country-foreign” contracts with arbitration clauses involve two companies located in China. The remaining two are contracts with both companies located in Mexico and Brazil. The contract between two Mexican companies was the only contract in that group to carve anything out from arbitration. That contract contained a single carve-out for confidentiality clause claims. Of the 9 cross-border contracts with arbitration clauses, seven of the nine involve a contract with one party located in the US. The other two contain no carve-out clauses. Of the 7 contracts involving one US party, 6 or 85.7% of them have carve-outs.

Arbitration clauses in technology contracts entered into between 2 US parties and between one U.S. party and a party from another country carved out disputes as shown in Table 6.

Type of carve-out	# of contracts with carve-outs	% of arbitration clauses with carve-out
Contracts Between Two U.S. Parties		
Any carve-out	13	65%
Injunctive relief claims	13	65%
Confidentiality clause claims	5	25%
Nonsolicitation clause claims	2	10%
Claims for monies owed	2	10%
Contracts with One U.S. Party		
Any carve-out	6	85.7%
Injunctive relief claims	6	85.7%
Confidentiality clause claims	4	57.1%
Claims to protect trademark	3	42.9%
Noncompete clause claims	1	14.3%
Claims for monies	1	14.3%

Surprisingly, in the contracts with two U.S. parties, the parties did not seem interested in specifically carving out disputes involving intellectual property claims, although the confidentiality clause and nonsolicitation clauses can work to help a company protect trade secrets. In this sense, they more closely resemble the CEO employment contracts than the franchise agreements. In addition, these parties are more likely to rely on preliminary relief and less likely to carve out the entire claim than was the case for CEO employment contracts. We lack an intuition for this difference beyond a surmise that perhaps the technology industry firms

are relatively more concentrated in California, where, as discussed below, carving out claims can jeopardize the enforceability of the entire arbitration clause.

With the arbitration clauses in cross-border technology contracts there is a small sample problem preventing any firm conclusions. But note that the cross-border agreements are more likely to contain claims carve-outs as well as carve-outs specifically addressed to protection of intellectual property. One possibility for this difference, assuming it is a real one, is that parties do not worry about California court treatment of carve-outs in the context of international arbitration. In general, although California courts often insist on imposing rules for arbitration that tend to hinder domestic arbitration, the rules are relaxed in the international context, presumably in an effort to compete for international arbitration business.⁸⁰

Note that the presence of carve-outs in technology contracts varied dramatically according to the location of the parties. When the contract involved one or more parties located in the US, carve-outs from arbitration were commonly present. Carve-outs in technology contracts involving a US business were more frequent than in the CEO employment contracts and less frequent than in the franchise contracts. When technology contracts were entered into by two parties both located outside of the US, regardless of whether those companies were located in the same country, only a single carve-out was present in a single contract. However, 86.7% (26 of 30) of the contracts involving foreign parties and containing arbitration clauses were contracts between two companies located in China.

The China company contracts are instructive. Despite significant investment by the Chinese government in the development of IP and other courts, the contracts indicate that parties remain reluctant to rely on such courts for resolution of their claims. The findings serve as a reminder that court resolution of a claim can only add deterrence benefits if they are perceived to be well-functioning.⁸¹ As discussed below in Part III, this finding suggests that it is particularly important for courts in the US and elsewhere to develop useful rules, precedents and procedures for application to claims involving the protection of information, innovation and reputation.⁸² These claims are less well handled via arbitration than are other commercial matters, so the value added by courts likely is higher.

Not surprisingly, the rate of the use of arbitration clauses is higher for cross-border contracts than for contracts entered into between two US parties.⁸³ Note however that the incidence of carve-outs in contracts that have arbitration clauses is about the same in these two

⁸⁰ *E.g.*, Cal. Code Civ. Proc., § 1297.351 (In international commercial conciliation, “[t]he parties may appear in person or be represented or assisted by any person of their choice. A person assisting or representing a party need not be a member of the legal profession or licensed to practice law in California.”).

⁸¹ Of course, a remaining puzzle is why Chinese contracting parties do not instead opt for foreign courts. We save a thorough exploration of this phenomenon for another day. We note here only that foreign court judgments might not be enforced by Chinese courts, and in any event, a foreign court might be reluctant to attempt to exercise its authority over actions taken in China.

⁸² *See infra* text accompanying notes 134-79.

⁸³ *E.g.*, Theodore Eisenberg & Geoffrey Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 351 (2007) (finding double the rate of arbitration clauses in transnational corporate transaction contracts than in domestic ones); *see* 1 BORN, *supra* note 15, at 71.

categories. This result is surprising given that court judgments are more difficult to enforce across borders than are arbitration awards.⁸⁴ Presumably the parties perceive that the deterrence benefits to court resolution of the matters are so much higher than arbitration that they offset the reduced deterrence benefits and increased dispute resolution costs associated with potential cross-border enforcement difficulties.

Finally, the rate of the use of arbitration clauses is highest for contracts entered into by two parties from the same country outside of the US. And in these cases the rate of carve-outs is dramatically lower. This suggests that, at least for companies using the US markets to raise capital, trust in the reliability of domestic courts is significantly lower than it is for US firms.

C. Joint Venture Agreements

We also examined the use of carve-outs in a small sample of joint venture agreements, both international and domestic, collected from SEC filings in 2008.⁸⁵ Of the twenty-one domestic joint venture agreements in the sample, nine (or 42.9%) included arbitration clauses and one (or 4.8%) included an arbitration clause applicable only to some issues (a “carve-in”).⁸⁶ Of the thirty-one international joint venture agreements in the sample, twenty-two (or 71.0%) included arbitration clauses.⁸⁷

As shown in Table 7, almost half (four of nine, or 44.4%) of the domestic joint venture agreements with arbitration clauses included a carve-out: three of nine (33.3%) permitted a party to go to court to seek provisional relief and one of nine (or 11.1%) permitted a party to go to court to seek injunctive relief. As with the technology contracts discussed above, fewer of the international joint venture agreements with arbitration clauses (four of twenty,⁸⁸ or 20.0%) included carve-outs: two of twenty (10.0%) contained carve-outs for injunctive relief; one of twenty (5.0%) included a carve-out for claims seeking provisional relief; and one of twenty (5.0%) carved out claims seeking to protect joint venture intellectual property rights or trade secrets as well as trade secrets or corporate opportunities of one (but not the other) of the joint venturers.⁸⁹

⁸⁴ See *supra* text accompanying note 46.

⁸⁵ The contracts previously were discussed in Drahozal & Ware, *supra* note 15, at 465-66.

⁸⁶ Joint Venture Agreement Between Myohionow.com, LLC and Lakes Ohio Development, LLC ¶ 7.3 (Apr. 29, 2008) (copy on file with author) (providing that if any provision of agreement is declared invalid, the parties are unable to negotiate a substitute provision, and a party “considers on reasonable grounds that its commercial interests ... are materially and adversely affected,” then “it may submit such matter to arbitration pursuant to rules set forth by the American Arbitration Association”).

⁸⁷ [The thirty-one international joint ventures consisted of thirteen joint ventures with no U.S. parties, fourteen with a U.S. party and at least one non-U.S. party, and four with missing information about party nationality but with the location of the venture itself outside the United States.](#)

⁸⁸ The text of the dispute resolution clause for two of the international joint venture agreements was redacted from the SEC filing. In both cases the clause was an arbitration clause, but in neither case was it possible to tell whether the clause included any carve-outs.

⁸⁹ Joint Venture Agreement Between Tambala Food Products and Millennium Group Worldwide ¶ 14.2.2 (Nov. 12, 2007) (copy on file with author).

Type of Carve-out	# of contracts with carve-out	% of arbitration clauses with carve-out
Domestic agreements		
Any carve-out	4	44.4%
Provisional relief claims	3	33.3%
Injunctive relief claims	1	11.1%
International agreements		
Any carve-out	4	20.0%
Provisional relief claims	1	5.0%
Injunctive relief claims	2	10.0%
IP, trade secrets, corp. opportunities	1	5.0%

Carve-outs are less common in international joint ventures involving at least one Chinese party, but the sample is not large enough for any sort of statistical testing. All ~~thirteen~~^{twelve} of the contracts with at least one party from China included arbitration clauses, but only one of those (~~7.7%~~^{8.3%}) used a carve-out. By comparison, three of the remaining ~~nine~~^{eight} (~~33.3%~~^{37.3%}) international contracts with arbitration clauses but without Chinese parties used carve-outs.⁹⁰

D. Franchise Agreements

Consider also the use of carve-outs in franchise agreements. Franchise agreements differ from the contracts discussed in the sections above in several respects. First, franchise agreements are not individually negotiated. The franchise agreements we studied are standard form contracts drafted by the franchisor.⁹¹ Second, the sophistication of franchisees may vary widely. Some franchisees are inexperienced individuals running their first business. Other franchisees are large, publicly traded corporations.⁹²

To examine the use of carve-outs we used two different samples of franchise agreements, both based on Entrepreneur Magazine’s Franchise 500 — an annual listing of top-ranked franchise opportunities.⁹³ The “2011 sample” is derived the top 100 franchises in 2011. The “1999 sample” is derived from the top 75 franchise opportunities in 1999 and then tracks changes in the terms of those franchise agreements over time.⁹⁴ For both samples, we gathered contracts for those franchises operating in the state of Minnesota. Any franchisor who grants a franchise right within Minnesota must file with that state a copy of the company’s standard franchise agreement.⁹⁵

⁹⁰ Six of these contracts had at least one U.S. party; two of those six used a carve-out.

⁹¹ Drahozal, *supra* note 18, at 722.

⁹² *Id.* at 766.

⁹³ The franchise rankings are available at <http://www.entrepreneur.com/franchises/rankings/franchise500-115608/2011,-4.html>.

⁹⁴ This sample is an updated version of one previously used in Drahozal, *supra* note 18, at 695; Drahozal & Hylton, *supra* note 15, at 549; Drahozal & Wittrock, *supra* note 22, at 71.

⁹⁵ Those contracts are made available by the Minnesota Department of Commerce. *See* <https://www.cards.commerce.state.mn.us/CARDS/security/search.do?method=showSearchParameters&searchType=new>

The 2011 sample consists of 86 franchise contracts filed as of July 2011.⁹⁶ Forty-three of the 86 contracts contained arbitration clauses (50%), and of the forty-three, all but one carved out one or more claims or proceedings from arbitration and provided a right to the parties to instead proceed in court. Below is a list of types of carve-out provisions found in the 2011 sample:

Type of Carve-Out	# of contracts with carve-out	% of arbitration clauses with carve-out
Any carve-out	42	97.7%
Injunctive relief claims	41	95.3%
Claims to protect trademark	29	67.4%
Noncompete clause claims	17	39.5%
Confidentiality clause claims	13	30.2%
Nonsolicitation clause claims	8	18.6%
Claims to protect real property rights	5	11.6%
Claims for moneys owed	5	11.6%
Non-disparagement clause claims	2	4.6%

Most of these carve-outs were also found in the CEO employment contracts. Carve-outs to protect real property rights were found in franchise contracts where the franchisor agreed to lease commercial property from the owner and then sublease it to the franchisee to conduct franchise operations. Under the sublease arrangement, the franchisor reserved the right to enforce its rights to possession of the property in court.⁹⁷ Carve-outs to collect monies owed simply provided that the franchisor could go to court to collect debts owed by the franchisee.

The 1999 sample consists of 68 franchises for which franchise agreements are available for all of the years studied: 1999, 2007, and 2012.⁹⁸ The overall use of carve-outs is broadly consistent with what we found in the 2011 sample. Every franchise agreement with an arbitration clause, with the exception of one in 1999, included some form of carve-out. The relative frequency of the carve-outs was almost identical to the 2011 sample.

⁹⁶ The samples overlap to some degree: of the 86 franchises in the 2011 sample, 32 also appear in the 1999 sample.

⁹⁷ See, e.g., Supercuts (5), Subway (9), Circle K (22), Snap Fitness (33) and Fantastic Sam's (50) agreements.

⁹⁸ The original 1999 Sample consisted of 75 franchises. Seven of those franchises have either stopped doing business in Minnesota or stopped doing business altogether (through merger or otherwise) since then.

	# (%) of contracts with carve-out		
	1999	2007	2012
Any carve-out	30 of 31 (96.8%)	29 of 29 (100.0%)	28 of 28 (100.0%)
Injunctive relief claims	29 of 31 (93.5%)	28 of 29 (96.6%)	26 of 28 (92.9%)
Claims to protect trademark ⁹⁹	21 of 31 (67.7%)	20 of 29 (69.9%)	20 of 28 (71.4%)
Provisional relief claims ¹⁰⁰	17 of 31 (54.8%)	17 of 29 (58.6%)	16 of 28 (57.1%)
Noncompete clause claims	8 of 31 (25.8%)	12 of 29 (41.4%)	11 of 28 (39.3%)
Confidentiality clause claims	5 of 31 (16.1%)	11 of 29 (37.9%)	11 of 28 (39.3%)
Claims to protect real property rights	9 of 31 (29.0%)	6 of 29 (20.7%)	3 of 28 (10.7%)
Claims for moneys owed	12 of 31 (38.7%)	9 of 29 (31.0%)	7 of 28 (25.0%)

The franchise agreements in the 1999 sample provide two additional insights. First, for franchisors, carve-outs are not a new phenomenon. They are widespread in the franchise agreements from 1999. Second, that said, the use of some carve-outs has changed, albeit only slightly, over time. Limiting the sample to franchise agreements that used arbitration agreements throughout the period illustrates the change.

	# (%) of contracts with carve-out		
	1999	2007	2012
Injunctive relief claims ¹⁰¹	22 of 23 (95.7%)	22 of 23 (95.7%)	22 of 23 (95.7%)
Claims to protect trademark	15 of 23 (65.2%)	17 of 23 (73.9%)	18 of 23 (78.3%)
Provisional relief claims ¹⁰²	13 of 23 (56.5%)	13 of 23 (56.5%)	14 of 23 (60.9%)
Noncompete clause claims	8 of 23 (34.8%)	11 of 23 (47.8%)	10 of 23 (43.5%)
Confidentiality clause claims	5 of 23 (21.7%)	10 of 23 (43.5%)	10 of 23 (43.5%)
Claims to protect real property rights	6 of 23 (26.1%)	5 of 23 (21.7%)	3 of 23 (13.0%)
Claims for moneys owed	8 of 23 (34.8%)	6 of 23 (26.1%)	7 of 23 (30.4%)

⁹⁹ Consistent with the 2011 Sample, franchise agreements in the 1999 Sample were coded as including an injunctive relief carve-out whenever the arbitration clause carved out some form of injunctive relief, including preliminary injunctions and injunctive relief as to a particular type of claim. In addition, three arbitration clauses included language providing that injunctive relief was available under the usual standards for granting such relief, without specifically mentioning the forum. Again, consistent with the 2011 Sample, these arbitration clauses were coded as including injunctive relief carve-outs. For both these reasons, the results reported here differ from the results reported in Drahozal & Wittrock, *supra* note 22, at 71.

¹⁰⁰ Two arbitration clauses included language providing that preliminary injunctive relief was available under the usual standards for granting such relief, without specifically mentioning the forum. Again, consistent with the coding of the clauses for injunctive relief carve-outs, *see supra* note 99, these clauses were also coded as including carve-outs for provisional relief claims.

¹⁰¹ *See supra* note 99.

¹⁰² *See supra* note 99.

The use of carve-outs for trademark claims and claims for provisional relief — already among the most common types — increased somewhat over the period. By comparison, carve-outs for moneys owed and for real property claims decreased, at least to some extent, over the period.

With the exception of the monies owed carve-outs, all these carve-outs involve contract provisions designed to protect the franchisor’s real property, intellectual property, and/or rights to information, reputation, and/or innovation in the contract. The tradeoffs between litigation and arbitration here seem to be substantially similar to those found in the CEO employment contracts: arbitration can provide confidentiality to the parties, but when the underlying dispute threatens to destroy information or other property value for the company, then litigation often seems to be preferred. Unlike the CEO employment contracts, however, one additional motivation for the arbitration agreement is a desire to avoid class actions by franchisees.¹⁰³ Note that the franchise contract carve-outs all seem to give the franchisor rather than the franchisees rights to proceed with litigation.¹⁰⁴ Like the CEO employment contracts, these contracts tend to be formed between two US parties. Although the CEO employment contracts likely are heavily negotiated on both sides, often the franchise contracts are not mutually negotiated. This difference is somewhat apparent in the specific language used in the carve-out clauses, but it does not seem to significantly affect the types of carve-outs present in the agreements.

The contracts in the 2011 sample were also separated into categories by type of franchise business for separate analysis. Categories included food, hospitality, education, exercise, cleaning, tools and auto, and others. Arbitration rates as well as carve-out rates for each of these categories are shown in Table 11.

Industry	# contracts from industry	# (%) of arbitration clauses in contracts	# (%) of arbitration clauses with carve-outs
Food	24	13 or 54%	13 or 100%
Hospitality (Hotels)	8	0	-----
Education	4	2 or 50%	2 or 100%
Exercise	5	5 or 100%	5 or 100%
Cleaning	8	4 or 50%	4 or 100%
Tools/Auto	10	7 or 70%	6 or 85.7%
Other	27	12 or 44.4%	12 or 100%

Note that the arbitration clause rate varied considerably (from 0 to 100%), but where arbitration clauses were present, at least one remedy or form of dispute was reserved for court resolution in all contracts but one. Rates of specific type of carve-out for each industry are shown in Table 12.

¹⁰³ Drahozal & Wittrock, *supra* note 12, at 281-82.

¹⁰⁴ Occasionally the contracts will include provisions that make this unilateral right to litigate more clear. For example, the Jiffy Lube franchise contract (30) empowers the franchisor to sue in court to collect monies owed, unless the franchisor counterclaims for breach of the franchise agreement, in which case the parties are to be sent back to arbitration.

Type of carve-out	Food	Education	Exercise	Cleaning	Tools/Auto	Other
Any Carve-out	13	2	5	4	6	12
Injunctive relief	13 or 100%	2 or 100%	5 or 100%	4 or 100%	5 or 71.4%	12 or 100%
Trademark	10 or 76.9%	0	2 or 40%	4 or 100%	3 or 42.9%	10 or 83.3%
Noncompete Clause	6 or 46.1%	0	1 or 20%	3 or 75%	2 or 28.6%	5 or 41.7%
Confidentiality Clause	6 or 46.1%	0	0	0	1 or 14.3%	4 or 33.3%
Monies Owed	4 or 30.77%	0	0	0	1 or 14.3%	0
Nonsolicitation Clause	3 or 23%	0	0	3 or 75%	0	2 or 16.7%
Real Property	1 or 7.7%	0	1 or 20%	0	0	3 or 25%
Nondisparagement Clause	0	0	0	2 or 50%	0	0

The use of specific types of carve-outs from arbitration vary significantly by type of franchise. Because rights to information, innovation, and property are all best protected through injunctive relief, that carve-out alone might enable the franchisor to also protect its interest in the other categories. Differences in the other types of carve-outs therefore could reflect differences in the length of contracts or (in some cases) could reflect differences in the underlying contract. For example, if there is no non-compete clause or confidentiality requirement in the agreement, then there is no need to carve out supporting claims from arbitration. In the 1999 Sample, however, all the franchise agreements with an arbitration clause but no carve-out for non-compete clause claims nonetheless included a covenant not to compete in 2012. Likewise, all the franchise agreements with an arbitration clause but no carve-out for confidentiality clause claims nonetheless included a contract provision imposing a duty of confidentiality on the franchisee. The absence of a carve-out was not due to the absence of contractual duty.

E. Mobile Wireless Services Contracts

Finally, for comparison purposes, we examined the use of carve-outs in one type of consumer contract. Mobile wireless services contracts have been at the center of recent litigation over the use of arbitration clauses and class waivers,¹⁰⁵ but little work has been done to examine systematically the use of arbitration clauses (much less carve-outs) in those contracts.¹⁰⁶

¹⁰⁵ Most notably in *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740 (2011).

¹⁰⁶ For exceptions, see Linda J. Demaine & Deborah R. Hensler, “Volunteering” to Arbitrate Through Predispute Arbitration Clauses: The Average Consumer’s Experience, 67 L. & CONTEMP. PROBS. 65 (Winter/Spring 2004); Amy J. Schmitz, *Legislating in the Light: Considering Empirical Data in Crafting Arbitration Reforms*, 15 HARV. NEGOT. L. REV. 115 (2010).

The market for mobile wireless services consists of facilities-based operators — operators that “offer mobile voice, messaging, and/or data services using their own network facilities”¹⁰⁷ — and mobile virtual network operators (MVNOs) — operators that “purchase[] mobile wireless services wholesale from facilities-based providers and resell[] the services to consumers.”¹⁰⁸ Four facilities-based operators operate nationwide: AT&T, Sprint/Nextel, T-Mobile, and Verizon Wireless. The rest operate regionally or locally. The largest MVNO is TracFone, which has more subscribers than all but the four nationwide facilities-based operators.¹⁰⁹ MVNOs may serve otherwise underserved market niches or provide extended services or geographic coverage for facilities-based operators.¹¹⁰

In February and March 2013, we collected consumer agreements from the web pages of the twelve leading facilities-based operators (all those that operate nationally or regionally) and the two largest MVNOs (TracFone and H2O Wireless) for which subscriber data are available.¹¹¹ Because facilities-based operators often include the customers of their wholesale customers (i.e., MVNOs) in their subscriber data, we report our findings for facilities-based operators separately from our findings for the MVNOs to avoid double-counting.¹¹²

Agreements from eleven of the twelve facilities-based operators, covering 99.9% of subscribers, included arbitration clauses.¹¹³ Ten of the eleven contracts with arbitration clauses, covering 99.7% of subscribers subject to arbitration, carved out small claims from arbitration.¹¹⁴

¹⁰⁷ Federal Communications Commission, Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions With Respect to Mobile Wireless, Including Commercial Mobile Services 30 (June 27, 2011) [hereinafter Fifteenth Mobile Wireless Competition Report].

¹⁰⁸ *Id.* at 35.

¹⁰⁹ *Id.* at 36.

¹¹⁰ *Id.* at 35.

¹¹¹ Market share data for the facilities-based operators is from Strategy Analytics, *Grading the Top 10 U.S. Carriers in the Third Quarter of 2012* (Nov. 26, 2012), available at <http://www.fiercewireless.com/special-reports/grading-top-10-us-carriers-third-quarter-2012>. Market share data for the two MVNOs is from the Fifteenth Mobile Wireless Competition Report, *supra* note 107, at 262 table C-6 (reporting 14.4 million subscribers for TracFone and more than 300,000 subscribers for H2O Wireless/Locus Telecommunications).

¹¹² Fifteenth Mobile Wireless Competition Report, *supra* note 107, at 37.

¹¹³ In 2011, the FCC reported that the total number of facilities-based operators exceeded 90, and that the companies “typically provide[d] service in a single geographical area, many of them rural areas.” *Id.* at 32. As of the first quarter 2010, the total number of MVNOs ranged from 43 to 61, although little or no data were publicly available on the subscriber base of the MVNOs. *Id.* at 36-37.

We do not have information on the use of arbitration clauses for facilities-based operators or MVNOs other than those described above. Given that the largest mobile services providers use arbitration clauses, it is a fair statement that the substantial (if not vast) majority of their customers are subject to arbitration clauses. Given the lack of data for the smaller mobile services providers, it is not necessarily the case that most or all mobile services providers use arbitration clauses. *Cf.* Peter B. Rutledge & Christopher R. Drahozal, *Contract and Choice*, 2013 B.Y.U. L. REV. 1, 18 (finding that most credit card issuers do not use arbitration clauses).

¹¹⁴ Small claims carve-outs also are widely used in credit card agreements. *See* Rutledge & Drahozal, *supra* note 114, at 1-22. Rutledge and Drahozal describe the use of carve-outs in credit card agreements as follows:

Far and away the most common carve-out in credit card arbitration clauses is for small claims (defined either by the dollar amount sought or by the claims being brought in small claims court). Of the issuers studied, thirty-two (of forty-seven, or 68.1%) excluded small claims from arbitration. Most of the agreements that did not exclude small claims were from small issuers (the

The one contract without a small claims carve-out (which covered 0.3% of subscribers) included instead a carve-out for collection actions. The only other carve-outs were in contracts used by very small companies. One had a carve-out for intellectual property claims, while another had a carve-out for indemnity claims.

Of the ten contracts with small claims carve-outs, four of ten (40.0%) covering 6.6% of subscribers applied to consumer small claims only. The remaining six (60.0%), which covered 93.4% of subscribers, carved out small claims brought by either consumers or the business. The carve-out for collection actions is very similar to a small claims carve-out for business claims only, to the extent the collection actions are brought in small claims court.

Table 13. Carve-outs in Mobile Wireless Services Contracts		
	# (%) of arbitration clauses with carve-outs	% of subscribers
Facilities-Based Operators		
Any carve-out	11 of 11 (100.0%)	100.0%
Small claims	10 of 11 (90.9%)	99.7%
Collection actions	1 of 11 (9.1%)	0.3%
Mobile Virtual Network Operators (MVNOs)		
Any carve-out	2 of 2 (100.0%)	100.0%
Small claims and/or collection actions	1 of 2 (50.0%)	2.0%
Claims for unauthorized sale, export, or tampering with equipment	1 of 2 (50.0%)	99.8%

By comparison, customer agreements from both MVNOs also included arbitration clauses. The TracFone agreement included a carve-out “for claims concerning the unauthorized sale, export, alteration and/or tampering of your TracFone, its software, the service and/or PIN numbers.”¹¹⁵ One version of the H2O Wireless agreement included a small claims carve-out for

fifteen issuers not including a small claims carve-out comprised only 1.6% of credit card loans outstanding, while the thirty-two including a small claims carve-out comprised 98.4% of credit card loans outstanding)...

Relatedly, five issuers (of forty-seven, or 10.6%; but 51.4% of credit card loans outstanding) excluded debt collection claims from arbitration....

Other types of carve-outs are less common in credit card arbitration clauses. Nine issuers (of forty-seven, or 19.1%; 3.8% of credit card loans outstanding) excluded from arbitration claims for interim relief, such as preliminary injunctions and attachments. Twelve issuers (of forty-seven, or 25.5%; 11.2% of credit card loans outstanding) excluded repossession and other self-help remedies, while six issuers (of forty-seven, or 12.8%; 3.6% of credit card loans outstanding) excluded claims in bankruptcy.

Id. at 21-23; see also Consumer Financial Protection Bureau, Arbitration Study Preliminary Results 32-33 (Dec. 12, 2013) (data on carve-outs for small claims), available at http://www.consumerfinance.gov/f/201312_cfpb_arbitration-study-preliminary-results.pdf.

¹¹⁵ TracFone Wireless, Inc., Terms and Conditions of Service ¶ 23 (June 24, 2011) (copy on file with authors).

both the business and the customer, while the other included a small claims carve-out for the customer and a carve-out for collection actions.¹¹⁶

Both the American Arbitration Association (through its Consumer Due Process Protocol) and JAMS (through its Minimum Standards of Procedural Fairness) require businesses to permit consumers to go to small claims court in lieu of arbitration.¹¹⁷ As such, it is difficult to draw any inferences about business or consumer behavior from the use of small claims carve-outs.¹¹⁸ On the other hand, that a majority of contracts representing the vast majority of customers also provides the business with the right to proceed in court with small claims suggests a possible cost-cutting motivation. In any event, other carve-outs appear to be much less common in contracts with consumers than in contracts with other businesses.

III. Implications

Our analysis as well as our empirical findings suggest a number of possible implications for future scholarship as well as for public policy related to both arbitration and courts. We discuss here the implications of our analysis and findings for (1) the contractual procedure scholarship; (2) the continuing role of courts in resolving business disputes; (3) the proper role of unconscionability doctrine as applied to carve-outs from arbitration clauses; and (4) the application of severability doctrines in policing arbitration clauses more generally.

A. Procedural Unbundling and Contractual Procedure

The rapidly growing literature on contractual procedure analyzes unbundled or a la carte procedures.¹¹⁹ Much of the literature has focused on the theoretical and normative implications of contracting for unbundled procedures. Some commentators have identified a range of benefits that sophisticated parties might obtain with unbundled procedure.¹²⁰ Others have highlighted potential dangers of unbundling for the enforcement of legal norms and the legitimacy of the adjudication process.¹²¹ As David Hoffman states, the “scholarship has generally proceeded to

¹¹⁶ H2O Wireless, Terms and Conditions (Feb. 2012) (copy on file with authors).

¹¹⁷ American Arbitration Association, Consumer Due Process Protocol princ. 5 (Apr. 17, 1998); JAMS Policy on Consumer Arbitration Pursuant to Pre-Dispute Clauses, Minimum Standards of Procedural Fairness ¶ 1(B) (July 15, 2009).

¹¹⁸ Moreover, the American Arbitration Association has reported that “few consumers exercise their right to have their matters heard in small claims court rather than in AAA consumer arbitration.” Federal Trade Commission, Repairing a Broker System: Protecting Consumers in Debt Collection Litigation and Arbitration 44 & n. 211 (July 2010) (citing Richard W. Naimark).

¹¹⁹ See *supra* text accompanying note 17.

¹²⁰ Kapeliuk & Klement, *supra* note 17, at 1483-84 (arguing that “ex ante, [the parties] can gain substantial advantages from modified rules both before and after the dispute emerges,” such as “reduc[ing] strategic and opportunistic behavior and litigation costs should a dispute arises,” “shap[ing] the parties’ ex ante substantive and procedural behavior,” and “creating information revelation mechanisms”).

¹²¹ Dodge, *supra* note 17, at 729 (contending that contractual procedure “has the capacity to reshape not only the role of the private right of action between contracting parties but also the broad swath of statutory, constitutional, and common law obligations that rely upon [procedure] as a primary mechanism of enforcement”); Bone, *supra* note 17, at 1397 (arguing that “party rule-making is most problematic when it alters procedures and rules designed to

work out ever-more-sophisticated theoretical frameworks to govern the appropriate relationship between private and public procedural rulemaking.”¹²²

As noted above, however, the available empirical evidence suggests that detailed provisions customizing procedural rules are in general quite rare in contracts between sophisticated parties. In samples of corporate contracts and credit card agreements, Hoffman found “literally only a handful of contracts ... in which parties expect the court to impose their own procedural rules.”¹²³ Moreover, even though one might expect a greater degree of procedural customization in arbitration clauses,¹²⁴ relatively little customization is found, at least in contracts between sophisticated parties.¹²⁵ Thus, O’Connor, Martin, and Thomas found that only a very small percentage of arbitration clauses in CEO employment contracts contained customized terms. To be sure, parties commonly chose an arbitral forum, an arbitration provider, and applicable off-the-rack procedural rules promulgated by the provider, all of which have implications for the governing rules applied to their dispute resolution proceedings. However, they did almost nothing to change the rules of procedure that would apply by default in these fora, the subject of much of the literature on customized procedure.¹²⁶

Several reasons might explain this surprising rarity of ex ante a la carte procedures. Individualized unbundling could interfere with cooperative mindsets, because such efforts signal to the other party that one anticipates future disputes.¹²⁷ Alternatively, unbundling may not occur because the lawyers drafting contracts are acting out of habit rather than optimization goals (or for other reasons contract are “sticky”).¹²⁸ By one account, unbundling is a type of innovation, and innovation typically happens only through shocks to a system which have not yet occurred.¹²⁹

A third possibility is that the individualized ex ante procedural unbundling focused on in the literature could be prohibitively costly for most parties. Drafting costs could inhibit the parties, but adding a sentence or even a paragraph to a high-value contract should not prove

frame, guide, or incentivize” the core of the adjudicatory process: “a commitment to a mode of reasoning that engages general principle and case-specific facts in an effort to reach reflective equilibrium”).

¹²²

¹²³ *Id.*

¹²⁴ For example, given that the authority of arbitrators depends on the parties’ agreement, one might expect arbitrators to be more likely to apply contractually-specified procedures than judges.

¹²⁵ By comparison, in standard form contracts between businesses and consumers, provisions modifying arbitral procedures are more common, although again the frequency varies widely depending on the type of contract. *E.g.*, Rutledge & Drahozal, *supra* note 113. Moreover, some franchise agreements also contain provisions customizing procedure as well as the sorts of carve-outs studied here. Drahozal & Wittrock, *supra* note 22.

¹²⁶ One might therefore think of this customization as the arbitration equivalent of a simple choice-of-court clause, where parties might choose a specific forum because in general they approve the procedures applied there by default.

¹²⁷ See Theodore Eisenberg, Geoffrey P. Miller, & Emily Sherwin, *Mandatory Arbitration for Customers but not for Peers: A Study of Arbitration Clauses in Consumer and Non-Consumer Contracts*, 92 JUDICATURE 118, 122 (2008). See generally Kathryn E. Spier, *Incomplete Contracts and Signaling*, 23 RAND J. ECON. 432 (1992); cf. Robert H. Gertner & Geoffrey P. Miller, *Settlement Escrows*, 24 J. LEGAL STUD. 87, 119 (1995) (mentioning dispute resolution procedures during contract negotiations can signal that a breach of contract claim is likely).

¹²⁸ See, e.g., G. MITU GULATI & ROBERT E. SCOTT, *THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* (2012).

¹²⁹ Hoffman, *supra* note 19, at ___ (manuscript at 40-44).

preclusive. Instead, procedural customization could prove costly because of problems of forecasting. Specifically, parties face a variety of different risks in their contractual relationships which could turn into disputes. A counterparty might not perform what she promised, she might perform but in a negligent manner, she might cause a personal or financial injury to others in the course of performance, or she might perform perfectly but steal a party's personal property, intellectual property, or other proprietary information, just to name a few possible risks. If these risks materialize, they could lead to disputes involving many possible claims, including breach of contract, negligence, trespass, conversion, actions for indemnity, intellectual property, etc. Given this diversity of possible risks and their accompanying legal claims, the optimal procedures for one potential dispute might well not prove optimal for others.¹³⁰ Forecasting and then articulating the best possible procedures for each of those disputes could well prove too costly, especially when the parties must agree that those procedures mutually benefit the parties. Support for this possibility can be found in the fact that procedural customization appears to be more common in the adhesion contract context,¹³¹ where the drafter can spread drafting costs across many contracts and where the specific provisions need not be subject to individual bargaining.

We think the third explanation has more merit than the first two. If signaling or sticky-contracts-awaiting-system-shock explains the lack of procedural customization, then we should not expect any routine contractual customization of dispute resolution. In fact, however, as this article has shown, carve-outs also provide a means by which parties contract for unbundled procedure, and carve-outs are common, in at least some types of contracts between sophisticated parties. This form of customization enables the parties to customize according to particular performance risks, which appears to better enable the parties to capture deterrence benefits relative to specification costs.

By unbundling the potential claims and remedies, the parties can then more effectively choose a bundle of court procedures to treat some contractual risks while choosing a bundle of arbitration procedures to treat others. This customization based on claim and remedy has the effect of enabling the parties to choose one bundle of default procedural rules to govern some claims and remedies while choosing a separate bundle of default procedural rules to govern other claims and remedies. It enables the parties to pick and choose the specific claims and remedies that are appropriately resolved in each venue. Moreover, by separating out some claims and remedies, this customization enables the parties to more carefully calibrate the fit between a chosen venue and the disputes it must handle.

Customization of the claims and remedies to be handled in each forum occurs despite the potential signaling effects of focusing on disputes.¹³² Moreover, prior habits of binary choice or

¹³⁰ Others have noted this potential difficulty in the context of customized procedure and more generally. Moffitt, *supra* note 17, at 461 (“[t]he transaction costs involved in the search for potential efficiency may, in certain contexts, outweigh the potential benefits that might derive from customization”); Karen Eggleston, et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91 (2000) (stating that complex contracts will often be left incomplete because of the transactions costs of covering every contingency).

¹³¹ See, e.g., Rutledge & Drahozal, *supra* note 113, at 37-50; Christopher R. Drahozal & Peter B. Rutledge, *Contract and Procedure*, 94 MARQ. L. REV. 1103 (2011); Demaine & Hensler, *supra* note 106.

¹³² Although claim and remedy customization, through carve-outs (or carve-ins), could signal a different type of consideration than specific procedural rule customization, in both contexts the negotiations entail fine-tuning the

court default doesn't seem to constrain the parties from this type of customization. Instead, the parties unbundle claims and remedies because it enables them to separate out different types of contract risks for differing protection mechanisms. This type of tailoring is easier to forecast and cheaper to incorporate than is the customization focused on in the contractual procedure literature. Indeed, claim and remedy customization might work to make feasible the other types of contractual customization because unbundling the differing risks makes it cheaper to customize the procedure that would apply for the category of risks to be handled in courts or arbitration. Nevertheless, the first cut at contractual customization should be, and apparently is, the unbundling of claims and remedies.

Thus, procedural customization is an empirical reality, albeit not in the form most commonly believed. The scholarship should readjust its focus accordingly.¹³³ More generally, our analysis suggests that the contractual procedure literature should pay more careful attention to the costs and benefits of customized procedure. Our model helps identify the key costs and benefits: the deterrence benefits (or costs) to the parties; the increase or decrease in process costs from the customization; and the specification costs of drafting and negotiating a customized procedure. Particularly important for the latter appears to be the difficulty of anticipating the types of disputes and claims as to which the parties *ex ante* might agree to more detailed procedures.

B. The Continued Necessity of Courts?

Carve-outs also provide information on when sophisticated parties view courts as providing value. All types of contracts studied showed contracting parties regularly using both arbitration clauses and carve-outs from arbitration.¹³⁴ This fact suggests that parties demand both arbitration and courts in a broad variety of contexts. Given that contractual relationships tend to involve multiple but differing performance risks, it is not surprising to find that parties might prefer to use courts to address some of those risks but arbitration to address others. The arbitration literature has identified some circumstances where parties might prefer courts to arbitration.¹³⁵ For example, scholars have previously noted that parties often prefer courts to arbitration for “bet-the-company” cases and cases in which they may need to obtain provisional relief.¹³⁶ Consistent with that literature, franchise contracts carve out trademark disputes (potentially a “bet-the-company” dispute for a franchisor, as well as one in which provisional

procedures that will apply in a given setting. Indeed, carve-outs could be viewed with more suspicion by counterparties, because unlike the situation where a given set of customized procedural rules would apply to both parties' claims, carve-outs often have the effect of causing one party's claims to be treated differently than at least some of the other party's claims. If signaling concerns do not work to defeat the negotiation of carve-outs, they are probably even less likely to work to defeat the negotiation of specific procedural rules.

¹³³ See also Hoffman, *supra* note 19, at __ (manuscript at 38) (“Obviously, the ability to choose arbitration for particular types of disputes should complicate our models of the background rule against which parties' silence on procedural terms should be analyzed.”).

¹³⁴ See *supra* Part II.

¹³⁵ Noyes, *supra* note 17, at 586-89, 591-92; Drahozal & Ware, *supra* note 15, at 453-57; Christopher R. Drahozal, *Why Arbitrate? Substantive Versus Procedural Theories of Private Judging*, 22 AM. REV. INT'L ARB. 163 (2011).

¹³⁶ Drahozal & Wittrock, *supra* note 22, at 79; Scott H. Blackmand & Rebecca M. McNeill, *Alternative Dispute Resolution in Commercial Intellectual Property Disputes*, 47 AM. U. L. REV. 1709 (1998); C. Mark Weidemaier, *Disputing Boilerplate*, 82 TEMPLE L. REV. 1 (2009).

relief might be required).¹³⁷ Likewise, a common carve-out is for collection actions (or for moneys owed), in which the law and facts are likely to be relatively clear and for which arbitration may do little more than add another procedural step before a party can take legal steps to collect a debt.¹³⁸

But our study enables a broader consideration of the types of claims where parties are likely to consistently rely on courts for enforcement. Some argue that there are entire categories of commercial disputes that no longer get resolved in courts because private parties prefer arbitration.¹³⁹ Even in situations where parties routinely refer matters to arbitration, however, our contracts suggest that they nevertheless continue to prefer courts as a mechanism for protecting information, innovation, reputation, and property.¹⁴⁰ If so, then courts should focus on providing the best possible substantive and procedural rules for the resolution of these disputes. That is the best way to provide value to private parties. This focus for court systems is non-trivial, for the fraction of value in commercial exchange attributable to innovation and information is very significant (perhaps one half or more) and that fraction appears to be growing over time.¹⁴¹

Consider, for example, court treatment of remedies available for breach of contract. One possible implication of the carve-out studies is that some parties conclude that disputes involving requests for injunctive relief can be more efficiently and effectively resolved in courts. Injunctive relief can take multiple forms, with some more valuable to parties attempting to protect information and innovation than others. Because injunctive relief is equitable, however, U.S. courts are not always willing to provide such relief if other remedies are available.¹⁴² This principle limits the granting of specific performance in lieu of monetary damages, and there is some evidence that the limitation is problematic for some contracting parties.

Significant controversy surrounds the question of whether courts should be more willing to order specific performance. The traditional common law rule is that courts will award specific performance only when damages would be inadequate,¹⁴³ and, even then, not in the context of personal services.¹⁴⁴ On the other hand, courts in civil law countries are less reluctant to order

¹³⁷ Drahozal & Wittrock, *supra* note 22, at 79-80; Drahozal, *supra* note 18, at 739.

¹³⁸ Stephanie Francis Ward, *They Dun Them Wrong*, ABA J., July 2008, at 18 (quoting Robert Markoff, president of the National Association of Retail Collection Attorneys: “If the consumer is not going to pay the arbitration award, you have to take them to court anyway”).

¹³⁹ See, e.g. Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 MICH. L. REV. 1724 (2001); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996).

¹⁴⁰ For an expanded version of the argument in this section, see Erin O’Hara O’Connor & Christopher R. Drahozal, *The Essential Role of Courts for Supporting Innovation*, 92 TEX. L. REV. ____ (forthcoming 2014).

¹⁴¹ See, e.g., Jean Raymond Homere, *Intellectual Property Rights Can Help Stimulate Development in Least Developed Countries*, 27 COLUM. J.L. & ARTS 277, 281 (2004) (stating that IP assets alone account for 40% of US corporate asset value and over 33% of European company asset value).

¹⁴² DOUGLAS LAYCOCK, *MODERN AMERICAN REMEDIES: CASES AND MATERIALS* 380 (4th ed 2010) (noting general principle that “equity will not act if there is an adequate remedy at law”).

¹⁴³ See, e.g. Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978); Michael J. Sechler, *Supply Versus Demand for Efficient Legal Rules: Evidence from Early English “Contract” Law and the Rise of Assumpsit*, 73 U. PITT. L. REV. 161 (2011).

¹⁴⁴ See, e.g., *Jetborne Int’l, Inc. v. Cohan*, 584 So.2d 176 (Fla. Ct. App. 1991); RESTATEMENT (SECOND) OF CONTRACTS § 367 (1981).

specific performance,¹⁴⁵ and there is evidence that the traditional common law rule has eroded in at least some American courts.¹⁴⁶ Scholars debate the policy merits of specific performance, with powerful arguments proffered on both sides.¹⁴⁷ In the meantime, behavioral scholars have demonstrated that average Americans tend to think specific performance is an appropriate, even preferred, remedy for breach of contract.¹⁴⁸

In a number of contexts, sophisticated parties seem to prefer specific performance as the most effective means to protect the value of their exchange. A recent empirical study conducted by Eisenberg and Miller showed that contracting parties commonly incorporate into their documents language designed to enhance the likelihood of obtaining an order for specific performance in the event of breach. Specifically, their review of more than 2300 contracts filed with the SEC in 2002 found that 31.5% of all contracts attempted to provide for specific performance as a remedy, with such provisions found in 57.8% of employment contracts and 53.4 % of merger agreements.¹⁴⁹ Interestingly, however, they found that parties were more rather than less likely to attempt to contract for specific performance when they opted for their disputes to be resolved in arbitration.¹⁵⁰ Unfortunately, Eisenberg and Miller did not code for the presence of carve-outs in the arbitration clauses.¹⁵¹ Parties seeking specific performance as a remedy for some claims might in fact designate courts for the resolution of those claims by placing carve-outs in their arbitration clauses. Alternatively, parties seeking specific performance might opt for arbitration rather than courts out of fear that courts are less likely than arbitrators to grant specific performance. If the latter explains the clauses, then courts might better serve party needs by announcing a clear willingness to order specific performance when parties contract for the remedy.¹⁵² And in any event, the Eisenberg and Miller findings help to show the importance of taking into account contractual carve-outs.

¹⁴⁵ Theodore Eisenberg & Geoffrey P. Miller, *Damages versus Specific Performance: Lessons from Commercial Contracts* (March 2013), available at <http://ssrn.com/abstract=2241654>.

¹⁴⁶ See *id.* Indeed, the Uniform Commercial Code provides that parties can agree to a specific performance remedy. UCC § 2-716(1).

¹⁴⁷ For examples of arguments in defense of the traditional rule, see Timothy Muris, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053; Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365 (1982); Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. PA. L. REV. 45 (1999). For examples of arguments in favor of liberal granting of specific performance, see Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 13-14 (1989).

¹⁴⁸ Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judging and Moral Heuristics in Breach of Contract*, 6 J. EMPIRICAL LEGAL STUD. 405 (2009).

¹⁴⁹ Eisenberg & Miller, *supra* note 145, at __ (manuscript at 35).

¹⁵⁰ *Id.*

¹⁵¹ O'Hara O'Connor & Drahozal, *supra* note 140, at __.

¹⁵² To be clear, however, the use of carve-outs does not provide evidence that parties prefer juries to arbitration, a possibility suggested by Eisenberg and Miller. Theodore Eisenberg & Geoffrey P. Miller, *Do Juries Add Value?: Evidence from an Empirical Study of Jury Trial Waiver Clauses in Large Corporate Contracts*, 4 J. EMPIRICAL LEGAL STUD. 539, 587 (2007) The most common types of claims that parties carve out of arbitration clauses either involve injunctive relief (including injunctions to enforce trademarks, covenants not to compete, and confidentiality agreements) or the use of specialized court procedures (collection actions and eviction actions), in none of which is a jury likely to play a role. We do not argue that juries never provide value to sophisticated parties in resolving their disputes. But we find little evidence of such value in this study.

Some scholars have noted a difference between common law and civil law countries regarding court ability and willingness to grant equitable relief more generally, as well as court willingness to exercise contempt powers.¹⁵³ In civil law countries, where courts are not thought to have any inherent equitable powers, such authority must be granted by statute and may therefore be weaker.¹⁵⁴ And even with an ability to coerce parties to comply with court orders, judges in countries where contempt authority is the exception rather than the rule may be relatively less willing than judges in the US to use conferred contempt powers. Given the types of claims that U.S. parties are carving out from arbitration, these authorities seem to create significant value for private parties.

A remaining question, which is too broad to adequately address here, is whether legal reforms should include the creation of specialized courts to handle claims involving information and innovation. Relatedly, states could experiment with lodging these claims in their business courts, which should have jurisdiction over most business contract disputes in any event.¹⁵⁵ Specialized courts might better serve party needs than courts of general jurisdiction, because the parties can more effectively rely on expert decision makers and potentially streamlined proceedings. Such determinations would inevitably critically involve matters outside the scope of our analysis, but our studies do have implications for court reforms.

Of course, our analysis implicitly assumes both that social welfare is equivalent to private welfare in these contexts and that courts might ever be motivated to promote either private or social welfare. As to the first point, if sophisticated parties transact in a market context without significant third-party effects, then private and social welfare should converge. Where parties are unsophisticated or where third parties are hurt by party efforts to protect information and innovation, then our analysis begins rather than ends the court reform discussion. As for the motivation of courts, US courts considering reforms at least sometimes take into account both efficient dispute resolution and party preferences.¹⁵⁶ Where those motivations are present, our findings can provide helpful insights.

Finally, our findings have implications for the development literature. Many scholars have noted the importance of strong courts and rule-of-law legal systems for a nation's ability to attract investment opportunities.¹⁵⁷ Some scholars argue that a state's legal rules must protect

¹⁵³ JOHN OWEN HALEY, *AUTHORITY WITHOUT POWER* 118 (1991); JOHN HENRY MERRYMAN, *THE CIVIL LAW TRADITION: AN INTRODUCTION TO THE LEGAL SYSTEMS OF WESTERN EUROPE AND LATIN AMERICA* 49, 55 (1985).

¹⁵⁴ See, e.g., Robert S. Barker, *Judicial Review in Costa Rica: Evolution and Recent Developments*, 7 SW J. L. & TRADE IN THE AMERICAS 267, 275 (2000).

¹⁵⁵ Christopher R. Drahozal, *Business Courts and the Future of Arbitration*, 10 CARDOZO J. CONFLICT RESOL. 491, 495-96 (2009) (discussing common jurisdictional grants in business court statutes).

¹⁵⁶ See Erin O'Hara O'Connor & Peter B. Rutledge, *Arbitration, The Law Market, and the Law of Lawyering*, draft manuscript on file with authors (discussing this dynamic in the context of the creation of business courts within the US).

¹⁵⁷ See, e.g., C.N. Cookson, *Long-Term Direct Investment in Brazil*, 35 UNIV. MIAMI INTER-AMERICAN L. REV. 345, 358 (2004) (noting importance of effective legal system for nation's ability to attract foreign direct investment); David F. Clossey & Jere R. Thomson, *A Global Law Firm Operating in a Global Market: Jones Day*, METROPOLITAN CORP. COUNS., May 2004, at 9, 9; David Hindman, *The Effect of Intellectual Property Regimes on Foreign Investments in Developing Economies*, 23 ARIZ. J. INT'L & COMP. L. 467 (2006); Susan D. Franck, *Foreign Direct Investment, Investment Treaty Arbitration, and the Rule of Law*, 19 PAC. MCGEORGE GLOBAL BUS. & DEV.

private arrangements, through property and contract rights,¹⁵⁸ and those rules must be considered stable, through the development of *stare decisis*,¹⁵⁹ long-term commitments to international investment treaties,¹⁶⁰ or otherwise. In addition, the judiciary needs to be independent of the other branches of government,¹⁶¹ and it needs to be sufficiently well-funded to attract high quality judges who can expeditiously resolve disputes.¹⁶²

Not all agree that this judicial investment is entirely essential, however. For example, Tom Ginsburg has noted that third-party dispute resolution can facilitate investment by “substituting for poor institutional environments.”¹⁶³ Other scholars have argued that nations can bypass decades of court and law reform efforts if they can credibly commit to enforcing arbitration clauses and arbitrator awards.¹⁶⁴ This emphasis on private arbitration as a substitute for ineffective domestic courts and legal systems is supported by the fact that more than 145 nations have signed the New York Convention¹⁶⁵ which obligates states to enforce arbitration clauses and arbitral awards.¹⁶⁶ Given common scholarly claims that the vast majority of parties to international contracts prefer to arbitrate disputes,¹⁶⁷ it seems possible that at least international investment can easily thrive without strong courts.¹⁶⁸

Our findings suggest that parties who mistrust local courts will instead rely on arbitration for the resolution of their disputes. But they also suggest that contractual value is lost if parties cannot rely on courts to protect the value of their information and innovation. Recall that parties

L.J. 337 (2007); Ruma Sarkar, *The Legal Implications of Financial Sector Reform in Emerging Capital Markets*, 13 AM. U. INT’L L. REV. 705 (1998).

¹⁵⁸ See, e.g., I.F.I. Shihara, *Judicial Reform in Developing Countries and the Role of the World Bank*, in JUDICIAL REFORM IN LATIN AMERICA AND THE CARIBBEAN: PROCEEDINGS OF A WORLD BANK CONFERENCE 219, 220 (1995).

¹⁵⁹ Cookson, *supra* note 157, at 351-52.

¹⁶⁰ See, e.g., W.M. Reisman & R.D. Sloane, *Indirect Expropriation and its Valuation in the BIT Generation*, 74 BRITISH YB. INT’L L. 115 (2003).

¹⁶¹ Shihara, *supra* note 158, at 219.

¹⁶² *Id.*

¹⁶³ T. Ginsburg, *International Substitutes for Domestic Institutions: Bilateral Investment Treaties and Governance*, 25 INT’L REV. L & ECON. 107, 113 (2005).

¹⁶⁴ ERIN A. O’HARA & LARRY E. RIBSTEIN, *THE LAW MARKET* 98 (2009).

¹⁶⁵ Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3.

¹⁶⁶ For a list of current member countries, see UNCITRAL, Status: 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, at

http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html.

¹⁶⁷ Winston Stromberg, *Avoiding the Full Court Press: International Commercial Arbitration and Other Global Alternative Dispute Resolution Processes*, 40 LOY. L.A. L. REV. 1337 (2007); William Wang, *International Arbitration: The Need for Uniform Interim Measures of Relief*, 28 BROOK. J. INT’L L. 1059 (2003); Jane L. Volz & Roger S. Haydock, *Foreign Arbitral Awards: Enforcing the Award Against the Recalcitrant Loser*, 21 WM. MITCHELL L. REV. 867 (1996); Robert S. Wrede, *Honolulu: Geneva of the Pacific?*, 7 PEPP. DISP. RESOL. L.J. 189 (2007); K.P. BERGER, INTERNATIONAL ECONOMIC ARBITRATION 8 n.62 (1993); A. Casella, *On Market Integration and the Development of Institutions: The Case of International Commercial Arbitration*, 40 EUR. ECON. REV. 155 (1996); Christopher R. Drahozal & Richard W. Naimark, *Commentary*, in CHRISTOPHER R. DRAHOZAL & RICHARD W. NAIMARK (EDS.), TOWARDS A SCIENCE OF INTERNATIONAL ARBITRATION: COLLECTED EMPIRICAL RESEARCH 57, 59 (2005) (discussing research finding that almost 90 percent of sample of international joint venture agreements contained arbitration clauses).

¹⁶⁸ We set aside the question of the desirability of arbitration for enforcement of bilateral investment treaties on grounds that neither our data nor our theory can effectively address the topic.

seemed to opt for court resolution of some claims in order to avoid having to shuffle back and forth between courts and arbitration when the claim is best enforced with injunctive relief. Although the problem could be resolved by empowering the arbitrator to grant such relief, arbitrator authority would not extend to third parties¹⁶⁹ and arbitrators would inevitably lack the muscle of the state in the event of violation. Moreover, even if arbitrators could effectively grant preliminary relief, the problems associated with bet-the-company claims and a need for clear law and potential precedent (i.e. patent validity) could still weigh decidedly in favor of court resolution of the claim.

Especially if today's high-technology trade and development is particularly valuable to a nation,¹⁷⁰ a credible commitment to allow parties to privatize their dispute resolution will not suffice to attract maximum investment opportunities. Strong, effective courts are also needed. Other nations' courts might at least partially substitute for local courts, and thus a policy in favor of enforcing choice-of-court clauses could also aid economic behavior. To the extent that a party's assets or conduct are local however, local courts that can reliably grant equitable relief based on a sound rule of law system may remain essential to preserving the value of private contracts.¹⁷¹

China seems to recognize the need for providing effective courts for the resolution of intellectual property claims. Recall that the technology contracts between Chinese firms (many of whom claimed foreign ownership interests in the contract) opted for arbitration at comparatively very high rates without any use of carve-outs. Recently, the Chinese government has invested significant assets into the development of specialized intellectual property courts despite the widespread use of CIETAC arbitration for international investment.¹⁷² In particular, to date about 400 intellectual property tribunals and panels have been set up across China.¹⁷³ However, China's struggles continue, due in large part to the fact that the distribution of IP cases to the new tribunals and panels has been extremely uneven. The busy courts have such congested dockets that they cut corners in deciding cases,¹⁷⁴ and those courts with very few cases are failing to provide an environment where the novice judges can master the field.¹⁷⁵ Likely it will take awhile before these difficulties are resolved, and awhile longer before parties feel confident returning to the courts. But this very significant investment represents an acknowledgement by the Chinese government that arbitration alone will not satisfy commercial party demands.

¹⁶⁹ This might matter, for example, in the context of noncompete clauses, where a former employer seeks to enjoin a new employer from taking advantage of the information and talents of the employee.

¹⁷⁰ This is presumably true for most nations. See, e.g., Hindman, *supra* note 157, at 469-72 (noting importance of high-tech investments to all nations and competition for such foreign direct investment across nations); Robert M. Sherwood, *Intellectual Property in the Western Hemisphere*, 28 U. MIAMI INTER. AM. L. REV. 565, 576-77 (1997) (study finding that IP protection in a nation has a statistically significant effect on foreign direct investment into the country).

¹⁷¹ *Showmethemoney Check Cashers, Inc. v. Williams*, 27 S.W.3d 361 (Ark. 2000) (consumer loan agreement with carve-out for collection claims).

¹⁷² Glenn R. Butterson, *Pirates, Dragons and U.S. Intellectual Property Rights in China: Problems and Prospects of Chinese Enforcement*, 38 ARIZ. L. REV. 1081, 1105-06 (1996).

¹⁷³ Z. Guangliang, *Discussion on IP Judicial Institution, Judges, and Ways to Hear IP Cases*, 2 CHINA PATENTS AND TRADEMARKS 80, 81 (2011).

¹⁷⁴ *Id.* at 82.

¹⁷⁵ *Id.* at 81.

Our evidence of high rates of carve-outs even in cross-border contracts suggests that private parties would value international agreement under the Hague Choice-of-Court Convention. The Convention,¹⁷⁶ concluded in 2005, would obligate member nations to honor choice-of-court agreements and to enforce judgments rendered in courts chosen pursuant to party agreement.¹⁷⁷ To date, only Mexico has ratified the Convention, although the US and the EU have both signed but not yet ratified it.¹⁷⁸ The Convention carries the promise of securing cross-border enforcement of court judgments for commercial parties, which could prove particularly valuable to those parties who wish to use carve-outs for some potential claims.¹⁷⁹

C. Court Scrutiny of Carve-Outs

A number of US state courts – most notably in California and Arkansas – consistently invalidate arbitration clauses that carve out certain types of disputes. California courts hold that arbitration clauses with carve-outs contained in employment contracts are unconscionable unless the drafting party (i.e., the business) can demonstrate a business reason for the carve-out.¹⁸⁰ Moreover, California courts have used the principle to invalidate even those arbitration clauses found in CEO and other executive employment agreements,¹⁸¹ and have never deemed a proffered business justification sufficient to save the arbitration clause.¹⁸² Arkansas courts require mutuality of the obligation to arbitrate, not accepting any justification for a carve-out that benefits the business over an employee or consumer.¹⁸³

¹⁷⁶ Convention on Choice of Court Agreements, June 30, 2005, 44 I.L.M. 1294, available at http://www.hcch.net/index_en.php?act=conventions.text&cid=98.

¹⁷⁷ Louise Ellen Teitz, *The Hague Choice of Court Convention: Validating Party Autonomy and Providing An Alternative to Arbitration*, 53 AM. J. COMP. L. 543 (2005).

¹⁷⁸ See Hague Conference on Private International Law, Status Table: Convention of 30 June 2005 on Choice of Court Agreements, available at http://www.hcch.net/index_en.php?act=conventions.status&cid=98 (last visited March 20, 2013).

¹⁷⁹ A caveat is in order here. We saw little evidence of contracting parties incorporating choice-of-court clauses into their carve-outs. This could be because parties contemplating a need for injunctive relief want to be able to obtain that relief wherever a contractual violation occurs. Presumably some parties feel comfortable designating a court in some circumstances, if only as a permissive matter, so the Convention should nevertheless prove useful for parties relying on carve-outs.

¹⁸⁰ *E.g.*, *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 692 (Cal. 2000); *Fitz v. NCR Corp.*, 13 Cal. Rptr. 3d 88 (Ct. App. 2004).

¹⁸¹ O'Hara O'Connor et al., *supra* note 19, at 156-57.

¹⁸² *Id.* at 155; *see, e.g.*, *Bridge Fund Capital Corp. v. Fastbucks Franchise Corp.*, 622 F.3d 996, 1005 (9th Cir. 2010) (“The only business justification offered by Fastbucks for the non-mutual judicial remedy provision was its need to seek provisional remedies, which is insufficient under California law to justify non-mutuality (because California law protects parties’ rights to seek provisional remedies in court regardless of any arbitration clause that may cover the parties’ dispute.)”); *Fitz v. NCR Corp.*, 13 Cal. Rptr. 3d 88, 105 (Ct. App. 2004) (“NCR’s concern that arbitration may not always meet its legitimate dispute resolution needs is not a proper business justification for the exception.”); *Mercuro v. Superior Court.*, 116 Cal. Rptr. 2d 671, 677–78 (Ct. App. 2002) (rejecting asserted business justification for carve-out of claims for injunctive relief).

¹⁸³ *Showmethemoney Check Cashers.* 27 S.W. 3d at 361.

Our findings cast doubt on both of these lines of cases.¹⁸⁴ Carve-outs are not outlier provisions that shock the conscience. To the contrary, we find that freely negotiated contracts — i.e., contracts between two sophisticated parties — regularly use carve-outs from arbitration clauses.¹⁸⁵ Moreover, courts should not automatically conclude that carve-outs found in employment contracts necessarily provide evidence of overreaching by the employer. Indeed, CEO employment contracts involve very sophisticated employees who typically negotiate their agreements with the assistance of counsel,¹⁸⁶ and yet they commonly use the very sorts of carve-outs held unconscionable or otherwise unenforceable by courts. As such, our evidence suggests that the seemingly un rebuttable presumption that such carve-outs are unfair to consumers or employees is unwarranted.

Likewise, our findings belie California’s requirement that the business reason justifying a carve-out be something other than the fact that arbitration is not well-suited for resolving a particular type of dispute.¹⁸⁷ Even in contracts between sophisticated parties, that is precisely the reason parties use carve-outs. And, given that these carve-outs are common across many different types of contracts, where relative bargaining power and contract drafting practices likely differ, they are unlikely to simply result from particular lawyer preferences or the dominant influence of one of the parties. No doubt more study of carve-outs is needed before reaching any firm conclusions, but we can at least tentatively conclude that the business justification is one of significant value to the contract.¹⁸⁸ Specifically, even where the clause tends to benefit just one of the parties, as is the case for the CEO employment contracts, the party not benefitted by the clause, if sophisticated, agrees to its inclusion, perhaps for a price. If so, this suggests that the benefit to the party proposing the term is worth more than the cost to the other party of accepting it. In effect, the California requirement essentially sets a standard that no business can in good faith satisfy.¹⁸⁹

¹⁸⁴ Conversely, our analysis supports, on a policy basis, the outcome in *THI of New Mexico at Hobbs Ctr., LLC v. Patton*, in which the Ninth Circuit held that the FAA preempts New Mexico’s application of unconscionability doctrine to invalidate arbitration clauses with carve-outs, 2014 WL 292660, at *6-*7 (10th Cir. Jan. 28, 2014).

¹⁸⁵ See *supra* Part II.

¹⁸⁶ Thomas et al, *supra* note 70.

¹⁸⁷ *Armendariz*, 6 P.3d at 694 (business justification must be “grounded in something other than the employer’s desire to maximize its advantage based on the perceived superiority of the judicial forum”).

¹⁸⁸ One might think that in some contracting contexts the terms of the agreement primarily are a function of the preferences of the party that presents the terms of the initial contract draft. For example, if the buyer in an M&A deal tends to present the terms of a first draft, and the seller can only focus on some of those terms in the negotiations, then many of the buyer’s terms will never be challenged, even if they do not mutually benefit the parties. Cf. Christel Karsten, *What Drives the Variation in Takeover Contracts: The Economics or the Lawyers?*, draft manuscript available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2081805 (empirical study showing that terms of takeover contracts are in part a function of economic circumstance and in part a function of the drafting practices of particular law firms). Such systemic concerns clearly affect our franchise contracts, but we have no reason to believe that the technology contracts, the joint venture agreements, or the CEO employment contracts are similarly affected.

¹⁸⁹ Even assuming there is no business reason that justifies the use of a carve-out, the state law restrictions on their use may make consumers and employees worse off rather than better off. Drahozal has shown previously that a requirement of mutuality may lead businesses to use mutual dispute resolution clauses when a non-mutual clause would make the consumer or employee better off. Drahozal, *supra* note 20, at 555-61.

The use of class waivers in arbitration clauses has analogous implications. Businesses may use an arbitration clause with a class arbitration waiver to reduce if not avoid class relief altogether. But avoiding class actions in that way involves more than simply waiving class relief. It also brings with it the other characteristics of the arbitration procedural bundle, which the parties may or may not otherwise prefer. (This point is consistent with

The issue of the enforceability of such carve-outs has also plagued the courts of other nations. Some nations' courts, including those in England and Hong Kong, have expressed a willingness to enforce jurisdictional clauses even when they provide asymmetric rights to a party to use courts or arbitration.¹⁹⁰ Others, however, have struck down such provisions as being unfairly unequal.¹⁹¹ Our analysis suggests that a categorical exclusion of forum provisions that provide unequal rights sweeps too broadly. Consider, for example, a recent case decided in the Russian courts. In *CJSC Russian Telephone Co. v. Sony Ericsson Mobile Communications Rus LLC*, two companies agreed to arbitrate their claims, but the service provider reserved a right to bring claims to court based on monies owed it by the other party. The court struck the clause as unfairly unequal, even though the case involved sophisticated parties who had chosen to have a particular claim resolved in courts rather than in arbitration.¹⁹² Our data and analysis suggest that the clause can be justified by sound business practice rather than overreaching by a party. Thus, as with unconscionability in US courts, a more nuanced analysis of similar foreign law doctrines such as “mutuality” and “inequality” seems warranted.

D. Severability Doctrines

Our findings also have implications for how courts apply severability doctrines. When a court decides that it is unable to refer a particular matter to arbitration, at least as contemplated by the contract, it can either strike the entire arbitration clause or just remove the offending portion or action from the scope of the clause. Our findings should caution against striking the entire arbitration clause in circumstances where the problem can be resolved by severing individual claims. We discuss the matter here as it arises under the unconscionability doctrine and with federal statutes addressing nonarbitrability.

1. Unconscionability

When a court finds that an arbitration agreement is unconscionable, it has discretion to either strike the entire agreement or modify it to excise the offending portion. Courts typically

the argument in Christopher R. Drahozal & Peter B. Rutledge, *Arbitration Clauses in Credit Card Agreements: An Empirical Analysis*, 9 J. EMPIRICAL LEGAL STUD. 536 (2012), that not all businesses are likely to begin using arbitration clauses after *AT&T Mobility LLC v. Concepcion*.) As such, the use of arbitration clauses as class action waivers may impose costs on the parties entirely separate from any costs (or benefits) from the elimination of class relief. The use of carve-outs may mitigate those costs by permitting parties to obtain the court bundle of procedures for some of claims or remedies, but not if state law effectively invalidates the use of such carve-outs.

¹⁹⁰ See, e.g., *China Merchants Heavy Industry Co. Ltd. V. JGC Group* [2001] HKLRD (Yrbk) 21 (Hong Kong); *Mauritius Commercial Bank Ltd. V. Hestia Holdings Ltd and Another* [2013] EWHC 1328 (Comm) (UK).

¹⁹¹ *CJSC Russian Telephone Co. v. Sony Ericsson Mobile Communications Rus LLC*, Case No. 1831/12 (19 June 2012) (highest arbitration court of the Russian Federation ruled invalid a contractual provision that gave Sony a unilateral right to bring monies owed claims to court even though all other claims by the parties were to be resolved in arbitration); see also *X v. Banque Privée Edmond de Rothschild Europe*, Cour de Cassation, Case No. 11-26022, (26 Sept. 2012) (French court ruled invalid clause in bank account agreement that forced the consumer to arbitrate in the courts of Luxembourg but gave the bank the option to choose a different court).

¹⁹² For a recent discussion of this and related cases, see Maxi Scherer & Sophia Lange, *The French Rothschild Case: A Threat for Unilateral Dispute Resolution Clauses?*, Kluwer Arbitration Blog (July 18, 2013), <http://kluwerarbitrationblog.com/blog/2013/07/18/the-french-rothschild-case-a-threat-for-unilateral-dispute-resolution-clauses/>.

consider whether the unconscionability infects the entire clause or just a portion of it. For example, when courts deem arbitration clauses to be unconscionable because they contain carve-outs, they often conclude that the carve-outs create nonmutual obligations which infect the entire arbitration agreement. As a result, instead of striking the carve-out, courts strike the entire arbitration agreement, which typically enables the employee or consumer to proceed in court with her claims.

In some cases an arbitration clause contains multiple problems that lead a court to strike the clause in its entirety. In other cases, however, the difficulty is more isolated. Even here, though, the entire arbitration clause sometimes is in jeopardy. A court will not strike or rewrite a portion of the arbitration agreement if the clause as modified by the court produces results that never would have garnered the parties' assent. Sometimes a court will strike an entire arbitration clause simply because it wishes to avoid the problem of rewriting the parties' agreement.

Our findings suggest that courts should be less hesitant to modify rather than invalidate an arbitration clause when the modification has the effect of taking particular claims out of the scope of the arbitration agreement. Our studies indicate that parties commonly carve-out claims from arbitration when those claims seem ill-suited for arbitration and the specification costs are sufficiently small. Thus, modification by courts on similar grounds might not interfere with the assent required for the enforcement of arbitration clauses.¹⁹³

2. Statutory Nonarbitrability Provisions

Consider also the structure of statutes that make specified claims nonarbitrable – that is, statutes that preclude arbitration of a statutory claim under a pre-dispute arbitration clause. In the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress enacted a series of such provisions, which preclude arbitration of whistleblower claims by employees of consumer financial services firms, commodities firms, and publicly-traded firms.¹⁹⁴ The provisions have in common that they are limited to arbitration under pre-dispute arbitration agreements, and that the claims at issue protect whistleblowers. But they differ in the scope of their effect. Two of the provisions invalidate the entire arbitration clause; the arbitration agreement is unenforceable *if* the arbitration clause requires arbitration of a dispute arising under this section.¹⁹⁵ The other provision does not invalidate the entire arbitration clause but only carves out the statutory claim

¹⁹³ By comparison, invalidating the entire clause puts the parties in the position of attempting to renegotiate post-dispute an agreement entered into pre-dispute (i.e., when there was uncertainty over whether a dispute would ever arise). As discussed earlier, *see supra* note 18, the parties might well come to a different agreement (or no agreement at all) after a dispute has arisen than before.

¹⁹⁴ 7 USC § 26(n)(2) (“No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.”); 18 U.S.C. § 1514A(e) (“No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.”); 12 U.S.C. § 5567(d)(2) (“[N]o predispute arbitration agreement shall be valid or enforceable to the extent that it requires arbitration of a dispute arising under this section.”).

¹⁹⁵ 7 U.S.C. § 26(n) (commodities whistleblowers); 18 U.S.C. § 1514A(e) (whistleblowers in publicly traded companies).

from arbitration; the arbitration agreement is unenforceable “to the extent that it requires arbitration of a dispute arising under this section.”¹⁹⁶

A similar issue has arisen as to claims under the Magnuson-Moss Warranty Act (MMWA). The MMWA permits a warrantor of consumer goods to establish a non-binding dispute resolution process, but does not expressly preclude the use of a binding arbitration clause. Most courts hold that claims under the MMWA are arbitrable.¹⁹⁷ But of those courts holding MMWA claims not arbitrable, some invalidate the entire arbitration clause¹⁹⁸ while others only carve out the MMWA claim from arbitration.¹⁹⁹

By comparison, the Supreme Court has flatly held that a court must compel arbitration of pendent state-law claims even when the court will be adjudicating a nonarbitrable federal statutory claim.²⁰⁰ In other words, when Congress does not address the issue, a nonarbitrable claim invalidates the arbitration agreement only to the extent the agreement provides for arbitration of the claim. The Court in *Byrd* rejected the "intertwining" doctrine under which some courts, in the interests of efficiency, had refused to send the pendent claims to arbitration when they were "intertwined" with the nonarbitrable claims.²⁰¹ The Court explained:

We therefore are not persuaded by the argument that the conflict between the two goals of the Arbitration Act — enforcement of private agreements and encouragement of efficient and speedy dispute resolution — must be resolved in favor of the latter in order to realize the intent of the drafters [of the FAA]. The preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is “piecemeal” litigation, at least absent a countervailing policy manifested in another federal statute.²⁰²

The Court also rejected the argument that the possible preclusive effect of the arbitral proceedings (another form of bifurcation cost²⁰³) justified the intertwining doctrine:

[I]t is far from certain that arbitration proceedings will have any preclusive effect on the litigation of nonarbitrable federal claims.... The question of what preclusive effect, if any, the arbitration proceedings might have is not yet before us, however, and we do not yet decide it.... Suffice it to say that in framing preclusion rules in this context, courts shall take into account the federal interests warranting protection. As a result, there is no reason to require that district courts

¹⁹⁶ 12 U.S.C. § 5567(d)(2) (whistleblowers in consumer financial services industry).

¹⁹⁷ *E.g.*, *Davis v. Southern Energy Homes, Inc.*, 305 F.3d 1268 (11th Cir. 2003); *Walton v. Rose Mobile Homes LLC* 298 F.3d 470 (5th Cir. 2002); *In re American Homestar of Lancaster, Inc.*, 50 S.W.3d 480 (Tex. 2001).

¹⁹⁸ *E.g.*, *Parkerson v. Smith*, 817 So. 2d 529, 534 (Miss. 2002).

¹⁹⁹ *E.g.*, *Koons Ford of Baltimore, Inc. v. Lobach*, 919 A.2d 722, 736 (Md. Ct. App. 2007).

²⁰⁰ *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985).

²⁰¹ *Id.* at 219 (describing intertwining doctrine as based on the view that the FAA's "goal of speedy and efficient decision making is thwarted by bifurcated proceedings").

²⁰² *Id.* at 221.

²⁰³ *See supra* text accompanying note 48.

decline to compel arbitration, or manipulate the ordering of the resulting bifurcated proceedings, simply to avoid an infringement of federal interests.²⁰⁴

Our findings support the Court's decision in *Byrd*, and suggest that if Congress desires to make a particular statutory claim nonarbitrable, it should invalidate an arbitration clause only to the extent that it covers the nonarbitrable claim. Sophisticated parties commonly are willing to bear the costs of cases bifurcated between court and arbitration to obtain the relative advantages of those two forums. As the Court concludes in *Byrd*, enforcing the parties' arbitration agreement should take precedence over concerns about "piecemeal" litigation, especially when parties themselves so act. Congress likewise should take this empirical reality into account in formulating statutory nonarbitrability provisions. If the parties view the costs of bifurcation as excessive, they can address the issue in their arbitration clause.

Conclusion

Procedural unbundling is alive and well, but not in the forms typically assumed by scholars. In a wide variety of contracts, parties routinely unbundle the procedures governing their anticipated disputes such that some claims and remedies are to be pursued in court and others in arbitration. By unbundling claims and remedies in this manner, parties can obtain greater deterrence benefits and lower dispute resolution costs without facing the prospect of prohibitively expensive specification costs. These latter costs are minimized, relative to individually unbundling procedures to be applied to all possible claims, because carve-outs and carve-ins enable parties to separate governing procedures based on the nature of the specific risks of nonperformance. For most parties, less perfectly crafted off-the-rack rules applied on the basis of carefully-tailored claims appear preferable to more carefully-tailored procedural rules that must then apply to all possible disputes.

The prevalence of unbundling by carve-outs in contracts involving sophisticated parties has policy implications for court treatment of unconscionability and nonarbitrability questions that arise in the context of enforcement of arbitration clauses. It also suggests that governments wishing to ensure that local courts provide value to commercial parties should focus on the substantive rules and procedures applied to claims that function to protect information, innovation, reputation, and property.

²⁰⁴ *Byrd*, 470 U.S. at 222-23.