Arbitration and the Harmonization of International Commercial Law: A Defense of *Mitsubishi*

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I.   INTRODUCTION

Contracts are valuable business tools when certain legal conditions are met. Courts should enforce terms to which the parties agree, and supply appropriate default rules when a dispute arises from contingencies not anticipated by the contract. Implicit in these conditions, but worth highlighting, is the necessity that courts be neutral, and not enforce the contract in favor of one party because of characteristics unrelated to the contract. Finally, when public policy demands that certain kinds of contract not be

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enforced, it is important that parties know what these restrictions are in advance.

These conditions are not always met within a state, but international transactions put extra pressure on them. In the absence of international treaties or conventions, parties to a contract cannot predict which law will be applied to them. If party A breaches, party B might be able to obtain a remedy only by pursuing A's assets located in A's country, but if party B breaches, party A might be able to obtain a remedy only by pursuing B's assets located in B's country. Either state might have a poorly developed or idiosyncratic contract law, with inappropriate default rules or numerous restrictions on the enforcement of terms. Additionally, either state might have a judicial system that favors nationals over foreigners. Although parties can try to anticipate these problems by placing a choice of law term in their contract, a judicial system that enforces contracts idiosyncratically would probably not respect a choice of law term.

This problem is the result of the diversity of commercial law regimes among states, and the diversity of their judicial systems. The solution to the problem is some sort of harmonization. However, harmonization can take many forms. One possible route to harmonization is an international treaty that establishes identical substantive commercial law in all states for international transactions, but it is unlikely that states would allow local public policy concerns to yield in all instances to the exigencies of international transactions. States have good reasons to apply antitrust laws, securities laws, usury laws, and other mandatory rules to domestic transactions, and would insist on applying them to international transactions as well. Because these restrictions vary a great deal according to local conditions, a clear and workable commercial law treaty could not specify the mandatory rules that would apply in every state.

A more modest route to harmonization would be an international treaty that establishes a single international system of substantive commercial law, with exceptions for variations in local mandatory rules. Creating identical default rules in all states would significantly reduce the amount of uncertainty in international commercial transactions, even if the exceptions for local mandatory rules would prevent uncertainty from being eliminated. The problem with this proposal, however, is the sheer difficulty of achieving agreement among all relevant states, which usually results in vague terms when treaties are signed. In addition, in the

absence of a common sovereign, local interpretations of the treaty, and thus the effective law in every state, would rapidly diverge.[1] This problem, which would occur in any centralized approach to harmonization, seems insurmountable.

A third possible route to harmonization is for every state to agree, by treaty, to enforce arbitration clauses in international commercial contracts. Under traditional choice of law principles, contracting parties can usually choose the law that will govern their contract. To the extent they can do so, and to the extent that the law is properly enforced, harmonization could be achieved. Although the law would not be identical in all states, the law would become fully predictable since parties could choose the state with the optimal law for their contract. Now, local courts may not respect the parties' choice of law, and, even if they do, they may indulge a bias against foreign parties. However, if the treaty enables the parties to choose a forum, with a particular private arbitrator, the parties would agree on a forum that respects their choice of law and that resolves disputes in a neutral manner. Harmonization would be achieved because the parties would be able to predict which law would govern their dispute and how it would be enforced. Therefore, all that is necessary is for the treaty to require local courts to enforce arbitration awards, except when arbitration awards violate local mandatory rules.

The New York Convention is this treaty.[2] It requires courts to enforce international arbitration awards, but allows courts to decline to enforce arbitration awards that fail to respect local mandatory rules. Because it enables parties to choose their optimal law and forum, it is unnecessary for every state to agree to identical substantive commercial law and to interpret the law consistently. In this way, the New York Convention's decentralized approach to harmonization is superior to the centralized approach.[3]

However, the decentralized approach appears to run up against the barrier that made the centralized approach unacceptable. As long as national courts have the authority to review arbitration

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1. An example is the Convention on the Law Applicable to International Sales of Goods, June 15, 1955, 510 U.N.T.S. 147. *See* Steven Walt, *Novelty and the Risk of Uniform Sales Law*, 39 VA. J. INT'L L. 671 (1999).

2. 9 U.S.C. §§ 201-208 (1994).

3. As urged by Paul Stephan, *The Futility of Unity and Harmonization*, 39 VA. J. INT'L L. 743; *see also* Andrew Guzman, *Developing Capital Markets in a Global Economy*, 39 VA. J. INT'L L. 607 (relying on international arbitration to enforce his system of portable reciprocity).

awards in order to ensure that they do not violate mandatory rules, they are free once again to indulge their bias against foreign parties and to force both parties to submit to the costly litigation that arbitration is designed to avoid. If courts overcome their biases, and enforce arbitration awards without subjecting them to de novo review, then arbitrators would be free to ignore mandatory rules if they wanted to. And arbitrators would want to ignore mandatory rules because they know that merchants, ex ante, prefer that their contracts be enforced as written and would prefer to pay for the services of arbitrators who enforce the contract rather than the mandatory rules that the contract may violate. The dilemma can be stated succinctly. If domestic courts enforce arbitration awards, rather than subjecting them to de novo review, arbitrators will ignore local mandatory rules. However, if courts subject arbitration awards to de novo review in order to ensure that mandatory rules are respected, the benefits of arbitration— predictability, neutrality, and minimization of litigation cost—are lost.

These problems haunt the recent U.S. Supreme Court jurisprudence on international arbitration, especially the well-known case of *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*[4] In *Mitsubishi*, the Court enforced an arbitration clause in a contract between Mitsubishi, a Japanese car manufacturer, and Soler, a dealership located in Puerto Rico. The dealership had resisted arbitration on the ground that the dispute involved U.S. antitrust laws, which are mandatory rules (in the sense that they cannot be waived by contract), and on the ground that an international arbitrator cannot be entrusted to respect those laws. The Court held, over a forceful dissent, that under the New York Convention the arbitration clause must be enforced. At the same time, however, in footnote 19, the Court said that if the international arbitrator did not properly respect U.S. antitrust laws, a U.S. court could refuse to enforce the arbitration award. The court also implied that a U.S. court could refuse to enforce an arbitration agreement ex ante if it believed that the arbitration clause was a "prospective waiver" of U.S. antitrust rules.[5]

The Court thus dealt with the enforcement dilemma by ignoring it, and the opinion's footnote 19 is resoundingly ambiguous: either courts should enforce arbitration agreements routinely or only

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4. 473 U.S. 614 (1985).
5. *Id.* at 637 n.19.

when they are sure that arbitrators will respect mandatory rules. Because the *Mitsubishi* Court assumed that the arbitrator *in that case* would respect American antitrust laws,[6] the holding provides no direction for courts when the arbitrator's stance is in doubt.

This result has been criticized by commentators. They insist that *Mitsubishi* must mean one thing or the other, and neither alternative is attractive. If the Court meant to hold that all arbitration clauses must be enforced, then international arbitration will flourish but arbitrators will not respect mandatory rules in the hope of attracting clients. If the Court included footnote 19 in order to signal that courts will review arbitration clauses in de novo trials, then courts can ensure that mandatory rules are enforced but international arbitration will lose its value. Commentators who care about local public policy believe these costs are outweighed by the importance of seeing mandatory rules enforced.[7] Enthusiasts for international arbitration go the other way.[8] No one, however, has claimed that *Mitsubishi* ensures that both goals—respect for mandatory rules and the benefits of international arbitration—are achieved. Most commentators believe that the holding of the majority and the dicta in footnote 19 contradict each other and that the Court should have seized one horn of the dilemma or the other rather than pretending that no dilemma exists.

This paper defends the *Mitsubishi* decision. Initially, the paper describes formally the conditions under which the criticism of *Mitsubishi* is correct, namely, that courts cannot ensure that mandatory rules are enforced while preserving the advantages of the international arbitration system (neutrality and cost savings). It then shows that these conditions are not necessarily plausible. The main contribution of the paper is a proof that the optimal strategy of courts, under plausible conditions, is to engage in *random* de novo review of arbitration decisions. This strategy results in arbitrators frequently respecting mandatory rules and courts refraining from always reviewing arbitration awards. Thus, manda-

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6. *Id.*

7. *See, e.g.,* Christine L. Davitz, *U.S. Supreme Court Subordinated Enforcement of Regulatory Statutes to Enforcement of Arbitration Agreements: From the Bremen's License to the Sky Reefer's Edict,* 30 VAND. J. TRANSNAT'L L. 59 (1997); Thomas E. Carbonneau, *The Exuberant Pathway to Quixotic Internationalism: Assessing the Folly of* Mitsubishi, 19 VAND. J. TRANSNAT'L L. 265 (1986).

8. *See* William Park, *Private Adjudicators and the Public Interest: The Expanding Scope of International Arbitration,* 12 BROOKLYN J. INT'L L. 629 (1986).

tory rules are often respected while neutrality and cost savings are often achieved. It is then argued that *Mitsubishi* appropriately, though perhaps not intentionally, implemented this strategy by creating conditions under which parties are unsure about how U.S. courts will react to arbitration awards that violate mandatory rules.

II.   INFORMAL DESCRIPTION OF THE MODEL.

The model supposes that there are four parties: two merchants, a court, and an arbitrator. For concreteness, assume that one merchant is an American company (A) and the other merchant is a Japanese company (J), and that they seek to enter into a contract for the sale of goods. The parties know that a contractual contingency might occur—such as a change in the market price of the goods or in the exchange rate of currencies—that would make the contract more favorable for one party and less for the other, and that, in such a case, the latter would try to escape its obligations under the contract. If a dispute arises, the parties would like, ex ante, for the dispute to be resolved by international arbitration for three reasons: the arbitrator is assumed to be more neutral than Japanese or U.S. courts, arbitration is cheaper than litigation, and the arbitrator might be willing to ignore mandatory rules that limit the value of the contract. For example, the Japanese party might want to avoid U.S. antitrust or securities laws, and the American party might be willing to waive its protection under those laws, were it permitted to, in return for a transfer. Arbitration is then seen as a way of contracting around mandatory national laws.

After the parties enter a contract, they find out whether the contractual contingency favors A or J. If it favors J, A might sue in American court claiming that the contract violated antitrust laws and should not be enforced. J would seek to stay litigation pending a resolution through international arbitration. It seems realistic to suppose that although the parties know whether the contractual contingency favors A or J, they do not know how a court would apply the antitrust laws.[9] The U.S. court will try the case de novo unless it believes that the arbitrator is likely to respect the antitrust laws. If the court tries the case de novo, it correctly enforces the contract if the mandatory rule does not apply, and cor-

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9. This assumption ensures that the parties do not always settle. If the parties had this information, they would always settle, and although the results would be the same, the analysis would be harder to understand.

rectly rescinds the contract if the mandatory rule does apply. For simplicity, attention is confined to the case where the contractual contingency favors J and the mandatory rule, if it applies, enables A to avoid the contract. Thus, either the contract is enforced in favor of J or rescinded because of a mandatory rule that favors A.

If the U.S. court enforces the arbitration clause, the arbitrator decides whether to respect the antitrust laws or not.[10] If the arbitrator ignores the laws or respects them but decides that J did not violate them, A loses the arbitration. J will seek enforcement of the arbitration award in a U.S. court if A's assets are in the United States, and A will argue that the arbitration award violates U.S. antitrust law because (whether true or not) the arbitrator has failed to respect U.S. antitrust laws. The court must decide whether to try the case de novo, thus defeating the purpose of arbitration, or enforce the award, thus risking the wholesale evasion of U.S. antitrust laws. The question is, how would these parties behave?

The model describes, initially, the basic intuition underlying the criticism of *Mitsubishi*. If courts enforce arbitration awards, then arbitrators will ignore mandatory rules, so courts will be tempted to review arbitration awards. If courts review arbitration awards in de novo trials, then arbitrators will respect mandatory rules, but then courts will be tempted to enforce arbitration awards. As long as courts care enough about the enforcement of mandatory rules, there will be no equilibrium. The model considers three equilibria that can occur. First, if the courts do not care too much about mandatory rules, and are greatly concerned about reducing court congestion, then there can be an equilibrium in which arbitrators ignore mandatory rules and courts enforce arbitration awards. Second, if courts care enough about enforcing mandatory rules, then in equilibrium they will choose a strategy of randomizing between enforcing and reviewing arbitration awards. Under plausible conditions, such a randomizing or "mixed" strategy would re-

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10. I assume that the arbitrator can either "ignore" mandatory rules or "respect" them. A third possibility—ignore the rules while giving lip-service to them—is subsumed under the "ignore" option for the purpose of the model. In fact, the arbitrator's options are more difficult and circumscribed. It is not clear whether they have the authority under the contract to enforce the mandatory rules of a legal system not chosen by the parties, and, yet, if they do not, they face the possibility that national courts will vacate their awards. As a result, their actual behavior is more complex. For a discussion, see GARY B. BORN, INTERNATIONAL COMMERCIAL ARBITRATION IN THE UNITED STATES: COMMENTARY AND MATERIALS 147-53 (1994).

sult in arbitrators also engaging in the mixed strategy of randomizing between the moves of respecting mandatory rules and ignoring them. Third, if courts cannot adopt a randomizing strategy, and they care enough about enforcing mandatory rules, they will always try cases de novo and parties will not use arbitration clauses.

Plausible conditions support the second equilibrium, and this equilibrium is superior (again, under plausible conditions) to either of the other equilibria. It uniquely ensures that mandatory rules are not always violated while enabling arbitration to occur in a way that preserves some (though not all) of its two advantages—neutrality and reduction in litigation costs. It will be argued that *Mitsubishi* might have produced this uniquely desirable equilibrium and that the ambiguity created by footnote 19 was essential to this result.

III. THE MODEL.

A. *Payoffs.*

The merchants. Let A_{ij} and J_{ij} be the payoffs for the parties, with $i \in \{A, J\}$ and $j \in \{M, N\}$. A_{ij} should be read: "A's payoff when the contract favors $\{A$ or $J\}$ and the mandatory rule $\{$applies or does not apply$\}$." For example, A_{AN} is A's payoff when the contractual contingency favors A and the mandatory rule does not apply, so the contract is enforced; J_{JM} is J's payoff when the contractual contingency favors J but a mandatory rule applies, so the contract is rescinded. Straightforwardly, $A_{AN} > A_{JN}$, $J_{JN} > J_{AN}$. A does better when the contract favors A, and J does better when the contract favors J. We assume that the mandatory rule is a U.S. law that allows the American party to escape the contract if it applies and allows the Japanese party to enforce the contract if it does not apply. For now, we do *not* assume that a symmetrical Japanese mandatory law protects the Japanese seller at the expense of the American buyer (but this possibility is discussed in Section D). For example, if a U.S. antitrust law applies, it enables A to escape the contract; if it does not apply, then J can enforce the contract. Hence: $A_{JM} > A_{JN}$, $J_{JM} < J_{JN}$. We assume that when the mandatory rule applies, A has the option of invoking it (by bringing suit) or not, and that when the contract favors A, A prefers to enforce the contract, rather than invoking the mandatory rule: $A_{AN} > A_{AM}$.

We assume that mandatory rules prevent the contracting parties from externalizing costs on third parties; therefore, the contracting parties' joint payoffs are greater if the contract is enforced than if it is struck down. When the contract favors J, it must be the case that $A_{JN}+J_{JN}>A_{JM}+J_{JM}$. We also assume that the arbitrator is more neutral than national courts. Let α and β represent the bias of the American and Japanese courts. When a U.S. court enforces a contract (because it is consistent with, rather than a violation of, mandatory rules), the American merchant's payoff is multiplied by $\alpha_A>1$ and the Japanese merchant's payoff is multiplied by $0<\alpha_J<1$, to reflect the fact that the American benefits from and the Japanese is hurt by the U.S. court's bias. Let $\alpha_A+\alpha_J<2$, to reflect the inefficiency of the bias. (Thus, $\alpha_A A_{JN}+\alpha_J J_{JN} < A_{JN} +J_{JN}$: ex ante, neutral adjudication is superior to biased adjudication.) The same holds for the Japanese court, with $\beta_J>1$ and $0<\beta_A<1$. We assume that a court is not biased when it enforces a mandatory rule to strike down a contract.

The court. Let m represent the payoff when no mandatory rule is violated (whether or not a contract must be rescinded), m>0, and t represent the cost of a de novo trial, t>0. The cost of enforcing an arbitration clause or award, rather than conducting a trial, is 0. If a mandatory rule is violated, the court's payoff is 0. We assume that m>t. Thus, the best result is that a mandatory rule is enforced without the need for a trial (that is, through arbitration) (m), the second best result is that the mandatory rule is enforced after a trial (m-t), and the worse result is that the mandatory rule is violated (0). When a court cares very much about the enforcement of mandatory rules, m rises relative to t; when the court cares very much about the problem of court congestion, t rises relative to m. Notice that the court receives m-t whenever it tries the case de novo, since it always correctly enforces the mandatory rule.

The arbitrator. We assume that the arbitrator's reputation depends on (i) his ignoring mandatory rules as much as possible, and (ii) the frequency with which courts enforce his awards rather than vacating them and trying the case de novo. The reason for this assumption is that parties use arbitrators in part to avoid mandatory rules and in part to avoid the cost of litigation and to ensure neutrality. The arbitrator has a stronger interest in the award being enforced than in ignoring the rule because an arbitrator whose awards are always vacated by courts has little value for parties, whereas an arbitrator who respects mandatory rules but is never

reversed at least confers the benefit of neutrality and cost savings. Put differently, the arbitrator can engage in a high-risk, high-return strategy of ignoring mandatory rules in the hope that courts will enforce his award rather than review it de novo, but risks the possibility that he will be exposed, so that, in the future, courts will never allow his awards to stand. Alternatively, the arbitrator can engage in a low-risk, low-return strategy of enforcing mandatory rules, so that, even if a court does review his award de novo, he will not be punished. Thus, the arbitrator can receive four payoffs. Let R_{mn}, with m ∈ {ignore, respect} the mandatory rule, and n ∈ {enforce, de novo} by the court. Then: $R_{ie}>R_{re}>R_{rd}>R_{id}=0$. We will assume that if A wins after the arbitrator respects a mandatory rule that favors A, and so does not sue, the payoff is R_{re}. If the parties do not use arbitration, the arbitrator's payoff is 0.

B.   *The Order of Play.*

Although the relevant mandatory rule might be U.S. or Japanese law, and lawsuits involving arbitration clauses can occur in either the United States or Japan, the model will focus on the subset of cases where the contractual contingency favors J and A sues in a U.S. court. Section D provides the analysis when the contractual contingency favors A and when the lawsuit occurs in Japan.[11]

Round 1. The parties jointly choose whether to include an arbitration clause or not and enter a contract. The merchants include an arbitration clause if both expect a higher payoff if they do than if they do not. If they do not include an arbitration clause, the game ends—and we could imagine that the merchants enter a contract, but depend on the national courts for enforcement in case of dispute. A receives $s(tA_{AM}+(1-t)\alpha_A A_{AN})+(1-s)(tA_{JM}+ (1-t)\alpha_A A_{JN})$, where s is the probability that the contract favors A and t is the probability that the mandatory rule applies. Because $\alpha_A A_{AN}>A_{AM}$, A's payoff is $s\alpha_A A_{AN}+(1-s)(tA_{JM}+(1-t)\alpha_A A_{JN})\equiv A_{exp}$. Similarly, $J_{exp}\equiv s\alpha_J J_{AN}+(1-s)(tJ_{JM}+(1-t)\alpha_J J_{JN})$. The court is assumed to obtain the benefit of ensuring that mandatory rules are respected while suffering the cost of litigation. The arbitrator receives nothing. Thus, payoffs for all the parties are: $\{A_{exp}, J_{exp}, \text{m-t}, 0\}$.

Round 2. Nature (i) realizes a contractual contingency that favors A or J; and (ii) realizes a contingency that makes the mandatory rule either applicable or not applicable. The probabilities

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11. A diagram of the game can be found in the appendix, *infra* p. 708.

could take any value, so let us assume that each probability is 0.5. Alternative values are discussed in section D.

Both A and J observe the contractual contingency, but neither observes the contingency with respect to the mandatory rule. If the contractual contingency favors J, we assume that A sues in a U.S. court to obtain an injunction against arbitration. Although it is possible that A would not sue in these circumstances because it believes that it would lose under de novo review (the mandatory rule does not favor it) or because it does not gain much if the mandatory rule does apply, we put these possibilities to one side for now, and discuss them later.

Round 3. The court decides whether to enforce arbitration or hold a de novo trial. If the court holds a de novo trial, the game ends, with the court correctly enforcing the mandatory rule if it applies and prejudicially enforcing the contract if the mandatory rule does not apply. Payoffs are, in the first case, $\{A_{JM}, J_{JM}, m\text{-}t, 0\}$; and in the second case, $\{\alpha_A A_{JN}, \alpha_J J_{JN}, m\text{-}t, 0\}$. (Recall that we assume for the purpose of analysis that the contractual contingency favors J.)

Round 4. The arbitrator decides whether to respect the mandatory rule or ignore it. If the mandatory rule applies, the arbitrator may respect the mandatory rule and hold in favor of A or ignore the mandatory rule and enforce the contract, holding in favor of J. If the mandatory rule does not apply, then the arbitrator's choice is much easier. Whether it respects the mandatory rule or not, the arbitrator holds in favor of J. We will assume that there is no difference between respecting and ignoring the mandatory rule in this case. For convenience, we will say that if the mandatory rule does not apply, the arbitrator "respects" it and holds in favor of J.

If the mandatory rule applies and the arbitrator respects the rule, the game ends with payoffs $(A_{JM}, J_{JM}, m, R_{re})$. A will not sue in a U.S. court because A would incur litigation costs without being able to obtain a better result. To be sure, J might sue in a Japanese court, but we ignore J's suits in this court because the analysis is the same as the analysis of A's suits in a U.S. court. We will return to this point later.

If the arbitrator ignores an applicable mandatory rule, or if the mandatory rule does not apply, A loses in arbitration and, we assume, brings suit in a U.S. court in order to obtain a de novo trial. Note that A does not know whether it lost because the mandatory rule did not apply or because it applied but the arbitrator ignored

it. A sues in the hope that the latter is the case and the court will try the dispute de novo.

Round 5. The U.S. court decides, in response to A's lawsuit, whether to enforce the arbitration award or conduct a trial de novo. The court, like A, does not know initially whether the mandatory rule applies or not and assigns a probability of 0.5 to each alternative. In addition, supposing that the mandatory rule applies, let the court assign probability p to the arbitrator's choice to respect the mandatory rule, and 1-p to the choice of ignoring it. The court knows that if the mandatory rule applies and A is now suing, the arbitrator must have ignored the mandatory rule; and that if the mandatory rule does not apply, the arbitrator respected the mandatory rule. In the first case, if the court enforces, payoffs are $\{A_{JN}, J_{JN}, 0, R_{ie}\}$; if the court conducts a trial de novo, payoffs are $\{A_{JM}, J_{JM}, m\text{-}t, R_{id}=0\}$. In the second case, if the court enforces, payoffs are $\{A_{JN}, J_{JN}, m, R_{re}\}$; if the court tries de novo, payoffs are $\{\alpha_A A_{JN}, \alpha_J J_{JN}, m\text{-}t, R_{rd}\}$.

Notice that the U.S. court will not face a suit when the contingency favors J, the mandatory rule applies, and the arbitrator respects the mandatory rule, holding in favor of A. A will not sue because it cannot do better if the court either enforces the award or conducts a trial de novo. Would J sue? J knows that if A wins, given that the contractual contingency favors J, the arbitrator must have (correctly) respected a mandatory rule that applies. However, the court will not then hold in favor of J whether it enforces the award or conducts a trial de novo. If J would incur any cost by suing, J will not sue.

C. *Equilibria.*

Now let us turn to equilibria. We want to consider two possibilities: first, whether it is possible that a court will always enforce arbitration awards or always try cases de novo; second, if not, what other strategies might support an equilibrium.

The PURE and NO ARBITRATION equilibria. Consider the last move of the game, which is the court's second move. We will refer to the court, when it takes this move, as C2. C2's decision depends on what it believes the arbitrator did—whether it respected the mandatory rule, or ignored it. As noted above, p represents the probability that C2 attaches to the arbitrator having respected the rule which favored A; 1-p represents the probability that the arbitrator ignored the rule, conditional on the rule favor-

ing A. Given that A sues and half the time the rule does not apply, the probability that the arbitrator respected a rule that applies is $p/2$, that the arbitrator ignored a rule that applies is $(1-p)/2$ and that the arbitrator "respected" an inapplicable rule is $\frac{1}{2}$. The court will enforce the award if and only if: $(0)(1-p)/2 + m/2 > (1-p)(m-t)/2 + (m-t)/2$; or, $p > (m-2t)/(m-t)$. Let $p^* = (m-2t)/(m-t)$. The value, p^*, refers to the probability that the arbitrator respected the mandatory rule such that C2 is indifferent between enforcement of the arbitration award and de novo review. To understand this expression, observe that if $p=1$, then $p>p^*$, and the court will always enforce. The court always enforces the award because the arbitrator always respects the mandatory rule. If $p=0$, then $p<p^*$, and the court will enforce only as long as $m/2>(m-t)$, or $m<2t$. This case arises when court congestion costs are so severe and mandatory rules so unimportant that the court does well even though the arbitrator always ignores them. The more general result is that as congestion costs rise relative to the cost of the violation of mandatory rules, the court is more willing to enforce an arbitration award, holding constant the arbitrator's probability of respecting the mandatory rule.

Now consider the arbitrator's decision in round 4. Let us use the labels RA to refer to the arbitrator when the mandatory rule applies and RN to refer to the arbitrator when the mandatory rule does not apply. As noted above, RN automatically respects the mandatory rule in the sense that he produces the same outcome in favor of J whether he pays attention to it or not. Consider RA. RA knows whether $p>p^*$, that is, whether the court will believe that the arbitrator has enforced the award. Suppose $p>p^*$. Then the arbitrator knows that the court will enforce its award, but if the court will enforce its award, the arbitrator should ignore the mandatory rule, as enforcement of an award that ignores the mandatory rule gives the arbitrator its highest payoff. Suppose $p \leq p^*$. Because the arbitrator knows that the court will always try the case de novo, it should always respect the mandatory rule. The reason is that by doing so it avoids the worst payoff, namely, being revealed at a trial to have ignored the mandatory rule.

Return now to the court. If $p<p^*$, it knows that the arbitrator ignored the mandatory rule. Nevertheless, the court will enforce the award if $m<2t$. The court enforces awards despite the arbitrator's refusal to respect the awards simply because the savings from reducing court congestion outweigh the cost of violating mandatory rules. This cost is limited because sometimes mandatory rules

favor J. In the antitrust example, the court might always enforce arbitration awards because it wants to keep antitrust cases off its docket. If p<p* and m≥2t, or if p>p*, there is no pure strategy equilibrium for the subgame beginning at the fourth round. The court does better by holding a de novo trial if the arbitrator ignores mandatory rules but the arbitrator does better by respecting mandatory rules if the court holds de novo trials. The court does better by enforcing awards if the arbitrator respects mandatory rules but the arbitrator does better by ignoring mandatory rules if the court enforces awards.

Suppose m<2t. At round 3, C1 (the court at round 3) enforces the arbitration award because m<2t implies that m-t<m/2. Nature does not act strategically, so skipping round 2 and turning to round 1, we find that if $m < 2t$, the parties will include an arbitration clause. The reason is that if the court enforces the clause, the arbitrator ignores mandatory rules, and the court later enforces the award, they gain the benefit of neutrality and violation of mandatory rules.[12] The PURE ARBITRATION equilibrium occurs when $m < 2t$. The strategy set is {include clause, enforce clause, ignore mandatory rule, and enforce award}. Payoffs are {A_{JN}, J_{JN}, m/2, $(R_{ie}+R_{re})/2$}.

Suppose m≥2t. At round 3, C1 tries the case de novo, because the payoff (m-t) is at least as great as any payoff it could obtain by enforcement. Anticipating that the court will try the case de novo, the parties do not bother including an arbitration clause because they do no worse than if they did. The result is the NO ARBITRATION equilibrium. Payoffs are {A_{exp}, J_{exp}, m-t, 0}.[13]

The PARTIAL ARBITRATION equilibrium. We saw that at round 5, C2 will be indifferent between enforcing the arbitration award and trying the case de novo when p*= (m-2t)/(m-t). To determine R's move at round 4, let q represent the probability that C2 enforces an arbitration award. At round 4, RN will always respect the mandatory rule, for reasons given above. RA will be indifferent between respecting a mandatory rule and ignoring it when $R_{re}=qR_{ie}+(1-q)R_{id}$, so that $q^*=(R_{re}-R_{id})/(R_{ie}-R_{id})$. The arbitra-

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12. I am cheating a little here. As described, A would decline to agree to enter the contract if A knew that the contractual contingency would favor J. Implicit in the analysis is the assumption that if the contractual contingency favors A, then A will do as well as J does when the contractual contingency favors J. I discuss this assumption in *infra* Part III.D.

13. As discussed below, this equilibrium is not possible if the court is permitted to have a mixed strategy.

tor becomes increasingly likely to respect a mandatory rule, as the penalty for being exposed as having ignored a mandatory rule rises (R_{id} falls), as the payoff from having an award enforced rises (R_{re} rises), and as the payoff from enforcement of an award that ignores mandatory rules falls (R_{ie} falls). Letting $R_{id}=0$, $q^*=R_{re}/R_{ie}$, C2 will choose q^*. If C2 chose $q<q^*$, the arbitrator would respect mandatory rules more often, but the gain to the court would be offset by the cost of having more trials. If C2 chose $q>q^*$, the court would save in trial costs, but this gain would be offset by the cost of the arbitrator's increased violation of mandatory rules caused by the arbitrator.

Consider now C1's choice at round 3. Because it knows that C2 will choose q^*, RN will respect the mandatory rule with a probability of 1, and RA will respect the mandatory rule with probability of p^*, it anticipates a round 5 gain from enforcement of the clause, equal to $1/2[p^*m+(1-p^*)(0)]+1/2(m)=(2m^2-3mt)/2(m-t)$. It must compare this gain to the payoff from de novo review, $m-t$. The court enforces the arbitration clause if $(2m^2-3mt)/2(m-t)>m-t$, or $m>2t$. If this is so, the parties, A and J, will include an arbitration clause. In the PARTIAL ARBITRATION equilibrium, the parties include an arbitration clause, C1 enforces it, RN respects the mandatory rule, RA respects the mandatory rule with a probability of p^*, and C2 enforces the arbitration award with a probability of q^*. Payoffs are rather complicated. A expects to receive $1/2(p^*A_{JM}+(1-p^*)q^*A_{JN}+(1-p^*)(1-q^*)A_{JM})+1/2(q^*A_{JN}+(1-q^*)\alpha_A A_{JN})$, with p^* and q^* defined as above. For the moment, represent this amount as A_{PAE}, and the comparable amount for J as J_{PAE}. R expects to receive $1/2[p^*R_{re}+(1-p^*)(q^*R_{ie})]+1/2(q^*R_{re}+(1-q^*)R_{rd})$, which we will again not bother to solve, but instead represent as R_{PAE}. Thus, payoffs are $\{A_{PAE}, J_{PAE}, (2m^2-3mt)/2(m-t), R_{PAE}\}$.

If $m<2t$, then C1 will try the case de novo and the parties will not include an arbitration clause. The NO ARBITRATION equilibrium is the result.

Evaluating the equilibria. It is helpful to describe the first-best outcome. This outcome is not simply the sum of everyone's utilities. A reasonable social policy encourages arbitration because it saves litigation and congestion costs and reduces bias, but not to the extent that it enriches arbitrators or enables merchants to evade mandatory rules. Accordingly, we assume that the arbitrator's payoffs can be ignored and that merchants ought to receive the unbiased payoffs which exceed the biased ones. Finally, mandatory rules should be respected but litiga-

tion and delay costs minimized. Accordingly, the first-best outcome is $(\frac{1}{4}A_{JN}+\frac{1}{4}A_{JM}+\frac{1}{2}A_{AN}, \frac{1}{4}J_{JN}+\frac{1}{4}J_{JM}+\frac{1}{2}A_{AN}, m, \varnothing)$.

Let us now suppose that the court can determine a strategy in advance. What should it be? Let us consider three possibilities: (1) never enforce arbitration clauses or awards; (2) always enforce arbitration clauses and awards; (3) enforce arbitration clauses but review awards stochastically.

Consider the first strategy. The court ensures itself of a payoff of m-t in the first round. Suppose m>2t. If the court instead used its mixed strategy, its payoff would be $(2m^2-3mt)/2(m-t)$. But if m>2t, then $(2m^2-3mt)/2(m-t)$>m-t. So the court should not use the first strategy if m>2t. Suppose, then, that m≤2t. If the court used the strategy, always enforce, its payoff would be m/2. However, if m≤2t, then m/2>m-t. Thus, the court should not use the first strategy at all.

An additional objection to the first strategy is that it creates bias and litigation costs for the parties. The other strategies do not, or at least not as much. Accordingly, the first strategy—of never enforcing arbitration clauses or awards—is never desirable.

We saw above that when m>2t, the court receives more from the mixed strategy than it does from the pure strategy of always enforcing. When m≤2t, the reverse is true. From the parties' perspective, the more arbitration there is, the less bias there is. So when m≤2t, everyone whose interests we care about—the parties and the courts—are better off with the pure strategy: the courts, because they care more about congestion costs than about respect for mandatory rules and the parties, because they evade bias costs and avoid mandatory rules. When m>2t, there is a tradeoff. The pure strategy prevents bias costs, but mandatory rules are never respected. The mixed strategy raises bias costs, but ensures that mandatory rules are sometimes respected. Under plausible assumptions, the mixed strategy will be superior.[14]

D.   *Some Qualifications and Extensions.*

The merchants' incentives to sue. I have assumed that A will always sue to prevent arbitration, and then again after arbitration, in order to persuade a court to vacate the arbitration award. The

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14. This can be shown mathematically by comparing payoffs for the courts and the merchants under the two equilibria. However, the math is messy and the intuition is clear, therefore I will not reproduce the math.

first assumption seems harmless. Perhaps, if litigation is costly and the moves of the court and arbitrator could be predicted, A would instead settle with J, but their settlement would reflect the equilibrium payoffs. The second assumption is more controversial: if A expects the court to enforce the arbitration award, A would never sue because he would incur litigation costs without improving his position. If A expects the court always to review the award de novo, he would always sue unless litigation costs exceed the gain from application of the mandatory rule (in the one case) or from biased litigation (in the other case). If A expects the court to use a mixed strategy, then A might sue or not. A's choice in turn affects the arbitrator's choice: if RA expects A never to sue, then RA should never respect the mandatory rule, but then A would expect the court to engage in de novo review in which A should sue after all.

The arbitrator's incentives. One might object to the assumption that R_{id} is low. It is possible that an arbitrator could obtain more business, not less, if a court reviews the award de novo and finds that the arbitrator ignored the mandatory rule because merchants seek arbitrators who ignore mandatory rules. Indeed, if most arbitration awards do not lead to litigation, but are instead accepted by the merchants, it might seem that merchants would prefer arbitrators who ignore mandatory rules to those who respect them. Moreover, it might seem likely that parties would not sue to enjoin many arbitration awards because doing so might give them a bad international reputation. The problem with this argument is that if merchants care so much about their reputation among other merchants, they would not sue to enjoin arbitration in the first place. If they never sued to enjoin arbitration, the *Mitsubishi* problem would never have arisen. So the correctness of the *Mitsubishi* decision depends on the assumption that at least some parties do not care much about obtaining an international reputation for litigating arbitration awards. If this is so, arbitrators must care about whether courts enforce their awards or not.[15] If courts do not enforce their awards, parties will not bother to use arbitrators. A more complete analysis would embed the model in a repeat game in which courts distinguish among arbitrators, refuse to enforce the awards of arbitrators who in the past have had awards overturned because they violate mandatory rules, and enforce the

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15. *See* Alan Scott Rau, *On Integrity in Private Judging*, 14 ARB. INT'L 115 (1998) (discussing arbitrators' incentives).

awards of arbitrators who in the past have had awards confirmed because they are consistent with mandatory rules. Such an analysis, which would be a straightforward extension of the model, would justify the assumption that R_{id} is low.

Multiple arbitrators. This response may raise doubts about the use of a single arbitrator in the analysis rather than multiple, competing arbitrators. Suppose the parties could choose among arbitrators. If arbitrators care relatively more about having a reputation for ignoring mandatory rules than about having their awards enforced, the arbitrators may become less likely to respect mandatory rules. So in equilibrium arbitrators may occasionally ignore mandatory rules, or, indeed, they would all ignore mandatory rules, and the PARTIAL ARBITRATION equilibrium becomes impossible, leaving only the PURE and NO ARBITRATION equilibria. The arbitrators face a collective action problem: they are better off if all respect the mandatory rule, but each has an incentive to deviate. One possible response is to construct institutions, like the International Chamber of Commerce, which ensure that arbitrators enforce mandatory rules and expel those who do not. Subsequently, courts might refuse to enforce only the awards of the latter. On the other hand, we might see market segmentation. Some arbitrators would enforce mandatory rules and others would not. The latter would be used only by parties who are highly unlikely to use national courts, perhaps because they care about their international reputations for litigiousness. The former arbitrators would be used by merchants who are less frequently participants in international transactions.

Foreign courts. We have ignored the role of Japanese courts and Japanese law. Now let us be more explicit about our assumptions.

First, the equilibria depend on the assumptions that A sues in a U.S. court only after the arbitrator holds against him, the contractual contingency favors J, and the mandatory rule either applies in favor of A or does not apply. However, it might be argued that A would bring suit in a U.S. court when the contractual contingency favors A and the U.S. court would have to take this possibility into account when determining its strategy. This objection is wrong and to see why, observe that if the contractual contingency favors A and the rule does not apply, the arbitrator will hold in favor of A so that A has no reason to sue in a U.S. court. If the contractual contingency favors A and the rule applies, the arbitrator will hold in favor of A and so A has no reason to sue.

Second, the equilibria depend on the assumption that if the arbitrator respects a pro-A mandatory rule, he will receive a payoff of R_{re}. One might object that if the arbitrator holds in favor of A, J will sue in a Japanese court, in an effort to obtain a de novo trial. Assume, for the moment, that the Japanese court properly enforces U.S. mandatory rules. J then gains nothing by bringing suit in a Japanese court. If the Japanese court does not properly enforce U.S. mandatory rules, perhaps because it is biased, and J does sue and obtains a de novo trial, then the Arbitrator's payoff is R_{rd}. Because $R_{rd}<R_{re}$, q^* declines. This makes the PARTIAL ARBITRATION equilibrium less likely to occur.

Third, the equilibria do not depend on the Japanese courts adopting the same strategy as U.S. courts. It is quite possible that for Japanese courts, m is lower relative to t; 'm', after all, refers to *U.S.* law, about which Japanese courts might care little. Japanese courts might always enforce while American courts sometimes enforce or never enforce. Thus, arbitrators would always ignore mandatory U.S. rules when the contract favors A (but this produces the same result as respecting these rules), whereas they might respect the rules when the contract favors J.

Fourth, one might point out that while the model only deals with U.S. courts' enforcement of U.S. mandatory rules to release Americans from contracts, we should also deal with Japanese courts' enforcement of Japanese mandatory rules to release Japanese from contracts. If everyone involved can always tell with certainty whether a court is honestly applying a mandatory rule or not, the introduction of Japanese mandatory rules and courts does not change the analysis. The model would be the same except the court would be Japanese rather than American and the mandatory rule would enable the Japanese merchant to escape the contract rather than enable the American merchant to do so.

It may be the case, however, that U.S. courts fear that their Japanese counterparts will not honestly apply Japanese mandatory rules and will use them opportunistically to allow Japanese parties to evade contracts whenever contingencies favor the Americans. Japanese courts might have a symmetrical fear about American courts. If merchants believe that national courts will manipulate mandatory rules in this way and strike down arbitration awards that do not favor nationals, then arbitration will cease to be attractive. This does not seem to be the case. Perhaps, the concern is that one national court might behave opportunistically in retalia-

tion against another national court's perceived opportunistic behavior which may not have been opportunistic at all.

E. *Application to* Mitsubishi.

We finally turn to *Mitsubishi* and ask, under what assumptions was it a correct decision? Many critics of *Mitsubishi* argue that if it is interpreted to mean that courts will enforce arbitration awards, then arbitrators will not respect mandatory rules. If, considering footnote 19, it is interpreted to mean that courts will review arbitration awards, then arbitrators will respect mandatory rules, but parties will not bother to use arbitration. We now see that this objection, which corresponds to our PURE ARBITRATION and NO ARBITRATION equilibria, rests on controversial assumptions.

Consider first the claim that if courts are required to enforce arbitration awards, arbitrators will not respect mandatory rules. While this is true, it is not a decisive objection to *Mitsubishi*. If court congestion is a severe problem (as it was in the mid-1980s)[16] and the relevant mandatory rules are not too important, the PURE ARBITRATION equilibrium may well be desirable. To use a concrete example, when arbitrators ignore an antitrust rule that would not in any case apply to the American party, arbitration reduces court congestion without resulting in a violation of public policy. Furthermore, if we do not think that antitrust law is terribly important at an international level, then PURE ARBITRATION is not objectionable.[17]

Consider now the claim that if courts are required to review arbitration awards, arbitration will cease being attractive to parties and they will stop using it. We think this would be an undesirable outcome. Critics of *Mitsubishi*, including the dissent, seem to think that the NO ARBITRATION outcome is tolerable, but there are two problems with this argument. First, it focuses on the

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16. *See* YVES DEZALAY & BRYANT G. GARTH, DEALING IN VIRTUE: INTERNATIONAL COMMERCIAL ARBITRATION AND THE CONSTRUCTION OF A TRANSNATIONAL LEGAL ORDER 159 (1996).

17. This result might seem to be in tension with recent cases affirming the right to pursue antitrust claims abroad under U.S. antitrust laws. *See* Hartford Fire Insurance Co. v. California, 509 U.S. 764 (1993). If it is the policy of the United States, or at least of the Supreme Court, to expand the coverage of U.S. antitrust laws, why allow parties to circumvent them using arbitration clauses? The answer might be that allowing parties to pursue extra-contractual antitrust claims abroad is a way to compensate for the weakening of antitrust laws as a result of the policy of encouraging arbitration. The policies are complements rather than contradictions.

violation of mandatory rules and ignores court congestion and bias costs but, as noted above, if court congestion and bias costs are significant enough, then PURE ARBITRATION dominates NO ARBITRATION. Second, the critics ignore the third alternative, PARTIAL ARBITRATION, which leads to our final claim.

This claim is that *Mitsubishi* can be most strongly defended if footnote 19 is interpreted as an ambiguous threat. If footnote 19 implies that courts will review arbitration awards with some probability greater than 0 and less than 1, it might produce the PARTIAL ARBITRATION equilibrium. This equilibrium may be superior to PURE ARBITRATION because arbitrators will often respect mandatory rules. It is superior to NO ARBITRATION because de novo trials are less frequently required creating savings in congestion and bias costs. If this claim seems peculiar, think of it as an application of Becker's theory of criminal enforcement. According to Becker, high sanctions coupled with a low probability of enforcement is superior to a system in which lower sanctions are applied with a higher probability, because the former regime economizes on enforcement costs while maintaining the optimal level of deterrence.[18] Similarly, if arbitrators incur significant enough costs when their violation of mandatory rules is discovered, courts can deter this behavior by reviewing arbitration awards only occasionally, rather than always. In the process enforcement costs are economized and the independent benefit of a reduction in bias is generated.

The *Mitsubishi* Court did not say that courts should review arbitration awards randomly and it is doubtful that it intended this meaning. Instead, the Supreme Court talked out of both sides of its mouth, clearly wanting to encourage arbitration while also fearing that its encouragement would lead arbitrators to ignore mandatory rules. Our claim is that, whatever the Court's motives, the effect of the opinion was to create ambiguity. If parties are, as a result, not sure whether American courts will review arbitration awards or not—and if American courts occasionally do review arbitration awards—that would be a good thing.

This might also explain why there have been no cases in which parties have sought to vacate arbitration awards in U.S. courts in the fourteen years since *Mitsubishi*, although there have been sev-

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18. Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968).

eral cases in which parties have sought to prevent arbitration.[19] If arbitrators fear the possibility of de novo review, they might respect mandatory rules. If they respect mandatory rules, the losing party knows that it cannot win in a U.S. court, even if the court grants a de novo trial. To avoid litigation costs, the party declines to sue.

IV. CONCLUSION.

It has been shown that, contrary to the views of commentators, one can sustain an international arbitration system that both respects mandatory rules and avoids the need for routine judicial review with its attendant costs and biases. Such a system can exist if courts review arbitration awards probabilistically. By creating uncertainty about whether U.S. courts will review arbitration awards, *Mitsubishi* may have produced such a system. The evidence suggests that international arbitrators are deeply concerned about their reputation for respecting mandatory rules. The relatively high status of international arbitrators, as well as federal courts' concern about congestion, probably accounted for the outcome in *Mitsubishi* and its continuing validity.[20]

I have not discussed many relevant issues. Further research should focus on the empirical assumptions of the model. One important extension is analysis of the differences among mandatory rules. Some mandatory rules are more important than others at an international level, justifying a greater frequency of review by courts. Further, although the model assumes that mandatory rules are designed to protect third parties against externalities, some mandatory rules are designed to protect one of the contracting parties.[21] Further work should analyze the extent to which the analysis applies to the second kind of mandatory rule. It is likely that the application is straightforward and that the results do not change.

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19. *See, e.g.*, Development Bank of the Philippines v. Chemtex Fibers, Inc., 617 F. Supp 55 (S.D.N.Y. 1985) (bringing suit under RICO); George Fischer Foundry Sys., Inc. v. Adolph H. Hottinger Maschinenbau GmbH, 55 F.3d 1206 (6th Cir. 1995) (claiming violation of antitrust law); Vimar Seguros y Reaseguros, S.A. v. M/V Sky Reefer, 515 U.S. 528 (1995) (claiming violation of the Carriage of Goods by Sea Act).

20. *See* DEZALAY & GARTH, *supra* note 16, at 159.

21. In fact, the cases decided after *Mitsubishi* generally involve statutes that appear to protect third parties rather than contracting parties, and in all of these cases the arbitration agreement was enforced. *See supra* note 19.

The basic model described in this paper can be extended beyond the issues surrounding international arbitration. Most obviously, it can be used to analyze domestic arbitration under the FAA. It can also be used to analyze appellate review of trial court decisions and judicial review of agency actions. The hypothesis is that courts should randomly review the decisions of lower courts and agencies rather than routinely subjecting them to de novo review or routinely deferring to them. This hypothesis suggests that intermediate standards of deference can be interpreted as stochastic strategies, since intermediate standards, in effect, require a court to look at a subset of facts which contain the operative facts only probabilistically.

APPENDIX