

MORE EFFICIENT ARBITRATION CLAUSES?

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### **Abstract**

*Over the past several decades the use of arbitration has become increasingly widespread. This has largely been due to its perception as a more efficient means of resolving disputes, delivering speedier results at a lower cost. In recent years however, these supposed advantages of arbitration have come under increased scrutiny in academic and professional debate regarding US and international arbitration. This paper analyzes the state of arbitration in Israel through the prism of this debate and identifies several possible inherent systemic failings that could explain its inefficiency. The key conclusion of this analysis suggests that in the ex-post stage (i.e. after a given conflict has arisen) all actors have conflicts of interest that grossly hinder the chances for efficient proceedings. This paper examines whether potential litigants can solve or mitigate these issues through better, tailor-made arbitration clauses. This paper further examines the fundamental problems that prevent such future issues from being resolved in the ex-ante stage. This paper proposes an innovative and creative approach to finding possible solutions, such as a hybrid mechanism that combines ex-ante and ex-post arrangements. Further research into a mechanism of this sort is needed. This paper approaches the debate from a new angle and may contribute to a better understanding of arbitration inefficiencies in the Israeli system and can hopefully contribute to the ongoing international debate regarding arbitration efficiency.*

### **Résumé**

*Au cours des dernières décennies, le recours à l'arbitrage est devenu de plus en plus répandu. Cette situation s'explique en grande partie par le fait qu'elle est perçue comme un moyen plus efficace de régler les différends, ce qui permet d'obtenir des résultats plus rapidement et à moindre coût. Ces dernières années cependant, ces avantages supposés de l'arbitrage ont fait l'objet d'une attention accrue dans le débat académique et professionnel concernant l'arbitrage américain et international. Cet article analyse l'état de l'arbitrage en Israël à travers le prisme de ce débat et identifie plusieurs défaillances systémiques inhérentes possibles qui pourraient expliquer son inefficacité. La principale conclusion de cette analyse suggère qu'à l'étape ex post (c'est-à-dire après l'apparition d'un conflit donné), tous les acteurs ont des conflits d'intérêts qui entravent considérablement les chances d'une procédure efficace. Le présent article examine si les parties potentielles peuvent résoudre ou atténuer ces questions par le biais de meilleures clauses d'arbitrage. Il examine plus en détail les problèmes*

*fondamentaux qui empêchent que de telles questions ne soient résolues au stade ex ante et propose une approche novatrice et créative pour trouver des solutions possibles, comme un mécanisme hybride qui combine des arrangements ex ante et ex post. Il est nécessaire de poursuivre les recherches sur un tel mécanisme. Ce document aborde le débat sous un angle nouveau et peut contribuer à une meilleure compréhension des inefficacités de l'arbitrage dans le système israélien et peut, espérons-le, contribuer au débat international en cours sur l'efficacité de l'arbitrage.*

## INTRODUCTION

For centuries, arbitration has been used as a means of resolving disputes among people without official state intervention, primarily among members of closed circles. With the rise of the Alternative Dispute Resolution (ADR) movement, arbitration has become increasingly popular and widespread over the past few decades in large part because it is perceived as a less costly and faster way of handling conflicts, particularly commercial disputes. In recent years, however, these supposed advantages of arbitration have come under increased scrutiny in academic and professional debate in arbitration in the United States and international arbitration. So, is arbitration truly a more efficient process and if not, why?

Numerous research papers and studies delve into this question and several differing analyses have been put forward. There is a consensus, however, that changes made to arbitration as an institution have resulted in decreased efficiency. Several researchers have put forward possible solutions, suggesting that various changes to behavior and conduct on the part of the relevant actors may reverse this problem.

This paper will focus on the arbitration process in Israel. Until 2008, arbitration was held in little regard among the country's legal and business communities who did not trust the process. Changes were made to the Arbitration Law to address these concerns and build up arbitration as a common means for resolving disputes. Since then, arbitration as a field has evolved in Israel and several private arbitration institutions were established, likely as a result of increased demand<sup>1</sup>. Despite this apparent increase in popularity, practitioners in the field of commercial litigation have experienced and observed glaring systemic inefficiencies in arbitration proceedings in Israel.

In the absence of empirical data regarding arbitration in Israel, this paper will look at the findings of researchers involved in the ongoing debate about arbitration efficiency who have written about the matter from an international perspective and will use those findings to identify possible inherent systemic failings in the Israeli arena. This paper will further examine whether the litigants themselves, as those who ultimately suffer the most from such inefficiencies, can take steps to prevent or at least mitigate some of these issues by drafting better *ex-ante* arbitration provisions. This paper will hence hopefully contribute to an improved understanding of the pitfalls of arbitration in Israel.

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<sup>1</sup> A. Reich, "Why Israel Should Adopt the UNCITRAL Model Law on International Commercial Arbitration", *Bar-Ilan Law Studies*, vol.30, issue 2, p. 707.

This paper concluded that the chief issue at the core of the overall systemic problem is that in *ex-post* stage (*i.e.* after a given conflict has already arisen between the parties) all the relevant actors, meaning the litigants, their counsels, and even the arbitrators themselves, likely have differing and conflicting interests. Unfortunately, seeking to solve this problem with better *ex-ante* arbitration clauses is not an easy task, and may require exhaustive and extensive forethought. All these issues will be addressed hereafter.

Part I. Background will present the general relevant background regarding ADR, arbitration, and arbitration as an institution in Israel. It will lay out the inefficiency problem at the heart of this paper. Part II. Possible reasons for the inefficiency of arbitration in Israel will examine the potential sources of the problem. Part III. More efficient arbitration clauses? will discuss the difficulties in solving or even simply mitigating some of these failings. Part IV. Thinking about possible solutions will suggest a new approach to the problem that incorporates solutions to the specific challenges discussed in this paper.

## **I. BACKGROUND**

There is a vast number of books, articles, and additional professional literature regarding Alternative Dispute Resolution and arbitration. Thus, this part will provide a relatively brief and succinct overview of the relevant background and concepts discussed in this paper.

One of the main incentives for the use of ADR is to save on costs<sup>2</sup> - including by lowering transaction costs - and time which can also lead to resolving disputes more efficiently in comparison with court proceedings<sup>3</sup>. Nowadays, ADR includes not only arbitration and mediation but also many other mechanisms, such as Conciliation, Fact-Finding, Mini-Trial, Summary Jury Trials, Court-Ordered Arbitration, Ombudsman, Med-Arb, Small Claims Courts, Rent-a-Judge<sup>4</sup>.

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<sup>2</sup> See J.-K. Lieberman, J. Henry, "Lessons from the alternative dispute resolution movement", *The University of Chicago Law Review*, 1986, vol. 53, n. 2, pp. 427-429.

<sup>3</sup> For an economic analysis of ADR see, for example, S. Shavell, "Alternative dispute resolution: an economic analysis", *The Journal of Legal Studies*, 1995, vol. 24, n. 1, pp. 1-28 and A. Van Aaken, T. Broude, "Arbitration from a Law & Economics Perspective" in T. Schultz, F. Ortino (ed.), *The Oxford Handbook of International Arbitration*, Oxford University Press, 2017.

See T. Stipanowich, "ADR and the 'Vanishing Trial': the growth and impact of 'Alternative Dispute Resolution'", *Journal of Empirical Legal Studies*, 2014, vol. 1, n. 3, pp. 843-912; R. Mnookin, "Alternative dispute resolution", *Economics and Business Discussion Paper Series*, 1998, Paper 232.

<sup>4</sup> K. Stone, "Alternative dispute resolution" in S. Katz (ed.), *Encyclopedia of Legal History*, Oxford University Press, 2004.

This paper will focus on only one form of ADR: Arbitration. In recent decades there has been a rise in the popularity of the ADR movement and the use of commercial arbitration has become similarly widespread<sup>5</sup>.

### I.A. Arbitration

Broadly speaking arbitration can be described as a dispute resolution process handled in front of a neutral third party who is referred to as the arbitrator (or a panel of arbitrators)<sup>6</sup>. An arbitrator is a private person, *i.e.* not necessarily an officer of the law or court system, which is usually nominated by the parties themselves or by a mechanism previously agreed upon by said parties<sup>7</sup>. The parameters of a given arbitration procedure are restricted to the issues and claims stated and agreed upon by the parties in an arbitration agreement<sup>8</sup>. The arbitration can be heard by an *ad-hoc* arbitrator<sup>9</sup> or within an arbitration institution<sup>10</sup>.

Arbitration was established as a practice even before law was introduced<sup>11</sup>. International arbitration was once, and often still is, a common way of solving disputes between countries<sup>12</sup>, or cross-border conflicts when a state entity is one of the sides in the dispute<sup>13</sup>. One can also find arguments supporting the use of arbitration as an alternative to court proceedings between civil litigants as early as the 18<sup>th</sup> century<sup>14</sup>. Despite the considerable history of arbitration, the Common Law did not enforce arbitration agreements until the 20<sup>th</sup> century<sup>15</sup>.

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<sup>5</sup> G. Born, "Keynote address: Arbitration and the freedom to associate", *Georgia Journal of International and Comparative Law*, 2009, vol. 38, p. 7, spec. pp. 8-10.

<sup>6</sup> R. Mnookin, *op. cit.*; L. Montgomery, "Expanded judicial review of commercial arbitration awards bargaining for the best of both worlds: *Lapine technology corp. v. Kyocera corp.*", *University of Cincinnati Law Review*, 2000, vol. 68, n.2, pp. 529-554 spec. p. 532. For simplicity's sake, in this paper arbitrator refers to a single arbitrator or a panel of arbitrators, unless stated otherwise.

<sup>7</sup> R. Mnookin, *op. cit.*

<sup>8</sup> R. Mnookin, *op. cit.*; L. Montgomery, *op. cit.*, pp. 532-533.

<sup>9</sup> "An arbitrator 'chosen for the particular case only'" in B. Aaron, "Some procedural problems in arbitration", *Vanderbilt Law Review*, 1957, vol. 10, n. 4, p. 736.

<sup>10</sup> W. Mattli, "Private justice in a global economy: from litigation to arbitration", *International Organization*, 2001, vol. 55, n. 4, p. 921.

<sup>11</sup> F. Emerson, "History of Arbitration Practice and Law", *Cleveland State Law Review*, 1970, vol. 19, p. 155.

<sup>12</sup> H. Fraser, "Sketch of the History of International Arbitration", *Cornell Law Quarterly*, 1925, vol. 11, p. 179.

<sup>13</sup> L. Bouchez, "Prospects for International Arbitration: Disputes between States and Private Enterprises", *Journal of International Arbitration*, 1991, vol. 8, p. 81.

<sup>14</sup> E. Wolaver, "Historical Background of Commercial Arbitration", *University of Pennsylvania Law Review*, 1934, vol. 83, p. 132; F. Emerson, *op. cit.*; Multiple contributors, *The advantages of settling disputes by arbitration*, F. Jollie, 1795, p. 5.

<sup>15</sup> L. Montgomery, *op. cit.*, p. 534.

### I.A.1. The Goals of Arbitrations and Incentives For Its Use

This paper will limit its scope to commercial dispute arbitration among sophisticated parties where none have excess power over the other side (at the point when the parties agreed to arbitration). In this type of disputes both sides have similar incentives to choose arbitration. This section will review those key incentives and the assumed advantages of arbitration:

*Saves time and lowers costs* - like all ADR procedures, parties choose arbitration because they are seeking quicker and less costly proceedings;

*Confidentiality* - because arbitration is usually a private procedure, the matters discussed are not accessible to the public as they would be in court proceedings. Therefore, the parties can enjoy the benefits of confidentiality and do not need to risk the possible disclosure of trade secrets or any other information related to their businesses/conduct/disputes;

*Flexibility* - the parties can jointly agree on matters such as the identity of the arbitrator and the latter's familiarity with the relevant subject, whether he will be bound to any specific jurisdiction or only to general commercial principles, and the rules to which they wish the arbitration procedure to be beholden;

*Judicial review* - arbitrator decisions and arbitration awards are appealable only on very limited grounds, namely due to faults in the procedure as opposed to factual mistakes or errors in applying the law, unlike court decisions or verdicts<sup>16</sup>.

This paper will focus on the parties' desire to save time and costs. As will be discussed below, this desire tends not to be fulfilled.

### I.A.2. Arbitration and The Efficiency Debate in Recent Years

As previously mentioned, one of the main incentives for parties to choose arbitration is to save time and lower costs in comparison with other judicial proceedings. This analysis will focus on this goal alone and will use the term "arbitration efficiency" to mean only this limited definition of the term even though "efficiency" in its broad economic definition can also be

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<sup>16</sup> P. Sanders, *Quo vadis arbitration?: sixty years of arbitration practice*, Kluwer law international, 1999, pp. 2-6; T. Oehmke, *Commercial Arbitration* (Vol. 2), Thomson/West, 2008; M. Kantor, "OTC Derivatives and Arbitration: Should Counterparties Embrace the Alternative", *Banking Law Journal*, 2000, vol. 117, pp. 414-416; R. Mnookin, *op. cit.*



measured by other parameters such as social welfare maximization and/or utility measures/maximization; and not only as "saving time and lowering costs"<sup>17</sup>.

As discussed in the previous section, mainstream writing on arbitration still commonly ascribes efficiency as a characteristic of arbitration. Arbitration has been praised for its efficiency for a long time and present-day writings on the subject tend to address this claim as axiomatic<sup>18</sup>.

Despite this automatic assumption regarding the efficiency of arbitration, a debate has begun in recent times among researchers about whether arbitration can still be considered an inherently efficient procedure. Some scholars' findings show that in recent years arbitration procedures have changed a great deal, and those same researchers also presented evidence that arbitration proceedings have become more and more costly<sup>19</sup>. Their findings also suggest that efficiency as it relates to the saving of time is no longer what it used to be<sup>20</sup>. In the following chapter, some of the findings presented by these scholars will be discussed in the context of Israeli arbitration. However before doing so the next section will present a review of the types of arbitration agreements and a brief general summary of the relevant characteristics of Israel's Arbitration Law.

### **I.B. Arbitration Agreements**

Arbitration agreements can be divided into two types of groups: post-dispute agreements and pre-dispute agreements<sup>21</sup>. This section reviews these two types of contract forms and their key features.

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<sup>17</sup> For example, M. Goltsman, J. Hörner, G. Pavlov, F. Squintani, "Mediation, arbitration and negotiation", *Journal of Economic Theory*, 2009, vol. 144, n. 4, pp. 1397-1420.

<sup>18</sup> For example, L. Willey, "Arbitrate, don't litigate! Avoiding the high costs of litigation", *The Entrepreneurial Executive*, 2005, p. 10.

<sup>19</sup> J. Gotanda, "Awarding Costs and Attorneys' Fees in International Commercial Arbitrations", *Michigan Journal of International Law*, 1999, vol. 21, p. 1; A. Weiss, E. Klisch, J. Profaizer, "Techniques and Tradeoffs for Incorporating Cost-and Time-Saving Measures into International Arbitration Agreements", *Journal of International Arbitration*, 2017, vol. 34, n. 2, pp. 257-273.

<sup>20</sup> See examples in T. Stipanowich, "Arbitration: The New Litigation", *Illinois Law Review*, 2010, p. 1; J. Fellas, "A fair and efficient international arbitration process", *Dispute Resolution Journal*, 2004, vol. 59, n. 1, p. 78.; I. Welser, "Chapter II: The Arbitrator and the Arbitration Procedure, Efficiency – Today's Challenge in Arbitration Proceedings" in P. Christian Klausegger, *Austrian Yearbook on International Arbitration*, 2014.

<sup>21</sup> S. Shavell, *op. cit.*; B. Hay, "Procedural justice-ex ante v. ex post", *UCLA Law Review*, 1997, vol. 44, n. 6, pp. 1803-1850.

### I.B.1. *Ex-Post* Agreements

These kinds of arrangements are arbitration agreements which the parties agreed upon only after the conflict between them arose. In that situation the parties have more detailed knowledge of the specific dispute they want to resolve<sup>22</sup>. Therefore, they can perform a better cost-benefit analysis of the procedure they believe will yield the best possible mechanism to deal with their particular conflict<sup>23</sup>.

Because arbitration is a voluntary procedure by which both parties must agree to be bound, it is not always easy to reach such an agreement at this stage of the dispute. Sometimes when the conflict already exists the parties find it hard to negotiate or to even agree on choosing arbitration<sup>24</sup>. At this stage the parties may temporarily diverge in a manner which could have been avoided had they agreed *ex-ante* to settle disputes through a particular procedure, such as arbitration<sup>25</sup>.

A good example of a situation such as this can be a plaintiff seeking a speedier procedure that will also grant him the award he believes he is entitled to while the defendant's interest at this stage (after the conflict has arisen) is to postpone payment to the plaintiff. If one would ask both parties if they prefer a quicker procedure before the conflict arose, meaning before they even knew which one of them would be the plaintiff and which the defendant, both would probably say they prefer a more rapid mechanism for solving future disputes<sup>26</sup>.

The aforementioned situation could explain why parties to a potential future dispute sometimes agree *ex-ante* on the manner in which they will settle future conflicts prior to their existence, and indeed no such conflict may ever arise<sup>27</sup>.

### I.B.2. *Ex-Ante* Agreements

*Ex-ante* arbitration agreements are also known as arbitration provisions or arbitration clauses, as they are usually provisions/clauses in contracts signed between the parties before

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<sup>22</sup> B. Hay, *op. cit.*

<sup>23</sup> *Ibid.*; S. Shavell, *op. cit.*; also see M. Bodie, "Questions about the efficiency of employment arbitration agreements", *Georgia Law Review*, 2004, vol. 39, n. 1, pp. 1-82, who uses cost-benefit analysis in the context of labor laws but whose analysis may also be relevant for commercial *ex-post* arbitration agreements.

<sup>24</sup> A. Weiss, E. Klisch, J. Profzaizer, *op. cit.*

<sup>25</sup> B. Hay, *op. cit.*

<sup>26</sup> See also A. Weiss, E. Klisch, J. Profzaizer, *op. cit.*

<sup>27</sup> For a theory of *ex-ante* selection in arbitration see C. Drahozal, "Ex Ante Selection of Disputes for Litigation", *Working Papers*, 2004.

there is any conflict between them<sup>28</sup>. At this stage, the parties are collaborative and they only foresee the potential for a future dispute between them. This potential future dispute may be something relatively predictable, such as a potential breach of contract, or it may come as a consequence of an unforeseeable situation.

Based on their own cost-benefit analysis the parties may decide that both prefer to bind themselves already at this early stage to a mechanism which will ensure that future potential disputes are resolved<sup>29</sup>.

Scholars have found that *ex-ante* arbitration clauses can increase the parties' well-being<sup>30</sup>, even though at this stage the sides face a knowledge problem - they do not know what kind of specific conflict they may end up having. They cannot always anticipate the scope of the dispute, whether it will center solely on professional issues or whether it will involve legal issues, and crucially they cannot predict which procedure will solve the dispute in the most efficient manner.

This paper focuses only on the pre-dispute (*ex-ante*) type of arbitration agreements, in other words, the arbitration clauses. This provision is common nowadays in many fields and in particular in commercial trading contracts, mergers and acquisition contracts, joint ventures and labor agreements<sup>31</sup>. As stated above, this paper will focus only on those clauses that are meant to solve commercial disputes, where both parties are sophisticated, and neither has excess power over the other side.

## **I.C. The Israeli Legal System and Arbitration**

### **I.C.1. General background on the Israeli legal system**

Israeli law originates from two different legal traditions, the laws of the Ottoman Empire and the common law following the British Mandate. As "based on Anglo-American common law"<sup>32</sup>, the court system is grounded on an adversary mechanism. Although the Israeli judicial

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<sup>28</sup> S. Shavell, *op. cit.*; B. Hay, *op. cit.*

<sup>29</sup> *Ibid.*

<sup>30</sup> See S. Shavell, *op. cit.*

<sup>31</sup> R. Mnookin, *op. cit.*

<sup>32</sup> N. Ebner, Y. Efron, Y. Winkler, G. Manobla-Landman, "Alternative Dispute Resolution in Israel" in G. Palo, M. Trevor (eds.), *Global Trends in Mediation: The Southern Mediterranean* Vol. II, Kluwer Law International, 2007.

system is well-developed, in recent decades it has suffered under an excessively heavy workload like many other legal systems<sup>33</sup>.

The next section will introduce a short overview of the relevant arbitration laws and mechanisms in Israel with an emphasis on commercial disputes.

### I.C.2. Arbitration in Israel

The Israeli Arbitration Law, 5728-1968 ("The Law"), regulates the arbitration procedures in Israel. This law, established in 1968, states that arbitration agreements between parties will be binding (Chapter B to The Law), including when such agreements are spelled out in an *ex-ante* provision (Article 1 of The Law). The Law governs the arbitrators' power and authority<sup>34</sup>.

Under Israeli law, arbitration is a voluntary procedure and is subject to the agreement of all relevant parties, the latter may also determine its scope and procedures. In case the parties have not defined the specific rules or procedures of arbitration, The Law provides default rules which will apply (Article 2 of The Law).

Judicial intervention in arbitration awards used to be allowed only on the basis of the closed list reasons stated in Article 24 to The Law and included only ten specific justifications<sup>35</sup>. This list limits judicial intervention mainly to faults in the procedure and does not allow such intervention in the case of factual mistakes or errors in the application of the law, even when the parties agree that the arbitration is subject to Israeli law and even when the mistake was an obvious one<sup>36</sup>.

In the 1980s, arbitration in Israel was used "primarily by labor and management, cooperative and friendly societies, and religious groups"<sup>37</sup>. Before the second amendment to The Law in 2008, arbitration as an institution in Israel suffered from a lack of public trust<sup>38</sup> and

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<sup>33</sup> A. Reich, *op. cit.*

<sup>34</sup> For a review in English of the main aspects of The Law, see E. Doron, A. Hertman, "Arbitration agreements under Israel's arbitration law", *IGLC -International Arbitration*, 2007.

<sup>35</sup> D. Lavi, "Not Only Arbitration and Not Only Mediation - a Proposal to Adopt 'Med-Arb' as a Response to the Weaknesses of the Institution of Arbitration in Israel", *Mishpatim Law Review*, 2011, p. 42.

<sup>36</sup> *Ibid.*; A. Straschnov, "Government Attitude toward Arbitration", *Contemporary Asia Arbitration Journal*, 2008, vol. 1, p. 91.

<sup>37</sup> S. Ottolenghi, "Arbitration Institutions in Israel", *Arbitration Journal*, 1983, vol. 38, n. 3, pp. 53-60; A. Polinsky, D. Rubinfeld, "Aligning the interests of lawyers and clients", *American Law and Economics Review*, 2003, vol. 5, n. 1, pp. 165-188 spec. p. 53.

<sup>38</sup> A. Reich, *op. cit.*

only around 650 cases of arbitration were initiated every year in comparison to the 1.3 million cases that were initiated in the court system on a yearly basis<sup>39</sup>. As a result of this lack of trust and in an attempt to lessen the workload of the Israeli court system The Law was amended, and two new features were introduced:

- The first feature was the parties' ability to agree that the arbitration award will be appealable through two possible tracks. In front of a “new” third party arbitrator<sup>40</sup> or alternatively in front of a court judge, if permission to do so is given by the latter, and only on the basis of a fundamental mistake in the application of Israeli law by the arbitrator, which resulted in a miscarriage of justice (Article 29B to The Law);
- The second feature was compelling the arbitrator to state the reasons why a particular award was given (Para. p to The Law First Addendum) unless the parties agree to release the arbitrator from this obligation<sup>41</sup>.

In Israel, there is no official public institution for arbitration and most arbitrations are handled by private arbitrators or a private partnership of several arbitrators<sup>42</sup>. Before the second amendment to The Law, the existence of private institutions for arbitration was not very widespread. However after the amendment came into force three new private arbitration institutions were established (and even nowadays the trend appears to indicate continued growth; see the Center for Arbitration and Dispute Resolution established in 2009, which has been expanded since then, and ITRO, The Institution for Arbitration and Dispute Resolution established in 2008 after the second amendment to The Law). This trend is likely sustained by the rise in popularity of commercial arbitration<sup>43</sup>.

One of the main purposes of the arbitration procedure in Israel is to enable the parties to benefit from a more efficient procedure, as The Law states (unless otherwise agreed by the parties):

"The arbitrator will act in the most effective manner, as he/she sees fit, to reach a speedy and just settlement to the dispute and will rule to the best of his/her judgment on the matter before him/her; the arbitrator will not be bound by material

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<sup>39</sup> D. Lavi, *op. cit.*

<sup>40</sup> Article 21A to The Law.

<sup>41</sup> D. Lavi, *op. cit.*

<sup>42</sup> N. Ebner, Y. Efron, Y. Winkler, G. Manobla-Landman, *op. cit.*

<sup>43</sup> Because these institutions are private and seek to maximize their profit, there is an assumption that they would not have been established or have been expanded if there was not an increase in the demand for commercial arbitration.

law, the laws of evidence, or by due process as enacted in the courts." (Para. o to The Law First Addendum).

Despite this statement, this paper suggests that although efficiency is one of the most important goals of the arbitration procedure as also stated in the language of the addendum itself, in practice the commercial arbitration proceedings in Israel suffer from failings and pitfalls that hinder the achievement of this goal.

#### **I.D. The Efficiency Problem in Israeli Arbitration**

In recent years, practitioners in the field of commercial litigation in Israel have experienced and observed that many of the arbitration procedures are highly inefficient in regard to lowering costs and saving time, despite the fact that both sides to these proceedings had *ex-ante* expectations that the integration of arbitration clauses in their agreements would lead to a quicker and cost-effective conflict resolution.

Some of the pitfalls that cause this inefficiency can be traced back to the litigants' conduct in the proceedings. In many instances litigants in arbitration proceedings tend to inflate the volume and number of their claims and defendants tend to submit more counterclaims than in court proceedings. Moreover, arbitrators have a hard time establishing orderly procedures or enforcing procedural discipline. Sometimes arbitration proceedings can end up lasting many years and costing the parties more than anticipated.

Unfortunately, no empirical research has ever been undertaken on this subject. The arbitration process in Israel is private and thus confidential; there are no public arbitration institutions and no regulations that require private institutions and arbitrators to publish information regarding the proceedings they carry out<sup>44</sup>. Therefore, it is doubtful that the relevant data can ever be gathered so as to allow for empirical research<sup>45</sup>.

Support for some of these observations can also be found in financial newspapers and periodicals in articles published over the years by writers focusing on some of the problems to be found in Israeli arbitration. We must admit that due to time constraints we did not attempt to carry out such empirical research for use in this paper. However, the absence of data or the

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<sup>44</sup> A. Reich, *op. cit.*

<sup>45</sup> The problems with empirical research regarding arbitration are well known in other jurisdictions (for example, see S. Franck, "Empirically evaluating claims about investment treaty arbitration", *North Carolina Law Review*, 2007, vol. 86, p. 1 and C. Schreuer, "The Future of investment Arbitration" in M. Arsanjani, *Looking to the future: essays on international law in honor of W. Michael Reisman*, Brill, 2010, pp. 787-804, spec. 788-789, including the reasons it is so difficult to obtain information regarding arbitration).

inability to obtain empirical evidence need not imply that it is impossible to discuss the failings of the Israeli arbitration system, it simply makes the task more complicated.

Another observation is that even sophisticated parties tend to use very simple and general arbitration clauses. Moreover, they do not try to negotiate and agree on tailor-made arbitration provisions in order to deal with some of the potential future problems and create a more efficient procedure. One could have expected these types of parties to demonstrate a learning process which would result in better and more detailed arbitration clauses. As this is not the case we have often wondered whether the drafting of better arbitration provisions could be a possible route to solving many of these problems, as the parties have flexibility in shaping the arbitration procedures.

To the best of our knowledge no scholar has thus far attempted to examine the body of recent writing regarding arbitration in the US and other international arbitration systems, and later used the findings of those researchers to try to explain the pitfalls of the Israeli arbitration system. This paper then presents a new approach to the issue and can contribute to a better understanding of the inherent problems in Israeli arbitration.

## **II. POSSIBLE REASONS FOR THE INEFFICIENCY OF ARBITRATION IN ISRAEL**

This part points out some of the failings that may be the cause of inefficiency in arbitration in Israel as described previously.

The failings that will be presented in this section are the result of structural pitfalls of the Israeli arbitration system or pitfalls that have been observed in arbitration proceedings in the US and in international arbitration that may also be applicable to the following analysis of the Israeli system. It should be noted that the order in which the following failings will be presented is arbitrary because no empirical research has examined the influence and effect of each failing in the context of the Israeli system. Note that the purpose of this paper is to try to focus on the macro (to see the "big picture") and thus to present a brief overview of the many problems at hand and attempt to explain their cumulative effect.

### **II.A. Conventional Arbitration Pitfalls**

Arbitration can be conducted in various ways. For instance, under conventional arbitration the litigants make their arguments to the arbitrator, who can decide to accept or decline their claims, and thus to award them with any amount the arbitrator believes is just (limited by the scope of the claim). Under "last offer arbitration" the arbitrator is compelled to

choose between offers made by both sides, finally deciding on one of them<sup>46</sup>. The decision of which mechanism to choose can affect the sides' incentives to either move towards the middle ground in their arguments or to inflate their claims and polarize them further.

The Israeli legal system is based on the adversary model which has similarities to the conventional model of arbitration. This can explain why arbitration proceedings in Israel are handled by the conventional mechanism. Game theory analysis of this mechanism shows that the arbitrator tends to split the difference between the plaintiff and the defendant<sup>47</sup>. Thus, each litigant has an inherent interest in inflating their claim<sup>48</sup>. The same logic can also explain the incentive for submitting a counterclaim.

As one can see, litigants in this kind of arbitration tend to stake out a more extreme position - conduct that may well prolong the proceedings and increase its overall costs, while also disincentivizing settlements<sup>49</sup>.

## **II.B. The Scope of Judicial Intervention in Arbitration Awards**

As previously mentioned, the scope for judicial intervention in arbitration awards in Israel is limited mainly to faults in the arbitration procedure itself. The judicial intervention of the court system in Israel is thus limited. However, one reason for this intervention which can affect the arbitration efficiency is stated in Sub-Article 24 (4) of The Law:

"24. Following a legal 'request for nullification' submitted by a litigant, the Court is entitled to nullify an Arbitration Award, entirely or in part, or to complete it, amend it, or to return it to the Arbitrator, for any one of the following reasons: [...] (4). The litigants were not given sufficient opportunity to make their cases or to produce their evidence."

This reason for intervention can explain why arbitrators find it difficult to limit the parties' submission of evidence, documents and the length of their arguments.

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<sup>46</sup> For a list of some of the optional mechanisms see Y. Sinar, M. Alberstein, "Court Arbitration by Compromise: Rethinking Delaware's State Sponsored Arbitration Case", *Cardozo Public Law, Policy & Ethics Journal*, 2014, vol. 13.

<sup>47</sup> Some will claim in the middle and others disagree, see the discussion in A. Van Aaken, T. Broude, *op. cit.*, pp. 20-21.

<sup>48</sup> S. Brams, "Negotiation Games: Applying game theory to bargaining and arbitration (Vol. 2)", *Psychology Press*, 2003, pp. 63-99.

<sup>49</sup> See also W. Notz, F. Starke, "Final-Offer Versus Conventional Arbitration as Means of Conflict Management", *Administrative Science Quarterly*, 1978, vol. 23, n. 2, pp. 189-203; D. Bloom, C. Cavanagh, "Negotiator Behavior Under Arbitration", *The American Economic Review*, 1987, vol. 77, n. 2, p. 353.



Interestingly, what is required of arbitration proceedings is not required of court proceedings. In order to make court proceedings more efficient Israeli judges have the authority to decide on procedural constraints that litigants must then comply with. For example, judges can limit the length of court documents, restrict the time for cross-examinations or even the number of witnesses that each litigant may summon. Even in the Israeli Supreme Court there is a common practice that for every civil appeal the Court Registrar limits the number of allowed argumentation pages.

Allegedly, arbitrators have the same authorities to shape the arbitration procedure rules so they will be more efficient. However, the existence of such potential judicial intervention may mean that even though arbitration is supposed to promote more efficient procedures, arbitrators opt not to exercise their authority and use those controls with the frequency and degree of magnitude that might be expected of a system whose *raison d'être* is efficiency.

### **II.C. No Court Fees**

When litigants initiate a pecuniary claim in the Israeli judicial system, they are obligated to pay court fees. These court fees are derived from the total claim amount (nowadays equal to 2.5% of the total claim amount, which is paid in two instalments). A litigant's potential award is limited to the claim amount for which they paid the court fees for in advance. This court fee payment is non-refundable, with a few exceptions, such as when claims are settled in mediation outside the courtroom.

This court fees mechanism creates a financial incentive for the parties to submit a claim that is limited only to their real award expectations (or otherwise pay excessive court fees). Correspondingly when defendants want to submit a counterclaim, they are also subject to the same court fees rule, so they have the same financial incentives.

However, in arbitration proceedings in Israel, there are no fees paid upfront which are based on the total claim amount, and no fees as a result of submitting counterclaims. Thus, the litigants do not have the same financial incentive to limit their total claims amount or to limit the submission of counterclaims.

Note that we are aware of the fact that the administrative cost and the arbitrator's wages can also increase in the case of a claim for a larger amount. However, this increase does not have the same effect as court fees for two reasons: Firstly, the parties do not pay those amounts upfront as they would with court fees. Secondly, because arbitration costs are usually split in

equal proportion between all parties, they all bear their share of the cost regardless of their own conduct during the proceedings.

This has similarities in economic principals to the Tragedy of the Commons<sup>50</sup> in the sense that even if the conduct of one of the sides results in an increase in cost, that side will not be the sole bearer of the cost of the increase and the others will have to cover their own proportional shares in that same increase. This means that one side's conduct can create externalities that impact the others. Because this is the case individuals can be said to have an incentive towards exhibiting excessive negative behaviors. Not only do arbitration litigants not have the same incentives to curtail such behavior as they would in a court case, in arbitration proceedings the cost of prolonging the procedure is borne proportionally by all parties and thus by default one side forces the others to also pay for the increase in cost.

#### **II.D. Bad Faith Conduct**

This is not the case in every claim but in some cases, litigants may have an interest in prolonging the proceedings<sup>51</sup> either because they are defendants seeking to gain more time before the arbitrator rules in favor of the plaintiff<sup>52</sup>, or because they are trying to prolong the procedure in order to increase the incentives for the opposite side to compromise and settle. Such conduct can be considered "bad faith conduct"<sup>53</sup>.

In the Israeli court system, the court has at its disposal measures to combat this kind of bad faith conduct. These measures can even include ignoring or striking out litigants' arguments. In arbitration, the most appropriate penalty for such conduct is through the awarding of costs and expenses<sup>54</sup>. However, these kinds of awards, as will be explained in the next section, are not very effective in arbitration. As discussed previously, if an arbitration litigant tries to prolong the proceedings it would be forcing the other parties to share the increased cost.

It is important to know that under Israeli Law the arbitrator potentially has all the authority necessary to take strong measures against bad faith conduct:

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<sup>50</sup> G. Hardin, "The Tragedy of the Commons", *Science*, 1968, vol. 162, issue 3859, pp. 1243-1248.

<sup>51</sup> M. Moses, "Arbitrator Power to Sanction Bad Faith Conduct: Can it Be Limited by the Arbitration Agreement?", *Australian Law Journal*, 2010, vol. 84, p. 82.

<sup>52</sup> Y. Shilo, "Integrating arbitration in the judiciary mechanism", *Mechkarei Mishpat Law Review*, 1989, p. 90.

<sup>53</sup> M. Moses, *op. cit.*; J. Hinchey, T. Burch, "An Arbitrator's Authority to Award Attorney Fees for Bad-Faith Arbitration", *Dispute Resolution Journal*, 2005, vol. 60, n. 2, p. 10.

<sup>54</sup> M. Moses, *op. cit.*

"If this arbitrator has ordered a litigant to do something related to the arbitration process and, for no justifiable reason, the litigant has not complied with that order, after warning that litigant the arbitrator is entitled to defer the suit, if an order has been issued against a prosecutor, or to vacate the defense and to settle the dispute as if the defendant did not offer a defense, if an order has been issued against a defendant".

Some of the scholars who have participated in the ongoing debate on arbitration efficiency have suggested that parties must change their conduct during arbitration<sup>55</sup> as part of their recommendations on dealing with the inefficiency problem. Of course, the adoption of these recommendations depends on the litigant's goodwill, and in such cases where the parties' interests diverge these recommendations become irrelevant and cannot solve the problem.

## II.E. Cost and Expenses Awards

There are two known rules regarding the awarding of costs and expenses in litigation proceedings - the American Rule and the English Rule. The former is more common in the US legal system and the latter in the English one. The American rule states that each side to any litigation must bear their own costs and expenses (including lawyers' fees). In contrast, the English rule states that the side that loses the proceeding must compensate the other side, paying full costs and expenses<sup>56</sup>. It is interesting to note that studies have found that among sophisticated parties to agreements the British rule is preferred alongside *ex-ante* arbitration provisions<sup>57</sup>.

The Israeli legal court system's approach lies somewhere in between. While judges usually award the side in favor of which they rule compensation for costs and expenses (including attorney's fees), the compensation sum is decided by the judge based on their own considerations and not on the actual out-of-pocket costs and expenses, which are usually higher<sup>58</sup>.

The Israeli Arbitration law provides the arbitrator with the authority to determine their own wage (Article 31 to The Law), with the default rule determining that these costs will be

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<sup>55</sup> For example, J. Shearer, "Reducing costs of arbitration through increasing the parties options", *Arbitration Journal*, 1985, vol. 40, n. 2, pp. 14-76.

<sup>56</sup> T. Eisenberg, G. Miller, "The English vs. the American rule on attorneys fees: An empirical study of attorney fee clauses in publicly-held companies' contracts", 2010, available online: <https://ssrn.com/abstract=1706054>.

<sup>57</sup> T. Eisenberg, G. Miller, *op. cit.*, pp. 26-28.

<sup>58</sup> T. Eisenberg, T. Fisher, I. Rosen-Zvi, "Attorneys' fees in loser-pays system", *University of Pennsylvania Law Review*, 2014, vol. 162, n. 7, pp. 1619-1662.

shared equally by all parties<sup>59</sup>. The arbitrator also has the authority to award parties with costs and expenses:

"The arbitrator is entitled to issue instructions regarding the expenses of the parties, including the lawyers' fees, arbitrator's wages and expenses, in total or in part, and may issue instructions regarding the deposit of these sums or the provision of guarantees of their payment; in cases where the arbitrator has issued no other orders, the litigants are obligated to pay his/her salary and expenses in equal parts." (Para. 5 to The Law First Addendum).

As is easily discernable, this is very generalized language that does not give the arbitrator uniform directives for determining these kinds of awards. Researchers have found that in the field of international arbitration, whenever such a general rule is in use, arbitration cost award decisions were arbitrary and not uniform<sup>60</sup>. It also has a negative impact on the parties as it is harder for them to estimate the consequences of their conduct as litigants in advance and even makes it more difficult to reach a settlement as a result of such uncertainty<sup>61</sup>.

## **II.F. "Arbitration the New Litigation"**

In the recent decades, commercial arbitration proceedings have become more and more similar to litigation<sup>62</sup>. Stipanowich in the "Arbitration the New Litigation"<sup>63</sup> argues that these changes also stemmed from the evolution of relevant regulation in the US, which have set out new and more formal rules for arbitration proceedings.

As aforementioned, in 2008 the second amendment to the (Israeli) Law, also follows this trend, as it enables the parties two optional tracks to appeal the arbitration award. Moreover, the arbitrator is now required to detail his reasoning for the award given. As explained, this amendment was intended to increase the parties' trust in the arbitration institution. However, it is also made the arbitration process more formal and thus may increase the cost of these proceedings.

## **II.G. The Lawyers as Another Potential Problem**

It is not something unique to arbitration proceedings but when the contract specifies that lawyers are paid by hourly fees there is an inherent conflict of interest because their

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<sup>59</sup> This is also the default rule of all the private arbitration institutions in Israel.

<sup>60</sup> J. Gotanda, *op. cit.*

<sup>61</sup> *Ibid.*

<sup>62</sup> T. Stipanowich, *op. cit.*; Moses, *op. cit.*

<sup>63</sup> T. Stipanowich, *op. cit.*, pp. 11-19.

compensation depends on the length of the proceedings<sup>64</sup>. There is evidence that such conflicts of interest can affect the representative's behavior<sup>65</sup>.

But even in cases where the lawyers' fees are not calculated by the hour, a conflict of interest can occur. It is not unreasonable to assume that clients' willingness to pay their legal fees, even using other billing mechanisms (like contingency or a lump sum), is tied to the scale of the claim. For example, one can assume that clients will find it reasonable to pay higher legal fees for a 10 million USD claim than for a one million claim.

## **II.H. The Arbitrator - A Solution or Another Problem?**

The arbitrator's responsibility is to carry out an efficient procedure, that is, a quicker and less costly one. However, if one analyzes their incentives one can conclude that they do not have any real incentives to do so. The arbitrator's wage is usually calculated by the hour. Thus, the arbitrators themselves have a conflict of interest with the parties and have little incentive to shorten the procedure.

Moreover, even when this is not the case, one can assume that the claims' magnitude may affect the parties' willingness to pay higher arbitration costs. This can also be intuited from online calculators offered by various international arbitration institutions which are meant to assist potential litigants in estimating the cost of such arbitration. Indeed, these calculators are based on two main parameters: the total amount of the claim and the number of arbitrators; not on the complexity of the issue or other allegedly relevant variables that one could assume would also be relevant in estimating costs.

One would expect that arbitrators, as professionals - and especially the most respected ones in the field of international arbitration - would not be affected by this systemic conflict of interest. However, researchers have found empirical evidence that supports the conclusion that arbitrators' conduct is affected by their desire for future compensation<sup>66</sup>. The arbitrator wants not only to get paid more as part of the current procedure, but they also want the parties to use them for future disputes and thus have fewer incentives to place harsh restrictions on the parties, even if these can promote the efficiency of the proceedings.

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<sup>64</sup> For example, see A. Polinsky, D. Rubinfeld, *op. cit.*

<sup>65</sup> See discussion in H. Kritzer, W. Felstiner, A. Sarat, D. Trubek, "The impact of fee arrangement on lawyer effort", *Law and Society Review*, 1985, pp. 251-278.

<sup>66</sup> See, for example, S. Puig, "Blinding International Justice", *Virginia Journal of International Law*, 2016, vol. 56, pp. 647-745.

This conflict of interest can also potentially decrease the incentive for arbitrators to call out bad faith conduct on the part of one of the litigants. If the arbitrator did not ban this conduct during the proceedings and only placed sanctions on the litigant at the very end, the counterparty may assume that failing to call out such behavior during the proceedings was a result of the arbitrator's conflict of interest (*i.e.* the arbitrator's potential incentive to have the proceedings prolonged) thus compromising the perception of the arbitrator's integrity.

In Israel, to the best of our knowledge, only one private arbitration institution offers a lump-sum total cost for arbitration proceedings. However, even in this case, the lump sum costs are derived from the total claims amount. The purpose of this private institution rule, as published in the Israeli financial press, was fairness: to fight the high cost of arbitration procedures and to promote certainty, so that parties will be able to accurately anticipate the cost of arbitration. Note that this kind of mechanism is also not free from difficulties as it can create a negative incentive for the arbitrator not to invest all the effort necessary to reach a just decision.

In cases where there is a panel of arbitrators in which each side has the right to appoint one or more arbitrators, there are also different possible conflicts of interest and biases<sup>67</sup>.

#### II.H.1. The Arbitrator's Reputation Has an Ambiguous Effect

Supposedly, the arbitrator's reputation and their desire to secure future compensation should mitigate the structured conflict of interest discussed above. However, the arbitrator's reputation has an ambiguous effect. On the one hand, the arbitrator has the incentive to fulfil the parties' initial aspiration and the institution's goals, namely, to handle the proceedings in a quick and cost-efficient manner so that they will have a good reputation. On the other hand, the arbitrator has the incentive to please the litigants and not to put harsh procedural restrictions on them, as this could damage their reputation with the litigants.

Finally, as discussed above, the arbitrator has an incentive to act in such a way that judicial intervention will not be imposed on their decisions, and will make sure the litigants will not be in a position to claim that they did not give them the opportunity to fully make all their arguments.

For the reasons mentioned above, and because due to the confidentiality of the arbitration proceedings details of a particular arbitrator's performance are not made public, it

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<sup>67</sup> S. Puig, *op. cit.*

can be said that reputation considerations have an ambiguous effect on the arbitrator's willingness to shorten the proceedings and make them less costly.

#### II.H.2. Arbitration Institutions (None) Competition Effect

In Israel arbitration institutions may also suffer from another, similar, structured conflict of interest. Whenever proper competition among arbitrators prevails, they will have the interest in attracting potential customers/litigants, and thus they will act to shorten the procedures. One can, as a matter of fact, observe such a process taking place over the past several years at international arbitration institutions as a result of jurisdictional competition<sup>68</sup>. For example, one of the measures was to state that the arbitrator's fees will be decreased if they prolong a procedure<sup>69</sup>.

However, in Israel, judging from the financial press, it appears that the primary competition among private arbitration institutions in Israel centres on recruiting prestigious former judges as arbitrators, and then charging a high fee for their services. The only encouraging indication for such competition is the relatively new tracks for quicker arbitration procedures for small claims arbitration proceedings offered by those institutions, some of which may also offer the option of lump sum payments for such proceedings.

*In summary* - All the failings discussed above demonstrate possible reasons why arbitration is so inefficient in Israel with regard to saving time and lowering costs. An overview of all these failings may indicate that all the relevant actors in arbitration during the *ex-post* conflict period (meaning after the conflict has arisen between the sides) have little to no incentive to confront or deal with these failings and act in a way that will fulfil the litigants' initial desires:

At this stage, the parties' interests sometimes diverge and at least one of them may wish to prolong the proceedings. Moreover, even when their interests are shared, the conventional arbitration mechanisms incentivize them to stake out more extreme positions rather than bring them towards the middle ground.

Lawyers have an inherent conflict of interest because they benefit financially from prolonging the proceedings.

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<sup>68</sup> M. Bühler, "Costs" in J. Trenor, *Global Arbitration Review - The Guide to Damages in International Arbitration*, 2016, pp. 253-270.

<sup>69</sup> *Ibid.*

Arbitrators have a similar conflict of interest and while one might expect the arbitrator's desire for a good reputation to serve as enough of an incentive to mitigate this issue, the issue of their reputation seems to have an ambiguous effect.

These conclusions lead to the question of whether the parties can negotiate and address such failings with a better drafting of arbitration clauses (*ex-ante*).

### **III. MORE EFFICIENT ARBITRATION CLAUSES?**

As discussed previously, ADR mechanisms in general and arbitration in particular enable parties to have greater flexibility in shaping the rules for resolution proceedings between them. One would expect therefore that sophisticated parties to an agreement would use that flexibility to attempt to draft better arbitration clauses in their agreements; provisions that will help them secure more efficient future arbitration proceedings. These provisions are called "tailor-made" or "self-tailored" provisions - clauses drafted specifically to fit a potential dispute that may arise between those specific parties<sup>70</sup>.

This part will try to discuss whether this learning process can indeed be a practical solution to the efficiency failures of arbitration in Israel. As mentioned previously in the *ex-ante* stage two sophisticated parties, neither of which having excess power over the other, share the same interest to agree upon a less costly and more time effective arbitration procedure<sup>71</sup>.

#### **III.A. These Provisions Cannot Address All the Failings**

As a starting point, if one looks at the failings described in the previous part, some of them are inherent structural failings that are not tied to the specific arbitration agreements between parties. Thus, even if they want to address those failings they do not have the ability to do it because even tailor-made provisions will not be able to solve these issues.

For example, the parties cannot resolve the conflict of interest between their lawyers and themselves or the future arbitrators by adding a clause to their agreement. It does not matter what the parties agree to between themselves; these conflicts of interest will not disappear.

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<sup>70</sup> S. Choi, "The Problem with Arbitration Agreements", *Vanderbilt Journal Transnational Law*, 2003, vol. 36, p. 1233.

<sup>71</sup> See also A. Weiss, E. Klisch, J. Profaizer, *op. cit.*, who has a good analogy to the *ex-ante* stage between the parties based on Rawls known use of the "Veil of Ignorance".



As discussed above, even if they choose, *ex-ante*, to only litigate before the only Israeli institution that does not bill hourly fees for arbitration, this will not solve the arbitrator's conflict of interest as this alternative wage mechanism also has pitfalls that create conflicts of interest.

Another limitation of the arbitration clauses is the inability to completely resolve arbitrators' concerns regarding potential future judicial intervention and their subsequent hesitancy in imposing restrictions on litigants. The parties cannot waive their privilege to request judicial intervention as this right is a mandatory law, even if all parties agree to waive this right in the *ex-ante* stages.

The conclusion from this section is that even though parties have flexibility and they can draft better arbitration provisions with more sophisticated arbitration mechanisms, these clauses will be limited in their ability to deal with all the possible failings that may prevent more efficient arbitration procedures.

The fact that better provisions cannot address all possible failings does not imply, though, that parties should not try to resolve or at least mitigate some of these failings. However, the next section will demonstrate why tailor-made clauses also have practical problems.

### **III.B. The Problems with Tailor-Made Arbitration Clauses**

Some of the failings of the Israeli arbitration system can allegedly be solved or at least mitigated by tailor-made provisions.

In order to promote more efficient arbitration, parties can add tailor-made arbitration clauses to their agreement, detailing various mechanisms, such as:

- Limit the length of their future arbitration documents;
- Incorporate financial incentives to submit only justified claims (and not to inflate those claims) - for example, to state that with every claim submitted the plaintiff has to provide a bank guarantee for the amount derived from the total claim amount, in order to ensure the counter sides' cost and expenses;
- Decide to waive the right to submit written arguments and elect to have an oral proceeding before the arbitrator;
- Decide on liquidated damages;
- Agree that the arbitration will be held before a professional expert in the relevant field.

Moreover, they can even decide that the arbitration process will be handled without either side being represented by a lawyer.

Of course, the above lists only some examples of such mechanisms out of many possible others<sup>72</sup>. The crucial point is that parties to commercial agreements must choose the right mechanisms and provisions to ensure maximum efficiency in connection with their specific engagement.

For example, an effective arbitration mechanism fit to solve a dispute over the purchase of specific goods or services will not have the same characteristics as a very complex agreement regarding the supply of numerous goods and services across different time periods and with many potential hurdles. Moreover, even in the latter type of engagement not every potential dispute suits the same mechanism. For example, a dispute regarding one specific payment is not the same as a dispute about the quality of goods or services.

For this reason, the *ex-ante* specific provisions are called tailor-made arbitration clauses as they are meant to suit specific future potential conflicts by dealing with specific complexities. As will be discussed in the next three sections—the drafting of such clauses faces considerable obstacles, which decrease and limit the ability of those tailor-made provisions to address the previously discussed failings.

### III.B.1. Transaction Costs and The Knowledge Problem

In order to draft tailor-made arbitration clauses, the parties (or their representatives) should try to anticipate what their future potential disputes may be and then draft arbitration procedural rules that will be effective for settling those specific potential disputes. This process increases the parties' transaction cost<sup>73</sup> in trying to predict all potential future disputes and then drafting provisions for them. These costs will be added to the transaction cost of drafting an *ex-ante* agreement.

From an economic point of view, one expects parties to be willing to bear these transaction costs only if the potential benefits gained by the inclusion of tailor-made clauses will outweigh the cost of including them. These gains should be calculated by taking the expected savings on arbitration costs in the event of a dispute and multiplying them by the

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<sup>72</sup> For example, see the latest suggestions for such mechanisms in A. Weiss, E. Klisch, J. Profaizer, *op. cit.*

<sup>73</sup> C. Drahozal, E. O'Connor, "Unbundling Procedure: Carve-Outs from Arbitration Clauses", *Florida Law Review*, 2014, vol. 66, p. 1945.

probability of such a dispute arising. This calculation should also factor in the time dimension as the transaction cost is an immediate out-of-pocket cost while any potential gains are future ones, and thus a discount factor should also be taken into consideration in the cost-benefit analysis.

The problem with such economic cost-benefit analysis is that it does not take into full account the Knowledge Problem<sup>74</sup>. This issue recognizes the complexities of ongoing real commercial markets and acknowledges the fact that even if one is willing to invest money in trying to predict the future, even unlimited investment in searching costs will not ultimately obtain all the relevant knowledge and/or anticipate all the potential future situations that may occur. So even if one is willing to pay the additional costs and invest their time and money in drafting such provisions, one still faces the risk that these provisions will not suit the actual future conflict.

In this context it is interesting to note that in very important economic writings (in the field of contract and corporate Law&Economics), third party mechanisms (such as arbitration) are suggested to decrease the investment needed in drafting costs of agreements and transactions for future specifications between parties. This suggestion is made in order to overcome such knowledge problems, meaning parties' inability even at tremendous cost to anticipate *ex-ante* all the potential future situations that may occur between them and draft a good enough and specific enough contract<sup>75</sup>. As one can see, continuing from the discussion presented above regarding the difficulties of drafting good enough and specific enough arbitration clauses - it is actually a vicious cycle— the drafting process of more efficient tailor-made arbitration clauses faces the knowledge problem, the very same problem that some scholars suggest can be dealt with by those very arbitration mechanisms.

### III.B.2. Parties' Lack of Willingness to Invest in Drafting

The drafting problem described above in the previous section can perhaps explain the results of empirical research which has found that sophisticated parties do not negotiate the terms of arbitration clauses and prefer to stick to standard provisions<sup>76</sup>. Additional research has found that parties to agreements do not want their lawyers to waste time and money in drafting

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<sup>74</sup> F. Hayek, "The use of knowledge in society", *The American economic review*, 1945, pp. 519-530 spec. pp. 522-525.

<sup>75</sup> O. Williamson, "Transaction-cost economics: the governance of contractual relations", *The journal of Law and Economics*, 1979, vol. 22, n. 2, pp. 233-261.

<sup>76</sup> S. Choi, *op. cit.*

arbitration clauses<sup>77</sup>. In addition, some studies also show that parties tend not to negotiate arbitration clauses *ex-ante* because they are concerned about damaging business ties or complicating the discussion<sup>78</sup>.

If that is the case, there is no reason to believe that in Israel the parties to such commercial agreements would prefer departing from the standard arbitration provisions (and as mentioned above, this paper does not offer empirical evidence). As there is no public entity for arbitration in Israel, such standard provisions are suggested only by private intuitions, by private lawyers and by the Israeli Bar Association. None of these offers any mechanisms or guidelines suggesting anything that may increase or promote efficiency in arbitration proceedings.

That can be explained by the difficulties described above in drafting generalized recommendations, and perhaps also by the fact that all of those suggestions come from entities with no interests in making the arbitration process more efficient.

### III.B.3. The Potential Inability to Enforce Tailor-Made Arbitration Clauses

One more risk that should be taken into consideration when drafting tailor-made arbitration clauses is the risk that such provisions will not be enforceable. While judges and arbitrators are already familiar with the wording of the standard provisions, the use of new ones carries with it the risk that these clauses will not be enforceable<sup>79</sup>, in effect rendering the entire arbitration agreement null and void. This could have severe consequence for the parties. For example, if the confidentiality of their future disputes is crucial to both and the tailor-made arbitration clause they drafted appears to be unenforceable, they may find themselves resolving their dispute in a public courtroom.

## IV. THINKING ABOUT POSSIBLE SOLUTIONS

The conclusion from our discussion thus far is that tailor-made arbitration clauses do not provide a simple solution for all the problems and failings dealt with in this paper. Does that mean that parties to a commercial agreement should give up and not try to improve the

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<sup>77</sup> H. Kirsh, "Pitfalls, Perceptions and Processes in Construction Arbitration", *Advoc. Quarterly*, 2012, vol. 40, p. 311; also see the discussion in T. Stipanowich, "Arbitration and Choice: Taking Charge of the 'New Litigation'(Symposium Keynote Presentation)", *DePaul Business and Commercial Law Journal*, 2009, vol. 7, n. 3, p. 383 for a more detailed report which explains why parties tend to stick to the standard arbitration clauses.

<sup>78</sup> T. Stipanowich, *op. cit.* 2009, p. 390.

<sup>79</sup> T. Stipanowich, *op. cit.* 2010.

efficiency of their potential arbitration proceedings? This paper suggests that the answer is no. However, this paper does suggest that the parties should be aware of the limits of relevant possible solutions that cannot address all these issues and failings. There is no simple solution for all cases but it might be possible to find some solutions to address some of the failings.

In the ongoing debate regarding arbitration efficiency in the US and in international arbitration institutions, some of the scholars have made recommendations centering on the conduct of the arbitration actors<sup>80</sup>. The newest writing on this subject suggests that parties include more time and cost saving measures to the *ex-ante* mechanisms<sup>81</sup>. This kind of suggestion ignores the limitations of arbitration provisions discussed in this paper. Therefore, a more innovative approach is required as the current suggested solutions do not seem feasible.

The solutions that will be described in this part are only initial recommendations. Their applicability and feasibility should be examined in future studies. This paper does not pretend to suggest a comprehensive solution, and perhaps such a solution is not even possible. The following ideas should be considered in that context.

#### **IV.A. The Simple Cases**

In simple cases where the parties are engaged in a straightforward contract and believe that they can easily predict and define possible potential future disputes in the *ex-ante* stage, they should consider investing the resources in drafting tailor-made arbitration provisions. In those simple cases, where the risk of an unexpected turn of events is low (for example, because it is the kind of transaction that people tend to get into on a daily basis, and thus they can easily predict what can go wrong and how), tailor-made arbitration clauses can offer solutions to at least some of the efficiency failings.

However even in these cases the parties should be aware of the limits and risks of such provisions, and perhaps should consider defining exactly which types of future conflicts will be addressed by the tailor-made provisions they have agreed upon in the agreement and all other possible future disputes (some of which could not possibly have been foreseen by the parties) should use the standard arbitration clauses or be resolved in the regular court system, as it could be that the tailor-made provision drafted by the parties does not suit a particular dispute and may end up damaging the parties more than helping them.

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<sup>80</sup> *Ibid.*; J. Shearer, *op. cit.*; I. Welser, *op. cit.*

<sup>81</sup> A. Weiss, E. Klisch, J. Profaizer, *op. cit.*

If the parties do not want to bear the necessary transaction costs involved in drafting such detailed provisions, they can also define some future potential disputes that will be discussed only in the new quick track arbitration offered by some Israeli arbitration institutions.

#### **IV.B. Mid-Arb and Other ADR Solutions**

Understanding all the aforementioned requires an understanding of the limitations of arbitration as they regard the issues of cost and duration. This understanding may lead the parties to consider other ADR solutions that can be more efficient in resolving disputes<sup>82</sup>.

Some scholars have suggested a hybrid mechanism that combines mediation and then, in the event that mediation fails to solve the issue, turns to arbitration<sup>83</sup>. This hybrid solution can save time and money for the parties, but it too has problems and limitations.

For example, in such mechanism the parties will fear to disclose information (and particularly informal information) in front of the arbitrator, as this information may influence the arbitrator in the event that mediation fails. Another major problem with the suggested mechanism is that because while playing mediator the arbitrator's suggestions are not binding, it can prolong the proceedings in cases where one side wishes to do so and thus abuse the mediation process by, for example, proceeding with the mediation process despite having no intentions of settling the dispute in this way. This kind of mechanism will also not solve the arbitrator's conflict of interest and can even exacerbate it, as the arbitrator will also have an interest in keeping the parties from reaching a settlement through mediation.

#### **IV.C. Introducing the Preliminary Arbitration Procedure**

Solutions to all the aforementioned limits will require innovative thinking. Such solutions may perhaps be a mechanism that can take into consideration the restrictions imposed by the knowledge problem *ex-ante*, and the parties' divergences *ex-post* - meaning a hybrid of *ex-ante* and *ex-post* mechanisms. For example, by *ex-ante* parties' agreement to *ex-post* expropriate the authority to shape the arbitration procedure from themselves and the arbitrator and pass it to a neutral third party as will be explained below.

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<sup>82</sup> See less costly ADR mechanisms in T. Stipanowich, *op. cit.* 2010.

<sup>83</sup> See suggestions in T. Stipanowich, *op. cit.* 2010; J. Rosoff, "Hybrid Efficiency in Arbitration: Waiving Potential Conflicts for Dual Role Arbitrators in Med-Arb and Arb-Med Proceedings", *Journal of International Arbitration*, 2009, vol. 26, p. 89.; A. Weiss, E. Klisch, J. Profaizer, *op. cit.*; and D. Lavi, *op. cit.*, which suggests this kind of mechanism as a solution to some other failings of arbitration specific to Israel.

This kind of hybrid solution can be, for example, the parties deciding *ex-ante* to pass on the authority of drafting their tailor-made arbitration clauses in connection with a specific dispute that may arise between them to a neutral third party that will provide them (*ex-post*) with the most efficient tailor-made arbitration clauses/procedural rules to solve their particular conflict. This process can be called Preliminary Arbitration Procedure.

In order to agree upon such a mechanism, the parties could simply add a section such as the following, or similar to their standard arbitration clauses:

"In case of dispute between the parties, they hereby agree to attend within \_\_\_\_ [Fill in the number of days] days a Preliminary Arbitration Procedure before \_\_\_\_\_ [Fill in the neutral third party identity] who will serve as a neutral third party and who will appoint an arbitrator for them and determine the specific arbitration procedures, terms and rules. This neutral third party will have all the authority given to the parties in shaping the arbitration process. Moreover, any of the third-party's decisions will be considered as a binding and valid agreement between the parties. This neutral third party should take into full consideration the parties' desire for a just, quick and less costly arbitration process while keeping the specific characteristics of the dispute in mind. The preliminary arbitration procedure will be short as possible, and in any case, will not last longer than \_\_\_\_ [Fill in the number of days] days."

The use of new wording of this sort in arbitration clauses will enable the neutral third party to determine the tailor-made rules that will promote arbitration efficiency, for example:

- They will appoint the specific arbitrator and decide whether they will be a professional in a specific field or former judge for example;
- They will be able to decide the arbitration procedures rules– such as the allowed length of any documents submitted; the number of witnesses allowed; the cause of the claim that will be discussed in the arbitration; determine the ability to submit counterclaims, etc.;
- They will define a deadline for the arbitration award;
- They will decide which of the parties will pay the arbitration fee in the first place, and what the guidelines will be for the awarding of costs and expenses;
- Any other additional rules that will promote a faster and less costly arbitration process, while taking into consideration the specific conflict characteristics<sup>84</sup>.

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<sup>84</sup> For more examples, see also suggestions in I. Welser, *op. cit.*, the suggestions made there for the arbitrator can suit this idea with a few changes.

This neutral third party will not face the same conflict of interest as the arbitrator, and they will also not be tied to the parties' *ex-post* divergence of interests or by their potential interesting in staking out more polarized positions. In this stage of the conflict, the knowledge problem regarding the specific dispute will be less of an issue than in the *ex-ante* stage when it required investment through transaction costs. Thus, this solution can perhaps provide the parties with a better, more efficient, tailor-made arbitration procedure that can suit their specific dispute. It can overcome the problems which were discussed in the *ex-post* stage and also the ones of the *ex-ante* stage; thus it is a hybrid *ex-ante* and *ex-post* mechanism. This mechanism will bind *ex-ante* the parties to a mechanism, the specifics of which will only be decided *ex-post*.

The identity of this neutral party can be a former judge or a very experienced lawyer in the litigation field, or even a business executive who has expertise in the relevant field. It can also be a former court registrar who has much experience in setting procedural rules. This will be up to the particular parties to decide, as they alone will know which characteristics could make them trust a third party.

Of course, this solution like any other solution, has its own limitations and problems. For example, it is perhaps counter-intuitive to think that adding another actor to the arbitration process will decrease arbitration time and costs. Another crucial question that arises is, of course, what could serve as an incentive for that neutral third party to make decisions in the best interests of the parties. Another problem, which can also be considered as an additional knowledge problem, is how this third party will be able to quickly understand the conflict at hand well enough to determine which provisions would be best to help resolve it. There are many other challenges and potential questions but unfortunately, they are outside the scope of this paper.

While assessing this proposal one should consider that at least one scholar has reported the use of a similar (but not identical) neutral party's pre-arbitration process described as “managing conflict in long-term contractual relationships by setting up dynamic programs for tailoring processes to disputes at the time conflict arises”<sup>85</sup>. Stipanowich explains the main features of this mechanism, and even reports on the successful use of this mechanism in several cases in Hong Kong:

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<sup>85</sup> T. Stipanowich, *op. cit.*, p. 56.



"Such an approach would obviate the need for a detailed pre-dispute template for conflict management and avoid negotiations over procedural details at contract time; it would permit a process to be specifically formulated for the dispute at hand. If a facilitated negotiation failed to produce agreement on procedures to be employed, the third-party neutral might even have the authority to formulate procedures. There are precedents for such an approach, including a contract-based conflict management program centered on the person of a 'Dispute Resolution Advisor' that was successfully employed on several construction projects in Hong Kong."<sup>86</sup>.

This report strengthens our belief that such a mechanism should be further developed in future studies<sup>87</sup>.

Another aspect that should be considered regarding this mechanism in future writings is also to suggest that this third party may try to mediate between the parties. There is a similar but not identical preliminary procedure (pre-trial) before a judge in the Israeli court system, where judges can also offer to mediate between parties. This procedure was established to try to increase the number of cases settled without court intervention.

This kind of solution, if it were to be found feasible, can benefit from the advantages of the Mid-Arb mechanism, without some (but not all) of its disadvantages. For example, it can mitigate the parties' fear that the arbitrator will be influenced by the informal information disclosed by them in the pre-arbitration mediation process - as the third party will not be the arbitrator himself, this concern will become irrelevant and thus may increase the chances to successfully mediate between the parties without having to resort to arbitration.

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<sup>86</sup> *Ibid.*

<sup>87</sup> For a more detailed report and discussion on the "Dispute Resolution Advisor" mechanism in Hong-Kong and conflict management approaches see, T. Stipanowich, "The multi-door contract and other possibilities", *Ohio State Journal on Dispute Resolution*, 1997, vol. 13, p. 303 spec. pp. 386-403.