Final Offer Arbitration

Chapter 21

Final Offer Arbitration

Final offer arbitration is a mechanism for resolving salary disputes in MLB when a player and his club cannot agree on a salary

- In MLB, rookies and veterans with only one or two years experience in MLB are not eligible for final offer arbitration
- If a player's agent and the general manager of the team cannot reach agreement on a salary, the player is entitled to put the dispute before a three-person arbitration panel
  - Three arbitrators are neutral – that is, none of them will favor one side or the other
- Final offers are submitted by both sides along with supporting documentation

Final Offer Arbitration

After considering the documentation from both sides, the panel must choose one of the offers; no offers are permitted.

If evidence shows that the **player's demand** is closer to market value than the team's offer:

- The panel will award the salary demanded by the player

If evidence shows that the **team's offer** is closer to market value than the player's offer:

- The panel must award the lower salary

Final Offers aren’t so Final

In theory, the offers submitted to the arbitration panel are final, but they really aren’t final.

Examples:

In 2007, Zambrano filed for arbitration after he and the Cubs couldn’t agree on a salary.

- Zambrano’s final offer: $15.5 million
- Cub’s final offer: $11.025 million

These offers were not final as the two sides reached an agreement on a one-year deal for $12.4 million

Final Offers

There are many example of settlements occurring after final offers have been exchanged.

The vast majority of the salary disputes submitted to arbitration are resolved (settled) before the panel acts on the case.

From 1990-2010: 1,987 cases were filed

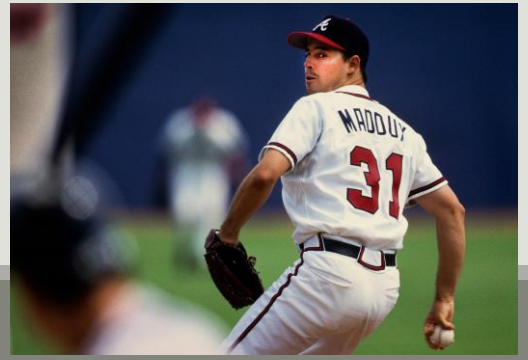
- 220 cases were actually heard
- 1,772 were settled

Break Point

The arbitration panel started at the **break point**, which is the midpoint of the between the two offers.

- If the panel determines that the value of a player is **higher** than the break point, then the player gets the salary that he demands.
- If the panel determines that the value of a player is **lower** than the break point, then the player gets the salary that the team offered.

Example: In 2003, Greg Maddux filed for arbitration. He asked for $16 million, whereas the Atlanta Braves offered only $13.5 million. The break point in this case was $14.75 million. So, Maddux could either get $16 million or $13.5 million after arbitration. If the panel believed that Maddux was worth more than $14.75 million, then he would be awarded $16 million.



Notation

To facilitate our economic analysis, we will use the following notation:

D	difference between team offer and player demand
p	player's estimate that player will win arbitration
q	team's estimate that player will win arbitration
C_P	player's cost of arbitration
C_M	team's cost of arbitration

The model

In this model, a player can accept a team's offer, or go to arbitration.

If a player believes that the team's offer is below market value, then he has something to gain.

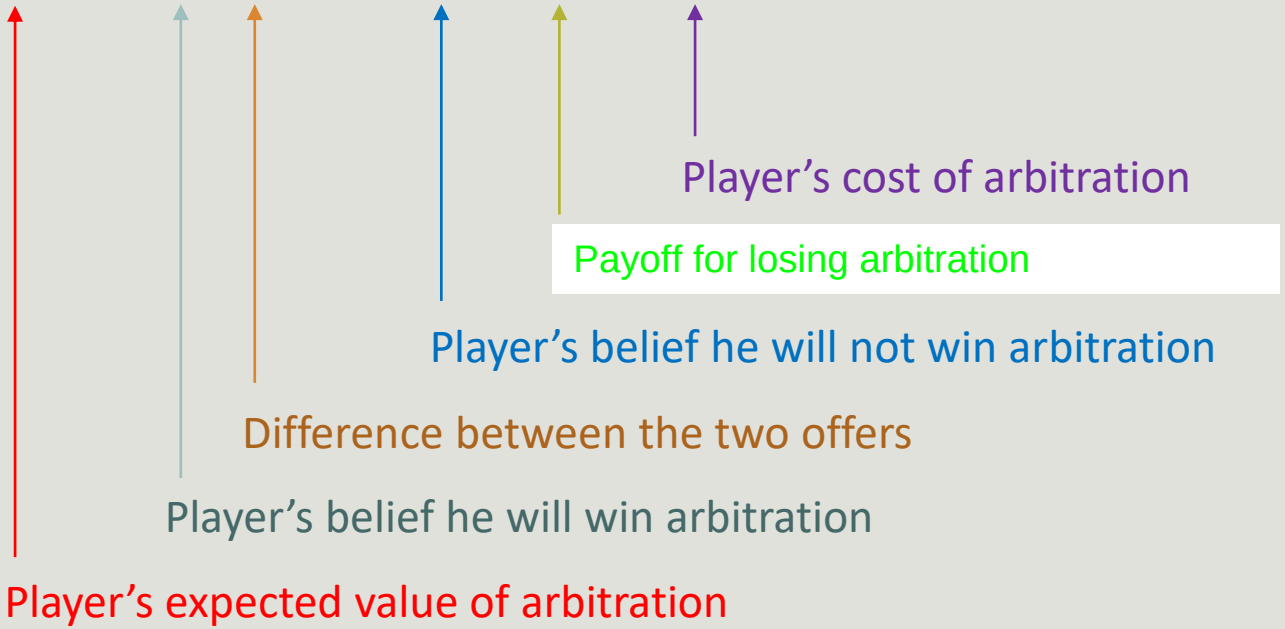
Notice that the team and the player are really fighting over the difference (D) between the two offers.

In this model, we assume that the team and the player are risk neutral, meaning they are only concerned with the expected outcome.

The model

Again, the player believes he will win the difference (D) with probability p (and thus he will not get D with probability 1-p). We can calculate the player's expected value of going to arbitration:

$$E[A]_P = p(D) + (1-p)(0) - C_P$$



The model

Now, the team believes that the player will win the difference (D) with probability q (and thus he will not get D with probability 1-q). We can calculate the team's expected loss is:

$$E[A]_M = q(D) + (1-q)(0) + C_M$$

Team's cost of arbitration

Payoff for losing arbitration

Team's belief he will not win arbitration

Difference between the two offers

Team's belief the player will win arbitration

Team's expected value of arbitration

Notice that we add the cost of arbitration in this case

The model

The player expects to win $E[A]_P$, while the team expects to lose $E[A]_M$ in the arbitration process.

Settlements occur when management expects to lose more than the player expects to win ($E[A]_M > E[A]_P$).

Notice that there are gains from trade (settlements in this case). If both parties agree on a settlement between $E[A]_M$ and $E[A]_P$, then both parties are better off.

Example

We will analyze the offer from the Maddux arbitration. Remember that the offer from the team was $13.5 million, and Maddux's demand was $16 million. Now suppose that given this, Maddux believes that he will win the arbitration with probability of 90%, and the team believes that they will win the arbitration with probability of 85%. Also suppose that the cost of arbitration to Maddux is $100,000, and the cost of arbitration to the team is $150,000. Thus, the expected value of the arbitration for the player is:

$$E[A]_P = .9(2{,}500{,}000) + (1 - .9)(0) - 100{,}000$$

$$E[A]_P = \$2{,}125{,}000$$

And the expected value of the arbitration for the team is:

$$E[A]_M = .85(2{,}500{,}000) + (1 - .85)(0) + 150{,}000$$

$$E[A]_M = \$2{,}275{,}000$$

Example

In this example, the team should settle as $E[A]_M > E[A]_P$.

The amount that the team should offer in a settlement should be between $E[A]_P$ and $E[A]_M$, or in our example, an offer between $2,125,000 and $2,275,000.