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EFFICIENT USE OF ARBITRATION: Drafting of Arbitration Clauses

The Use of Arbitration:

State and Federal Courts use Alternative Dispute Resolution ("ADR") as a means to steer cases away from traditional litigation and towards other forms of controversy resolution, most commonly mediation and arbitration. Federal Courts resort to the use of ADR where they are not otherwise limited by other legal authority, such as a statute or the Code of Federal Regulations. State and Federal Local Rules strongly embrace the use of these nontraditional processes of resolution in an effort to conclude civil disputes. Courts recognize that early-on settlement efforts prior to incurring significant costs of litigation not only reduces caseloads on Courts, but tend to increase the likelihood of settlement.

Criticism of Alternative Dispute Resolution:

ADR is typically a result of Court Order, contractual agreement by the parties, or other consensual participation. One of the significant perceived advantages of ADR, especially arbitration, is the reduction of costs incurred for attorney fees as well as the claim that justice can be secured more quickly. Yet, these goals are often frustrated. Virtually every attorney who focuses upon litigation in their practice is able to describe first-hand where participating in arbitration accomplished none of its perceived advantages of reduction of cost or delays, but made such worse.

Often little can be accomplished pertaining to amending terms and conditions upon which arbitration will be conducted when such is Court ordered. Yet, to the extent arbitration is a consequence of either an Arbitration Agreement or, more typically, an Arbitration Clause in a contract, thoughtful drafting can significantly improve the arbitration process. This paper is an attempt to assist those drafting Arbitration Agreements and Arbitration Clauses in achieving the benefits of arbitration while minimizing potential frustration.

The Scope of Alternative Dispute Resolution:

Where arbitration is the result of contract, parties will almost universally be required to participate in arbitration. Arbitration Clauses where they exist are broadly interpreted mandating arbitration. Courts routinely grant Stays where parties attempt to pursue traditional litigation despite an arbitration clause mandating arbitration. A significant exception where a contractual obligation to arbitrate is avoided

involves core bankruptcy proceedings. Here, there exists a line of cases recognizing the primacy of the Bankruptcy Code above and beyond the traditional ability of parties to freely negotiate their terms and conditions of a contract. Otherwise, the preference of Courts to require arbitration can result in even third party beneficiaries to a contract being required to arbitrate. Where it is found parties either sought or received direct benefit from a contract and even acknowledging that the third party did not execute the contract containing the arbitration clause, arbitration often results. Only where an underlying contract containing an arbitration clause is found to be unconscionable do Courts regularly refuse to enforce these Arbitration Clauses.

Suggestions as to Drafting Arbitration Clauses and Contracts:

Of course, this begs the question as to how one should draft an arbitration clause or what terms should be placed in an Arbitration Agreement so as to reduce attorney fees and costs attendant to arbitration while moving a case more quickly forward through arbitration. These suggestions are made:

(1) Regrettably, lawyers often spend very little time thinking through the arbitration language used in their contracts. It is very common for attorneys to "copy and paste" grafting arbitration language used in other contracts simply inserting that verbiage into a contract. This is unfortunate. While an arbitration clause may be perfectly suitable in one context it might be unworkable in a different one. It is disheartening to see an arbitration clause obviously designed for domestic relations case placed in a Master Service Agreement for an oil and gas project. Potential arbitration terms that could be better crafted are not considered when drafting possibilities are squandered by this mindless "copy and paste" process. The most basic rule of drafting Arbitration Clauses is do not just "copy and paste".

(2) It is important to identify as precisely as possible what issues are going to be subject to arbitration. Where an arbitration clause does exist in a contract, these tend to be thereafter broadly interpreted not only in the favor of requiring arbitration, but to typically include virtually all issues that might be subject to that contract. Generally speaking, Courts tend to interpret arbitration clauses liberally for reasons including arbitration creates less work for the Courts. As such, if the drafter wants to exclude certain subjects from arbitration these subjects need to be clearly and unambiguously excepted in the arbitration clause. A failure to define with specificity the issues that are subject to arbitration can easily result in the type of litigation that arbitration is specifically designed to avoid. There is nothing more frustrating in the arbitration process than to appear in Court to have a Court determine what is or is not subject to arbitration. This problem creates the type of increased expense and delay that undermine the arbitration process as conceived. The practice point emphasized here is to make sure to be specific pertaining to subject matters subject to and excluded from an arbitration clause.

(3) It also makes sense to communicate what Rules should govern your arbitration. It is very common that generic arbitration provisions state arbitration will be conducted, but there

is no language identifying the Rules that will be utilized. There is nothing wrong with reviewing the various types of Rules that are available through the American Arbitration Association to become familiar with these and decide whether or not these might be used. Be aware that there are several different types of Rules available through the American Arbitration Association. To merely state that the parties to a contract will be utilizing the Rules of the American Arbitration Association does not provide adequate direction. Also, recall that a commercial contract may be subject to implied terms and conditions so that certain industry standards are incorporated. Be certain the Rules of arbitration selected conform with both substantive and procedural law. This can also be a complication as to international contracts. Be mindful of the Rules selected to avoid delay and cost. No one enjoys having to have a Court intervene to select the Rules under which their arbitration will be conducted.

(4) It is very important to think through precisely now many arbitrators you would like: a single arbitrator or a panel. It is important to acknowledge there is nothing magic about having attorneys act as arbitrators[1]. There is nothing wrong with thinking ahead as to expertise that might be appropriate as to one acts as an arbiter. For instance, one complication involving oil and gas industry related arbitration is that trial judges and jurors often have little understanding or appreciation of the terms, customs, processes, or anything else involving the oil and gas industry. Accordingly, if a contract involves the oil and gas industry, it might be appropriate to identify the skill set of the individual that would best be able to understand the underlying facts to come to a just result (a petroleum engineer, geologist, or title analyst, etc.). Also, if there is a single arbitrator, how is that individual going to be selected? If a panel is going to be used, how will the panel be selected? Think through these issues as well.

(5) Issues pertaining to the treatment of nonparties to a contract that may be impacted by the same contract merit consideration at the drafting phase. It can become very expensive in determining who is subject to arbitration when there are parties and nonparties benefiting from or relying upon a contract. A common complication involves the circumstance where a contract is not bilateral such that there are more than two parties to a contract. It is not unusual to read Arbitration Clauses that are clearly drafted envisioning only a two party contract, when the contract ultimately has three or more signators. These multiparty contracts need to more thoughtfully address the process of asserting and defending claims by multiple parties. Once again, the goal is to avoid having to appear before a Court to by Order establish that which could have been clarified by a well thought through arbitration clause.

(6) It is also important to consider the remedies that are available through arbitration. Arbitration Clauses often focus upon financial damages without much thought involving equitable relief or other types of nonfinancial awards, not to mention interest and costs.

[1] Although it is always suggested to make sure that if a panel is selected to have at least one panel member be an attorney as they tend to be more familiar with the process.

Significant expense and delay can occur where proceedings are bifurcated because it is a Court that entertains issues involving Temporary Restraining Orders or Preliminary Injunctions, with the remainder of a case to be arbitrated. This type of hybrid litigation is extremely costly and produce significant delays. It can almost always be avoided through drafting.

(7) If it is the intent for arbitration to be final, binding, and non-appealable, such should be stated in the arbitration clause. As a practical matter, the setting aside of an arbitration award is very rare. Some of the grounds for vacating an arbitration award include an award that is the result of corruption, fraud, or the implementation of undue means; where the rights of a party are prejudiced by the significant impartiality of an arbitrator who fails to act as a neutral, acts in a corrupt fashion, or engages in misconduct or willful misbehavior; or where an arbiter has exceeded his powers. Thus, the successful vacation of an arbitration award is rare. Nonetheless, if it is the intent of the parties to engage in binding arbitration, it merits a clear and concise statement of the objective. On the other hand, if the parties believe arbitration should not be binding, this should be stated as should the post-arbitration procedural steps. Be aware, Courts tend to treat arbitration awards as binding even in cases where this term is not stated in the contract. It is important to be clear and unambiguous in even drafting to avoid post-arbitration litigation that could otherwise be easily avoided.

(8) One of the most confounding issues involving arbitration is the cross-currents of the expense and cost in the discovery process. The conundrum is always how does an attorney meaningfully prepare for a case if there is no discovery. Remember, at the time of drafting an arbitration clause or contract it is often not clear as to what party will have what information pertaining to the disputed topics or claims. Not allowing discovery results in the possibility of "trial by ambush". Depending upon the issues and who possesses what information, a lack of Discovery could be either good or bad. The point being made here is to attempt to think through Discovery issues at the drafting process stage. There is nothing wrong with limiting the number of depositions, the amount of time allotted per deposition, the number of interrogatories, the number of requests for production of documents, and the like in an arbitration clause. While these limitations may not be perfect, their inclusions tend to be a better alternative than appearing before a Court to have a Judge detail how discovery will be pursued or not pursued in your case.

(9) While contracts often contain a choice of laws provision, many contracts are silent pertaining to the same. Parties are encouraged to think through this choice of law question at the time of drafting. Remember to at least look at the law of arbitration in the selected state at the time of drafting. In Federal Court be acquainted with the Federal Arbitration Act. Above and beyond the issue as to what law will apply, it also makes sense to designate where arbitration will occur. This is particularly so where there are multiple parties, several of whom have principle offices located in different states. One does not want to appear in a Court arguing as to the location of an arbitration.

(10) Commercial contracts are often not stand alone propositions. When negotiating complex projects, or even projects that are not very complex, there are frequently numerous contracts, primary and ancillary, that define the totality of the transaction. It is not uncommon that a dispute will involve the alignment or reconciliation of various contracts. Where these differing contracts themselves have different forms of Arbitration Clauses, this can create significant complication in moving forward with arbitration. It is rare a Court would conclude that inconsistent Arbitration Clauses will negate the obligation to arbitrate. However, one wants to be able to move forward with arbitration that is consistent with the goals of decreasing attorney fees and reducing delay. When multiple contracts are part of a project, the Arbitration Clauses efforts need to be made to align these terms and conditions from the very beginning.

(11) It is also important to think through timelines and the process of arbitration. For instance, how much time will be allowed to select the arbitrators? It is also important to think through issues such as the amount of time being allotted between the selection of the arbitrators and the conducting of the arbitration itself. It is necessary to think through how much time should elapse between the conclusion of the arbitration hearing and the publication of an award. It is important to think through issues such as if there is a panel must the panel rule unanimously or by majority? There exist issues pertaining to the content of the award. Do the parties want a formal Award as would be issued by a Judge with alignment of fact and law? Should instead an award simply state the amount of damages or some other form of relief without any benefit of analysis? One should also think through the mechanics of enforcing an Award, including reducing the Award to a Judgment. One could go on and on. However, the point is to think through the arbitration process and its timelines. Ultimately, the arbitration process should be designed to advance under circumstances where there is adequate time to consider and organize, but not so much time that cases are allowed to languish.

(12) Lastly, it is very common that Arbitration Clauses will include awards of attorney fees and costs. Yet, it is not uncommon this will include language such as “the prevailing party shall be entitled to their reasonable attorney fees and costs incurred in the arbitration process”. Unfortunately, this type of language does nothing to define who is a prevailing party, except in only the most obvious of cases. Nor does it define the relief a party is entitled to as a “prevailing party”. Does an attorney fees award include a pre-arbitration award, a post-arbitration award, etc.? It does little to define whether or not attorney fees and costs will be addressed at the initial arbitration hearing itself or whether this issue will be bifurcated. Is such a damage or a cost? Such does address issues where there are various claims and defenses and certain parties prevail on some claims or defense and not others. One also needs to be mindful of multiple party cases especially where there are claims or defenses asserted against some parties, but not others. The point here is not to go through all the various complexities that can occur pertaining to the dynamics of an award of attorney fees and costs. Rather, the focus is emphasizing that terms and conditions need to be thought through in the underlying contract. Otherwise, these issues might be determined to the chagrin of the Court.

CONCLUSION:

The drafting of an arbitration clause can be time consuming. However, arbitration sometimes is the recipient of a "black eye" as counsel and parties complain, sometimes rightfully, that the arbitration process had not saved attorney fees or costs, not produced any better sort of justice, nor reduced delay. We see in this paper why that might be.

The axiom of "an ounce of prevention is worth a pound of cure" is applicable when it comes to Arbitration Clauses and contracts. The quality of arbitration is often dictated by the language used in the contract. Poorly drafted Arbitration Clauses and contracts complicate the ability to resolve issues. This is unfortunate because most issues can be, if not eliminated, at least significantly narrowed by proper drafting. Unfortunately, many lawyers do not spend the time drafting a meaningful arbitration clause or contract. By resorting to the process of "copy and paste", the arbitration process is often built upon the weakest of foundations. Often when the primary objectives of arbitration process are not realized such is not really the fault of the arbitration process, but lax drafting.