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# Arbitration's Costs and Dangers

Avoiding litigation is good, right? Not in every situation.

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When they are negotiating the terms of commercial contracts, companies frequently assume that inclusion of an arbitration clause is a no-brainer. After all, what business wants to invite costly, time-consuming litigation if it gets into a dispute with its contracting party? Better to provide in advance for a cost-effective, quick means of resolving litigation.

So out comes the standard boilerplate clause, often accompanied by a fee-shifting provision and, maybe as an afterthought, some specification of how arbitrators will be chosen. Savings with the stroke of a pen, right?

Not always. In fact, businesses are finding out more and more that arbitration can be every bit as costly and time-consuming as the average litigation. Indeed, a company can go through arbitration and end up feeling like it has just bought the proverbial pig in a poke. For example, according to the 2007 New Jersey State Bar Association Report on Arbitration, for the court year ending August 2001, almost 75 percent of the 27,285 arbitration awards were "rejected," meaning that after the arbitration had concluded, one of the litigants opted to litigate the dispute in a court of law.

How does something that promises such adjudication satisfaction end up being so downright unpleasant? It probably has something to do with not "getting" what arbitration is all about from the get-go. Arbitration holds its own hidden risks and dangers that are too easily glossed over. The wise company will weigh carefully such costs before simply including an off-the-rack arbitration clause in a commercial agreement.

## Still Popular

Arbitration remains a popular form of dispute resolution. According to the American Arbitration Association's 2005 annual report, its 2005 caseload included 142,000 filings, slightly down from its 2004 caseload of 159,000 filings—a decrease, but still indicative of an active arbitration docket. For more than 60 years, arbitration has been used in a wide variety of contexts to resolve disputes, from simple commercial matters to those involving residential leases, medical informed consent forms, banking and credit card agreements, attorney-client fee arrangements, and health maintenance organization agreements.

It is easy to ascertain what U.S. courts think about arbitration: They love it. This affection for arbitration is not difficult to understand. With their overburdened dockets, judges see a lot to like in a set of adjudicatory procedures that promise to resolve disputes with less mess and fuss, freeing the court system to focus on "real" problems.

Approval of arbitration flows to some extent, as well, from contract law. Parties in "arms-length" transactions—such as where the contracting parties are independent and commercially sophisticated—are deemed to have taken into account the ramifications of making the choice to opt out of a court proceeding (regardless of whether they really have done so). In fact, U.S. courts also readily enforce arbitral clauses in situations in which the clause was never technically bargained for, such as in consumer agreements or employment relationships.

As a result, it is extremely difficult, if not impossible, to get arbitral decisions overturned through the court system—let alone reviewed. The proof is in the small number of decided cases in which an arbitral decision or procedure is challenged. For example, according to Stephen Huber's article "The Arbitration Jurisprudence of the Fifth Circuit" for the *Texas Tech Law Review*, between June 2002 and May 2003, the 5th Circuit issued 155 written opinions, with only 21 of them involving issues relating to arbitration. Indeed, the trend is for courts to conclude that an enforceable arbitration clause swallows up just about every dispute under the contract—including whether a dispute could be decided by arbitration in the first place. Once you've committed to arbitrate a potential dispute, you're not likely to attract a lot of sympathy from a court if things don't work out as you would have hoped.

## Eyes Wide Open

So when should companies contemplate arbitration, and when would they be better off without it? The following are

factors any company thinking about including an arbitration provision in a contract should consider:

**1. What's your business?** Companies with large numbers of customers, or which commonly engage in multiple individual transactions of varying magnitude, such as the financial services and securities industries, are likely to find that arbitration clauses live up to their billing. More and more, companies that enter into contractual relationships with consumers use arbitration clauses—even when the consumer has not directly bargained for inclusion of such a dispute resolution clause. Arbitral clauses have also been viewed as effective in resolving employee disputes.

Where companies are wise to think of arbitration as a means of resolving their contractual problems, the common denominator in all such circumstances is frequency. Companies whose businesses inevitably involve transactions with numerous entities are more likely to benefit from designating arbitration as a means of resolving disputes. Arbitration clauses can, in such circumstances, help companies avoid becoming entangled in multiple concurrent court proceedings. The savings and efficiencies clearly outweigh foreseeable disadvantages.

But the disputes of other kinds of industries and businesses do not necessarily lend themselves to easy resolution in arbitration. A company with fewer business contracts overall, or one that has only a few discrete contracts with a particular party, might want to weigh carefully whether arbitration provides the most cost-effective forum in which to adjudicate a conflict.

**2. How complex is any anticipated dispute likely to be?** Certain industries tend to have the same sorts of disputes, repeatedly. Take the securities markets, for example, where arbitration clauses for resolving disputes between not only employees and their financial services employers, but also for those between customers and traders over failed investments, have long been commonplace.

The same is true of long-term supply contracts between businesses, in which one entity makes something that the other needs on a constant and regular basis, resulting in a series of discrete but recurring transactions. Under such circumstances, a predictable and regularized system for adjudication, perhaps even employing the same set of arbitrators skilled in the nature of the disputes at issue, is preferable to going through the lengthy courtroom proceedings.

Disputes of a more complex or idiosyncratic nature, however, may require the added protections available only in a court of law. Although federal and state procedural rules may seem baroque to the outsider, such rules have been polished and revised repeatedly over the years, in an effort to ensure not only that litigants are afforded full discovery opportunities, but that they also have a full and fair chance to present their evidence in the courtroom.

**3. Can you live with the result?** It is exceedingly difficult to undo an arbitrator's decision. Legal mechanisms exist for appealing arbitration awards and, in fact, businesses often do just that, hoping to use the pain of the litigation process to leverage a settlement. But generally, an arbitral award cannot be vacated unless it can be shown that the arbitrator demonstrated a "manifest disregard" for applicable law, or possessed a conflict of interest that was not evident to the parties going into the arbitration.

Of course, arbitrators do get things wrong, even where the legal standard for demonstrating "manifest disregard" for applicable law cannot be satisfied on appeal. Their errors are not limited to their conclusions either. For example, commercial entities often do not anticipate the extent to which arbitrators are empowered to make evidentiary decisions—such as how long to permit a witness to testify, or what evidence should or should not be admitted—that can affect the outcome of arbitration.

In fact, Section 17c of the Uniform Arbitration Act of 2000 states that "an arbitrator may permit such discovery as the arbitrator decides is appropriate in the circumstances, taking into account the needs of the parties to the arbitration proceeding and other affected persons and the desirability of making the proceeding fair, expeditious, and cost effective." Evidentiary decisions that could be appealed in the litigation context are almost impossible to overturn in arbitration. Once the process is completed and an arbitral award has been rendered, you can expect to be forced to live with the outcome of the arbitration, even if it is in some sense demonstrably unjust.

**4. Beware of fee shifting.** Many arbitral clauses are just one element of a more comprehensive "dispute resolution" provision in a contract. Sometimes, ostensibly to discourage parties from using litigation as a business tactic, parties will include a "loser pays" fee-shifting provision. Arbitrators then can enforce the terms of such provisions in a contract, including, for example, making an award of fees to the party deemed to have prevailed.

In so doing, however, an arbitrator can make two possible mistakes. First, the arbitrator might have trouble deciding who, in fact, prevailed. In a dispute involving a neutral matter, such as one over valuation of an asset, parties could reasonably disagree as to the proper valuation and require arbitration to resolve their differences. Yet, once the underlying issue is resolved, an arbitrator could feel constrained to enforce the provision and identify a "loser" responsible for fees. Second, arbitrators may make an unjust award of fees that ignores not only prevailing rules for fee determinations, but could also be based on faulty evidence presented by the winner. Arbitrators have been known to accept fee petition arguments in which charges not relating to the arbitration were nevertheless presented to an arbitrator as a recoverable fee.

**5. Why not mediate instead?** Because it is nonbinding, mediation may at first glance seem to be a waste of time—if you're in a dispute, why would you want to spend time in a process that cannot guarantee a resolution? But in many respects, mediation offers all the benefits of arbitration—lower costs, faster results—without the limitations. It provides a less formal opportunity for both sides to present their views on a dispute, without having to engage in expensive discovery. It can be performed at the outset of a dispute,

or later, within the context of a raging litigation (and in fact, courts more and more require parties to attend nonbinding mediation before permitting a case to be brought to trial). Mediation therefore does not preclude litigation, as arbitration does, but complements it. And the average mediation can be performed in a day.

The nature of the mediator's function is the hidden strength of the mediation process. Arbitrators are essentially private judges, paid to determine an outcome in an impartial fashion. Although arbitrators often seem interested in reaching equitable outcomes to the benefit of all parties, they in fact have no intrinsic interest in the outcome. Mediators, by contrast, are brought to a dispute expressly to find common ground, if possible, and thus have a strong interest in ending a dispute in a manner most fair to all parties.

When drafting a contract, companies need to understand one thing: Arbitration is no panacea. It can be every bit as draining and costly as a courtroom litigation and is in other regards unsuitable as the mechanism for resolving many kinds of commercial disputes. Careful in-house counsel will keep that in mind before blindly inserting an arbitration clause into every new contract.

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