Getting it right

Is arbitration really the answer for resolving your business disputes?

Over the past two decades, more and more businesses are including arbitration provisions in their contracts with vendors, suppliers, employees and other counterparties. Behind this trend is the fact that the court system can be slow, cumbersome, very expensive and confusing to business managers. Arbitration generally cuts through all this and delivers a result much quicker and at a lower dollar cost, facilitating decision making by managers because disputes are resolved faster.

However, including arbitration clauses in contracts is not always the right call, says Eric N. Macey, a founding partner at Novack and Macey LLP.

"While arbitration is generally quicker and more cost effective, that is not always the case, and arbitration results are not necessarily generally better," says Macey. "In fact, they can be very, very mixed.

Smart Business spoke with Macey about the problems that can arise with arbitration and how to avoid them.

What kinds of problems are inherent to arbitration that aren't necessarily present in a typical court case?

One is the issue of what I call 'rent-a-judge.' When you file a lawsuit, the court system assigns a judge to your case, and you don't pay for that judge. In arbitration, if the parties don't agree on an arbitrator, you have to have some method to select that person. This can be set out in your contract's arbitration provision, or you can use third-parties such as JAMS or the American Arbitration System to select an arbitrator.

Sometimes the selection of the arbitrator becomes a long, drawn-out dispute in itself. Moreover, you and your adversary have to pay the arbitrator for his or her time. And in some instances, your arbitration may call for three arbitrators — one selected by you, one selected by your adversary and the third selected by the chosen arbitrators. Now you are contributing to the fees of three arbitrators, and they typically are not inexpensive.

What other problems can arise?

Another concern is that court proceedings offer you a full range of procedural safeguards that you don't have in arbitrations. There are no rules of evidence in arbitration, and there are no rigorous procedural rules for pretrial disclosures, which can create significant problems.

Eric N. Macey
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For example, you don't necessarily have the right to take depositions of individuals involved in the dispute in arbitrations. Consequently, you can get to the hearing and have no idea what that individual is going to say if he or she is called by your adversary as a witness. This wouldn't happen in a court proceeding.

Another example is the issue of hearsay. Hearsay is just 'rumor' testimony, that is, what someone else told you, and under the rules of evidence, hearsay is inadmissible. The person who told you something must be the one to testify about it. An arbitrator or panel of arbitrators are not bound by these rules of evidence, so they are free to admit hearsay.

Thus, in an arbitration, if your opponent testifies that a supplier in China said one of your managers did something that hurts your case, that testimony may be admissible. A court would doubtfully admit such testimony.

If the arbitrator or arbitration panel makes a mistake, can you appeal, as with a court decision?

Yes, but the rules for modifying or vacating an arbitration award are very, very limited. Courts favor arbitration and give arbitrators a lot of deference in upholding their awards. It typically is not up to a court to determine whether the arbitrator followed rules of evidence or procedure, or even followed the law. What matters to a court reviewing an arbitration award is whether the award was within the scope of the arbitrator's authority set out in the parties' contract and whether the award is reasonably consistent with the terms of the contract.

When should businesses include arbitration provisions in their contracts and when should they keep them out?

As a rule of thumb, the more sophisticated the contractual relationship, the less likely I would want to include an arbitration provision. For example, if you are hiring a new CFO and negotiating a three-year employment contract, an arbitration provision makes sense. Alternatively, if you are selling a product line or division with innumerable financial terms and warranties and representations, I would leave out the arbitration provision.

Here is another example. If I am entering a one-off contract to buy product that is not cost prohibitive, I would include an arbitration clause, but if it is a contract to purchase variable amounts of a product over time that is integral to my business with fluctuating pricing and quality standards, I would opt to keep the clause out.

What can business managers do to avoid some of the problems you have raised?

Arbitration is based on a private contractual relationship. The key issue, then, is the arbitration provision in your contract. That provision governs your entire arbitration process. So when you are negotiating the contract, don't just add a standard arbitration provision and think everything will take care of itself, because it won't.

You need to consider whether the provision covers such things as the selection of arbitrators, the location of the arbitration, whether any pretrial procedures should be included, whether the provision should prevent the arbitrator from issuing awards for punitive damages or loss profits, whether the arbitrator has to provide reasons for his or her decision and how quickly the arbitrator must render his or her award. These are just some of the items that need to be thought through as part of an arbitration provision. <<

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