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| **Arbitration Clauses: A Business Imperative**  (and how to craft the predispute arbitration clause) |
| by James J. Damis Harvard College (1958); Columbia Law School (1961); Member of the Oregon State Bar since 1962; Sole Practitioner, Portland; Administrator, Arbitration Service of Portland (www.arbserve.com)  **Summary.** Doing business in today's litigious society without taking advantage of an arbitration clause is like driving a car without a seat belt: it is a dangerous and unnecessary risk. Why would a business ever want to subject itself to the whims, inexperience, uncertainties, and the anti-business prejudices of a jury—not to mention the horrendous costs and delays of courthouse litigation? The use of a predispute arbitration clause in business agreements acts as both a shield and a sword. If properly implemented, mandatory and binding arbitration is a time-tested technique that has proven effective for business disputes.  **Private Arbitration.** Private arbitration is the referral of a dispute to an impartial third person chosen by the parties who agree in advance to be bound by the arbitrator's decision after a hearing in which both parties have an opportunity to be heard. Private arbitration requires an agreement to resolve a dispute through arbitration and is expressly authorized by Oregon's private arbitration statute (ORS 36.600-36.740) and the Federal Arbitration Act (9 USC Sections 1-14). An arbitration award may be submitted to the court clerk for confirmation as a judgment of the court. (ORS 36.715; 9 USC Sections 9, 13). Although an oral agreement to arbitrate is enforceable on common law principles (see Halvorson-Mason v. Emerick Constr. Co., 304 Or. 407 (1987)), practical considerations require a written agreement.  **Business Clients Favor Arbitration.** A national survey conducted by Business Week found that most business leaders believe that something is seriously wrong with the legal process in this country. Its cover story headlines summarized its findings:  "Too many lawyers, too much litigation, too much waste. Business is starting to find a better way."  An overwhelming 97% of the surveyed executives favored a greater use of alternative dispute resolution, such as mediation and arbitration. Trade journals tout ADR. The lawyer who suggests or includes arbitration clauses is viewed by the business client as looking out for its interests. The largest law firm in Michigan requires its attorneys to use an ADR clause in every agreement or justify its non-inclusion. Law firms around the country recognize the marketing advantages of proclaiming their expertise in ADR. The Colorado Bar Association has determined that the failure of an attorney to explain ADR options to a client constitutes an ethical violation. A proper predispute arbitration clause permits a business to control its dispute resolution destinies by preselecting the forum and procedure for resolving future disputes.  **The Advantages of Private Arbitration.** The construction industry learned decades ago what the U.S. business community also has now discovered: compared with litigation, arbitration has the following significant advantages:  Speed: An arbitration hearing usually occurs within 90 days, many months sooner than a court trial could be scheduled (and Oregon's budget crisis will further delay trial scheduling).  Economy: Arbitration's informality and streamlined procedures are designed to quickly get at the crux of a dispute, and eliminate the time-consuming and paper shuffling burden of formalized litigation, which reduces attorney's fees and costs.  Fairness: An able arbitrator with experience in the subject matter of the dispute is far better equipped to deal with complicated issues than is a jury or an inexperienced trial judge struggling in an unfamiliar area.  Convenience: Arbitration hearings are scheduled promptly according to the convenience and availability of the parties, rather than the vicissitudes and postponements of congested court dockets.  Privacy: A business can avoid unfavorable publicity, and both sides prefer the privacy, sensitivity and informal setting that arbitration provides.  Settlement Enhancement: The ability to negotiate fair settlements dramatically increases because the speed and predictability brought by the arbitration process are forceful agents of realty.  Finality: Binding arbitration eliminates the delays and costs of appeals that can occur in litigation.  Because business disputes often involve complex factual and legal issues, arbitration's defining attribute also offers the most important benefit of all: the opportunity to select as the trier of fact and law a person who possesses high expertise in the subject area of the dispute and who is also intellectually able, conscientious, and impartial.  **Shield and Sword Benefits of Arbitration Clauses.** Because a predispute arbitration clause serves as both a sword and a shield, its importance to business clients cannot be over-emphasized.  As a shield, an arbitration clause discourages frivolous suits against your clients (especially "target" defendants) by removing the tantalizing attraction of a jury prejudiced against businesses. Arbitration also dramatically increases the likelihood of a successful and less expensive defense by having such matters decided by a truly impartial person who possesses expertise in the subject area of the dispute.  As a sword, an arbitration clause enables your clients to seek and obtain their just entitlements far more quickly and less expensively. Having the matter decided by an experienced arbitrator ensures far greater predictability than a quixotic and untrained jury.  **"But there's no appeal!"** Some litigators (nervous defenders of their courtroom turf) are quick to point out that a court cannot change an arbitrator's decision on the facts or the law. True enough. But remember that finality is itself of great practical benefit. Remember also: most courtroom fact-finding errors rarely rise to the level of reversible unreasonableness; judicial errors are not reversed unless prejudicial; appeals are expensive; most appeals do not succeed; and, successful appeals too often result in the dubious "new trial" reward of having to repeat the same expensive process. Litigators who would sacrifice the benefits of arbitration on the holy grail of appellate review fail to acknowledge a more pragmatic explanation of an adverse award: if they could not persuade an astute arbitrator (or, in large cases, a panel of three able people), perhaps they did not deserve to win. In sum, the right to appeal is vastly overrated.  **Splitting the Baby and Other Unfounded Worries.** An old fallacy (now heard less frequently) is that arbitrators give each side half a loaf. Although a jury must often broker compromises to reach a verdict, a good arbitrator does not split the baby. Statistics of the American Arbitration Association refute this old saw. Arbitration Service of Portland's awards reveal that over 80% of the awards are entirely (or almost entirely) in favor of one of the parties. Another unsupported fear is that claims against a business might increase because initiating an arbitration is so much easier and less expensive than filing a lawsuit. Not so, according to the experience of the Bank of America, which began using predispute arbitration clauses in loan agreements in California several years ago. (The use of arbitration clauses by banks nationwide has dramatically increased.) A large New York-California law firm conducted a survey of businesses that used a predispute arbitration clause in their employment agreements, and reached the same conclusion: There was no evidence that an arbitration clause resulted in an increase in claims. (That law firm believes that an employer's use of a predispute arbitration clause is one of the best ways an employer can protect itself and routinely proposes its use.)  **Types of Agreements Suitable for Arbitration Clauses.** Nearly every business agreement is suitable for a predispute arbitration clause, including business formation agreements (partnerships, shareholder agreements, LLC's, joint ventures and property co-ownerships), loan and financing agreements, leases, commercial agreements, business-consumer agreements, sale agreements, construction contracts, insurance policies, escrow agreements, settlement agreements and employment contracts. The attorney should analyze the type of future disputes most likely to arise between the parties in connection with the proposed agreement. If the overall benefits to a client favor the use of arbitration, use whatever bargaining powers available to insist upon a predispute arbitration clause.  **Employment Disputes (a good example).** Consider the expanding risks faced by your business clients from employee claims. The use of an arbitration clause by an employer (with respect to its non-union employees) dramatically reduces such costs and risks. Whether an arbitration clause is used in the employment context for non-union employees is solely the employer's decision, because the employer can require its inclusion as a condition of employment. An arbitration clause also serves the employee's interest because it ensures that the employee's claim will be resolved with reasonable promptness and fairness. (The fact that the plaintiffs' bar may lament the absence of an employee-friendly jury merely illustrates the penchant by all lawyers to have the playing field tilted in their favor.) The following cases illustrate the current judicial trend validating arbitration clauses generally and holding that arbitration clauses also govern employee claims that are based on state and federal statutes:   * *Gilmer v. Interstate/Johnson Lane Corp.*, 111 S. Ct. 1647 (May 13, 1991): an employee's age discrimination claim (based on the federal Age Discrimination in Employment Act) was subject to compulsory arbitration because of a predispute arbitration clause and because of the requirements of the Federal Arbitration Act, which "manifest a liberal federal policy favoring arbitration agreements" (111 S. Ct. at 1651). * *Saari v. Smith Barney, Harris Upham & Co.*, 968 F.2d 877 (9th Cir 1992): claims arising under the Employee Polygraph Protection Act must be arbitrated if required by the contract. * *Perry v. Thomas*, 107 S. Ct. 2520 (1987): conversion, breach of fiduciary duty. (In spite of a California statute that precluded arbitration of wage claims, the Supreme Court declared that the preemptive effect of the Federal Arbitration Act has created a body of federal substantive law of arbitrability that is enforceable in state and federal courts, and the predispute arbitration clause between the employer and employee must be honored.)   **An Indelicate Indictment.** The benefits to a business are so overwhelming and the counter arguments are so negligible that the current under-utilization of arbitration clauses is puzzling. Employment law specialists from two "national" law firms (one on each coast) separately told this author that the principal reason for the non-use of predispute arbitration clauses by employers is a fear by their law firms that arbitration will reduce their attorneys' fees earned from court litigation. (Gasp! Say it isn't so.) Aside from the ethical impropriety, most lawyers recognize that such short-term pocketbook considerations are financially detrimental in the long run. More importantly, good lawyers want what is best for the client. The use of arbitration clauses is growing, but too many lawyers still are too unfamiliar with arbitration clauses and the arbitration process. (This ignorance partly is caused by lawyer specialization: attorneys who draft and review instruments lack sufficient dispute resolution experience to understand the arbitration process.)  **The Procedural Rules of Arbitration.** Remember that private arbitration is a substitute for formal litigation's vast array of procedural rules. To be effective, the arbitration clause must ensure an efficient procedural processing and provide for the selection of an appropriate arbitrator. Therefore, the arbitration clause must either designate a specific arbitration organization (and thereby incorporate the rules and arbitrator selection process of that organization) or it must set forth in the arbitration clause itself detailed rules on how the arbitration is to be initiated, the selection, qualifications, and compensation of the arbitrator, discovery, determining the date, site, and procedures of the hearing, etc. Usually one party to a dispute is satisfied with the status quo and too often this reluctant party will take advantage of an incomplete or open-ended arbitration clause to continue to avoid the resolution of the dispute. Disputes governed by incomplete clauses will present continuing procedural problems, and the difficulties encountered will be in direct proportion to the contentiousness of opposing counsel. Those same human frailties (stubbornness, procrastination, unreasonableness, and simple stupidity) that often make settlement impossible also will magnify the problems that can arise from incomplete arbitration procedures. Therefore, the arbitration clause must be drafted to ensure that the arbitration process will move forward quickly and fairly in spite of difficult people.  **Arbitration Organizations and Their Benefits.** Many arbitration clauses require arbitration "in accordance with the rules of" a designated arbitration organization. Naming a specific arbitration organization in this manner is the most effective way to avoid the many problems created by incomplete arbitration clauses or quarrelsome participants. Requiring arbitration through an able arbitration organization will ensure an efficient beginning-to-end processing of the dispute by a neutral party. The arbitration organization also will provide the parties with a list of proposed arbitrators. Because the procedural rules, practices, and costs of different arbitration services vary, it is important for the business attorney to know which arbitration organizations are available and how they differ. The two organizations most frequently used in Oregon to arbitrate commercial and business disputes are Arbitration Service of Portland and the American Arbitration Association.  **Arbitration Service of Portland.** ASP is designated in printed business forms used throughout Oregon by realtor associations, banks, title companies, motor vehicle dealers, and other businesses that use arbitration clauses. To administer those disputes, ASP has created arbitrator panels in Portland, Salem, Eugene, Medford, Bend, Pendleton, and elsewhere. ASP was designed and is administered by an Oregon attorney and has the following features:   * High quality arbitrators, each with a minimum of ten years in practice. * Arbitrators are pre-screened for expertise in the subject area of the dispute. * Reasonable fees and costs. (In a typical two-party one-arbitrator dispute less than $250,000, the filing fee is $700. The arbitrator receives his/her regular hourly, but not to exceed $495/hr.) * Sophisticated procedural rules include:   + full discovery (pursuant to ORCP)   + 14-day pre-hearing statement of proof (to avoid "trial by ambush")   + presumed admissibility of certain documents and affidavits   + provisional process is preserved (to allow interim injunctive relief and other provisional remedies from a court pending final resolution through arbitration)   + consolidated hearings of related disputes   ASP administers more private arbitrations in Oregon than any other arbitration organization.  **The American Arbitration Association.** The AAA was created several decades ago and offers national coverage. Business litigators are familiar with the arbitration procedures of the AAA as well as its many shortcomings: AAA's full service administrative fees are high, its response time inexplicably slow, its procedural rules are frustratingly silent on discovery and surprisingly unsophisticated. For Oregon, AAA's nearest administrative office is Fresno, its staff has no lawyers to discuss complicated or unusual procedural issues, and is sometimes bureaucratic and inexperienced. AAA administers its Oregon arbitrations from its Fresno office. Nevertheless, in spite of AAA's expense and its procedural and administrative defects, an arbitration clause naming AAA is better than no clause at all. Moreover, for clients engaged in multi-state transactions who desire a standard clause, AAA can provide national coverage. If an AAA designation is used, some of AAA's procedural deficiencies can be mitigated by supplementing the arbitration clause with additional provisions (discussed below).  **Crafting the Arbitration Clause.** The following is a basic predispute arbitration clause that offers a choice of arbitration organizations. (To eliminate the option of choosing AAA, delete the language in brackets.)  *Arbitration Required/ Mediation First Option. Any dispute or claim that arises out of or that relates to this agreement, or to the interpretation or breach thereof, shall be resolved by arbitration in accordance with the then effective arbitration rules of Arbitration Service of Portland, Inc. [or the American Arbitration Association, whichever organization is selected by the party who first initiates arbitration by filing a claim in accordance with the filing rules of the organization selected,] and judgment upon the award rendered pursuant to such arbitration may be entered in any court having jurisdiction thereof. The parties acknowledge that mediation usually helps parties to settle their dispute. Therefore, any party may propose mediation whenever appropriate through [one of] the above named organization[s] or any other mediation process or mediator as the parties may agree upon.*  (Note on arbitration's interface with mediation. When normal dispute resolution negotiations falter, mediation is always the first alternative to consider. But, mediation is a voluntary and cooperative process and, unlike arbitration, it cannot be forced upon the other party. A dispute resolution clause should not require mediation as a legal condition precedent to arbitration or litigation, because it allows a defendant in bad faith to use the mediation process as a delay tactic.)  **Attorneys' Fee Clause.** If an attorneys' fee provision is desired, the attorneys' fee clause should specifically cover arbitration:  *Attorneys' Fees. In the event suit or action is brought, or an arbitration proceeding is initiated, to enforce or interpret any of the provisions of this agreement, or that is based thereon, the prevailing party shall be entitled to reasonable attorneys' fees in connection therewith. The determination of who is the prevailing party and the amount of reasonable attorneys' fees to be paid to the prevailing party shall be decided by the arbitrator(s) (with respect to attorneys' fees incurred prior to and during the arbitration proceedings) and by the court or courts, including any appellate court, in which such matter is tried, heard, or decided, including a court that hears a request to compel or enjoin arbitration or that hears any exceptions or objections to, or requests to modify or vacate, an arbitration award submitted to it for confirmation as a judgment (with respect to attorneys' fees incurred in such proceedings).*  **Additional Provisions to Consider.** Customizing the arbitration clause for specific types of agreements will depend on such factors as the size, location, type and complexity of the transaction. Particularly when AAA has been designated, it is especially important to consider supplementing AAA's rules with additional provisions, such as the following:   * Requiring an arbitrator to be an attorney with not less than ten years in practice and who has expertise in the pertinent area of the law. * Specifying that the arbitration shall be decided by a sole arbitrator if the amount in controversy does not exceed a specific dollar amount, and a three-person panel for disputes exceeding that sum. * Establishing a fair arbitrator compensation (to increase the likelihood of arbitrator acceptance). * Designating the city in which the hearing shall be held. * Permitting a party to apply to a court for provisional process (without waiving any arbitration rights) pending the initiation or completion of the arbitration. * Establishing discovery procedures (for example, in accordance with ORCP). * Requiring an exchange of the documents and a list of witnesses (including experts) 14 (or more) days prior to the hearing.   **Providing for the Selection of the Arbitrator.** In addition to providing for an efficient procedural processing, the arbitration clause also should ensure the selection of an experienced and able person to serve as arbitrator. *Quality is paramount.* If the predispute arbitration clause requires arbitration pursuant to the rules of a designated arbitration service, a list of proposed arbitrators will be submitted to the disputants by that arbitration organization after an arbitration has been initiated. Although the parties then will have an opportunity to participate in the arbitration or selection process, the quality of the arbitrators being proposed is crucial. Therefore, in addition to reviewing the procedural rules of the arbitration service being proposed, the attorney should ask for a sample list of arbitrators. *You pick one; I pick one.* Arbitration clauses that do not designate an arbitration service sometimes require that each side select its own (non-neutral) arbitrator, with those two non-neutrals then selecting a third arbitrator. There are defects in this procedure. Selecting the third arbitrator can be time-consuming, and a stalemate will require a request to a court and the like-it-or-lump-it designation of the chief arbitrator. Using three arbitrators, only one of whom is neutral, is unnecessarily expensive and often a distasteful arrangement to the two non-neutrals. Moreover, such clauses rarely establish even minimum qualifications for the arbitrators and lack procedures to monitor any conflicts of interest or to conduct an appropriate challenge should a conflict arise. *Three-person panels.* The parties must also decide at what monetary level the dispute should be decided by a panel of three arbitrators rather than a sole arbitrator. Whether the figure should be $50,000 or $100,000 (for example) represents an attorney's assessment of when the additional expense and scheduling complications of a three-person panel is justified. *Preselection.* One method to ensure high quality arbitrators (and that provides an accelerated selection process) is to preselect and include in the arbitration clause a list of arbitrators, named in order of preference, with the ultimate selection being based upon availability and absence of any conflicts of interest.  **Conclusion.** The benefits of arbitration for the resolution of business disputes far outweigh the litigative alternative. An informed business client rarely would choose courthouse litigation over arbitration. For shame, then, on the unenlightened attorney who, by failing to include an arbitration clause, allows the opponent to dictate the forum, time, expense, and decision maker. The business lawyer should protect the client at the outset whenever appropriate by crafting a predispute arbitration clause that will ensure the resolution of any future dispute efficiently, promptly, less expensively, and with far greater likelihood of a fair result. |
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