feature

A Real Alternative?

Including an ADR Clause in Your Deal Documents

by Anthony Rospert

The conventional wisdom is that when drafting business documents it is in your best interest to include an alternative dispute resolution ("ADR") clause. Such provisions for resolution of future disputes are employed in all different types of commercial contracts. These clauses vary but typically involve some form of either mandatory arbitration or mediation between the parties to a contract.

The traditional view is that these provisions are meant to be a true "alternative" to the high costs and risks that come with the uncertainties of litigation. Nonetheless, the growing trend is that clients are becoming frustrated and disappointed with the ADR process as it is not living up to their expectations. The root cause of their frustration can be traced back to not taking into account their specific goals and objectives when drafting the ADR clause and instead, using generic, boilerplate provisions that are short on details. By customizing ADR clauses to suit your particular goals and priorities, ADR can be a true alternative to the rigors of litigation.

Falling Short of Traditional Expectations

Clients include ADR clauses in their contracts believing they can avoid expensive, drawn out litigation. Indeed, most companies believe that ADR is quicker, cheaper and more efficient in resolving disputes. The primary reason that this view remains prevalent is that ADR, in concept, avoids expensive discovery and e-discovery obligations and allows the parties to focus on the "real" disputed issues in a case. By allowing parties to voice their disputes in a non-confrontational setting, parties can also test the strengths and weaknesses of their positions and can fashion different remedies and salvage long-term business relationships through creative resolutions. The trend is, however, that ADR is falling short of these expectations leading to dissatisfaction among participants to the process.

ADR is becoming more costly, time-consuming and subject to the same difficulties as litigation. The reasons are twofold: 1) use of extensive discovery and evidentiary devices, and 2) more time consuming procedures with less finality.

Burdensome Discovery and Evidentiary Process

By employing ambiguous ADR provisions, parties leave it to the intermediary or the parties themselves after they are embroiled in the conflict, to fill in the blanks concerning the discovery and motions to be allowed, the date and length of hearings, and other process details.[1] As a result of the open-endedness, more complex discovery devices are being used in ADR, such as multiple depositions and extensive document exchanges that rival those in federal court. Further, mediation and arbitration briefing along with post-hearing briefs are approaching hundreds of pages in length that are not all dissimilar than summary judgment motions and trial briefs. In addition to the legal costs, ADR is also requiring the expense of significant in-house resources that tie-up business people within a corporation to assist with the process. The unlimited discovery and presentation of evidence is leading to a process that is much more akin to litigation. This occurs because parties are sacrificing the traditional expectations of ADR in favor of the procedural safeguards associated with litigation. Ultimately, general counsels that once turned to ADR as means to cut their companies' legal expenses are now taking a second look at that decision.[2]

Drawn Out Process Lacking Finality

The ADR process is also becoming longer as the results are being challenged more frequently in court. For example, despite a presumption of validity inherent in arbitration awards, parties challenge arbitrator decisions on issues of non-disclosure or evident partiality. Evident partiality is established from the nondisclosure itself, regardless of whether the nondisclosed information necessarily establishes partiality or bias. The consequences for nondisclosure is usually vacation of the arbitration award. Accordingly, parties that are unhappy with an arbitrator's decision or are attempting to derail the process midstream when a party senses that it may end up on the losing end of an arbitrator's decision are using evident partiality as a convenient weapon. This results in delays and greater transaction costs.

One of the disadvantages of ADR is that parties forfeit their appeal rights. In response, drafters are using contractual provisions to expand the role of courts in reviewing decisions by arbitrators. This is leading to additional delay in seeking a speedy resolution of the dispute. These provisions attempt to expand the statutory grounds for challenging an arbitration award by allowing courts to vacate decisions and conduct review of an arbitrator's award.

Although the United States Supreme Court limited parties' ability to contract for judicial review under the Federal Arbitration Act, such review could still occur under state statutory and common law.[3]

Likewise, even though mediation does not have the pitfalls associated with judicial review, as it is ultimately the parties not the intermediary that is the one resolving the dispute, mediated settlements are also being challenged in court. While arbitrations are generally enforceable through state and federal law, mediations are only enforceable under contract. These challenges rely on contract principles premised on whether the parties actually struck an enforceable agreement or whether certain prerequisites to the settlement have been met. If a party to a mediated settlement does not fulfill the obligations assumed by it in the settlement, the other party could sue again and file a breach of contract claim. In such a case, the costs, delays and loss of effectiveness may double.

Bucking the Trends: ADR Provisions That Suit Your Needs and Goals

In a survey by the American Arbitration Association, the chief reason for using arbitration "was that it was written into contracts."[4] However, very little time negotiating a transaction is devoted to crafting an ADR clause that allows clients to maintain control over the process to meet their particular needs. Rather, the usual approach is to lift ambiguous, boilerplate language from a previous transaction without much discussion or consideration of the client's specific goals. "The trouble with this approach is that by the time a concrete dispute arises the parties are furious with each other, highly suspicious of anything suggested by the other side, and are very reluctant to give up any procedural options that might later come in handy."[5] Such a one-size-fits-all approach will result in frustration and disappointment for those participating in an ADR process as their traditional expectations will never materialize.[6] With recent trends, the most important thing lawyers can do when drafting ADR clauses is to ensure that it will meet client goals and priorities.

In customizing ADR clauses it is first important to identify your goals which can include: 1) flexibility; 2) low costs; 3) quick, speedy outcome; 4) fairness; 5) legal due process; 6) results comporting with industry standards; 7) predictability and consistency in the result; 8) finality; 9) privacy and confidentiality; and 10) the preservation of the business relationship.[7] The trade-offs in making these value choices should be clear as changes that reduce the risk of abnormal awards (such as increasing the fairness of the process by having a panel of arbitrators or providing for expanded judicial review) are likely to increase costs, and vice versa.[8] Once the goals are understood and hierarchy established, a drafter can better tailor the ADR clause to meet client expectations.

Customizing the ADR Clause

In order to combat the growing trends in ADR, it is critical that the ADR clauses in commercial agreements specifically lay out provisions providing for the selection of the intermediary, the scope of discovery, the time and presentation of evidence and judicial review of the awards or settlements. For example, if your ADR clause does not specifically provide how discovery will take place within the process, it is likely that the process will resemble a process similar to litigation. Indeed, litigators are using the ambiguities in these clauses to give them free reign to treat the process as another piece of litigation not an "alternative."[9] Thus, if your goals are to minimize the cost and time spent, and preserve corporate legal department resources, then including a clause that limits the exchange of documents or the number of depositions is preferable. Conversely, limiting discovery may reduce the accuracy of the ADR process, possibly resulting in more erroneous awards or brokered settlements.[10]

An issue clients should be cognizant of when attempting to limit or expand the scope of the ADR process is that a court may invalidate the provision. Indeed, courts have found ADR clauses to be unconscionable or unenforceable where a party attempted to place limitations on discovery, the selection of the intermediary, costs of the process, timing and length of the proceedings and the confidentiality provisions. The good news is that most of the cases where courts invalidated the ADR clauses involved consumer and employment contracts rather than two parties with equal bargaining power. Moreover, an equal or greater number of courts have found identical provisions not to be unconscionable.[11] Thus, the risk that a court may find the ADR unenforceable appears to be small particularly where the commercial transaction involves two sophisticated parties.

The Newest Trend: Escalation Clauses

There is a growing trend to draft escalation clauses in commercial documents. Escalation ADR clauses allow parties to turn to negotiation or mediation first instead of diving into binding arbitration or litigation. Such provisions "for the resolution of the disputes acknowledge the logic of relying initially on approaches that tend to be less formal, more flexible, more efficient and less costly than binding adjudication," and only turning to arbitration or litigation as a final step in the funneling process.[12] For some clients, litigation will be the final step if they view arbitration as a true "alternative" to litigation.

One of the problems in using an escalation clause it that it too can become costly. This usually happens when a person different from the previous mediator is appointed as arbitrator.[13] There, the parties will have to pay two sets of fees and a substantial portion of the proceedings will need to be repeated, thus, leading to a rise in costs. In addition, valuable time may be lost when an unsuccessful mediation has preceded an arbitration. Drafters and clients cognizant of this problem can provide a provision in the ADR clause that allows a prior mediator to be appointed an arbitrator. If a client values low costs and a speedy resolution over perfect impartiality and fairness, then such an ADR clause can be highly beneficial to the client in meeting their goals and priorities

In Some Cases a Jury May Be Faster and Cheaper

There are some cases where litigation may achieve client goals more effectively than an alternative forum. In those cases when you know the other side will be unreasonable and confrontational, a jury may be cheaper. Likewise, clients may avoid arbitration in "bet-the-company" cases in which an erroneous outcome could jeopardize the continued existence or have a devastating effect on a company.[14] It may be in your best interest to not include an ADR provision in your commercial documents in these situations. By carefully considering goals and priorities at the outset, clients can identify the strengths and weakness of including a customized ADR clause in the contract or whether potential disputes would be better suited following the litigation path.

Conclusion

Understanding the trends in the use of ADR clauses is important for clients interested in limiting the delays and costs that traditionally come with full-blown litigation. In order to achieve the goals and expectations of ADR, companies and their lawyers need to be more deliberate when drafting ADR clauses in their contracts before a dispute arises. ADR clauses, when properly drafted and taking into account your goals and priorities, can add real business value by ensuring a process that is comparatively inexpensive and a real alternative to the judicial system.