Five Ways to Improve Commercial Arbitration Clauses

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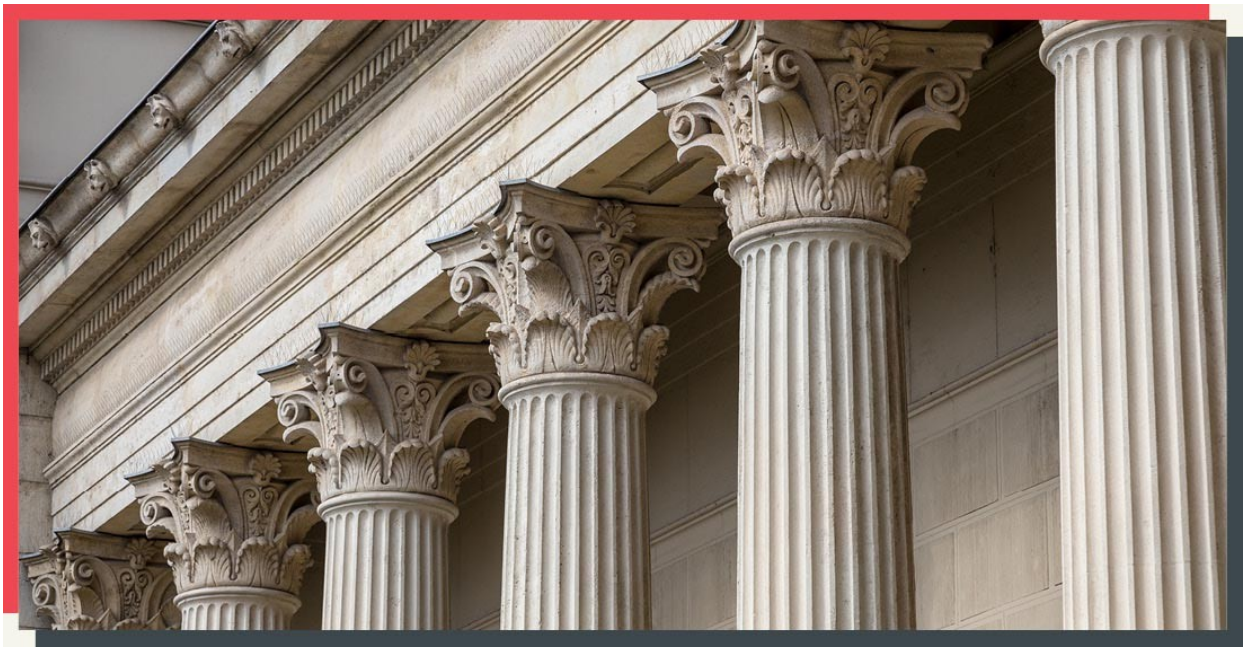

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Consumer arbitration has been in the news lately, with Elon Musk under congressional scrutiny for Tesla Inc.'s use of arbitration clauses and Ticketmaster Entertainment Inc. facing a class action in the U.S. District Court for the Central District of California by Taylor Swift fans criticizing its use of arbitration.

But while compulsory consumer arbitration may get most of the public attention, arbitration clauses have also become ubiquitous in commercial contracts between sophisticated businesses.

This trend carries risk for businesses that do not carefully consider the pros and cons of arbitration. Although commercial arbitration was once used sparingly for disputes particularly well-suited to resolution through less formal procedures, those days are over.

Today, commercial arbitration clauses are so popular that they're often inserted into commercial contracts by rote. That's because arbitration has the potential to streamline any disputes that may arise from an agreement, mitigate negative press, reduce legal costs and expedite resolution.

Unfortunately, parties may be disappointed to find that arbitration can sometimes present the same downsides commonly associated with conventional litigation — including high costs, contentious discovery battles and delays — without the benefit of detailed procedural rules and substantive law that make traditional litigation more predictable.

Fortunately, there are ways to mitigate these pitfalls, but such work must be done at the time of contracting. Below, we discuss some of the difficulties that arise from commercial arbitration in practice and offer, from a litigator's perspective, some tips to help attorneys and clients negotiating commercial relationships to avoid a future arbitration morass.

1. Assess the value of confidentiality.

Arbitration clauses are often included in commercial contracts because attorneys assume that maintaining confidentiality over any future dispute is paramount for their clients.

Before assuming that secrecy is beneficial, attorneys should consider whether, depending on the nature of any potential litigation, their client might benefit from public visibility into their disputes, or would dislike the inability to discuss any potential dispute with colleagues and industry partners.

In addition, even the very existence of arbitration proceedings may be required to remain confidential, which can present unwanted restraints for clients when a dispute is being litigated across multiple forums.

Disclosing the outcome of an arbitration — or simply that the arbitration is underway — might be a useful strategic tool in a multifront litigation, but certain arbitration clauses may not permit it.

While no one has a crystal ball, we suggest sitting down with your clients to discuss the potential dispute that may arise from the proposed commercial relationship, and whether, in such a situation, confidentiality would help or hinder your client's interests.

If confidentiality is in fact king, then consider including in the agreement the guardrails discussed below.

2. Prevent arbitrator selection from being a hold up.

In traditional litigation, the process of assigning judges to cases is simple: Courts assign each new complaint to a single, randomly selected judge without input from the parties.

Arbitration, by contrast, allows the parties to drive the process of selecting one or more arbitrators to hear their dispute. This can be mutually advantageous, as all parties have an opportunity to block the appointment of arbitrators they consider unacceptable.

However, this approach can also delay the arbitration from the onset if the parties have not agreed to a clear-cut, expeditious appointment process.

The rules of major arbitration organizations such as the American Arbitration Association and JAMS — which are often incorporated by reference in arbitration agreements — provide guidelines for the arbitrator selection process.

But they also assume that the process will begin with informal negotiation between the parties, which can result in weeks or even months of discussion between the parties before they finally agree. If one party has an incentive to delay the proceedings, the process can become costly and tedious.

Attorneys drafting arbitration clauses should consider providing additional detail on the arbitrator selection process to avoid getting stuck in the negotiating phase.

For example, a contract might provide that the parties must exchange lists of proposed arbitrators within one week after commencement of the arbitration, then exchange rank-and-strike lists one week later, with each side allowed only a limited number of strikes to prevent a deadlock.

The contract could further specify that if a party misses its deadline to submit a list of proposed arbitrators or a rank-and-strike list, it is automatically deemed to consent to the other side's first-choice arbitrator.

This is merely one example of a possible structure that could be written into the arbitration agreement to ensure that arbitrators are selected efficiently.

3. Bring discipline to discovery.

Civil litigation in the U.S. permits liberal, though not unlimited, discovery, including production of documents, oral depositions, interrogatories and requests for admission. In arbitration, there is far less consensus about the type and amount of discovery allowed.

Parties in arbitration often have extensive debates about the parameters each side must apply in searching and reviewing documents.

Whether outside counsel has the same kind of obligations to oversee the process as they do in court is also open to debate, along with the number of depositions allowed and the boundaries of third-party discovery.

Arbitrators enjoy great discretion regarding these questions, and case law from public courts provides only persuasive guidance. This can lead to frequent motion practice over discovery issues, and the results can be unpredictable.

Of course, disputes about the scope of discovery are not unique to arbitration, as any attorney with experience in public commercial litigation can attest.

But because the rules and standards are more open-ended in arbitration, discovery disputes often extend to questions of procedure and scope that would be considered basic and uncontroversial in court.

Parties seeking to minimize their discovery burdens may argue that because the dispute is in arbitration, they cannot be compelled to satisfy even routine obligations expected in court.

Document discovery, in particular, is an area where we have observed a sharp contrast between litigation and arbitration. In litigation, well-established case law and industry standards across jurisdictions require that the collection, review and production of documents must be managed carefully and thoroughly by counsel, even if that process is labor-intensive.

But in arbitration, we have seen parties advocate for only cursory and informal document searches and reviews. While arbitrators have the authority to compel parties to conform with robust processes, obtaining such an order can require expensive and time-consuming motion practice, and is not guaranteed.

These patterns demonstrate why attorneys drafting an arbitration clause should think carefully about the scope of discovery their client may desire if a dispute arises, and add language to define and clarify that scope. Would your client want as many of their opponents' documents as possible? Or does your client have reason to minimize discovery into their internal records and the questioning of their employees?

If your client would be in a position to want robust discovery, consider clauses that require the parties to abide by the Federal Rules of Civil Procedure governing discovery or require the arbitrator to apply the case law of a specific jurisdiction when ruling on discovery collection and production disputes.

If minimal discovery is the goal, consider including language that prohibits depositions and third-party discovery, and that provides narrow areas and methods of document discovery.

4. Avoid hearing delays.

The informality of arbitration can help the parties ensure that the merits hearing is scheduled for a mutually convenient time.

However, parties with an incentive to delay resolution of a dispute can abuse the opportunity by refusing to agree to dates that would cause mild inconvenience, or seeking to cancel scheduled hearing dates for reasons that would fall short of the good-cause standard in traditional litigation. It's a pattern that can lead to many months, or even years, of delay.

If your client will likely be the party seeking expedient resolution, a well-drafted arbitration agreement can mitigate this issue by providing, for example, that the merits hearing must take place within 100 days of the arbitrator's appointment unless good cause is established according to a specific jurisdiction's case law.

5. Add predictability to arbitrators' decisions.

While there are no guarantees in litigation, attorneys can often make sophisticated predictions of how courts are likely to rule on specific issues based on existing precedent. But arbitration can upend these expectations, making the ultimate results harder to forecast.

Unlike judges, who are bound by decisions from higher courts and subject to reversal if they violate them, arbitrators typically enjoy broad discretion in ruling on substantive questions, and their awards cannot be invalidated except in extreme cases.

Moreover, because arbitral decisions are usually confidential, there is no accessible body of arbitration law remotely on par with the voluminous case law produced by public courts and published online, and to the extent an attorney can identify a prior, on point arbitration decision, arbitrators are not bound by their colleagues' rulings.

The success of claims and defenses may always be less predictable in arbitration than in litigation, but attorneys can mitigate this unpredictability when drafting arbitration clauses — a goal that is likely beneficial for every type of client. Commercial contracts could specify that, in any arbitration, the arbitrators must apply the substantive and procedural case law of a specific jurisdiction.

For example, if the parties have selected New York law to govern their agreement, the arbitration clause might provide that the arbitrator(s) must follow cases from the Appellate Division of the Supreme Court of New York, First Department in the event that there is any conflict with cases from other departments.

Additionally, when negotiating high-stakes commercial arrangements, attorneys may want to consider building in an opportunity to appeal the initial award to a separate panel of arbitrators with authority to reverse the award if it is infected with clear error.

Reject rote arbitration clauses and go bespoke.

We hope this discussion will encourage attorneys and in-house counsel to reassess the use and utility of arbitration clauses.

They should never be included in a contract without a review of their possible consequences and a frank assessment of how they might be weaponized against the client. The advice of litigators at the contract drafting stage, particularly those with arbitration experience, is invaluable in this regard.

Attorneys who are drafting agreements — and the in-house counsel who approve them — have great latitude to design arbitration clauses that fit the needs and concerns of the client.

While it can seem most convenient to insert a boilerplate clause that simply incorporates a stock set of arbitration rules by reference, clients may be better served by custom-written arbitration terms that make the process more predictable while preserving its speed, privacy and other benefits.

Counterparties may push back against some of the bespoke arbitration provisions attorneys propose, but it's much better to have an argument about the rules of arbitration before a contract is signed than to wait until a dispute erupts.

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