The Perfect Arbitration Clause?

Wojciech Wandzel, Maciej Truszkiewicz

Is there such a thing as a perfect arbitration clause? Commercial lawyers have been struggling with this question for decades. In reality, a perfect arbitration clause does not exist because every contract involves different needs and circumstances, many of which do not surface until long after the clause has been drafted. Indeed, the difficulty of identifying one "ideal" arbitration clause demonstrates one of the key advantages of arbitration: It is a form of dispute resolution that adapts to different kinds of disputes and surrounding circumstances.

While there may not be one perfect arbitration clause for every situation, this article identifies the key factors to consider and key mistakes to avoid when drafting an arbitration clause for your client.

The Basis for Every Arbitration Clause: An Agreement to Arbitrate

An arbitration clause is a provision of a contract under which the parties agree to have their disputes decided by an independent and nongovernmental body. This definition identifies a crucial aspect of every valid arbitration clause: a clear and unequivocal agreement of the parties to arbitrate. Without it, the other provisions won't matter. Will the arbitration be the exclusive means of dispute resolution? Will the decision be binding? Will it be appealable? If so, under what standards? May the parties seek emergency relief in court while the arbitration is pending?

Other elements required for a valid arbitration clause include the capacity to enter into a contract, the applicability of the clause to the parties to the dispute at hand, and the lack of other legal deficiencies - such as procedural or substantive unconscionability - in the clause at issue. Only after these requirements are met may the parties start to negotiate an arbitration clause that addresses their unique situation.

The goal is to draft a clause that satisfies the parties' expectations for resolving their disputes. The parties must agree on a specific procedure to avoid unnecessary delays or costs and have a tribunal enter an award that is enforceable. Drafters are expected to educate their clients about advantages and disadvantages of arbitration and other alternative dispute resolution procedures so that the clients may make a well-informed choice.

Suggested Guidelines and Common Mistakes to Avoid

The following rules will help any attorney attempting to draft an arbitration clause.

Use unambiguous terms. The arbitration clause must use unambiguous terms, especially with respect to the agreement of the parties to arbitrate their disputes. Otherwise, the arbitration clause may not be enforceable, putting the parties at risk of wasting time and money arguing about whether the dispute belongs in court or arbitration. Such an outcome goes against the nature of arbitration, which ideally conserves resources by providing an efficient mechanism by which to resolve disputes. Any ambiguity in the arbitration clause relating to the parties' agreement to arbitrate may lead to the involvement of courts and, ultimately, to the failure of arbitration.

Don't wait until the last minute. An arbitration clause must be drafted with great care. Frequently, contract drafters insert an arbitration clause into the main contract just before the contemplated transaction is set to close. This type of hurried drafting rarely leads to an effective arbitration clause. The parties' expectations cannot be addressed at the last minute, especially when there is great pressure on all sides to close a deal.

Time is required to ensure that an arbitration clause anticipates the likely nature of future disputes. Prior to drafting, lawyers should think through and discuss with their clients, among other things, (a)

whether arbitration is the desired procedure; (b) which disputes should be resolved in arbitration; (c) whether the clients want to use other forms of dispute resolution (e.g., mediation) before resorting to arbitration; and (d) where and how a future award is to be enforced. Only after discussing these key considerations will drafters have the ability to safely address their clients' concerns, leading to arbitration clauses that satisfy their clients' needs and produce a successful result.

These recommendations may seem obvious, but many lawyers fail to devote adequate attention to drafting viable arbitration clauses. One of the worst mistakes is to identify a nonexistent or improperly named forum to administer the arbitration. Such mistakes are often exacerbated by the failure to designate which forum's rules (and which version of those rules, because they are often changed) govern the proceedings. Carelessness in these matters undoubtedly leads to the necessity of determining the real intent of the parties, driving up costs and wasting time.

Set out the agreed-upon procedure. An arbitration clause must include all steps in the dispute resolution process. A key omission may cause the whole process to fail and frustrate the goal of avoiding litigation.

In most cases, a valid arbitration clause simply provides that all disputes "arising from or relating to the contract" (or some variation thereof) will be resolved in arbitration. Such a clause reflects the parties' intent to arbitrate all disputes. Although valid, such a thinly drafted clause may raise more questions than it solves because it does not address any procedural issues such as (a) whether a court or arbitrator will decide the threshold issue of arbitrability; (b) whose rules apply; (c) which forum, if any, will administer the arbitration; (d) whose law will govern; (e) where will the arbitration be held; (f) in what language will the arbitration be conducted, and (g) how many arbitrators will be chosen, and how will they be selected. (Must they be attorneys? Must they have particular experience or credentials?)

Some of these issues may be addressed by statute, and such statutory provisions should be considered when drafting the arbitration clause. If the parties reside in different jurisdictions with different laws, however, serious procedural questions may persist. Drafters should mitigate potential problems by including a choice-of-law clause, anticipating what default statutory procedures would apply in the absence of a specific term to the contrary and taking conscious steps to fulfill the client's expectations accordingly.

Avoid unnecessary details. Although certain details are necessary to memorialize the agreement of the parties, the parties are not served by an arbitration clause that is "too detailed," especially on nonessential terms. The more detailed the arbitration clause, the greater the chance there will be complications in applying the clause. An arbitrator may interpret an overly detailed arbitration clause as ambiguous and therefore decide not to arbitrate or decide that only certain disputes are arbitrable. Again, this could waste money and time, and it could deprive the parties from their main goal: avoiding litigation.

For example, problems could arise if the parties provide a complicated procedure for pre-arbitral remedies. In such a case, a defendant might be able to use an overly detailed arbitration clause as a tool to delay the process of proceeding to arbitration, thereby delaying any arbitral award. This would be contrary to the general goals of arbitration: obtaining a timely award without additional costs. Similarly, problems could arise if the arbitration clause provides that arbitration may be governed by more than one set of rules. If these rules differ from one another, the arbitration provision could cause major challenges for arbitrators trying to determine which rules apply. Again, such unnecessary details would be contrary to the general goals of arbitration: obtaining a timely award without additional costs.

Avoid unrealistic expectations. The drafter should avoid including unrealistic arbitration procedures. A common mistake is for drafters to introduce extremely short time limits for different stages of arbitration. Although a shortened proceeding may seem to be desirable, especially with provisional measures, it is best not to propose overly abbreviated time limits for filing written submissions, appointing arbitrators, conducting discovery, conducting hearings, and rendering an award.

Another common mistake is for drafters to include unrealistic requirements for approving arbitrators (e.g., specified nationality, knowledge, specific experience, and (d) unusual educational background). If the parties mandate stringent requirements for each of these attributes, there may be no arbitrators available who satisfy them. Again, this could cause a situation where the fundamental goals of arbitration (efficiency and avoidance of litigation) may not be achieved.

Avoid turning your arbitration into litigation. Another mistake frequently made by drafters of arbitration clauses is mimicking rules of litigation in their arbitration clauses. The main reason most parties choose arbitration is to avoid litigation. Arbitration is more flexible than litigation and lets arbitrators adapt procedures and time frames to be most appropriate for the relevant dispute and surrounding circumstances. Forcing the parties to comply with the rules of litigation may lengthen the proceedings (for example, by permitting multiple depositions, protracted discovery requests, or the application of strict evidentiary standards).

Applying litigation rules also may complicate matters further if the contract governs cross-border disputes. Rules of litigation generally do not address cross-border disputes, whereas many arbitral institutions have rules that address them. In such cases, it is more advisable for the arbitration clause to set out the parties' agreement on provisions made available by a certain arbitral institution, rather than relying on litigation rules that may or may not apply. The rules of procedure set out by reputable arbitral institutions are generally sufficiently comprehensive and well adjusted to the special character of arbitration.

Avoid drafting a one-sided arbitration clause. Although a lawyer's job is to advocate zealously for his or her client, lawyers must be careful to avoid drafting an arbitration clause that maximally secures the interests of their clients to the disadvantage of the other parties to the agreement. Exaggeration in this field and drafting the clause to one party's advantage may lead to the conclusion that the clause is punitive and, thereby, unenforceable.

Drafters should be especially cautious in drafting arbitration clauses for consumer and employment agreements, where the parties may have uneven bargaining power. A perfect example of an overreaching arbitration clause that may not be enforceable is one that contains a provision under which the parties must appoint an arbitrator from a list prepared by one of the parties. State courts may find that such a biased arbitration clause is punitive or otherwise inequitable and declare the arbitration agreement nonbinding.

Essential and Optional Elements of an Arbitration Clause - In a Nutshell

Essential element: The parties' express consent to arbitrate. The most crucial component of the arbitration clause is the memorialization of the parties' express intent to arbitrate. Only when such consent to arbitrate is made explicit is it possible that the arbitration clause will be enforceable and arbitration will be conducted. It is also highly advisable to state whether the jurisdiction of an arbitral tribunal is exclusive in order to avoid misunderstandings in this matter.

Essential element: The scope of arbitrability. Another essential provision of the arbitration clause is a description of the scope of arbitrable disputes. Often, the parties wish to submit to arbitration all disputes that are somehow connected to their contractual relationship. To denote this broad scope of arbitrable disputes, lawyers tend to use two traditional and widely accepted phrases: to arbitrate all disputes "arising out of" or "in connection with" the relevant contract. Lawyers should be careful when selecting one of these two phrases; although they sound similar, they have different meanings. Disputes "arising out of" the contract generally are interpreted to relate to disputes that are strictly associated with the contract, while disputes "in connection with" the contract are generally interpreted to include disputes that are more loosely linked to the contract, such as torts. It is advisable for drafters to consult applicable law on how such arbitration clauses are interpreted, to ensure that the clause, as drafted, covers the scope of disputes the parties want to arbitrate.

Essential element: Arbitration procedures. The arbitration clause should identify a set of procedures that governs the arbitration. For the beginners in this field, we recommend using rules provided by one of the reputable arbitration forums in your jurisdiction. These typically are recognized worldwide and verified by years of practice. If the parties can agree, the arbitration clause should set out whether the parties wish to be bound by the arbitration procedures of a particular forum and whether they want that forum to administer the case. Failure to specify may lead to unnecessary disagreements down the road.

Essential element: Provision for entry of judgment. Another absolutely essential part of the arbitration clause is a description of how to enter judgment after an arbitration award is issued. In some countries, this element is a prerequisite for enforcement of an arbitral award.

Other elements to address. A good arbitration clause should address at least the following elements, either expressly or indirectly, by incorporating a relevant set of arbitration rules and procedures: (a) the language in which the arbitration must proceed, (b) the location for the arbitration, (c) the number of and method of selecting arbitrators, and (d) the procedural and substantive law that will govern the arbitration. Drafters are reminded that an arbitration agreement can be interpreted separately from a main contract; therefore, it is advisable for the arbitration clause to set out the governing law for arbitration itself.

Drafters also should describe in the arbitration clause how the arbitrator or panel of arbitrators might be able to award interim relief. Otherwise, it is possible that only courts may be competent to grant it. Second, drafters should consider including language in their arbitration clause that requires arbitrators to justify their award. Otherwise, the arbitrator or panel may not be obligated to render a reasoned award.

Some additional considerations include (a) how to address pre-arbitration stages of dispute resolution that parties may regulate as mandatory (e.g., negotiation or mediation); (b) provisions that might be necessary by reason of participation of more than two opposite parties (e.g., a parent company and its subsidiary); (c) the scope of discovery; (d) confidentiality imposed on the parties (either by agreement or by the arbitration rules governing proceedings); and (e) the competence of an arbitral tribunal to award attorney fees.

Final Thoughts

It is impossible to draft a perfect arbitration clause in isolation from the circumstances of the case and the parties' expectations. For that reason, the most appropriate approach to drafting the perfect arbitration clause for your client is to follow the suggested approach above and consider the suggested elements that should be addressed in the arbitration clause. Only well-thought-out arbitration clauses have the possibility of addressing the parties' expectations (their real intent) for the arbitration proceedings. However, even drafting an almost perfect arbitration clause does not provide a guarantee that the wording of the clause will not cause problems in the future. Lawyers and their clients should bear in mind that unforeseen controversies may result even from the most carefully drafted arbitration clauses, due to cultural and linguistic differences, force majeure, and other unexpected circumstances.

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