Contractual Dispute Resolution Clauses Help Businesses Manage Risk

When businesses make deals, the negotiators naturally focus on the benefits they anticipate. Too often, they do not want to think about what might go wrong.

But, like the GEICO ad says, "15 minutes can save you 15% or more." A little time devoted to considering the risks of the deal and how they might be addressed in the contract can be an excellent insurance policy, saving tens of thousands of dollars and months or years of time should a problem develop. Once a dispute occurs, if the parties have not included a dispute resolution process in their contract, it becomes much more difficult for them to agree on one.

In what situations should contractual dispute resolution provisions be considered? They are worth thinking about in any transaction that involves risk. Such provisions are particularly useful in co-ownership agreements (such as partnership and shareholder contracts), vendor and supplier contracts, joint venture agreements, licensing agreements, real and personal property leases and sales of assets or businesses. They are sometimes used in consumer contracts.

What should they say? Dispute resolution clauses must be carefully tailored to the type of businesses involved, the kinds of disputes that are likely to arise and the relative sizes of the companies.

Effective dispute resolution clauses should include these key elements:

1. Which disputes are included? Companies may include or exclude certain types of disputes from contractual dispute resolution provisions. However, "carve-outs" should be done with caution because they can lead to collateral litigation about the characterization of a particular dispute and whether it is covered by the contract. This can result in added expense, delay and uncertainty while a court resolves the issue. So, unless there are good reasons for limiting the types of disputes that will be subject to dispute resolution provisions, it is a good practice not to exclude particular disputes.

2. How will each procedure be triggered? This is usually done by written notice.

3. Who will be involved at each step?

4. When and where will each step take place?

5. How long will each step last (subject to extension by mutual agreement) and what triggers the next step?

6. How will the mediator and/or arbitrator be selected?

7. Will the procedure be administered by a provider organization, such as Judicial Arbitration and Mediation Service (JAMS), the American Arbitration Association (AAA) or the International Institute for Conflict Resolution and Prevention (CPR)?

8. How will mediators and arbitrators be paid?

9. What provision, if any, should be made for discovery?

10. Will the proceeding and outcome be confidential? (Not possible for litigation.)

11. Can a party seek injunctive relief while dispute resolution processes are occurring: for example, to protect its intellectual property? (Yes, if the contract provides for it.)

12. Will there be a requirement of "good faith participation?" Contract drafters sometimes include this requirement, but it, too, can lead to collateral litigation because "good faith" is subjective and hard to define, and litigating whether a party participated in good faith can result in further expense and delay.

Arbitration clauses should also specify whether there will be one or three arbitrators, what substantive law will be applied and whether there will be a simple decision or a reasoned award.

An increasing number of companies are using "step-clauses." When a dispute or problem arises, the contract requires the parties to meet and negotiate, as business people normally do. If that does not produce agreement, they must engage in mediation. Only when that does not resolve the problem may they turn to arbitration or litigation. The point of step clauses is to give business people an opportunity to resolve disputes, quickly, efficiently and cost effectively before turning to the expensive, time-consuming and risky processes of litigation and arbitration.

If negotiation and mediation do not result in agreement, should companies arbitrate or litigate? Arbitration is typically preferred (1) when it is critical for the decision-maker to have particular expertise because the subject-matter of the dispute is highly technical; (2) when confidentiality is important; and (3) when, in the international context, a U.S. judgment will not be recognized and enforced in the country of the opposing party. Companies may prefer litigation to protect intellectual property, establish a legal principle or precedent, obtain a definitive ruling on the meaning of a contract clause or achieve a public vindication. Companies that are subject to frequent lawsuits may not want a dispute resolution clause at all and go right to litigation if they want to deter future litigation by establishing a "no settlement" reputation.

Although arbitration was conceived as a faster, more efficient, less expensive alternative to litigation, its utilization by businesses has decreased recently because the time and cost have become comparable to litigation. In addition, it is not always governed by clear legal rules (for example, how much and what kinds of discovery will be allowed), there is a perception that many arbitrators decide cases by "splitting the baby," and appeal rights are limited. For example, under the Federal Arbitration Act, the grounds for appeal are limited to fraud, serious misconduct or acts that exceed the arbitrator's powers. A belief that the arbitrator has made

serious errors of fact or law is generally not grounds for appeal. Some arbitration providers have established procedures and broadened grounds for appeal within their arbitration process.

Drafting effective arbitration clauses can be fraught with difficulties. For example, contracting parties may agree that their arbitrators shall have particular subject matter knowledge say, in physics or chemistry. But if they designate a provider organization to administer the case, and that organization does not have arbitrators with the requisite knowledge, the parties may end up litigating that issue or the entire case.

In addition to incorporating dispute resolution clauses in appropriate contracts, smart companies have established in-house protocols to deal with problems as soon the company becomes aware of them. General Electric, Du Pont and GlaxoSmithKline, for example, have established legal models based on early case assessment, whose goals are to gather facts and develop strategies that meet their business and litigation objectives. These protocols serve as a guide for companies when they engage in the various dispute resolution processes.

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