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CLIENT ALERT

Pitfalls of Arbitration

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Arbitration of disputes is a widespread alternative to lawsuits filed in court. Arbitration is common in many commercial transactions such as loans, credit card agreements, stockbroker agreements and construction contracts. Arbitration is contractual, that is, it occurs only when the parties agree to do it. Arbitration clauses appear in many standard business contracts, and most parties never give a thought to them, until there is an actual dispute.

The Allure of Arbitration

The allure of arbitration is the promise of a quicker, less expensive process. Arbitration is also private, not open to the public like court files and judicial proceedings. Arbitration awards are not published, and are not precedential in other unrelated cases. But arbitration is not for everyone, and will not work for every situation.

Good Faith

Like any contract, a successful arbitration depends on the good faith of the parties. If arbitration is to achieve its goals, all parties must respect the process and cooperate. Just as one should not even enter into a routine contract with an untrustworthy party, one should not freely agree to arbitrate a dispute with an adversary who cannot be trusted to proceed in good faith. Arbitration respondents have been known to delay and even thwart the selection of arbitrators, refuse to comply with deadlines or discovery orders, fire their attorneys or even their own appointed arbitrators at strategic moments, threaten the arbitrators, refuse to pay the party's share of expenses, or throw other roadblocks in the way of the arbitration. Other than making an award by default or as a sanction, arbitrators do not have the powers of a court to forcibly deal with parties who so disrespect the process. If you have such an adversary, arbitration may not be advisable.

Waiver or Enforcement of Arbitration Agreements

Once agreed upon, arbitration is mandatory unless all parties waive it. One party can always file a

complaint in court, but the other party can move for a stay of the litigation and to compel the parties to arbitrate the dispute. On the other hand, if the underlying contract includes no agreement to arbitrate, it would still be possible for parties to agree to arbitrate even after a dispute has arisen.

Arbitration Expenses

Contrary to popular expectations, arbitration can be just as expensive as court, possibly even more so. While high expense is never the intent of arbitration, it is too often the outcome. Arbitration fees can be steep. All of the following examples are costs *in addition to* the attorneys fees, expert witness fees, court reporter fees, copy expenses, *etc*. that the parties would incur whether the case proceeds in court or in arbitration. The standard fee schedule of the American Arbitration Association ("AAA") currently calls for an upfront administrative fee of $8,700 for a commercial or construction arbitration where the claim is between $500,000 and $1,000,000. These fees vary with the amount of the claim and they apply equally to any counterclaims. Amending claims can result in additional fees. By contrast, the maximum filing fee in the Circuit Court of Cook County (excluding eviction cases) is $334, and it includes the services of the Judge, the Clerk and other courthouse personnel plus the use of courthouse facilities.

An arbitrator is usually an experienced professional individual or a business executive who will be paid by the hour or by the day for his or her services. The arbitrator may have preparation time and travel expenses to be reimbursed. Arbitrator fees can add $1,500 to $3,000 per arbitrator per day. Depending on the provisions of the arbitration agreement or the applicable rules, the case may call for three arbitrators, thereby tripling the expense. Judges and juries, by contrast, are paid by the taxpayers. An arbitration needs a suitable place to conduct hearings, which normally entails a rental expense. There is no fee for the use of a court room for a case pending in that court. The longer an arbitration goes, the more these expenses will mount. At the end of the arbitration, an arbitrator will typically insist that all fees and any administrative expenses be paid in full before the award is issued. At that moment, if one party thinks the arbitration has gone badly, that party may not pay its share of the invoice. The arbitration itself could exhaust the ability of a party to pay bills. Then, the other party is faced with the prospect of starting over in court or advancing the other party's share of the costs just to find out whether the award is favorable or not.

Scheduling

Unless retired, arbitrators typically have other occupations or careers that they are taking time away from to serve as arbitrators. Thus, they will have other appointments and conflicts that need to be taken into account when scheduling arbitration hearings. Judges, on the other hand, work full time hearing cases, and have no other occupations competing for their time. Clearing court dates for the parties, witnesses and legal counsel is difficult enough, but adding in the schedules of one to three arbitrators compounds the conflicts and is often the source of additional delay.

Discovery

A common motivation for arbitration is to avoid or minimize the delay and expense of discovery. But arbitration does not mean that there will be no discovery. Typically, the arbitrator would require the parties to at least produce relevant documents and identify witnesses prior to the arbitration hearing. Depending on the parties' situations, this limited discovery may be sufficient, or one or both of them may think they need more. In a complex case involving sufficient dollars, one or more parties may try to take depositions, significantly raising the costs, and the arbitrator normally has the discretion to allow it. The AAA rules actually contemplate that in so-called "large-complex" arbitrations (cases involving claims or counterclaims of $500,000 or more) the arbitrator has the discretion to allow additional discovery which could turn out to be as much as would have been available in court. The only way to be sure discovery is limited is to cover the issue in the arbitration clause of the underlying contract. But who thinks of that when the contract is being negotiated?

Motion Practice

Motion practice tends to add cost to cases litigated in court, but arbitration is not immune from this expense. Motions to dismiss, motions to strike, motions for judgment on the pleadings, motions for summary judgment, motions to compel discovery and more all involve additional time and therefore expense. Motion practice is actually commonplace in business vs. business arbitrations. When motions are filed, parties usually submit briefs and request oral hearings, exactly as if in court.

Arbitration Administration

To reduce expenses, parties may be tempted to arbitrate privately without a third party administrator like AAA. Non-administered arbitrations are just as valid as the administered variety, and they will indeed avoid third-party administration fees, but they will instead require the arbitrator himself or herself, or his or her assistant, to become the administrator. Someone has to schedule hearings, arrange locations, keep files, issue bills, monitor payments, replace any arbitrator who is challenged or who resigns, and communicate with the parties. Typically, the arbitrator in such a situation would charge an additional administration fee for his or her own services and to cover the cost of using an administrative staff person.

Arbitration Rules

Non-administered arbitrations can also suffer from a failure to agree on a set of procedural rules. Parties rarely think about arbitration rules at the time of contracting, so the lack of rules often becomes an issue in non-administrated arbitrations. The AAA has arbitration rules, which are automatically enforced in AAA-administered arbitrations unless the parties agree otherwise. It would be possible for parties to a non-administered arbitration to agree to use the AAA rules, but the AAA rules do not fit well when there is no independent administrator. The AAA rules naturally assume that the AAA itself will act as administrator. For a non-administered arbitration, consider using the International Institute for Conflict Prevention and Resolution Rules for Non-Administered Arbitration available at www.cpradr.org.

Multiple-Party Issues

Many business disputes are multi-party affairs. In a construction project, for example, the parties may include an owner, architects and engineers, construction managers, one or more general contractors, multiple subcontractors and possibly material suppliers and manufacturers. Mortgagees, sureties and title companies may be involved, too. Each relationship will be governed by its own contract, which may or may not require arbitration of disputes. Even if several of the contracts require arbitration, that does not necessarily mean they refer to the same arbitration or to one that some third-party has initiated. Moreover, some parties may be willing to waive arbitration and proceed in court, while other parties may seek to compel arbitration, according to perceived self-interest. In such a situation, any given party could end up litigating and arbitrating in different forums simultaneously, with no single outcome being binding on any of the others. In arbitration, there is no arbitrator-in-chief overseer who can order the consolidation of separate but related cases.

Arbitrator Powers

Arbitrators do not have the same power as a court to fashion and enforce appropriate relief. Arbitrators can interpret contracts and award money damages, which is the classic remedy. Depending on applicable state law or the arbitration rules, the arbitrator may be powerless to issue injunctions or to grant other equitable relief, such as compelling an unwilling party to specifically perform a contract, for example a contract to sell real estate. Even in jurisdictions or under agreements that expressly give the arbitrator equitable powers, the arbitrator does not have the ability to enforce the award or other interim rulings. An arbitrator can use carrots to persuade a party but an arbitrator has limited sticks to wield. An arbitrator cannot issue garnishments or order the Sheriff to seize the losing party's assets. It is questionable whether an arbitrator can foreclose on real estate and conduct public sales of property to pay liens and convey good title to a third party purchaser. Absent the consent of all parties, an arbitrator cannot adjudicate the rights of third-party lienors. Even if no third-parties were involved, bidders may be unwilling to participate in an arbitrator's sale, and title companies may not insure titles that depended on the actions of an arbitrator. Arbitrators cannot hold parties or witnesses in contempt or call upon a bailiff to take someone into custody or jail an obstreperous witness for misconduct. For any of these remedies, a court has to order them.

Enforcement of Arbitration Awards

When a court case is concluded and a final judgment is entered, it is ordinarily immediately enforceable unless the judgment debtor obtains a stay of enforcement for appeal and submits a surety bond to guaranty payment in the event the judgment is affirmed and the debtor is then unable to pay. When an arbitration is concluded, however, any prevailing party who has been awarded damages has only a piece of paper that allows him or her to go to court and request a judgment. If the adverse party does not voluntarily pay, this additional step means another delay and another opportunity for the opponent to

resist payment. It also incurs the very court fees that arbitration was supposed to avoid. This delay also gives the losing party an opportunity to take defensive action to hide assets.

Compromise Awards

Arbitration awards are sometimes more susceptible to compromise outcomes than the parties might like. It is unlikely that a three-arbitrator panel will be unanimous on all issues. To forge a majority or, even better - unanimity, arbitrators have been known to horse trade with each other to push the outcome into the middle ground. All-or-nothing arbitration awards are possible, but there is a greater risk of compromise, compared to court.

Arbitration Appeals

Finally, arbitration awards are effectively non-appealable except under very limited exceptions. The fact that the arbitrator is wrong, either on the facts or on the law, is not sufficient to overturn the award (unless the arbitration agreement states that the arbitrator is required to follow specified law and that any award may be reviewed by a court for errors of law). To overturn an arbitration award, the petitioner must show fraud, corruption, "evident partiality," an unfair hearing (such as refusal to hear relevant evidence) or that the arbitrators exceeded their authority.

Conclusion

Arbitration has its place, but it is not necessarily advisable to automatically include an arbitration clause in every contract. Some situations are suitable for arbitration, but others are not. Even in the suitable situations, it is advisable to deal with certain issues in the underlying contract, rather than wait for the actual arbitration. Issues such as: administered versus non-administered arbitration, the number of arbitrators, the applicable procedural rules, the possibility of third-party complications, any limitations on discovery, and whether the arbitrator's award is reviewable for errors of law are all issues that could be addressed in the contract. Above all, do not automatically request an arbitration clause, or accept one "as is" without giving consideration to whether it's actually suitable to your situation.

If you have any questions about this newsletter, please contact Ray Fylstra or your KFTR attorney at 312.630.9600.

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