Don’t dismiss the details when writing an arbitration agreement

For years, both the business community and the legal profession have been urged to use alternative forms of dispute resolution to avoid the cost and unpredictability of litigation. Many clients believe that arbitration agreements are a panacea that will free them from costly, time-consuming litigation, and produce equal or better outcomes from informed neutrals while avoiding the randomness often associated with jury pools.

Certainly no one can question that court-ordered mediation in North Carolina has been useful in reducing the number of cases tried to a very small percentage of cases filed. Arbitration has also proven to be a faster, cheaper and more flexible alternative to traditional litigation. However, relying on arbitration to resolve disputes may have unintended consequences when the parties do not first carefully consider the implications of arbitration and their agreement to arbitrate. Accordingly, it is important to know when arbitration agreements should be used and how to draft them in a way that best protects your interests and the outcome of your case.

Using arbitration agreements

Arbitration is a creature of contract, and private agreements to arbitrate are generally enforced according to their terms. An arbitration agreement may be a clause tucked within a broader contract or a separate agreement. It can specify in advance the rules and process for an arbitration proceeding. However, there are pitfalls in an improperly drafted arbitration agreement not tailored to the parties’ needs.

Parties frequently overlook the existence of a standard arbitration clause in a proposed contract that could affect their rights down the road. An example of this can be seen in a recent ruling from the N.C. Business Court. It said that an arbitration agreement can be binding even if it is not in writing. In that case — Morton v. Ivey, McClellan, Gatton & Talcott LLP — the parties circulated drafts of a written partnership agreement, but the agreement was never executed. The draft agreements contained an arbitration provision. Even though no written agreement was ever signed, the parties acted pursuant to the terms of the partnership agreement for several months. The parties eventually terminated the partnership and began litigation. The defendant then moved to enforce the arbitration provision contained in the unexecuted draft documents.

The court concluded that under the Revised Uniform Arbitration Act an enforceable arbitration provision need only be contained in a record, and not necessarily in a written agreement. The court ultimately ordered the case to binding arbitration, and the draft arbitration provision governed the resolution of the parties’ dispute even though they never signed a written agreement.

Considerations for drafting arbitration agreements

While standard arbitration rules establish default procedures for arbitrations, parties are free to enter into almost any arbitration agreement that they choose. You should carefully consider whether arbitration is appropriate for your dispute-resolution needs and if so actively participate in drafting any arbitration agreement to ensure that it includes appropriate protections.

When parties agree to resolve their dispute through arbitration, they generally relinquish the right to certain procedural niceties associated with a formal trial, such as the right to pretrial discovery and the protections of procedural and evidence rules. Parties who have been through arbitrations understand that the rules of evidence and procedure used in proceedings are very lax. The law that has developed over the years around experts, leading questions and other important issues may not — and in fact usually is not — followed. Procedural matters such as expert designations and the use of discovery devices are not typically provided for under default arbitration rules. In many arbitration proceedings discovery of any kind, including depositions, interrogatories or document requests, is not permitted. Consequently, parties may be left trying complex disputes on the fly with little or no advance knowledge of the other side’s arguments or evidence.

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As seen in the August 2013 issue of Business North Carolina magazine.
However, because arbitration is contractual in nature, parties may be able to protect their right to conduct discovery by including appropriate provisions in the arbitration agreement. Parties in commercial disputes should consider including provisions outlining the scope and extent of permissible prehearing discovery. This should not be dismissed as lawyers trying to force costly discovery into the process. The protections afforded by discovery and the avoidance of trial by ambush typically benefit businesses involved in litigation. Similarly, parties may be able to rely on the procedures normally followed in court cases by including language in the agreement specifying that certain procedural and evidence rules will apply in any arbitration proceeding.

Rules of evidence and civil procedure may not be the only things that arbitrators choose to ignore absent a carefully drafted arbitration agreement. Arbitrators generally are not required to follow applicable law and their decisions can be based on what the arbitrator perceives to be fair rather than what the law directs. Some arbitrators view themselves as not bound by judicial precedent in the same way that judges are but instead view their charge as one to “do equity” and achieve a desired result. While this may sound appropriate on some level, decisions by most businesses are made with some reliance on the known backdrop of well-established legal precedent whether in the commercial or negligence setting. Businesses face increased uncertainty and cannot effectively reduce their potential liability risks if that established law is not followed when disputes arise.

Parties likewise can use arbitration agreements to minimize the risk that the outcome of their case will be dictated by something other than the controlling law. Parties should manifest clear intent to be bound by the substantive law of a particular state by inserting a choice-of-law provision in the arbitration agreement itself. Parties can further decrease the chance that an arbitrator will decide a case based on his perception of fairness by including a clause that requires the arbitrator to follow established law and providing that any failure to do so is an act by the arbitrator in excess of his or her authority. Such provisions are generally more beneficial to businesses, which are more likely to rely on statutes of limitation, statutes of repose, or the lack of qualification of experts in defending claims against them. Be wary of an agreement that does not address these points. It may jeopardize your ability to rely upon years of developed commercial, product liability or tort law and, instead, require you to trust an arbitrator’s notion of what the law ought to be.

Regardless of how much thought and care goes into drafting an arbitration agreement, it is important to note that arbitrations nonetheless may lead to puzzling and unexpected results. Arbitrators may determine that they have discretion to disregard any provision requiring them to adhere to legal precedent, or follow evidence or discovery rules. It also is important to remember that arbitration rulings are almost always final. A misapplication of the law or facts is not a basis to challenge a binding ruling, as appeals generally are only available upon some charge of misconduct by the arbitrator. Therefore, parties have little recourse if arbitration is selected and results in an unexpected or unsatisfactory outcome.

Conclusion

Taking an active role in drafting an arbitration agreement places you in the best position to protect yourself. Consider including provisions for prehearing discovery, particularly in more complex disputes. Also include clauses that mandate that any arbitration proceeding will not only be governed by the laws of North Carolina, but also will be controlled by North Carolina’s rules of evidence and procedure. If properly drafted, an arbitration agreement will provide the streamlined and cost-efficient resolutions that benefit businesses, without sacrificing the predictability that comes with litigating cases inside the court system.