LEGALMANAGER

Axing Arbitration

■ BY PHILLIP M. ARMSTRONG

IN THESE LITIGIOUS TIMES, the courtroom is almost as central to conducting business as the boardroom. In an effort to curb litigation costs, many companies make alternative dispute resolution clauses a standard provision in their commercial contracts. These clauses often include three steps, beginning with relatively informal negotiations, proceeding to mediation, and ending, if all else fails, with formal arbitration. But arbitration can sometimes do more harm than good.

There are three steps commonly included in an ADR clause:

Step One: Negotiation. Representatives from each side meet face-to-face in an effort to resolve the dispute through direct negotiation.

Despite the best intentions, companies that include arbitration in their alternative dispute resolution clauses may ruin their chances for settlement.

Step Two: Mediation. If direct negotiation doesn't resolve the dispute, the ADR clause typically requires the parties to enter into mediation. Often the mediation provision will set forth the method of selecting the mediator and provide deadlines for completion, among other details of the process.

Step Three: Arbitration. If mediation is unsuccessful, then the parties submit to binding arbitration, which may involve a single arbitrator or the more traditional three-member panel.

At first glance, it seems ideal to move disputants into increasingly structured environments until resolution is finally achieved. But ADR clauses that incorporate all three steps may actually hinder the prospects of reaching a satisfactory result. Indeed, too often the arbitration step undermines the rest of the process. The first two steps, negotiation and mediation, are most likely to lead to settlement when the only alternative is costly and time-consuming litigation. With arbitration as a viable option, the parties tend not to negotiate or mediate with the same sense of urgency or purpose, making settlement less likely.

Moreover, arbitration itself rarely achieves a result satisfactory to both parties. In mediation, on the other hand, disputing parties have greater control over the process and play a more active role in crafting a resolution. Solutions reached by the parties themselves tend to be more satisfying to both sides and go a long way toward preserving business relationships. Arbitration awards issued by one "judge" or a panel of three, on the other hand, seldom result in an equitable compromise similar to one the disputants would craft themselves. In fact, the

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American Arbitration Association's 1992 study of more than 4,200 commercial arbitrators found that arbitrators almost always decide cases in favor of one party over the other rather than split the award.

Even litigation offers greater formal opportunities to settle than does arbitration. Each step of the litigation process—from discovery to pretrial and settlement conferences—forces the parties to focus on the merits of their case and consider settlement as new information is obtained. Moreover, companies are beginning to find that arbitration can be as costly as full-fledged litigation. Since the goal of arbitration is winning the case (or obtaining a favorable award from the arbitrator), as opposed to resolving the case, lawyers prepare for arbitration the same way as they do for litigation. And all companies have experienced the frustration of spending more money on legal fees and related costs than the amount in dispute.

When arbitration serves as a backstop to mediation, it provides a disincentive to negotiate in good faith.

Arbitration taken alone can be an effective way to resolve commercial disputes when specialized expertise is needed. In construction cases, for example, the parties might be better served by an arbitration panel of industry experts as opposed to a judge or jury with little or no knowledge of the construction industry. But when arbitration serves as a backstop to mediation, it too often provides a disincentive to negotiate in good faith.

When disputing parties know at the outset that failure to reach an agreement through negotiation and mediation will result in protracted litigation, they are more likely to settle. Companies with sufficient resources to litigate a matter therefore have an even greater incentive to skip the arbitration step, which can rob them of substantial bargaining leverage. Deep pockets or no, companies should consider eliminating arbitration from their ADR clauses—the first step to better settlements and more satisfying resolutions.

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