SYSTEM SLOWDOWN

Can arbitration be fixed?

BY MARY SWANTON

Eric C. Liebeler recalls a nightmare arbitration

involving Honeywell International Inc., where he is now chief litigation counsel. The liability phase of the $50 million breach of contract dispute, originally scheduled for 10 days, lasted 45 days spread over 18 months. Faced with the prospect of an equally draining damages phase, the company settled, but not before legal fees topped $5 million and each of the three arbitrators took home $480,000.

"The arbitrators weren't very hard edged," Liebeler says. "We got no traction whatsoever on any dispositive motions, we got no traction whatsoever on any evidentiary rulings. Either side could put in any evidence they wanted without any relation to the federal rules of procedure."

Bottom line: the arbitration took too long and cost too much.

Liebeler isn't alone in his views. Grumblings from in-house counsel about the cost and speed of domestic commercial arbitration are growing louder. Anecdotal evidence suggests that efficiency is highly variable, depending on the arbitrators and the parties involved, and statistical proof of time and cost savings compared to litigation is scant.

The American Arbitration Association (AAA) cites an analysis of its 2003 cases with claims between $75,000 and $250,000, showing the median time to complete an arbitration to be 10 months, compared to 22 months to resolve a case in the federal court system. But attorneys say the cost and time differences evaporate as the claim size increases.

"In some cases arbitration will be faster and cheaper, but in major commercial disputes that will not necessarily be the case," says Larry Schaner, partner at Jenner & Block.

That's partly because commercial arbitration cases have grown larger and more complex at the same time that some states, such as New York, have established commercial courts with mandates to move cases along. It's also because some attorneys import the complexity of litigation into an arbitration process intended to streamline procedures.

Kathy Bryan, former head of litigation at Motorola who now leads the International Institute for Conflict Prevention and Resolution (CPR), argues arbitration can be fixed. She cites the introduction of expedited rules, rising standards for arbitrators and the ability of in-house counsel to shape the arbitration process by writing parameters into their contracts. But she recognizes that they will only choose arbitration in domestic contracts if they see clear advantages over going to court.

"There is tremendous dissatisfaction with domestic arbitration," Bryan says. "It's too expensive, too process oriented, not responsive enough and the quality of arbitrators is all over the map. General counsel after general counsel gets burned, and litigation lawyer after litigation lawyer gets burned. They are turning away from arbitration in droves."

Arbitration Gripes

Some are turning away because they believe any benefits of domestic commercial arbitration are outweighed by the risks of forfeiting protections inherent in the U.S. judicial system: rules of evidence, reasoned judgments and the right to appeal.

"Arbitrators don't have to have reasoned decisions and sometimes the parties are left scratching their heads," says David Schlecker, partner at Anderson Kill & Olick. "Then you are essentially stuck with the decision because the right of appeal is very limited."

Others point a finger at arbitrators for failing to keep the process running efficiently. Liebeler puts the blame for the protracted Honeywell case squarely on the arbitration panel.

"There is an incentive for them to spread it out," he says, noting that arbitrators, who are paid by the hour, failed to put time limits on the process.

A few in-house counsel complain that arbitrators tend to be conservative in their rulings and "split the baby" in making awards to avoid alienating either party, thereby protecting their self-interest in being selected for future cases. The AAA has a 2000 study rebutting that claim, and several in-house and outside counsel knowledgeable about arbitration say they have never experienced that result. But the perception persists.

"I have heard stories of companies getting an adverse decision and telling the arbitrator, 'you are off the list,'" says Richard Reuben, associate professor of law at the University of Missouri–Columbia. "It would be naïve to suggest that does not have some kind of impact on the arbitrators' judgment."

Attorneys also complain that arbitrators are less likely to dismiss a frivolous case early in the process because they are mandated to produce an award that will stand. Thus companies are forced to spend money preparing a case they should have been able to avoid.

"Arbitrators should be more willing to grant dispositive motions earlier," says John Gardiner, partner in Skadden Arps Slate Meagher & Flom. "Arbitrators are worried about running the risk of their awards being challenged. They should not be so skittish about getting rid of frivolous claims."

A related criticism is that arbitrators are reluctant to assign the costs of the arbitration to the losing side.

"If the arbitrators find that a case has been brought improperly, there should be greater willingness to assign costs so there is more disincentive to bring weak cases or vastly exaggerated claims," Gardiner says.

In Reuben's view, all that makes arbitration "not that much different from litigation, except you are getting less."

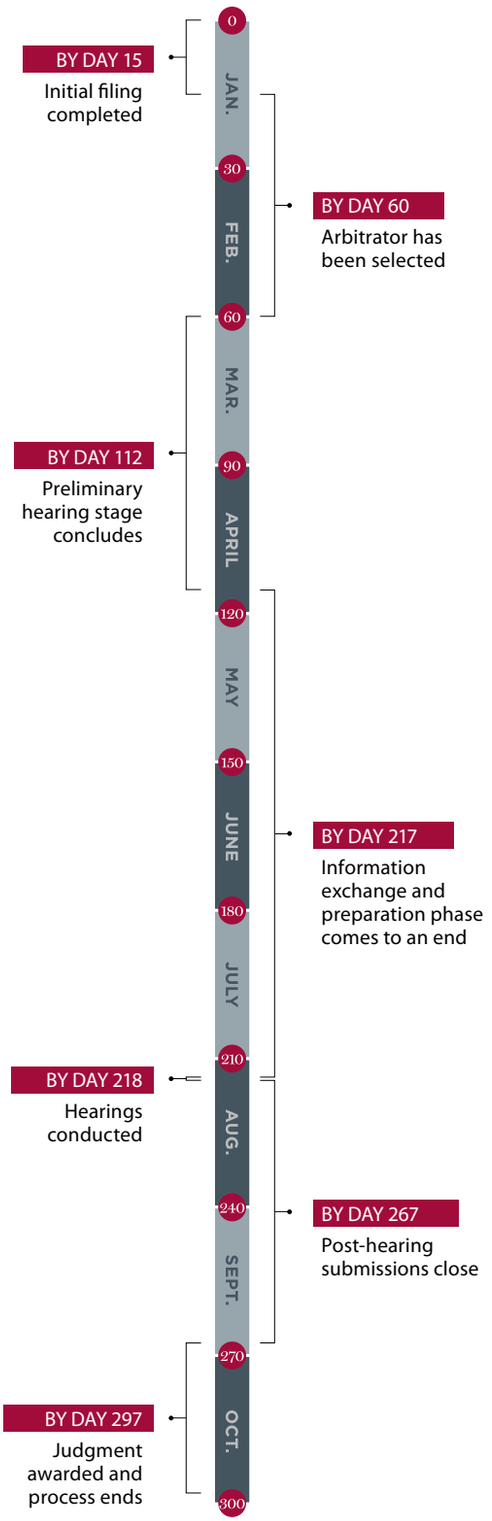
Counsel Criticized

While arbitrators bear the brunt of the criticism for arbitration's shortfalls, outside counsel aren't immune from blame. Arbitration is designed to save costs by streamlining the processes that make litigation so expensive. But lawyers undermine that advantage by using litigation strategies in arbitration and looking for every loophole to exploit to their client's advantage. They also may have self-interest in mind: like arbitrators, outside counsel have a financial stake in extending the process.

"The inside counsel who are complaining about arbitration are people whose outside counsel have imported into the arbitration process all the bells and whistles that accompany a federal or state court litigation," says Rick Jeydel, general counsel of

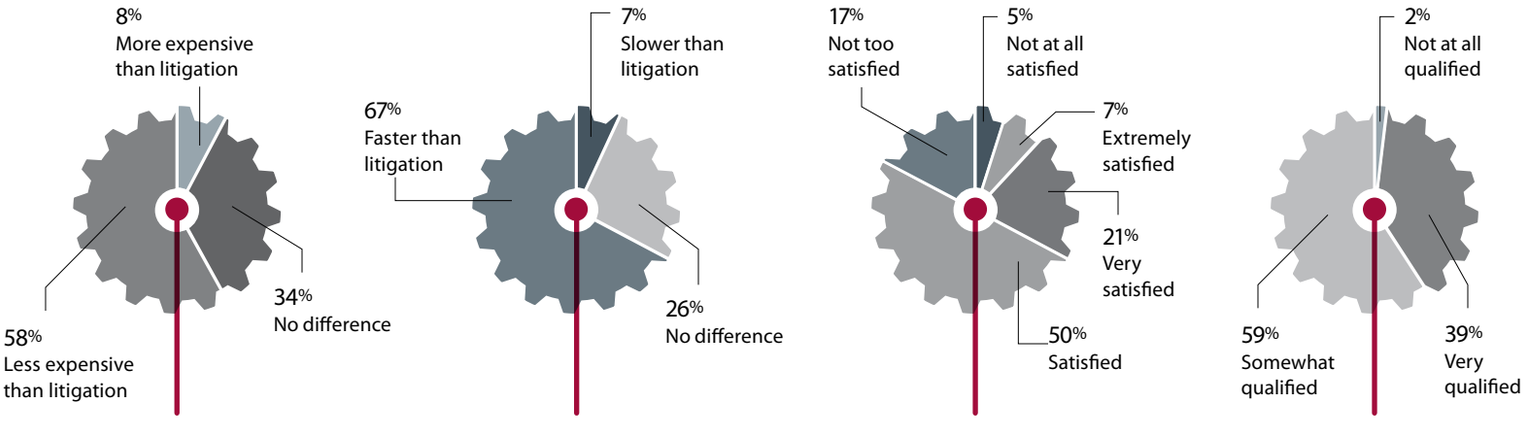
QUICK RESULTS

The AAA studied the commercial arbitration cases it handled in 2003 with claims between $75,000 and $250,000. The study found a median completion time of 297 days, or about 10 months, compared to 22 months for cases filed in the federal courts. Anecdotal information suggests that larger cases often take as long as litigation.



ARBITRATION PERSPECTIVES

AAA surveyed 254 in-house counsel in 2003. They gave the following responses:



COST FACTOR
How does the cost of arbitration compare to litigation?

FASTER V. SLOWER
How does the speed of arbitration compare to litigation?

SATISFACTION FACTOR
How satisfied are you with arbitration?

ARBITRATOR CREDENTIALS
How qualified are arbitrators?

Kanematsu USA Inc., who also serves as an arbitrator.

Outside counsel also are criticized for failing to adequately research the arbitrators they agree to use. Law firms often maintain lists of arbitrators to exchange with opposing counsel, but that may not result in the best choice, says Bryan, who believes in-house attorneys shouldn't rely on their outside counsel to select the arbitrator.

"You should be very thoughtful about the arbitrator you select," agrees J. Michael Watson, senior counsel at Wells Fargo. "I would encourage devoting a lot of time and energy to being sure the arbitrator you select is knowledgeable in the subject area of the dispute."

And make sure the arbitrator has time for you, adds Thomas Carbonneau, director of Penn State University's Institute for Arbitration Law and Practice, to avoid delays in scheduling hearings. "It becomes a real problem if these people are handling three or four arbitrations simultaneously," he says.

But that's just the first step in assuring an efficient arbitration. Jay Welsh, general counsel of JAMS, an arbitration services provider, says the responsibility for limiting costly procedures lies with the attorneys rather than the arbitrators.

"We get blamed for a lot of things that really are the result of counsel overspending," Welsh says. "We've got to do what the lawyers want to do. For example, they often want a lot of discovery. It that's what they want, that's what they get."

Diligent Drafting

If in-house attorneys want something different—a process that moves along quickly and cheaply—they can get that, too. They control a powerful and often unused weapon to curtail arbitration abuses—the arbitration clause in their contracts. That clause sets parameters for the process.

"You can use the agreement as your sledge hammer" to move the process along, Carbonneau says. "There is no reason in-house counsel should feel powerless."

But too often, attorneys simply drop standard arbitration clauses into contracts. That's partly because companies often aren't thinking about disputes when they enter an agreement.

"When you enter into a transaction, you are in love with each other," says Richard Chernick, managing director of JAMS Arbitration Practice. "You don't know what kinds of disputes will arise."

That creates a dilemma. Providing too much specificity may be a mistake, if it limits flexibility in structuring the arbitration to fit a wide range of possible disputes. Too little specificity opens up the possibility of long negotiations before the process ever starts or leaving too much discretion to the arbitrators to set the rules of the game.

"Dispute resolution contracts should be drafted with care, and often they aren't," Schaner says. "A lot of bad forms are running around that end up in contracts."

Arbitration specialists agree on certain points that belong in most commercial arbitration clauses. Both parties to the contract must first agree on the kinds of disputes to be arbitrated. Many companies incorporate "step clauses," providing an initial period for mediation. If mediation fails, the dispute goes to arbitration.

The parties should specify which organization will handle the arbitration, and where the arbitration will take place. This determines the rules that will apply and the arbitrators who

will hear the case. They also should decide whether one arbitrator or a panel of three should handle the proceeding. Using one arbitrator will expedite the process and simplify scheduling, as well as reduce arbitration fees. But in large, complicated disputes, using three arbitrators mitigates the risk of an off-the-wall decision. Wells Fargo addresses this conundrum by setting a threshold dollar amount. If the dispute is worth more than that amount, the parties will use three panelists. If it's worth less, they will select one arbitrator to resolve the dispute.

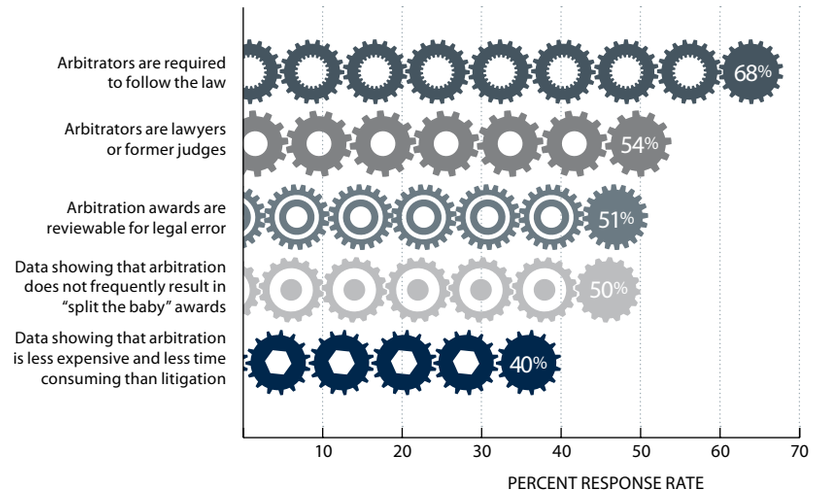
While parties to a dispute can require the arbitrators to provide a written justification of their award, that step adds time and cost. Because the basis for appeal is extremely limited, many arbitration attorneys think it's a waste of money to include that requirement in a contract.

Perhaps most importantly, in-house attorneys should recognize that the best way to assure cost-effective arbitration is to build in time and process limitations.

"I see very few limits on discovery in arbitration clauses, and that's a shame," Jeydel says. "You can write it in, but almost nobody does. You can also put a time limit on the proceeding and that will eliminate arbitrators who can't schedule the time to get it done." Jeydel recommends adopting the expedited rules of AAA, which like other arbitration groups, offers a fast-track arbitration model.

FIXING THE PROBLEM

In 2006, the National Arbitration Forum and the ABA Section on Tort Trial and Insurance Practice (TIPS) surveyed TIPS members about what changes in arbitration would cause them to use arbitration more frequently:



SOURCE: 2006 NAF-ABA-TIPS SURVEY

The Payoff

So while the speed and efficiency of arbitration has been oversold, there are ways to make the process live up to its potential. And there are many situations where arbitration pays off.

These include ongoing business relationships where arbitration may be less stressful to the relationship and "David v. Goliath" situations where a jury may perceive a corporation as the big guy taking advantage of the little guy. A key advantage of arbitration is that the proceedings are closed. So cases where trade secrets may be revealed or negative publicity could ensue are good candidates for arbitration.

"There's nothing worse for a board of directors than seeing a lawsuit plastered all over the front page," Welsh says.

In some sectors, in-house counsel favor arbitration because cases involve complex financial or technical issues and the parties benefit by selecting arbitrators with expertise that a judge or jury won't have.

"In arbitration, you have knowledgeable professionals hearing the case who know what you are talking about," says Jerome Bales, partner at Lathrop & Gage, who serves as an arbitrator in construction industry cases. "Sometimes judges say, 'I hate construction cases—they are too complicated.'"

Arbitration also avoids the specter of huge punitive damage awards and virtually eliminates the prospect of a costly, lengthy appeal, which can save substantial time and money in relatively small, simple disputes.

Even critics such as Liebeler agree that arbitration has a role to play in many domestic commercial disputes. Those include "cookie cutter" agreements and other cases where the legal arguments are straightforward and the size of the case makes it unlikely that the company would appeal, even if it loses.

"There are circumstances where Honeywell would absolutely insist on arbitration," he says.

So arbitration, with all its warts, is here to stay. As a result, all sides—arbitration providers, law firms and in-house counsel—are moving to address the complaints. The arbitration organizations are tightening rules and training and promoting expedited procedures. Law firms are recognizing that in-house counsel won't be satisfied with an arbitration that costs as much as litigation. In-house attorneys are taking a more active role in supervising the process.

"The people who do arbitration are getting more sophisticated," Schaner says. "They realize that many of the advantages may be lost if it's not done right. A recalibration of expectations is taking place. In-house and outside counsel both realize that to reach the objective of saving time and money, arbitration has to be handled intelligently." ■