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So You Think Your Arbitration Agreement is "Good Enough"?

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Perhaps it takes a real life horror story to drive home the point that realizing the undoubted potential benefits of commercial arbitration requires using counsel with arbitration expertise to draft the arbitration agreement and conduct the resulting arbitration. Here is such a story – of how an unfortunately unremarkable arbitration agreement turned out to be horribly inappropriate when called into action.

Experienced arbitration counsel spend a lot of energy impressing on corporate colleagues and in-house counsel the importance of using arbitration expertise when drafting arbitration agreements. Sometimes it seems we're not taken seriously - that our audience thinks it's "good enough" to just paste some generic arbitration agreement into their contract. Nothing could be further from the truth.

A real life horror story might drive the point home. Names have been omitted, and details fudged, to protect the guilty…I mean innocent. But this **is** a true story.

Once upon a time, a business and employee negotiated an employment contract. It provided the business would pay the employee about $150,000 per year. It required that disputes between the parties be resolved by arbitration. Each party would appoint one arbitrator and those two would appoint a chair. The arbitral tribunal's award would be final and binding, and could be converted to a court judgment to be enforced. That was it.

So what? Was this agreement really all that bad? Well… yes. And it actually did come back and bite the parties, quite painfully.

Here's how. The parties' relationship didn't work out. The employee began an arbitration to resolve his claims for about $200,000 in damages.

But, what, exactly, was so wrong with this arbitration agreement? Let's start at the beginning. While arbitration in general probably was an appropriate mechanism to resolve disputes under this contract, the specific **kind** of arbitration these parties designed was not. Three arbitrators? At a combined hourly rate of, as it turned out, around $1,500? To resolve disputes which were highly unlikely to (and in fact didn't) involve more than the low six figures? That's just not economic or practical, as these parties found, to their cost.

Some of the specific deficiencies in the arbitration agreement:

1. The parties didn't agree on a "seat" of the arbitration, the place where the arbitration legally takes place. The law of the seat is normally the law governing the arbitration (the lex arbitri, in Legalese). Not having agreed on a seat, the parties hadn't agreed on a governing law either.
2. The parties didn't agree whether the arbitration would be administered by an arbitral institution or ad hoc (administered by the arbitrators).
3. The parties didn't agree on procedural rules for the arbitration.

The parties appointed their arbitrators. They chose a chair. The parties then raised preliminary issues. The employee, saying the business wouldn't be able to satisfy an award, unilaterally amended his arbitration notice to also claim against two related companies, who were not parties to the employment

contract. They, not surprisingly, disputed the tribunal's jurisdiction over them. The parties disagreed about what the seat of arbitration and the arbitral law were, about whether the arbitration was administered or ad hoc, and about what procedural rules the tribunal should use, all issues that they could have, and should have, resolved in the arbitration agreement.

Those preliminary issues really highlighted the deficiencies in the arbitration agreement. For example, how, exactly, was the tribunal to resolve them, given the lack of procedural rules? What law governed the arbitration, given the lack of a seat? What was the role of the arbitral institution one of the parties had used to appoint "their" arbitrator? It became apparent that, given those deficiencies, resolving those issues was going to be a significant task. As is common practice, the tribunal required the parties to post security for its fees for doing so.

But the employee balked. He tried to unilaterally "suspend" the arbitration he had begun, so he could try to sue the companies, apparently thinking that would be cheaper. The companies didn't accept he could. Another preliminary issue.

The employee refused to post his share of the security, perhaps thinking that would make the arbitration go away. But, showing some arbitration smarts, one of the companies posted it for him, and the arbitration continued. The companies applied to have the claim dismissed, or the arbitration terminated, because of the employee's failure to post security. Another preliminary issue.

The tribunal set a schedule for the parties to deliver written submissions on all these issues. Somewhat surprisingly, they did. But before the tribunal could decide the issues, the parties settled the claim. Why? I don't actually know. But it probably wouldn't be far from the mark to suggest they woke up, smelled the awful coffee they'd brewed and realized there was no way to cost-effectively resolve their dispute using the process they'd designed (but that a court would likely stick them with it anyway). As part of the settlement, the parties paid their shares of the tribunal's fees, and bore their own legal costs. Those amounts were no doubt significant, particularly relative to the amount at stake. The necessity that the parties pay them likely seriously distorted the monetary terms of their settlement.

Of course, there's nothing wrong with settlement. It's usually the best way to resolve disputes. The point is that these parties' carelessness in drafting their arbitration agreement effectively deprived them of the option of resolving their dispute on its merits. It likely **forced** them to settle.

How much more cost-effective would it have been if the parties had spent a fraction of their legal costs and the tribunal's fees on the arbitration expertise necessary to design a process that was appropriate for the kinds of disputes likely to actually arise under the employment contract? Does the phrase "penny wise, pound foolish" ring any bells?

The sad thing is, these parties are probably now disillusioned about arbitration as a dispute resolution mechanism. Their arbitration was a horror show. But there was nothing wrong with their choice of arbitration in general. The problem was their design of the specific arbitration agreement. Really, the parties were victims of their own failure to use the arbitration expertise necessary to design an effective process. In this case, "good enough" wasn't nearly good enough.

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