Strategies for Drafting an Effective Arbitration Clause

For a full PDF copy of this article, click here.

Claims and disputes in the construction industry are commonplace. On a construction project of any complexity, disputes are often the rule—not the exception. During the lifetime of most construction companies, it is likely that the company will become embroiled in a claim or dispute that cannot be resolved without resorting to arbitration or litigation. While it is best to avoid construction claims and disputes from the beginning of a project, it is important to resolve them quickly and efficiently once they arise. The efficient resolution of claims and disputes is often crucial to the economic success of the project.

Claims and disputes involving construction projects tend to be technically complex and factually intensive. As a result, the resolution of construction claims and disputes can be time consuming and costly. Absent reaching a negotiated or mediated settlement of a claim or dispute, arbitration may be the best way to reach a satisfactory resolution for all involved. The goal in arbitration is to achieve a just, efficient and cost effective resolution of the dispute. When first introduced to the construction industry, arbitration was hailed as a less expensive and more efficient alternative to the litigation of complex construction claims and disputes. Regrettably, for many in the construction industry, the distinct benefits of arbitration—speed, cost and efficiency—have proved to be illusory where parties have allowed arbitration to evolve into a process which too closely resembles the litigation process. If approached right, however, arbitration can be a much better way than litigation to resolve complex construction claims and disputes quickly and efficiently.

One primary advantage of arbitration over litigation is that the contracting parties generally have greater ability to tailor the dispute resolution process to their individual needs and preferences. If there is a particular aspect of arbitration which you find objectionable, a careful revision of your contract’s arbitration clause may supply the desired “fix.” Whether you are an owner, contractor subcontractor, or supplier, consider the following checklist of considerations which you should observe in creating an effective arbitration clause in a contract with a lower-tier contractor, subcontractor, or supplier:

- **Pre-select the hearing locale in your arbitration provision.** In order to make the arbitration proceeding less expensive, pre-select a location for the hearing that is most convenient for you and the likely witnesses that you will need to present in the event a later dispute is arbitrated. By requiring that the hearing be conducted in your own “backyard,” you can also minimize the possibility of having an arbitrator or a panel of arbitrators selected from your opposition’s home territory. Once an arbitrator is selected, the parties can always mutually agree to have the hearing conducted in a different location if it makes more sense at that time.

- **Consider including an election to arbitrate clause.** In many jurisdictions, it is permissible to structure your arbitration clause so as to allow one party to require arbitration at its sole option, as opposed to litigation or some other dispute resolution procedure, by that one party unilaterally electing to arbitrate after the dispute has
arisen. Depending on the facts of your case and the contract provisions and legal principles at play in the dispute, you may determine that litigating your dispute has some distinct tactical advantages over arbitrating your dispute. By reserving the right to elect or reject arbitration after the dispute has arisen, you then can judge the likely suitability of the dispute for arbitration versus litigation after all of the elements of the dispute are known. To determine whether including an election to arbitrate clause is a viable option, you must check the law governing your contract, and you should also check the law in the locale of the project. If your election to arbitrate clause is not valid and enforceable under the controlling law, you may find an opposing party arguing that the entire arbitration provision is unenforceable.

- **Limit pre-hearing discovery.** Most arbitration proceedings are conducted under the rules of an arbitral institution such as the American Arbitration Association. Even if the arbitration clause adopts the standard rules of the administering arbitral institution or service, the parties may contract to limit or alter those “standard” rules. For example, the arbitration clause might provide that there will be no pre-hearing discovery at all or that pre-hearing discovery will be limited to only an exchange of relevant documents or to those documents that each party intends to use as hearing exhibits. Similarly, the arbitration clause might provide that pre-hearing discovery depositions will be limited in number, duration, and scope. For example, you could agree that there will be no more than two four-hour depositions of fact witnesses and one four-hour deposition of expert witnesses by each party. Contractually limiting discovery in this way could dramatically reduce the costs to each party by avoiding any unnecessary and time-consuming discovery and by making protracted and costly discovery disputes much less likely. Given that the parties in an arbitration proceeding have necessarily been in a contractual relationship with one another, each party should already be in possession of most of the relevant facts. Thus, the downside risk of dramatically limiting discovery may be minimal.

- **Establish a protocol for pre-hearing discovery and exchange of any electronically stored information.** Certain electronically stored information, such as email communications and project scheduling files, may become critically important in the resolution of a construction claim or dispute. Consider whether such information should be exchanged in native file format in its original form instead of in paper or PDF format. If so, considering addressing this issue from the outset by detailing such requirements in the arbitration clause. Also, consider requiring that any paper documents be exchanged in separate, searchable (embedded OCR) PDF files.

- **Differentiate between complex and small disputes.** The arbitration clause may provide separate sets of rules and procedures (e.g., allowed discovery procedures, number of arbitrators) depending on the size and complexity of the arbitration dispute. If the dispute is particularly small, the arbitration clause might provide that the parties waive the right to any hearing before the arbitrator and that the parties agree to submit the dispute to the arbitrator in writing, with appropriate page limitations for each side’s argument. Or, if a hearing is to be allowed in disputes of a certain size, the arbitration clause might limit the time in which each side must present its case to the arbitrator to a specific number of hours or days.

- **Specify the arbitrator selection process.** One of the great benefits of arbitration is the ability to have your dispute resolved by an arbitrator who has general or specialized knowledge of the construction industry. The arbitration clause can limit the number of
arbitrators, as well as specify the manner in which the arbitrator is to be selected. If you wish to require that the arbitrator possess certain qualifications relevant to the construction industry or to the specific project involved, then you can specify such qualifications in the arbitration agreement. If, for example, you are an owner of a high-rise construction project who does not want a contractor as an arbitrator, you can contractually agree that your arbitrator must be an architect or have some experience as an owner’s representative on high-rise construction projects or possess other defined qualifications. If the arbitration will require a three-member panel of arbitrators, you could, for example, require that the panel of three arbitrators consist of one contractor, one architect, and one construction attorney. If you are an owner, your agreeing to have on the panel one arbitrator with experience as a contractor may assuage any concerns that your contractor may have regarding the dispute resolution process. In the alternative, you might pre-select and name a selected or mutually agreeable arbitrator in the arbitration clause.

- **Specify the number of arbitrators.** For small disputes the appointment of one arbitrator is the norm. For larger, more complex, disputes a three-arbitrator panel is typically used. For example, if the parties have not otherwise agreed, the American Arbitration Association’s Construction Arbitration Rules & Mediation Procedures provide for the appointment of one arbitrator where the claims or counterclaims are under $1,000,000. However, if a claim or counterclaim of any party is $1,000,000 or more, the AAA will appoint three arbitrators if the parties are unable to agree that only one arbitrator shall be used. If you want to avoid the added expense of a three-arbitrator panel, then expressly address this issue up front in your arbitration clause. If you desire a three-arbitrator panel for larger claims ($5,000,000 and above as an example) then expressly address this issue up front in your arbitration clause.

- **Empower the arbitrator to allocate or award attorneys’ fees.** Absent specific statutory authorization or agreement by the parties, the law is unsettled regarding whether arbitrators have the authority to award attorneys’ fees. While there is no such prohibition in the Federal Arbitration Act, some states forbid arbitrators to award attorneys’ fees unless specifically empowered to do so by the parties’ agreement. Accordingly, if your contract contains a prevailing party attorneys’ fee provision, which requires the loser to pay fees, then make sure that within the arbitration clause itself you expressly authorize the arbitrator to include in the award an allocation or award of attorneys’ fees. Absent such express authority, the arbitrator may leave each party with the responsibility to pay its own attorneys’ fees.

- **Provide for consecutive hearing days.** Arbitrations typically “grow” in overall duration when hearings are not scheduled to begin and conclude on consecutive days. With each recess in the arbitration process, each party finds more witnesses, more documents, or more questions which must be presented when the hearings resume. This, of course, results in a longer overall duration and therefore higher costs to each party. Contractually agree that the arbitration hearing will be scheduled to start and conclude on consecutive hearing days. Another way to control the overall duration of the arbitration proceeding is to impose outside limits on the time allowed to each party for the presentation of its case.

- **Consider requiring the arbitrator to strictly enforce contract terms and to adhere to legal principles.** Typically, an arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties.
Parties sometimes complain that contractual and legal principles are lost in an arbitrator’s desire to “do the right thing.” If you are proud of the favorable contract terms you have negotiated, consider drafting the arbitration clause to require that the arbitrator strictly follow the contract terms and/or established legal principles in making a final decision and that the arbitrator’s failure to do so will be grounds for an appeal. Understand, however, that such a requirement is of limited effect unless accompanied by a requirement that the arbitrator issue a reasoned opinion whereby the arbitrator’s required enforcement of contract terms and adherence to established legal principles can be demonstrated.

- **Consider a mandate for reasoned opinions accompanying the arbitrator’s award.** Unless the parties request or require otherwise, there is no requirement that an arbitrator provide the parties with a specific form of the award. If it is important to you to know why the arbitrator decided as he or she did, provide in the arbitration clause that the arbitrator will write a reasoned opinion explaining the award and that the arbitrator will specifically identify the manner in which each separate claim or counterclaim is decided. You may also require that the arbitrator include with the award the arbitrator’s “findings of fact” and “conclusions of law” on specific issues presented in the case. Note, however, that requiring an arbitrator to issue findings of fact and conclusions of law may significantly increase costs to the parties. When faced with this requirement the arbitrator will typically request that each party submit individually their proposed findings of fact and conclusions of law for the arbitrator’s consideration. If the submission is made after the conclusion of the evidentiary hearing, the arbitrator will not officially close the hearing until after the submissions are made. If so, this will delay publication of the final arbitration award given that the publication deadline will run from the date that the hearing is officially closed.

- **Identify conditions precedent to arbitration.** Consider the wisdom in requiring that the parties participate in some non-binding process, such as structured settlement negotiations between principals or mediation, as a condition precedent to either party’s resort to the arbitration process. Even a streamlined and carefully-tailored arbitration proceeding can be distracting and destructive of business relationships. More often than you might expect, the early involvement of an experienced mediator or a structured settlement meeting between the principals of opposing parties may resolve difficult construction disputes more quickly and less expensively than participating in arbitration.

- **Provide for consolidation and joinder of other parties.** Oftentimes, complex construction claims and disputes will involve multiple parties. If you are concerned that other parties may be involved in a construction claim or dispute, preserve your right to join those parties in the arbitration based solely on your determination of the likely involvement or interest of the other party in an arbitration proceeding. In addition, your arbitration clause might allow you to invite others (e.g., subcontractors or sureties) to participate in an arbitration and be bound by its result, even if that third party is not made an official party to the arbitration proceeding. If you include a consolidation and joinder provision in your contract, then make certain that you include a similar provision in all of your downstream subcontracts and purchase orders so that you can join lower-tier subcontractors and suppliers in the arbitration if they are needed to obtain a full and final resolution of a claim or dispute.

The checklist above is not exhaustive, but it should quickly
demonstrate that much can be done to improve on a standard boilerplate arbitration clause. You should review your standard form contracts, subcontracts, and purchase orders and think about those aspects of arbitration that are important to your satisfaction with the arbitration process. Then, consult with your construction attorney to help craft an arbitration clause that will be enforceable and that will meet your unique objectives.

© Smith, Currie & Hancock LLP

(This article originally appeared in Construction Connection newsletter. www.constructionconnection.com).

Gene invites you to connect with him on LinkedIn at: http://www.linkedin.com/in/constructionlawgeneheady

Eugene (“Gene”) J. Heady is a Partner in Smith, Currie & Hancock’s Atlanta office. He is rated AV® Preeminent™ by Martindale-Hubbell and was selected as one of Georgia’s Top Rated Lawyers of 2014. Smith, Currie & Hancock is a well-respected national law firm focusing on construction law, government contracts, environmental law, and commercial litigation. Gene is also a mediator and arbitrator and is a member of the American Arbitration Association’s national Panel of Construction Arbitrators. Gene is a regular contributor to the Construction Connection Newsletter. He has over 30 years of experience as a problem solver in the construction industry. Following a successful career in the construction business, Gene began practicing law in 1996. He represents and assists owners, general contractors, builders, subcontractors, suppliers, architects, engineers, designers, sureties, real estate developers, and manufacturers in avoiding and resolving disputes related to construction projects throughout the continental United States, Alaska and the Caribbean. His work involves private, local, state and federal government contracts and commercial, industrial and institutional construction projects. Gene literally grew up in the construction industry; his father was a successful electrical contractor. Unlike most construction attorneys, Gene has hands-on experience. Gene has worked with the tools, at the drafting table and at the helm of a construction company. In 1981, Gene earned a B.S. degree in Engineering from the University of Hartford, majoring in Electrical Contracting. Before law school, he worked in the electrical construction business as a project engineer, project manager, and construction business owner. Gene is a prolific writer and has published numerous works related to the construction industry and alternative dispute resolution. He is also a frequent lecturer on construction law topics. Contact Gene at gjheady@smithcurrie.com or directly at 404-582-8055.