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Arbitration: Cost-Saver or Star Chamber?

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One of the most frequently-asked questions from in-house counsel is what we really think of arbitration. Is it actually an efficient and frugal alternative to the cumbersome litigation process, as it is marketed? Or is it a star chamber, where legal disputes are decided without the protections of the legal system, in secret and without judicial review?

This question arises because it is increasingly common for contracts to mandate arbitration over litigation. These provisions are standard in employment and consumer agreements, where a dispute can affect an individual's personal reputation. They are frequently found in reinsurance contracts and, increasingly, in ordinary insurance policies. Other likely targets are contracts involving healthcare and the construction industry.

The answer to whether arbitration is a good and useful alternative to traditional litigation in the court system is: It Depends. (Sorry!)

As a brief primer, in arbitration the ordinary structure of dispute resolution in this country—the court system grounded in the U.S. Constitution—is tossed aside. It is replaced with an agreement among the contracting parties about how disputes should be resolved.

Everything that is non-negotiable in the court system is up for grabs in arbitration. Parties can agree, for example, that arbitrators are free to set their own rules for their proceedings, unburdened by the guardrails that govern the courts or the nation's leading arbitration associations. They can agree that the arbitrators need not adhere strictly to other state and federal laws. They even are free to have their disputes decided by persons with no training or experience in assessing the admissibility and credibility of evidence, in managing discovery or in running trials.

While the analogy is imperfect, arbitration is to the court system what Uber is to taxi licensing industry and AirBnb is to hotels. It is an agreement to "go private" in hopes of achieving a more direct and efficient result, with the trade-off of foregoing the ordinary protections. The significant difference is that while people are fully aware that they are calling an Uber instead of hailing a cab, contracting parties often do not realize they have given up their rights to the court system.

Several key considerations shed light on whether arbitration is a good idea—or bad. They are: (1) who are the contracting parties; (2) who are the arbitrators; and (3) what rules and procedures control.

1. The Contracting Parties

The first consideration in evaluating arbitration is the financial resources of the contracting parties. If the balance is relatively even, such as between a general contractor and a limited contractor, arbitration may work out fine. But if the balance is uneven, as between employee and employer or even policyholder and insurance company, arbitration may be a terrible choice.

The reason is simple. But for relatively modest filing fees and cost awards, litigants do not pay to use the court system.

Judges, court clerks and other administrative assistants are financed by state and federal funds, not by litigants. They do not charge litigants for their time, meals, travel or lodging. There is no rental fee for the courtrooms. All that litigants pay are their own legal fees (which they pay in arbitration as well).

In arbitration, however, all of these costs fall to the contracting parties. Arbitrators generally are pricey—and there usually are three of them. The contracting parties pay for every moment the arbitrators spend on a dispute, including learning the facts, reading the filings, hearing the evidence and rendering decisions. The litigants pay for everything else as well, like the arbitrators' lodging, travel and meals and the rental costs of hearing rooms.

Most arbitration provisions call for these costs to be split automatically among the contracting parties unless the arbitrators decide otherwise. So any party considering arbitration must be prepared to pay not only its own legal counsel, but also the legal fees of at least the arbitrator that the party selects—plus half the fees of the third one. When there is a significant financial imbalance between contracting parties, arbitration can quickly become unfair, if not downright impossible. Individuals alleging wrongful termination can hardly afford to arbitrate against former employers. Many times, policyholders alleging wrongful denials of coverage cannot afford to arbitrate against their corporate insurance companies—especially since, in a dispute involving multiple companies, the insurers band together to divide up the fees.

Many advocates of arbitration assert that these costs are outweighed by the speed of the arbitration process. The American Arbitration Association, for example, states on its home page that arbitration is three times faster than litigation on average. But speed does not necessarily translate into efficiency and cost-savings. While backed-up court dockets may slow the resolution of judicial proceedings, there are no direct costs during the period of delay. But a fast-paced arbitration—such as one that involves a liberal approach toward motion practice, oral arguments, admissibility of expert witnesses, sequential evidentiary hearings, etc.—will produce enormous invoices from arbitrators.

In short, speed—maybe. At least sometimes. But cost-savings and efficiency? Not at all guaranteed.

2. The Arbitrators

The second consideration to whether arbitration is worthwhile is what restrictions are imposed by mandatory arbitration provisions on who is eligible to decide the dispute. It is common for arbitration provisions to set forth such requirements.

Insurance companies, for example, often mandate—in unilateral, non-negotiated standard forms—that at least a majority of the arbitrators must be persons who have served as executives of insurance or reinsurance companies. This requirement precludes policyholders from selecting arbitrators with experience in their own industries. When a mandatory arbitration provision requires that the arbitrators have experience in the industry of only one of the contracting parties, the playing field can be rigged from the start. Even when arbitrators with an insurance background work hard to be sensitive to the concerns of policyholders, and to evaluate the evidence fairly, the risk of bias cannot be ignored.

Look at it from a practical perspective. If insurance companies did not believe that arbitration is better for them than litigation, and that they benefit from having the arbitrators be insurance executives, they would not put these mandatory provisions in their standard-form insurance policies.

A mandatory arbitration provision can turn into a trap for the unwary when a financially strapped policyholder seeking insurance benefits that have been denied is forced to have the issue decided by three insurance industry executives. The risk is clear.

3. The Rules and Procedures

Since arbitration is an alternative to ordinary litigation, arbitration provisions often are not bound by the state and federal rules of civil procedure and evidence. Instead, they often pick and chose among whether these provisions should apply, whether the arbitration should follow the rules of a particular arbitration association and even whether the arbitrators can create their own rules.

This fact increases the "wild west" flavor of arbitration over litigation.

State and federal rules of civil procedure and evidence are easy to find and well-understood, with precedent available to address ambiguities. But when they are tossed aside, and arbitrators are empowered to take actions that courts have rejected, all sorts of trouble can arise.

Expert testimony is a handy example. There is well-established precedent in the courts about what qualifications are required of expert witnesses and what types of opinions they can offer. Experts will not be allowed to testify in court about standard practices in industries in which they have never worked. They also will not be allowed to offer "opinions" about the ultimate issue: how the judge should decide the case.

In far too many circumstances, however, arbitrators have allowed experts with no industry experience to testify about standard industry practices. Thy also have allowed such "experts" to opine about how the case should be decided. To justify such improper practices, the arbitrators have relied on their rights under the mandatory arbitration provision to set their own rules.

Thus, there is an inherent risk in arbitration that individuals who lack training in the judicial process, and who are not subject to the ordinary guardrails and protections, will allow the creation of an improper record that leads to unsupported and unfair results.

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Arbitration is here to stay. If you have not gone through an arbitration by now, it's likely to happen very soon. It is mandated too frequently for anyone to ignore.

So the best approach is to educate yourself as fully as possible about the arbitration process and its inherent risks. Remember to investigate if your contracts have mandatory arbitration provisions. Negotiate the provisions if you can. Give thought to how the arbitrators are to be selected and what rules are to be applied. And remember, always, to ask that these provisions be removed if you decide that you prefer to litigate the "old-fashioned" way.

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