

# Drafting Dispute Management Clauses: Principles of Risk Management for Commercial Contracts

by  
F. Peter Phillips<sup>1</sup>

As corporations around the world seek alternatives to American litigation, many have voiced dissatisfaction with the quality of the dispute resolution processes with which they are presented.

Mediation is not final, the complaint goes: It is treading water; it is a costly and time-consuming added layer of procedure; it is unenforceable; it is “soft;” it is annoying; it is ineffective. Arbitration is out of control; arbitrators are unaccountable and prejudiced; outcomes are incorrect and too often seem compromises; the process is as expensive and complex as litigation but without the possibility of appeal; arbitration administrative bodies are too expensive and unsophisticated.

Yet few of these disgruntled users of ADR processes look to themselves, or their professional advisors, as the cause of their own dissatisfaction. Arbitration is always a creature of contract, and mediation almost always is. ADR processes are meant to be party-directed and party-controlled. Might it not be, then, that dissatisfied parties have only themselves to blame?

## **“The Fault Lies Not in the Stars, But In Ourselves”**

A contracting party agreeing to a deal must assess not just the value of the deal but also the risk of the deal’s falling through, and must decide how to preserve the value

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<sup>1</sup> F. Peter Phillips is Senior Consultant to the International Institute of Conflict Prevention and Resolution (CPR Institute) in New York City ([www.cpradr.org](http://www.cpradr.org)). He is an arbitrator, mediator and ADR consultant practicing through Business Conflict Management LLC ([www.BusinessConflictManagement.com](http://www.BusinessConflictManagement.com)).

of the deal in the event of breach of the agreement. Managing that risk through orthodox choice-of-law clauses, jury waivers, or bare arbitration provisions too often results in dispute resolution processes that are unresponsive to the commercial needs of the company or the demands and risks of the particular deal.

This article addresses some of the considerations that managers should keep in mind when papering a deal. Attention to dispute management issues at the time of contract drafting may avoid costly and risky experiences later, and will in any event firmly place responsibility and accountability where it belongs – on the parties themselves.

### **Some Initial Premises**

Companies often spend weeks or even months negotiating with critical partners (such as IT providers or licensors) on agreements stretching over many years. Yet the provisions addressing the consequences of disputes arising under the agreement are seldom subject to discrete negotiation. Indeed, the dispute resolution provision is sometimes referred to as the “Midnight Clause” because it is stuck in late in the last evening, a mere bagatelle or afterthought.

The first premise is that *there are no perfect contracts*. There are no deals in which all parties’ interests and capabilities remain constant throughout the term, and in which all parties share an identical understanding of their rights and obligations. Opportunities arise (or fail to materialize). Currencies fluctuate. Subcontractors go out of business. Government approvals are withdrawn. Public funding is not renewed. Hurricanes happen. All sorts of contingencies occur that the initial drafters of the

contract did not anticipate. Risks that were inchoate at the time of the contract become real at some time down the road.

This is for no fault of the contract drafters. No drafter can foresee every change on the ground, or every good-faith interpretive disagreement, that will occur over the term of the deal. Since that is so, it is incumbent upon the drafters to devise processes for the management and resolution of unknown and unknowable contingencies.

Accepting the necessity to plan for contingencies, the second premise follows from the first: Conflict resolution processes that are embedded in the initial agreement must be designed to *protect the value of the deal*. The analysis should be straightforward: Identify the value that the client seeks from the venture, assume a risk of nonperformance from some unidentified cause, and devise methods to manage that eventuality designed to preserve, to the extent possible, that value.

In practice, this might involve such questions as: Should the counterparty be required to continue performance during a dispute? Should judicial access be agreed upon (or waived) for immediate preliminary relief? Should the client have the right to cease payment upon certain conditions? Would the client better avail itself of legal precedent (trial) or commercial rationality (arbitration)? Is the counterparty critical to other areas of the client's business, so that the overall relationship is more important than this particular deal? Should "buffers" be built in to make it difficult for the counterparty to abruptly terminate performance? Does the counterparty have assets in the client's home jurisdiction that may be subject to attachment?

Conscious and rigorous analysis of the deal, on the assumption that disputes will inevitably occur, is the first step in drafting contract clauses that add value to the client

and to the deal as a whole. The next step is to negotiate and draft such clauses with sophistication.

### **Threshold Strategic Questions**

A threshold question is whether the contract is cross-border. A “cross-border” deal may be one where the counterparties are residents of different countries. But it may also be where performance is to take place in a different country, or payment is to be made in a different currency, or where collateral is located outside the country of performance, or where governing law is different from the law of the residency of all of the parties to the deal.

Cross-border dispute resolution is different from domestic. The selection of neutrals, the rules chosen for the ADR process, the reliability and integrity of the enforcing courts, the cultural predispositions of the parties and their legal representatives, the restrictions on civil courts’ powers compared with those in common law countries, the practicality of enforcing a judicial judgment compared with enforcing an arbitral award under the New York Convention – all of these questions arise uniquely in cross-border disputes. This article will not specifically address international dispute resolution, and the contract drafter is cautioned that it is a whole different world, with a different set of challenges.

The other strategic principle is “front-loading” dispute resolution resources. Dispute resolution processes are divided into two categories – processes in which the parties retain control over the procedure and the outcome, processes in which they cede that control. The first category includes “consensual” processes, such as negotiation, facilitated negotiation, early neutral evaluation, joint expert evaluation, summary mini-

trial; the second category includes “adjudicative” processes, both private (arbitration) and public (trial).

Most commercial enterprises prefer consensual processes. They yield more commercially rational results, remain in the control of the disputants, are confidential, and hinge on business rather than legal concerns. The transaction costs for consensual processes tend to be lower than adjudicative processes by orders of magnitude. It is therefore almost always advisable to frame contractual dispute resolution clauses so as to exhaust consensual processes before incurring the costs and other disadvantages of adjudicative means of dispute resolution. This structure is called “stepped” or “tiered” clauses – negotiation leading to mediation (or other ADR methods) and only then leading to arbitration or litigation.

### **The Do’s and Don’t’s of Dispute Management Drafting**

The drafter seeking to preserve the value of the deal must be familiar with the rudimentary concerns of dispute risk management. These are the fundamental questions that each drafter should be asking, to determine whether its dispute resolution agreement is fit for the task.

- ✓ **Notice:** To whom should notice of a dispute be given? How soon after the event giving rise to the dispute must notice be given? What specificity should the notice contain?
- ✓ **Scope:** Are all matters to be treated the same way or are certain matters (such as breaches of confidentiality or misuse of intellectual property) to be carved out of the scope of the clause and subject to immediate judicial relief?
- ✓ **Rules and Initiation:** How are formal processes such as mediation or arbitration formally initiated, and what rules will be followed?
- ✓ **Administered or Unadministered:** Shall the formal processes be administered by an ADR provider body (such as JAMS, AAA or ICC) or will the parties

- choose rules that give them and the neutral that authority (such as UNCITRAL or CPR)?
- ✓ **Time Periods:** To ensure efficiency and commercial good faith, shall the various steps of the process be limited? For example, shall mediation commence automatically if a negotiated agreement has not been reached within XX days?
  - ✓ **Designated Representatives:** Shall the parties designate the level and seniority of their negotiators, and the identification of an agreed-upon arbitrator or mediator? Should the negotiation stage continue at a higher level if the initial negotiators are unsuccessful?
  - ✓ **Location:** Shall the mediation or arbitration occur at the location of one party, or in a third place? (This provision can persuade a skeptical counterparty to agree to the provision, especially in circumstances of unequal resources such as franchise or employment disputes.)
  - ✓ **Information Exchange:** Shall initial notice of a dispute be accompanied by documents and information sufficient to advise the receiving party of the facts giving rise to the claim? Shall the factual basis of defenses be promptly exchanged as well? In arbitration, shall costly discovery processes, such as electronic communications, interrogatories and depositions, be limited?
  - ✓ **Privilege and Confidentiality:** Are the various ADR processes to remain confidential? Are statements and information exchanged in the course of settlement discussions inadmissible in a subsequent proceeding?
  - ✓ **Conditions Precedent:** Must negotiations take place prior to mediation, and must mediation take place prior to arbitration or litigation? Any exceptions?
  - ✓ **Tolling:** Shall the statute of limitations be tolled during the course of the consensual ADR stages?
  - ✓ **Provisional and Interim Relief:** May the parties seek immediate provisional relief from a court or an arbitrator? If so, with respect to what relief, and to what end?
  - ✓ **Continuing Performance and Right of Termination:** Are the parties to continue to perform during the pendency of the dispute? Do the ADR provisions erode any party's termination rights?
  - ✓ **Selection of the Neutral:** Shall the mediator or arbitrator be selected pursuant to institutional rules, or do the parties wish to delineate criteria to guide the selection (i.e., XX years in private practice, former government official, YY years in procurement, etc.)? If the parties choose to control the selection of the neutral themselves, how shall that selection process be structured?

- ✓ **Awards, Costs and Fees:** How shall the costs of the mediation be allocated? Is an arbitral tribunal free to make any award it wishes or shall its powers be bounded in some way? May punitive or consequential damages be awarded? May the tribunal award attorney fees to the prevailing party?
- ✓ **Form of Award:** Shall the arbitral award be reasoned (written)? Shall the tribunal be required to issue its award within a specified period of time after close of the hearing?
- ✓ **Customized ADR Processes and Other Issues:** Parties may wish to create an ADR process that suits their precise needs. For example, shall they jointly engage a neutral expert to opine on technological or other issues in dispute? Shall the arbitrator offer to mediate the matter after drafting the award but before issuing it? Shall the arbitration take place in a specified language and, if so, who pays for the translation? What law shall govern (a) the substance of the contract, (b) the arbitration process, and (c) the enforcement of the arbitration award?

Obviously, it would be burdensome to include all of these considerations in the dispute management clause of an ordinary agreement. However, in matters of great concern or significance to the parties, it is useful to refer to the “checklist” above in order to be assured that the drafters have done their best to preserve that value of the deal for their respective clients.

### **Model Clauses and Other Resources**

The best single volume on ADR contract drafting is *Drafting Dispute Resolution Clauses*, by Kathleen M. Scanlon (Helena Tavares Erickson, ed.) (see <http://cpradr.org/CPRStore/tabid/67/CategoryID/4/List/1/Level/1/ProductID/4/Default.aspx>). In addition to a trenchant analysis and series of useful guides, the book contains a compendium of actual dispute resolution clauses used by leading global companies, including clauses used in cross-border deals.

The American Arbitration Association offers an excellent online publication, *Drafting Dispute Resolution Clauses* (<http://adr.org/si.asp?id=4125>) which provides a

host of model clauses for general commercial use as well as for industry-specific application.

Several prominent ADR organizations have promulgated model clauses for inclusion in commercial contracts. For example, the ICC suggests the following arbitration clause for cross-border contracts:

All disputes arising out of or in connection with the present contract shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules.

CPR Institute provides a host of model contract clauses for various settings, but suggests this as a standard clause for mediation:

If the dispute has not been resolved by negotiation as provided herein within [45] days after delivery of the initial notice of negotiation, [or if the parties failed to meet within [30] days after delivery], the parties shall endeavor to settle the dispute by mediation under the CPR Mediation Procedure [then currently in effect OR in effect on the date of this Agreement], [provided, however, that if one party fails to participate in the negotiation as provided herein, the other party can initiate mediation prior to the expiration of the [45] days.] Unless otherwise agreed, the parties will select a mediator from the CPR Panels of Distinguished Neutrals.

...and this standard clause for arbitration:

Any dispute arising out of or relating to this [Agreement] [Contract], including the breach, termination or validity thereof, which has not been resolved by mediation as provided herein [within [45] days after initiation of the mediation procedure] [within [30] days after appointment of a mediator], shall be finally resolved by arbitration in accordance with the CPR Rules for Non-Administered Arbitration [then currently in effect OR in effect on the date of this Agreement], by [a sole arbitrator] [three independent and impartial arbitrators, of whom each party shall designate one] [three arbitrators of whom each party shall appoint one in accordance with the 'screened' appointment procedure provided in Rule 5.4] [three independent and impartial arbitrators, none of whom shall be appointed by either party]; [provided, however, that if one party fails to participate in either the negotiation or mediation as agreed herein, the other party can commence arbitration prior to the expiration of the time periods set forth above.] The arbitration shall be governed by the Federal Arbitration Act, 9

U.S.C. §§1 et seq., and judgment upon the award rendered by the arbitrator(s) may be entered by any court having jurisdiction thereof. The place of arbitration shall be [city, state].

CPR also offers a very well-drafted and detailed model “tiered” ADR provision (contemplating negotiation-mediation-arbitration) on its web site at

<http://cpradr.org/ClausesRules/ModelMasterArbitration/tabid/160/Default.aspx>.

A sophisticated drafter may wish to supplement these models with some of the considerations mentioned above, but they do satisfy many fundamental concerns.

### **Conclusion**

From a managerial perspective, commercial contract disputes are unidentifiable but anticipatable contingencies. They are best viewed not as affronts or interruptions, but rather as predictable events that, if handled skillfully, will yield improvements in a contractual relationship that has proved flawed.

Business disputes can be managed, and their risk controlled, just as other business contingencies can be managed: through foresight, attention and sophisticated techniques of negotiation and risk allocation.