Is Arbitration Effective in Construction Contracts?

Ideal arbitration scenarios:

In many circumstances, arbitration is fantastic and does exactly what it purports to do - make better resolutions quicker and cheaper. For example, consider the following illustrations:

In a dispute between a seller and a buyer of widgets over the quality of widgets, the parties send for an expert in widget quality. The expert arrives a short period of time later and resoles the dispute. The expert is asked to decide because she is an expert in widget quality and is a part of the industry in which both buyer and seller are members. The parties may not be happy about the decision, but likely let it end the dispute.

Another setting for effective arbitration is an issue contained in a collective bargaining agreement. The union will present a grievance of a worker who may claim, for example, that she was wrongfully terminated. The grievance cannot be resolved by the union and employer, so they they call for the permanent arbitrator. The arbitrator is someone who has been previously designated as the decider of these disputes in the collective bargaining agreement. The arbitrator is likely someone who is respected in the industry and who is aware of the needs of the employer and understands the reasonable expectations of the workers. The arbitrator comes to the plan, hears each side's witnesses, and makes a decision that day or within a few days. The arbitrator's decision is followed by both parties.

In both examples, arbitration is terrific because it is quick and inexpensive - likely because the disputes are not exceedingly complex. The parties accept the decision even if they are not happy with it; no one goes to court. Unfortunately, construction disputes do not fall into similar patterns.

Arbitration in the context of construction disputes:

There are so many variables, industries, and issues in the construction industry that it is difficult to designate one expert for everything ahead of time. For example, disputes may involve simple technical matters, or some may require special testing. Other issues may deal with contractual matters. There may be quality control issues. And, of course, there are payment/reimbursement issues.

Some specific considerations:

1(a). If the job is now over, then questions arise dealing with transactions dating back several years. There could have been intervening conferences and/or settlements, and certainly the parties communicated with each other - perhaps modifying agreements. If it was a large project, there could be substantial amounts of documents to be researched and cataloged. And discovery (the production of documents and other evidence) has not traditionally been compelled, though that appears to be changing recently.

1 (b). If the project is current and ongoing, disputes need to be resolved quickly to keep things running. The correctness of the decision is less important to the project as a whole than simply getting a decision and moving on. Generally, that is why the American Institute of Architects ("AIA") contract documents allow for the architect (or other) to be the Independent Decision Maker ("IDM"). The unhappy party (or parties) generally reserves its rights and seeks arbitration or litigation once the project is completed. [Ed.'s note: This approach is a band-aid. It's not bad, and it fills a need. But it postpones (and likely prolongs) the process. We have a better approach, which we will detail in Part 3 of this series.]

2. There are several separate entities involved in construction. Usually, one thinks of the traditional triangle of construction as owner-architect-contractor. However, there are usually many, many more involved, especially if it is a larger project. Subcontractors, materialmen, other suppliers, sureties, and multiple insurers are often involved.

3. Some construction projects may involve goods, services, or materials from multiple states, which may rise to interstate commerce. This is largely a significant legal designation because it indicates that such disputes may fall under *either* state or the federal arbitration statutes. What that means is that the award may be reviewable in either state or federal court, which may incentivise post-arbitration trips to the courthouse - which is what arbitration is designed to avoid in the first place!

4. The parties often choose an arbitrator or select from names provided by an outside organization such as the American Arbitration Association ("AAA"). In AAA proceedings, each party selects three names, the opposing party chooses three names, and the AAA eventually decides for each party who will be the arbitrator. In theory, arbitrators generally are chosen because they are fair-minded and have specific expertise in the subject of the dispute. The thinking is that these expert-arbitrators would need less education about the technical matters than would a judge or jury. Theory and practice, however, often are not the same. The arbitrators on the list provided may not really have technical knowledge of the specific subject. Further, as mentioned above, an expert in one field or area may not necessarily have the correct experience in all of the multiple areas in which construction disputes arise.

5. Finally, arbitration (and all ADR) works best when the parties have a continuing relationship and have reason to make arbitration work. If the parties are going to work together again, for example, each has incentive to be fair and reasonable. Construction companies do not usually have this incentive to make arbitration work.

Arbitration is becoming more like traditional litigation:

Unfortunately, arbitration (in general) is becoming more like traditional litigation and less like the transformative, faster-better-cheaper dispute resolution mechanism it is intended to be. There resolutions achieved may be fair but the possibility of saving the parties time and money are diminished. The main reason for this is because attorneys for both parties attempt to utilize some of the more time and cost-intensive techniques of litigation. For example, they will often introduce numerous exhibits, question witnesses over and over about the same subject, asking leading questions, and making "for-the-record" objections.

It is nearly impossible to compare the time and expense of arbitration with the duration and cost of litigation because the same dispute never goes through both processes. We can only guess what it might cost to either litigate or arbitration a particular construction dispute. It seems clear, however, that importing litigation techniques into arbitration is costly and takes time.

These changes require one to ask, "If the justification for incorporating an arbitration clause in a construction contract is to obtain a speedier resolution at less cost, why are so many lawyers trying to transform the arbitration process into litigation?"

The answer is a complex one. A number of commenters, most prominently Justin and Jonathan J. Sweet, feel that arbitration in construction contexts largely because of the arbitration clauses (which were mandatory until 2007) contained in AIA contracts.*

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* Sweet, Justin and Sweet, Jonathan J., "Sweet on Construction Industry Contracts: Major AIA Documents."Aspen Law & Business, New York, NY, 1999.

So should you insert an arbitration clause into your contracts?

Here is where we give the ubiquitous attorney answer: "It depends."

It depends on the parties, the likely disputes, the size of the project, the arbitrator chosen, and on a number of other factors.

What we will say is this: if done properly, arbitration can be very successful and efficient as a way to deal with the disputes that inevitably come in the construction industry. But it is not the great panacea for all disputes that some make it out to be.

The truth is that, for a large number of disputes, standard arbitration clauses are not going to result in quicker or cheaper outcomes. We believe that the results will be fair due to the general good work that arbitrators perform. But companies and individuals who enter contracts with standard arbitration clauses shouldn't think they are agreeing to a faster and cheaper dispute resolution system.

In another paper, we'll detail specific ways to tweak arbitration clauses that will ensure quick and timely resolutions. We believe that arbitration, as an idea, remains viable. We just have to do a better job of articulating how it will be applied to the specific problems that arise.

ConstructLaw, L.L.C. provides contract reviews, and drafts construction contract supplements concerning arbitration and other issues in Louisiana. We also provide fact-finding and dispute resolution services. If you have specific questions or needs, feel free to contact us at any of our myriad communication mediums (email: alan@myconstructlaw.com; phone: 318.841.1253; facebook: http://bit.ly/d0ef7o; twitter: www.twitter.com/myconstructlaw; via our website: www.myconstructlaw.com; or our blog at www.louisianaconstructionlaw.blogspot.com).