Drafting ADR Clauses for IT Contracts

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Drafting effective dispute resolution clauses is a challenge for technology lawyers. Clients are not really interested in this part of the contract. To them it is just part of the "boilerplate", potentially important but rarely read. Even more rarely understood or appreciated.

Most lawyers consider themselves lucky to get clear instructions from a client on whether to include an arbitration clause or not. As for what the clause should say, that's the lawyer's job. We'll never need to use it anyway…

If, after considering the pros and cons of mediation and/or arbitration over litigation, parties decide on an ADR clause, they must pay attention to drafting a clause that reflects their intent. A good dispute resolution clause can mean the difference between an effective settlement and long, expensive process. And the dispute resolution clause should not start or stop with arbitration. In most information technology contracts, dispute avoidance is as important as dispute resolution.

We strongly endorse an escalation approach to dispute resolution. This is a familiar concept to technology clients, who use a similar escalation process to diagnose and fix technology problems. They can readily appreciate the benefits of the same approach to legal problems.

But beware of escalation processes that are too long or complicated. No one will want to follow them. But they may be forced to do so to get to the next step.

If the parties have gone through their internal escalation process and are still at an impasse, we believe that the next step should be mediation – or a less formal facilitated negotiation. "Facilitated negotiation" appeals to many clients because it seems less legalistic than mediation. The facilitator will use many of the same techniques as a mediator, but it somehow seems more acceptable to use this approach earlier in the process, before the parties have commenced a formal dispute.

Finally, if all of the escalation and mediation steps have failed, the clause will generally provide for arbitration rather than litigation. And there are many flavours of arbitration, so it is worth considering whether its necessary to customize the default rules that would otherwise apply.

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Some initial drafting tips and traps:

- keep any multi-tier escalation clause short and simple

- remove all references to "reasonable endeavours" and "good faith negotiations"

Don't say:

> "In the event of a dispute, the parties shall use all reasonable efforts to amicably resolve the dispute through good faith negotiations. If the dispute is not so resolved, then…"

What does this mean? What does it require the parties actually do? By what standard is compliance to be measured? How long must the negotiations go on? Can you enforce it?

There is a temptation to add such "feel good" wording to ADR clauses. They often add nothing to the process and can cause serious problems. For example, there are many cases where one party has sought to delay the ADR process by seeking to argue that the parties have not yet engaged in "good faith" negotiations.

1.   Escalation

The first step in the escalation process should be the senior managers who have day to day responsibility for the contract, project or relationship. They have a vested interest in resolving a dispute and in avoiding escalating it to their managers or senior executives.

There should be a very short deadline before it is escalated. This will focus the operational staff on finding a solution to avoid escalation. They can always extend the time, if they are making progress. But if they can't resolve the problem, it should not be allowed to fester.

The responsible executives should be identified in the contract. The time periods for each step of the process should be spelled out. One week may be too short; a month is usually too long.

In larger, more complex contracts, there may be multiple levels of escalation, to give the parties several opportunities to fix things. Avoid too many levels. Two steps (e.g. project manager and senior executive) is often enough. Experience shows that positions can simply harden as an issue winds its way through any organizational bureaucracy.

Escalation to the executive ranks should be done formally, through a joint statement of the issues and positions. Ad hoc escalation can also harden positions and exacerbate the problem. Each executive only hears one side of the story. A joint statement can often point the way to possible resolution.

In most cases, kick the matter up to the most senior executives who can reasonably be expected to get involved in the matter. Let them make a business decision. They can delegate the implementation to the project managers.

2.   Mediation

Many people question whether contracts should include mandatory mediation at all. They argue that, parties can always choose to mediate, if it makes sense at the time, but they shouldn't be forced to do it. We argue that mediation can act as a useful "circuit breaker" to prevent escalation and encourage settlement of a dispute. Experience shows that parties will use mediation if it's in the contract; if it's not, they will go straight to arbitration or litigation.

However, because the resolution of a dispute by mediation requires mutual consent, it shouldn't be the only form of dispute resolution in an IT contract. There must be a further step, such as arbitration, if there is no settlement.

If you do include a mediation clause, it must be sufficiently certain to be enforceable. It must address the mediation process and in particular, how the mediator is to be appointed – usually by mutual agreement. The clause should also address what happens if the parties cannot agree on a mediator.

One option is to simply bypass mediation, if the parties cannot agree. But this defeats the purpose of having a mandatory mediation step. Another option is to specify that the mediator is to be appointed by a named institution, such as the ADR Institute of Ontario. The goal is to at least get a mediator appointed and let him or her see if they can get the parties talking in a meaningful way.

It can also be helpful to adopt a set of mediation rules such as the Mediation Rules of the ADR Institute of Canada, Inc.

Section I of the National Mediation Rules provides a Model Dispute Resolution Clause for Mediation.

> All disputes arising out of or in connection with this agreement, or in respect of any legal relationship associated with or derived from this agreement, shall be mediated pursuant to the National Mediation Rules of the ADR Institute of Canada, Inc. The place of mediation shall be [specify City and Province of Canada]. The language of the mediation shall be English or French [specify language]. [2]

Section II provides a Model Dispute Resolution Clause – Mediation and Arbitration.

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[2] http://adric.ca/pdf/ADRMEDIATIONRULES2014.pdf

All disputes arising out of or in connection with this agreement, or in respect of any legal relationship associated with or derived from this agreement, shall first be mediated pursuant to the National Mediation Rules of the ADR Institute of Canada, Inc. Despite this agreement to mediate, a party may apply to a court of competent jurisdiction or other competent authority for interim measures of protection at any time. All disputes remaining unsettled after mediation shall be arbitrated and finally resolved pursuant to the National Arbitration Rules of the ADR Institute of Canada, Inc. [the Simplified Arbitration Rules of the ADR Institute of Canada, Inc.]. The place of mediation and arbitration shall be [specify City and Province of Canada]. The language of the mediation and arbitration shall be English or French [specify language].

One serious flaw in many combination mediation/arbitration clauses is the failure of the parties to put a time limit on the duration of the mediation process. Without time limits built-in, a party could attempt to frustrate the process by maintaining that the arbitration process cannot start until after the mediation is complete and that the mediation process had not yet run its course. We suggest adding a time limitation to all such clauses including the ADRIC example above to avoid this problem. [3]

With this type of provision, it is very likely that courts in Ontario will insist that you at least attempt mediation before arbitrating.[4]

3.   Arbitration

When negotiating the arbitration clause in an IT agreement, it is useful to understand the differences among the most commonly-used sets of rules. One of the main advantages of arbitration is the ability to adapt the procedural rules to meet the needs of the parties and their contract. One cannot do that effectively unless one knows what each set of rules does and does not allow.

There are several online resources comparing some of the pros and cons of various international arbitration rules, including the model arbitration clauses and rules of the American Arbitration Association (AAA), International Chamber of Commerce (ICC), United Nations Commission on International Trade Law (UNCITRAL), and the World Intellectual Property Organization (WIPO).[5]

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[3] For other examples of mediation and arbitration clauses see:
WIPO Model Clause at http://www.wipo.int/amc/en/arbitration/contract-clauses/index.html
ICC Model Clause at https://iccwbo.org/dispute-resolution-services/arbitration/arbitration-clause/
LCIA Model Clause at http://www.lcia.org/Dispute_Resolution_Services/LCIA_Recommended_Clauses.aspx

[4] See for example: Lougheed v. Garden City Entrepreneurs Inc., [2008] O.J. No. 833 (S.C.J.).

[5] See for example,2015 comparison chart prepared by Baker Hostetler at
https://www.bakerlaw.com/files/uploads/Documents/Events/2015/Litigation/Updated-Arbitration-Rules-Comparison.pdf
See also Nachtraub, Kevin, "Drafting Dispute Resolution Clauses: Options and Common Pitfalls", Les Nouvelles, Vol. XLVIII, No. 1, March 2008, page 65.
But be careful, as specific rules may have changed, since the comparison was made.

When drafting an arbitration clause in a domestic contract, one cannot simply refer to the provincial *Arbitration Act* (or, for international contracts, the *International Commercial Arbitration Act)* and leave it at that.

These statutes provide a basic framework for arbitration, but they do not provide an administrative process – all arbitrations are ad hoc – or detailed procedural rules, so they leave much to the agreement of the parties or the determination of the arbitrator.

For commercial agreements, parties might consider the Arbitration Rules of the ADR Institute of Canada, referred to above.[6] These rules have recently been updated with attention to the arbitration statutes of each of the provinces, and provide an efficient and flexible framework for most commercial arbitrations. They also provide an efficient process for urgent interim relief, if needed.

The Simplified Arbitration Procedure, with shorter time lines and expedited procedures, should also be considered in appropriate cases, such as billing disputes or issues relating to change orders.

Regardless of the applicable law and procedural rules the parties select, to be effective, the arbitration clause must:

- *Define the scope of the arbitration* – what issues can be arbitrated and, most importantly, what cannot? We suggest that careful thought be given before excluding matters from arbitration. Is there a risk that this will result in multiple proceedings? Is that what the parties want?

- *Provide for the selection of impartial and neutral arbitrators* – how many will there be? What skills or qualifications will the arbitrator require? We suggest a single arbitrator, unless the matter is particularly complex or there is an enormous amount of money at stake. Three arbitrators simply cost more. The proceedings are more complex. Scheduling meetings and hearings is more difficult. But recognize that under many rules the default is three arbitrators, unless the parties expressly require a single arbitrator.

- *Establish any special rules* – Most arbitration statutes and procedural rules allow the parties to decide such things as the scope of discovery, exchange of documentary evidence, time and procedure for hearings, time for rendering a decision. Under most rules, the arbitrator determines those things, if the parties have not otherwise agreed. So the parties must turn their minds to the

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[6] http://adric.ca/arbrules/

applicable arbitration rules and rules of civil procedures and decide whether they want to make any changes. E-discovery is a particularly difficult problem in IT contract disputes, since IT projects tend to generate an enormous number of documents. Most arbitration rules limit discovery or leave the scope of discovery in the hands of the arbitrator.

- *Determine the arbitrator's powers* – Do the rules require the parties to expressly grant or withhold the power of the arbitrator to grant appropriate relief? Does the arbitrator have the power to grant an interim injunction, a permanent injunction, order specific performance, award specific kinds of damages? All of these must be considered in the context of the chosen rules.

- *Consider whether the arbitration decision is final* – In most cases the arbitrator's award is final and binding, but that is not necessarily the case. Some arbitration statutes allow appeals on questions of law, or mixed fact and law, either as of right or with leave of the court. The arbitration clause may also provide for general or specific rights of appeal. The appeal may be to a court of law, or it may be to a second arbitration panel.

- *Provide means for enforcing the arbitration award* – The parties should ensure that the award can be entered and enforced by the courts of each jurisdiction where such enforcement may be needed.

Avoid these common drafting mistakes:
- Permissive vs. mandatory wording (words such as "may" vs. "shall")
- Ambiguous conditions precedent – or obligations that may be read as such
- Reference to non-existent institutions or rules
- Unworkable time limits or procedural limitations
- Failure to include all necessary parties; specifying the wrong party
- Failure to specify place, language or substantive law for international arbitration
- Provisions that are contrary to the substantive law or procedural rules specified (most laws and rules allow parties to agree on arbitration terms, but some rules cannot be waived)

4.   Hybrid Processes

Parties may also want to consider hybrid ADR processes that go beyond the basic steps described above. These include such things as "final offer selection," "med-arb" and project umpires. Other options include expedited arbitration and early neutral evaluation.

With final offer arbitration, also widely known as "baseball arbitration," the arbitrator is limited to choosing one of two options tabled by the parties. The theory is that by

limiting the choices, the arbitrator can't simply "split the baby" and the parties are forced to take positions and table offers that are more reasonable than they might otherwise. If the parties want to use this approach in their agreement – or for a specific dispute that arises – they must define the arbitrator's mandate in their agreement.

"Med-arb" is a process where the same neutral acts as both mediator and arbitrator. Advantages include cost and time. The parties benefit if the dispute is settled in mediation, or if some issues are resolved, reducing the scope of the arbitration phase. And there's no need to bring a new person up to speed on the details of the case, if it proceeds to arbitration. But there are also risks, if there is no mediated settlement and it goes to arbitration. The two biggest are impartiality and confidentiality.

- *Impartiality* – The neutral or the parties may say something during mediation which raises questions of bias if the case goes to arbitration. The mediator has to be careful not to offer opinions on the merits of the case or say anything that makes it appear that they have prejudged it. This makes it harder for the mediator to play any kind of evaluative role.

- *Confidentiality* – In standard mediation practice, a party may give information to the neutral in private. This is a problem, if the mediator is going to act as arbitrator. Must all information be disclosed to the other party? Can the mediator/arbitrator use it in making the final decision? And what if someone intentionally discloses confidential or privileged information, then seeks to disqualify the mediator from continuing to act because they know too much?

The med-arb agreement and procedural rules must be very carefully thought out to avoid these potential traps. One approach is to agree up front that <u>nothing</u> parties say to the mediator will be held in confidence. All information will be disclosed to the other side, and may be used in a later arbitration phase, if relevant. And neither party may seek to disqualify the neutral from acting as arbitrator on the basis of anything <u>they</u> have disclosed to the mediator. Of course, the mediator/arbitrator can always step down, if he or she believes impartiality or fairness has been compromised during the mediation phase. Better to withdraw, perhaps, than to proceed over the serious objections of a reluctant party and risk having an award thrown out later.

The project umpire model is based on the dispute resolution board (DRB), which has been used in the construction industry for more than 30 years. DRBs usually have three members, due to the size and technical complexity of large construction projects. Smaller projects can achieve the same result with a single umpire.[7]

The umpire is appointed at the beginning of the project and is available, as needed, for the duration of the project. The umpire is given all of the contract documents, briefed

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[7] For more information on DRBs, see www.drb.org.

on the project at a kick-off meeting, and receives regular progress reports. He or she is briefed on potential disputes as soon as they arise. Some disputes may be resolved by an informal discussion between the umpire and the parties, with the umpire acting as a facilitator or mediator. If there is no resolution, the umpire will adjudicate the dispute and render a decision. Usually, there is an informal hearing and written submissions. Each party has the opportunity to present its position and any relevant information and documents. The other party has an opportunity to respond. The umpire can ask questions and seek additional information. The intent is to determine the facts as expeditiously as possible.

The umpire's decision can take a number of forms, depending on what the parties have agreed. It may simply be a neutral evaluation of each side's position. It may a non-binding recommendation or a binding arbitration decision (with or without a right of appeal). Whether binding or not, the umpire's determination usually resolves the dispute because it is both informed and impartial. (Experience in the construction industry shows very few decisions are challenged.)

The cost for a project umpire is usually built into the project cost or shared equally by the parties. It is a fraction of the cost of other forms of dispute resolution.

Some of these options should be considered up front, when an agreement is being negotiated. For example, engaging a project umpire will require negotiation and drafting the terms of the umpire's mandate and terms of reference as part of the overall governance and project management process.

Others may be considered when a dispute actually arises. For example, a pricing dispute may be referred to expedited arbitration or a final offer selection process to minimize the impact on the rest of the project.

It is necessary to draft ADR clauses that actually do what we intend! If parties don't take care in drafting the ADR clause, the result may actually be a dispute resolution procedure that is worse than litigation. So drafters should take at least as much care with the ADR clause as any other provision in an agreement.

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