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A Business Law Update

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Arbitration of Business Ownership Disputes: Great in Theory, Not Always So in Practice

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Business partners and co-owners aren't always going to see eye-to-eye. While they may share the same goals and interests in the broadest sense – building and sustaining a successful company – everything under that umbrella is subject to debate, disagreement, and dispute. Even the strongest bonds between co-owners won't necessarily prevent conflicts. Just like partners in an enduring marriage will inevitably fight from time to time, business partners are almost destined to come to loggerheads eventually.

Given the likelihood of disputes between co-owners, having a plan to resolve conflicts is in the best interests of all parties. That is why many businesses include dispute resolution mechanisms in their operating agreements or bylaws. Without an agreed-upon way to resolve intractable or existential ownership disputes, the parties will likely wind up in court, embroiled in expensive, time-consuming, and disruptive litigation.

Most business owners understand they should avoid litigation whenever possible. But when they can't come to a resolution on their own, having a neutral third party do it for them may be the only way to bring hostilities to an end and salvage both the business and the business relationship. This can be accomplished either in court, with a judge as the neutral third party, or by arbitration, with one arbitrator or perhaps a panel of three arbitrators acting as the neutral third party. Because the potential cost and delay of litigation is widely known, many business owners turn to an arbitrator rather than a judge to resolve matters.

Arbitration offers many advantages in business ownership disputes but is not without potential downsides if proper planning is not performed before a dispute arises. Before including an arbitration provision in your governing documents or agreeing to arbitration to resolve a pending dispute, here is what you need to know.

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What Is Arbitration?

In arbitration, the parties select a third-party neutral to hear testimony and review evidence and make a decision. The parties may agree to conduct discovery or file motions to narrow the issues in dispute before the hearing. The rules of procedure and evidence are typically more relaxed than in litigation.

Arbitration can be either binding or non-binding. In binding arbitration, the parties agree to abide by the arbitrator's decision as if it was a judge's ruling. In contrast, in non-binding arbitration, a party may reject the arbitrator's findings. Consequently, non-binding arbitration is not necessarily going to resolve the parties' dispute.

Why You Should Choose Arbitration Over Litigation – And Why You Shouldn't

As alluded to above, arbitration and litigation share many characteristics. So what makes arbitration an attractive alternative to fighting things out in a courtroom, and what potential downsides lurk behind that attractiveness?

Control

Civil lawsuits are governed by strict rules of procedure and evidence, as well as the judge's pre-trial rulings, which the parties must follow whether they like them or not. In an arbitration agreement, the parties themselves have the power to set the terms of engagement. For example, a party in litigation could conceivably take countless depositions and engage in expansive discovery that can take months or years and cost tens of thousands of dollars. In arbitration, the parties can agree to limits on discovery, such as a maximum number of depositions and a time to complete them. There are sets of standardized rules that the parties can choose to adopt and incorporate into their agreement to arbitrate.

The parties can also agree to be bound by the arbitrator's decision, thus cutting off any avenues for appeal and bringing finality to the process.

But as appealing as these limits may be in the abstract, they may ultimately put one party at a significant disadvantage when matters come to a head. Discovery limits may prevent a party from getting the information and evidence they need to support, defend, or advance their position. And by agreeing to binding arbitration, the losing or disappointed party gives up their ability to challenge the decision and obtain a different outcome.

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Speed

Litigation can drag on for years due to protracted discovery and motion practice or crowded court dockets that simply can't facilitate timely trials. In an arbitration agreement, the parties can agree that a final hearing must commence within a set period, such as 60 or 90 days from the date of the first scheduling conference with the arbitrator. A limit can also be set for the duration of the final hearing itself.

Cost

The parties' control over the arbitration process *can* manifest in far lower costs than protracted litigation. By limiting discovery and other aspects of the process, the parties can keep legal fees from spiraling out of control, as often happens in litigation when both sides engage in trench warfare without any end in sight. Of course, if the parties give themselves the same wide berth in arbitration as they would in a lawsuit, any potential cost savings are wholly illusory. And of course, the limitations in the arbitration agreement are only as good as the arbitrator's willingness to strictly enforce them.

Confidentiality

Feuding owners are not a good look for any company, especially in the eyes of investors, other shareholders, customers, and suppliers. Since court proceedings are public records except in rare circumstances, all of those folks – as well as the media - will be able to see the ugly details of the dispute. If the parties would rather not air their dirty laundry publicly, they can include a confidentiality provision in their arbitration agreement.

Sometimes, however, the threat of bad publicity for a party or the company can give the other party leverage they lose if they agree to confidential arbitration. This is another example of how arbitration can be more appealing in the abstract than in practice.

Make an Informed Choice

As explained above, arbitration can have certain advantages for businesses who want to control the process by which disputes arising out of their agreements are adjudicated. Arbitration can be cost-effective, efficient, confidential, and final. But, it can also result in a war that is just as expensive and lengthy as litigation, and in some instances, much more so. For that reason, the decision as to whether to include an arbitration clause in an agreement should be approached with caution, with due care being given to issues such as: applicable rules, limits on discovery and the duration of the proceedings, and choice of arbitrator(s).

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If you have questions or concerns about arbitration or how to address disputes between business owners, please contact your Bodman attorney or one of the authors, Jill M. Miller and Michelle Thurber Czapski. Bodman cannot respond to your questions or receive information from you without first clearing potential conflicts with other clients. Thank you for your patience and understanding.

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