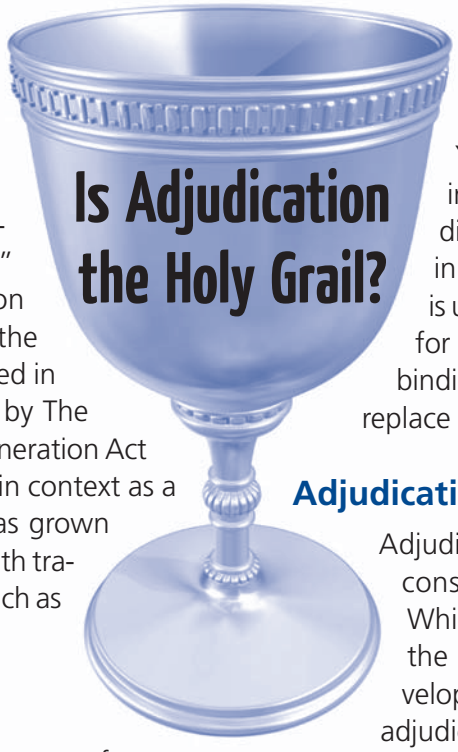
Is Adjudication the Holy Grail?



By PROFESSOR DOUG JONES, AM

This article seeks to build upon a contribution by Harvey J. Kirsh Esq. in the Fall 2008 issue of JAMS Global Construction Solutions entitled "Adjudication" as a Method of Resolving Construction Disputes. In that article, Kirsh details the statutory adjudication process introduced in the United Kingdom in the mid 1990s by The Housing Grants, Construction and Regeneration Act 1996. Here, we will place adjudication in context as a method of resolving disputes which has grown and developed out of a dissatisfaction with traditional methods of dispute resolution such as litigation and, increasingly, arbitration.

The evolution of adjudication

The rise of adjudication can be seen as part of an evolutionary process. It has not burst onto the scene unannounced, but has its roots in various practices which have been around for many years.

Expert determination, also known as contractual adjudication, is a relatively recent development in the ongoing quest by commercial parties for faster, cheaper and more efficient dispute resolution.

Most will be familiar with the way that arbitration developed as a reaction to the excessive cost and delay associated with litigation. However, with its establishment came an increasing tendency to mimic court procedure, so that arbitration ceased to be perceived as a cheaper, more efficient alternative to litigation.

In reaction to this, expert determination has developed. It entails submitting a dispute to an independent third party for determination outside the auspices of arbitration legislation. In one respect, it was not a new idea, because for a great many years commercial parties had been agreeing to submit issues to third parties for determination. However, these had traditionally been narrow in scope, typically involving the third party only in a process of valuation (of real estate or shares, for example). The novel aspect was to submit entire disputes rather than narrowly defined issues of that kind.

In some cases, the adjudication was set up as a precursor to arbitration, while in other cases the adjudication was meant as a final dispute resolution procedure instead of arbitration or litigation. The FIDIC standard forms are an example of the former approach. FIDIC's Red, Yellow and Silver Books incorporate an independent and impartial Dispute Adjudication Board (DAB), made up of experts in their respective fields. Here, adjudication is used as a contractually agreed mechanism for "on the run" dispute resolution, which is binding in the interim but does not necessarily replace final arbitration or litigation.

Adjudication now a core technique

Adjudication, in its various forms, has taken construction dispute resolution by storm. While there is no hard statistical evidence of the increased use of adjudication, the development by institutions of formal rules for adjudication is a good indication of its growth and popularity. Indeed, adjudication is becoming a core dispute resolution technique at both domestic and international levels.

If adjudication could be shown to have distinct benefits over arbitration then this could go some way in explaining its increased use in the place of arbitration. Accordingly, what follows is a comparison of these methods of dispute resolution, with the objective of identifying some central procedural and substantive differences.

Expert determination is predominantly criticized on the basis of enforcement issues. It is suggested that parties cannot confidently predict that their "final and binding" expert determination agreement will be enforced in the face of court proceedings commenced in respect of its subject matter. Essentially, the substantive obstacle to enforcement of such an agreement is the courts' lack of statutory basis for staying concurrent court proceedings to allow the unfettered operation of the expert determination procedure. In contrast, the court does have the statutory power to stay its proceedings in favor of arbitration. However, the tendency of courts to give weight to the freedom of parties to contract has meant generally that courts have restrained from interfering with expert determination agreements unless the expert has acted outside his or her terms of reference as set out in the contract.

See "Holy Grail" on Page 10

Holy Grail

Continued from Page 9

While parties to an arbitration may rely on assistance from the courts, pursuant to arbitration legislation, in the event of procedural difficulties, parties to an expert determination do not have such support. If the expert determination process breaks down because, for example, the parties cannot decide upon the appointment of an expert, or if the agreement between the parties is incomplete as to a procedure necessary for the expert determination to be effective, then the agreement to use expert determination may be unenforceable and therefore void. In an effort to avoid these difficulties, parties usually incorporate into the expert determination agreement a set of standard rules promulgated by a professional body.

There is no legislative basis upon which the expert determination itself may be enforced. Any avenue of enforcement of an expert determination is therefore dependant on the terms of the contract between the parties. For agreements with an international dimension, the purely contractual nature of expert determination presents particular difficulties as parties must rely on the various conventions, treaties and national laws governing the enforcement of foreign judgments. Launching such an action would incur considerable expense in terms of time and money. In this respect, arbitration would appear to have a distinct advantage over expert determination in light of the New York Convention, which is widely observed, simple and effective. The formalities require a party to simply produce to the relevant court the original or a certified copy of the arbitral award and the original arbitration agreement and the court will grant recognition and enforcement provided none of the grounds for refusal are satisfied.

Legislative redress

There have been attempts at the legislative level to redress the problems inherent in expert determination. Legislative support of adjudication goes some way to filling the lacuna in the general law and better allows adjudication to proceed and be enforced. However, while the statutes go some measure towards rectifying deficiencies in contractual expert determination, the statutory regimes themselves are not without problems.

Statutory adjudication

It was Lord Denning who said that cashflow is the "lifeblood" of the construction industry. However, it is well known to all that in the "chain of contracts" typically used to deliver a construction project, the arteries are frequently blocked. Contractors, and to a greater extent subcontractors and those further down the contractual chain, often face great difficulty in obtaining expeditious payment for the work they have carried out.

In Australia, England and many other jurisdictions, various pieces of legislation have been introduced in an effort to provide a measure of protection to contractors and subcontractors against such payment risk. In Australia, such legislation began with the relatively unsuccessful Contractors' Debts Act 1897 (NSW), with the recent introduction of statutory adjudication in several Australian states, under Security of Payment legislation, representing the latest legislative attempt of this kind.

In introducing its security of payment legislation, the Queensland Parliament noted that while earlier legislative measures improved subcontractors' chances of being paid, they did "not necessarily result in improved cash flow." Such legislation offered some protection to subcontractors against head contractor insolvency, but did not necessarily speed up the money getting to the subcontractor. All it did was to ensure that money was not dissipated by the contractor while any dispute was being resolved. In contrast, the new security of payment legislation focuses on trying to ease the contractor's difficulty in getting paid by providing a quick enforcement process in the form of adjudication. Because the matter being adjudicated upon is the subcontractor's right to progress payments, not final liabilities, any injustice done in the adjudication can theoretically be corrected in the determination of those final liabilities in arbitration or litigation. Arguably, all that really happens is that payment risk gets transferred to the upstream party until such time as the courts or arbitrators render a final determination. The interim nature of the process frees up the adjudicator from feeling the need to go into exhaustive detail to get the matter exactly correct.

This indeed represents a revolution in legislation designed to protect contractors and subcontractors.

Enforcement issues

The Australian Security of Payment legislation, like expert determination, suffers from difficulties with regard to enforcement. Recent amendments to the legislation have attempted to limit the number of ways in which an adjudication can be appealed, however, it is apparent that the courts continue to grapple with the interpretation of the legislation.

The NSW Court of Appeal decision in *Brodyn Pty Ltd t/as Time Cost* and *Quality v Davenport* (2004) has significantly narrowed the circumstances in which an adjudication may successfully be challenged. In this case, *Hodgson J* established essential pre-conditions required to prevent a successful challenge to an adjudicator's decision, including:

- The existence of a construction contract between the claimant and respondent, to which the legislation applies.
- The service by the claimant of a payment claim on the respondent.
- The making of an adjudication application by the claimant to an authorised nominating authority.
- The reference of the application to an eligible adjudicator, who accepts the application.
- The determination by the adjudicator of a valid application, by determining the amount of the progress payment, the date on which it becomes or became due and the rate of interest payable, and the issue of a determination in writing.
- A bona fide attempt by the adjudicator to exercise the power afforded to it under the legislation.
- The absence of a "substantial" denial of natural justice.

It should be noted, however, that several issues remain uncertain in respect of a challenge to an adjudication, such as the precise definition of "essential pre-condition", and the specific circumstances in which it will be held that natural justice has been denied or a bona fide attempt by the adjudicator to exercise its powers has not been made.

Given the difference, why adjudication?

It would seem then that the concept of adjudication, although a reaction to the cost and delay of arbitration, is in theory a poor substitute for arbitration as a means of resolving disputes in commercial contracts in a binding way. Adjudication suffers a number of drawbacks, significantly in relation to difficulties with enforcement. Regardless of these difficulties, parties are increasingly preferring adjudication, begging the question: why?

With regard to expert determination, the chief practice is to refer disputes to arbitration by default, that is, when expert determination has failed. This is achieved through a multi-tiered dispute resolution clause allowing adjudication to act as a filtering process for arbitration. With this filtering system only the complex disputes or those disputes requiring more extensive procedures, extra cost and time, will result in arbitration. This system produces a more efficient dispute resolution process, saving the parties both time and money by addressing more basic disputes at a lower level.

In addition, it is increasingly clear that some parties are opting for expert determination instead of arbitration, with time spent on careful drafting of the expert determination clause to ensure that disadvantages in using expert determination over arbitration can be minimized. In order to draft the expert determination clause effectively parties are having to include a mini-set of arbitral rules in their dispute resolution agreements. This means that parties are going to great lengths to develop sophisticated dispute clauses either to avoid using arbitration, or to take advantage of benefits offered by expert determination which arbitration cannot provide.

The two lines of thought are related. In recent years arbitration has achieved a reputation for being costly and time consuming. While some commentators have suggested that this reputation is unfounded, it is undoubtedly responsible, at least in part, for the increased use of expert determination. Expert determination on the other hand, has been praised for its speed and cost-effectiveness, two of the most desirable features of any dispute resolution process.

Another significant feature of expert determination is its informality. Expert determination is an abbreviated, flexible form of issue resolution. Unless otherwise agreed by the parties, there is no need for formal pleadings, discovery or witness statements. There is also no formal hearing, no cross-examination or oral submissions and the expert is given as much power as stipulated in the contract. The fact that expert determination is a creature of contract creates a real sense of control by the parties over the dispute process. This, coupled with a general dissatisfaction with the formal procedures of arbitration, is perhaps one reason why parties are adopting expert determination over arbitration despite such virtues of arbitration as expedited arbitration procedures and the wealth of legislative and curial assistance available to parties involved in arbitration.

Also related to the issue of informality is a perception that there is an increased opportunity to preserve relationships through expert determination than with litigation and arbitration. The perception is that because parties are in a non-confrontational, informal dispute,

See "Holy Grail" on Page 12

Holy Grail

Continued from Page 11

the parties are more likely to achieve a commercial rather than a legal settlement. In contrast, arbitration is perceived to be more like litigation which requires parties to take an adversarial stance.

In the case of statutory adjudication, it must be remembered that the legislation contemplates only an interim process. The regime is not designed to make irrevocable decisions concerning liability; that is still the job of arbitrators (or the courts). Rather, it transfers the payment risk to the owner until such time as a final decision is rendered by the arbitrator. Transferring payment risk from the contractor to the owner represents a policy decision aimed at ensuring that contractors and sub-contractors can continue to operate in the market without being burdened by the risk of insufficient capital or cash-flow. Only time will tell whether this policy choice is the correct one, and whether the transfer of money from owner to contractor results in a reduction in the number of large disputes that come before the Supreme Court by encouraging the parties to find a commercial solution to the dispute.

The use of statutory adjudication has dramatically increased in recent years, particularly in NSW with the number of adjudications increasing significantly in the year following amendments to the NSW Act. It is apparent that those in the industry are becoming more comfortable with its processes and less threatened by the strict time conditions and prospect of adjudication.

Statutory adjudication offers a fast, inexpensive and informal option for effectively resolving payment disputes and improving cash-flow. Importantly, there is no need for parties to characterise the payment claim as necessarily adversarial. It is simply a procedure, binding in the interim, for securing payment.

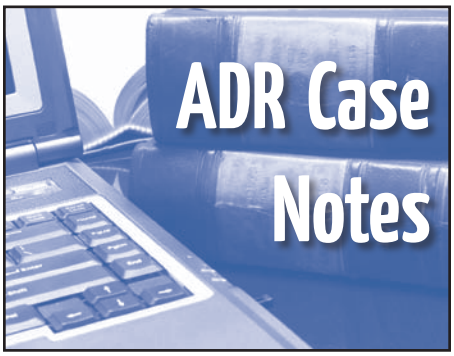
Conclusion

Overall, because there is no real statistical evidence to consider, it could be suggested that the favorable perception of adjudication is the result of literature promoting its use. Without research to quantify adjudication in terms of its effectiveness, it is difficult to displace these attitudes or assess whether they are justified. It is, however, suspected that the continued adherence to the process by government agencies with significant experience of it is not unconnected with some perceived commercial advantage arising from the process.

Even if it is near impossible to ascertain a practical reason for choosing adjudication over arbitration, it is clear that adjudication has struck a chord with business and government, especially in the construction industry. The arbitration process certainly still has a part to play in resolving commercial disputes, however in order to remain useful, it must develop.

Time may emphasize the ability of arbitration to be streamlined while maintaining its unique legislative underpinnings. However, until these improvements are achieved, adjudication represents the best opportunity to ensure an efficient, informal dispute resolution process. ■

Professor Jones is a leading arbitrator in the Asia-Pacific region with an office in Sydney, Australia and Chambers in London. More information is available at his website: http://www.dougjones.info.



The FAA's "Federal Question" Jurisdiction Trap in Compelling Arbitration: *Vaden v. Discover Bank*, 2009 WL 578636 (March 9. 2009).

The U.S. Supreme Court set a federal question jurisdiction "trap for the unwary" in a case involving a motion to compel arbitration under the Federal Arbitration Act. In *Vaden*, a federally regulated bank commenced suit to collect a $10,000 claim (a sum well below the $75,000 threshold required for federal diversity jurisdiction) in Maryland state court. The defendant debtor answered with a class-action counterclaim and an affirmative defense of usury. In reply, the bank alleged preemption of the debtor's allegations by federal banking law and moved to compel arbitration of those claims under the Federal Arbitration Act. Although both parties and the Court itself agreed that the invocation of federal banking law raised a "federal question" sufficient to establish federal court jurisdiction, the Court ruled in a 5-4 decision that it would look only to the bank's complaint and not to the bank's reply to determine whether a "federal question" was raised to invoke federal jurisdiction over a motion to compel arbitration under the FAA, and held that, because the bank's "garden-variety, state-law-based contract action" – as distinct from its reply to