

FINAL OFFERS AND SEALED OFFERS AS A MEANS OF REDUCING THE TIME AND COST OF ARBITRATION

Dr. Andreas Reiner^{*1}

UDK: 341.63

347.918:339

Izvorni znanstveni rad

Primljeno: listopad 2012.

International arbitration procedures have become more and more costly and time consuming - both for the arbitrators and the parties. Therefore, some specific procedural options have developed - "final offer arbitration" (FOA) and "sealed offer arbitration"- which, alongside with their numerous advantages, actually lead to some new problems. The article discusses those advantages and disadvantages of the two novelties in arbitration, trying to perceive them both from the common law and civil law point of view.

Key words: international arbitration, time and cost of arbitration, final offer arbitration (FOA), sealed offer arbitration (FOA)

* Dr. Andreas Reiner, Attorney at Law, Arbitrator and Mediator, ARP Andreas Reiner & Partners, Freyung 6/12, Vienna, Honorary Professor at the University of Economics and Business, Augasse 2 - 6, Vienna

¹ It is the author's great honour and pleasure to offer felicitations to Professor Krešimir Sajko on the occasion of the anniversary of his appointment by contributing the present article to this *liber amicorum*. Professor Sajko is one of the great European and international experts in the realm of arbitration, both as an academic and theoretician and as an advisor on legislation (for example his involvement in the Mediation Act of 2009), in his role as president of the Croatian Permanent Court of Arbitration, Zagreb, and, finally, as an arbitrator of international renown. Professor Sajko has maintained his interest in the field of arbitration to the present day, but has additionally expanded his academic and practical focus to mediation. Without any doubt, Professor Sajko's interest in mediation is a manifestation of his quest for balance and harmony and, perhaps, also the reflection of a certain degree of reserve, if not indeed frustration, in the face of some of the modern-day developments in international arbitration. It thus seemed appropriate to dedicate an article to him which delves into techniques aimed at reducing the duration and the cost of arbitration and which incorporate mediation-inspired elements.

I. INTRODUCTION

Lengthy, time-consuming procedures resulting in high costs have long been and are - increasingly - a concern in international arbitration. As the ICC Commission noted in its 2007 Report, “*Techniques for Controlling Time and Costs in Arbitration*”², statistics show that “[t]he increasing and, on occasion, unnecessary complication of the proceedings seems to be the main explanation for the long duration and high cost of many international arbitrations. The longer the proceedings, the more expensive they will be”³.

The reasons for the tendency of arbitrations nowadays to become more lengthy and costly are legion. They also include behavioural factors, with certain lawyers and certain law firms regularly putting their own (economic) interests ahead of those of their clients. The increased (economic) power of large law firms has also led to a shift in power between those firms and many of their clients, who have either lost or given up control over their own cases.

Another reason for the protracted length of arbitral proceedings and thus for increased costs lies in the overstretched diaries of arbitrators. One cannot avoid the impression that some of the very arbitrators who delight in imposing rigorous timetables on parties, who limit opening statements to ten or fifteen minutes, even in major cases, and who restrict claimants’ direct examination to a few minutes (even where the respondent has submitted important rebuttal evidence) are the same arbitrators who then take many months to render their award. Of course, it cannot be gainsaid that it will always be more pleasant to exercise control and mete out discipline on others than to impose it on oneself.

Arbitral institutions are currently developing a greater awareness of the obligations they owe to parties, and are beginning to exercise stronger oversight over arbitrators’ availability and the time-efficient performance of their duties. The International Court of Arbitration of the ICC recently adopted a useful - and courageous - stance in this regard by requiring potential arbitrators, prior to their confirmation or appointment, not only to confirm their availability in general terms but to disclose the number of cases they are presently handling.

² ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, ICC Publication 843, International Chamber of Commerce (2007).

³ ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, *op. cit.* in fn. 2, Introduction on page 11.

The ICC Court adopted this policy in the face of vehement opposition by certain arbitration practitioners, some of whom are likely to be those same individuals whose failure to exercise reasonable time-management may have prompted or indeed necessitated the ICC's initiative in the first place. Unsurprisingly, the younger generation has (privately or indeed openly) applauded this initiative - and rightly so. The quality of university teaching and professional training in the field of arbitration has improved and intensified to such a degree over the last twenty to thirty years that there is no reason to limit the appointment of arbitrators to those above the age of forty or fifty.

In addition to these human factors, the length and the cost of arbitral proceedings are, of course, also driven by the procedural rules followed and the procedural techniques applied.

In an effort to reduce the complexity and duration of proceedings, which unavoidably generate increased costs in arbitration, the ICC Commission has made a number of proposals in its Report as to the best techniques for implementation, focusing mainly on tailoring procedure in a way which expedites the proceedings. As the Report states, the “[t]echniques embody two underlying principles. First, wherever possible, the parties and the arbitral tribunal should make a conscious and deliberate choice early in the proceedings as to the specific procedures suitable for their case. Second, the arbitral tribunal should work proactively with the parties to manage the procedure from the outset of the case”⁴. Strong emphasis is thus placed on cooperation between the arbitrator(s) and parties.

Two techniques the Report does not discuss are “*final offer*” arbitration (also called “*baseball*” arbitration) and “*sealed offer*” arbitration, both of which are aimed at expediting arbitrations and capping costs as well as at having the arbitrator(s) and parties work proactively together promoting settlements. This paper will describe both types of arbitration and illustrate how and in what types of cases they may be used in order to save time and costs.

⁴ ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, *op. cit.* in fn. 2, Introduction on page 13.

II. “FINAL OFFER” ARBITRATION (ALSO KNOWN AS ‘BASEBALL’ ARBITRATION)

a) What is ‘Baseball’ or ‘Final Offer’ Arbitration?

“Baseball” or “final offer” arbitration [“FOA”]⁵ was an idea first introduced in 1966 by Carl Stevens, when he considered the negative effects of conventional arbitration.⁶ In fact, “Stevens introduced the idea of the ‘chilling effect’ of conventional arbitration and suggested that a scheme where an arbitrator was restricted to choosing between the final offers of the parties, and was unable to compromise between them, would overcome this problem”. The ‘chilling effect’

*“predicts that the availability of interest arbitration as a dispute resolution procedure decreases the parties’ willingness to engage in serious negotiations. Because an impasse will be submitted to an arbitrator, one or both parties have an incentive to refuse to bargain prior to the arbitration if they believe they will receive a better outcome from arbitration than from negotiation”*⁷.

Furthermore, because parties underestimate the risks in arbitration, and may believe that the arbitrator will simply ‘split the baby’, they “assume extreme positions designed to influence the arbitrator’s decision.”⁸ The parties may also conclude that any change in their initial bargaining position will reduce the likelihood of obtaining a favourable award⁹. Although it has been observed that ‘splitting the baby’ finds greater validity in theory than in practice,¹⁰ FOA still serves an important

⁵ Also referred to as “last best offer” arbitration.

⁶ Carl Stevens, *Is Compulsory Arbitration Compatible with Bargaining*, Industrial Relations, Vol. 5, Issue 2 (1966) 38-52.

⁷ Elissa M. Meth, *Final Offer Arbitration: A Model for Dispute Resolution in Domestic and International Disputes*, American Review of International Arbitration, 10 (1999) 383-421, 387.

⁸ The cost consequences of inflated claims should act as a deterrent, but they do not, at least not sufficiently, given many arbitrators’ reluctance to use their powers as to costs in order to sanction abusive procedural behaviour.

⁹ Elissa M. Meth, *op. cit.* in fn. 7, 387.

¹⁰ Stephanie E. Keer/Richard W. Naimark, *Arbitrators Do Not ‘Split the Baby’ - Empirical Evidence from International Business Arbitrators*, Journal of International Arbitration, Vol. 18, Issue 5 (2001) 573-578, 574: “[in the] sample, the arbitrators rarely arrived at an award amount that could be interpreted as ‘splitting the baby’. In fact, the majority of awards resulted in outright ‘wins’ or ‘losses’ (66% of the time). Of the remaining 34% of the cases, the results were widely distributed, with awards from 10% to 90% of the amount claimed. This would imply that

role: that of reaching a settlement, and if not settlement, then forcing parties to move away from extreme positions.

What FOA does is to force parties to adopt a compromising approach, thereby arriving at a more mutually compatible view of their dispute. At the same time as FOA focuses the parties' minds on compromise, it reduces the discretion of arbitrators, essentially vesting them only with the power to issue an ultimatum; indeed, "*the powers of the arbitrator concerning the award are narrowed down to a choice between two final offers submitted by the parties after a phase of final negotiations. Without being able to adjust either offer, or to opt for a solution somewhere between the two, the arbitrator is bound to choose between the two*"¹¹. Because one party will either win or lose, "[t]he parties, aware of being exposed to the risk of not simply losing part of their claim in some form of compromise, and thus potentially ending up somewhere close to the initial target, but losing the entire case, are each impelled to provide an offer that will appeal to their opponents"¹². It is this risk that pushes parties to make a more "*realistic offer in good faith*"¹³. As a result, given the mind frame of concession and bargaining that FOA creates, parties are far more likely to reach a settlement. As such, FOA acts as a "*psychological, economic, and political incentive for the parties to reach their own agreement*"¹⁴, an incentive that conventional arbitration lacks.

In American major league baseball, in which this technique was often used to resolve salary and employment disputes (hence the name "baseball" arbitration), a settlement rate of ninety percent was achieved. This does not mean its success rate is or would be as high in other kinds of disputes, but "baseball" arbitration is certainly an option to be considered.

arbitrators, as a rule, make decisive awards and do not 'split the baby'"; see also, John Wood, *Last Offer Arbitration*, British Journal of Industrial Relations, Vol. 23, Issue 3 (1985) 414-424, 417.

¹¹ Christian Borris, *Final Offer Arbitration from a Civil Law Perspective*, Journal of International Arbitration, Vol. 24, Issue 3 (2007) 307-317, 308.

¹² *Ibid.*, 308.

¹³ *Ibid.*, 308.

¹⁴ Elissa M. Meth, *op. cit.* in fn. 7, 388.

b) The Various Manifestations of FOA

Many varieties of FOA exist: issue-by-issue¹⁵; package¹⁶; dual offer¹⁷; multi-round¹⁸; with the stipulation of a penalty¹⁹; with the use of an independent fact-finder²⁰ and, finally the use of FOA for purposes of quantification (only).

i) Issue-by-Issue FOA

In issue-by-issue arbitration, the various contentions in the dispute are individually arbitrated and final offers are made in relation to each and every contention in the dispute. Although severance of all issues in a dispute would at first blush appear to be the most thorough and thus most equitable way to resolve the dispute, where FOA is concerned, if there are too many issues in dispute, this raises the concern that “*an arbitrator will favour middle-ground positions*”²¹ and thus simply split the award between the two parties by granting each party an equal number of victories on the issues in dispute; this then would discourage parties to settle, as the arbitrator would no longer be left with a single choice between two offers but instead would be able to balance between the parties’ position.

However, an even greater difficulty with issue-by-issue FOA is that some issues may be interlinked and it may be difficult to decide which issues merit being decided upon individually. As Wood aptly states, “[t]here can be, no doubt, room for endless dispute on the concept of separate issues”²². Indeed, the mere need to ascertain the issues in dispute could further fuel the dispute between the two parties, rather than cut it short. If, at the end of the discernment process, there are too many issues to be decided, then this will only lengthen the arbitral process rather than shorten it.

¹⁵ Elissa M. Meth, Elissa M. Meth, *op. cit.* in fn. 7., at 394; Christian Borris, Elissa M. Meth, *op. cit.* in fn. 11, 309.

¹⁶ Elissa M. Meth, *op. cit.* in fn. 7, 394.

¹⁷ Elissa M. Meth, *op. cit.* in fn. 7, 396; Christian Borris, *op. cit.* in fn. 11, 311.

¹⁸ Christian Borris, *op. cit.* in fn. 11, 310.

¹⁹ *Ibid.*, 309.

²⁰ Elissa M. Meth, *op. cit.* in fn. 7, 396.

²¹ Christian Borris, *op. cit.* in fn. 11, 310.

²² John Wood, *op. cit.* in fn. 10, 419.

If, however, there is only one issue or if there are only a few clear-cut issues in contention, then issue-by-issue FOA may be suitable and effective.

ii) *Package FOA*

In package arbitration, a single offer is made by each party for all issues in contention. This places more pressure on the parties, because the arbitrator does not have as much discretion. Indeed, “[t]he lack of discretion is replaced by high party risk: one party will have its entire offer rejected by the arbitrator. This risk maximises each party’s incentive to reach a negotiated settlement”²³. If the parties do not reach a settlement, package arbitration nonetheless provides them with “a clear incentive to make reasonable offers”²⁴. However, package FOA, as its name suggests, places all the issues in a dispute under a single blanket offer. Some cases do require a singling out of issues in order to come to a fairer resolution. Package arbitration does not allow for this. It may very well be the case that “the arbitrator (...) will inevitably be faced with two complicated packages [to choose from]. Unless he is very lucky (...) he will find both packages are unsatisfactory”²⁵. As Wood questions, should the only option then be for “the arbitrator to weigh the packages and choose the least objectionable”²⁶? This clearly is not a suitable alternative if the parties expect an equitable and well-reasoned award.

Having said this, however, one must bear in mind that package FOA may be an attractive alternative in the interests of saving time and money, particularly in simple and small/very small monetary disputes.

iii) *Dual Offer FOA and Multi-Round FOA*

Dual offer FOA allows the parties to submit two final offers to the arbitrator, so that the arbitrator then has four offers to choose from. As Meth states, “[t]his approach provides all involved with more information about each party’s preferences, and increases the probability that one of the offers will be attractive enough to

²³ Elissa M. Meth, *op. cit.* in fn. 7, 395.

²⁴ Christian Borris, *op. cit.* in fn. 11, 309.

²⁵ John Wood, *op. cit.* in fn. 10, 419.

²⁶ John Wood, *op. cit.* in fn. 10, 419.

induce the other to settle”²⁷. Furthermore, as Borris notes, although “*this approach is of little benefit in cases involving solely monetary claims*”²⁸, in cases where there are non-monetary concerns, the ability to make a dual offers would mean that the arbitrator is able to make alternative proposals, and, as a result, “*the chances of finding a solution acceptable to both sides are increased*”²⁹.

Multi-round FOA “*gives parties more opportunity to adjust their position and, ideally, reach a settlement. Especially if combined with a sequence of negotiation rounds between the offers, multi-round FOA can be instrumental in solving more complex disputes*”³⁰. The problem, however, with multiple rounds is that it “*leaves the parties with plenty of opportunity for strategic manoeuvring. A strong, risk-seeking party is likely to start out with a rather over-stated position, in the attempt to influence not only the arbitrator, but also the other party in the following round*”³¹. As such, multi-round FOA can actually work against the goal of pushing parties towards making reasonable offers such that they settle, and may instead encourage them to strategise. Further, if the parties do not settle, both the arbitrator and other party may be influenced by the risk-taking party and as a consequence the more reasonable or equitable solution may not be reached when the arbitral award is ultimately made.

Moreover, another problematic element of multi-round FOA is that it takes up more time than normal FOA, and, as the ICC Report suggests, the goal should actually be to avoid multiple rounds, repetition of arguments, etc., in order to save time.³²

iv) FOA as to Quantum

None of the types of FOA described thus far appear to be techniques which are particularly appealing and generally applicable. Furthermore, the associated procedural risks are non-negligible. It is difficult to see how the varieties of FOA described thus far can substantially reduce the duration and the cost of arbitra-

²⁷ Elissa M. Meth, *op. cit.* in fn. 7, 396.

²⁸ Christian Borris, *op. cit.* in fn. 11, 311.

²⁹ *Ibid.*, 311.

³⁰ *Ibid.*, 310.

³¹ *Ibid.*, 310.

³² ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, ICC Publication 843, International Chamber of Commerce (2007) item 44-84.

tion. Even if it is possible to use the above-referenced techniques to achieve some savings in terms of time and cost, the element of gambling inherent in them makes it rather less likely that they will be accepted by and integrated within other legal cultures, such as in continental Europe.³³

However, there is one area in which FOA may be used as an innovative technique, first in assisting the parties in reaching a settlement, and, second, if no settlement is reached, in speeding up the quantification phase of arbitrations and reducing the attendant costs.

Many arbitrations raise questions of principle (questions of contract interpretation, questions of prescription, questions of liability) and questions of quantification. In such cases “*bifurcation*” may be advisable.³⁴ Bifurcation of proceedings is one of the techniques suggested by the ICC in its Report, because bifurcation can “*genuinely be expected to result in a more efficient resolution of the case*”³⁵. In the first phase, the arbitrators rule as to liability on the merits, and in the second phase, they render a decision on the damages to be awarded. As Meth states, “[o]ften liability will be based on legality, whereas damages will be based on facts. Bifurcating these cases and using FOA in the second stage will allow parties to focus on the legal issues in the liability phase without confusion by factual issues that go to damages. Once liability is assessed, the parties can submit the damages dispute to FOA”³⁶. The liability phase of the proceedings assists good-faith parties in becoming more familiar with one

³³ This holds true with even greater force in respect of two other types of FOA: FOA with the stipulation of a penalty and FOA with the use of an independent fact-finder. In the first case, the losing party is additionally required to bear all of the costs of the arbitration, as a penalty (Elissa M. Meth, *Final Offer Arbitration: A Model for Dispute Resolution in Domestic and International Disputes*, American Review of International Arbitration (1999) 383-421, 399), creating a “*turbo effect*” which is said to be “*instrumental in bringing about a speedy settlement*” (Christian Borris, *op. cit.* in fn. 11, 309). However, it seems rather questionable whether such a “*penalty*” would create confidence in such a system and whether it would be perceived as a method of dispute resolution that leads to fair results. The role of an independent fact-finder in FOA is described as evaluating “*the proposals of each party*” or making “*a recommendation that the arbitrator considers along with the parties’ final offer*” (Elissa M. Meth, *op. cit.* in fn. 7, 396). One wonders, however, what the purpose is of differentiating between an independent fact-finder and a - considerably downgraded - arbitrator.

³⁴ This can be a formal bifurcation with an interim or partial award or a de-facto-bifurcation with a procedural order indicating at a certain stage of the proceedings - without prejudice - on what basis the parties shall plead their case on quantum.

³⁵ ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, *op. cit.* in fn. 2, item 41.

³⁶ Elissa M. Meth, *op. cit.* in fn. 7, 415.

another and with the arbitrator(s). Consequently, “parties can rely on the information they learn during phase one when they create their final offers in the damages phase. In addition, the interactions between the parties during this phase will provide an opportunity for the parties to become familiar with each other and build trust”³⁷. It is precisely this working relationship, created by phase one of the arbitration, that can promote settlement before phase two commences³⁸. If the parties’ offers are sufficiently close, this will generally lead to a quick settlement, or if phase two must be carried out because no settlement was reached, a just outcome can be reached relatively quickly based on the parties’ offer.

The distinction between a phase on liability and a phase on quantum corresponds in part to the distinction between “disputes of rights” and “disputes of interest”.³⁹ This distinction is of importance. “[R]ights disputes are concerned with difficulties of the application of rules, derived either from law or from collective agreements or contracts, to particular situations.” Issues of quantification, however, most often are “disputes of interest”. This does not mean that quantification may not raise important and delicate legal issues, but generally speaking, quantification involves assessments and evaluations which necessarily include a considerable degree of subjectivity. By trying to settle the quantum or by choosing LOA, the parties reduce that risk.⁴⁰

c) Specific Situations in Which FOA Should be Considered

As already indicated, FOA is particularly useful in resolving simple monetary disputes and, more generally, in the quantification phase following a determination on liability.

³⁷ *Ibid.*, 416.

³⁸ This working relationship between the parties and the arbitrator(s) is also one of the main principles upon which the ICC Report was drafted, namely that the parties and arbitrator(s) work together to manage the procedure and outcome of the case; see ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, *op. cit.* in fn. 2. Introduction on page 13.

³⁹ Ramsumair Singh, *Final Offer Arbitration in Theory and Practice*, *Industrial Relations Journal*, Vol. 16, Issue 9 (1986) 329-338, 333.

⁴⁰ See John Wood, *op. cit.* in fn. 10, 422: “[The arbitrator’s] personality, experience and supposed bias is uppermost in their minds. So power is handed to him guardedly and grudgingly. This is especially so since he is dealing with an interest dispute and so is much less fettered than a judge whose work is basically concerned with a rights issue. There can be no doubt that one of the significant advantages of last offer arbitration is that the role of the arbitrator is considerably reduced”

As Borris notes, “in order for the negotiation mechanism to function properly, it is advisable to use FOA in disputes in which the parties’ positions can be measured against a homogenous standard. This is usually the case when the parties’ positions can be easily quantified in monetary terms”⁴¹. When a specific amount is in dispute between two parties, the use of FOA can lead to settlement for the following reasons: (1) parties know that they will save both time and money if they settle; (2) they also know that the offers being made genuinely reflect the amounts that both parties think are reasonable; (3) animosity between the parties decreases and they are encouraged to work together to find a resolution; (4) they possess certainty, in that they will be in control of the outcome, as opposed to the arbitrator; (5) they possess flexibility in their negotiations which they do not if they choose not to settle and to arbitrate instead.⁴² Even if parties choose not to settle, however, in monetary disputes, the use of FOA expedites the arbitral process, as the two parties collaborate and come to a better understanding of each other’s viewpoint. This may help to limit submissions, witnesses, rounds, fact-finding inquiries, etc., which render the arbitration more costly and lengthy.

In addition, FOA may be an appropriate technique for the adaptation of long-term contracts, such as long-term delivery contracts, where the principle of adaptation is either agreed between the parties or ordered by the arbitrator but the extent of the adaptation is disputed.

Similarly, FOA is also advantageous in disputes where losses are speculative in nature. For instance, in cases where there has been a breach of contract or non-performance of a contract for reasons of, say, frustration, hardship, or impracticability, the parties may be inclined to claim an exaggerated sum from the other party because the losses they have suffered are merely speculation as to what might have been. Since parties are more likely to exaggerate their losses in such cases, FOA would provide incentive for parties to limit their claims to a reasonable amount.⁴³

Finally, FOA is considered to be particularly useful in intellectual property [“IP”]-related arbitrations. In IP-related disputes, “[b]ecause of the complexity of the issues and the vast range of projected values for IP, disputants have extremely divergent perception of damages. The result is difficulty in reaching a settlement, which subjects the

⁴¹ Christian Borris, *op. cit.* in fn. 11, 316.

⁴² Elissa M. Meth, *op. cit.* in fn. 7, 411-413.

⁴³ *Ibid.*, 418.

parties to lengthy and expensive litigation"⁴⁴. As a consequence, the "[u]se of FOA as a form of alternative dispute resolution could be highly effective in the field of IP, because parties in this context have an extraordinarily high interest in rapid resolution. Typical IP litigants wish to quickly conclude their disputes so they may exploit market trends, fads, and avoid obsolescence of certain technological media and content"⁴⁵.

III. SEALED OFFER ARBITRATION

a) What is Sealed Offer Arbitration?

A sealed offer ["SOA"] is a

*"written offer to settle a dispute which has been referred to arbitration made 'without prejudice save as to costs'. What distinguishes the sealed offer from an ordinary offer to settle a dispute is the cost penalty (...) which the arbitral tribunal is expected to attach to it, against the offeree who does not accept the offer and fails subsequently to achieve a more favourable award by continuing the proceedings"*⁴⁶.

This is a way to provide parties with an incentive to settle: "[i]t is well recognised that the risk of an adverse award of costs provides great incentive to settle a dispute, whether in litigation or arbitration"⁴⁷. This notion is not new in common law countries; indeed, although one could say that the "*loser pays principle is ingrained into the psyche of the English litigator and that of those who practise in the many common law countries which follow this principle, e.g. Australia*"⁴⁸, SOA has been used to combat the imbalances that arise due to the use of this principle so that, instead, the party likely to be the losing party may cap its potential costs.⁴⁹ Within Europe, a different approach is taken towards cost awards: "[i]n countries such as Austria, Germany, Sweden, and Switzerland, the civil procedure rules

⁴⁴ Spencer B. Gordon, *Final-Offer Arbitration in the New Era of Major League Baseball*, *Journal of American Arbitration*, Vol. 6 (2007), 153-180, 175.

⁴⁵ *Ibid.*, 175.

⁴⁶ Poupak Anjomshoaa, *Cost awards in international arbitration and the use of "sealed offers" to limit liability for costs*, *International Arbitration Law Review*, Vol. 10, Issue 2 (2007) 1.

⁴⁷ Jonathon Wood, *Protection Against Adverse Costs' Awards in International Arbitration*, *The Journal of the Chartered Institute of Arbitrators*, Vol. 74 (2008) 139-147, 141.

⁴⁸ *Ibid.*, 141.

⁴⁹ Michael Bühler, *Awarding Costs in International Commercial Arbitration: an Overview*, *ASA Bulletin*, Vol. 22, Issue 2 (2004), 249-279, 263.

require a proportional allocation reflecting each party's relative success of the claims and defences. The same approach is prevalent in the arbitration practice in those countries"⁵⁰. There is a notably different tradition in the U.S., where requiring costs to be borne evenly between the two parties is more common.⁵¹

Sealed offer arbitration can be a useful tool to cut time and costs in arbitration. Disputes as to costs contribute to rendering arbitrations lengthier and more expensive.⁵² Therefore, in order to save time and money in arbitration, one way of expediting costs proceedings is sealed offer arbitration.

Furthermore, the spectre of cost claims and cost issues as well as the expectation that the arbitrators may split the costs 50/50 may hinder settlements. Sealed offer arbitration, much like FOA, induces parties to negotiate prior to the arbitration, since it significantly increases the stakes of losing the arbitration. It encourages and may often lead to settlement, avoiding the costs and time of arbitration altogether.

b) SOA's Development in English Law

Sealed offer arbitration originated from the *Calderbank* letter. This was an offer "expressed to be 'without prejudice, save as to costs' [and] was first developed in relation to claims for financial relief in matrimonial cases where settlements are more complex, involving the sale of matrimonial assets and their division among the parties"⁵³. Thus, if the individual who lost the case had previously put in a sealed offer more advantageous to the other side than the judge's or arbitrator's decision, then that party would not have to bear the costs of the winning party in addition to his/her own. It then became a popular procedure and began to be used for other kinds of dispute. The notion of the *Calderbank* letter can now be found in Part 36 of the English Civil Procedure Rules. The way it works is that

"the offer is inadmissible and therefore not to be seen by the tribunal until issues of liability and quantum have been decided. The party making the offer is claiming

⁵⁰ *Ibid.*, 262.

⁵¹ Poupak Anjomshoaa, *op. cit.* in fn. 46, 2.

⁵² See Poupak Anjomshoaa, *op. cit.* in fn. 46, 2: "[a]s noted by Derains and Schwartz, increasingly claims for the reimbursement of costs constitute a substantial part of the relief sought in ICC arbitrations; in large arbitrations, it is not uncommon for cost claims to total several million US dollars".

⁵³ Jonathon Wood, *op. cit.* in fn. 47, 142.

*privilege in respect of the offer, subject to the express reservation of the right to bring the offer to the notice of the tribunal on the issue of costs should the offer prove to be unacceptable to the other party*⁵⁴.

This method is used frequently in England⁵⁵; indeed, it is even noted in model arbitration rules for particular industries, like in the Construction Industry Model Arbitration Rules of the Joint Contracts Tribunal Ltd.⁵⁶

Originating with the *Calderbank* letter, the notion of sealed offer arbitration has been developed further and is now very commonly used in English domestic arbitrations. Its definition was first outlined in the *Tramountana Armadora S.A. v. Atlantic Shipping Co S.A.* case.⁵⁷

Because the ‘loser pays all’ or ‘costs follow the event’ principle results in an unreasonable award, as “*even where the loser may have defeated the winner on a number of points and the recovery of the latter is significantly less than the amount originally claimed, so long as the recovery is for more than a nominal amount*”⁵⁸, the loser must still bear both the costs of the winning party and its own. As such, SOA became a very popular mechanism “*devised specifically to counteract this seemingly harsh approach to allocating costs*”⁵⁹. The losing party, often the respondent, can alleviate the result of this approach by

⁵⁴ *Ibid.*, 142.

⁵⁵ Jonathon Wood, *op. cit.* in fn. 47, at 142.

⁵⁶ Rule 13.9: “*In allocating costs the arbitrator shall have regard to any offer of settlement or compromise from either party, whatever its description or form. The general principle which the arbitration should follow is that a party who recovers less overall than was offered to him in settlement or compromise should recover the costs which he would otherwise have been entitled to recover only up to the date on which it was reasonable for him to have accepted the offer, and the offeror should recover his costs thereafter*”.

⁵⁷ Jonathon Wood, *op. cit.* in fn. 47, 142.: “*A ‘sealed’ offer is the arbitral equivalent of making a payment into court in settlement of the litigation or of particular causes of action in that litigation. Neither the fact, nor the amount, of such a payment into court can be revealed to the judge trying the case until he has given judgment on all matters other than costs. As it is customary for an award to deal at one and the same time with both parties’ claims and the question of costs, the existence of a sealed offer has to be brought to the attention of the arbitrator before he has reached a decision. However, it should remain sealed at that stage and it would be wholly improper for the arbitrator to look at it before he has reached a final decision on the matters in dispute other than as to costs, or to revise that decision in the light of the terms of the sealed offer when he sees them*”.

⁵⁸ Poupak Anjomshooa, *op. cit.* in fn. 46, 3.

⁵⁹ *Ibid.*, 3.

*“making a ‘sealed’ settlement offer in the course of the arbitration. Such offer will not be revealed to the tribunal until the substantive issue have been decided. Only then is it ‘opened’: if the arbitrator finds that the claimant would have recovered the same or more by accepting the offer, the claimant is to recover his costs up to the time when the offer could have been accepted, but is to pay the respondent’s costs incurred for the period after that time”*⁶⁰.

Equally, a claimant who over the course of the arbitration concludes that he may not obtain as favourable an outcome as requested in the arbitration may put in a sealed offer for settlement to the respondent. If the respondent refuses to settle, then the claimant may notify the arbitrator that he put in a sealed offer before the arbitrator has made her decision. When the decision has been made, the arbitrator may open the sealed offer, and if she finds that the respondent would have had to pay less in damages if he had accepted the claimant’s offer, then the arbitrator may impose on the respondent must bear the claimant’s full costs from the point at which the respondent could have accepted the offer.

Described as a *“mechanism crucial in any forum where costs are awarded in accordance with the English principle that ‘costs follow the event’”*⁶¹, SOA is increasingly being used in Hong Kong, Canada, and Australia.⁶²

c) The Potential Use of SOA in International Arbitration

In international arbitration, a relevant number of arbitrators follow the ‘loser pays all’ or the ‘costs follow the event’ principle. Indeed, “[s]ome recently published arbitral decisions hold that according to ‘general principles’ or ‘in accordance with basic procedural principles followed in arbitration’, the costs of the arbitration should be borne by the party which loses the arbitration”⁶³. The principle is outlined in the arbitration laws of certain countries, for instance, in the English Arbitration Act 1996, Section 61(2)⁶⁴.

⁶⁰ Michael Bühler, *op. cit.* in fn. 49, 263.

⁶¹ Poupak Anjomshoaa, *op. cit.* in fn. 47, 3.

⁶² *Ibid.*, 3.

⁶³ Michael Bühler, *op. cit.* in fn. 49, 259.

⁶⁴ See Poupak Anjomshoaa, *op. cit.* in fn. 46, 2: “under the AAA International Arbitration Rules, the LCIA Arbitration Rules, the UNCITRAL Arbitration Rules, and the Rules of the

There is no doubt that this is not a universal rule in international arbitration,⁶⁵ and that there continue to be variances, and these variances depend largely on the national backgrounds of the arbitrators.⁶⁶ Continental arbitrators will often opt towards a costs award based on the proportion by which each party has won or lost, American arbitrators will take an ‘each pay their own’ approach. Indeed, as Fouchard, Gaillard, and Goldman note,

*“[i]t is increasingly common for the arbitral tribunal to order the party which is defeated on the merits of a dispute to pay all or a substantial part of the costs of the arbitration. That is traditionally the practice in some common law countries and now frequently occurs when the arbitral tribunal has its seat in continental jurisdictions such as France or Switzerland”*⁶⁷.

In light of this movement in international arbitration, SOA provides a mechanism for those parties who consider themselves to be at risk due to the use of this approach as a way to cap their costs. SOA is also helpful in the “each pay their own” - systems which many rightly consider to be fundamentally unfair when the arbitrators are likely to adopt a proportionality-approach rather than the more rigid “loser pays all” - approach, SOA is still a useful tool to limit the cost risk, to favour settlements and to render the arbitral process more efficient.

d) Advantages to Sealed Offer Arbitration

The advantages of SOA are evident. Firstly, SOA is more likely to result in an equitable cost award than the ‘loser pays all’ principle. Secondly, for the party that feels it may lose the award, it provides that party with a mechanism

*Arbitration Institute of the SCC, there is a general expectation that the legal costs of the ‘successful party’ will form part of the award on costs with the ‘losing party’ being ordered to compensate the successful party for its reasonable legal and other costs”. See also Hunter/Landau, *The English Arbitration Act 1996: Text and Notes* (1998), 52 footnote 97: “Although this section provides as a general rule that the winning party should be entitled to recover its costs, the exception confers very wide power on the tribunal in the way in which its discretion is exercised.”*

⁶⁵ Michael Bühler, *op. cit.* in fn. 49, 260.

⁶⁶ Poupak Anjomshoaa, *op. cit.* in fn. 46, 2.

⁶⁷ Philippe Fouchard/Emanuel Gaillard/Berthold Goldman, *International Commercial Arbitration* (1999) 686.

by which to cap its costs in the arbitration.⁶⁸ Indeed, SOA provides “*invaluable ammunition to those who have no choice but to defend exaggerated or unduly inflated claims brought against them*”⁶⁹. Thirdly, it presents both parties with the incentive to compromise. The party most likely to lose the case is inclined to put in a sealed offer before the arbitration ends, and the party making a claim is less likely to exaggerate or inflate its claim. SOA “*encourage[es] (...) both parties to make their claims as realistic as possible and thus facilitates settlements*”⁷⁰.

In the context of the ICC Report of 2007 on making arbitrations shorter and cost-effective, SOA is an easy and effective way of allocating costs. Furthermore, in terms of quickening the arbitral process, it prevents either party from making exaggerated claims, because if they do, it is likely that there will be a consequence; namely, they will have to bear extra costs. This encourages parties to act in good faith during the arbitration, which in turn results in an avoidance of unnecessary procedural steps (submissions, hearings, witness statements, fact-finding inquiries, etc.) which lengthen the arbitral process and make it costlier. In addition, it pushes parties (and their lawyers) to settle, because bearing costs is a risk that parties often do not want to take.

e) Disadvantages to Sealed Offer Arbitration

One disadvantage to SOA is that it may lead to a bifurcation of the proceedings, which may in fact end up lengthening the arbitral process. An award on costs usually is not separately conducted: “*the general practice in international arbitration is to decide both issues together. Especially in the ICC regime, with its scrutiny process of any award rendered, such a split may be overly burdensome unless the amount of costs at stake justifies a separate final award on costs*”⁷¹. SOA is conducive to bifurcating awards because the arbitrator(s) must first make a decision on the merits of the case before opening the sealed offer and subsequently deciding the costs issue. However, how much this would lengthen the process is questionable. Often the request for an immediate decision on costs delays the issuing of the decision on the main claims, so that the postponement of the cost

⁶⁸ Poupak Anjomshooa, *op. cit.* in fn. 46, 3.

⁶⁹ *Ibid.*, 3.

⁷⁰ Michael Bühler, *op. cit.* in fn. 49, 269.

⁷¹ Michael Bühler, *op. cit.* in fn. 49, 263.

decision should speed up the issuing of the award. In SOA the only additional procedural step is to open the sealed offer and decide the costs accordingly.⁷²

Another problem is that some arbitrators and parties may not be aware of SOA and how exactly it functions. Because

*“parties from civil law [and other] jurisdictions will not be accustomed with the ‘sealed offers’ practice[, ... it is imperative that] (...) a tribunal intending to adopt the English approach should thus inform the parties at the very outset of the proceedings that they may submit such offers, and that the tribunal intends to take them into consideration when deciding on costs”*⁷³.

The importance of making clear to all parties involved what exactly SOA entails is hugely important, particularly in making clear the fact that the offer is made *“without prejudice, save as to costs”*. In certain arbitrations, SOA has been rejected as a mechanism where one party has attempted to use it against another because the consequences of refusing an offer under SOA were not well explained to the other party.⁷⁴

Furthermore, SOA has been accused of being too exacting as an approach. As Bühler states, *“[a]ll in all, an allocation of costs based on the outcome of the case rarely can or should be a strict arithmetic exercise. Although arbitrators should not use ‘too broad a brush’, pointillism is of no use either”*⁷⁵. Accordingly, Bühler argues that the approach that should be used should depend on the case at hand.

A further disadvantage is the fact that the use of SOA takes away from the reason for which the ‘loser pays all’ principle is used, which is that it *“provides economically efficient deterrence for such conduct and furthers compliance with contractual obligations”*⁷⁶. However, this rule assumes that all arbitral disputes are black and white and that there is a distinct victim and a violator, winner and loser, in the case, which is not always so.

The potential of influencing the arbitrator by making a sealed offer is yet another disadvantage of SOA. The party that is making the sealed offer may be afraid that the arbitrator will think that it is accepting liability by making the offer. This discourages parties from participating in SOA, and if it is true

⁷² Indeed, the ICC Report explicitly suggests that bifurcation can be a good way to expedite the arbitral procedure; see ICC Commission, *Techniques for Controlling Time and Costs in Arbitration*, *op. cit.* in fn. 2, item 41.

⁷³ Michael Bühler, *op. cit.* in fn. 49, 264.

⁷⁴ Jonathon Wood, *op. cit.* in fn. 47, 145-146.

⁷⁵ Michael Bühler, *op. cit.* in fn. 49, 265.

⁷⁶ *Ibid.*, 268.

that the arbitrator is influenced, it may lead to a biased award being handed down. But as Anjomshoaa notes,

“[a]ny sophisticated arbitral tribunal should appreciate that an offer of compromise may have been made simply because the offeror is keen to remove any uncertainty from its accounts, for commercial or other reasons, and despite the lack of any belief in the merits of the compromised claims. Equally, the tribunal cannot dismiss the possibility of the offer being one to settle the offeree’s claims for a nominal sum, aimed solely at obtaining some costs protection”⁷⁷.

It is therefore unlikely that if a party decides to put in a sealed offer, such a decision will be held against it.

On balance, the advantages of SOA clearly outweigh its potential disadvantages.

IV. CONCLUSION

Both FOA and SOA foster an environment of compromise between the parties to a dispute, making it more likely that the dispute will end in settlement. This is the main aim of these two kinds of arbitration. When these kinds of arbitration continue through to the arbitration stage, they encourage the parties to act in good faith with one another so that they may avoid unnecessary and repetitive steps in the arbitration, which are often taken when parties act unreasonably, and instead want to over-exaggerate their claims. If used wisely, both FOA and SOA can be instrumental to cutting time and costs in arbitration, as well as re-introducing an approach which is collaborative rather than adversarial.

⁷⁷ Poupak Anjomshoaa, *op. cit.* in fn. 46, 5.

Sadržaj

Andreas Reiner*

KONAČNA PONUDA I ZAPEČAČENA PONUDA KAO SREDSTVO
SMANJIVANJA VREMENA I TROŠKA ARBITRAŽE

U članku se raspravlja o dvjema tehnikama koje arbitražu čine učinkovitijom te smanjuju njezine troškove, ali i usmjeravaju arbitre i stranke na zajedničko aktivno ostvarivanje nagodbe. Te tehnike su arbitraža na temelju konačne ponude ("final offer" arbitration, "baseball" arbitration) te arbitraža na temelju zapečaćene ponude ("sealed offer" arbitration).

U prvome dijelu članka definira se arbitraža na temelju konačne ponude te se navode argumenti u korist i protiv takve tehnike, a definira se i uloga arbitra u toj vrsti postupka. Uz to, predstavlja se i nekoliko vrsta arbitraže na temelju konačne ponude: arbitraža problem po problem (issue-by-issue), paket (package), dvostruka ponuda (dual offer), arbitraža u više krugova (multi-round), arbitraža s određenjem kazne (with the stipulation of a penalty), arbitraža putem nezavisnog utvrđivanja činjenica (with the use of an independent fact-finder) i, konačno, arbitraža s ciljem izračunavanja visine dosuđenoga (for purposes of quantification). Također, naznačuju se i područja u kojima bi se ta tehnika mogla koristiti - jednostavni novčani sporovi te faza izračunavanja visine dosuđenoga nakon utvrđenja osnovanosti zahtjeva.

Drugi dio članka odnosi se na arbitražu temeljenu na zapečaćenoj ponudi, koja se definira te se iznose njezine prednosti i mane. Uz to, objašnjava se razvoj ove tehnike u engleskom pravu.

Zaključuje se kako navedene tehnike služe arbitraži na mnogo načina - povećavaju učinkovitost, pojeftinjuju je te potiču postizanje nagodbe između stranaka.

Ključne riječi: međunarodna arbitraža, vrijeme i trošak arbitraže, arbitraža na temelju konačne ponude, arbitraža na temelju zapečaćene ponude

* Dr. Andreas Reiner, arbitar, izmiritelj, odvjetnik, Odvjetničko društvo Andreas Reiner & Partners, Freyms 6112, Beč, naslovni profesor Sveučilišta za ekonomiju i poslovanje, Angasse 2-6, Beč