Drafting the Arbitration Clause: A Primer on the Opportunities and the Pitfalls

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A review of some of the crucial issues that should be considered in order to draft an effective arbitration clause.

The arbitration clause is often thrown into the contract at the last minute as the parties toast the conclusion of their negotiations. Usually little more than an afterthought, it deserves considerably more attention from the careful lawyer. Because the arbitration clause can become highly significant down the road if the parties’ relationship deteriorates, arbitration practitioners have recognized that the clause should be shaped in a thoughtful and careful way to the transaction and the parties’ needs for an economical and efficient dispute resolution process. The opportunity to do this is before the heat of battle. It is during the drafting of the contract.
The ability to choose the terms of the arbitration clause is one of the signal advantages of arbitration, and it is this ability that differentiates arbitration from court litigation, where parties are bound by local court rules and the civil procedure laws of the jurisdiction in which the court sits. Drafters have the opportunity to streamline the resolution of any subsequent dispute, to ensure that it is heard by appropriate decision makers, and to maximize the chances of enforcing the ultimate decision. Conversely, carelessness in drafting can lead to “pathological clauses” that are not enforceable, procedural requirements that are impossible to satisfy, and provisions that endanger the enforceability of the final award.¹

While length constraints and the vagaries of the many kinds of contracts containing arbitration clauses preclude an exhaustive review of all of the considerations that should go into drafting an arbitration clause, we review some of the most crucial issues that should be considered. The “boilerplate” arbitration clause and the arbitration provision used in the last deal are not sufficiently tailored to be inserted automatically in all contracts.

Do No Harm

Litigation over the arbitration clause is the last thing parties want, but that is precisely what will occur when arbitration is demanded against an unwilling respondent under a poorly drafted arbitration clause.

First Steps in the Analysis

The first step the drafter should take is to raise a number of questions with the client, such as: What kinds of disputes are likely to arise? Is the client likely to be a claimant or respondent? Will there be a need for prompt resolution from a business perspective? Will there be a need to assert extra-contractual claims (i.e., claims that are beyond the subject of the contract containing the arbitration clause)? Is confidentiality important? Does the transaction have international ramifications? Answers to these and other questions will help the drafter craft an appropriate arbitration clause for the transaction. They will also alert the drafter to the need to consult, during the drafting process, with counsel in other jurisdictions, including those abroad, where the arbitration may be seated or enforcement may be sought.

Scope of the Arbitration Agreement

Based on the client’s answer to the question about the nature of possible future disputes, the drafter can determine the appropriate scope of the arbitration clause. If the parties agree to limit arbitration to certain types of disputes (for example, only contract disputes, or only payment disputes, or disputes under a certain dollar value), the drafter can tailor the clause to cover just those disputes. But care should be taken in adopting this approach as it may lead to challenges to the arbitrator’s jurisdiction with the consequent increased costs and risk of inconsistent results.

If the parties want a broad arbitration clause for the resolution of all disputes between them, it is important to use language that has been accepted by the courts of the applicable jurisdiction.

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commercial rules) contain the following straightforward, broad arbitration clause, which has been tested in court:

Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.⁴

American Arbitration Association (AAA) Drafting Dispute Resolution Clauses² and the International Bar Association’s (IBA) Guidelines for Drafting International Arbitration Clauses,³ both of which provide detailed guidance on the subject.

The AAA Commercial Arbitration Rules (AAA
If they also desire to resolve claims in the arbitration that are not related to the subject of the contract, such as an unrelated offset, the contract must include a provision to that effect.

Selection of the Arbitral Forum and Rules

A properly drafted arbitration clause will serve to bind the parties to arbitrate the disputes specified, and will be enforceable, but the careful drafter should not stop there. Additional details specifying how, when, and where to conduct the arbitration should be addressed. Failing to specify these issues could lead to procedural disputes that may require court intervention. Such skirmishing can be nipped in the bud by addressing these issues in the arbitration clause.

The first issue is whether to have ad hoc arbitration, or arbitration administered by a neutral arbitral institution. Some litigants think that ad hoc arbitration is cheaper because no payments need to be made to an administering institution. But that view may be shortsighted, since there are a great many advantages to administered arbitration, including the help of a case administrator assigned by the institution to help the arbitrator and the parties’ attorneys move the proceedings along, and the use of the institution’s arbitration rules and roster of neutrals. In addition, the institution serves as a neutral intermediary to deal with challenges to arbitrators and manage payments of the arbitrator’s compensation. The presence of the arbitral institution may lessen the chances that court intervention will be needed to resolve procedural issues. In addition, it may improve the chances of enforcement and may even be required in some jurisdictions.

If administered arbitration is desired, thought should be given to the rules of the institution. The rules of the major arbitral institutions are similar in many ways, but they are by no means identical; they may differ significantly on such issues as the availability of punitive damages, confidentiality, and hybrid ADR processes, such as “med-arb.” The AAA commercial rules and the international arbitration rules of the International Centre for Dispute Resolution (ICDR rules), the AAA’s international division, provide that the selection of the AAA or ICDR to administer the arbitration is deemed a selection of the AAA and ICDR rules—and the selection of the AAA or ICDR rules constitutes a selection of the AAA or ICDR as the arbitration administrator.5

In addition, attention should be paid to the version of the rules the parties wish to govern their disputes. Many institutional arbitration rules are revised from time to time and provide that the rules in effect at the time of the filing of the arbitration govern, absent a contrary modification in the arbitration agreement.6 Modifications of other provisions in the selected institution’s rules should be approached with caution to avoid the possibility that the institution may conclude it cannot administer the dispute under the rules as amended by the parties.

If selecting an ad hoc proceeding, the selection of ad hoc arbitration rules is advisable to provide a framework for the conduct of the arbitration.

Selection of Arbitrators

Qualifications. The opportunity to select the arbitrators is one of the chief advantages of arbitration. The parties can choose the decision maker they believe is best suited to the dispute (rather than just being stuck with a judge randomly assigned to the case). Parties can make the most of this unique opportunity by having the drafter of the arbitration clause include arbitrator qualifications or other selection criteria.

The drafter can specify in the agreement the kind of experience, expertise, or other qualifications that the parties want the arbitrator to have. For example, the arbitration agreement could require the arbitrator to possess a specified amount of experience as an attorney or arbitrator, familiarity with the law of a specific jurisdiction, expertise in a particular legal field, or work experience in a particular industry. Care should be taken, however, to avoid making the arbitrator qualifications so constricting that it will be difficult or even impossible to find arbitrators who satisfy them.

Selection Method. The two most common methods for selecting arbitrators are the list method and the party-appointment method. Both methods allow the parties to select their decision maker. Under the list method, frequently used at the AAA and the ICDR, the case administrator, after input from the parties as to their preferences, usually provides a list of 10 to 15 names from the panel of arbitrators. The parties “strike” the names they don’t want and “rank” the remaining names in order of preference (known as the “strike and rank” method).

Under the party-appointment system, one arbitrator is selected by each side and the chair is jointly selected by those two arbitrators, often in consultation with the parties. Under the AAA commercial rules, if the party-appointed mechanism is not specified in the arbitration clause, the list “strike and rank” method will be employed. This method is also utilized at the ICDR.

There has been considerable debate in recent years about the desirability and fairness of the party-appointed arbitrator system, but it remains popular, especially in international cases. The
AAA and ICDR will administer a party-appointed process if called for in the arbitration agreement.

Default methods of arbitrator selection are provided in the AAA rules in the event the parties’ chosen process fails for some reason to result in the constitution of the panel. In an *ad hoc* proceeding, it is wise to provide in the arbitration agreement for a default appointing authority, to ensure the appointment of the arbitrator.

**Number of arbitrators.** The arbitration agreement may specify the number of arbitrators, but if it does not, the rules the parties have selected may make the choice for them. If the parties want to control the costs of their arbitration, specifying only one arbitrator in the arbitration agreement should be considered.

If the parties anticipate disputes that will not be especially significant (e.g., in terms of dollar amount, disruption, or impact on their respective businesses), a single arbitrator may do the trick. If larger disputes are possible, three arbitrators may be preferable, although the parties must recognize that three arbitrators will increase both the costs of resolving disputes, and the length of proceedings, due to difficulties in coordinating the arbitrators’ schedules. Alternatively, the agreement can provide for one arbitrator for certain types of disputes (e.g., those under a certain dollar amount), and three for others.

**Selection of the Seat**
The selection of the seat of the arbitration, which need not be the place where the arbitration is physically held, is a critical choice. The seat selected should be one that is friendly to arbitration. It is generally the procedural law of the seat that is applicable to the arbitration and sets the baseline requirements. It is the jurisdiction that will deal with issues relating to the appointment of arbitrators, challenges to arbitrators, and jurisdiction over a party or a claim. Another important fact is that, although other courts may, in very limited circumstances, refuse to recognize and enforce an arbitral award, the seat of the arbitration is the only forum that can vacate the award.

A seat should be selected that will recognize and enforce the agreement to arbitrate, not interfere in the arbitral process; assist the arbitration proceedings when necessary; and act expeditiously. In making this selection, the parties should also consider whether the law of the seat allows non-nationals to appear as counsel in an arbitration proceeding, specifies criteria for arbitrators to be qualified, determines the language of the arbitration, or requires any special procedures in the arbitration itself. The selection of an arbitration-friendly seat, versus one not-so-friendly, can make a huge difference in the efficiency of the arbitral proceedings and the enforceability of the award.

Another factor to be considered when selecting a seat is whether cross-border enforcement of the award is likely. The laws and procedures of the jurisdictions where enforcement might be sought (as well as requirements as to the conduct of the arbitration) should be researched to avoid problems later if an award from the seat will be the subject of enforcement proceedings. There are traps for the unwary here. An award might not be enforceable in some countries, depending on the seat from which it emanates. For example, although India is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, it will only recognize awards from the 44 countries that have been “notified” by India. Some important jurisdictions are not on that short list.

**Arbitrability—Who Decides the Scope of Arbitral Jurisdiction?**
The drafter should consider whether to include a provision stating that the arbitrators have the authority to determine their own jurisdiction. The precise application of this principle of “competence-competence” varies from country to country. In the United States the delegation to the arbitrator must be “clear and unmistakable.”

The rules of most arbitral institutions specify that the arbitrators are empowered to determine their own jurisdiction, and several appellate courts in the United States have held that the adoption of these institutional rules in the arbitration agreement constitutes the requisite “clear and unmistakable” delegation of this power to the arbitrators. However, to provide clarity on this issue and avoid a potentially long and costly detour into the courts at the commencement of an arbitration, the drafter may consider incorporating
into the arbitration agreement language that expressly delegates this power to the arbitrators.

Streamlining the Arbitration

Another opportunity afforded by arbitration is the ability to tailor the process to the transaction and the parties’ needs. As arbitration has increasingly been used in large-stakes disputes, it has become commonplace for some attorneys to treat arbitration proceedings like full-blown court litigation—dragging out the process by using expansive, time-consuming and expensive discovery. Arbitration is not litigation and using litigation procedures in arbitration runs counter to the purpose for which arbitration was originally conceived—as a swift and efficient alternative dispute resolution process.

To avoid falling victim to this trend, the parties should agree during the negotiation and drafting of their contract to an authentic arbitration process, one that will preclude litigation maneuvering and return arbitration to its roots as an expeditious and less costly mechanism for resolving disputes. Before such measures are added to the arbitration agreement, care must be taken to think through the nature, size, and complexity of the likely disputes and determine the procedures necessary to obtain a fair result.

One option could be for the drafter to incorporate into the arbitration clause the ICDR Guidelines for Arbitrators Concerning Exchanges of Information in international arbitration. This can be done to streamline discovery in domestic arbitrations as well. Another helpful source of ideas for limiting pre-hearing procedures can be found in the Protocols developed by the College of Commercial Arbitrators.

In order to circumscribe discovery, the parties’ counsel should decide what forms of discovery they will need or want, and what methods of discovery they might want to avoid. For example, depositions can be expressly precluded, and a standard of need for document production can be set at a high bar. It also may be possible to agree on e-discovery limitations in the arbitration clause. It might even make sense to dispense with e-discovery altogether.

When limitations on discovery are practicable and can be agreed upon, putting them in the arbitration agreement will help defray (and even avoid) tremendous costs and business disruptions. When a dispute arises, if the parties find their agreement with regard to discovery to be too onerous, they can always agree to change it by mutual consent. The agreement can also provide for adjustments of the discovery limitations at the discretion of the arbitrator upon a requisite showing of need.

The parties can also provide for time limitations, whether because business considerations mandate an expeditious outcome, or because it will foster cost-savings in the arbitration. Typically, such provisions require that the arbitration conclude within a certain number of days from the filing of the demand, or from the appointment of the arbitrators, or require that the award be issued a certain number of days from the closing of the hearing. The drafter should be careful to make time limitations subject to adjustment at the discretion of the arbitrators, to avoid putting the award at risk if the time limits cannot be met.

Form of Award

Party autonomy extends to providing for the type of award to be rendered. The parties can provide for a “bare” award that merely states what relief is granted and to whom, a reasoned award, or a more detailed award with findings of fact and conclusions of law (which is rarely used). The parties may wish to have a reasoned award so they have the satisfaction of knowing the basis for the decision and/or to obtain guidance for future conduct. On the other hand, there may be circumstances in which the parties do not want a reasoned award because it might contain specific findings that could be harmful to them in some way in the future. In arbitration, unlike court, parties can prevent such findings by limiting the nature of the award to be issued in the arbitration agreement.

Under the AAA commercial rules, unless a request for a reasoned award is made in writing by the parties prior to the appointment of the arbitrators, the arbitrators need not render a reasoned award. Parties rarely consider this point at the commencement of the arbitration, so if a reasoned award is desired, it is best to provide for it in the arbitration agreement.

In the past, many arbitrators felt that a reasoned award would provide grounds for a court to refuse to enforce it (despite the fact that a merits review is generally prohibited under the Federal Arbitration Act and most state laws). More recently, there has been a shift by many arbitrators towards providing at least some reasoning in their awards as a reaction to several court decisions that, while enforcing the awards, nevertheless criticized them for their lack of reasoning.

In the international context, it must be noted that some jurisdictions outside the United States require arbitral awards to be reasoned in order to be enforceable. The ICDR rules, like the rules of many institutions, require a reasoned award unless the parties have agreed that no reasons be given.
Confidentiality

Another opportunity offered by arbitration is the ability to provide for confidentiality and avoid the public exposure attendant to court proceedings. Many practitioners wrongly assume that arbitration is “confidential.” It is generally accepted that arbitrators and administering institutions have an obligation to keep arbitral proceedings confidential. But in many legal regimes and under many institutional rules, the parties have no such obligation, absent an express confidentiality agreement. Thus, although arbitration is “private,” the confidentiality obligations of the parties depend on their express agreement, local law (which varies by jurisdiction), and the rules chosen to govern the arbitration.

If the confidentiality of future disputes is important, it is best to include in the arbitration agreement itself language binding the parties to confidentiality. The ability of the parties to agree on anything diminishes precipitously after a dispute arises and litigation tactics take over. Therefore, confidentiality, like virtually all of the procedural issues that arise in the course of an arbitration, is best addressed during the drafting of the arbitration clause while the parties are working harmoniously. Further, any contractual confidentiality agreement must contain exceptions, such as allowing disclosures required by law. It must also allow submissions to a court necessary for enforcement of the award. If court proceedings ensue, it may not be possible to maintain confidentiality.

Interim Measures

Interim measures, such as attachments or preliminary injunctions, can be as important in arbitration as in litigation. Jurisdictions vary as to whether the arbitrators or the courts have the authority to issue interim measures of protection. Most institutional arbitration rules authorize arbitrators to issue interim measures, and parallel jurisdiction is available in many cases. The AAA commercial rules expressly provide: “A request for interim measures addressed by a party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.” Given the variability of local law on this point and certainly in ad hoc arbitration, the parties may wish to consider providing express authority for the courts to issue interim measures, or for the arbitrators to do so, and review the enforceability of such a provision in the relevant jurisdictions.

When the parties need interim relief prior to the appointment of the arbitrator, there could be a delay in obtaining relief because, unlike the courts, where such an application can be made at any time, there is no panel of arbitrators waiting to rule on such a request when the arbitration is first commenced. In addition, empanelling arbitrators takes time.

The AAA was a leader in developing an emergency arbitrator procedure under which an arbitrator could be appointed to hear a request for interim measures of protection so that relief would be available before the panel is constituted. The emergency arbitrator rules are part of the ICDR international rules. However, they are optional under the AAA commercial rules and therefore must be affirmatively elected in the arbitration clause. The drafter should consider electing the optional emergency arbitrator rules in the arbitration clause if the contracting parties have selected the AAA commercial rules to apply.

Rules providing for an emergency arbitrator to be appointed to hear a request for interim measures prior to the constitution of the tribunal are optional under the AAA commercial rules and therefore must be affirmatively elected in the arbitration clause.

Attorney Fees and Costs

Arbitration agreements often contain provisions addressing how attorney fees will be paid. Some provide that each party will bear his or her own attorney fees (known as the American rule), while others provide that the “prevailing party” shall recover its attorney fees and costs from the losing party (the loser pays rule). Arbitration agreements may provide that if an enforcement proceeding is necessary to obtain payment, the losing party will pay the attorney fees and costs of the enforcement proceeding. The purpose of this provision is to encourage voluntary compliance with the arbitral award. Likewise, an arbitration clause may provide that the party demanding arbitration must pay all filing and tribunal fees, subject to adjustment, if at all, in the final award. Alternatively, it may provide that a respondent...
who fails to pay his or her share of the costs of the arbitration shall suffer specified consequences. Fee- and cost-shifting provisions are intended to deter frivolous arbitration demands and court challenges. In addition, they can help streamline the proceeding. However, their use should be carefully considered.

Arbitrators generally apply the American rule in U.S. arbitration proceedings conducted under the AAA commercial rules, absent a reason to do otherwise. Under these rules, the arbitrator is authorized to award attorney fees “if all parties have requested such an award or it is authorized by law or their arbitration agreement.” However, the ICDR rules, consistent with international practice, provide that the arbitrators “shall fix the costs of the arbitration in its award,” leaving the arbitrators’ discretion, if there is no provision in the arbitration agreement dictating the application of the American rule. It should be noted that some jurisdictions outside the United States do not enforce agreements to have each party bear its own attorney fees and costs unless that agreement is reached after the dispute has arisen.

**Other Essential Terms**

Under virtually all regimes, arbitration agreements must be in writing. In arbitration agreements involving a U.S. party, or where enforcement in the United States may be sought, it is important for the drafter to include an “entry of judgment” provision in order to avoid further litigation on issues of enforcement. The entry of judgment language in the AAA standard arbitration clause states: “Judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.”

To avoid later disputes as to where the arbitration hearing will take place, the drafter should identify with specificity the locale of the hearing. Absent such a provision, the choice may be made under the applicable rules.

If the transaction is international, the drafter should specify in the arbitration agreement the language in which the arbitration will be conducted and in which the submissions should be made. It may also be appropriate to specify the currency in which any damages awarded should be paid and, if a party is a government that would be entitled to sovereign immunity, include a waiver of such immunity and an agreement to submit to the jurisdiction of the court and to entry of judgment.

The law chosen by the parties to govern their contract will dictate the law governing claims that are asserted thereunder. But what about claims that do not arise under the contract but which the parties nevertheless agree may be arbitrated? Where the parties agree on arbitration of extra- contractual claims, the drafter should include the substantive law to govern those claims.

The applicability of the FAA can also be a puzzle unless the arbitration clause expressly says that the FAA applies. The FAA applies to transactions “involving commerce.” The term “commerce” is broadly defined under the FAA. The breadth of the FAA has led many courts to hold that the FAA preempts many aspects of state law. Yet, because the applicability of the FAA is not always clear (and courts can be inconsistent in their understanding of its reach), the drafter should expressly provide in the arbitration clause for the FAA to govern, if this is what parties want, and most do. If the FAA governs, state law provisions will then be applicable only to the extent not in conflict with the FAA.

Contracts of adhesion (such as take-it-or-leave-it contracts between parties of unequal bargaining power, e.g., consumers) are always drafted by the stronger party. Since mandatory arbitration provisions in adhesion contracts could be challenged in court on unconscionability grounds, the drafter must be very familiar with state unconscionability law and adhesion contracts. This is necessary to avoid putting into the clause any provisions that may cause the courts to find the arbitration clause to be unconscionable and unenforceable.

There are a host of other issues that could be important in drafting an arbitration clause. Addressing all of them is beyond the scope of this article, but that does not relieve careful practitioners from considering them and deciding whether it would be appropriate to include them in the arbitration clause.

**Step Clauses**

In recent years, “step clauses,” which call for the parties to take certain preliminary steps before they can commence arbitration, are being used with greater frequency. Their popularity may be due to the fact that they give the parties an opportunity to resolve disputes in a less adversarial forum. The contract usually requires a “business persons only” negotiation first, followed by mediation to help the parties amicably resolve the matter before incurring the costs and expenses of arbitration. Requiring mediation first can make it easier for all parties to come to the table. There is no need for either side to “suggest” mediation, which often makes counsel worry that the suggestion alone shows weakness.

Some courts have held that a step clause cre-
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ates a condition precedent that must be satisfied before the commencement of arbitration. Accordingly, it is important for the drafter of a step clause to include time limits for completing each step so that it is clear when the next step can be taken.

We do not recommend providing for “good faith” participation in a dispute resolution provision. The good faith requirement may sound nice, but it is a fuzzy, easily circumvented term that can lead to court fights over what constitutes “good faith” participation and whether it has been satisfied.

Additional considerations in drafting a step clause include whether the statute of limitations will be tolled during any of the preliminary processes, and whether to allow applications for interim relief during the mediation. If time is money, the step clause can be varied to have the mediation run concurrently with the arbitration.

Where mediation is used alone, or is part of a step clause, designating an administering institution in the mediation clause can help make the mediation proceed smoothly. The institution’s rules provide the procedures for notice and selection of the mediator, and the case manager assigned to the case can help facilitate the initiation and management of the mediation. If the mediation is not administered, these procedures must be included in the mediation portion of the step clause.

Conclusion

The arbitration clause provides an opportunity to tailor the dispute resolution process in the manner desired by the contracting parties. This opportunity should not be squandered. The drafter must be careful to include in the arbitration agreement all provisions that will be needed to ensure its enforceability, as well as the enforceability of any awards that are issued, while still satisfying the parties’ needs. The arbitration clause is an essential element in providing users with the kind of arbitration they say they want: one that resolves disputes with a minimum of time and business disruption and at lowest cost.

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ENDNOTES

1 Although pathological clauses may sometimes be saved by the courts, they may, in other instances, preclude enforcement of the arbitration agreement. Examples include: arbitration clauses that are unclear as to whether binding arbitration is intended; naming an institution that does not exist or is misspelled; providing too little time for the arbitration to take place with no safety valve for extensions; or providing too much specificity for the arbitrator’s qualifications.

2 This publication can be downloaded from the American Arbitration Association’s Web site at www.adr.org (click on Education & Resources).


4 The AAA’s standard arbitration clause is in the introduction to the AAA Commercial Arbitration Rules (AAA commercial rules).

5 AAA commercial rules, R-1 & R-2;

6 ICDR international rules, art. 1. Other institutions have similar rules.


8 Available for downloading at www.adr.org (click on Education & Resources).


10 Rule R-42(b).

11 ICDR rules, art. 27(2).

12 AAA rules, R-34(a).

13 ICDR rules, art. 37.

14 AAA commercial rules, optional rule O-1-8.

15 AAA commercial rules, R-43(d)(ii).

16 See, e.g., ICDR rules, art. 31.

17 Additional provisions that might be considered include whether to: (1) limit the types of damages that the arbitrator can award (e.g., by excluding punitive and consequential damages); (2) specify the interest rate to be applied; (3) limit specific issues for expert determinations; (4) permit summary disposition on written submissions; (5) waive the right to appeal (or, alternatively, allow appeals as permitted by law); (6) allow joinder and consolidation in certain circumstances; (7) include class action provisions; (8) empower the arbitrator to decide the case based on the equities (ex aequo et bono); (9) provide for a special type of arbitration (such as high-low or baseball arbitration); or (10) provide for online dispute resolution mechanisms.