

## Outside Counsel

## Expert Analysis

# What Is Expert Determination? The Secret Alternative to Arbitration

Arbitration, of course, is well known in the United States. What is not generally known is that there is an alternative to arbitration. The law recognizes two well developed and distinct types of alternative dispute resolution proceedings each of which lead to a final and binding result: (i) arbitration and (ii) expert determination. Expert determination is a powerful alternative to arbitration which, when properly understood, can be preferable to arbitration for certain types of disputes. Expert determinations are governed by their own body of law that is separate, distinct, and materially different from the law of arbitration.

The lack of present awareness of the law of expert determination in New York is particularly surprising. The New York Legislature over 50 years ago enacted specific legislation governing expert determinations as a form of dispute resolution separate from arbitration. This legislation, which has become virtually unknown among contemporary practitioners, is found in CPLR Article 76 (as opposed to Article 75, which governs arbitration) and is supplemented by extensive case law. The Legislature added Article 76 to the CPLR specifically in order to ensure that the parties' election to have their dispute resolved by expert determination, as opposed to arbitration, is fully recognized and enforced by the New York courts. See *In re Penn Central*, 56 N.Y.2d 120, 126-27 (1982).

The law of expert determination is the subject of a report recently issued by the Committee on International Commercial Disputes of the New York City Bar called "Purchase Price Adjustment Clauses and Expert Determinations: Legal Issues, Practical Problems and Suggested Improvements."<sup>1</sup> The author served as chair of the subcommittee that drafted the report.

The report sets forth the general jurisprudence of the law of expert determinations. It takes a

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particularly close look at cases concerning purchase price adjustment disputes, described below. While New York law is particularly well developed in this general area, there has been substantial confusion in the federal courts and in courts of other states concerning whether a particular dispute resolution clause provides for expert determination or arbitration. The report also examines some of the issues that have been the subject of litigation relating to such clauses, and makes suggestions as to how parties can draft these clauses so as to better express their intent and to minimize litigation.

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Agreements governing the purchase and sale of private companies often include a provision allowing for an adjustment in the purchase price as of the closing date. Parties include such clauses because there can be a substantial period of time between the signing of the purchase agreement and the closing of the transaction. During this time, the value of the company may change. Purchase price adjustment clauses commonly contain their own dispute resolution mechanism. The parties usually agree that any dispute concerning the adjustment to the purchase price is to be submitted to an independent accounting firm for a final and binding determination.

Contracts providing for the final and binding

resolution of an issue by submission to one or more experts can be found in a wide range of other commercial agreements.<sup>2</sup> These include, for example, the determination of rent adjustments under long-term leases,<sup>3</sup> the price to be paid upon exercise of an option to purchase shares in a private company or an option to purchase real property,<sup>4</sup> and the amount of loss under an insurance policy.<sup>5</sup>

### Recognition

Expert determination, as distinct from arbitration, is recognized under the laws of many other countries, including England, Canada, Australia, New Zealand, Belgium, Germany, Hong Kong, Italy, France, and The Netherlands, among others. While each country has its own rules regarding expert determinations, what is important is that "[m]ost jurisdictions concur that arbitration laws do not apply to expert determination proceedings."<sup>6</sup> This is the same position taken in the current draft of the Restatement Third of the U.S. Law of International Arbitration, which distinguishes and excludes expert determinations from its definition of arbitration.

New York state courts have regularly confirmed determinations made by independent accounting firms in purchase price adjustment disputes under the statutory authority of New York CPLR §7601, while at the same time recognizing and explaining why such proceedings are not arbitrations and not governed by arbitration law. See, e.g., *Westmoreland Coal v. Entech*, 100 N.Y.2d 352 (2003) (petition pursuant to CPLR §7601 to compel party to submit purchase price dispute to independent accounting firm); *Doosan Infracore v. Ingersoll-Rand*, No. 652170/2010 (N.Y. Sup. Ct. March 15, 2011) (confirming accounting firm's purchase price adjustment).

Indeed, Section 7601 was enacted in order to provide for judicial enforcement of expert determinations as separate and distinct from arbitration. Section 7601 provides that a "special proceeding may be commenced to specifically enforce an agreement that a question of valuation, appraisal or other issue or controversy be determined by a person named or to be selected." A report to the New York Legislature, submitted

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in support of legislation that led to the enactment of what is today Article 76 of the CPLR, recited the long and broad use of expert determinations, as follows:

Many business agreements contain provisions for determination by a designated third party...of valuation, appraisal of loss, verification of performance, ascertainment of quantity or quality, fixing of boundary lines, or other specific questions relevant to the transaction. Agreements of this kind were recognized as valid at an early date.<sup>7</sup>

Courts had previously held that such agreements could not be specifically enforced under the statute governing arbitration, because they were not arbitrations. See *In re Delmar Box*, 309 N.Y. at 63-64, 66. CPLR § 7601 provides the courts with broad statutory authority to enforce expert determination clauses, including the authority to confirm the decision made by the expert and enter it as a court judgment. See *In re Penn Central*, 56 N.Y.2d at 128-30.

### Differences From Arbitration

While arbitration and expert determination have many similarities, there are also important differences. The laws governing expert determination and arbitration are materially different in several important ways, involving matters of both substance and procedure. The city bar report describes and explains those differences, focusing on four points. (The city bar is presenting a public program on expert determinations, with particular focus on purchase price adjustment clauses, on Jan. 13, 2014.)

First, a close analysis of the case law reveals that the fundamental difference between an expert determination and arbitration can be found in the scope of authority the parties are delegating to the decision-maker. As more fully discussed in the report, in a typical expert determination, the authority granted to the expert is limited to deciding a specific factual dispute concerning a matter within the special expertise of the decision maker, usually concerning an issue of valuation. The decision-maker is expected to use his or her specialized knowledge to resolve the specified fact issue. The parties do not normally grant the expert the authority to decide legal claims, make binding determination of law, interpret contracts, decide liability, or award damages. As a consequence, expert determinations can be much faster, more focused, and substantially less expensive than arbitration.

In arbitration, on the other hand, the parties normally intend to delegate to the decision-maker full authority to decide all legal and factual issues necessary to resolve all claims that fall within the scope of the arbitration clause. The grant of authority to an arbitrator, but not to an expert, is analogous to the powers of a judge. Arbitrators are expected to rule on issues of law, make

binding interpretations of contracts, resolve disputed issues of fact, determine liability, and award damages or other forms of relief. Arbitration ordinarily encompasses the resolution of the entire controversy submitted to arbitration, while an expert determination is usually limited to the resolution of specific issues of fact. Where the fact issue resolves the entire controversy submitted, an expert determination can be confirmed by a court as a judgment. See *In re Penn Central*, 56 N.Y.2d at 128-30.

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Second, there are very significant differences in procedure. Arbitration requires procedural protections appropriate to an adversarial proceeding. An arbitrator is required to decide the matter only on the evidence submitted by the parties. Arbitrators are expected to hold a hearing or otherwise provide the parties with a fair opportunity to present their evidence. Most importantly, an arbitrator may not engage in any independent investigation, hear evidence outside the presence of the parties, or participate in any ex parte communications.

In an expert determination, these procedural restrictions do not automatically apply. Experts may act on the basis of their own special knowledge and expertise. The expert, subject to any limitations imposed by the parties in the contract, has inquisitorial powers and can exercise that discretion to gather information from any source that in the expert's judgment is required to resolve the matter, including by independent investigation and ex parte communication. As a result, not all the evidence an expert considers must be presented at a hearing in the presence of the parties. These more informal procedures also allow for an expert determination to be structured so as to provide a faster resolution of a specified factual issue than if the same issue were to be resolved by arbitration.

Third, there are substantial differences in the standard of review. Review of an arbitration award is governed by the Federal Arbitration Act (FAA). The grounds to set aside an

arbitration award are limited. See 9 U.S.C. §10. Courts will not review an arbitration award on the grounds that the arbitrator may have made an error of law or mistake of fact. Furthermore, the parties cannot by contract change the standard of review set forth in the FAA.

Expert determinations are governed by state law, not the FAA. The standard under New York law, as well as the law of many other states, is that such determinations will be binding on the parties in the absence of "fraud, bad faith or palpable mistake."<sup>8</sup> Moreover, parties can contractually set the standard of review to be applied in reviewing the expert's determination. For example, the parties may agree that the expert's determination shall be final and binding on all parties, except in the case of manifest error.

Fourth, an arbitration award is enforceable in the United States under the FAA and, in contracting states, under the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). Expert determinations are governed solely by state law and most likely would not be afforded the benefit of the New York Convention.

### Conclusion

An increase in awareness of the law of expert determination, as an alternative to arbitration, will allow parties to choose the form of dispute resolution most appropriate to their specific needs.

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1. The full report is available at [www2.nycbar.org/Publications/reports/](http://www2.nycbar.org/Publications/reports/).

2. The terms historically used to distinguish expert determination from arbitration are "appraisal" or "appraisement." See *In re Penn Central*, 56 N.Y.2d at 126-27 ("Historically, the courts have recognized a basic distinction between appraisal and arbitration.") Today, as under English law, the more appropriate term for this alternative to arbitration is expert determination.

3. See *Rice v. Ritz Assocs.*, 450 N.Y.S.2d 7 (1st Dept. 1982) *aff'd*, 58 N.Y.2d 923 (1983) (rent adjustment under lease).

4. See, e.g., *Tonkery v. Martina*, 78 N.Y.2d 893 (1991) (purchase price upon exercise of option to be fixed by three appraisers); *Trio Asbestos Removal v. Marinelli*, 37 A.D.3d 475 (2d Dept. 2007) (valuation of shares to be sold to be determined by the company's accounting firm).

5. See, e.g., *Lee R. Russ & Thomas F. Segalla*, 15 Couch on Insurance §209:8 (3d ed. 2012).

6. See John Kendall, Clive Freedman and James Farrell, *Expert Determination* at 2, 309 (4th ed. 2008).

7. See Law Revision Comm'n, "Recommendation to the Legislature Relating to Enforcement of Agreements for Appraisal or Valuation and to Arbitration of Certain Non-Justiciable Issues," N.Y. Legis. Doc 65(C), at 385 (1957).

8. See, e.g., *Liberty Fabrics v. Corporate Props. Associates*, 5, 636 N.Y.S.2d 781 (1st Dept. 1996).