ARBITRATION CLAUSES: HOT QUESTIONS AND COOL ANSWERS

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The Road to Enforceability

This article aims to explain the basic considerations of drafting arbitration clauses. Arbitration clauses can save a business time and money, but only if they are drafted in a way that is enforceable. Pre-dispute agreements to arbitrate were not always enforceable in court.

The origins of arbitration in America date back to the colonial era where it was popular in certain areas of commerce (*e.g.*, admiralty) because the parties could pick a decision maker who was experienced in the trade or industry of the disputants. Arbitrators were usually recognized experts in their fields and frequently were not lawyers. Proceedings tended to be simple, informal, and short. As practiced in these early days of our country, arbitration was thought to be more predictable and expedient than pursuing dispute resolution in the courts.

Prior to the enactment of the Federal Arbitration Act (FAA) in 1925 – 9 U.S.C. §§ 1, *et seq*. - *pre*-dispute arbitration agreements were prohibited and thus unenforceable. Hostility of United States courts towards arbitration grew out of the practice of English courts opposing anything (arbitration included) that deprived the courts of jurisdiction. A good discussion about the early history of arbitration preceding the enactment of the FAA can be found in *Allied-Bruce Terminex Cos. v. Dobson*, 513 U.S. 265 (1995) and *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991).

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The FAA was enacted to overcome the American judiciary's longstanding refusal to enforce pre-dispute arbitration agreements and to place such contracts on an equal footing with contracts in general. The central purpose of the FAA was to force courts to validate and enforce arbitration agreements just as they would any other contract. Effectively, the FAA legislatively overruled the long line of cases refusing to enforce pre-dispute arbitration agreements. What has followed is a line of Supreme Court precedent recognizing the validity and enforceability of pre-dispute arbitration agreements and mandating trial courts to compel arbitration and stay litigation whenever disputes are subject to an arbitration agreement. 9 U.S.C. §§ 3, 4. *See, e.g.*, *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 625 (1985) (The liberal policy favoring arbitration requires courts to "rigorously enforce agreements to arbitrate.").

Arbitration Is a Creature of Contract

Section 2 of the FAA provides in relevant part:

> A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2. It is thus a cardinal principle that arbitration "is a matter of consent, not coercion." *Volt Info. Sci. v. Leland Stanford Jr. Univ.*, 489 U.S. 468, 479 (1989). As such, "a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit" but will only be required to arbitrate a dispute where a valid arbitration agreement exists that covers the dispute at hand. *AT&T Tech. v. Commc'ns Workers,* 475 U.S. 643, 648 (1986); *Cromus Inv., Inc. v. Concierge Serv.*, 35 Cal. 4th 376, 384-85 (2005).

QUICK LOOK
The strong public policy in favor of arbitration does not extend to those who are not parties to an arbitration agreement . . .

Because arbitration agreements are to be treated the same as other contracts, it should come as no surprise that disputants who want to escape the effect of a pre-dispute arbitration clause generally try to do so by invoking state contract law principles and defenses.

- **Formation Defense:** Whether the arbitration clause is enforceable (*e.g.*, was there mutual assent? Is the agreement illusory and a sham? Is the clause void because it is unconscionable?)
- **Interpretation Defense:** Whether the dispute falls within the scope of the arbitration clause (*e.g.*, is the clause "narrow"? Are there express limits on which types of disputes are subject to arbitration or which type of relief is available through arbitration?)
- **Waiver Defense:** Whether the other party has engaged in conduct that amounts to an express or implicit waiver of the contractual right to arbitration (*e.g.*, has the party seeking to compel arbitration participated in and received the benefits of court litigation through motion relief and/or discovery not available in arbitration?)

This perhaps explains why there are so many reported cases concerning the above subjects!

Basic Drafting Considerations and Opportunities

When participating in any dispute resolution process, most parties expect some level of expediency and fairness. A well-drafted arbitration clause can greatly improve the process in terms of meeting the parties' expectations relative to these matters. The reverse is also true. A poorly drafted clause or the use of a clause that does not fit the parties' relationship and/or transaction can complicate the process, open the door to unnecessary expense, and leave parties and their counsel unsatisfied with the process, irrespective of the outcome. Before looking at specific contract drafting considerations and opportunities, some of the characteristics and positive attributes of arbitration should first be reviewed:

- **Voluntary:** both/all parties must agree to use this dispute resolution process.
- **Party Control:** the parties have control over defining the process, picking what rules will govern the process, and selecting their decision maker.
- **Private:** the proceedings are not open to the public and there is no public record of the papers filed or evidence submitted at the evidentiary hearing on the merits.
- **Expert Decision Maker:** the parties can define the qualifications and selection criteria for the decision maker; they can require subject matter and/or process expertise.
- **No Case Precedent:** the prior decisions of the named arbitrator or awards rendered in prior arbitrations are not binding in the current dispute and the award issued in the current dispute will have no precedential value in subsequent court or arbitration proceedings.
- **EEF:** the process is efficient, economic, and fair *if* done right.

Like other dispute resolution processes, there are negative attributes that counter-balance the positive attributes of commercial arbitration discussed above. The most frequently voiced objections include the following:

- No right to appellate review, and the review afforded by vacatur is limited to process errors that do not reach the merits of the arbitrator's decision.
- When the expense associated with the arbitrator and provider are factored in, arbitration is just as expensive as litigation.
- Arbitrators are not required to follow the law when making their decisions.
- Arbitrators are unwilling to make the "tough decision" for fear of alienating a source of business and thus resort to "splitting the baby."
- Lack of confidence in the arbitrator's neutrality, especially with "repeat players."
- Concern that the other party will not participate in good faith and that, in turn, will require court proceedings to resolve process issues.

Because the parties have the power to shape and control the arbitration, define the criteria by which their decision maker will be selected, and dictate what decision-making power the arbitrator does (or does not) have, one would think that these positive attributes would tip in favor of arbitration as the preferred method of dispute resolution for business/commercial disputes. However, a 2011 study by the RAND Institute for Civil Justice found that while businesses included arbitration clauses in over 75% of their employment and consumer contracts (generally contracts of adhesion), those same businesses responded that they include arbitration clauses in only 6% of their business-to-business/negotiated contracts. *See* Douglas Shontz, et al., *Business-to-Business Arbitration in the United States/Perceptions of Corporate Counsel*, http://www.rand.org/ content/ dam/rand/pubs/technical_ reports/2011/ RAND_TR781.pdf. Chief among the reasons given for not including arbitration clauses in their business-to-business contracts were the frequently noted objections set forth above.

Basic Clause Considerations

When considering an arbitration clause, there are a number of questions to ask. The following are a few to consider:

Disputes That Can Be Included in Agreements to Arbitrate

Generally, one must be a party to an arbitration agreement to be bound by it. "The strong public policy in favor of arbitration does not extend to those who are not parties to an arbitration agreement, and a party cannot be compelled to arbitrate a dispute he has not agreed to resolve by arbitration." *Buckner v. Tamarin*, 98 Cal. App. 4th 140, 142 (2002). There are three exceptions to this rule: (1) an agent can bind a principal, (2) spouses can bind each other, and (3) a parent can bind a minor child. *Id.* In a recent decision, the court of appeal explained that while plaintiff had signed a residency agreement for her mother that contained an arbitration provision, she did so as her mother's power of attorney and not in her personal capacity. *Monschke v. Timber Ridge Assisted Living, LLC*, 244 Cal. App. 4th 583, 587 (2016). Accordingly, there was no basis to infer that plaintiff had agreed to arbitrate her wrongful death claim because such a claim was not derivative or brought on behalf of the decedent's estate. Rather, the claim belonged to plaintiff and her siblings and they had no arbitration agreement with the care facility.

In a two-party transaction, it is easy to identify and provide for signature of the two parties. But what happens in a more complicated transaction that involves multiple contracts that do not involve all of the same parties, such as a real estate development project where there may be a general contract between the project owner and the general contractor, subcontracts between the general contractor and its sub-contractors, bonding agreements between the general contractor and its bonding company, indemnification agreements between the bonding company and the principals of the general contractor, etc.? In the scenario where there are related transactions, if one aspect fails or goes into default, there are likely to be claims, cross-, and counter-claims. If the entirety of "the dispute" is intended to be resolved through arbitration, care must be taken to include an arbitration clause (hopefully the same one) in all of the related contracts—or incorporate the "master agreement" (if there is one) into the subsidiary agreements—at the front end when the contracts are being negotiated and drafted.

Requirements for a Meeting of the Minds on Arbitration

While both the FAA and the California Arbitration Act (CAA) require that an arbitration agreement be set forth in a writing, neither specify that the writing must be signed by the parties. Since arbitration agreements are to be treated the same as general contracts, that is the law that supplies the answer. As a matter of general contract law, mutual manifestation of assent can be expressed by written or spoken word or by conduct. *Binder v. Aetna Life Ins. Co.*, 75 Cal. App. 4th 832, 848 (1999). In California, a party's intent to contract is judged objectively, by the party's outward manifestation of consent. *Cedars Sinai Med. Ctr. v. Mid-West Nat'l Life Ins. Co.*, 118 F. Supp. 2d 1002, 1008 (C.D. Cal. 2000). The test is whether a reasonable person would infer from the conduct of the parties that there was a mutual agreement. *Hilleary v. Garvin*, 193 Cal. App. 3d 322, 327 (1987); *Meyer v. Benko*, 55 Cal. App. 3d 937 (1976). For example, in *Windsor Mills, Inc. v. Collins & Aikman Corp.*, 25 Cal. App. 3d 987 (1972), the court held that no agreement to arbitrate existed where the arbitration clause was buried in small print on the reverse side of an "Acknowledgment of Order" sent to plaintiff after the order was placed. For another example, in *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147 (7th Cir. 1997), an arbitration clause included in the paperwork packed in a box with the purchased goods was deemed "accepted" when the consumer retained the goods. For a final example, in *Lee v. Intelius, Inc.*, 737 F. App'x 1254 (9th Cir. 2013), an arbitration clause was held to be unenforceable because it was buried on a website through two, small-print hyperlinks.

In application, so as to avoid litigating the issue of mutual assent, better practice is to have a signed writing where all parties expressly agree to arbitration. In the digital age, this is not always possible, so other means are necessary to demonstrate assent via conduct; *e.g.*, "clicking" an acceptance of terms and conditions posted on a website before concluding the shopping cart transaction; replying to an email verification before receiving a document for e-signature and/or e-initial. *See, e.g.*, *Nguyen v. Barnes & Noble, Inc.*, 763 F.3d 1171 (9th Cir. 2014) (arbitration clause contained in "Terms and Conditions" posted on website was not enforceable because the customer's ability to browse the website and discover the "Terms and Conditions" was insufficient to show that the customer actually did so); *Ruiz v. Moss Bros. Auto Grp., Inc.*, 2014 WL 7334221 (arbitration clause contained in an employee's employment agreement was unenforceable because the employer could not explain or demonstrate how the electronic signature made it onto the agreement); *cf. Espejo v. S.n California Permanente Med. Grp.*, 2016 WL 1613487 (arbitration clause contained in an employment agreement that was executed electronically by employee was enforceable because the employer explained the step-by-step process used to obtain electronic signatures, unique to each employee).

ON POINT
Providers generally provide case managers, hearing rooms, and other infrastructure to manage the case from start to end.

Disputes That May Be Subject to Arbitration

Before parties may be ordered to arbitration, a valid agreement to arbitrate must exist and the particular dispute must fall within the scope of that agreement. *Volt Info. Sci., Inc. v. Board of Trustees of Leland Stanford, Jr. Univ.*, 489 U.S. 468 (1989). When discussing and determining the scope of what disputes are subject to arbitration, the courts talk generally in terms

of "narrow" or "broad" clauses. A narrow clause seeks to limit the arbitration obligation to a narrow set of disputes, typically breach of the underlying contract. A broad clause, on the other hand, seeks to require arbitration of a broad set of disputes—tort, contract, statutory—that arise out of or relate to the underlying contract or the relationship thereby created between or among the parties. So, words matter! *See, e.g.*, *Parker v. Twentieth Century-Fox Film Corp.*, 118 Cal. App. 3d 895, 903 (1981); *Merrick v. Writers Guild of Am., West, Inc.*, 130 Cal. App. 3d 212, 217 (1981); *Advanced Micro Devices, Inc. v. Intel Corp.*, 9 Cal. 4th 361, 381 (1994); *Vianna v. Doctors' Mgmt. Co.*, 27 Cal. App. 4th 1186, 1189 (1994); *Med. Staff of Doctors Med. Ctr. in Modesto v. Kamil*, 132 Cal. App. 4th 679, 684 (2005); *Efund Capital Partners v. Pless*, 150 Cal. App. 4th 1311, 1322 (2007).

ON TOPIC
A poorly drafted clause or the use of a clause that does not fit the parties' relationship and/or transaction can complicate the process

Unless there is a reason to limit the scope of arbitration, it is generally recommended that a "broad clause" be used so as to eliminate interpretation disputes about scope and to assure that all matters touching the parties' relationship are heard and determined in a single proceeding and result in a single decision (versus overlapping proceedings and the prospect of inconsistent rulings). The following is an example of a broad clause:

> Any dispute or difference of any kind whatsoever arising out of, relating to or in connection with this contract, whether in contract, tort, statutory or otherwise, including any questions regarding the existence, scope, validity, breach, revocation of termination of this contract, shall be finally settled by binding arbitration . . . .

"Administered" Versus "Ad Hoc" Arbitrations

An "administered" arbitration means one that is submitted to and managed by a provider organization such as the American Arbitration Association (AAA) or Judicial Arbitration and Mediation Services (JAMS). An "ad hoc" arbitration refers to an arbitration that is submitted directly to the arbitrator and is managed by the arbitrator per the instructions of the parties.

Some of the pros associated with an "administered" arbitration is that the provider's rules will govern the arbitration, unless otherwise provided in the parties' agreement, and those rules should address all aspects of the proceeding, meaning that the parties do not need to spend time discussing or agreeing on the procedures that will govern the arbitration. Additionally, a provider such as the AAA or JAMS hosts a panel of highly trained and experienced arbitrators, and will facilitate pre-appointment disclosures and negotiation of the arbitrator's fee. Providers generally provide case managers, hearing rooms, and other infrastructure to manage the case from start to end. The downside associated with an "administered" arbitration is that providers charge fees for their services either directly or through an "add on" to the arbitrator's fee from which the provider then takes a percentage. The following is an example of language for an "administered" arbitration:

> The arbitration shall be administered by the American Arbitration Association in accordance with its Commercial Arbitration Rules then in effect.

The obvious upside associated with "ad hoc" arbitrations is that there are no fees or add-ons. The downside of an "ad hoc" arbitration is that it presumes that the disputing parties, their counsel, and the arbitrator will be able to work together and achieve consensus on rules, protocols, scheduling, etc. It is frequently the case that disputing parties are unable to agree upon much of anything. If that circumstance materializes in an "ad hoc" arbitration, then it will be difficult to move the case towards an evidentiary hearing and may necessitate getting the court involved to direct and monitor the proceedings. Such a development could prove to be expensive in terms of attorney's fees, filing fees, and other costs associated with the court proceedings needed to move the arbitration forward.

Single Arbitrator Versus Panel of Three

While a panel of arbitrators may bring more collective wisdom and experience to bear on the issues, it comes at an expense that is roughly three times that of a single arbitrator. If the number of arbitrators is not specified in the arbitration clause, then the provider's rules will govern the issue. Irrespective of complexity—or lack thereof—provider rules will generally require a three-arbitrator panel when the dispute involves an amount in controversy over a certain amount (*e.g.*, $500,000 or $1,000,000). If potential disputes might fall in both the large and/or small dollar range, a clause could be drafted that specified the range for a single arbitrator and the range for a panel of three arbitrators. For the cost-conscious consumer of neutral services, this is a matter that should be addressed in the arbitration clause.

This is part one of a two-part article on drafting arbitration clauses. Part two will cover advanced drafting considerations and opportunities, and will be published in a later issue of Orange County Lawyer.

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