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Five Arbitration Issues Rece

By Scott D. Marrs a

Arbitration can be an efficient and cost-effective way of resolving disputes. Arbitration can lead to positive results for the resolution of business disputes, including less adversarial relationships, faster decisions, and lower dispute resolution costs. Although arbitration may be the answer, all arbitrations are not created equally. Because arbitration is a creature of contract, the rights and obligations of the parties and the arbitrators are, to an important extent, borne out of the arbitration clause itself. The appropriate arbitration language will often depend on the circumstances and how the courts have recently interpreted and applied arbitration provisions, laws, and rules. This article answers five questions about arbitration recently considered by the courts:

1. Can the parties agree that an arbitration award is appealable?
2. Under what circumstances does a party waive its right to arbitrate?
3. What effect does an unconscionable contract provision within an agreement have on enforceability of the arbitration clause contained therein?
4. Do arbitrators have the power to compel discovery from non-parties?
5. Are heirs and beneficiaries bound by a decedent's arbitration agreement?

The cases discussed below will help contract negotiators and drafters devise a better arbitration agreement, help practitioners better advise their clients, and update arbitrators on what courts are thinking and doing in the realm of arbitration.

1. Can the parties agree that an arbitration award is appealable?

Modern arbitration arose from the time-consuming and costly nature of traditional litigation. One characteristic of binding arbitration is, of course, no (or only a limited) right to appeal. The Federal Arbitration Act (FAA) governs arbitration agreements that involve or affect interstate commerce¹ and provides extremely limited circumstances where an arbitration decision may be appealed: (1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where the arbitrators are guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made. 9 U.S.C. §10 (2006).

Although the FAA greatly limits any right to appeal, to what extent can the parties *agree* that an arbitration award is appealable (i.e., agree to judicial review)? In the recent *Hall Street Associates, Inc. v. Mattel, Inc.*² decision, the U.S. Supreme Court further restricted a court's ability to vacate an award, holding that contractual agreements to expand judicial review in arbitrations governed by the FAA are prohibited and unenforceable. This decision resolved a significant split among federal courts of appeals. The court held that the FAA's four statutory



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grounds to vacate or modify an arbitration award (set forth above) are *exclusive* for parties seeking review under the FAA. Thus, legal error (such as an alleged misapplication of the law) will never be a sufficient ground on which to appeal an arbitration award under the FAA.

However, *Hall Street* left open the possibility that state law (statutory or common law) might provide a basis for expanded review (indicating that the FAA does not preclude a “more searching review based on authority outside the [FAA],” including “state statutory or common law”). The Supreme Court of California was listening. Six months after *Hall Street* was handed down, it rendered an opinion in *Connection, Inc. v. DIRECTTV, Inc.*,³ affirming a party’s contractual right to expand judicial review of arbitration awards under the California Arbitration Act. The court enforced the parties’ agreement that “[t]he arbitrators shall not have the power to commit errors of law or legal reasoning, and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error.” The court also explained that, although the California statute does not provide for appellate review, this does not limit the parties’ contractual right to expand review.

Is “manifest disregard of the law” dead or alive as a basis for judicial review?

There is a split of authority on whether manifest disregard for the law as a ground for vacatur of an arbitration award survives the *Hall Street* decision. A recent 5th Circuit case, *Citigroup Global Markets Inc. v. Bacon*,⁴ held that manifest

disregard of the law is not a valid statutory ground for vacatur under the FAA. The Court noted, however, that several other circuits have reached a contrary conclusion. For example, the 2nd, 6th, and 9th Circuits have recently held that *Hall Street* only applies to *contractual* expansions of judicial review, and thus does not prohibit judicial review for manifest disregard of the law.⁵

In a highly anticipated ruling on April 27, 2010, the U.S. Supreme Court passed on the opportunity to settle this issue. In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 559 U.S. ____ (2010), a 5-3 decision written by Justice Samuel Alito,⁶ the Supreme Court ruled that an arbitration panel may not compel a party to submit to class arbitration unless the party contracted to arbitrate. Apart from the implication this ruling has on future class arbitrations, the Court left open the door for the appeal of an award for manifest disregard for the law. Although the Court noted that the 2nd Circuit held that the manifest disregard standard did survive *Hall Street*, it made clear that it was not ruling on the issue of whether manifest disregard survives *Hall Street* as an independent ground for review or as a judicial gloss on the enumerated grounds for vacatur under the FAA. Instead, the Court concluded that the arbitration panel had exceeded its powers when it imposed its own view on class arbitration.

Although *Stolt-Nielsen* punted on the issue of whether manifest disregard survives *Hall Street*, many see this as an implicit acknowledgement that the manifest disregard standard survives *Hall Street*, thus calling into question appellate court decisions



specifically striking down the doctrine as dead. Because the Supreme Court left the door open, the continued viability of the manifest disregard standard will likely be a fertile ground for debate in future cases.

Solution: Provide for the right to appeal to an arbitration panel rather than to the courts.

Given the recent scrutiny of “judicial review” arbitration provisions, the parties may consider another approach to hedge against anomalous awards — providing for review by a different arbitration panel. This solution bypasses “judicial review” prohibitions since such review would be outside the realm of the courts, and within the parties’ right to contract for arbitration. The American Arbitration Association (AAA) rules neither authorize nor prohibit appeals. However, they do give parties the freedom to contract for procedures that work best in their given circumstances: “The parties, by written agreement, may vary the procedures set forth in these Rules.”⁷ As such, parties may want to consider whether crafting an appellate process — ideally limited solely to errors of law — to hedge against an anomalous award. The following “appeals” provision (approved by the AAA) may provide this framework:

Within 30 days of receipt of any award (which shall not be binding if an appeal is taken), any party may notify the AAA of an intention to appeal to a second arbitral tribunal, constituted in the same manner as the initial tribunal. The appeal tribunal shall be entitled to adopt the initial award as its own, modify the initial award or substitute its own award for the initial award. The appeal tribunal shall not modify or replace the initial award except [for manifest disregard of law or facts] [for clear errors of law or because of clear and convincing factual errors]. The award of the appeal tribunal shall be final and binding, and judgment may be entered by a court having jurisdiction thereof.⁸

2. Under what circumstances does a party waive its right to arbitrate?

In certain circumstances, the right to enforce an arbitration clause is unwittingly waived. Waiver generally occurs where the party substantially invokes the judicial process to the other party’s detriment.⁹ Although courts strongly favor arbitration, and waiver is difficult to establish,¹⁰ a party may impliedly waive arbitration by statements or actions that are inconsistent with its right to seek arbitration.

One recent case provides a good summary of circumstances where waiver may or may not be found. In *Perry Homes v. Cull*,¹¹ Texas homeowners sued their homebuilder in court, rather than invoking agreed-upon arbitration. The plaintiffs took depositions, opposed the homebuilder’s request for arbitration, but then attempted to invoke arbitration themselves later on in the case. The Supreme Court of Texas stressed the strong presumption in favor of arbitration, and described par-

ticular actions that have been held *insufficient* to constitute a waiver of the arbitration clause: (1) filing a lawsuit; (2) moving to dismiss a claim for lack of standing; (3) moving to set aside a default judgment and requesting a new trial; (4) opposing a trial setting and seeking to move the litigation to federal court; (5) moving to strike an intervention and opposing discovery; (6) serving written discovery; (7) noticing (but not taking) a single deposition and agreeing to a trial resetting; (8) taking four depositions and moving for dismissal based on standing.

The court then utilized the totality of circumstances test, and considered the following factors in determining whether a waiver had occurred: (1) which party invoked arbitration; (2) how long the moving party waited before initiating arbitration; (3) whether the party initiating arbitration was previously aware of the ADR clause; (4) the amount of activity related to the merits, rather than arbitrability or jurisdiction; (5) the amount of expense and time already incurred in litigation; (6) whether the moving party had previously opposed arbitration; (7) whether the moving party filed affirmative claims or dispositive motions in the case; (8) whether arbitration would preclude important discovery; (9) whether activity in court would be duplicated in arbitration; and (10) the pending trial date, if any.

Must the other party be prejudiced for waiver to apply?

Consistent with 10 federal circuit courts, the Texas Supreme Court in *Perry Homes* held that the party arguing waiver must show that the moving party’s delay in seeking arbitration caused it *prejudice*. The court concluded that the litigation process was substantially invoked (i.e., arbitration waived) by: taking 10 depositions, filing a 79-page objection to the defendant’s request for arbitration, filing five motions to compel production of documents, serving numerous notices of deposition, and waiting very late in the case to invoke arbitration. The court defined “prejudice” under the FAA to mean inherent unfairness (i.e., an attempt to have it both ways by switching between litigation and arbitration to gain an advantage). The court concluded that the plaintiffs’ act of initially objecting to arbitration, and then insisting on it after the defendants acquiesced to litigation, constituted a manipulation of litigation that satisfied the “inherent unfairness” requirement of prejudice.

3. What effect does an unconscionable provision in a contract have on enforceability of the arbitration clause contained therein?

Drafters of arbitration agreements occasionally put a clause in the arbitration agreement prohibiting the claimant from recovering attorney’s fees in the event the claim prevails in arbitration. Is this permissible? One recent case sheds light on this issue. In *Security Service Federal Credit Union v. Sanders*,¹² the court was confronted with a partially unconscionable contract that also contained an arbitration clause. One portion of the contract limited the consumer’s right to receive attorney’s fees and costs under the Texas Deceptive Trade Practices Act



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(DTPA), and dictated that the consumer was responsible for the other party's attorney's fees (contrary to the DTPA). The court noted that if intended by the parties, an illegal or unenforceable provision can be severed from the contract and the remainder can be enforced. This intent was evidenced by the arbitration clause itself, which expressly provided for severability. The unenforceable attorney's fees provision was thus severed from the rest of the agreement, and the remainder of the agreement, along with its arbitration clause, was enforceable.

4. Do arbitrators have the power to compel discovery from non-parties?

The subpoena power of a court of law generally allows the court to compel discovery from a non-party that is subject to the court's jurisdiction. The extent to which an arbitration panel has similar authority to compel discovery from a non-party is not clearly defined. Recent case law has adopted a limited view of the arbitrators' power to compel non-party discovery. In *Matria Healthcare, L.L.C. v. Duthie*,¹³ the court noted that an arbitrator's subpoena power over non-parties under Section 7 of the FAA is limited to compelling them to testify or produce documents at the hearing. The court held that this subpoena power does not extend to compelling third parties to produce documents or appear for a deposition before the hearing.

The recent holding in *Life Receivables Trust v. Syndicate 102 at Lloyd's of London*¹⁴ applies this rationale, refusing to give effect to an arbitration panel's order compelling production of documents from a third party. The Second Circuit noted that arbitrators may order a non-party to produce documents so long as that person is called as a witness at the hearing.

5. Are heirs and beneficiaries bound by a decedent's arbitration agreement?

The answer to this question often depends on whether the wrongful death action is an independent or *derivative* cause of action under state law. This is the approach taken in the majority of states, including Texas, Mississippi, Alabama, and Michigan. If the beneficiaries only have standing to sue if the decedent would have had a right to sue (i.e., derivative of the

decedent's rights), they will be bound by the decedent's agreement to arbitrate. See *In Re Labatt Food Service*¹⁵ (heirs bringing wrongful death claims are bound by the decedent's arbitration agreement since the Texas Wrongful Death Act expressly conditions the beneficiaries' claims on the decedent's standing to sue for his injuries). However, a minority of states, such as Utah and Missouri, have held to the contrary.¹⁶

Conclusion

Arbitration is a living and ever-changing process. Counsel must keep apprised of the latest developments and decisions affecting arbitrations to determine how current arbitration clauses will be interpreted, and how to best draft arbitration provisions for their clients.

Notes

1. The FAA only preempts state laws that *conflict* with the FAA — there is no intent to occupy the field. Thus, state arbitration statutes may govern arbitration agreements that involve only interstate commerce, to the extent such statutes do not conflict with the FAA. See *Volt Info. Sciences, Inc. v. Bd. of Trustees of Leland Stanford*, 489 U.S. 468, 477 (1989) (California stay provision is not preempted by the FAA).
2. 128 S.Ct. 1396 (2008).
3. 44 Cal. 4th 1334, 190 P.3d 586 (2008).
4. 562 F.3d 349 (5th Cir. 2009).
5. See *Comedy Club Inc. v. Improv West Assocs.*, 553 F.3d 1277, 1290 (9th Cir. 2009); *Coffee Beanery, Ltd. v. WW, L.L.C.*, 300 Fed. Appx. 415, 419 (6th Cir. 2008).
6. Justice Sonya Sotomayor recused herself from the decision.
7. AAA Rule R-1(a).
8. *Drafting Dispute Resolution Clauses, A Practical Guide* (Amended and Effective Sept. 1, 2007), Page 37, American Arbitration Association, found at: <http://www.adr.org/si.asp?id=4125>.
9. *In re Citigroup Global Markets*, 258 S.W.3d 623, 625 (Tex. 2008).
10. See *id.* at 626 (no waiver found where the party seeking arbitration participated only in jurisdiction transfer proceedings and not in the merits of the dispute).
11. *Perry Homes v. Cull*, 258 S.W.3d 580 (Tex. 2008).
12. 264 S.W.3d 292 (Tex. App. — San Antonio 2008, no pet. h.).
13. 584 F. Supp. 2d 1078 (N.D. Ill. 2008).
14. 549 F.3d 210 (2d Cir. Nov. 25, 2008).
15. 279 S.W.3d 640 (Tex. 2009)
16. See, *Bybee v. Abdulla*, 189 P.3d 40, 43 (Utah 2008) (beneficiaries not bound because wrongful death is an independent cause of action under Utah law); *Lawrence v. Manor*, 273 S.W.3d 525 (Mo. 2009) (beneficiary not bound because under Missouri law the wrongful death act creates a new cause of action belonging to the beneficiaries).

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