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Arbitration: Risk Takers vs. Risk Avoiders – But Which is Which?

I. Introduction

This presentation will address the practical aspects of arbitration from a defense perspective. The discussion will include issues relevant to the initial decision to seek or oppose arbitration in professional liability cases, including, for example, the scope of arbitration provisions, potential conflicts of interest and other claims handling considerations. In addition, the presentation will offer practical strategies that insurers and defense attorneys can use to maximize the benefits of arbitration. In this regard, the panelists will cover topics such as negotiating agreements that limit expense, solutions to the dispositive motion dilemma, and the effective presentation of evidence.

II. The Pros and Cons of Arbitration

Arbitration is generally more flexible than litigation, which arises in large part from the agreement of the parties on issues such as timing, discovery, privacy, and procedures. The time to resolution in arbitration can be considerably shorter, as much as a quarter of the time by some estimates. Although some level of discovery is allowed in arbitration, it is often not as broad as discovery in the litigation process. And while that discovery may not be as broad, it is often less expensive. Furthermore, arbitrations are not generally open to the public, unlike court proceedings, thereby affording greater privacy. (This may or may not be a desirable feature depending on your celebrity status and/or appetite for publicity.)

On the other hand, factors such as the cost of a paid "decider," the risk that discovery limitations prevent a full airing of all facts, and the concern about unknown arbitrators (and therefore unpredictable results) weigh against voluntarily agreeing to arbitration. The decision to arbitrate should not be based on speculation or unsupported anecdotal evidence. While there are valid considerations that weigh in favor, there are equally valid concerns about submitting a matter to arbitration.

III. To Seek or to Oppose Arbitration

A. Underwriting considerations.

Arbitration is governed by both state and federal law, and in the last century has secured a favored status in the realm of dispute resolution, in black letter law if not in practice. Congress enacted the Federal Arbitration Act (FAA) in 1925 in response to courts' hostility to arbitration agreements. *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 338 (2011). The FAA reflected a federal policy favoring arbitration as a matter of private contract and—perhaps more importantly—an intent to preempt state attempts to invalidate arbitration provisions. Arbitration clauses may therefore only be invalidated by contractual defenses such as fraud, duress, or unconscionability, not by a state's general resistance to arbitration or unilateral exclusion of certain claims from arbitrability. It can be difficult to successfully oppose a valid arbitration clause, so to the extent that an insured has agreed to a valid arbitration provision, it is often enforceable.

B. Scope of Arbitration Provisions

General principles

Because arbitration is a creature of contract, arbitration provisions are somewhat malleable. As a general rule, then, the parties may expressly agree which claims are arbitrable, or they may expressly agree to allow the arbitrator to decide which claims are arbitrable. The scope of the arbitration provision may hinge on only a few words: for instance, the Florida Supreme Court distinguishes between what it considers to be narrow provisions that cover claims "arising out of" the subject contract and broad provisions that cover claims "arising out of or relating to" the subject contract. *Jackson v. Shakespeare Found., Inc.*, 108 So. 3d 587, 593 (Fla. 2013). The Oklahoma Supreme Court simply stated that a court should permit arbitration "unless the court can say with 'positive assurance' the dispute is not covered by the arbitration clause." *Harris v. David Stanley Chevrolet, Inc.*, 273 P.3d 877, 879 (Okla. 2012).

The parties may agree to arbitrate according to specific rules, such as the rules of the American Arbitration Association. The other side of that coin is that the court will apply default provisions regarding the scope of the arbitration clause absent an express agreement. *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83 (2002).

This policy of deference to contract creates an atmosphere in which arbitration is arguably elevated above litigation in some respects, in that when a party demonstrates that a claim is subject to a contractual arbitration provision, that claim must be arbitrated to prevent parallel litigation. *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 20 (U.S. 1983). In other words, courts generally take pains to avoid the possibility that an issue subject to a valid arbitration clause is determined in litigation and will often stay the litigation. Courts reason that when parties agree to arbitrate and enter into a contract to secure that right, that right is lost if the claim is litigated without the opportunity to arbitrate. Therefore the litigation must be stayed with respect to arbitrable claims when a party moves to compel arbitration under a valid arbitration provision.

Directors and Officers

Directors may include arbitration provisions in consumer contracts and in bylaws. *Concepcion* demonstrated that states may not simply invalidate arbitration clauses on the basis of contractual defense as a mere pretext. The California Supreme Court's decision in *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005) generally barred class action waivers on the basis of unconscionability, but the United States Supreme Court ruled that the FAA allowed arbitration provisions with class action waivers, suggesting that the Court would treat unconscionability quite narrowly. Even so, directors who intend to take their entities public should take note: even after *Concepcion*, the Securities and Exchange Commission still took a dim view of mandatory arbitration clauses with class action waivers, causing at least one company to withdraw the provisions to avoid delays in going public. Barbara Black & Jill I. Gross, *Investor Protection Meets the Federal Arbitration Act*, 1 Stan. J. Complex Litig. 1, 7-8 (2012).

On the other hand, the SEC does have certain powers expressly granted it aside from the ones it assumes. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) contains several carve-outs that disfavor arbitration, including a grant of power to the SEC to forbid arbitration clauses between broker or dealers and their clients under certain circumstances. Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 Del. J. Corp. L. 751, 818 n. 129 (2015).

Design Professionals

For design professionals who deal with prime contracts and subcontracts, litigation stays present particular pitfalls. Indeed, any professionals who contract with clients and subsequently subcontract with others must ensure that the primary contract comports with the subcontracts so disputed issues are not split between arbitration and litigation. For example, assume that a prime consultant contracts with an owner to perform design services and does not include an arbitration provision. Yet the prime consultant contracts with sub consultants for specialized services and includes an arbitration provision in the sub consultants' subcontracts. The owner sues the prime consultant for claims that implicate a sub consultant's design work, so the prime consultant sues the sub consultant as a third-party defendant. The sub consultant moves to compel arbitration, and the issue involving that sub consultant is stayed in the litigation between the owner and the prime consultant to avoid parallel litigation. This puts the prime consultant in the conflicting position of attempting to prove the sub consultant's liability in arbitration when it will later attempt to disprove any liability in litigation with the owner. From a claims handling perspective, this can prolong the dispute and delay resolution.

Attorneys

Attorneys encounter varying approaches to arbitration provisions related to fee disputes and malpractice claims. Claims related to attorney-client fee agreements are generally enforceable. Robert J. Kraemer, *Attorney-Client Conundrum: The Use of Arbitration Agreements for Legal Malpractice in Texas*, 33 St. Mary's L.J. 909, 918 (2002). But even after *Concepcion*, the Louisiana Supreme Court held that an arbitration clause referring to "any other dispute" was unenforceable in light of its requirement of "[e]xplicit disclosure of the nature of claims covered by the arbitration clause, such as fee disputes or malpractice claims." *Hodges v. Reasonover*, 103

So. 3d 1069, 1077 (La. 2012). The First Circuit, however, considered *Reasonover* in light of a motion to compel arbitration of a legal malpractice claim and determined that it was frivolous to suggest that broad language referring to "any other dispute" was insufficient to cover malpractice claims. *Bezio v. Draeger*, 737 F.3d 819, 822 (1st Cir. 2013). Other states' policies vary: California, New York, and New Jersey require that attorneys advise their clients of the benefits of arbitrating a legal malpractice claim, while Illinois and Pennsylvania require that an independent attorney provide the advice. Louis A. Russo, *The Consequences of Arbitrating A Legal Malpractice Claim: Rebuilding Faith in the Legal Profession*, 35 Hofstra L. Rev. 327, 352 (2006). Indeed, the ABA Model Rules of Professional conduct do not "prohibit a lawyer from entering into an agreement with the client to arbitrate legal malpractice claims, provided such agreements are enforceable and the client is fully informed of the scope and effect of the agreement." Model Rules of Prof'l Conduct R. 1.8 cmt. (14) (2013). Notably, the Texas Supreme Court recently ruled an arbitration agreement enforceable even when it contained an arbitration provision that carved out only fee claims by the attorney. *Royston, Rayzor, Vickery, & Williams, LLP v. Lopez*, 467 S.W.3d 494, 497 (Tex. 2015).

Employment contracts

The FAA applies broadly to the arbitrability of employment contracts with the exception of workers involved in interstate transportation. An exemption clause in the FAA states that the act does not apply "to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce." 9 U.S.C. § 1. While the language is broad, the Supreme Court has held that the language should not be applied as broadly as the Court's New-Deal-era interstate commerce decisions would suggest. *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 112, (2001). The Court therefore held that the broad "any other class of workers language" exemption only applied to transportation workers.

Insurer-Insured

State law may limit arbitrability of claims between an insurer and insured. The McCarran-Ferguson Act ("MFA"), states that "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance." 15 U.S.C.A. § 1012 (West 2015). The Fifth Circuit applied the MFA in a "reverse preemption" case, upholding a Mississippi law that invalidated arbitration provisions for uninsured motorist claims. *Am. Bankers Ins. Co. of Florida v. Inman*, 436 F.3d 490, 494 (5th Cir. 2006). Yet the Third Circuit nonetheless compelled arbitration in an insurance carrier's agreement with its clients in spite of Pennsylvania law that disfavored arbitration. *Brayman Const. Corp. v. Home Ins. Co.*, 319 F.3d 622, 623 (3d Cir. 2003).

C. Arbitrating a Claim

Knowing that an arbitration clause is at issue allows the parties to make the arbitration demand early on to minimize the costs of litigation, usually in the form of discovery. This, of course, requires an analysis of the pros and cons of arbitration as it relates to your client's case.

Perhaps more importantly, it requires an idea of the other party's position on the arbitration issue to determine whether arbitration can be used as leverage. As noted below, counterclaims and other claims that fall outside the scope of an arbitration provision may have to be litigated separately—and often after—arbitration and therefore may delay resolution. Given that quality, such claims have the potential to be used creatively by all sides.

D. Potential Conflicts of Interest Issues

Uncovered claims/damages

Arbitration involves many of the same concerns that litigation involves regarding claims and damages that are not covered. For example, consider the implications of contract damages versus tort damages under a liability policy.

Insured's affirmative claims

Depending on the scope of the arbitration provision at issue, the insured's affirmative claim may or may not be covered by the arbitration provision. To the extent that the arbitrable and non-arbitrable claims have overlapping issues, as noted above, the arbitrable claim may be decided first while staying litigation of the non-arbitrable claim. This presents the potential for delays in resolution in addition to the cost increases for what is often unavoidably duplicative activity surrounding related—but not necessarily overlapping—issues.

Non-signatories

Non-signatories to a contract generally cannot be compelled to arbitrate their claims. *Oklahoma Oncology & Hematology P.C. v. US Oncology, Inc.*, 160 P.3d 936, 944 (Okla. 2007); *Alterra Healthcare Corp. v. Estate of Linton ex rel. Graham*, 953 So. 2d 574, 579 (Fla. Dist. Ct. App. 2007); *Pinnacle Museum Tower Assn. v. Pinnacle Mkt. Dev. (US), LLC*, 282 P.3d 1217, 1227 (Cal. 2012). There are, however numerous common-law exceptions under contract and agency principles. Federal courts have generally recognized six theories that may bind non-signatories to arbitration agreements: (1) incorporation by reference; (2) assumption; (3) agency; (4) alter ego; (5) equitable estoppel, and (6) third-party beneficiary. *Thomson–C.S.F., S.A. v. American Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir.1995); *E.I. DuPont de Nemours & Co. v. Rhone Poulenc*, 269 F.3d 187, 195-97 (3d Cir.2001), *Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 629 (6th Cir.2003); *Bridas S.A.P.I.C. v. Gov't of Turkmenistan*, 345 F.3d 347, 356 (5th Cir. 2003). These principles often also work in reverse: a non-signatory, for example, may compel a signatory to arbitrate a dispute when the signatory has executed a separate contract with the non-signatory that incorporates by reference the contract with the arbitration clause. *Thomson–C.S.F., S.A.*, 64 F.3d at 776. And if the non-signatory may enforce the agreement, the non-signatory may also invoke the stay-of-litigation provisions. *Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 632 (2009). It is important to note, however, that a party may not normally be compelled to arbitrate as a third-party beneficiary simply because that party derives an indirect benefit from the contract that contains the arbitration clause. *Fleetwood Enterprises, Inc. v. Gaskamp*, 280 F.3d 1069, 1075 (5th Cir.).

If a party has an arbitration provision in a contract with a corporation or other business entity, the party generally may not avoid arbitration by suing the individual employees, officers, or directors. *Hirschfeld Prods. v. Mirvish*, 218 A.D.2d 567, 569 (N.Y. App. Div. 1995); *In re Vesta Ins. Group, Inc.*, 192 S.W.3d 759, 762 (Tex. 2006). Courts reason that distinguishing between employees, officers, and directors and the corporations they serve creates an easy path to circumvent the arbitration provision.

The same principle does not apply, however, to corporate *affiliates*. *Zurich Am. Ins. Co. v. Watts Indus., Inc.*, 417 F.3d 682, 688 (7th Cir. 2005). Courts reason that corporate affiliates are created for the very reason of separating contracts and liabilities and therefore should not be treated as the same corporation for purposes of compelling arbitration. An exception to this general rule is if two corporations actually act as alter egos. *Bridas S.A.P.I.C. v. Gov't of Turkmenistan*, 447 F.3d 411, 416 (5th Cir. 2006); *Comer v. Micor, Inc.*, 436 F.3d 1098, 1101 (9th Cir. 2006).

Waiver of/Consent to arbitrate

Even with a valid arbitration clause, a party may waive its right to arbitrate by "(1) taking actions that are completely inconsistent with any reliance on an arbitration agreement; and (2) delaying its assertion to such an extent that the opposing party incurs actual prejudice." *Johnson Associates Corp. v. HL Operating Corp.*, 680 F.3d 713, 717 (6th Cir. 2012). If a party participates in in prior litigation that gives it benefits such as additional discovery, it may waive the right to arbitration. *The Hillier Grp., Inc. v. Torcon, Inc.*, 932 So. 2d 449, 456-57 (Fla. Dist. Ct. App. 2006). And once a party consents to arbitration, it may not be able to withdraw that consent, and certainly will not be able to do so after an unfavorable ruling! *Louis Michel, Inc., v. Whitecourt Const. Co.*, 189 N.E. 767, 770 (N.Y. 1934). Courts generally will not intervene to vacate an arbitrator's ruling absent evidence that the arbitrator ignored the parties' agreement or acted irrationally. *Sooner Builders & Investments, Inc. v. Nolan Hatcher Const. Servs., L.L.C.*, 164 P.3d 1063, 1072 (Okla. 2007); *Cobler v. Stanley, Barber, Southard, Brown & Associates*, 265 Cal. Rptr. 868, 876 (Cal. Ct. App. 1990); *Crossmark, Inc. v. Hazar*, 124 S.W.3d 422, 434–35 (Tex. App.—Dallas 2004, pet. denied).

IV. Strategies to Maximize Benefits of Arbitration

A. Establishing the Arbitration Framework

Arbitration agreements are often included in professional services agreements. Lawyers, for example, are actually encouraged to arbitrate fee disputes with their clients. Comments to the Model Rules of Professional Conduct of the American Bar Association suggest that "even when it is voluntary, the lawyer should conscientiously consider submitting" a fee dispute with his client to arbitration. Comments to Rule 1.05, ABA Rules of Professional Conduct. Fee disputes often trigger counterclaims of profession negligence, which also would fall under the arbitration clause.

Even when the engagement agreement does not require arbitration, the professional may find it advantageous to propose because it provides a better opportunity to keep allegations of

professional negligence confidential, something the insured may value far more than the money at stake.

1. Carrier/insured control

Silent engagement agreements and post-dispute decisions to arbitrate afford the opportunity to decide how the arbitration will be set up.

a. Administered or not
b. Which arbitration service
c. Extent of arbitration service involvement

2. Defense counsel strategies

The insured and the carrier should consider their trial timing goals and ensure that their defense counsel can accommodate their preferences.

B. Selection of arbitration service

Work with the arbitration service to tailor the list of arbitrator candidates before it comes out.

1. Establish what qualifications and experience arbitrator candidates should have
2. Consider requesting only arbitrator candidates who can be available at particular time for trial

C. Selection of arbitrator(s)

1. Check candidates' websites, LinkedIn, Google.
2. If strikes are limited, consider objections for cause.

D. Establishing procedure and rules

Control the arbitration process.

1. Scheduling

a. The parties should be the masters of their destiny on timing.
b. Work with opposing counsel in advance of arbitrator selection and in advance of scheduling conference

2. Discovery – What is necessary rather than normal

Just because certain discovery is routinely conducted doesn't mean it should be conducted in every case. Arbitration rules allow for reining in discovery when that is appropriate.

The AAA Commercial Rules, for claims of at least $500,000.00, provide for the exchange of documents. Rule 22, Commercial Arbitration Rules for Large, Complex Disputes (2013). Absent an agreement of the parties to conduct additional discovery – interrogatories, depositions, admissions – parties need the arbitrator's approval for it. Rule 22(a) of the AAA Commercial Rules states:

> The arbitrator shall manage any necessary exchange of information among the parties with a view to achieving an efficient and economical resolution of the dispute, while at the same time promoting equality of treatment and safeguarding each party's opportunity to fairly present its claim and defenses.

The rules of JAMs provide for "voluntary and informal exchange" of all non-privileged documents and other information, including electronically stored information relevant to the dispute "immediately after commencement" of the arbitration. Rule 17, JAMS Comprehensive Arbitration Rules (2014).

JAMs rules also permit each party to take one deposition of an opposing party or of one individual under the control of the opposing party. Rule 17(b) states that the "necessity of additional depositions" shall be determined by the Arbitrator based upon:

(1) the reasonable need for the requested information,
(2) the availability of other discovery options, and
(3) the burdensomeness of the request on the opposing Parties and the witness.

In practice, this can mean a limit on the number of depositions, on the number of hours of depositions per side, limits on interrogatories, and rules on discovery from experts. It also can allow for tight controls on electronic discovery.

3. Dispositive motions

Discuss the idea of having dispositive motions with the arbitrators at the initial scheduling conference. Set a deadline for the filings.

AAA limits the filing of dispositive motions. Rule 33 of the AAA Commercial Rules requires that, before filing a dispositive motion, the moving party request permission to do so. In that request, the moving party must show:

(1) The motion is likely to succeed, and
(2) The motion will dispose of or narrow the issues in the case.

The JAMs rules are more liberal. Rule 18 of the Comprehensive Arbitration Rules states that the arbitrator may permit the filing of a motion of a particular claim or issue, provided the interested parties have reasonable notice to respond.

Bear in mind that the Federal Arbitration Act allows for the vacating of an award if evidence has been improperly excluded. 9 U.S.C. § 10(a)(3) states that a court may vacate an award "where the arbitrators were guilty of .. . . refusing to hear evidence pertinent and material to the controversy . . . ."

E. Presenting the case effectively and efficiently on paper

So long as you include all your affirmative defenses in your initial answer, your pleadings can be fairly cursory. Many arbitrators really start paying attention to the merits when the prehearing briefs are filed.

F. Presenting the case effectively and efficiently at the hearing

1. Expedited presentation of evidence

a. Submission of case strictly on paper
b. Joint exhibits
c. Direct testimony by affidavit with only cross live
d. Witnesses via video conference, by agreement

2. Alternative handling of expert testimony

a. Submission of written reports
b. Hot-tubbing

3. Control over award

a. Bracketed Arbitration Option – JAMs Rule 32 sets out procedure for setting floor and cap on awards. Arbitrators are not told but award is modified, if necessary, to conform
b. Baseball Option – JAMs Rule 33 provides that parties submit their proposed awards and arbitrator(s) choose between them

G. After the hearing

1. Confidentiality of case and award
2. Enforcement
3. Appeals
a. AAA rules allow for an appeal if the parties have included an agreement to appeal in their agreement or agree in writing later.

Rule A-10 of the appellate rules states that a party may appeal based on the assertion that:

(1) the Award is based on an error of law that is material and prejudicial; or

(2) the Arbitrator(s) made determinations of fact that are clearly erroneous.

b. JAMs Rule 34 allows for appeals if both parties agree.

c. Optional Arbitration Appeal Procedure Exists

V. Practical Differences between Arbitration and Litigation

A. Opportunity for Faster Pace
B. Control of Scheduling
C. Control of Process
D. Expert Fact Finder
E. Peer Fact Finder
F. Alternatives in Evidence Presentation