HOW TO WRITE A BAD ARBITRATION CLAUSE!

JOHN K. BOYCE, III
Law Offices of John K. Boyce, III
Trinity Plaza II
745 East Mulberry, Suite 460
San Antonio, Texas 78212
Ph: (210) 736-2224 Fax: (210) 735-2921
jkbiii@boycelaw.net
www.boycelaw.net

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JOHN K. BOYCE, III

Attorney · Arbitrator · Mediator

Trinity Plaza II
San Antonio, Texas 78212-3166
(210) 736-2224
(210) 735-2921(f)
jkbiii@boycelaw.net
www.boycelaw.net

Experience 30+ years in a commercial transaction and litigation practice in state and federal trial and appellate courts. Extensive experience in the formation, maintenance, merger, and acquisition of a variety of business entities: corporations, limited liability corporations, limited partnerships, hedge funds, and preparation of various agreements connected therewith: cross-purchase, buy-sell, redemption, sale and leaseback transactions; preparation of securities memoranda and related compliance work; extensive commercial litigation for both lenders and borrowers involving financial transactions, lending agreements, guaranties, mortgages, contracts, and real estate; creditors' rights representing large publicly-held equipment lessors and financiers in collection matters; forensic accounting and professional malpractice; representing landowners, producers, and pipelines in oil and gas/energy royalty, lease, title, contract, regulatory, and transmission line easement disputes; AV rated by Martindale-Hubbell

Professional Licenses Admitted to Texas Bar, 1978; U.S. District Court: Western, Southern, and Northern Districts of Texas; U.S. Court of Appeals: Fifth Circuit; former Registered Investment Advisor, Texas Securities Board (Series 65 license)(currently inactive)

Professional Associations

Past Chair, Alternative Dispute Resolution Section, State Bar of Texas
Fellow, College of Commercial Arbitrators
Chair, Texas Arbitration Council
Chartered Institute of Arbitrators (MCIArb)
Association of Attorney-Mediators
College of the State Bar
Fellow, Texas Bar Foundation
San Antonio Bar Association.

Other Professional Associations

arbitration panelist:

Commercial Panel (Large Complex Case and Securities subpanels), American Arbitration Association
Distinguished Neutral (Banking, Accounting, and Financial Services Panel, Hedge Funds Panel, San Antonio ADR Panel) International Institute for Conflict Prevention and Resolution (CPR Institute)
American Health Lawyers Association(AHLA)
Financial Industry Regulatory Panel (FINRA)
adjunct professor, Strauss School of Dispute Resolution, Pepperdine University School of Law

Education University of Texas at Austin (BA, Economics, with high honors, 1975, Phi Beta Kappa (junior year), and Juris Doctor, 1978)

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I. INTRODUCTION

Arbitration is here to stay. Driven by what parties perceive as deficiencies of the formal judicial system, including expense, protracted length, gamesmanship, belligerency and wastefulness, arbitration has grown exponentially in the last ten years. Because of its confidentiality, empirical statistics are difficult to come by. Nonetheless, the American Arbitration Association, the largest administrator in the world, notes a 46% increase in total case filings 2007 to 2012 — i.e., from 127,729 to 187,596 cases per year (including commercial, employment, labor, construction and no-fault issues).

Courts, both federal and state, continue wholeheartedly to sanction this trend. Hence, arbitration is highly favored under the law. *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*,460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983); *Safer v. Nelson Financial Group*, 422 F.3d. 389, 293 (5th Cir. 2005); *Ponderosa Pine Energy, LLC v. Tenaska Energy, Inc.*, 376 S.W.3d 358, 369 (Tex. App. — Dallas, 2012, no pet. history) (citing *Prudential Securities , Inc. v. Marshall*, 909 S.W.2d 896, 898 (Tex. 1995).

It is a bedrock principal that arbitration is a *consensual* process. Its authority is derived from the arbitration clause itself. No matter how favored it may be, arbitration is, at its heart, the product of an agreement, and, generally, a court cannot force a party to arbitrate in the absence of their agreement to do so. *Freis v. Canales*, 877 S.W.2d 283, 284 (Tex. 1994) (orig. proceeding) (per curiam); *see also see also Rolland*, 96 S.W.3d at 345; *In re EGL Eagle Global Logistics, L.P.*, 89 S.W.3d 761, 764 (Tex. App. — Houston [1st Dist.] 2002, orig. proceeding) (mand. denied). In the words of the Dallas Court of Appeals:

> Although arbitration is encouraged, it is a contractual matter and, in the absence of an agreement to arbitrate, a party cannot be forced to forfeit the constitutional protections of the judicial system and submit its dispute to arbitration.

Jenkins & Gilchrist v. Riggs, 87 S.W.3d 198, 201 (Tex. App. — Dallas 2002, no pet.).

Because arbitration is contractual, courts or arbitrators, are called upon to construe clauses to determine, *inter alia* : 1) whether, in the first place, a particular clause compels arbitration, 2) what is the scope of that arbitration- i.e. which claims are arbitrable and which ones are not, 3) what is the procedure for managing the given arbitration, and 4), indeed, whether the very clause, itself, is unconscionable. In this respect, the court will utilize traditional state law principals of contract law ensconced over the centuries: offer, acceptance, consideration, rules of interpretation, procedural and substantive unconscionablity, and so forth. Thus, an arbitration clause is no different from the host of other contract clauses: venue, entirety, governing law, liability, and damages.

Because the arbitration clause is the "DNA" of the whole process, it is critical that the clause be drafted properly. Much the time, the clause is treated like cut and paste boilerplate with little thought given to it. It is often drafted by transactional attorneys who have no experience in arbitration but is enforced by litigators who have all too much. The drafting attorney may be ever creative (as we attorneys pride ourselves) but, in doing so, outsmart himself in cobbling together what turns out to be an unmanageable process. Remember: all clauses have consequences, maybe some of them unintended.

But once a dispute has occurred, can't the parties modify the clause to fit the circumstances? Of course, but by then it is usually too late because the parties have already drawn lines and are suspicious of altering a process that might seem to favor the other side. Note that ninety-nine percent of all arbitrations involve *pre*-dispute clauses.

On his quest in search of the perfect arbitration clause the drafter will travel a road littered with poorly drafted clauses. While the perfect clause may never be found, bad clauses are easy to spot. This presentation explores those clauses. Each of the following examples is an actual clause(s) contained in an agreement

II.

"Any controversy or claim arising out of or relating to this agreement shall be submitted to arbitration pursuant to the Federal Arbitration Act."

Comments:

1. The Federal Arbitration Act ("FAA") 9 U.S.C. §1 *et seq.* is a *substantive* statute- that is, it creates the framework of arbitration. It was enacted in an era when pre-dispute arbitration clauses violated common law. It does *not* purport to be a procedural statute. The FAA does not address a host of procedural issues typically addressed in rules. Among other issues, it does not address:
   a. the arbitrator selection process (except that the FAA allows a court to appoint one if the parties cannot agree);
   b. hearing mechanics;
   c. conduct of discovery;
   d. interim measures;
   e. form and timing of the award; and,
   f. venue of dispute

2. Who is the administrator?

III.

"Arbitration. Except for Tenant's right to terminate under Paragraphs 4 and 5 (relating to use and termination) above, any claim, dispute or other matter in controversy which cannot be resolved privately ("Dispute") concerning the matters covered by this Work Letter shall be resolved exclusively by arbitration administered by the American Arbitration Association ("AAA") in the city where the Building is located or the closest city in which the AAA maintains an office."

Comments:

1. "Use and termination" is a broad term that could easily become wrapped up with "any claim, dispute or other matter in controversy" thus inviting a challenge to its scope and arbitrability.

2. What procedural rules do the parties intend to use? AAA Rule-1(a) would mandate the AAA rules simply because the AAA was named the administrator.

3. Venue is confusing: "city where the building located or closest city in which the AAA maintains an office". What if the suit does not relate to a building? This clause invites a challenge to scope and arbitrability.

IV.

"Arbitrations shall be governed by the Federal Arbitration Act, 9 U.S.C. §1 et seq., and administered under the AAA Commercial Arbitration Rules in effect on the date the Dispute is submitted to arbitration, except that the arbitrator shall be an architect experienced in tenant improvement design and construction or an experienced tenant improvement construction contractor, in each case as appropriate to the matter in dispute, and, in either case, such arbitrators will be professionally licensed or certified to practice in their respective fields by the State in which the Building is located."

Comments:

1. See comments to clause I, *supra*.

2. This clause does not make clear whether there will be an administrator.

3. The arbitrator selection criteria are confusing and potentially narrow- i.e. "architect experienced in tenant improvement design and construction or an experienced tenant improvement construction contractor" and "appropriate to the matter in dispute" together with the licensing requirements. Could an architect be found that would not be biased? (A AAA manager said it would be a nightmare to locate a suitable arbitrator and meet requirements of this clause).

4. Why not under the construction rules?

5. This is a built-in motion to vacate.

V.

"The arbitrator shall base the arbitration award on accepted design and construction industry customs and practices, applicable law and judicial precedent and, unless both parties agree otherwise, shall include in such award the findings of fact and conclusions of law or industry practice upon which the award is based. Judgment on the award rendered by the arbitrator may be entered in any court having jurisdiction thereof. The prevailing party in the arbitration shall be entitled to reasonable attorneys' fees and expenses incurred in the resolution of said Dispute."

Comments:

1. The phrase "award on accepted design and construction industry customs and practices, applicable law and judicial precedent" … "findings of fact and conclusions of law or industry practice upon which the award is based" and "prevailing party" are ambiguous.

2. *Hall Street Associates v. Mattel*, 128 S.Ct. 1396 (2008) limited the grounds for vacatur/modification to those set out §10 and 11 of the FAA:

    a. award procured by "corruption, fraud, or undue influence";
    b. "evident partiality" by the arbitrators;
    c. misconduct in refusing to postpone the hearing or admitting evidence;
    d. where arbitrators "exceeded their powers";
    e. evident material miscalculation;
    f. award beyond the scope; and,
    g. award imperfect in form

    Could those "findings of fact and conclusions of law" be a basis for vacatur?
3. Another invitation to a motion to vacate.

VI.

"Any controversy, dispute or claim arising out of or in connection with interpretation, performance or breach of this Agreement which cannot otherwise be resolved between the parties shall be resolved expediently and with the least possible cost and therefore agree to submit the foregoing to an impartial arbitrator. If any part of this section shall be held to be unenforceable, its unenforceability shall not affect the obligation to arbitrate thereunder."

Comments:

1. No procedural or substantive rules.

2. The phrase "expediently and with the least possible cost" and "impartial arbitrator" is ambiguous.

3. Another invitation to pre and post arbitration litigation.

VII.

"Duty to arbitrate shall extend to any officer, shareholder, principal, agent, trustee, third-party beneficiary, guarantor or non-signatory to this Agreement."

Comments:

1. Absent imposition of judicially created doctrines, non-signatories cannot be bound by an arbitration clause.

VIII.

"Arbitration shall be submitted within 30 days after the dispute arose and failure to do so shall constitute a waiver of all rights to raise any claims in any forum and such limitation shall not be subject to tolling, legal, equitable or otherwise."

Comments:

1. The clause may be impossible to perform. "Submitted" and "dispute arose" are ambiguous. Does that mean a demand letter couldn't be sent?

2. Invitation to litigation; great clause for a reluctant party to squeak out of arbitration.

IX.

"The dispute shall be submitted to AAA which will appoint the arbitrator.
All disputes will be resolved either by a single arbitrator or a panel of three, as determined by the company, in its sole discretion
The panel shall be knowledgeable regarding and have experience as arbitrators of commercial disputes."

Comments:

1. No governing law or set of procedures. (Under R-1 AAA would administer case under commercial rules, by default.)

2. First clause: arguably conflicts with AAA Rule 11.

3. Second clause: conflicts with first and arguably unconscionable, particularly if in a consumer context.

X.

"The matter shall be heard within 45 days of filing of the claim and shall be concluded within 2 days Arbitrator shall have no authority to award punitive damages or consequential damages or issue injunctive relief or specific performance."

Comments:

1. First clause: impractical and conflicts with AAA rules.

2. Second clause: ties the hand of the panel with potential of asymmetric results.

3. Easy for party opposed to arbitration to squeak out.

XI.

"There shall be no discovery.
Discovery shall be in accordance with applicable civil discovery rules as a court of competent jurisdiction in state where the proceedings are to be heard, including all pre-trial discovery."

Comments:

1. First clause: conflicts with AAA rules R-21.

2. Second clause: hamstrings the arbitrator. It sets up a conflict between the AAA commercial rules and state or federal civil rules. For example, would a state or federal motion to compel be allowable? Would failure to civil rules be grounds for vacatur in not adhering to the clause?

3. If parties included the language, " as a non-binding guide only " this clause might be acceptable.

XII.

"The arbitrators shall be bound by the Federal Rules of Evidence and Federal Rules of Civil Procedure Arbitrator shall have sole discretion to the amount and extent of pre-hearing discovery which is appropriate."

Comments:

1. First clause: conflicts with AAA R-21 and 31.

2. Second clause conflicts with the first and with AAA R-21 and 31. How do you be bound and have discretion at the same time?

3. It sets up a conflict between the AAA commercial rules and state or federal civil rules. Would a state or federal motion to compel be allowable? Would failure to civil rules be grounds for vacatur for not adhering to the clause?

4. If parties included the language "as a non-binding guide only" clause might be acceptable.

XIII.

"Each party shall bear its own attorney's fees and other costs, but the prevailing party shall be entitled to recover its attorney's fees and other costs."

Comments:

1. First clause: potential of asymmetric results. Note that AAA R-43(d) generally allows for attorney's fees.

2. Second clause: "prevailing party" is ambiguous and conflicts with first clause.

XIV.

From a lending agreement:

G. ARBITRATION. Except as otherwise provided in Paragraph F above, and except for controversies, disputes or claims related to or based on the Marks, an lease or sublease of real estate (except for the determination of fair commercial rent under Section 4.A and Section 13.F of the Agreement) or the enforceability of the restrictive covenants contained in Section 7.C and section 13.E, all controversies, disputes or claims arising between us and/or our officers, directors, agents, employees or attorneys (in their representative capacity and you and/or your shareholders, partners, officers, directors employees shall be submitted or arbitration to the St. Louis, Missouri office of the American Arbitration Association on demand of either of us. Such arbitration proceedings shall be conducted in St. Louis, Missouri and, except as otherwise provided in this Agreement, such claims shall be heard by one arbitrator in accordance with the then current Commercial Arbitration Rules of the American Arbitration Association. The arbitrator shall apply the rules of evidence and discovery which are applicable to like controversies heard in the United States District Court for the Eastern District of Missouri, in St. Louis, Missouri. The arbitrator shall have the right to award or include in his award any relief which he deems proper in the circumstances including, without limitation, money damages (with interest or unpaid amounts from the due date), specific performance, injunctive relief and attorneys' fees and costs, provided that the arbitrator shall not award exemplary or punitive damages. The award and decision of the arbitrator shall be conclusive and binding upon each of us and judgment upon the award may be entered in any court of competent jurisdiction. Each of us agreed that any contest of such award shall be in the courts specified Paragraph I below. We both agree to be bound by the provisions of any statute of limitations provided herein or, if shorter, any statute of limitations which would otherwise be applicable to the controversy, dispute or claim which is the subject of any arbitration proceeding initiated hereunder. We both further agree that, in connection with any such arbitration proceeding, we both shall be bound by (i) the provisions of Rule 13 of the Federal Rules of Civil Procedure with respect to compulsory counterclaims (as the same may be amended from time to time), provided any-such compulsory counterclaim shall be filed within thirty (30) days of the filing of the original claim; (ii) the provisions of the Federal Rules of Civil Procedure relating to discovery; and (iii) the Federal Rules of Evidence. Without limiting the foregoing, we both shall be entitled in any such arbitration proceeding to the entry of an order by a court of competent jurisdiction pursuant to an opinion of the arbitrator for specific performance of any of the requirements of this Agreement. This agreement to arbitrate shall continue in full force and effect subsequent to and notwithstanding the expiration or termination of this Agreement. We both hereby agree that arbitration shall be conducted on an individual, not a class-wide, basis.

H. GOVERNING LAW. Except to the extent governed by the United States Trademark Act of 1946 (Lanham Act, 15 U.S.C. Section 1501 et seq., as amended), or other federal law, this Agreement, the relationship between you and us and any dispute between you and us and any of our affiliates, officers, directors, shareholders and employees shall be governed by and interpreted in accordance with the internal laws of the state of Missouri.

I. FORUM AND VENUE. We, you and your owners hereby agree that [an in] junction, to compel arbitration or to enforce an arbitrator's award shall be brought only in the Federal District Court for the Eastern District of Missouri in St. Louis, Missouri, unless such court shall lack jurisdiction, in which case, such action shall be brought only in the state courts in St. Louis County, Missouri; provided that we shall have the option in our sole discretion to bring any such action in the state or federal courts of the state in which you conduct business. Any other cause of action which is not required to be arbitrated pursuant hereto, including but not limited to *any* action against any of our affiliates, officers, directors, shareholder and employees, shall be brought only in the state or federal courts [of] general jurisdiction in St. Louis, Missouri, and we and our affiliates, officers, directors, shareholders and employees, you and your owners hereby irrevocably consent to the jurisdiction of such courts and hereby waive any objection to the jurisdiction or venue of such courts.

Comments:

1. The various exceptions to arbitrability swallow the rule. This invites pre and post hearing disputes over the scope of the clause- i.e. what is and is not arbitrable. That defeats arbitration as being expeditious.

2. Non-signatories cannot be compelled to arbitrate.

3. As stated in comments to clause X. and XI., application of the Federal Rules of Civil Procedure and Federal Rules of Evidence conflict with the AAA Commercial Rules and could potentially be grounds for vacatur on

refusing to hear evidence, FAA §10(a)(4), "exceeding powers", §10(a)(5), or award based on "matters not submitted", §11(b).

4. If one party retains option to select venue the clause could be unconscionable in a consumer or employment context.

5. Non-arbitration issue: can parties waive jurisdiction?

XV.

"Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration pursuant to the Federal Arbitration Act and administered by the American Arbitration Association under its Commercial Arbitration Rules with hearing thereon in San Antonio, Texas, and judgment on the award rendered by the arbitrators (s) may be entered in any court having jurisdiction thereof."

Comments:

1. easily understood

2. flexible to address unforeseen circumstances

3. clear governing law

4. broad coverage of claims: minimal risk of arbitrability challenges; courts will construe any doubts in favor of arbitration

5. relies on the time-tested commercial rules to do what they are designed to do

6. venue clear

XVI. CONCLUSION

Most drafters opt for broad clauses that rely on time tested procedural rules whose consequences are predictable. They recognize they cannot foresee the potential disputes, amidst changed circumstances, which may arise many years after the execution of a contract. In an era where claims cross over many subject areas- for example, it is difficult to distinguish contractual claims from torts- broad provisions also minimize the potential of court challenges on which claims are arbitrable. This is especially true when there is an underlying judicial presumption in favor of arbitration anyway. Thus broad clauses tend to promote the expeditious, cost-efficient resolution of controversy which is what arbitration is all about. There are circumstances, nonetheless, where the parties have sound reasons for the type of claim, either from its complexity, subject matter, or size, which they want to go into arbitration, and which ones should remain in conventional litigation. [1] They may prefer the courthouse when a matter involves public policy, or they perceive that a court may offer more suitable relief. Regardless, all well drafted clauses have these features in common:

1. Commit the parties to the process;
2. Define what is- and is not- arbitrable;
3. Expressly state what substantive arbitration law- ex. the FAA- governs the arbitration. Clauses do *not* rely on the substantive law in the general contract to determine what arbitration law applies to the arbitration though governing law provisions do govern the substantive issues in the arbitration itself; [2]
4. State what arbitration procedural rules will apply- for example, "the AAA commercial rules"; and,
5. Provide for entry of judgment

The overwhelming acceptance of arbitration reflects the belief that it can be "better, faster, and cheaper" than conventional litigation. A well drafted clause insures that these goals are indeed met.

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[1] An example of a software program which allows parties a do-it-yourself, "menu" approach in designing a clause is the AAA's www.clausebuilder.com. The site gives parties reasonable options at each step in the process. The author cautions, however, that designing such a clause should be done only in the context of professional advice to avoid the assembly of a quilt work of provisions which may not work together as a whole.

[2] This is true even though the vast majority of disputes involve interstate commerce triggering application of the FAA.