Drafting Commercial Arbitration Clauses

By Neil R. Bardack

1. Why Arbitration?

Arbitration is the only pre-dispute contractual means to avoid a jury trial in California. Enforcement of an arbitration clause by a court is mandatory unless there is a defense that would apply to the enforcement of contracts generally. Businesses should consider the following potential benefits of arbitration:

- control discovery
- control timing of the hearing
- ability to select arbitrators with specialized background
- allows due diligence vetting of potential arbitrator(s)
- select locale of hearing
- public not entitled to attend
- no public file for reporters to inspect until award confirmed in court
- private administration of filings
- informal proceeding
- rules of evidence generally do not apply unless parties agree
- trial delays due to state court crisis

2. What Can Be Covered In The Arbitration Clause?

Arbitration clauses are contract provisions and are interpreted as such. A properly drafted clause can delineate the scope of the arbitration and the limits of the arbitrator’s authority. However, once signed the clause cannot be changed by the arbitrator without the parties’ agreement, so it is important to understand what has been agreed to. An award must resolve every issue that is within that authority under the clause. What should be included in the clause depends on the nature of the potential disputes in the client’s industry. However, an agreement
that may be found to be adhesive, typically employment and consumer agreements, create additional drafting problems separately discussed below.

Subjects typically addressed in a commercial arbitration clause are:

- specifying arbitrator qualifications and number
- party-appointed arbitrators
- confidentiality
- choice of Law - state or federal procedural; state’s substantive
- award must be based upon state law with errors of law reviewable by a court
- venue punitive damages
- scope of discovery
- attorneys fees and costs to prevailing party
- splitting of arbitrator fees and administration costs
- provisional remedies
- time limit for award
- specify or limit claims subject to arbitration
- specify which tribunal will administer and whose rules to apply
- require mediation prior to demanding arbitration

3. **Several Important Differences Between The California Arbitration Act (“CAA”) And The Federal Arbitration Act (“FAA”)**

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<tr>
<th>California Arbitration Act: CCP § 1280</th>
<th>Federal Arbitration Act: 9 U.S.C §1</th>
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<td>- A party can expressly expand the grounds for court review beyond the statutory grounds to overturn or modify an award, <em>i.e.</em>, review on the merits, validity of arbitrator’s reasoning or sufficiency of the evidence</td>
<td>- Parties may not expand the statutory grounds for court review</td>
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<td>- A court can stay the arbitration pending a lawsuit involving other parties not bound to arbitrate (CCP § 1281.2(c))</td>
<td>- Under the FAA, an arbitrator may not award punitive damages unless he or she is authorized to do so either in the clause or by statute</td>
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<td>- Unless the arbitration clause expressly provides that the arbitrator(s) decide, under California it is the court who determines defenses to the enforcement or revocation of the contract as a whole and arbitral issues</td>
<td>- Unless the rules of the tribunal specify otherwise under federal arbitration law, it is the arbitrator who determines defenses to the enforcement of the contract as a whole. The court decides if there is a valid arbitration clause.</td>
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An important consideration at the outset when drafting an arbitration clause is to determine whether the arbitration will procedurally be governed by the FAA or CAA (or other state arbitration act). The table above outlines the several important differences in proceeding under the CAA that are not available under the FAA. The FAA affects all disputes involving interstate commerce, and it preempts state arbitration statutes unless the contract states explicitly that state procedure shall be relied upon.

4. Importance of Choosing the Arbitration Tribunal

The language in the clause will be supplemented by inclusion of the rules of the tribunal chosen to administer the arbitration which are incorporated into the clause as a matter of law, unless otherwise specified. When the rules of a tribunal are included in the clause, that organization will also be the administrator, even if not so stated. Most tribunal rules address issues of the arbitrator’s jurisdiction, scope of discovery and arbitration proceedings. A court must accept the rules as controlling over the FAA or CAA or California Code of Civil Procedure, except where the parties state otherwise. An important factor in specifying a tribunal’s rules is that the clause becomes “self-executing”, that is, unless stayed by a court order, a party can proceed with arbitration even over the objection or refusal of the other party. Commonly considered tribunals include: American Arbitration Association, JAMS, AAA/International Centre for Dispute Resolution, International Chamber of Commerce and China International Economic and Trade Arbitration Commission (CIETAC).

5. Sample Clauses That Address Some Of These Issues

The language chosen to describe the parties’ intent to arbitrate disputes is critical as over the years certain wording has taken on judicial significance, which if over looked in drafting, may lead to unintended results. Case law generally categorizes clauses as “narrow versus broad” and the language chosen will signal, without any further provision, what the parties intended to arbitrate. A narrow clause (i.e., disputes “arising under the agreement”) could exclude all but disputes that require an interpretation of the agreement. In a broadly worded clause (i.e., disputes “arising out of or relating to the parties’ agreement or relationship”) every dispute, including contract, tort and even statutory claims must be arbitrated. Normally, a court would determine in advance what disputes the parties agreed to arbitrate unless the tribunal rules are incorporated into the clause which do specify that the arbitrator has this authority (i.e., AAA Rule 7 or JAMS Rule11(c)). The parties’ agreement can change or limit the scope of the arbitrator’s authority to determine jurisdiction otherwise the default would be to the rules.

Example #1:

“Any dispute, claim or controversy arising out of or relating to this Agreement or the breach thereof, or out of the business relationship of the parties, shall be determined by binding arbitration in San Francisco, California before a neutral arbitrator(s) and administered by [insert arbitration tribunal] and in accordance with its rules and judgment on any award rendered by the arbitrator may be entered in any court having jurisdiction thereof.”

1) this is a very broad clause and encompasses contractual and non-contractual disputes, requiring tort and statutory claims to be submitted to binding arbitration;

2) identifies the place of arbitration, number of arbitrators and specifies tribunal rules;
3) tribunal’s rules will determine allowable discovery;
4) requires arbitrators to be neutral and therefore impartial;
5) if tribunal’s rules provide, arbitrator can determine own jurisdiction over dispute;
6) confirmation could occur under the CAA or FAA (if interstate commerce is involved);
7) no choice of law is stated and the arbitrator is not bound to apply the law of any jurisdiction;
8) the arbitrator will have broad equitable authority to award or grant any remedy or relief that the arbitrator deems just and equitable but the remedy must bear a reasonable relationship to the underlying agreement.

Example #2:

“Any dispute, claim or controversy arising out of or relating to this Agreement or the breach, termination, enforcement, interpretation or validity thereof, including the determination of the scope or applicability of this agreement to arbitrate, shall be determined by binding arbitration in San Francisco, California under the rules of the [arbitration tribunal] before [one/three] neutral arbitrator(s). The arbitrator(s) has the discretion to allow and to limit discovery. The arbitrator(s) are not empowered to award punitive damages, except where permitted by statute and the parties waive any right to recover any such damages. The arbitrator(s) shall determine a prevailing party and award attorneys’ fees and costs but has the discretion to determine as to any issue or claim who may be the prevailing party and award a percentage of the fees and costs to that party. California law shall govern this Agreement and the rights of the parties, exclusive of conflict or choice of law rules. Judgment on the award may be entered in any court having jurisdiction under the provisions of the California Arbitration Act, except that in the determination of whether to confirm the award, the court can review the merits, reasoning or application of law made by the arbitrator(s). This clause shall not preclude parties from seeking provisional remedies in aid of arbitration from a court of appropriate jurisdiction.”

1) broadly worded clause requiring all claims that “touch” the contract, including torts or statutory claims to be submitted to binding arbitration;
2) requires the arbitrator, and not a court, to determine all threshold decisions on what issues should be arbitrated;
3) sets the place of arbitration, the number of arbitrators and specifies tribunal’s rules;
4) arbitrator has complete discretion to control the type and extent of discovery;
5) provides for prevailing party attorneys fees award and requires the arbitrator to make an allocation of fees, if not all claims are successful;
6) precludes arbitrator awarding punitive damages (unless allowed by statute);
7) provides for choice of law and requires the arbitrator to apply the law of that jurisdiction, limiting otherwise very broad equitable powers given to arbitrators in fashioning an award;
8) specifies that under the California Arbitration Act, the trial court can review the merits of the award and errors in the application of law; and

9) parties have the option to seek provisional remedies in court i.e., injunctive, prejudgment attachment and protective orders rather than submitting them to the arbitrator.

6. Additional Language to Consider

- Setting Outside Time Limits

“The award shall be made within [specific number] months of the date the demand for arbitration is filed with [tribunal], and the arbitrator(s) agrees to comply with this schedule before accepting appointment. This time limit may only be extended by the written mutual agreement of the parties.”

1) most tribunal rules have internal dates to move the process along but not an outside date;

2) outside time limits are jurisdictional and unless parties agree otherwise, the arbitrator has no authority to extend the time limit and an award made outside the deadline could be vacated;

3) too short a deadline could conflict with the client, witness and attorney schedules or availability of evidence but cannot be extended by arbitrator without party agreement.

4) many tribunals [i.e., AAA Expedited Procedures for amounts under $75,000] have expedited procedures for matters under certain amounts that require the hearing to occur in a shortened time frame, i.e., 30 days from filing demand;

- Limit Scope Of Damages Or Remedies:

The arbitrator has no authority to award [exemplary or punitive damages] or [consequential damages] or [lost profits].

1) arbitrators do not have to consider due process concerns or supreme court limits on awards of exemplary or punitive damages;

2) clause may also limit authority to award certain kinds of damages or to limit the monetary amount.

- Limits On Discovery:

Only discovery specified in the [tribunal rules] shall be permitted. At the request of a party, the Arbitrator is empowered to permit and limit depositions but in exercising such discretion, the arbitrator shall take into consideration the nature of the dispute and the amount in controversy or when good cause requires such limits.

1) most tribunal rules govern discovery, e.g., AAA Rule-21 allows only exchange of information in cases under $1 million; and if over, Rule L-4(d) gives arbitrator discretion to allow depositions; JAMS Rule 17(b) allows one deposition per side in all arbitrations, but under Expedited Rule 16.2, arbitrator has discretion to allow additional fact and expert depositions.
• **Specify The Qualifications Of The Arbitrator:**

The dispute shall be heard by a single arbitrator who shall be a [certified public accountant] [practicing attorney for at least ten years] [retired judge] [electrical engineer].

or

In the event that any party’s claim exceeds [$1 million], exclusive of interest and attorneys’ fees, the dispute shall be heard and determined by a panel of three neutral arbitrators. At least one of the arbitrators shall have experience and knowledge of [technology, securities etc.].

1) arbitrators do not have to be lawyers;

2) many tribunals maintain panels based upon expertise in specific areas and try to match potential arbitrator panels to the subject matter of the dispute, and would have to do so when the clause specifies;

3) a mixture of backgrounds and qualifications can be specified for the make up of the panel;

4) AAA Rule L-2 (a) requires three (3) arbitrators on claims over $1M, unless parties agree otherwise.

• **Require Negotiation Or Mediation As Condition Of Demanding Arbitration:**

If a dispute, claim or controversy arises out of or relates to this Agreement which cannot be settled through negotiation, the parties agree first to try in good faith to resolve their disagreement by mediation administered by the [specified tribunal or other mutually agreed mediator]. If they do not reach such resolution and within a period of 60 days after the conclusion of the mediation, then upon notice by either party to the other, all such disputes, claims or controversies shall be submitted to binding arbitration before [tribunal] on the terms set out below.

1) requiring mediation as a condition precedent to demanding arbitration can result in resolution of some or all claims, thereby limiting the scope of arbitration;

2) mediation can be expensive for small monetary disputes.

7. **Drafting Issues That Apply Only to Contracts of Adhesion**

A contract may be considered one of adhesion where the terms of a contract are non-negotiable and there is a disparity of bargaining power between the parties. The obvious examples are standard form agreements with banks, consumers and employment contracts with rank and file non-executive level employees. Where an agreement is found to be adhesive, courts have been willing to find the agreement un-enforceable (in whole or in part). The primary defense is unconscionability. Since AT & T Mobility v. Concepcion (which approved clauses in consumer agreements waiving the right to bring a class action) there has been a sea change of uncertainty about what restrictions in arbitration agreements could render the agreement unconscionable. Arbitration clauses in employment agreements can be enforceable if not unduly harsh, but for now the following rules should still be considered to avoid an agreement being found unconscionable as harsh and one-sided:
1) Class action waivers are enforceable under *Concepcion*, but a recent decision of the NLRB prohibits requiring an employee to sign an arbitration agreement preventing class, joint or collective claims a violation of the Act, at least to non-supervisory employees. Rarely are executive employment agreements adhesive.

2) Arbitration clauses must clearly obligate both parties to arbitrate all potential claims.

3) Arbitration clauses must require a written decision and allow for limited judicial review.

4) Employers must agree to pay the costs unique to arbitration.

5) Avoid overly harsh or unfair provisions such as a shortened statute of limitations.

6) Incorporate the tribunal rules of a recognized arbitration tribunal.

7) Require the arbitration to be governed by the FAA.

8) Do not preclude right to recover specific damage claims i.e. punitive damages.

9) Forum must bear reasonable relationship to the contract.

10) Limiting discovery is permissible where arbitrator has discretion to permit additional discovery on good cause shown.

An arbitration clause in an employment or consumer agreement will be scrutinized for unfair and harsh provisions. How to strike a balance between protecting the client and avoiding a clause from becoming unenforceable as unconscionable is beyond this discussion.