

DRAFTING ARBITRATION CLAUSES:  
A Litigation Perspective

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## INTRODUCTION

### A. Potential Benefits of Arbitration

#### 1. Prompt and Efficient Resolution

a. "... by agreeing to arbitrate, a party trades the procedures and opportunity for review of the court room for the simplicity, informality, and expedition of arbitration." *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, Ill S. Ct. 1647, 1655 (1991).

2. Cost-Effective: with a properly drafted arbitration clause, parties can save time and money in dispute resolution.

B. A well-drafted clause is critical to achieving the benefits of Alternative Dispute Resolution ("ADR"). Many pitfalls can arise from a poorly drafted provision. For example, one can end up in a pitched court battle over whether a particular dispute is arbitrable or over the correct scope of discovery. These developments defeat the purpose of arbitration as a speedy, cost-efficient dispute resolution method.

C. Federal policy reflected in the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1988) ("FAA"), places arbitration agreements on "the same footing as other contracts." *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1974), quoting H.R. Rep. No. 96, 68th Cong., 1st Sess. 1, 2 (1924). Federal policy "is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate." *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*, 489 U.S. 468, 476 (1989).

D. Most states share this policy position, having enacted arbitration statutes promoting arbitration. *See Point V.A., infra.*

## II. TYPE OF DISPUTE RESOLUTION METHOD

### A. Arbitration

1. This is the dispute resolution mechanism most often found in contracts.

2. Binding arbitration is preferred.

B. Mediation: This can be an effective ADR mechanism that can be required, usually in a non-binding fashion, by contract.

C. Combination Mediation/Arbitration: Some contracts provide for a non-binding mediation procedure before requiring mandatory, binding arbitration. The mediation process can be less expensive and may permit development of a win-win result.

### **III. SCOPE OF ADR CLAUSE**

A. Factual vs. Legal Issues: Some clauses distinguish between arbitrability of questions of fact and law.

1. *J.P. Greathouse Steel Erectors, Inc. v. Blount Bros. Constr. Co.*, 374 F.2d 324 (D.C. Cir.), *cert. denied*, 389 U.S. 847 (1967) ("Questions of Fact" arbitration clause): Following arbitration, the district court confirmed the arbitration award. On appeal, the Court of Appeals reversed, concluding that the issue arbitrated was a breach of contract issue necessarily raising both questions of law as well as of fact. 374 F.2d at 325.

2. Drafting a clause to submit only fact issues, and not legal issues" to arbitration is not recommended.

B. Different Dispute Resolution for Different Issues

1. You may wish to submit different types of disputes to different disputes resolution forums. *See, e.g., Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2d Cir. 1959), *cert. granted*, 362 U.S. 909, *cert. dismissed*, 364 U.S. 801 (1960) (disputes regarding merchandise quality referred to special trade association arbitration, while all other disputes submitted to procedures under the auspices of the American Arbitration Association).

2. Technical issues, such as calculation of production royalty or determination of ore grade, may be better suited to resolution by an industry panel, while fraud and misrepresentation, or repudiation claims are better suited to resolution by thoughtful, judicious attorneys.

3. If one chooses this approach, the differing types of disputes should be defined clearly.

C. All Encompassing Clause

1. A typical "broad form" clause: "Any disputes arising out of, in connection with, or that relate in any way to, this agreement...."

2. The repudiation, fraud, or illegality claim: "a party to a contract claiming contract repudiation, fraud in the inducement, and/or illegality may argue that the other party may

not seek the benefits of an arbitration clause in a contract that has been repudiated or which is illegal."

a. Repudiation: The great weight of authority supports application of the "all disputes" arbitration clause even in the face of a repudiation claim. *See, e.g., Mewbourne Oil Co. v. Blackburn*, 793 S.W.2d 735, 737 (Tex. App. - Amarillo 1990); *Rancho Pescado, Inc. v. Northwestern Mut. Life Ins. Co.*, 680 P.2d 1235, 1241 (Ariz. App. 1984).

b. If the arbitration clause itself is specifically repudiated, arbitration may not be available. *See, e.g., Shearson Lehman Hutton, Inc. v. McKay*, 763 S.W.2d 934, 938 (Tex. App.- San Antonio, 1989, no writ). The principle guiding these decisions is that arbitration agreements or clauses are separable from the remainder of the agreement. *See id.* at 938; *see also U.S. Insulation, Inc. v. Hilro Constr. Co.*, 705 P.2d 490, 493 (Ariz. App. 1985).

c. Fraud in the Inducement: Fraud claims are arbitrable unless the alleged fraud addresses the arbitration clause itself. *See Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 400 (1967) (under the FAA, fraud in the inducement "is for the arbitrators and not for the courts."); *R.M. Perez & Assoc., Inc. v. Welch*, 960 F.2d 534, 538 (5th Cir. 1992); *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 410-11 (2d Cir. 1959), *cert. granted*, 362 U.S. 909, *cert. dismissed*, 364 U.S. 801 (1960) (decided under the FAA; suggesting state law may require a difficult analysis).

d. Illegality: Claim of illegality of part of a contract cannot avoid arbitration. *See, National R.R. Passenger Corp. v. Consolidated Rail Corp.*, 892 F.2d 1066, 1070-71 (D.C. Cir. 1990).

e. Notwithstanding the authority cited, one may want to consider making specific reference to repudiation, fraud, and illegality claims in the arbitration clause.

3. Generally, at least in contracts subject to the FAA, ambiguities regarding the scope of an arbitration clause will be resolved in favor of arbitration. *Volt Information Sciences, Inc.*, 489 U.S. at 47, *quoting Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 25 (1983); *see also Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) ("intentions are generously construed as to issues of arbitrability").

4. In spite of a broad form, some types of claims will not be arbitrable. For example, anti-trust claims are generally not arbitrable as a matter of public policy. *See Applied Digital Technology, Inc. v. Continental Casualty Co.*, 576 F.2d 116 (7th Cir. 1978). The draftsman should consider public policy issues in drafting the clause.

#### D. Level of Detail

1. The answer to the question of how much detail to include in an arbitration clause may depend on the nature of the agreement and the types of disputes that may arise under the

agreement. However, even with straightforward agreements and anticipated disputes that are "simple," a certain amount of detail is appropriate.

2. In drafting the ADR clause, one should keep in mind the issues addressed in the remainder of this outline.

#### **IV. ARBITRATION SERVICES/ASSOCIATIONS**

A. Various organizations exist which have arbitration rules and procedures that can be incorporated by reference into an arbitration clause. For example, a common reference is the Commercial Arbitration Rules of the American Arbitration Association. The United Nations Commission for International Trade ("UNCITRAL") Rules are often used for contracts with international implications or subject matter.

B. If you choose this route, be sure you reference the proper edition of the rules. If you do not, the arbitrators may choose the edition to apply. *See Mobil Oil Indonesia, Inc. v. Asamera Oil (Indonesia) Ltd.*, 372 N.E.2d 21 (N.Y. 1977).

C. Also, review the Rules carefully to determine whether there are specific provisions that you would rather replace with specific contract language.

#### **V. APPLICABLE STATUTES**

A. State and federal statutes address arbitration matters.

1. *See, e.g.*, Ariz. Rev. Stats, §§ 12-1501, *et seq.*; California Arbitration Act, Cal. Civ. Proc. Code Ann. 1280 *et seq.* (West 1982); Colo. Rev. Stat. §§ 13-22-201 *et seq.* (1982) ; Federal Arbitration Act, 9 U. S. C. §§ 1-14 (1988) ("FAA"); Nev. Rev. Stat. §§ 38.015 *et seq.* 1979; Utah Code Ann. §§ 78-31-1 *et seq.*; §§ 44-7-1 through 22 NMSA 1978 (New Mexico).

2. The Alternative Dispute Resolution Act of 1990, 5 U.S.C. §§ 571-583 (Supp. 1993), promotes use of ADR by federal agencies, and provides that agreements to arbitrate matters to which the act applies are enforceable. 5 U.S.C. § 576. (The act applies to any "controversy that relates to an administrative program. . . ." *Id.* at § 572(a). "Administrative program" is defined as "a Federal function which involves protection of the public interest and the determination of rights, privileges, and obligations of private persons through rulemaking, adjudication, licensing, or investigation. . . ." *Id.* at § 571(2). However, exceptions apply to significant policy issues requiring establishment of precedent. *See Id.* at § 572 (b).)

B. Be sure to review the statutes that may apply to your contract. Applicable statutes may provide procedures for arbitration that would obviate spelling out various matters in the contract. At the same time, the statutes may provide for procedures which you would prefer to address in different fashion in the contract. In the latter situation, one must take

care not to draft the provisions in a fashion contrary to public policies expressed in the statutory scheme.

C. The FAA, which applies to contracts involving interstate commerce, includes the following significant provisions:

1. Section 2 validates written arbitration agreements in contracts "involving commerce" and in "maritime transaction(s)". ("Commerce" is defined in Section 1 to exclude employment contracts of railroad employees or other transportation workers engaged in foreign or interstate commerce.)
2. Section 3 provides that courts "shall" stay actions on contracts with arbitration clauses, if requested by one of the parties. Section 4 authorizes U.S. District Courts to compel arbitration, "upon being satisfied that the making of the agreement for arbitration...is not in issue."
3. Section 5 authorizes appointment of arbitrators if the contract doesn't provide for any appointment process or if the process fails.
4. Section 7 authorizes arbitrators to "summon" witnesses to the arbitration hearing, together with material documents.
5. Section 9 provides for confirmation of arbitration awards. Section 10 provides that awards may be vacated on the following limited grounds:
  - a. When award was obtained through fraud, corruption or undue means;
  - b. Evidence shows where an arbitrator was partial or corrupt;
  - c. Where arbitrators were guilty of misconduct resulting in prejudices; or
  - d. When arbitrators exceeded their powers, or "so imperfectly executed them...."
6. Section 11 authorizes modification of the award to address material miscalculations and erroneous descriptions in order to effect the intent of the parties.

D. The FAA preempts state laws which "require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984).

## **VI. ARBITRATOR SELECTION**

A. Single, Identified Arbitrator

1. Identify the arbitrator when contract is signed; be sure to provide for selection of a successor.

2. Decide whether you want a lawyer or business person.
3. The advantage of this approach is the contracting parties are more likely to be able to agree on an arbitrator when negotiating the original contract. The disadvantage is lack of flexibility.

#### B. Single Arbitrator For Each Dispute

1. Identify the arbitrator as each dispute arises.
2. The advantage here is flexibility; you can select a decision-maker with knowledge of the specific dispute. The disadvantage is it may be more difficult to agree on an arbitrator.
3. To overcome the disadvantage, you may want to establish parameters for selection in the agreement. Or, you may want to develop a list of arbitrators in the contract from which to choose.
4. In the event the parties cannot agree, be sure to provide for some alternative method to submit select the arbitrator. Many contracts provide for submittal of the selection to the Chief Judge of the U.S. District Court in a particular district. You may want to be sure the court will cooperate.

#### C. Three Arbitrator Panel

1. Each party chooses a "party-appointed" arbitrator for each dispute.
2. The party-appointed arbitrators meet and select a third, neutral arbitrator.
3. Again, plan for deadlock, if the party-arbitrators cannot agree. Provide for a disinterested judge to select the "neutral" if the party-appointed arbitrators cannot agree.
4. Not surprisingly, the "neutral" usually decides the case.
5. Parties generally cover their own arbitration expenses, and split the neutral's cost, unless the contract provides that the prevailing party is entitled to recover costs, fees, etc.

### **VII. ARBITRATION INITIATION; STATEMENTS OF CLAIMS AND DEFENSES**

"Just as [parties] may limit by contract the issues which they will arbitrate, so too may they specify by contract the rules under which that arbitration will be conducted." *Volt Information Sciences, Inc. v. Board of Trustees of Leland Junior Stanford University*, 489 U.S. at 479.

A. The procedure to commence arbitration should be clearly stated. Often, the trigger is a letter notifying the opposing party that one is invoking the arbitration clause and identifying, if appropriate, the part-appointed arbitrator. For example: "Either party invoking arbitration shall notify the other of the name of an arbitrator.... it

B. The clause then should specify time frames for all procedural steps, including when the opposing party must name its arbitrator, when the selection process is to be completed, what happens if the second party doesn't name an arbitrator in timely fashion, etc.

C. Depending on the contract subject matter and type of dispute, parties may wish to provide for exchange of statements of claims and defenses, much in the way the "notice" pleading process operates in federal courts. The general denial or demurrer process does little to advance resolution of a dispute. of course, using this process necessarily takes some time; if you need dispute resolution completed in a short time, the statement of claims approach may be unworkable.

D. Alternatively, the parties could provide that the arbitrators would call a prompt pre-hearing conference at which time the dispute would be discussed and the arbitrators would decide the proper pre-hearing procedure and schedule. This approach places a great deal of discretion in the arbitrators , but it also provides flexibility.

## **VIII. DISCOVERY**

A. After the issue is joined, discovery is the next order of business if you wish to provide for it.

1. "(D)iscovery procedures .have often been considered to be inconsistent with the reasons for arbitration." *United Nuclear Corp. v. General Atomic Co.*, 93 N.M. 105, 117, 597 P.2d 290, 302, *cert. denied*, 444 U.S. 911 (1979); *see also Board of Educ. Taos Mun. Schools v. The Architects, Taos*, 103 N.M. 462, 464, 709 P.2d 184, 186 (1985) (taking judicial notice that the "scope of discovery is considerably diminished under arbitration...").

2. Rules of Civil Procedure should not apply to discovery under arbitration clauses, unless the parties agree to it. However, in order to avoid a dispute on this point, one should take care to specifically exclude applicability of liberal Rules of Civil Procedure.

3. If parties want. discovery in arbitration, the agreement should so provide.

B. Applicable statutes may or may not provide for any discovery; review those statutes to determine what is provided and what contractual flexibility you may have.

1. The Uniform Arbitration Act, § 7 provides that parties may apply to the arbitrators to issue subpoenas for "the production of books, records, documents and other evidence..." *See, e.g.*, § 47-1-7 NMSA 1978. This provision may permit discovery at the discretion of

the arbitrator. *See Prime South Homes, Inc. v. Byrd*, 401 S.E.2d 822 (N.C. 1991) (arbitrators control discovery under North Carolina's Act, comparable to the uniform Arbitration Act N.C. Gen. Stat. § 1-567-8). Further, § 7 permits depositions for use at the hearing, upon application to the arbitrator.

2. Notwithstanding this authority, parties still should specify discovery procedures in their agreements.

3 If the statute is silent and the clause doesn't expressly provide for it, discovery may not be available. At this point, you may be in a position of having to reach agreement with the other party regarding discovery -- not always an easy task when you're fighting on the merits.

C. The contract should provide clearly what discovery is appropriate and that the arbitrators are to control the scope of discovery and resolve discovery disputes.

1. The terms of the arbitration clause should control the scope of discovery. *See, e.g., City of Pinehurst v. Spooner Addition Water Co.*, 432 S.W.2d 515, 518 (Tex. 1968).

2. Of course, a wide range of discovery options exist. But, by allowing too broad a discovery scope, the parties may lose the benefit of arbitration as an efficient, speedy dispute resolution mechanism.

3. Exhibit exchange, depositions of witnesses to be called at hearing, and perhaps deposition of a few key employees are among the options to consider. This approach allows each side to prepare for the arbitration hearing without driving up the cost of arbitration and delaying resolution. However, one may want to limit the number of depositions, the length of depositions, and perhaps prescribe their location, if appropriate.

D. Again, consideration of discovery matters should be viewed in light of necessary dispute resolution time frames. If, by contract, the process must be completed in forty-five days, discovery should necessarily be limited.

## **IX. HEARING PROCEDURES AND RULES**

A. Rules of Evidence: avoid application of formal rules of evidence. Many arbitrators will not have the background to use the rules, and the hearing could bog down. Not only that, but an erroneous evidentiary ruling might then be advanced as a basis for overturning (or not confirming) the arbitration award. It is probably best to allow the arbitrators to decide the appropriate weight to be given any evidence.

B. Testimony: Live or prepared testimony should be considered. Do you want to be able to introduce affidavits? Signed statements of witnesses? You may wish to provide expressly for that type of submittal.

## **X. FEES AND COSTS**

A. Consider whether you want to award the prevailing party its costs and/or fees. If so, you may want to define "fees" or "costs" and/or put a cap on those items.

B. Most clauses provide that each party foots the bill for its arbitrators, and that the parties split the fees and expenses of the neutral arbitrator.

## **XI. CONTRACTUAL LIMITATIONS PERIOD**

A. After reference to appropriate statutory requirements, the parties may wish to include a contractual limitations period to specify the time within which a claim must be submitted to arbitration.

B. This type of provision should be accompanied, if appropriate, with a clear statement that arbitration is the exclusive form for resolution of disputes.

## **XII. CONCLUSION**

Properly drafted, a contractual arbitration provision can provide a cost-effective, prompt dispute resolution mechanism.

## **XIII. BIBLIOGRAPHY**

A W. Gray, "Drafting the Dispute Resolution Clause," ch. 10, *Commercial Arbitration for the 1990s* (ABA Section of Litigation 1991).

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