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Arbitration Consolidation Decision Reserved for Arbitrator

The Seventh Circuit has ruled that an arbitrator should decide whether an arbitration agreement prohibits consolidated arbitration. According to the court, the issue is a question of procedure rather than a question of arbitrability.

In *Employers Insurance Co. of Wausau v. Century Indemnity Co.*, 443 F.3d 573 (7th Cir. Apr. 4, 2006), Century entered into reinsurance agreements with Wausau and other reinsurers. Several reinsurers, including Wausau, refused to pay when Century sought reimbursement for claims paid to its insureds.

Century sought to compel these reinsurers to participate in a consolidated arbitration. Wausau agreed that it was required to arbitrate, but rejected consolidated arbitration because its reinsurance contracts with Century contained no express provision regarding consolidated arbitration.

Wausau contended that consolidation was a question of arbitrability that must be addressed by the court. Century argued that it was a procedural issue to be resolved by the arbitrator unless the arbitration agreement provided otherwise.

The Seventh Circuit concluded that consolidation is not a question of arbitrability, relying in part on *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002). In *Howsam*, the U.S. Supreme Court explained, “One might call any potentially dispositive gateway question a ‘question of arbitrability,’ for its answer will determine whether the underlying controversy will proceed to arbitration on the merits.”

Examples of arbitrability disputes are “whether the parties are bound by a given arbitration clause” or “a disagreement about whether an arbitration clause in a concededly binding contract applies to a particular type of controversy.”

The court’s holding is consistent with decisions by the First and Fourth Circuits in similar cases.

Applying *Howsam*, the court found that the question of consolidation did not address whether the arbitration clause covered the dispute, but rather whether Wausau could be required to participate in an arbitration consolidated with other reinsurers. The court’s holding is consistent with decisions by the First and Fourth Circuits in similar cases. See *Shaw’s Supermarkets, Inc. v. United Food & Commercial Workers Union, Local 791*, 321 F.3d 251 (1st Cir. 2003); *Dockser v. Schwartzberg*, 433 F.3d 421 (4th Cir. 2006).

Most recently, a New Jersey federal court came to the same conclusion in another reinsurance case and empowered an arbitration panel to determine whether arbitrations with different respondents under distinct reinsurance contacts could be consolidated. See *Markel International Insurance Co. v. Westchester Fire Insurance Co.*, No. 05-5522 (WHW), 2006 WL 2310788 (D.N.J. Aug. 10, 2006).

True Mutuality in the Obligation to Arbitrate Protects Agreement Enforceability

An arbitration agreement that requires arbitration of all disputes between the parties, but that proceeds to carve out exceptions so broad that nearly every claim that could be brought by one party falls within the exceptions, can be challenged and potentially invalidated on either contract formation or unconscionability grounds.

Illusory Promise

In ***Gonzalez v. West Suburban Imports, Inc.***, 411 F.Supp.2d 970 (N.D. Ill. 2006), Gonzalez claimed West Suburban violated the Truth in Lending Act and committed fraud by double counting a trade-in vehicle to increase the sale price of the purchased vehicle. West Suburban sought to compel arbitration, and Gonzales argued that the Arbitration Agreement was unenforceable because there was no mutual obligation to arbitrate.

West Suburban contended that they would not have sold the car without the executed Arbitration Agreement. And, therefore, the agreement was part of a larger purchase transaction with sufficient consideration.

The court concluded: “The express language of the Agreement makes clear that it is intended to require [Gonzalez] to arbitrate any claims that they could assert against [West Suburban], but it imposes no such reciprocal obligation on [West Suburban].”

The court found that the extensive exceptions listed in the definition of “dispute” left no claim that West Suburban Imports would be required to arbitrate. Accordingly, such promises are illusory and unenforceable because West Suburban had not obligated itself to arbitrate any disputes.

Moreover, the court found West Suburban’s argument that broader consideration existed “unpersuasive.” The Arbitration Agreement was a separate document that contained survival language that bound the parties

to arbitration regardless of the survival of any of the separate agreements related to the vehicle purchase.

As a result, the arbitration agreement was a separate contract that the court reviewed independently of the other purchase documents, and the specific lack of mutuality in the obligation to arbitrate caused the court to invalidate the arbitration clause.

Unconscionability

The borrower in ***Wisconsin Auto Title Loans, Inc. v. Jones***, No. 2003AP2457 (Wis. May 25, 2006), used his car as collateral to obtain an \$800 loan from Title Loans. The preprinted loan agreement contained an arbitration provision whereby the parties agreed to arbitrate all claims “save and except [Title Loan’s] right to enforce [Jones’] payment obligations in the event of default, by judicial or other process, including self-help repossession.” Under this provision, if Jones initiated arbitration, he would have to pay the first \$125.00 of the filing fee.

When Jones defaulted, Title Loans sued to recover possession of his car. Jones counterclaimed, and Title Loans moved to compel arbitration of the counterclaims.

The court held that the arbitration provision was both procedurally and substantively unconscionable. Procedural unconscionability turned upon the fact that “[t]he formation of the contract was a product of the parties’ unequal bargaining power and did not reflect a real and voluntary meeting of the minds of the contracting parties.”

The court’s finding of substantive unconscionability was based almost entirely on the one-sidedness of the carve-out provision allowing Title Loans to seek a replevin and deficiency judgment in court. The court noted that “[t]he doctrine of substantive unconscionability limits the extent to which a stronger party to a contract

may impose arbitration on the weaker party without accepting the arbitration forum for itself.”

The agreement’s terms allow a borrower to assert affirmative defenses to a replevin action in court, but require the borrower to take the same arguments to arbitration in order to bring a substantive claim against the lender. The court found that this “possibility of dual forums...imposes an unnecessary and undue burden on the borrower.”

As further support for its holding, the court cited to other factors that “compound the substantive unconscionability.” Those factors included the requirement that Jones pay the first \$125 of the filing fee despite his presumed indigence and the reference to “self-help repossession” when Wisconsin law would not allow it.

Conclusion

Parties who draft arbitration provisions which impose unequal obligations to arbitrate disputes run the risk of a court invalidating the arbitration agreement either for lack of consideration or based on the unconscionability doctrine.

Instead, parties should commit equally to the arbitration process and ensure that the remedies available in arbitration are the same as those available in court. See, e.g., National Arbitration Forum *Code of Procedure*, Rule 20(D) (“An Arbitrator...may grant any legal, equitable or other remedy or relief provided by law.”).

For example, arbitrators are empowered to decide rights of possession, and the Federal Arbitration Act entitles parties to court enforcement of the resulting award. Ultimately, parties benefit from drafting truly mutual agreements in which both parties enjoy the advantages of arbitration.

Arbitrators May Award Punitive Damages

Punitive Damages Award Does Not Violate California Public Policy

When an arbitrator awards punitive damages, the reasoning behind the award is irrelevant and the award will be confirmed, so long as the arbitrator did not manifestly disregard the applicable law or contravene public policy.

In *Sarofim v. Trust Company of the West*, No. 05-20309 (5th Cir. Feb. 8, 2006), Trust Company of the West (“TCM”) handled over \$12 million of investments for Sarofim. After the Sarofim portfolio lost over \$6 million, Sarofim requested arbitration and was awarded \$6.3 million in compensatory and \$2.9 million in punitive damages for TCM’s breach of fiduciary duty.

TCM argued that the punitive damages award was an attorney’s fees award in disguise, and that the award should be vacated for manifest disregard of California law. The Fifth Circuit refused to vacate the award, concluding that the

arbitrator did not “manifestly disregard” the law.

In California, punitive damages are available when a defendant is proven liable by clear and convincing evidence of malice, oppression, or fraud. Cal. Civ. Code § 3294(a). Although the award made no mention of Section 3294(a), the Fifth Circuit concluded that the decision “contains enough information to infer these things.”

Parties can specifically require arbitrators to follow the law, and courts can then determine whether the arbitrators exceeded their power in issuing the award.

The award did not contravene California public policy, which sets no limit for punitive damages awards in arbitration.

Additionally, the award did not contravene California public policy, which sets no limit for punitive damages awards in arbitration.

Rifkind & Sterling, Inc. v. Rifkind, 33 Cal.Rptr. 2d 828, 833 (Cal.Ct.App. 1994). Rather, the \$2.9 million award served

California’s twin goals of “punishing” wrongdoers and “detering” others from engaging in similar conduct.

As the Fifth Circuit emphasized, these arbitrators were not required to explain their award. Parties can require arbitrators to make findings of fact, conclusions of law, and supporting reasons. This option helps the parties understand the decision of the arbitrators and helps courts more easily review awards.

Further, parties can specifically require arbitrators to follow the law, and courts can then determine whether the arbitrators exceeded their power in issuing the award. Parties can include these follow-the-law provisions in their agreement and reduce the great deference awards receive under the manifest disregard of the law standard. See, e.g., National Arbitration Forum *Code of Procedure* Rules 20 and 37.

Did You Know?

Recent United States Supreme Court opinions addressing arbitration issues have displayed a clear trend toward liberal enforcement of private agreements to arbitrate and granting broad authority to arbitrators. Examples:

■ **Buckeye Check Cashing, Inc. v. Cardegna**, 126 S.Ct. 1204 (2006), determined that challenges to the validity of the underlying contract containing an arbitration clause are for the arbitrator to decide.

■ **Green Tree Financial Corp. v. Bazzle**, 539 U.S. 444 (2003), emphasized that matters of contract interpretation “should be for the arbitrator, not the courts, to decide.”

■ **Citizens Bank v. Alafabco, Inc.**, 539 U.S. 52 (2003), indicated that the general practice of commercial lending has sufficient impact on the national economy for the Federal Arbitration Act to govern individual loan transactions.

■ **PacifiCare Health Systems, Inc. v. Book**, 538 U.S. 401 (2003), held that arbitrators, rather than courts, have the power to determine the meaning of contractual damages provisions.

It is clear that core principles of arbitration law—respect for private agreements to arbitrate and deference to arbitrator determinations—are alive and well in the nation’s highest court.

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Selecting the FAA Preempts State Arbitration Law

According to a California Court of Appeal where the Federal Arbitration Act (FAA) is explicitly invoked in an arbitration agreement, it preempts state arbitration law.

In *Rodriguez v. American Technologies, Inc.*, 39 Cal. Rptr. 3d 437 (Cal. Ct. App. 2006), Rodriguez sued a contractor and several insurers in connection with repair work done on his home. The agreement called for arbitration “pursuant to the Federal Arbitration Act.”

The contractor moved to compel arbitration, arguing that the FAA required the court to compel arbitration regardless of whether the lawsuit involved other parties. Rodriguez argued that California law gave the court discretion to refuse to compel arbitration.

The court determined that parties can explicitly choose to have their agreement governed by the FAA rather than by California arbitration law and that, by stating in the agreement that all disputes would be decided “pursuant to the Federal Arbitration Act,” the parties in this case did exactly that.

The court also noted that, unlike contracts in other cases, the contract contained no language limiting the FAA’s application and did not mention applying California arbitration law to the dispute.

Under these circumstances, the court found no ambiguity in the agreement and determined that the FAA should govern all aspects of the arbitration. The FAA does not allow judges to refuse to compel arbitration in the face of a valid arbitration agreement, the court held, so the arbitration should go forward.

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