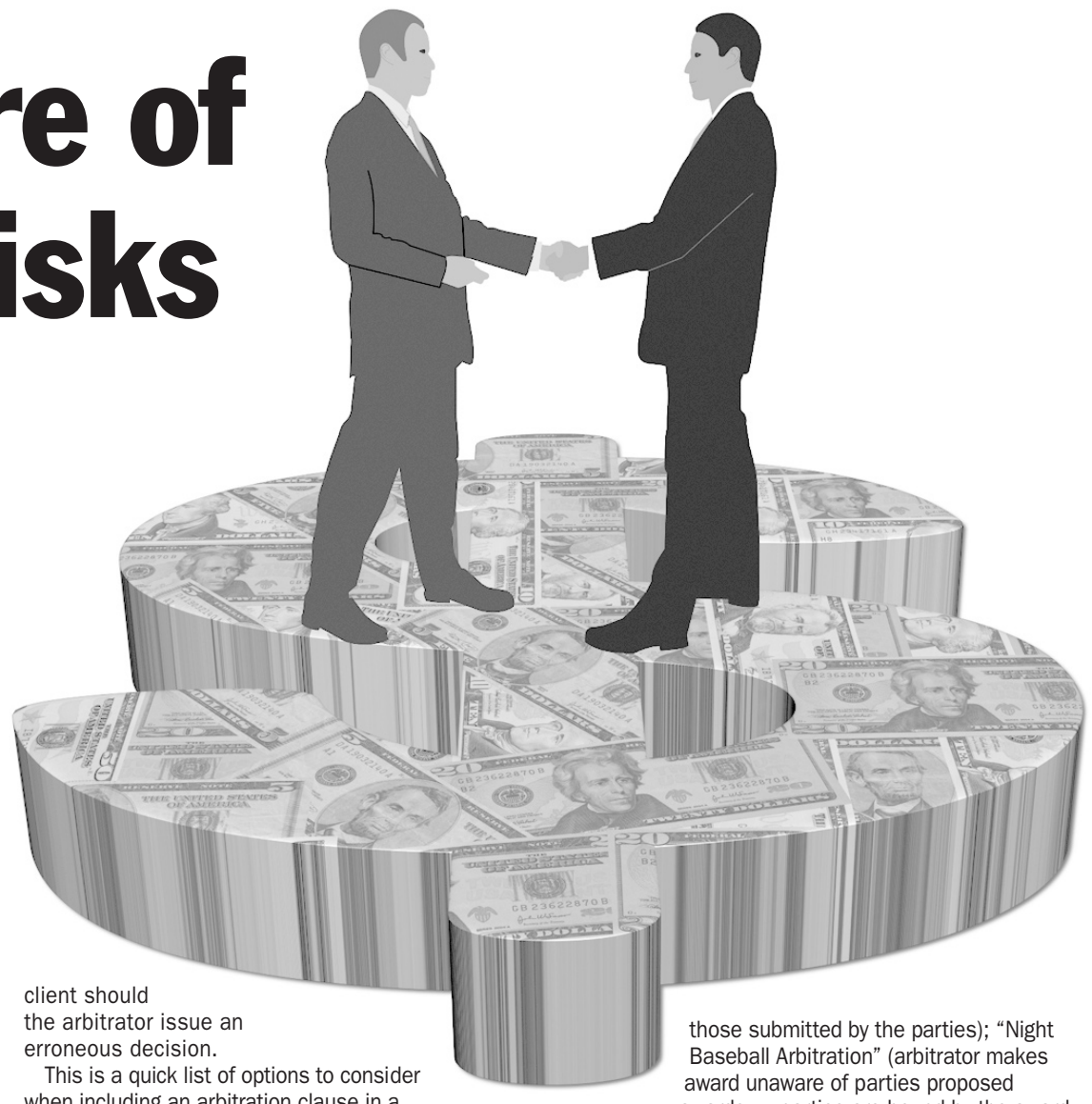
Arbitration: Beware of The Unintended Risks



By Larry C. Russ and Michael S. Brophy

Arbitrators are human and occasionally make mistakes. When mistakes are made, even clear errors of law, there is little that can be done to overturn an arbitrator gone wild.

The legal community has focused a great deal in the last few years on companies' efforts to expand the scope of contractual arbitration provisions. Both large and small companies have attempted to compel costly disputes to arbitration. Whether it is through attempts to enforce class action waivers, to impose arbitration clauses into form consumer contracts and webpage terms and conditions, or to force employees to give up certain judicial rights in order to maintain employment, companies are thought to be the champions of the contractual arbitration movement.

It is often the post-arbitration costs of a clearly erroneous award or poorly reasoned analysis that counsel often fail to consider when opting for arbitration.

Corporate counsel often include arbitration clauses in contracts even after considering the obvious risks and drawbacks of arbitration. For example, arbitrators have busy schedules and hearings, and trials can drag on for months. Lengthy arbitration sometimes *increases* costs while limiting the parties' ability to conduct discovery. In addition, the parties have to deal with the arbitrator's natural incentive to make money and look for future business. This can lead to lenient rulings on expanding the scope of the arbitration and discovery, and judgments aimed at pleasing both sets of counsel (i.e., "splitting the baby").

Yet it is often the post-arbitration costs of a clearly erroneous award or poorly reasoned analysis that counsel often fail to consider when opting for arbitration. In some instances, corporations who have worked diligently to impose arbitration provisions in their contractual relationships are later saddled with a grossly unjust or poorly reasoned adverse arbitration award. These same corporations are then surprised to learn that the governing arbitration laws and rules often make it impossible to correct a final award that contains serious and costly errors of fact or law.

Contractual arbitration clauses can be a valuable tool to limit costs and exposure. But it is important to consider the serious risks caused by unjust arbitration decisions when dealing with future contracts and present contracts that already contain standard arbitration clauses.

The arbitrator is human, he or she can and will make mistakes. But unlike the court systems, there is little ability to correct these errors.

Once the arbitrator issues an award, it is not directly enforceable by the prevailing party until confirmed by court proceedings. However, erroneous arbitration awards are not subject to judicial review except on certain statutory grounds. The California Arbitration Act (CAA), for example, outlines specific grounds for correcting or vacating an award. The court cannot correct the award unless there was an evident miscalculation of figures or an evident mistake in the description of any person, thing or property referred to in the award; the arbitrators exceeded their powers but the award may be corrected without affecting the merits of the decision upon the controversy submitted; or the award is imperfect in a matter of form, not affecting the merits of the controversy. This creates a restrictive environment where few mistakes can be corrected. Even if arbitrator recognizes he or she made an error, the arbitrator may not be able to correct it.

Similarly, the CAA does not permit the reviewing court to vacate an award unless the award was procured by corruption, fraud or other undue means; there was corruption in any of the arbitrators; the rights of the party were substantially prejudiced by the misconduct of a neutral arbitrator; the arbitrators exceeded their powers and the award cannot be corrected without affecting the merits of the decision upon the controversy submitted; the rights of the party were substantially prejudiced by the refusal of the arbitrators to postpone the hearing upon sufficient cause shown therefore or by the refusal of the arbitrators to hear evidence material to the controversy or by other conduct of the arbitrators contrary to the provisions of this title; the arbitrator making the award failed to timely disclose a ground for disqualification or failed to follow the disqualification rules.

Within these statutory categories of review, the Superior Court defers significantly to the authority of the arbitrator. Under most situations, an arbitrator's view of his or her own authority is entitled to judicial deference. Without contractual limitations, an arbitrator has significant powers to provide any remedy. For example, if any rational relationship exists between an arbitration award and the breach it is aimed at compensating for, then an arbitrator can craft a remedy that was not advocated by either party *and may be undesired by both parties*. The remedy granted may confer benefits different from those that would have been obtained by a party through full performance of the contract.

In some cases of serious abuse, courts interpreting the CAA may permit limited judicial review when the arbitrator's construction of the contract "presents such an egregious mistake that it amounts to an arbitrary remaking of the contract between the parties." *See Pacific Gas & Elec. Co. v. Sup. Ct.*, 15 Cal.App.4th 576, 590-593.

Also, the Court of Appeal recently held that judicial review is appropriate where a ruling deprives an employee of its right to a hearing. An award may be set aside where the remedy granted bears no "rational relationship" to the breach of the underlying contract. But these are narrow exceptions not typically available to most corporate defendants.

It is useful, therefore, to consider how to proceed with arbitration in a manner designed to protect your client should the arbitrator issue an erroneous decision.

This is a quick list of options to consider when including an arbitration clause in a contract.

Reserve the right to appeal errors of law and include a choice of law provision to ensure that the CAA governs. Stipulate to certain procedures streamlined to prevent errors of law. Require the arbitrator to propound a tentative award and permit the parties to file briefs to allow the arbitrator to consider any potential errors before the arbitrator issues a final award. Identify ways to insure knowledgeable arbitrators and avoid biased arbitrators (neutral location, require certain relevant background for arbitrator, method of selection, etc.) Include specific mechanisms for handling the arbitration to limit the arbitrator's scope and explicitly limit the arbitrator's authority. Identify specific topics or issues for arbitration to limit the arbitrator's ability to stray into other issues. Address other rules designed to preserving rights (governing law, venue, format of decision, discovery procedures, motion practice rules, confidentiality, remedies). Opt for judicial reference — consider obtaining cost-saving and confidentiality by utilizing a judicial reference instead of arbitration.

This is a quick list of options to consider if you are about to issue an arbitration demand or are facing a potential or actual arbitration demand stemming from an existing arbitration clause.

Meet and confer about stipulating to amend or modify the arbitration clause to adopt some or all of the changes above.

Agree to limit damages exposure through a modified arbitration format. These could include "Baseball Arbitration" (arbitrator must chose an award amongst those submitted by the parties); "Night Baseball Arbitration" (arbitrator makes award unaware of parties proposed awards — parties are bound by the award closest to that awarded by the arbitrator's final award); and "High-Low Arbitration" (arbitrator is unaware of parties' proposed awards — if arbitrator's award exceeds highest proposed award, the parties are bound by the highest proposed award; if arbitrator's award is lower than lowest proposed award, the parties are bound by the amount of the lowest proposed award). Raise every conceivable objection at arbitration. It is also important to keep the various grounds for challenging a bad ruling clear in your mind during the arbitration. For example, if the parties raised an issue outside of the scope of the arbitrator's authority at trial and the parties failed to object, the parties may be found to have waived the right to complain when those issues appear in the final ruling. Seek ability to file post-trial briefing prior to issuance of award. Seek to invalidate underlying contract or clause, or to add claims that expand dispute to fall outside scope of clause. Conduct extensive diligence on your neutral. Interview counsel on both sides of past disputes. Consider arbitration experience, not just judicial experience. Some excellent judges are less effective as arbitrators for a number of reasons. Hire a court reporter to transcribe the arbitration. If you are going to have any chance of establishing that the arbitrator "exceeded" his or her authority or that vital evidence was excluded, a written record will serve as key evidence.

This should help counsel ensure that their clients have the most tools available should an arbitrator issue a clearly erroneous arbitration decision.

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Letter to the Editor

Nava v. Ulmer: Democracy in Action

In response to Justice J. Anthony Kline's article *"Judicial Election Presents Political Dangers"* (July 12): I know Richard Ulmer. He was part of the Latham & Watkins trial team in *Jasmine v. Marvell* before he took the bench last year. I do not share Justice Kline's good opinion of this judge. I was privileged, therefore, to contribute $500 to Michael Nava's initial campaign, and I certainly plan on giving Mr. Nava additional monies in his present efforts to put Mr. Ulmer back in private practice come November. This is not personal. Dick Ulmer is a perfectly pleasant man, while I do not know Mr. Nava at all. But Dick Ulmer, unfortunately, is just what you'd expect, given his background as a long time Big Law partner. A true "the corporation is always right" kind of a guy. And more of those kinds of judges the San Francisco Superior Court does not need.

As his own letter reflects, Justice Kline apparently does not like observing democracy in action. Most people feel the opposite. Including many people who practice law for a living in front of Justice Kline. Including me. Thank goodness for folks like Michael Nava, who are willing to stand up for themselves and challenge the establishment where it lives.

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