Alternatives

TO THE HIGH COST OF LITIGATION

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DIGEST

ARBITRATION

Thankful for Unanswered Prayers? Unconscionability 'Equilibrium'

BY DONALD R. PHILBIN JR.

Much has been written about what the U. S. Supreme Court has done to enforce arbitration agreements. In case after case, it has interpreted the Federal Arbitration Act expansively, holding that, among other things,

- Congress invoked the full preemptive power of the Commerce Clause (*Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 272, 277 (1995));
- there is a "national policy favoring arbitration" (*Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983));
- the act preempts inconsistent state laws (*Vaden v. Discover Bank*, 129 S.Ct. 1262, 1271 (2009), and
- the act separates the arbitration clause from the surrounding contract for purposes of deciding who decides arbitrability (*Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395, 420-421 (1967)).

But University of Houston Law Center Prof. Aaron Bruhl notes that the "Supreme Court has been less aggressive in combating unconscionability rulings than one might expect, given its strongly pro-arbitration preferences." Aaron-Andrew P. Bruhl, "The Unconscionability Game: Strategic Judging and the Evolution of Federal Arbitration Law," 83 *N.Y.U. L. Rev.* 1420, 1499 (2008). In his article, Bruhl meticulously analyzes cases "seeking to enforce arbitration agreements invalidated by lower courts on the basis of unconscionability (and related state law defenses)."

Because the FAA makes written agreements to arbitrate enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract," there are a wide variety of outcomes and much depends on venue.

Bruhl notes—and sent this author a list of—dozens of certiorari petitions raising the unconscionability issue since 2000—many filed by prominent Supreme Court litigators. Several of these petitions urge the Supreme Court to rule that arbitrators, not courts, should decide whether an arbitration clause is unconscionable under state law, and to modify *Prima Paint* and *Buckeye Check Cashing Inc. v. Cardegna*, 546 U.S. 440 (2006), accordingly.

And the petitions have gone unanswered.

Perhaps Garth Brooks was right in 1990 when he sang the country chart topper "Unanswered Prayers." Congress's consideration of the Arbitration Fairness Act and other bills may be subtly influencing the Supreme Court not to paint a

Don Philbin is an attorney-mediator, negotiation consultant and trainer, and arbitrator based in San Antonio. He has worked as a commercial litigator, general counsel, and president of communications and technology-related companies. He has mediated hundreds of matters and serves as an arbitrator on several panels, including the Panels of Distinguished Neutrals of the CPR Institute, which publishes this newsletter. He is an adjunct professor at the Straus Institute for Dispute Resolution at Pepperdine University School of Law in Malibu, Calif. This article is based in part on a longer article appearing at 76 *Defense Counsel Journal* 338 (2009).

(continued on page 149)

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tion process: If the mediation process does not result in a solution within a fixed period, the parties may shift to arbitration. In other circumstances, when the parties feel strongly that mediation is their choice for resolving the dispute, they bypass evaluative mediation and proceed directly with facilitative mediation. Finally, if the dispute is complex and involves technical matters, the parties often prefer to have one or more co-mediators.

Overall, due to the long and exhaustive process of Egyptian judicial proceedings, ADR is the preferred dispute resolution method. Due to the lack of experience among judges with regard to technical issues, parties in certain industries usually prefer arbitration to judicial proceedings. Nevertheless, realizing the value of mediation and the advantages over arbitration it provides, the larger corporate community is pursuing mediation over arbitration.

* * *

The original Egypt chapter in Wolters Kluwer International "Arbitration and Mediation in the Southern Mediterranean Countries"—see the page 147 sidebar—was written by May El Batouti, Said Hanafi, Karim El Helaly and Heba Osman.

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Unanswered Prayers

(continued from page 145)

bright line rule in the area. The fact is that the Court has not answered these prayers while the efficacy of consumer arbitration has been greatly hampered by state unconscionability law. This may be causing some in Congress to wonder if they should enact broad legislation that may have adverse, unintended consequences on commercial arbitration generally, and international arbitration in particular.

Could the Supreme Court be allowing "squishy state law doctrines like unconscionability" (Bruhl at 1463) to work as pressure release valves, knowing that Congress is considering legislation that would override several of its pro-arbitration decisions? Could Congress be considering substantial arbitration policy shifts not because it wants London to become the unrivaled commercial arbitration capital, but to keep pressure on the Court not to formulate bright-line rules that reduce the effectiveness of these state-law challenges?

SILENT NEGOTIATION

Both sides of the issue are unhappy. "Pro-arbitration forces decry the rise of unconscionability analysis, while consumer activists and employee advocates find unconscionability an unsatisfactory defense against the spread of arbitration." Id at 1486.

Mediators often smell a potential solution when opposing sides are equally tentative. No one would expect the Supreme Court and Congress to admit they may effectively be engaged in a silent negotiation of sorts concerning the FAA, but they nevertheless seem to have found a rough state of equilibrium that attempts to strike a balance between a perceived need for states to protect consumers and the concomitant demand that arbitration agreements be enforced as written.

Collision? Or Coexistence?

The issue: The states and the Supreme Court—and now Congress—are at odds over arbitration fairness.

The problem: Who decides unconscionability? The law is hardly settled—but the nation's top Court rejects petitions in cases that would re-examine and reassess, and which would provide Federal Arbitration Act certainty.

The solution: It may be best left as it is, with a federal policy favoring arbitration. International practitioners still fear that the proposed Arbitration Fairness Act overreaches.

No doubt the U.S. still has a stated policy favoring arbitration. Along with Germany, Switzerland, and the United Kingdom, it can be considered one of the principal seats of arbitration for international, commercial transactions. That has huge implications for U.S. business interests. Can you imagine doing a deal across the globe and having to seat your arbitration in a foreign land because your counterparty wants the law of the "seat" country to support arbitration? For a more extensive discussion of the potential implications of pending legislation on international, commercial arbitration, see American Bar Association Resolution on Arbitration Fairness Act, adopted Aug. 3-4, 2009 ("ABA Resolution"); the committee report and the resolution are available at the link for the House of Delegates at www.abanet.org.

But many courts have carved an important exception, particularly in consumer cases: Courts get to decide whether arbitration agreements are unconscionable under applicable state law, which varies—sometimes significantly—from state to state. And, in the absence of a choice-of-law clause, applicable state law is subject to the vagaries of a judicial forum's conflict-of-law rules.

This approach has the tacit support of the same Supreme Court that has so often declared, and continues to declare, a powerful, federal, pro-arbitration policy. Yet a truly pro-arbitration policy might well commit these determinations to the arbitrators, subject only to deferential judicial review.

A BRIEF HISTORY

One could reasonably wonder why the U.S. Supreme Court is tacitly or otherwise addressing state law doctrine at all.

Early in the last century, members of the New York business and legal community sought to bolster the city's image as a national and international center of commerce and finance. Revocability of predispute arbitration clauses was thought to undermine that effort. After the group

(continued on next page)

Unanswered Prayers

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persuaded the New York Legislature to repeal the common-law rule of revocability in 1920, it sought to resolve the remaining state-by-state patchwork of arbitral hostility with a uniform federal law.

Congress reconciled those state differences by adopting the New York approach in the Federal Arbitration Act of 1925. To some (Justice Hugo L. Black, and later, Chief Justice William H. Rehnquist, Justice Sandra Day O'Connor, and others), the FAA was a procedural statute applicable only in federal courts. And even as the New Deal and World War II expanded federal authority, "the Supreme Court did not expand the scope of the FAA to match the full reach of that expanded constitutional power." Id at 1428.

But that changed. And while the current Congressional debate over arbitration takes on partisan overtones, the Court lineup often has inverted those expectations. "[T]he FAA found support from left-leaning nationalist Justices." Id at 1429. In fact, one of the Court's most liberal members, Justice William J. Brennan Jr., wrote *Moses H. Cone Mem'l Hosp.* announcing a "liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary."

Justice Clarence Thomas, on the other hand, has consistently taken the position that he does not believe that the FAA applies to state court proceedings, and presumably would permit state courts to nullify arbitration agreements under state law as they see fit. Justice Antonin Scalia, writing for a 7-1 *Buckeye Check Cashing* majority, however, effectively put to rest any remaining question as to whether the FAA applied in state courts and whether Section 2 created a body of federal, substantive law favoring the enforcement of arbitration agreements.

A STATE LAW CARVE-OUT

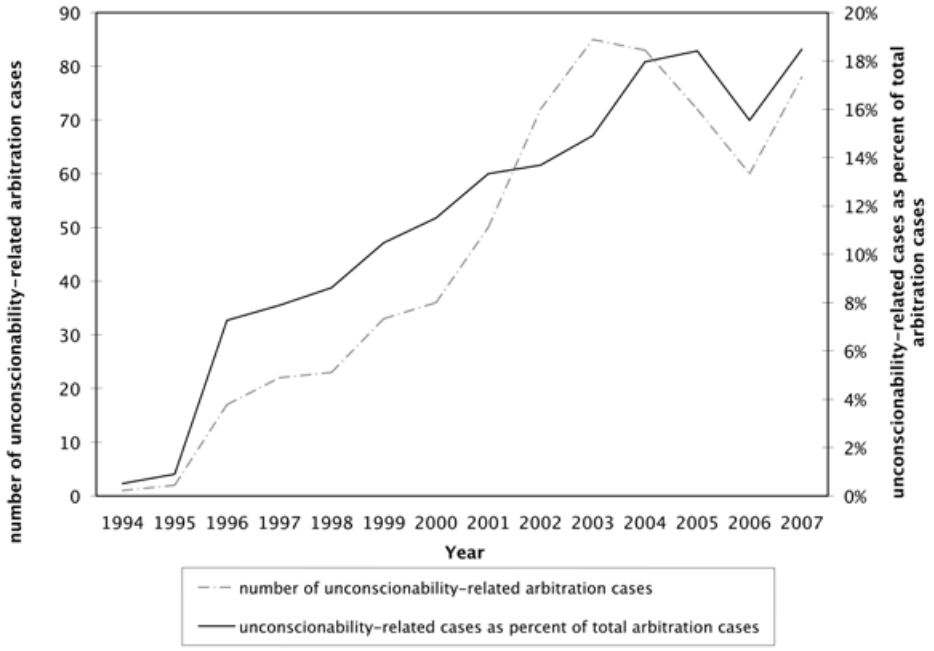
So we are left with federal substantive law that carves out state common-law defenses applicable to contracts generally. Written agreements to arbitrate are enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. §2. Because the FAA does not confer independent subject matter jurisdiction on the federal courts, and because *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938)—decided 13 years after the FAA was enacted—declared that state law provides the rule of decision in diversity cases, state courts are left to apply their own common-law defenses as exceptions to the FAA.

It's no real surprise that the results are seemingly inconsistent, and geographically diverse. One California study found that "unconscionability challenges to arbitration agreements, which accounted for about two-thirds of all unconscionability challenges, succeeded at a rate several times higher than the rate for other types of contracts." Bruhl, supra, at 1457, citing Stephen A. Broome, "An Unconscionable Application of the Unconscionability Doctrine: How the California Courts Are Circumventing the Federal Arbitration Act," 3 *Hastings Business L.J.* 39, 44-48 (2006). A divided panel of the Ninth Circuit recently held that the court should determine unconscionability even though the agreement specified that the arbitrator would decide any enforceability issues, *Jackson v. Rent-A-Center West Inc.*, 2009 WL 2871247 (9th Cir. Sept. 9, 2009), and a recent California appellate court opinion illustrates the slippery slope of questionable enforceability. *Parada v. Superior Court*, 98 Cal.Rptr.3d 743 (Cal. App. 4 Dist., Aug. 26, 2009).

Litigants have historically sought to avoid arbitration by raising a variety of common-law contract defenses, such as lack of consideration, administrative preemption, unconscionability, fraud and duress, and material breach. As many of the other oft-argued defenses have become less successful, unconscionability has become favored. Prof. Bruhl graphs the assertion of this defense to show its rise in number and as a percentage of overall arbitration challenges. (See chart below.)

The increase is borne of necessity and creativity. The unconscionability argument takes advantage of the tension between federal and state law by allowing sympathetic judges a route to deny a motion to compel, with a better chance of appellate success. Because lower courts cannot simply hold arbitration clauses per se unconscionable, their analyses typically "focus on particular aspects of arbitration clauses that allegedly render them unconscionable or otherwise impermissibly frustrate the plaintiff's substantive rights." Examples include:

(1) limitations on the type or amount of relief, such as bans on punitive damages;
(2) provisions forbidding class-wide relief;
(3) "nonmutual" clauses;
(4) clauses that select allegedly biased arbitrators;



Source: Aaron-Andrew P. Bruhl, "The Unconscionability Game: Strategic Judging and the Evolution of Federal Arbitration Law," 83 N.Y.U. L. Rev. 1420 (2008).

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(5) cost-allocating clauses; and
(6) confidentiality provisions.

Many states require that "an agreement display some degree of both procedural and substantive unconscionability before it will be invalidated." Procedural unconscionability concerns problems with contract formation, such as oppression or surprise, while substantive unconscionability concerns the fairness of the arbitration clause itself, such as whether it is "one-sided or overly harsh." Other states require only one form of unconscionability for success. In Washington State, for example, "substantive unconscionability alone can support a finding of unconscionability." *Kam-Ko Bio-Pharm Trading Co. Ltd-Australisia v. Mayne Pharma (USA) Inc.*, 560 F.3d 935 (2009) (citing *Alder v Fred Lind Manor*, 103 P. 3d 773, 782 (2004)).

As a practical matter, it becomes difficult for appellate courts to determine whether the trial court has analyzed the arbitration clause in the same way it would have if the contract did not contain an arbitration clause. Those "apples-to-apples" comparisons are often difficult to make. And typically the result is that the remainder of the contract remains enforceable so that the consumer has something on which to base its claim on the merits.

SEVERABILITY IS THE SOURCE

Some of the unconscionability defense's popularity is a byproduct of the *Prima Paint* severability principle—that the arbitrator generally decides defensive issues unless they are directed specifically at the arbitration clause. Rather than proving to an arbitrator that an entire contract was fraudulently induced, litigants are carefully aiming procedural and substantive unconscionability rifle shots at arbitration clauses.

Such questions usually go to the court, not the arbitrator under *Prima Paint*. And it makes a difference which court answers them. "[V]acatur was attempted more often and succeeded more often, both on an absolute and on a percentage basis, in just three states than anywhere else in the nation. Of 120 cases in which vacatur was sought in a state court, 27 were brought in California, 25 in New York and 12 in Connecticut." Lawrence R. Mills, et al., "Vacating Arbitration Awards: Study Reveals Real-World Odds of Success by Grounds, Subject Matter and Jurisdiction," *Dispute Resolution Magazine*, 23, 25 (Summer 2005).

Some courts are more likely to find expressly or assume tacitly that the challenge goes to the arbitration clause and proceed to determine unconscionablity. "[I]t is fair to say that, rightly or wrongly, many courts have for a long time ruled on unconscionability challenges to various aspects of arbitration agreements (and many courts still do) occasionally expressly stating that the matter was for the court, other times simply so assuming without a second thought. Even fairly recently, defendants did not even argue that such matters were for the arbitrator." Bruhl, supra note 8, at 1472. Others may apply *Prima Paint* and leave the unconscionability question to the arbitrator.

While the distinction between a challenge to the arbitration clause itself and one to the contract as a whole might seem esoteric, it is often the pressure point. If parties litigate the arbitration clause in court, the claimed benefits of arbitration, such as time and cost savings, may be lost.

On the other hand, if litigants are left to the arbitration process they are trying to avoid, they are denied meaningful review of an issue that may arguably concern the validity and enforceability of the arbitration agreement itself.

DOES TENSION EQUAL BALANCE?

The availability of relatively easy fixes begs the original question: Is the tension between state and federal law keeping the domestic arbitration system in a relative state of balance? For example, a pro-arbitration fix might be the Supreme Court modifying the *Prima Paint* severability doctrine, so that arbitrators decide unconscionability challenges, even if they are directed at the arbitration clause itself.

That would certainly limit FAA satellite litigation on this subject. But the Court has passed on a number of opportunities to do that. And it may be that certain unconscionability challenges directed to an arbitration clause arguably should be determined by a court, subject to ordinary appellate review, as opposed to the limited and deferential review available under FAA Sections 10 and 11.

The easy fix on the anti-arbitration side would be for Congress to amend the FAA to abrogate the severability doctrine. For example, the House version of the Arbitration Fairness Act of 2009 provides that courts, rather than arbitrators, should rule on challenges to the validity or enforceability of an agreement to arbitrate, "irrespective of whether the party resisting arbitration challenges the arbitration agreement specifically or in conjunction with other terms of the contract containing such agreement."

That too would likely precipitate unintended consequences, particularly in international arbitration, and industry and commercial arbitration involving only sophisticated business entities. New York attorney Edna Sussman raises a number of unintended consequences of the act, suggesting it might:

(1) be a "serious threat to . . . the United States as a friendly place to arbitrate";
(2) add significant costs and delays to many arbitrations;
(3) risk breaching the spirit of longstanding treaty obligations;
(4) impose a significant additional burden on the courts; and
(5) alter the economics of numerous transactions.

Edna Sussman, "The Unintended Consequences of the Proposed Arbitration Fairness Act," 56 *Federal Lawyer* 48 (May 2009); see also ABA Resolution, supra.

Certain of her concerns may have been addressed in the Senate version of the bill, or could be addressed in future versions of the House or Senate bills, and other consequences may in fact be intentional. What may not be so intentional is the impact the legislation may have on the acceptability of the U.S. as an arbitral seat and the implications that might have on the transactions of U.S. companies. If anything is clear from the geographical reactions to arbitration enforceability discussed above, it is that it matters where you litigate. And the seat of arbitration is generally where satellite arbitration litigation will be venued.

There are a number of implications to U.S. companies having to seat their arbitrations outside the U.S. Sussman quotes foreign arbitrators who expect

(continued on next page)

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Unanswered Prayers

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that to happen: "[t]he proposed legislation would have a marked impact on the acceptability of the United States as an arbitration-friendly jurisdiction." A New York State Bar Association report by its dispute resolution section on the Arbitration Fairness Act and other federal arbitration bills goes further: "As the changes in U.S. law become known, the U.S. will no longer be viewed as a friendly forum for international arbitration, and parties engaged in international commerce would shun the U.S. for fear of being dragged into U.S. domestic courts." See also the ABA Resolution, supra.

Most everything reduces to a balancing test. That's not to say, however, that everyone agrees on the weight to be attached to each side of the balance. Here, concerns over alleged abuses in consumer arbitration, and to a lesser extent employment, franchise and civil rights arbitration, spurred clarion calls for change.

Congress is pressed to fundamentally change an 80-year-old law that was designed to make New York, and later the U.S., more arbitration-friendly and, some would say, business-friendly.

Existing laws were used to force the National Arbitration Forum, of St. Louis Park, Minn., one of the largest providers of consumer arbitration services, to withdraw from the consumer debt arbitration field. The nation's largest provider of arbitration services, the New York-based American Arbitration Association, followed suit and voluntarily suspended its consumer debt arbitration business. Two of the largest banks and credit-card providers, J.P. Morgan Chase and Bank of America, have abandoned consumer arbitration in their credit card relationships.

So there is effectively no forum for this type of consumer arbitration, and the bank issuers of most credit cards do not need one. The balance has shifted considerably and that may beg the question of whether the Arbitration Fairness Act's radical surgery is still worth the unintended consequences.

There are few better at balancing tests than Harvard Law School Prof. Cass Sunstein. He is a great thinker and prolific writer on the relationship between law and human behavior. Sunstein understands behavioral economics and scenario planning, decision analysis, and psychology. President Barack Obama has nominated Sunstein to be his regulatory czar—officially, the head of the White House Office of Information and Regulatory Affairs. Since there are regulatory proceedings pending or contemplated that would affect, among other areas, securities and consumer arbitration, there is a good chance that Sunstein will have a chance to regulate with a scalpel rather than a meat axe, and not have to preside over or recommend the vetoing of sweeping legislation that may have significant adverse but unintended consequences.

For now, the Court is leaving prayers for a bright-line rule unanswered. And Congress has continued to consider, but not pass, sweeping changes to the 1925 FAA. While those on both sides will continue their fight to push that balance one way or the other, it could well be that a workable, if often uncomfortable, policy equilibrium is actually working. In this roughly balanced state, the U.S. maintains the nominally pro-arbitration stance that the New Yorkers thought they needed to be a financial and commercial law capital nearly a century ago. At the same time, state law defenses, especially unconscionability, provide pressure valves that keep the system in an equally disagreeable state of equilibrium.

Unfortunately, we won't really know if such a state of suspended equilibrium exists until one side or the other tips the balance. Only then will the unintended consequences of the policy shift become evident.

So perhaps we should be thankful for unanswered prayers.

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Survey: Difficult Arbitration E-Discovery Process Questions Suggest Increasingly Complex Future Problems on Costs, Scope

BY DEBORAH ROTHMAN AND THOMAS J. BREWER

In Part I last month, the authors introduced Points 1 and 2 of their survey on electronic discovery in arbitration, conducted with Fellows at the College of Commercial Arbitrators, an international professional association that promotes ethical best practices (see www.thecca.net). In this month's conclusion, Deborah Rothman and Thomas J. Brewer return with Points 3-6, covering the rest of the main areas of E-discovery disputes revealed in their survey, and finish with predictions for practices in dealing with E-discovery in arbitration.

DISCOVERY

• PART II OF II •

Deborah Rothman (www.deborahrothman.com) and Tom Brewer (www.tjbrewer.com) are full-time ADR neutrals based, respectively, in Los Angeles and Seattle. **This article is adapted from the authors' presentation at the College of Commercial Arbitrators October 2008 Annual Meeting in San Francisco. The authors express their appreciation to College Fellows who responded to the survey discussed in the article.**

* * *

3. Who should bear the cost of searches for electronically-stored information (ESI)?

Several survey respondents have had this issue, and almost all of them see this as

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