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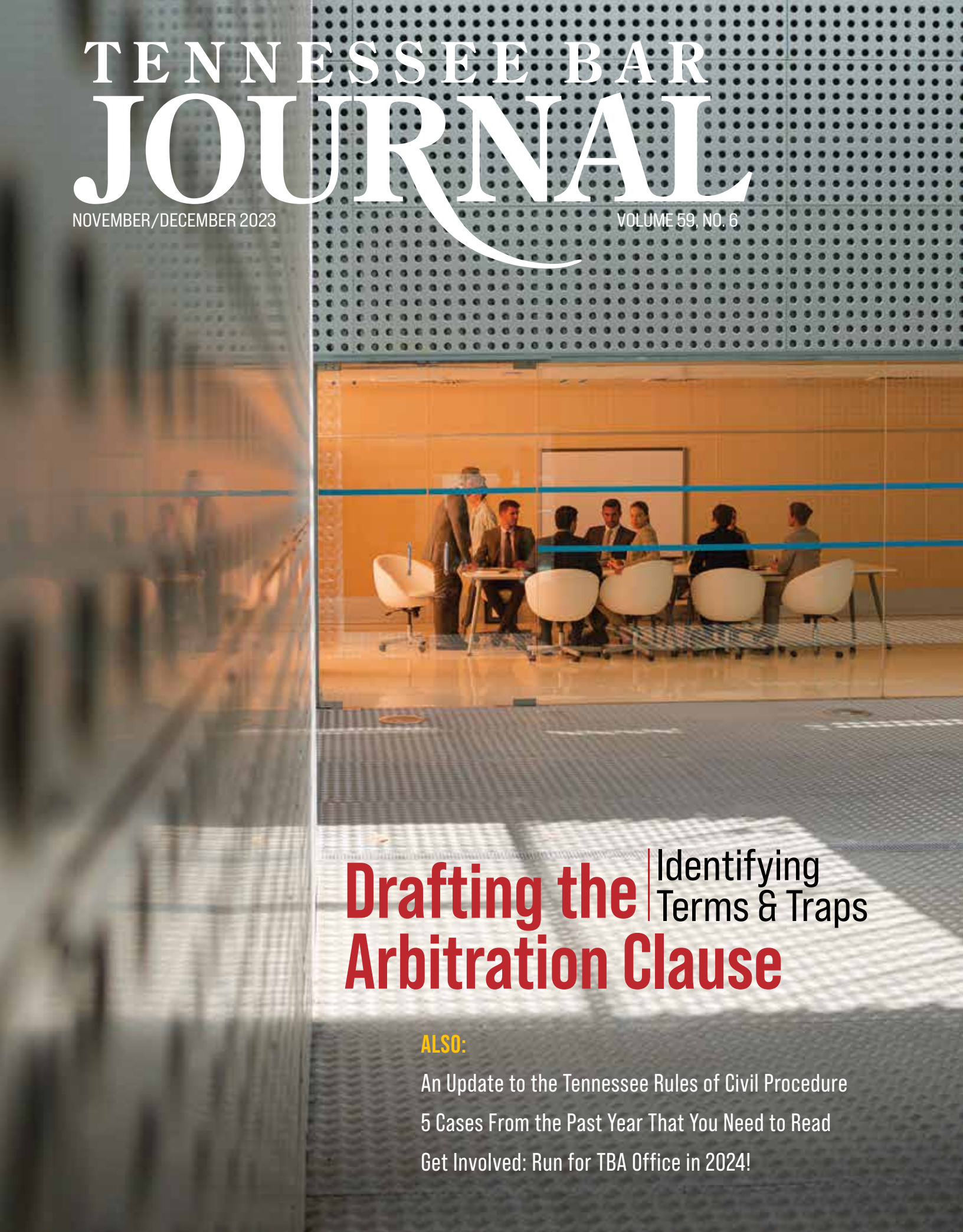

# Drafting the Arbitration Clause

## Identifying Terms & Traps

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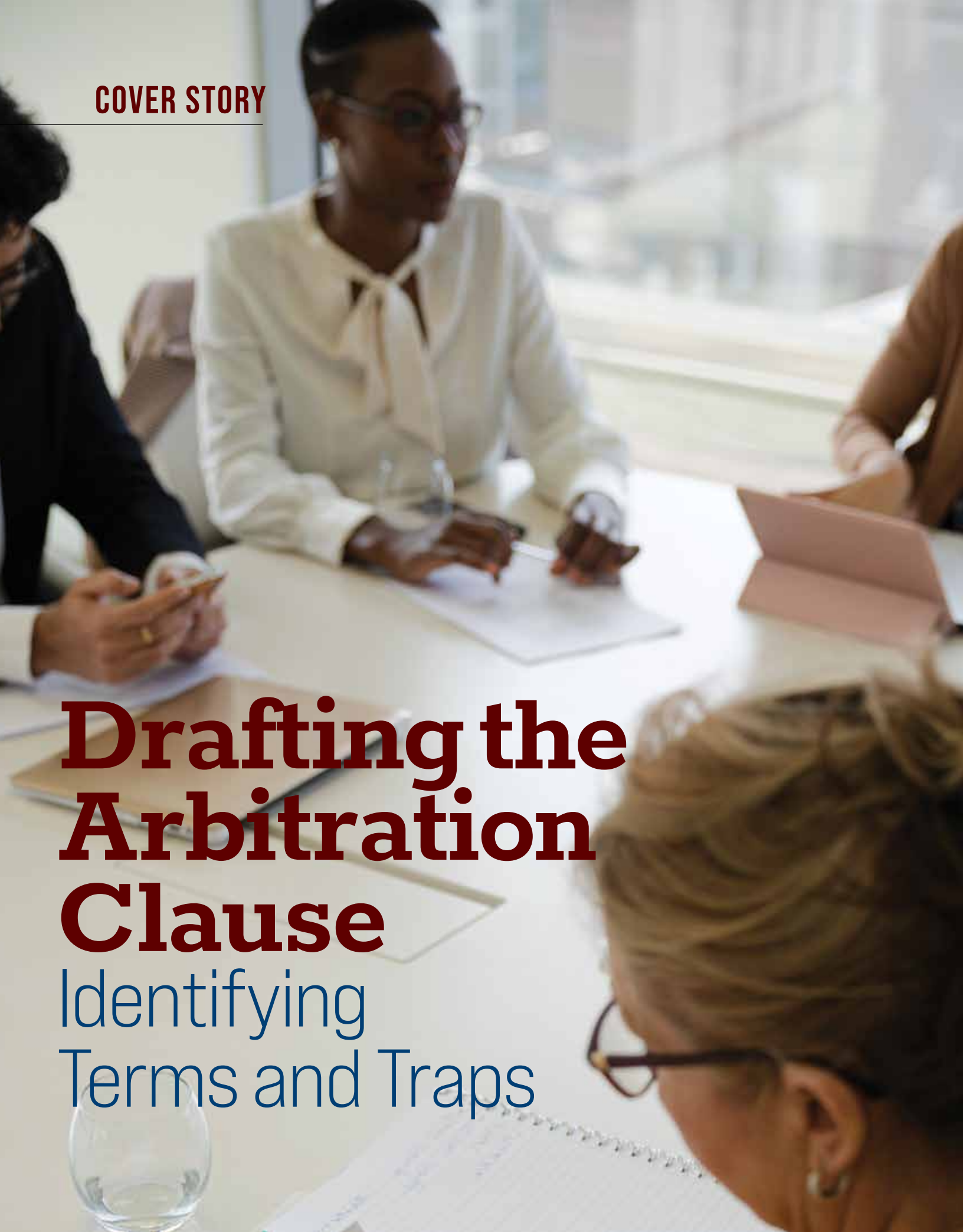

# Drafting the Arbitration Clause

## Identifying Terms and Traps

By Matt Sweeney and Mark Travis

Contract negotiations have dragged on. Then, at the last minute, the buying party insists on adding a new provision that states: "All disputes under this agreement shall be settled by arbitration." Should your client agree — or negotiate over the language?

## So, What is Arbitration Anyway?

Arbitration is imagined to be "litigation light" — a confidential, speedier, more efficient and less expensive way to resolve disputes. Maybe. While most arbitrations are private, the assumption of confidentiality, or at least complete confidentiality, may be misplaced. Additionally, as arbitration becomes more common, it has assumed some of the less desirable characteristics of civil litigation. Extensive discovery is becoming common, making arbitrations more expensive — and longer. Legal and procedural protections of the parties are few and, for all practical purposes, arbitrator decisions are final and unreviewable. Consequently, the primary premise for engaging in arbitration may be unwarranted, unless the arbitration process is fully understood and the arbitration provision is carefully drafted.

Enacted in 1925, the Federal Arbitration Act ("FAA" or "the Act") was intended to enable commercial entities to arbitrate business disputes.[1] In more recent years, however, without any material amendment to the Act,[2] the U.S. Supreme Court has broadly interpreted its scope and application to include an assortment of agreements, whether negotiated, adhesion and most everything in between.[3] Presumably, in the vast majority of disputes, courts will enforce contractual arbitration clauses under either the FAA or state counterparts.

Arbitration, as authorized by the FAA or the state counterparts, is primarily contractual. The FAA applies to all disputes involving a maritime transaction or a contract evidencing a transaction involving interstate or foreign commerce.[4] The state arbitration acts may apply to those disputes if specifically invoked by the parties and to all other disputes not subject to the FAA.[5] The FAA and the state arbitration laws (the "Arbitration Acts"), while authorizing arbitration, provide neither structures nor procedures for resolving the underlying disputes.[6] The parties, therefore, are free to agree on their own rules and procedures, or to appoint an administrative agency and to follow its rules and procedures for the resolution of

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the types of disputes they select.

Arbitration has stages similar to litigation, but they have different significance. Whereas stages of litigation are set by statute or rule, the arbitration stages are selected and defined by the parties. In the arbitration agreement the parties have the authority to and typically select a forum under which a dispute will be heard — the FAA or one of the state Arbitration Acts. In the agreement, they commonly will select an arbitrator or a means and criteria for selecting one. When the dispute arises, the claimant will make a written claim or demand and respondent an answer, yet none of the Arbitration Acts set pleading standards and although the parties could, they rarely specify any such standards in their agreements.[7] Prehearing motion practice is of limited use in arbitration. Generally, the motion to dismiss unavailable due to the lack of pleading standards and summary disposition is rarely granted. The FAA makes no provision for discovery while some Arbitration Acts grant the arbitrator discretion to permit it. Nonetheless, both parties frequently make broad discovery requests, including non-party requests, which even if allowed, may not be enforceable — yet the unavailability of same may be outcome-determinative in some cases.[8]

An arbitration is private and held in a conference room, not a courtroom. Generally, the parties can agree to keep all aspects of the proceedings confidential, but only during the arbitration process, not when brought to court for enforcement of, or challenge to, the award. The arbitrator will preside at the hearing, take evidence, consider legal issues and issue an award. Neither the federal nor state rules of civil procedure or evidence apply to the proceeding, unless authorized by the arbitration agreement, and the arbitrator is not required to follow the law.[9]

The final key difference between arbitration and litigation relates to the review of the outcome. Whereas a party may appeal a court decision based on factual or legal error, review of an arbitration award is much more limited. While the parties in their arbitration contract may include an administrative appeal under an administrator's internal rules, the Arbitration Acts themselves do not provide any judicial right comparable to the review available for a court decision or a jury verdict.[10] Furthermore, The U.S. Supreme Court has ruled that the parties cannot contractually agree to allow a court review under any other standards.[11] An arbitration decision may be set aside, i.e., "vacated," only on very narrow grounds.[12]

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## Other Considerations

In addition to understanding what arbitration is and what it is not, it is important to consider the types of disputes likely to arise between the parties and whether those interests can be protected adequately in arbitration. All claims are not necessarily well-suited to arbitration. Arbitration may not be right for a potential dispute that may have broader implications, such as one involving franchise system rights. Litigation with rights of appeal may be a better fit for intellectual property disputes. A partnership termination dispute involving rights to a newly acquired book of business might be better resolved in court. Such claims can be carved out from the arbitration agreement for judicial resolution.

Another factor to consider in deciding upon arbitration is whether there is a comparable or better litigation alternative that can be achieved by a carefully drawn contract provision. For example, parties can contractually agree to waive a jury,[13] punitive damages,[14] consequential or incidental damages[15] or, potentially, class actions.[16] To address confidentiality concerns, they could require pre-litigation mediation, non-binding arbitration or neutral evaluation. To limit costs, the agreement might also provide for recovery of fees and costs by the prevailing party.

## Drafting Considerations

Should the parties conclude that arbitration is the best alternative, they should carefully draft a provision that will effect what they want to achieve.

### 1. Choice of Law.

Choice of law in this context includes both substantive law and specifically, which arbitration law will apply. Just as there are strategic reasons relative to the former, selection of the arbitration forum may also be strategic. In almost any context parties may select state arbitration laws, so long as they do not conflict with the essential features of the FAA.[17] Although a complete analysis of the differences between the FAA and the TUAA are beyond the scope of this article, suffice it to say that the Tennessee law specifically authorizes party and non-party discovery, and specifically authorizes motions for summary disposition.[18]

### 2. Arbitrator Selection and Case Administration.

The selection of the arbitrator is critical due to his nearly unbridled authority to manage and decide the case. Arbitrator selection may be the most crucial decision the parties will make and potentially one that is outcome-determinative. If agency administration is selected, the agency will provide the parties with a list of potential arbitrators from which they may select, and a set

of rules to govern the arbitration process. If the parties' agreement instead authorizes selection by agreement and the parties fail to agree, they can seek court appointment of an arbitrator.[19] While self-administration by the parties or by an arbitrator is allowed, self-administration can be awkward, and, while it might save agency fees, if the arbitrator is the administrator he will likely charge hourly fees for that work as well, resulting in no savings or greater charges. Additionally, even when the parties self-administer the arbitration, for ease of administration they should adopt an administrative agency's procedural rules.[20]

It is not uncommon (and indeed, strongly advised) for the parties to specify arbitrator qualifications in their agreement (e.g., former judge, specific subject matter expertise or years of experience) to best assure the selected arbitrator is well-suited for the task. Some agreements, instead of providing for one arbitrator, require a panel of three. In this situation, each party selects an arbitrator and those two arbitrators select a third to serve as chair. While this provision provides some perceived risk protection, unless there is a need for specific expertise on the panel that a single arbitrator cannot provide, the panel may provide little any actual benefit (yet at quite a price), particularly when all three must fully participate in all matters — substantive, procedural or administrative. Furthermore, when a panel includes party-appointed arbitrators unexpected problems may arise, even though all are presumptively considered neutral.[21]

**3. Covered Claims.**

Arbitration clauses may be broad,[22] narrow[23] or anywhere in between, and may include carveouts. Accordingly, it is possible for agreements to bifurcate disputes, with certain claims being arbitrated, while others are litigated at the same time. Such an allocation, if done properly, does not render the agreement unconscionable for lack of mutuality.[24] While this division may seem inefficient, there may be valid reasons for dissecting potential claims, such as the protection of intellectual property. Case law and the language regarding scope of the agreement to arbitrate should be carefully considered to best ensure that the provision includes and excludes matters as the parties intend.

Except in situations with broadly drawn arbitration provisions and no carveouts, one of the foundational questions in many disputes is whether a particular claim is arbitrable and who decides the issue — a court or the arbitrator. Under Section 4 of the FAA, arbitration clauses are separable from the contract as a whole. Generally, courts decide whether a claim is arbitrable, while the arbitrator decides challenges to the validity or enforceability of contract containing the arbitration provision.[25] However, where the arbitration provision contains a "delegation clause," the arbitrator has the authority to decide both issues, even if the delegation occurs by the unknowing incorporation of an administering agency's rules recognizing such arbitrator authority.[26]

**4. Process and Procedure.**

As neither the TUAA nor the FAA address process and procedure in any detail, the parties will need to draft their own or select an administrator who will provide them, or a combination of both. If written discovery and depositions are desired, or if the parties want to limit them, the agreement should outline what will be allowed, with the understanding that at least under the FAA, non-party discovery may not be allowed.[27]

Similarly, the FAA does not provide for dispositive motions, although courts have held summary disposition is available.[28] As noted earlier, the recent amendment to the TUAA authorizes summary disposition, although it sets no standards. Rule 33 of the AAA Commercial Rules provides that an arbitrator may allow the filing of, and ruling on, a dispositive motion only if the arbitrator determines the moving party has shown the motion likely to succeed and dispose of or narrow issues in the case. Rule 23 of the AAA Employment Rules is similar, except it requires the movant to show "substantial cause" the motion is likely to succeed. To provide greater definition and to encourage arbitrator use, the parties may want to provide in the agreement that if summary disposition is sought it will be considered under federal (or state) Rule 56 standards.

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**5. Confidentiality.** Confidentiality is often a concern and/or advantage of arbitration. Contrary to the general belief of many, however, neither the FAA nor the TUAA provide for confidentiality. Some administrative agency rules provide for confidentiality, at least for the agency and the arbitrator.[29] It also is important that the parties understand that arbitration awards are not self-executing and any confidentiality recognized by agency rules will not apply to the award (and the underlying proceedings), once a motion to enforce or to vacate the award is filed in court. Accordingly, it is advisable for the parties to carefully consider and provide for confidentiality that will best protect the parties during the arbitration and thereafter.

**6. The Award and its Enforcement.** Neither the FAA nor the TUAA specify standards for an award, such as findings and conclusions. The American Arbitration Association provides for three types of awards: a Standard Award that states only who has prevailed and the amount of any damages awarded, a Reasoned Award in which the arbitrator briefly explains her decision and how damages were determined, and Findings and Conclusions. While the parties can decide later in the process, they should consider including in the agreement the form of the award. The Standard Award is the least expensive, because it takes less time to prepare, but it provides no explanation for the arbitrator's decision, thus it is best used in smaller matters. In the Reasoned Award the arbitrator will explain at some level of detail how she reached the decision and computed or calculated damages. The level of detail in the Reasoned Award depends upon the particular arbitrator, as there are no criteria. Findings and Conclusions are best suited for complex cases due to the expense of preparation.

As earlier noted, arbitration awards are not self-executing. A court will enforce an award unless it is modified in minor part, remanded to the arbitrator, or vacated. The grounds upon which vacatur may be granted are both narrow and fairly consistent between the FAA and TUAA: (1) corruption, fraud or undue means;[30] (2) evident partiality or corruption by arbitrator;[31] (3) the arbitrator refused to postpone the hearing for sufficient cause or refused to hear material evidence to the prejudice of a party; [32] (3) or the arbitrator exceeded his powers.[33] At common law, "manifest disregard of the law" constituted an additional ground for vacatur. However, in *Hall Street Associates v. Mattel,* the Supreme Court held the grounds specified in Section 10 of the FAA are exclusive and cannot be enlarged by the parties' contract.[34] Similarly, in *Pugh's Lawn Landscape Co. v. Jaycon Development Corp.*, the Tennessee Supreme Court held that review under the TUAA is limited to the specific grounds in the statute.[35] Nevertheless, there is a federal circuit court split on how Hall Street should be interpreted and the extent to which "manifest disregard" still applies as a ground to vacate an award.[36]

## Conclusion

Arbitration clauses are not fungible, and some may have unintended consequences. An effective arbitration provision requires an understanding of arbitration, the parties, their relationship and foreseeable disputes. With that information, the parties can draft the provision to accurately state what they intend and what will make an arbitration effective and efficient. Sample clauses are available from many sources and such provisions can be found in many agreements.[37] While those provisions may provide core language for consideration, they should not simply be incorporated into any agreement without a clear understanding of the clause, its purpose and limitations. A knowingly drafted bespoke arbitration clause provides the parties with the best protection.

### NOTES

1. 9 U.S.C. §1 et seq.

2. Save for the "Ending Forced Arbitration of Sexual Assault and Sexual Harassment Act of 2022," 9 U.S.C. §§401, 402. See, Mark Travis, "When One Door Closes: New Law Ends Arbitration of Sexual Harassment Claims," 58 *Tennessee Bar Journal* 20 (May/June 2022) available at www.tba.org/Travis_ArbitrationHarrassment. (Last viewed Sept. 10, 2023).

3. Gabriel Benjamin Herman, "Adhesive Contracts and Arbitration Agreements: Judicial Favoritism and Contractual Relations Between American Business and Non-Drafting Parties," at 2946; https://bit.ly/3RncKCc. (Last viewed Sept. 8, 2023).

4. 9 U.S.C. § 2. The sweep of "interstate commerce" is expansive according to the

U.S. Supreme Court. *Allied-Bruce Terminix Companies Inc. v. Dobson*, 513 U.S. 265 (1995).

5. *Volt Information Sciences Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989) (parties may choose to proceed under state arbitration law, interstate commerce notwithstanding).

6. Most states have adopted the Uniform Arbitration Act or the Revised Uniform Arbitration Act, sometimes with modifications. Tennessee law has been based on the former, but as of July 1, 2023, is based on the latter. See, *Tenn. Code Ann.* §29-3-301, et seq. (2023).

7. *See, e.g.*, R4 and R5 of the American Arbitration Association (AAA) Commercial Rules that requires the demand include "a statement setting forth the nature of the claim including the relief sought and the amount involved" and that an answering statement be sent, and if not timely filed, the claim shall be deemed denied. *Compare*, Rules 8-11, Federal Rules of Civil Procedure; *Bell Atlantic v. Twombly*, 550 U.S. 544 (2007); and *Ashcroft v. Iqbal*, 556 U.S. 662, 685 (2009).

8. There is a split in authority in the federal circuits on whether non-party discovery is allowed and enforceable by the courts under the FAA. *See, Am. Fed. of Tel. & Radio Artists v. WJBK TV*, 164 F.3d 1004 (6th Cir. 1999).

9. *See e.g.*, R34(a) AAA Commercial Rules.

10. See, "Optional Appellate Arbitration Rules," American Arbitration Association, https://bit.ly/46iJpNC. (Last viewed Sept. 8, 2023).

11. *Hall Street Assocs. LLC v. Mattel Inc.* 552 U.S. 576 (2008).

12. *See* 9 U.S.C. § 10, *Tenn. Code Ann.* § 29-5-324 (2023).

13. *See, e.g., Poole v. Union Planters Bank N.A.*, 337 S.W.3d 771, 777-778 (Tenn. Ct. App. 2010), perm. app. den (2010).

14. *Commercial Painting Company Inc. v. The Weitz Company LLC*, 2022 WL 737468 *26 (Tenn. Ct. App. Feb. 16, 2021).

15. *Id.*

16. *See*, Jacqueline Prats, "Are Arbitration Agreements Necessary for Class-Action Waivers to be Enforceable?" 92 *Florida Bar Journal* 64 (November 2018). https://bit.ly/3rdd1gv. (Last viewed Sept. 8, 2023)

17. A general choice of state law provision will not invoke a state arbitration law; the state arbitration law must be specifically identified. *Mastrobuono v. Shearson Lehman Hutton Inc.*, 514 U.S. 52 (1995) and *Preston v. Ferrer*, 552 U.S. 346 (2008).

18. *Tenn. Code Ann.* §§ 29-5- 316 and 318 (2023).

19. *Tenn. Code Ann.* § 29-5- 308 (2023); FAA, 9 U.S.C. §5.

20. *See, e.g.*, "Employment Arbitration Rules and Mediation Procedures," American Arbitration Association, www.adr.org/employment; "Commercial Arbitration Rules and Mediation Procedures," American Arbitration Association, www.adr.org/commercial; "AAA Construction Rules and Mediation Procedures," American Arbitration Association, www.adr.org/construction; "Comprehensive Arbitration Rules & Procedures," JAMS Arbitrators & Arbitration Services, www.jamsadr.com/rules-comprehensive-arbitration. (Each last viewed Sept. 8, 2023).

21. "The Code of Ethics for Arbitrators in Commercial Disputes," American Arbitration Association, https://bit.ly/3RssmV5. (Last viewed Sept. 8, 2023). CONTINUED ON PAGE 27 >

22. *Brown v KareMore Int'l Inc.*, 1999 WL 221799 *2 (Tenn. Ct. App. April 19, 1999) ("all issues related to the parties' relationship, whether sounding in contract, tort or otherwise").

23. *Dale Supply Co. v. York Int'l Corp.*, 2003 WL 22309461 *2 (Tenn. Ct. App. April 3, 2002). ("as arising from the breach of this agreement").

24. *See* Jackson Lucky, "Analyzing unconscionability in arbitration agreements," *Plaintiff Magazine* (September 2022), https://bit.ly/48koOdD. (Last viewed Sept. 8, 2023); *Global Client Solutions LLC v. Ossello*, 367 P.3d 361 (2016) (arbitration agreement rendered unconscionable by unilateral carveout).

25. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967).

26. *Rent-A-Center, West Inc. v. Jackson*, 561 U.S. 63 (2010). It should be noted that if agreement references AAA Rules, which gives the arbitrator authority to make that determination, delegation is satisfied. *Henry Schein Inc. v. Archer & White Sales Inc.*, 139 S.Ct. 524 (2019); *Blanton v. Domino's Pizza Franchising LLC*, 962 F.3d 842 (6th Cir. 2020).

27. Similarly, the arbitration agreement could incorporate the expert witness report standards in Rule 26(a)(2)(B), Fed.R.Civ.P.

28. *See, e.g., Sherrock Brothers Inc. v. DaimlerChrysler Motors Co. LLC*, 260 Fed. Appx. 497, 501-502 (3d Cir. 2008); *Louisiana D. Brown 1992 Irrevocable Trust v. Peabody Coal Co.*, 205 F.3d 1340 (6th Cir. 2000) (unpublished table decision) ("Arbitration may proceed summarily and with restricted inquiry into factual issues").

29. R-45 AAA Commercial Rules; R-23 AAA Employment Rules.

30. *Tenn. Code Ann.* § 29-5- 324(a)(1)(A) (2023); FAA 9 U.S.C. §10(a)(1).

31. *Tenn. Code Ann.* § 29-5-324 (a)(2)(A) (2023); FAA, 9 U.S.C. §10(a)(2).

32. *Tenn. Code Ann.* § 29-5-324(a)(4) (Acts of 1983, Ch. 462; FAA 9 U.S.C. §10(a)(3).

33. *Tenn. Code Ann.* § 29-5-324 (a)(3); FAA 9 U.S.C. §10(a)(4).

34. 552 U.S. 576 (2008).

35. 320 S.W. 3d 252 (Tenn. 2010).

36. *See, e.g., Coffee Beanery Ltd. v. WW LLC*, 300 Fed. Appx 415 (6th Cir. 2008).

37."Drafting Dispute Resolution Clauses," American Arbitration Association, https://bit.ly/46gNHWd;"Alternative Dispute Resolution (ADR) Clauses," JAMS Arbitrators & Arbitration Services, www.jamsadr.com/clauses; "Administered Arbitration," CPR Dispute Resolution, https://bit.ly/3ZpWX7D; "Dispute Resolution Services: Arbitration," American Health Law Association, www.americanhealthlaw.org/dispute-resolution-services/arbitration. *See also*, "Mutual Agreement to Arbitrate Employment-Related Disputes (TN)," Bass Berry & Sims PLC https://bit.ly/3RttHL9. (Each last viewed Sept. 8, 2023)