WHAT TO TELL YOUR CLIENT WHEN YOU ARE ASKED, SHOULD WE AGREE TO ARBITRATION

By Daniel S. Kaplan

July 2001

Arbitration is often viewed as a low-cost, speedy and non-public means of dispute resolution. With the right arbitrator who understands commercial transactions, this can be the case. Unfortunately, sometimes arbitration can be a client's worse nightmare, with huge delays, staggering legal fees, and unsatisfactory awards. Whether arbitration is the preferred forum for dispute resolution depends on many factors. To illustrate some of these factors, I offer some real life horror stories.

"Attack of the Killer Tomatoes"

One of the larger arbitration matters I was involved with, I refer to as "Attack of the Killer Tomatoes." This saga began when a very well respected multinational company sold approximately $1.5 million worth of tomato processing equipment. This equipment was intended to make tomato paste aseptic (so it would not spoil) in a new state of the art tomato paste processing facility in California. Unfortunately, the new facility met with an early demise. The buyer blamed the company's equipment. The company said the problem was how the buyer operated its company. The buyer then sued the seller in California State court for $10 million in compensatory and exemplary damages.

The seller then hired a prominent Chicago law firm to handle the dispute and a local California law firm was hired as local counsel. The first major decision that had to be made was whether to permit the case to proceed in the California courts, or whether to

invoke the arbitration clause. Conventional wisdom suggests that when a lawsuit is filed in your opponent's backyard, it is wise to try to remove the case to federal court or somehow try to get it out of the local state court.

Invoking an arbitration clause to get out of state court is not always as cut and dry as one might think. Even with an extremely broad arbitration clause, opposing counsel may assert that the arbitration agreement was procured by fraud. Or, an even more common strategy, is to name related parties in the lawsuit who are not parties to the contract. The net result is a flurry of litigation regarding who are proper parties and what claims belong in what forum – which all generate legal fees that take away from what could be used towards a settlement. In the killer tomato case, after much legal wrangling, the lawsuit was stayed and the matter proceeded to arbitration in California under the auspices of the American Arbitration Association.

The decision to invoke an arbitration clause almost always impacts how the case will be prepared for resolution. Most private dispute resolution forums have no formal discovery procedures and most arbitration clauses do not specify how discovery is to handled. Usually, discovery is left to an unknown arbitrator who may take a totally proactive or no-action approach.

In the killer tomato case, the seller had nearly all the relevant documents. To disprove the claims, the seller was forced to recreate nearly all the business records using third-party sources and a premier accounting firm. The costs to obtain discovery through this means were staggering. Fortunately, the effort paid off. Buyer got nothing and the seller was awarded the balance remaining on the purchase contract which was over $500,000. Soon thereafter the arbitrator awarded seller approximately $1.4 million in

attorneys' fees and nearly $700,000 in costs, pursuant to the prevailing party provision in the arbitration clause. The client would have been elated if that was the end of the story. It was not.

Most attorneys are aware that valid grounds for reversing an arbitration award are narrow. Generally, grounds for reversal include bad faith, fraud or that the arbitrator clearly chose not to follow the law. The fact that the arbitrator misapplied the law or the facts is not usually grounds for judicial review.

Unknown to Chicago counsel, the local counsel in the state court case hired the arbitrator as an expert witness in an unrelated case. The local counsel was not involved in the arbitration and the arbitrator understood that local counsel was not involved. After the award was entered, seller sought information regarding possible bias and a disclosure was made regarding the expert witness issue. I believe and there is evidence to suggest that buyer knew there was some referrals between local counsel and decided he would use this as an "ace in the hole," if the award was not in its favor. Nobody associated with the Chicago counsel had any knowledge of the referral, or any reason there were such referrals.

Seller then moved to have the arbitration award set aside for possible bias. Not that the arbitrator was bias, but that he might have been. The lower court refused to vacate the award, but the appellate court reversed. That opinion is now part of the public record. Years and millions of dollars later, the matter was sent back to arbitration to start all over again.

"Pizza Wars"

Our firm represents several restaurant franchisors and franchisees. We are often called upon to resolve disputes involving pizza restaurant franchisees, which I refer to as "pizza wars." When we get a new arbitration matter from a new client, I usually ask why an arbitration clause is included in the franchise agreement. The response is that our transaction lawyers said arbitration is quicker and less costly than the court systems and the disputes do not have to be part of the public record.

To illustrate why this is often not the case, I again will give real life examples. When a franchisee comes to us who has not paid royalty, has received a notice of default and does not have an arbitration clause, we usually advise the client to try to get the royalty payments current or allow us to work out a payment schedule. If the franchisee has already been terminated under that same scenario the case can be very difficult. There is a strong body of law that provides that a franchisor has the right to control its Trademarks. Once a franchisee is terminated, generally it loses the right to use the trademark. Therefore, if the franchisor brings a preliminary injunction motion, the court "should" (but does not always) order a franchisee to cease using the trademarks, and then leave only damages for wrongful termination remaining. Of course, once the franchisee is forced to stop using the trademarks and if the franchisor controls the location, the franchisee usually is without a means of paying its bills and its lawyers.

Many franchisees, however, understand that anything is possible in arbitration and they usually do not even need to be represented by legal counsel. If there is an arbitration clause either side can often force a delay of many months and sometimes years – sometimes without paying royalty while the arbitration is pending. The common

technique for delay begins with an allegation that there are offsets or setoffs or that an accounting needs to be done. The fact that there is no merit to these assertions and that this is really a liability and not a damage issues, does not detract from the fact this often allows the franchisor a year or two of operations. It also forces the franchisor to disclose this dispute in its offering circular which obviously can play havoc on selling new franchises. In a court of law, this could often be easily resolved with a dispositive motion. It is rare, however, to have an arbitrator resolve issues on dispositive motions before the actual hearing. And, there is a real risk of alienating an arbitrator if one goes to court to stay arbitration of certain issues.

Franchisees are also aware that arbitrators have an economic incentive to hear all "evidence" because they are paid by the hour or the day. I am not suggesting that most arbitrators purposely try to prolong a hearing. Rather, if they fail to hear "all the evidence" or bar evidence, the unsuccessful party might try to use this as grounds for appeal. It is simply wiser and more economically advantageous for the arbitrator to just sit back and take it all in. I have had cases go to arbitration that were based on claims accruing more than five years before the claim was brought, even though the contract says all claims must be brought within one year. I have had claims go to arbitration based solely on a claim of an oral guarantee, even though the respondent swore in writing that no such guarantee existed. Many times franchisees plead that there were a litany of alleged earnings, expansion and location claims, even though they signed written acknowledgments that there were no such representations. What may be even worse, I have had to defend against claims seeking hundreds of thousands of dollars which are

nothing more that prayer for compassion for the little guy (when I represent the little guy, I also make that prayer, although I call it a claim for "equitable relief).

In a Court of law, the judge usually sets the trial schedule and continuance must be based on "good cause." Not so in arbitration. Respondents can submit forms blocking out month after month without any reason for doing so. I have even seen arbitrations continued because the terminated franchisee claims he does not have time to take-off from the business (which is terminated and operating in violation of the contract). Arbitrations are often delayed based on newly discovered evidence, even though the so called newly discovered evidence was known more than a year ago. Worse yet, the Franchisor is assessed a fee by the arbitration tribunal each time a matter is continued. Worst of all, the delays allow the terminated franchisee (who is not paying royalty) to fund the litigation costs with the non-payment of royalty. I have even had arbitrations continued because the arbitrator decided (for reasons unknown) that he no longer wanted to be the arbitrator. There is no refund of the fees paid already and there is no discount for re-educating a new arbitrator.

Clients also need to be aware of how inefficient an arbitration can be. I have had hearings where the arbitrator could not start until late and then allowed the hearing to end early because opposing counsel had a tennis game – and my client paid for an entire days arbitration fees. Try to explain to a good client or a judge why the attorney's tennis game should take precedence over your client's business. take I have had arbitrations that should have taken two days, last over a month because the arbitrator would not bar any evidence and would allow redundant an irrelevant "cross examination" that often takes three or four days over issues not any where found in the arbitration demand,

answer, counterclaim or discovery involving issues that are the subject of a different dispute resolved long ago. This when no judge would deny a motion *in limine* barring all the so-called cross-examination.

Rather than follow rules of evidence, arbitrators usually follow the rule that they "will give it what ever weight they feel is appropriate." This is a signal to the other side that if they do not have a legitimate case, maybe if they spread enough around the arbitrator will "split the baby."

So what do you tell your client when he says should I include an arbitration clause? I usually say that before you decide to arbitrate, choose the tribunal, be specific as to the arbitrator's authority, set forth discovery procedures and evidentiary rules, and most importantly, give them examples of what might happen.