Wait, What Happened? Recent Developments Affecting <u>Commercial Arbitration You May Have Missed</u>[1]

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We all try to stay on top of developments in the commercial arbitration field. Most can confidently recite the holdings from recent key Supreme Court decisions and a sprinkling of other notable or notorious rulings. But for most of us our busy schedules stand in the way of keeping up with the rapid pace of developments in the ever-evolving world of commercial arbitration.

The tidal wave of case law developments has multiple drivers. Certainly, the Supreme Court's enduing embrace of the Federal Arbitration Act ("FAA") is the foundation upon which these developments are built. The FAA's savings clause which provides that arbitration agreements are valid absent a generally applicable contract defense, while generally buttressing the enforceability of arbitration agreements, opens the door to state law-based contract defenses. Those defenses, while having common roots, are often interpreted differently from state to state. Add to the mix 50 state arbitration laws being interpreted by 50 sets of state courts and the FAA itself being interpreted by 13 federal courts of appeal and 94 district courts. With over 100 federal courts and 50 state court systems all placing their respective fingers on the scale of commercial arbitration law it is not surprising that legal developments in the commercial arbitration field are occurring at a fast and furious pace.

This article is an attempt to provide just a taste of those developments. We have selected three important but arguably under-the-radar topics of importance to commercial arbitrators: (1) the extent to which non-signatories can be bound by or may invoke an arbitration provision to which they are not party; (2) claims challenging awards on evident partiality grounds, and (3) the legal defense of unconscionability in the arbitration context.

I. <u>Non-Signatories</u>

Issues involving non-signatories to arbitration agreements arise in two scenarios: (1) when a party to an agreement containing an arbitration provision wants to compel a non-signatory to arbitrate an issue involving the subject matter of that same agreement, and (2)

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when someone who is not a party to an agreement containing an arbitration provision wants to compel arbitration or join an existing arbitration to assert a claim against a signatory to that agreement.

Under state law, an arbitration clause may possibly be enforced by or against a non-signatory under the following legal theories: (1) incorporation by reference; (2) agency; (3) assumption; (4) veil-piercing/alter ego; (5) equitable estoppel; (6) third-party beneficiary; and (7) waiver and/or estoppel.

When analyzing non-signatory cases, courts typically apply a number of broadly accepted principles, including:

- The FAA preempts any state law that prohibits outright arbitration of a particular type of claim. *AT&T Mobility v. Concepcion*, 563 U.S. 339 (2011).
- Where there is a valid and enforceable arbitration provision between two parties, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).
- Before the FAA's presumption in favor of arbitration swings into play, the parties themselves must have agreed to have their disputes arbitrated. *Stolt-Nielson S.A. v. AnimalFeeds Int'l Corp*., 559 U.S. 662, 681 (2010).
- Unless the parties clearly and unmistakably provide otherwise, the gateway question of whether an agreement creates a duty to arbitrate is an issue for the courts. *Moses H. Cone Memorial Hosp. v. Mercury Construction Corp.*, 460 U.S. 1, 24-25 (1983).
- In determining whether an arbitration provision is enforceable, a court relies on generally applicable principles of state contract law. *Stolt-Nielson S.A. v. AnimalFeeds Int'l Corp*., 559 U.S. 662, 681 (2010); *Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 630-631 (2009).

In the past year, there were a number of significant cases addressing whether non-signatories may (or must) join arbitration proceedings. Here are two of particular interest.

In *GE Energy Power Conversion Fr. SAS, Corp. v. Outokumpu Stainless USA, LLC*, 140 S. Ct. 1637 (2020), the underlying dispute arose in connection with the construction of machinery at a manufacturing plant in Alabama. The plant owner executed an agreement with a general contractor to furnish and install the machinery. The general contractor, in turn, entered into a subcontract with a French company to manufacture the motors for the machinery.

The general contract contained a broad arbitration clause. Following their installation, the motors failed. By that time, the original owner of the mills had sold the mills. The new owner, as a successor-in-interest, sued the French subcontractor in Alabama state court to recover damages for the allegedly defective motors and the subcontractor immediately removed the case to federal court and then moved to compel arbitration under the general contract to which it was not a signatory.

The district court granted the motion to compel arbitration, but the Eleventh Circuit reversed based on its conclusion that the New York Convention (a treaty that requires the approximately 160 countries who have signed it to recognize and enforce arbitration awards issued by co-signatories) expressly requires that parties actually sign an arbitration agreement before they can be bound by it. The non-signatory subcontractor appealed to the United States Supreme Court, which agreed to hear the case.

SCOTUS determined that the New York Convention does not prevent a court from applying domestic or state law principles to permit a non-signatory of an agreement containing an arbitration clause to enforce the underlying agreement against a signatory thereto, thereby permitting the party who never signed to argue it has standing to arbitrate based on equitable estoppel. SCOTUS also noted that even if the New York Convention requires a signed agreement, it does not state that arbitration agreements can be enforced only by the parties who signed them. Rather, it found that the New York Convention is silent with respect to that issue and determined that its provisions contemplate that domestic or state law may fill in the gaps.

GE Energy Power is important because it resolves a split among the federal circuit courts. Prior to the decision, the Ninth and Eleventh Circuits had held that the New York Convention does not allow non-parties or non-signatories to an arbitration agreement to compel arbitration while the First and Fourth Circuits permitted non-signatories to international agreements to enforce those agreements through the doctrine of equitable estoppel. The bottom-line take away: the rules for determining whether non-signatories can arbitrate are now identical in both domestic and international disputes.

In *Landry v. Transworld Systems Inc.*, 484 Mass. 334 (2020), the plaintiff rented a car from Enterprise who contended he returned it in a damaged condition. Enterprise repaired the car and sent Landry the bill. Landry balked at paying and Enterprise assigned the debt to Transworld, a debt collection agency.

According to Landry, Transworld called his cell phone eight times in seven days in violation of state consumer protection laws. More than a tad upset, Landry then filed a class action lawsuit against Transworld in Massachusetts state court. In response, Transworld moved to compel arbitration pursuant to the FAA, pointing out that Landry had signed Enterprise's form lease agreement. In support of its motion, Transworld asserted it had standing to enforce the arbitration clause because it acted as Enterprise's "agent" for debt collection purposes and it was also a third-party beneficiary of the lease agreement.

The Massachusetts Supreme Judicial Court was asked to decide whether there was an enforceable arbitration agreement between the non-signatory, Transworld, and the signatory, Landry. It denied Transworld's motion to compel arbitration based, in large part, on its findings that (i) Landry's claim was against Transworld alone and not Enterprise; (ii) only claims between Landry and Enterprise were subject to arbitration; and (iii) based upon the wording of the collection agreement between Enterprise and Transworld, Transworld was unable to establish it was Enterprise's agent or third-party beneficiary.

What is clear from all the foregoing is that our courts will not automatically reject cases involving non-signatories simply because a party never executed a written agreement to arbitrate. Whether a court permits or compels a non-signatory to join an arbitration is dependent, as it should be, on the underlying facts and the applicable law.

II. <u>Evident Partiality</u>

An arbitration award will be vacated upon a showing of evident partiality, but the circuits are spilt on the issue of what constitutes sufficient evidence. "Six circuits will vacate an award only when a reasonable observer would have to conclude the arbitrator was partial towards one of the Parties. . .. Only two circuits find evident partiality any time an arbitrator fails to disclose information that might create an impression of possible bias." *Monster Energy Co. v. City Beverages, LLC*, 940 F.3d 1130 (9th Cir. 2019), <u>cert. denied,</u> 141 S. Ct. 164 (2020). For the majority of the circuits, the standard of proof is "clear evidence of impropriety" which means the bar is relatively high to marshal enough proof. Merely alleging bias or even showing an appearance of bias is insufficient. What these circuits are looking for is clear bias and some kind of significant compromising connection.

In *OOGC America v. Chesapeake Exploration, LLC,* 975 F.3d 449 (5th Cir. 2020), the parties' arbitration agreement precluded the selection of an arbitrator who had connections with an outside (but related) third party company. The Arbitrator failed to disclose that he had previously done work for and had professional relationships with executives at that third party company. The arbitration was scheduled to be conducted in four phases. When the first two sections were completed and the losing party discovered the Arbitrator's connections, the partial award was challenged.[2] The federal district court judge stopped the remaining arbitration proceedings, and in his injunction used words like "lied", "deceit" and "corrupt". The Fifth Circuit reversed, holding that the facts were insufficient to support vacatur because the complaining party failed to show that there was a "significant, compromising connection" between the Arbitrator's failure to disclose and the outcome of the arbitration. The court required proof of a "specific prejudicial effect" on the award.

The minority view imposes a higher threshold. In *Monster Energy Company*, 940 F.3d 1130 (9th Cir. 2019), cert. denied, 141 S.Ct. 164 (2020), the arbitrator (1) failed to disclose a minority interest he had in the arbitration organization itself and (2) failed to disclose that the arbitration organization had conducted a "nontrivial" number of arbitrations with one of the parties. The Ninth Circuit vacated the award and held that the standard of review is that of "a reasonable impression of bias"", similar to that applied to Article III judges.

Collateral attacks on the award on the basis of evident partiality are also impermissible. In *Texas Brine Co., LLC v. American Arbitration Association*, 955 F. 3rd 482 (5th Cir. 2020), one of the parties sued the AAA and two arbitrators alleging conflicts of interest and claiming fraudulent conduct. The Court held that this was a collateral attack and impermissible.

The key take away is that most of the circuits will require a herculean effort to overturn an arbitration award on evident partiality grounds, requiring a nexus between the alleged partiality and the result in the award.

III. <u>Unconscionability</u>

Parties seeking to avoid arbitration or to vacate an arbitration award face a daunting task. Public policy strongly favors the enforceability of arbitration agreements, the Supreme Court has repeatedly reminded us, and the grounds for vacatur under the FAA are narrowly construed and applications to vacate arbitration awards rarely succeed. Apart from the statutory grounds offered by the FAA and comparable state laws for vacating awards, challenges may also be directed at flaws in the formation of the contract, the scope of the arbitration provision, and at the parties subject to the arbitration clause itself, for example, as to whether non-

[2] The AAA also removed the arbitrator after he declined to withdraw.

signatories may invoke or be subject to arbitration as previously discussed. One ground that is increasingly being invoked is the contract defense we thought we left behind in law school, that is, the contract defense of unconscionability.

Under the FAA, agreements to arbitrate "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. One of these grounds is unconscionability. See *Kindred Nursing Ctrs. Ltd. Partnership v. Clark*, 137 S. Ct. 1421, 1426 (2017).

Unconscionability comes in two flavors, procedural and substantive, and are often confused.

Procedural unconscionability looks to the "contract formation process and . . . such matters as the size and commercial setting of the transaction, whether deceptive or high-pressured tactics were employed, the use of fine print in the contract, the experience and education of the party claiming unconscionability, and whether there was disparity in bargaining power." *Gillman v. Chase Manhattan Bank, N.A.*, 73 N.Y.2d 1 (1988). Procedural unconscionability focuses on "oppression or surprise due to unequal bargaining power." *Baltazar v. Forever 21, Inc.*, 62 Cal.4th 1237 (2016).

Substantive unconscionability focuses on contract terms that are "overly harsh", "unduly oppressive", or "so one-sided as to shock the conscience". Baltazar, 62 Cal. 4th 1237. Settings in which substantive unconscionability claims have been asserted include: arbitration fee-splitting that may serve to deny the chance to vindicate legal rights; loser pays provisions in the statutory context; the unilateral right to modify or eliminate the right to arbitrate or, more broadly, the lack of mutuality with respect to significant contractual rights; unfair forum selection clause, e.g., providing an inconvenient venue for one party; strict limits on discovery particularly where statutory rights are involved; reduced statute of limitations; broad limitations on damages; confidentiality provisions in statutory rights cases, and; an inequitable arbitrator selection process.

Most states require both procedural and substantive unconscionability to be present for the defense to be proven. States requiring both forms of unconscionability to be present include California, Florida, Maryland, Massachusetts, Nevada, New York, Ohio, Rhode Island, West Virginia. Some states will apply the defense if either procedural or substantive unconscionability is present. These states include: Kentucky, Missouri, New Mexico, Vermont, and Washington. Some courts hold that, even in states where both procedural and substantive unconscionability is required, the defense may be applied in an "egregious situation, one or the other may suffice." See *Urban Investments, Inc. Branha*m, 464 A.2d 93, 99 (D.C. App. 1983); *Dallas Aerospace, Inc. v. CIS Air Corp*., 352 F.3d 775, 787 (2d Cir. 2003).

Courts divide as to when unconscionability is to be determined. Some look to the presence of unconscionability at the time of contract formation. *Kenyon Ltd. Partnership v. 1372 Kenyon St. Nw. Tena*nt's *Ass'n.*, 979 A.2d 1176, 1186-87 (D.C. 2009) (unconscionability gauged at time of making of contract where contract becomes unconscionable due to changed circumstances). See also Cal. Civ. Code §1670.5. Other courts focus on the impact, or lack thereof, of unconscionable terms at the time the contract term is challenged. See *Plummer v. McSweeney*, 941 F.3d 341, 346 (8th Cir. 2019) (prohibitive expense to client of arbitration "cured" by law firm's offer to bear costs).

The question often arises in the vacatur setting as to who rules on whether an arbitration agreement is unconscionable – a court or an arbitrator? Generally, courts decide questions of contract formation in the absence of a clear and unmistakable delegation of such issues to the arbitrator. Claims of unconscionability, therefore, are properly submitted to the arbitrator where the arbitration agreement includes a clear delegation provision. This is so even if a party is challenging the arbitration agreement itself unless the challenge is directed at the delegation provision within the arbitration agreement. *Bolden v. DG TRC Management Co*., 2019 WL 2119622 (S.D.N.Y.).

The decision in *Williams v. Community Bank,* 821 Fed. App'x. 292 (5th Cir. 2020) presents an instructive setting in which the unconscionability defense was invoked. In *Williams*, bank customers sought a loan to purchase a vacant lot. The bank convinced its customers to form an LLC and obtain a business loan. The loan documents included an arbitration agreement. The bank customers sued, alleging various statutory consumer protection law violations. The federal district court granted the bank's motion to compel arbitration. The bank customers appealed, alleging that the arbitration agreement was procedurally and substantively unconscionable.

The bank customers alleged that the loan agreement was procedurally unconscionable because: the bank did not provide truthful information; they were unfamiliar with the "pre-printed, complexly-worded agreement"; they lacked bargaining power, and; they were less financially sophisticated than the bank representatives with whom they negotiated. The bank customers alleged that the agreement was substantive unconscionability because it included a fee-shifting clause in the agreement requiring a party seeking over $75,000 in damages to pay the arbitrator's fees and administrative fees and included that the prevailing party was entitled to have its or their attorney fees reimbursed.

The Fifth Circuit rejected the bank customers' unconscionability claims in full. The court ruled that the bank customers failed to show that they lacked knowledge of the arbitration agreement and terms. In doing so, the court pointed out that the arbitration terms were conspicuous, with key terms highlighted, and that the arbitration provision was stated in plain terms. The court noted that the customers were not denied the opportunity to review and inquire further with respect to the agreement and failed to show that they involuntarily entered into it. The court pointed out that the fact that the loan agreement was a contract of adhesion did not necessarily make entry into the agreement involuntary and that the customers were free to seek alternative loans in marketplace. The Fifth Circuit added that even if the agreement's terms were false and deceptive, the challenged terms did not relate to the arbitration provision. In particular, the court emphasized that the customers were not fraudulently induced into agreeing to arbitration and that the arbitration agreement was not overly one-sided. The court also rejected the customers' contention that the cost of arbitration was excessive or shifted the financial burden unfairly. In doing so, the court noted that the prevailing party provision allowed for recovery of arbitration fees and that the agreement included an extreme hardship provision which allowed for deferral or reduction of arbitration fees. In any event, the agreement authorized the arbitrator to apportion fees, as necessary.

◦ Steps can be taken by drafters of contracts to minimize the risk that its terms, including an arbitration provision, may be found to be unconscionable or, if unconscionable, precluding enforcement of that term. Most notably, a provision allowing for the severance of an illegal contract term is an effective approach as most courts will sever the illegal term to maintain the enforceability of the agreement overall. Severance is appropriate where "the interests of justice would be furthered by severance; the strong preference is to sever *unless* the agreement is 'permeated' by unconscionability." *Mango v. The College Network, Inc.,* 1 Cal. App.5th 277 (2016). <u>See</u> *Begole v. North Mississippi Medical Ctr., Inc.*, 761 Fed. App'x 248, 252 (5th Cir. 2019), <u>reh'g</u> <u>denied</u> (March 12, 2019) (substantively unconscionable waiver of punitive damages provision does not render arbitration agreement unconscionable because offensive term can be severed). A severance provision will generally be enforced where the unconscionability did not permeate the agreement as a whole and removal effectively removed the unconscionable terms while leaving the enforceable terms intact. *Pichardo v. American*

Financial Network, 2019 WL 153704 (Cal. App.) (offensive arbitrator selection provision removed and contract enforced). Severance would be inappropriate where there are "multiple defects [that] indicate a systemic effort to impose arbitration" are present and no single provision can be severed to remove the taint of unconscionability. *Beltran v. AuPairCare, Inc.,* 907 F.3d 1240, 1262 (10th Cir. 2018). See also *Ridgeway v. Nabors Completion, 7*25 Fed. Appx. 472, 474 (9th Cir. 2018) (cost-shifting provision not unconscionable where "except as otherwise provided by law" provision allowed for removal of offensive term).

The presence of a clause permitting a contracting party to opt out of the potentially offensive provision within a reasonable period of time after entering into the agreement will generally be looked upon favorably by a court deciding whether to enforce an otherwise unconscionable term. See *Larsen v. Citibank FSB*, 871 F.3d 1295, 1313 (11th Cir. 2017) ("existence of an opt-out provision strongly weighs against a finding of procedural unconscionability"); *Heidbreder v. Epic Games*, 438 F. Supp.3d 591 (E.D.N.C. 2020) (30-day opt out provision provided parties "meaningful choice over the arbitration provision" which undercuts unconscionability claim).

The increased growth of arbitration as a means of dispute resolution in the commercial setting brings with it increased challenges to such efforts. Claims of unconscionability are commonly invoked in such settings, guaranteeing that arbitrators and courts will be asked to address and resolve such claims with greater frequency moving forward.

Conclusion

Certainly, we have merely dipped our toes into the swelling tide of legal developments in the commercial arbitration field. A lesson learned, we hope, is that developments in the field of commercial arbitration are occurring far and wide and require vigilant effort on the part of commercial arbitrators to stay abreast of them.