

American Arbitration Association

Hosts, as Part of a Continuing Series of Programs:

Recent Developments in ADR: The Supreme Court, Eighth Circuit and Missouri

a Two-Hour Discussion

by

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at

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The Agenda

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Summary of Presentation

This program examines recent cases from the Supreme Court of the United States, the Eighth Circuit Court of Appeals, and Missouri's appellate courts involving alternative dispute resolution, principally arbitration. All the cases, with a few significant exceptions, are from the year 2002 to present.

All courts, state and federal, continue to decide important cases that define how and when arbitration will proceed and what powers the arbitrator has to decide the issues pending before him or her. The courts continue to favor arbitration and to reinforce the enormous power that arbitrators have to control the process and decide the outcome.

This program will review these significant cases and explore the depth and reach of ADR as a parallel to traditional litigation, focusing when appropriate on the maturation of ADR as a legitimate means to resolve serious disputes. The program will also look at the rare instances when the court found that an arbitrator overstepped his or her authority.

Biography of James R. Keller

Mr. Keller has been a neutral on the Commercial and Construction panels of the American Arbitration Association since 1999 wherein he has served as an arbitrator in more than 50 cases ranging in dollar value of dispute from \$2,000.00 to more than \$15,000,000.00.

He is a partner at Herzog, Crebs & McGhee, where he concentrates on complex business and real estate litigation, construction law and ADR. Over the past 24 years, he has tried more than 80 jury and bench trials in various state and federal courts, with 40 of them lasting at least one week, several lasting almost a month, one taking five months (a case in state court in Benton, Illinois) and the longest consuming nine months (a jury trial in federal court in Buffalo, New York). Mr. Keller also represents clients in arbitration as well, including many hearings before the AAA in the past couple of years.

Mr. Keller is the chair of the AAA's St. Louis Regional Construction Advisory Committee, the Co-Chair of the Construction Committee of BAMSL and the Vice-Chair of the ADR Committee of the Missouri Bar. He has written more than 40 articles in the past four years on ADR, construction and consumer fraud. He is the legal writer for the St. Louis Construction News & Review and on the list of certified mediators in federal court and approved mediators in state court. He was the trainer for updating other AAA neutrals in the St. Louis region on the law in 2002 and 2003 and he represents AAA in various matters. He is a frequent speaker on the topics of ADR and construction at seminars for the Missouri Bar, AAA and other groups.

Large Arbitration Award

Missouri Appellate Court: Some arbitration awards are becoming sizable. The myth that only juries and some judges will award serious compensation is just that, a myth. A dramatic, recent example is *Neel v. Strong*, 114 S.W.3d 272 (Mo. App. E.D. 2003). This is the tobacco litigation. The State of Missouri, the tobacco companies and the lawyers agreed that the fees of the counsel for Missouri would be paid by the tobacco companies and that the amount of the fees would be set by binding arbitration. Arbitration set the attorney fees at \$111,250,000.00, payable over 25 years. That comes to \$4,450,000 per year.

Applicable Law (the Federal Arbitration Act or State Law)

U.S. Supreme Court: The Federal Arbitration Act (FAA), Title 9, U.S. Code, §§ 1-15, controls arbitrations that involve interstate commerce. Otherwise, state law controls. The United States Supreme Court recently added even more reach to the already lengthy arms of the FAA. In *The Citizens Bank v. Alafabco, Inc.*, 123 S. Ct. 2037 (2003), the high court decided recently to reinforce a very broad definition of what activity constitutes interstate commerce in connection with an arbitration.

The Court held that the FAA covers a transaction of debt restructuring that occurred within the State of Alabama, in part because the general practice of the bank in question otherwise "involved" interstate commerce in a substantial way. The Supreme Court rejected the argument that a transaction between citizens of the same state in that state could not involve interstate commerce.

The Court found compelling that Alafabco engaged in business in other states using loans from The Citizens Bank, and that the debt was secured by all of Alafabco's inventory including goods assembled from

out-of-state parts, and that commercial lending has a broad impact on the national economy. In reaching this result, the Supreme Court granted a petition for writ of certiorari and reversed the Supreme Court of Alabama.

Missouri Appellate Court: The Eastern District of Missouri recently gave some further direction on how it harmonizes arbitrations when both the FAA and Missouri's Arbitration Act could apply to the dispute. In *Clayco Const. Co., Inc. v. THF Carondelet Dev., L.L.C.*, 105 S.W.3d 518 (Mo. App. E.D. 2003), the Court noted that the parties agreed that the FAA was applicable.

"We are bound to apply federal law and may not apply substantive or procedural state law which is in derogation of federal law." The Court further noted, however, that it is "not bound by the procedural provisions of the FAA, provided that Missouri's procedures do not defeat the rights granted by Congress."

The Agreement to Arbitrate

The Eighth Circuit: Recently, many litigants have been attacking arbitration agreements by arguing that they do not allow the arbitrator to award all relief that could be available in a court of law, and thus the agreement is not enforceable. "Whether the Agreement validly limits the arbitrator's remedies for an AFPA violation does not affect the validity of the agreement to arbitrate. Rather, issues of remedy go to the merits of the dispute and are for the arbitrator to resolve in the first instance." *Arkcon Digital Corp. v. Xerox Corp.*, 289 F.3d 536, 539 (8th Cir. 2002).

This decision reaffirms that the courts have been resolving doubts about arbitration in favor of arbitration, even when the agreement may attempt to limit statutory rights to certain claims. *Id.* at 538. The federal courts continue to voice confidence in arbitrator decisions and to offer solid recognition for the authority of arbitrators to adjudicate disputes.

In 2001, the Eighth Circuit decided, contrary to precedent from other jurisdictions, in two different cases that a court's role in the arbitration process is limited to determining whether a valid agreement to arbitrate exists. Once this is resolved, the arbitrators will decide "all other issues" including matters that typically fall within the court's purview, such as whether the parties' agreement, which excludes recovery of punitive damages, violates public policy and is unenforceable.

The cases are *Larry's United Super, Inc. v. Werries*, 253 F.3d 1083 (8th Cir. 2001) and *Gannon v. Circuit City Stores, Inc.*, 262 F.3d 677 (8th Cir. 2001).

- “At this juncture, our jurisdiction extends only to determine whether a valid agreement to arbitrate exists, not to determine whether public policy conflicts with the remedies provided in the arbitration clause.” *Verries* at 1086.
- “Our role in determining whether a court should compel arbitration is limited. We must determine simply whether the parties have entered a valid agreement to arbitrate and, if so, whether the existing dispute falls under the coverage of the agreement....Once we conclude that the parties have reached such an agreement, the FAA compels judicial enforcement of the arbitration agreement.” *Gannon* at 680.

The Eighth Circuit also decided that an arbitration agreement is important enough that it remains viable and enforceable after an employee no longer works for the employer and their agreement has terminated. The case is *Lyster v. Ryan’s Family Steak Houses*, 239 F.3d 943 (8th Cir. 2001).

In this case, the agreement provided that all potential claims that an employee may have against his or her employer, which otherwise could have been pursued in state or federal court, had to be arbitrated. The court broadly construed this arbitration agreement to allow arbitration even when the employee did not follow the requirements for claim submission with the Equal Employment Opportunity Commission (EEOC) or the Missouri Commission on Human Rights (MCHR). The failure to follow these requirements may have provided strong legal defenses in a court of law, but they carried no weight in deciding whether the dispute was subject to arbitration. Consequently, any further arguments along these lines would have to be presented to and decided by the arbitrator.

In *In re Arbitration Between Dow Corning Corp. v. Safety National Casualty Corp.*, 335 F.3d 742 (8th Cir. 2003), the Eighth Circuit held that when the arbitration agreement does not expressly state in some manner that the award shall be “final and binding” or incorporate by reference the “rules of the American Arbitration Association or a similar arbitral body,” then the arbitration is not binding and litigation after the award can take place. The court could not locate any federal case “in which an arbitration agreement entirely silent on this question was construed as providing for binding arbitration.” *Id.* at 746.

Missouri Appellate Court: Nowhere has arbitration been under more attack recently than by parties who assert that they did not execute an agreement to arbitrate and thus they cannot be forced against their will

into this forum for dispute resolution when they prefer traditional litigation. Construction projects, in particular, seem to involve this issue since there are so many parties necessary to begin and complete the job and thus there are many layers of agreements. This leads to the practice of referring to other contracts, both to save time in repeating obligations and to make certain that multiple parties have the same obligations.

When a contract refers to another contract, and the referenced contract contains an arbitration provision, it is quite possible that the parties have agreed to binding arbitration even though it was not specifically discussed in the body of the main contract between the two parties.

In *Dunn Industrial Group, Inc. v. City of Sugar Creek and Lafarge Corp.*, 112 S.W.3d 421 (Mo. 2003), the Missouri Supreme Court concluded that a mere reference to another contract that contained a binding agreement to arbitrate was not enough, however, especially since the party resisting arbitration had been consistently resolute in its opposition throughout the process of litigation and arbitration. Instead, there must be a specific incorporation by reference to the contract in question.

Of further note, the Supreme Court of Missouri also stated: “in a majority of state courts, including Missouri, due to the strong federal policy in favor of arbitration, arbitration agreements are enforced against guarantors or sureties where the arbitration agreement is incorporated by reference into the guaranty or performance bond.” *Id.* at 435.

Dunn also discussed the two kinds of arbitration provisions: those that are broad and require arbitration of everything and those that are narrow and limit arbitration to certain, predetermined issues. The court decided that the contract provision requiring arbitration of “any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration in accordance with the Construction Industry Rules of the American Arbitration Association” included claims for extra work, changes in the scope of work and mechanic’s lien claims. *Id.* at 428.

Standard of Review by the Appellate Court

Missouri Supreme Court: In *Dunn Industrial Group, Inc. v. City of Sugar Creek, Mo.*, 112 S.W.3d 421 (Mo. 2003), the Missouri Supreme Court stated that an “appellate court’s review of the arbitrability of a dispute is *de novo*.” *Id.* at 428, citing *Fru-Con Constr. Co. v. Southwestern Redevelopment Corp.*, 908 S.W.2d 741, 743-44 (Mo. App. E.D. 1995). It also applies the usual rules of contract interpretation.

Jurisdiction (Courts and the Arbitration Tribunal)

U.S. Supreme Court: In *Pacificare Health Systems, Inc. v. Jeffrey Book*, 123 S. Ct. 1531 (2003), the high Court reaffirmed that the courts can decide in the first instance any “gateway” question of arbitrability. The Court has decided, however, to place a “limited scope” on the phrase ‘question of arbitrability.’ *Id.* at 1536.

Accordingly, the Supreme Court has limited judicial inquiry about whether the parties are subject to arbitration to narrow circumstances “where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate,” quoting from *Howsam v. Dean Witter Reynolds, Inc.* 537 U.S. 79 (2002) (Slip op. at 4).

Applying this test, the Supreme Court deferred to an arbitrator the decision whether arbitration agreements were legal and enforceable that prohibited punitive and exemplary damages when the claimant’s claim included treble damages under RICO. “Given our presumption in favor of arbitration...we think the preliminary question whether the remedial limitations at issue here prohibit an award of RICO treble damages is not a question of arbitrability.” *Id.* at 1536. Thus, the arbitrator will decide this issue.

In *Howsam v. Dean Witter Reynolds, Inc.*, 123 S. Ct. 588 (2002), the U.S. Supreme Court held that the timeliness of an arbitration was subject to decision by an arbitrator rather than a court, thereby reversing the Tenth Circuit. The case focused on a rule of the National Association of Securities Dealers (NASD), which provided that no dispute “shall be eligible for submission to arbitration ... where six (6) years have elapsed from the occurrence or event giving rise to the ...dispute.”

The court stated that the question whether the parties have submitted a particular dispute to arbitration, the “question of arbitrability,” is an issue for judicial determination unless the parties clearly and unmistakably provide otherwise. This is the “gateway question.”

The time-limit rule, the Court concluded, is not a question of arbitrability, but rather it is a prerequisite such as notice, laches, estoppel and other conditions precedent to an obligation to arbitrate, and as such, it is a matter for the arbitrator to decide. “Moreover, the NASD arbitrators, comparatively more expert about their meaning of their own

rule, are comparatively better able to interpret and to apply it.” *Id.* at 592.

In other words, the Supreme Court has deferred to the expertise of arbitrators, over its own lower-court judges, to resolve the dispute. Consequently, “parties to an arbitration contract would normally expect a forum-based decision maker to decide forum-specific procedural gateway matters.” *Id.* at 593.

Eighth Circuit: In *Bailey v. Ameriquest Mortgage Co.*, 346 F.3d 821 (8th Cir. 2003), the Eighth Circuit reinforced its earlier decisions that there is only a narrow exception to the general rule that agreements to arbitrate federal statutory claims are enforceable. That narrow exception is when the agreement to arbitrate resulted from some sort of fraud or overwhelming economic power that would provide grounds for the revocation of any contract.

The trial court had applied a broader standard in deciding that the parties did not have to arbitrate. The Eighth Circuit responded: “In our view, the court’s analysis reflects an outmoded judicial hostility to arbitration that the Supreme Court has consistently rejected in construing the FAA.” *Id.* at 823. “[T]he Court has evidenced its confidence that arbitrators are perfectly capable of protecting statutory rights when the parties have conferred the authority to decide statutory claims.” *Id.*

Further, the court held: “When an agreement to arbitrate encompasses statutory claims, the arbitrator has the authority to enforce substantive statutory rights, even if those rights are in conflict with contractual limitations in the agreement that would otherwise apply.” *Id.* at 824.

Sometimes there are simultaneous lawsuits and arbitrations involving the same parties. *Taylor v. Southwestern Bell Telephone Co.*, 251 F.3d 735 (8th Cir. 2001), involved a court lawsuit over an employee’s termination allegedly due to discrimination. Her union had filed a grievance procedure on her behalf and later a demand for arbitration. The Eighth Circuit noted that an arbitrator’s inquiry could extend beyond that of a court or jury in a discrimination action, to include issues such as whether the employee’s punishment was disproportionate. Depending on the circumstances and the scope of the arbitration agreement, both actions could be underway at the same time.

Missouri Appellate Court:

2003 Case: Recently, the Western District concluded that Missouri courts do not have jurisdiction to compel or stay an arbitration that is pending outside Missouri under the Uniform Arbitration Act or Missouri's Arbitration Act, Sec. 435.430 R.S.Mo. 2000. By contrast, the court noted that the Revised Uniform Arbitration Act—not yet adopted in Missouri—provides that jurisdiction to enforce an agreement to arbitrate does not turn on the location of the arbitration. Instead, jurisdiction is based on standard concepts of personal and subject matter jurisdiction.

In *Deiab v. Shaw*, 2003 Mo. App. LEXIS 1187 (Mo. App. E.D. 2003), the Eastern District held that before a party can appeal a trial court's decision to compel arbitration and stay further court proceedings there must be nothing else pending in the trial court. In this case the parties had filed a lawsuit and a counterclaim that were stayed. Since these stayed actions were still pending with the court, there was no final, appealable order on the arbitration issue.

2002 Cases:

Typically, after someone files a petition, if there is a written agreement to arbitrate, the defendant moves the court to stay the lawsuit and requests an order compelling arbitration. Before a court can grant a motion to compel arbitration, the court must first decide whether the agreement containing the arbitration provision is valid and legally binding. *Estate of Burford by Pam Bruse v. Edward D. Jones & Co.*, 83 S.W.3d. 589 (Mo. App. W.D. 2002). Only then does the arbitrator have jurisdiction.

In *Edward D. Jones*, the court determined that co-conservators did not have authority to enter into an account agreement on behalf of the estate without prior court approval and therefore the agreement was void. The language of the arbitration clause was “wholly irrelevant” if the party never entered into the contract as a whole or agreed to be bound by arbitration.

The court rejected the argument that the validity of the account agreement was an issue to be decided by the arbitration tribunal and not the court. “Missouri courts have held that under either the Missouri Arbitration Act or the Federal Arbitration Act ‘before a court may grant a party’s motion to compel arbitration, it must decide whether the agreement containing the arbitration is valid and legally binding.’” *Id.*

In *Estate of James Athon and Joe Athon v. Conseco Finance Servicing Corp. and Ronsee*, 2002 Mo. App. LEXIS 1716, decided August 20, 2002, the Western District reversed a trial court's order denying a motion to

compel arbitration. The estate had sued Conseco alleging that it wrongfully trespassed onto the estate's property and repossessed a mobile home.

The appellate court found that the claims in dispute, including those in tort, were subject to an arbitration agreement. The agreement had provided in part: "All disputes, claims or controversies arising from or relating to this Contract or the parties thereto shall be resolved by binding arbitration by one arbitrator selected by you with my consent."

The court stated that the Federal Arbitration Act (FAA), 9 U.S.C. § 2 (1999), applied to the case because the contract between the parties involved interstate commerce. Further, the claims of respondeat superior, conversion, trespass, interference with expectancy of inheritance and unlawful repossession of personal property all involved issues whose resolution "requires reference to or construction of some part of the Contract." For arbitration not to apply, the tort claim had to be independent of the contract terms and not require reference to the underlying contract.

2001 Cases:

In *Workman v. Orkin Exterminating Co.*, 66 S.W.3d 743 (Mo. App. S.D. 2001), the Southern District reversed a trial court's order denying without explanation a motion to compel arbitration. The appellate court applied the FAA since employees for Orkin had to cross state lines and the material Orkin used came from another state.

Plaintiffs sued for actual and punitive damages, alleging that Orkin failed to treat as outlined in their agreement and that it did not prevent termite problems. Orkin moved for arbitration. The appellate court agreed with Orkin that the FAA mandated enforcement of the arbitration agreement. The court rejected plaintiffs' argument that since the treatment "had not been performed" the arbitration agreement had no effect, stating that the record on appeal did not contain any evidence concerning Orkin's performance.

In *Metro Demolition v. H.B.D. Contracting*, 37 S.W.3d 843 (Mo. App. E.D. 2001), the appellate court agreed that a trial court correctly denied a motion to stay litigation pending arbitration with regard to one particular subcontract. The subcontract incorporated by reference the provisions of a prime contract between the owner and the contractor that included binding arbitration. The problem was that the prime contract was not in existence at the time of the incorporation and thus the incorporation was not valid. The court set out the elements to consider in deciding whether an arbitration agreement warrants an order staying litigation. They are:

- (1) whether the parties agreed to arbitrate;
- (2) the scope of the agreement;
- (3) if federal statutory claims are asserted, whether Congress intended those claims to be arbitrable; and
- (4) if the court concludes that some but not all claims are arbitrable, whether to stay the balance of the proceeding pending arbitration.

Id. at 846.

Venue

Missouri Appellate Court: In a very recent case, the Eastern District decided that a contract requiring the purchaser of an automobile in Missouri to arbitrate disputes over car repairs pursuant to AAA's Commercial Arbitration Rules in Baxter County, Arkansas, was a contract of adhesion. *Swain v. Auto Services, Inc.*, 2003 Mo. App. LEXIS 1915 (Mo. App. E.D. 2003). The plaintiff had purchased through the automobile dealer a vehicle service plan from Auto Services, an Arkansas corporation. The venue provision in the agreement stood apart from the rest of the arbitration agreement and thus the court decided it would undermine the liberal federal policy favoring arbitration agreements to invalidate the entire agreement.

Therefore, the only part of the agreement found to be unconscionable was the venue requirement calling for Arkansas. But the court offered additional comment worth noting: "On remand, the court may consider whether the existence of large arbitration costs—half of which Swain must pay under the 'fee-sharing' provision in this arbitration clause—effectively precludes Swain from pursuing his claims and renders the agreement to arbitrate invalid under *Green Tree Financial Corporation—Alabama v. Randolph*, 531 U.S. 79, 90-92." The appellate court declined to decide this issue in part because the parties have not yet had the opportunity to conduct discovery to determine "whether the costs of arbitration are, in fact, prohibitively expensive in this case—especially in light of our holding that the arbitration need not occur in Arkansas." *Id.* at 4.

Waiver of Arbitration

Eighth Circuit: The Eighth Circuit in *National American Insurance Co. v. Transamerica Occidental Life Ins.*, 324 F.3d 462 (8th Cir. 2003), held that it is for the arbitrator or panel of arbitrators, not the court, to determine if a party to the arbitration has waived its right to proceed in arbitration. The Court relied on a recent decision from the United States Supreme

Court, *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002), wherein the Court stated: “the presumption is that the arbitrator should decide ‘allegations of waiver, delay, or a like defense to arbitrability.’”

In *Kelly v. Marc Golden*, 2003 U.S. App. LEXIS 24609 (8th Cir. 2003), the Eighth Circuit found waiver of a party’s right to arbitration when that party initiated a lawsuit and failed to object or move to compel arbitration throughout a year of court proceedings. “He vigorously pursued discovery and did not raise an arbitration claim until after the district court had ruled against him on all of his motions on the merits of the case.” *Id.* at 2.

The court cited the elements of waiver as: the party (1) knew of an existing right to arbitration; (2) acted inconsistently with that right; and (3) prejudiced the other party by these inconsistent acts. “Golden was prejudiced by Kelly’s delay in seeking arbitration. He incurred expense and experienced substantial delay as a result of the extensive litigation and would be required to extensively duplicate his efforts if he were now required to participate in arbitration.” *Id.* at 2-3.

Missouri Appellate Court: Recently, the Western District decided, in a case of first impression, that there was a waiver of the right to arbitrate when the plaintiff filed in a court of law a petition for injunctive relief seeking replevin and then engaged in significant trial-oriented activity. The case is *Getz v. Recycling, Inc.*, 71 S.W.3d 224 (Mo. App. W.D. 2002). Since waiver cases are fact intensive, the following facts are necessary to understand the court’s decision.

Plaintiff, a recycling company, had leased, pursuant to a written contract, a piece of equipment to business owners who owned a rock crushing business. The business owners complained that the equipment was useless for its intended use and thus they only paid rent for one month. Getz sued in equity for replevin and an injunction, and sought declaratory relief and damages for breach of contract. Getz also sought a temporary restraining order (TRO) after the business owners refused to return or surrender the piece of equipment. The business owners counter sued.

The court set a hearing on the TRO and entered a show-cause order on why the court should not order an injunction and replevin. The parties resolved this dispute by agreeing to the return of the equipment and the posting of a replevin bond of \$45,000 pending resolution of the underlying lawsuit. Counsel also discussed the arbitration agreement and they decided that rather than enforcing its terms, they would stipulate to the return of the equipment and the bond.

A month later, plaintiff filed an application to stay the court proceedings and to move the dispute to arbitration pursuant to the arbitration agreement. Defendants did not timely respond to the motion, so the court treated it as being unopposed and granted the request.

The court transferred the case to a new judge who granted defendants' motion to set aside the earlier order. This judge scheduled the case for trial and Getz appealed.

The appellate court concluded that the arbitration agreement covered the claim and counterclaim, including defendants' allegations of negligent misrepresentation and misrepresentation. The agreement had provided: "In the event of any dispute as to the terms and/or conditions as set forth in the agreement, arbitration is to be conducted under the rules of the American Arbitration Association in Phoenix, Arizona at a time and location to be specified by GETZ RECYCLE, INC. or its authorized representative."

To find waiver, the court noted, requires a finding of prejudice and the burden of showing prejudice is on the party seeking waiver. The problem is whether a party whose arbitration agreement is silent on injunctive relief can seek a TRO in a court and then arbitrate the substance of the claim.

The court found that a four-month delay between filing the lawsuit and the application to stay the proceeding pending arbitration was not substantial, citing as support *McIntosh v. Tenet Health Sys. Hosps., Inc./Lutheran Med. Ctr.*, 48 S.W.3d 85, 89 (Mo. App. E.D. 2001). In *McIntosh*, there was no waiver where the period of time before seeking arbitration was less than a year after filing the lawsuit and the substantial discovery already conducted could be used in the arbitration.

Other events, however, more clearly pointed to waiver, according to the court. First, there was the TRO activity, and then Getz's counsel led defendants to believe that it would not invoke the arbitration clause. While the court noted that "bad faith" is not an element to a finding of prejudice, this conduct may have influenced the outcome.

The court thus concluded that Getz's actions deprived the defendants of the main goals of arbitration, namely "speedy and low-cost dispute resolution." *Id.* at 231. The court further found that plaintiff "misused the court process." *Id.*

Given the substantial amount of trial activity, there was prejudice and given that the arbitration agreement did not allow for injunctive relief,

the appellate court decided there was a waiver of plaintiff's right to arbitrate.

Punitive Damages

U.S. Supreme Court: In a remarkable showing of judicial restraint, the United States Supreme Court decided recently to defer to the arbitrator a decision whether the arbitration agreement's language prohibited an award of punitive damages and thus was unenforceable. The case is *Pacificare Health Systems, Inc. v. Jeffrey Book*, 123 S. Ct. 1531 (2003).

The Supreme Court had been asked to decide whether the claimants in the underlying arbitration could be compelled to arbitrate claims arising under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1961 *et seq.*, "notwithstanding the fact that the parties' arbitration agreements may be construed to limit the arbitrator's authority to award damages under that statute."

Claimants argued that if the agreements precluded an award that otherwise could be recovered in a court of law, the agreements were unenforceable because they could not obtain "meaningful relief" for their statutory claims in an arbitration forum.

There were four arbitration agreements in question, two of which prohibited any award of punitive damages, one prohibited an award of exemplary damages, and one prohibited an award of extra contractual damages of any kind, including punitive and exemplary. Part of the debate was over whether RICO's potential for treble damages was like punitive damages or was a form of remedial damage. Rather than sort out in a court of law this critical question, the Supreme Court held:

In short, since we do not know how the arbitrator will construe the remedial limitations, the questions whether they render the parties' agreements unenforceable and whether it is for courts or arbitrators to decide enforceability in the first instance are unusually abstract. As in *Vimar*, the proper course is to compel arbitration.

Id. at 1536. In reaching this result, the Supreme Court reversed the Eleventh Circuit.

Federal District Court, Western District of Missouri: In an unpublished but highly publicized case the U.S. District Court for the Western District of Missouri recently vacated an arbitrator's award of \$6,000,000 in punitive damages because the award violated the parties' arbitration agreement. The case is *Stanley William Stark and Patricia*

Garnet Stark v. Sandberg, Phoenix & Von Gontard, et al., Case No. 01-0407-CV-W-3-ECF, decided May 5, 2003.

The Starks sued EMC Mortgage Corporation and others for alleged violations of the Fair Debt Collection Practices Act and the Truth in Lending Act. The arbitration agreement included this language: “If the terms of this Agreement and the Arbitration Rules are inconsistent, the terms of this Agreement shall control...The parties agree that the arbitrator shall have all powers provided by law, this Agreement, and the Loan Agreements.”

However, the agreement also provided that the arbitrator could not award any “consequential, punitive, exemplary or treble damages.” The arbitrator, outraged by respondent’s conduct, believed these provisions were sufficiently ambiguous such that he had the power to award punitive damages because he could have done so by law.

The district court decided that the parties’ agreement clearly stated that it controlled in case of any conflict and under this agreement punitive damages clearly could not be awarded. Thus, the arbitrator exceeded his jurisdiction. The district court noted: “Were it not for the Court’s obligation to confine the scope of the arbitration to matters the parties actually agreed to arbitrate, the punitive damage award (or some part of it) would stand.”

The rest of the arbitrator’s decision was not attacked. It provided for a recovery of \$1,000 to each of the Starks, \$22,780 in attorney fees to be paid by EMC to the Starks and EMC had to pay the arbitrator fees and costs.

Missouri Appellate Court: For years, Missouri litigators considered arbitration to be an unlikely forum for the award of punitive damages, at least until the decision in *Groceman v. Pulte Homes Corp.*, 53 S.W.2d 599 (Mo. App. W.D. 2001). The Western District upheld an arbitrator’s award of punitive damages, despite facts that that many would argue did not seem to support such a result.

The case involved a contract dispute (with fraud allegations) over the construction of a house, alleged to have several structural defects, including roof deflection, inadequate rafters, and ceiling cracks. On its face, this case hardly seemed to be the kind that would muster any serious concern that punitive damages were a realistic possibility, especially since it was in arbitration. The arbitrator—appointed by the court—awarded \$50,000 in actual damages and another \$50,000 in punitive damages against the contractor.

Probably few arbitrators will consider *Pulte Homes* to be a catalyst to start awarding punitive damages. Its importance is that if punitive damages are appropriate, the arbitrator now has court support for his or her decision and absent a showing that the arbitrator “manifestly disregarded the law,” the courts will uphold the decision

In addition, there is the decision in *Hoskins v. Business Men’s Assurance*, 79 S.W.3d 901 (Mo. 2002). The Supreme Court of Missouri upheld the constitutionality of Sec. 537.675 R.S.Mo (2000), dealing with the state’s lien of 50 percent on any final judgment for punitive damages. While the case did not involve arbitration, it is noteworthy because the statute in question includes this provision: “Cases resolved by arbitration, mediation or compromise settlement prior to a punitive damage final judgment are exempt from the provisions of this section.”

This, coupled with the decision in *Pulte Homes*, may convince many, who previously shied away from arbitration because of a perception that punitive damages would not be awarded by an arbitrator or affirmed by a court, to reconsider the merits of arbitration in Missouri.

Attorney and Arbitrator Fees

1. Attorney Fees: Attorney fees can be awarded if covered in the agreement between the parties (in either the arbitration provision or some other part of the agreement); if allowed by common law or statute; or according to AAA’s Rules if all the parties to the arbitration request such relief from the panel. See Rule 45 Commercial Dispute Resolution Procedures and Rule 46 Construction Industry Dispute Resolution Procedures.

Eighth Circuit: In *Bob Schultz Motors, Inc. v. Kawasaki Motors Corp., U.S.A.*, 334 F.3d 721 (8th Cir 2003), the Eighth Circuit upheld a district court’s decision not to confirm an arbitrator’s award that found a Kawasaki dealership agreement to be a contract of adhesion and unconscionable in providing that the prevailing party—in this case Kawasaki—could recover all costs and attorneys’ fees. This decision meant that Kawasaki, even though it won in arbitration, could not recover costs and attorney fees of \$1.7 million.

The Eighth Circuit noted that two other circuits agree with its decision that it is for the arbitrator to consider challenges to attorney-fee provisions or other limits on remedies in the arbitration provisions. *Id.* at 726.

In *Gas Aggregation Services, Inc. v. Howard Avista Energy, LLC*, 319 F.3d 1060 (8th Cir. 2003), the Eighth Circuit affirmed a decision of the district

court to vacate an award of attorney fees because the panel recognized the law did not support such a recovery and the panel awarded the attorney fees anyway. See the next section for a more detailed discussion of this case.

Missouri Appellate Court: In a case of first impression, the Eastern District vacated an arbitrator's award of attorney fees where the fees related to litigation previously decided by the Missouri courts (rather than attorney fees due to the arbitration itself). The case is *Strain-Japan R-16 Sch. v. Landmark Systems*, 51 S.W.3d 916 (Mo. App. E.D. 2001).

The case involved a dispute over construction of an addition to a school. The School District withheld \$72,000 plus from final payment to the contractor claiming defective work by the general contractor Landmark Systems, Inc.

Landmark filed a demand for arbitration with the American Arbitration Association. The District filed a petition in circuit court requesting a stay of the arbitration and argued that the agreement was unenforceable. The court granted a Temporary Restraining Order, then dissolved the TRO and declared the contract to be enforceable.

Landmark amended its demand for arbitration to include a request for attorney fees incurred in the court action but not the arbitration. The arbitrator awarded to Landmark without explanation the remaining contract price minus costs to repair certain items, interest, and \$41,530 in attorney fees.

The appellate court applied the Federal Arbitration Act (FAA) to decide whether the arbitrator correctly awarded the attorney fees. The FAA's grounds for vacating an award include an arbitrator exceeding his or her powers.

Given this standard, the appellate court concluded that the arbitrator did exceed his powers under 9 U.S.C. § 10(a)(4) by awarding the attorney fees since they related to litigation other than the arbitration before him. "There was no express or written provision in the contract allowing for attorney's fees from a prior litigation to be recovered." *Id.* at 923.

2. Arbitrator Fees: In the recent case of *Bond v. Twin Cities Carpenters Pension Fund*, 307 F.3d 704 (8th Cir. 2002) the Eighth Circuit decided that a pension plan that required that arbitrator fees be split equally between the parties was not in accord with ERISA's statutory and regulatory framework.

The plan required binding arbitration and the payment of a split-fee initially of the arbitrator's fee to be adjusted, if at all, upon the final determination by the arbitrator. It is this fee splitting that turned the Eighth Circuit to reverse the district court and decide that this "arrangement" was not "reasonable" within the meaning of federal statutory law. The court found that such arrangements discourage the pursuit of "many legitimate claims by those who cannot afford such costs."

Enforcing and Upholding Arbitrator Awards

The Eighth Circuit: In *MidAmerican Energy Co. v. International Brotherhood of Elec. Workers Local 499*, 345 F.3d 616 (8th Cir. 2003), the Eighth Circuit noted that while judicial review of arbitration awards is limited, awards will be vacated upon a showing that the award contravenes an "explicit public policy" or was procured by fraud. The court did not find that the award in question (which included a reinstatement to work of a terminated employee) violated any express public policy on the safety for the liquid natural gas industry.

The court did find, however, that evidence uncovered after the arbitration suggested that the employee may have lied about his reason for leaving work on the night in question. An anonymous caller tipped the employer off to someone who later testified in deposition that the employee was having an extramarital affair with her and was with her on the night in question. Since the arbitrator's award expressly relied on the employee's honesty, and since this new evidence cast doubt on this subject, the Eighth Circuit decided that the case needed to return to the district court for further proceedings. "[I]f fraud is proven, the entirety of Turner's involvement in the arbitration process would be shown to be a sham" and thus the court concluded, "the alleged fraud is material to the case at hand." *Id.* at 623.

In *Schoch v. InfoUSA, Inc.*, 341 F.3d 785 (8th Cir. 2003), the Eighth Circuit declined once again to decide whether the parties to an arbitration agreement can expand the scope of judicial review of an award beyond the parameters set out in the FAA and federal case law. The court decided that the parties' agreement did not expressly contain a requirement for "heightened judicial scrutiny" and thus the court was not going to decide the issue.

The court further noted that the circuits are split on this issue and "[o]ur court has specifically reserved resolving this issue until the circumstances require it." *Id.* at 789. The court also discussed the two, "extremely narrow" judicially created reasons to overturn an award. They are: (1) the award is "completely irrational," meaning it fails to draw

its essence from the agreement, and (2) the award evidences a “manifest disregard of the law.” The court found neither to exist in the present case.

An excellent recent discussion about the standard for appellate review of lower court decisions on arbitration awards can be found in *Gas Aggregation Services, Inc. v. Howard Avista Energy, LLC*, 319 F.3d 1060 (8th Cir. 2003). “We review a district court’s decision to vacate an arbitration award *de novo*.” *Id.* at 1063.

The Eighth Circuit reiterated that the FAA requires that an arbitration award be upheld unless it is obtained by corruption, fraud, or undue means; or where there is evident partiality or corruption in the arbitrators; or where the arbitrators exceeded their powers. *Id.* at 1065 and *see* 9 U.S.C. § 10(a)(1)-(2). In addition, the Eighth Circuit has held that besides these statutorily pronounced reasons an arbitration award will be vacated only where it is “completely irrational or evidences a manifest disregard for the law.” *Id.* at 1065, *citing Hoffman v. Cargill Inc.*, 236 F.3d 458, 461 (8th Cir. 2001).

Applying these standards, the Eighth Circuit in *Gas Aggregation* affirmed part of a district’s decision to vacate a panel’s award of attorney fees. The Court determined that by the panel’s written decision it recognized the law in Minnesota to be that the Consumer Fraud Act did not allow the award of attorney fees in disputes between businesses. Yet the panel went ahead and awarded attorney fees. “This ruling ignores the relevant law. Where an arbitration panel cites relevant law, then proceeds to ignore it, it is said to evidence a manifest disregard for the law.” *Id.* at 1069.

In *Finley Lines Joint Protective Board Unit 200, Brotherhood of Railway Carmen Division, Transportation Communications International Union v. Norfolk Southern Railway Company*, 312 F.3d 943 (8th Cir. 2002), the Eighth Circuit reaffirmed that judicial review of an arbitration award is very limited, and review of the decision of a public arbitration board under the Railway Labor Act “is among the narrowest known to the law.” *Id.* at 946. The dispute was over the exclusion of a polygraph test when the collective bargaining agreement required that the arbitrator “receive all evidence.”

The court stated that “Arbitrators have broad procedural discretion.” In fact, arbitrators may even look to outside sources, including prior unrelated awards, “without straying beyond their jurisdiction to interpret and apply the collective bargaining agreement.” *Id.* at 947. Accordingly, the “manner in which the Board resolves evidentiary disputers ‘does not

fall within any of the narrow jurisdictional grounds for review under 45 U.S.C. § 153 First (q).”

Parties who disregard arbitrator awards may want to reconsider their thinking. The Eighth Circuit has made clear that arbitrator awards and orders, once confirmed by the District Court, are not subject to trifling or disregard without incurring a substantial consequence, including contempt of court. The case is *International Brotherhood of Electrical Workers, Local Union No. 545 v. Hope Electrical Corp.*, 293 F.3d 409 (8th Cir. 2002).

A corporation had failed to comply with two arbitration awards. The union asked the District Court to enforce the awards, which it did, and when the corporation did not comply with the court’s orders, the union sought an order of contempt. Considerable procedural maneuvering and additional motion activity followed.

In the end the Eighth Circuit upheld the district court’s contempt order using an abuse of discretion standard for review. “As a general matter, when a litigant refuses to respect the authority of the court, it is not an abuse of discretion for the court to hold the litigant in contempt and impose a sanction to coerce compliance.” *Id.* at 418.

In another recent case, *United Steelworkers of America, AFL-CIO, Local 9452 v. MacSteel, Arkansas Division of Quantex Corp.*, 68 Fed. Appx. 750 (8th Cir. 2003), a party challenged the arbitrator’s award as exceeding his authority when the arbitrator allegedly ruled on matters not before him, including a ruling on whether employees could take their lunch period in increments.

The Eighth Circuit upheld the award, noting that if “the arbitrator is arguably construing or applying an agreement, we cannot overturn the arbitrator’s decision even if we are convinced that the arbitrator committed serious error.” The court will “vacate an arbitration award only if, for example, the award exceeds the arbitrator’s power or if the award fails to draw its essence from the agreement.” The Court upheld the arbitrator’s award.

In *In re Arbitration Between Dow Corning Corp. v. Safety National Casualty Corp.*, 335 F.3d 742 (8th Cir. 2003), the Eighth Circuit rejected arguments that an award should be overturned due to certain nondisclosures by one of the arbitrators, some ex parte contacts with counsel and limiting cross examination of one party’s expert. The court provided some broad, helpful comments on these issues:

Nondisclosure: “When the parties agree to arbitration before disinterested persons who have experience in a specialized business or type of problem, the relatively small number of qualified arbitrators may make it common, if not inevitable, that parties will nominate the same arbitrators repeatedly.” *Id.* at 750. “At the outset of the arbitration process, arbitrators must disclose “a substantial interest in a firm which has done more than trivial business with a party.” *Id.*

Ex Parte Contacts: “[T]he ex parte contacts, even if arguably improper, simply do not demonstrate evident partiality. Umpire Lyon had an ‘administrative’ reason for contacting counsel (to discuss scheduling) and a basis for deciding that he needed to contact them one at a time.” *Id.* at 751.

Limiting Cross Examination: “Arbitrators have broad discretion to limit the cross-examination of witnesses at arbitration hearings.” *Id.* at 752. There is no showing that this procedural ruling demonstrated the arbitrator’s “evident partiality” within the meaning of § 10(a)(2) of the FAA.

In *Smart v. Sunshine Potato Flakes*, 307 F.3d 684 (8th Cir. 2002) the Eighth Circuit considered a complicated set of procedural facts involving actions pending in state and federal court. Initially, the plaintiff had filed a diversity action in federal district court in North Dakota, but it was stayed pending arbitration. The arbitrator entered an award in favor of defendant Sunshine for \$688,530.00 after the hearing on the arbitration in New Mexico. Plaintiff Smart then filed an action in state court in North Dakota to vacate the award pursuant to North Dakota’s version of the Uniform Arbitration Act.

Sunshine filed an improper motion to remove that action to federal district court since Sunshine failed to allege diversity jurisdiction. Sunshine then moved the federal district court to lift the stay from the original action and confirm the arbitration award. After more motions and skirmishes by the litigants, the Eighth Circuit ruled finally that the federal district court properly granted Sunshine’s motion to confirm the arbitration award. Ultimately, Sunshine successfully chose the third option.

Further, the court concluded that the doctrines of preclusion, estoppel, and election of remedies do not bar a party from “sequentially pursuing alternative venues that may be available.” *Id.* at 686. “Rather, the statutory time limits on filing lawsuits, seeking judicial review of arbitration awards, and exercising one’s right of removal protect the courts and litigants from an excessively protracted search for alternative venues.” *Id.*

Finally, the court reaffirmed its own power when others suggest that a federal court should defer to another action pending in state court. “[W]hen the issue is whether a federal court should defer to a pending suit in state court, as in this case, the order in which jurisdiction was obtained, while still a relevant factor in applying the abstention doctrine, is far less apt to be determinative because of the federal court’s ‘virtually unflagging obligation’ to exercise its jurisdiction.” *Id.* at 687.

In *Brotherhood of Maintenance of Way Employees and Wabash Federation v. Terminal Railroad Association of St. Louis*, 307 F.3d 737 (8th Cir. 2002), the Eighth Circuit reversed a district court’s decision to grant summary judgment in favor of the railroad and reinstated the arbitration award for the union. The central issue was whether the arbitration panel exceeded its jurisdiction, as set out in the parties’ agreement, by allowing the union to submit written arguments when the arbitration agreement had provided that the parties would present the file to the panel “with no alterations of any kind.”

The Eighth Circuit noted, “our review of the arbitration award itself is among the narrowest known to the law.” *Id.* at 739. The court stated that an award should be set aside or vacated if the arbitrator ignores the plain language of the agreement or exceeds his or her jurisdiction. The court then decided that the arbitration agreement was ambiguous on this point and thus the arbitrator’s decision is “procedural.” *Id.* at 740. “An arbitrator’s procedural determinations should be set aside by a court when the arbitrator is guilty of misconduct or bad faith.” *Id.*

In *Motion Control Corp. v. Sick*, 2003 U.S.App. LEXIS 26380 (8th Cir. 2003), the Eighth Circuit recently held that an action filed in state court to confirm or challenge an arbitration award cannot be removed to federal court, based on diversity of citizenship, if any of the defendants is a citizen of the state where the action is pending. There is no ancillary jurisdiction over the action merely because the federal court has another lawsuit pending before it by the same parties to the arbitration.

Missouri Appellate Court: A good general discussion of the mechanic’s of attacking an award by motion and appeal can be found in *Doyle v. Thomas*, 109 S.W.3d 215 (Mo. App. E.D. 2003). The decision also discusses the correlation between Missouri’s Arbitration Act and the FAA. The holding in the case, however, is not particularly noteworthy.

In *Lantz Welch v. Grant Davis, et al.*, 114 S.W.3d 285 (Mo. App. W.D. 2003), the Western District stated that its review of a circuit court’s decision to confirm an arbitration award is governed by *Murphy v. Carron*, 536 S.W.2d 30, 32 (Mo. Banc 1976). Thus, the appellate court

will affirm unless it is not supported by substantial evidence, or it is against the weight of the evidence, or it erroneously declares or applies the law.

The Court further noted that even if the arbitrators had considered evidence that should not have been admitted in deciding the submitted issue, it is “of no consequence.” “This is an issue of legal error, and the courts will not consider claims of legal error in arbitration proceedings.”

In *Decker v. Kamil*, 100 S.W.3d 115 (Mo. App. E.D. 2003), the Eastern District noted that the “scope of judicial review of an arbitration award ‘is among the narrowest known to the law.’” *Id.* at 117. “A party challenging an arbitration award is not entitled to reconsideration of the merits of the case and bears the burden of proving the invalidity of the award.” *Id.*

Thus, the appellate court upheld a trial court’s decision to affirm an arbitration award. The party challenging the award had not shown that there was an evident miscalculation of figures or an evident mistake in any description referenced in the award, such that the award violated § 435.410(1) R.S.Mo.

Of note to all neutrals is how the arbitrator handled a request from the trial court as to whether he had considered one of the party’s cash contributions to the corporation, and if not, to correct the award accordingly. The arbitrator responded by writing there was no miscalculation as he had considered the “alleged” cash advances. This was an astute way to handle the court’s request.

Class Action Lawsuits and Arbitration

U.S. Supreme Court: Arbitrators now can decide whether to certify a proceeding for class arbitration, given the recent decision in *Green Tree Financial Corp. v. Lynn W. Bazzle*, 123 S. Ct. 2402 (2003). Under the terms of the arbitration agreement, the parties agreed to submit to the arbitrator “all disputes, claims, or controversies arising from or relating to this contract or the relationships which result from this contract.” *Id.* at 14.

The Supreme Court found that this meant that the arbitrator, not the court, would decide whether the agreement forbids class certification. The question did not fall within the narrow scope of a gateway issue that courts will resolve, for it “concerns neither the validity of the arbitration clause nor its application to the underlying dispute between the parties.” *Id.* at 15-16.

Rather, it “concerns contract interpretation and arbitration procedures. Arbitrators are well situated to answer that question.” *Id.* at 16.

Eighth Circuit: In *Dominium Austin Partners v. Emerson*, 248 F.3d 720 (8th Cir. 2001), the question was whether the trial court erred in denying a request of plaintiffs to arbitrate their disputes as a class. The underlying dispute involved limited partners and other partnership entities that had invested in low-income housing. The Eighth Circuit agreed with the trial court that the claims would be sent to arbitration as individual claims and not as a class action. Since the arbitration agreements were silent on class actions, the court concluded that the district court was without power to consolidate the arbitration proceedings.

The court also decided to send to the arbitrator for his or her consideration arguments that one of the parties was fraudulently induced to adopt the entire package of amendments to the agreement and arguments that the arbitration agreements had been waived because of a tardy submission of the demand for arbitration.

The recent decision from the Supreme Court should affect how this decision will be applied and enforced in the future.

Replacing an Arbitrator

Replacing an arbitrator is an infrequent but extremely troublesome problem, given that some arbitrations take months to a year or more from selection of the arbitrators to the final award after the hearing. During this time a host of events, such as sickness, job relocation, family responsibilities and conflicts, may necessitate the replacement of one of the three arbitrators on the panel.

The FAA provides in § 5 that the agreement controls this situation, but where the agreement is silent, then the court shall designate a replacement arbitrator. Recently, the Eighth Circuit in *National American Insurance Co. v. Transamerica Occidental Life Ins. Co.*, 328 F.3d 462 (2003), followed this procedure. In doing so, the Court expressly distinguished and refused to follow cases from other federal circuits that have created a “general rule” that “where one member of a three-person arbitration panel dies before the rendering of an award and the arbitration agreement does not anticipate that circumstance, the arbitration must commence anew with a full panel.”

Unlawful Delegation to an Arbitrator

Missouri Appellate Court: “Allowing disputes over wages to go to the arbitrator results in a delegation of legislative authority, and as such it cannot be allowed.” *International Brotherhood of Elec. Workers, Local Union No. 53 v. City Power & Light Dept., City of Independence*, 2003 Mo. App. LEXIS 1791 (Mo. App. W.D. 2003). The union had filed an action seeking to compel arbitration of a dispute arising under a labor agreement between the union and the City. Wages and hours for public employment in Missouri must be fixed by statute or ordinance and cannot be the subject of bargaining.

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