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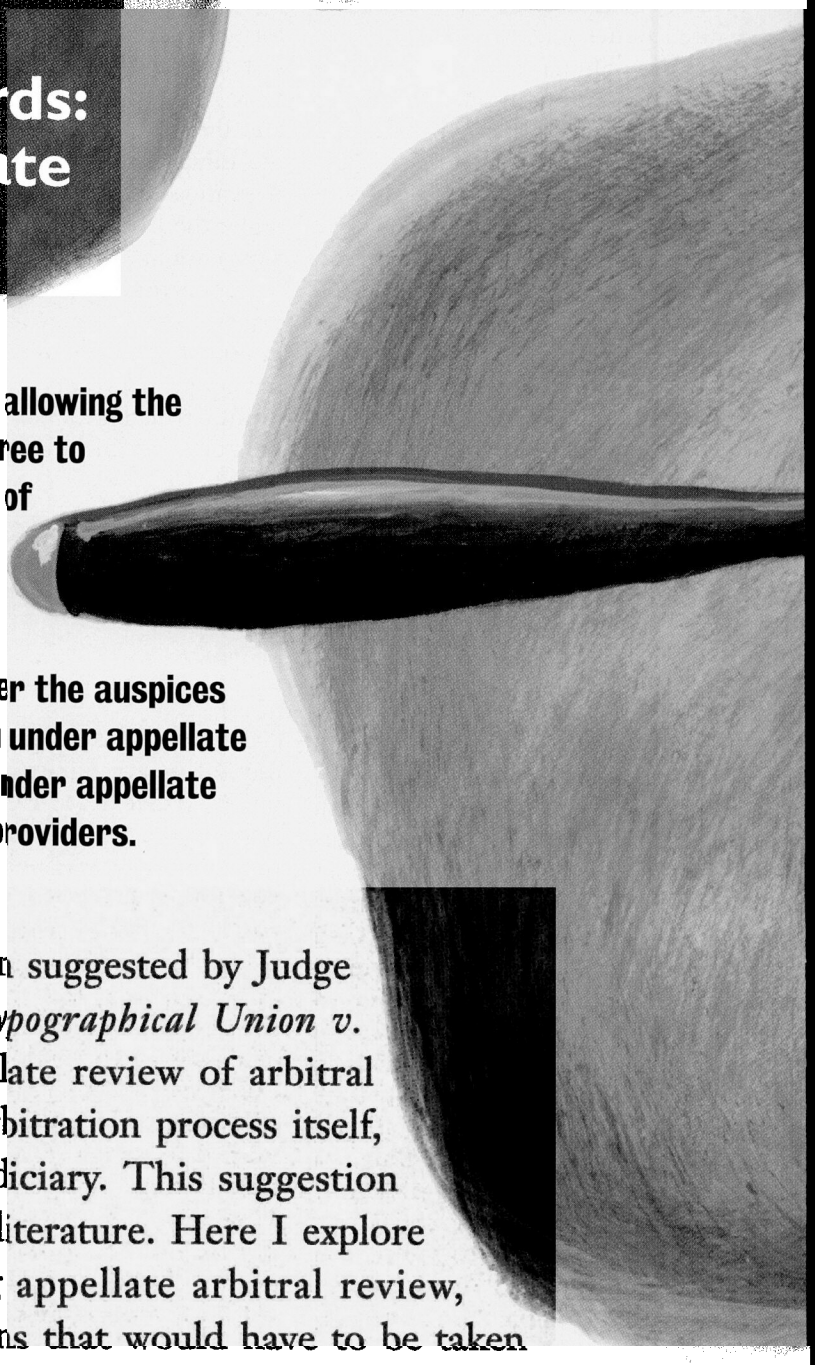
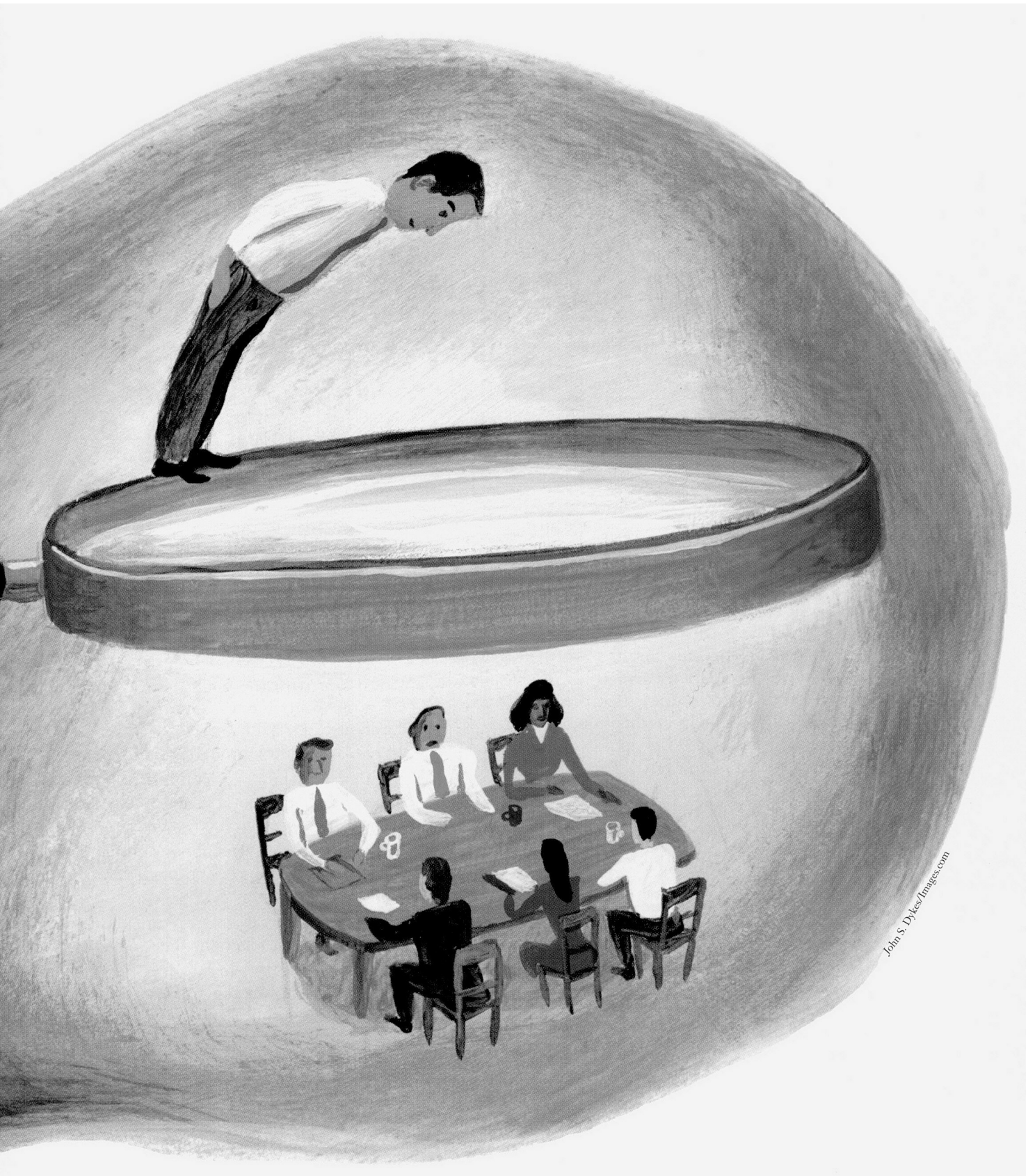
A Practical Approach to Affording Review of Commercial Arbitration Awards: Using an Appellate Arbitrator



This article explores the advantages of allowing the parties to a commercial contract to agree to appellate arbitrator review in the case of an alleged error of law in order to address concerns about the finality of arbitration. The appellate process the author advocates would take place under the auspices of the American Arbitration Association under appellate procedures crafted by the parties, or under appellate procedures promulgated by other ADR providers.

In this article I discuss an option suggested by Judge Richard Posner in *Chicago Typographical Union v. Chicago Sun-Times*,[1] that appellate review of arbitral awards be handled as part of the arbitration process itself, without the involvement of the judiciary. This suggestion has received little attention in the literature. Here I explore the implications of implementing appellate arbitral review, including the practical considerations that would have to be taken into account by an attorney who wishes to implement the suggestion.



I do not advocate providing for arbitral appellate review for every dispute.[2] I believe that review would be appropriate only when the nature of the claim requires the arbitrator to resolve *legal* issues. For example, many standard-form service agreements contain a provision requiring the consumer to agree to a liquidated damage clause. These provisions have been subject to myriad legal challenges, such as unconscionability[3] and "unenforceable exculpation."[4] Many courts enforce these clauses as a matter of law, but some do not. The failure of an arbitrator to follow judicial mandates concerning these issues when interpreting service agreements could lead to an appearance of "lawlessness."[5] It is precisely for this reason that some attorneys decide against incorporating an arbitration clause in an agreement. They are concerned that an arbitrator may misunderstand the applicable law (which, unlike the doctrine of manifest disregard of the law, is not a recognized ground to vacate an award)[6] and therefore misapply it.

While the finality of arbitration awards is a clear benefit of arbitration, the risk that the law might not be applied correctly is of sufficient concern to some attorneys that they do not recommend that their clients assume that risk. Providing for an arbitral appeals process would help alleviate this concern.

Authority for an Appellate Process

Neither the Federal Arbitration Act (FAA) nor the Uniform Arbitration Acts (both the 1955 UAA and the 2000 revision (UAAs) provides for broad appeals of arbitral awards. These statutes limit judicial review on specific grounds, most of which involve wrongdoing or over-reaching by an arbitrator. At the same time, neither statute prohibits the parties from crafting their own review clause.

Both the FAA and the UAAs make any agreement to arbitrate valid and enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract."[7] The courts have given a liberal interpretation to this statutory language.[8] No court I am aware of has ever held that having an appeals provision in an arbitration agreement constitutes a ground for revoking a contract. So I can say with a reasonable degree of confidence that there is no statutory prohibition on providing for appellate review of arbitration awards.

So how would you go about establishing a procedure for an appeal of an award? One possibility is a contractual provision conferring appellate jurisdiction on a court. Some courts balk at the notion that private parties can create appellate jurisdiction where it might not otherwise exist. Other courts seem willing to recognize contractual judicial review provisions on the theory that jurisdictional concerns are trumped by the desire to support the arbitration system.[9] The federal courts are split on the issue and the Supreme Court has yet to speak on the subject.[10] State court rulings, which are few in number, evidence concerns similar to those raised by the federal judiciary.[11] All this suggests that trying to contractually bind the judiciary is chancy and unpredictable.

The author says that providing for contractual judicial review by a court is "chancy and unpredictable." The alternative is "to provide for an appeal to an appellate arbitrator or tribunal."

The alternative is to provide for an appeal to an appellate arbitrator or tribunal. This approach has a number of advantages:

- Consistent with the philosophical underpinnings of arbitration, the approach extends the flexibility afforded contracting parties seeking to resolve disputes through arbitration.
- It eliminates the uncertainty of trying to involve the judiciary in a manner not otherwise provided for by arbitration statutes.
- It eliminates concerns about confidentiality presented by an appeal through the judicial system.
- It allows the parties to structure the appeals process so as to maintain the goals of speed and efficiency.

In order to implement this suggestion in a meaningful way, arbitral institutions would have to allow the parties to provide for an appellate procedure. The arbitration rules of two major ADR organizations, the International Institute for Conflict Prevention and Resolution (CPR) (formerly the CPR Institute for Dispute Resolution) and the Judicial Arbitration and Mediation Services (JAMS), envision some kind of appeals process while the rules of a third, the National

Arbitration Forum (NAF), acknowledges the possibility of such a process. But it is the rules of the American Arbitration Association (AAA) that I believe would best serve the needs of the practitioner seeking to structure a workable and efficient mechanism for appellate review, even though these rules make no mention of any kind of appeals process.

The CPR[12] and JAMS[13] arbitration rules provide a formal structure for "internal" appellate review. Both sets of rules permit an appeal based on law and/or fact (similar to judicial appeals). They require timely notice of appeal and compliance with rules governing the selection of the appellate arbitrator, arbitrator challenges, the record on appeal, the exchange and length of briefs, oral argument, arbitrator compensation, and confidentiality of proceedings.

Their rules also define the powers of the appellate arbitrator. CPR Rule 8.2 allows the appellate arbitrator to modify or set aside the original award because of an error of law or fact, or because it is subject to one of the grounds for vacating an award in FAA § 10. JAMS Rule D authorizes the appellate arbitrator to affirm, reverse, or modify the original award. Both schemes require the appellate arbitrator to prepare a written statement explaining the appellate decision.

According to the author, providing for an appellate arbitrator process in the case of errors of law would give the parties a fair hearing without lots of extra cost and time.

There is nothing objectionable about these rules. Moreover, the parties can diverge from them if they choose. But the fact that special rules already exist in the JAMS and CPR schemes suggests that to obtain uniform administration, it would be better not to depart from them. However, the complexity and formality of these appellate schemes could create unwanted delay and expense.

The rules of the NAF[14] do not establish an appeals process. But they do acknowledge the possibility that the parties may want to have an appeals process. Rule 1(D) states:

> Parties may modify or supplement these rules as permitted by law. Provisions of this Code govern arbitrations involving an appeal or a review *de novo* of an arbitration by other Arbitrators.

NAF Rule 5(K) further provides for review of substantive legal issues by a court:

> Review and Enforcement. An Award may be enforced in any court of competent jurisdiction, as provided by applicable law. An Award may be reviewed by a court with jurisdiction to determine whether the Arbitrator properly applied the applicable law and whether the arbitration complied with applicable procedural and arbitration laws.[15]

Read together, the NAF's rules appear to envision two alternatives. One is an appeal *de novo* before an arbitrator with no restrictions as to the scope of the appeal. The other is an appeal directly to a court with jurisdiction. Both procedures could be costly and time-consuming because they are not limited to issues of law. Moreover, an appeal to a court may be problematic given the current state of case law that evidences judicial resistance to the concept of private agreements conferring jurisdiction.

As noted above, the AAA arbitration rules (take the commercial rules as an example) neither authorizes nor prohibits appeals. Instead, the rules judiciously favor giving the parties maximum flexibility to provide for procedures that serve them best. AAA Rule R-1(a) provides in part: "The parties, by written agreement, may vary the procedures set forth in these Rules." This broad authorization makes it possible to mix and match the rules to serve the specific needs of those seeking to construct a viable and efficient appellate process. I believe that this rule would authorize the parties to craft an arbitral appeals process limited to determinations about the application and interpretation of law. These are issues that can be decided within weeks of the issuance of the award that is the subject of the appeal. This type of appeal process could give counsel and their clients the comfort they need to prevent an aberrant award.

Rationale for Appeals of Legal Issues

Why do I propose limiting the appeal to issues of law (e.g., their application and interpretation), rather than *de novo* review? True, an errant award could involve a misunderstanding of facts. But *de novo* review would undermine the purpose of arbitration to provide an expeditious and cost-effective dispute resolution procedure.

Arbitration is first and foremost about resolving issues of fact. A party whose presentation of facts is not accepted by the arbitrator will always conclude that the arbitrator's factual findings are just plain wrong. However, the possibility that another fact finder might view the facts differently doesn't mean that the first arbitrator was wrong or rendered an unfair award. Allowing *de novo* review would open the door to the proverbial "second bite at the apple"[16] (i.e., a second hearing on the facts and law). Once that door opens, the cost of resolving the dispute could greatly increase, as could the time needed to decide the matter (with attendant opportunities for delay).

By contrast, an appeal on the law alone does not require a complete and accurate record, so it gives the parties a fair hearing without lots of extra cost and time. If the award is reversed on a legal ground (either because the arbitrator applied the wrong law or misapplied the right law), the appellate arbitrator could issue a correct award so that the parties do not have to go back and arbitrate again.

Under the proposed procedure, if the original award is reversed on a legal ground (either because the arbitrator applied the wrong law or misapplied the right law), the appellate arbitrator could issue a correct award so that the parties do not have to go back and arbitrate again.

Drafting the Agreement to Arbitrate

The AAA rules allow the parties "to vary the procedures" set forth in those rules, if they wish. This presumably would include adding an arbitral appeal process, since the AAA rules do not contain default procedures for conducting an appeal. The AAA might not want to administer an appeal without specific procedures crafted by the parties.[17] I recommend including the following elements in an arbitration clause that provides for an appeal to an appellate arbitrator:

1. A statement of the arbitration law and the substantive law to be applied to any dispute to be resolved by arbitration.
2. A requirement that all rulings by the arbitrator(s) shall explain in writing the basis for the award and the principle facts on which it is based. This is less than a requirement that the arbitrator(s) prepare findings of fact and law. An explanation of the basis for the award should be enough in most cases.
3. A statement that a party may appeal an award to an AAA arbitrator or panel (Appellate Arbitrator) only on the ground that the arbitrator(s) misapplied or misinterpreted the law.
4. A statement that while an appeal is pending, no party shall enter judgment on the original award or seek vacatur as permitted by law.
5. A declaration that the appeal to an Appellate Arbitrator is to be treated as an Expedited Procedure under the AAA [Commercial Arbitration] rules.[18]
6. A statement that the final ruling of the Appellate Arbitrator shall be final and binding.
7. A statement of the powers of the Appellate Arbitrator.

Putting this all together, the clause could read as follows:

> Any controversy or claim arising out of or relating to this contract shall be governed by the substantive laws of _____ and any arbitration of this dispute shall be conducted under the arbitration law of _____.
>
> All awards in this matter shall explain the basis therefor in writing, including the principle facts on which awards are based.
>
> Within 20 days of receiving the final award, any party may appeal an issue of law (that is, a claim that the arbitrator misapplied or misinterpreted the law) to an AAA Appellate Arbitrator by notifying the AAA Case Manager of the desire to appeal. The appeal shall be considered an Expedited Procedure and therefore subject to AAA Expedited Procedure E-3 (Serving of Notices),[19] E-4 (Appointment and Qualifications of Arbitrator),[20] E-9 (Time of Award)[21] and E-10 (Arbitrator's Compensation).[22]
>
> There shall be no record of the appeal and

there shall be no exchange of documents other than briefs supporting or opposing the appeal. Each party may file and exchange one brief no longer than 10 pages. There shall be no other briefs.

Upon the exchange and filing of these briefs, the matter shall be submitted for decision to the AAA Appellate Arbitrator(s). There shall be no oral argument. While the appeal is pending no party shall seek to enforce the final award or seek to enter judgment thereon under federal or state law.

The Appellate Arbitrator(s) shall have the power to (1) affirm the original award in whole or in part; (2) dismiss some or all of the claims or counterclaims that were the subject of the original award; and (3) vacate the original award in whole or in part and issue a new award based on the factual findings set forth in the original award.

The award of the Appellate Arbitrator(s) shall explain the basis for the award in writing and it shall be final.

This language should make it possible to appeal an issue of law without offending AAA Commercial Arbitration Rule R-46 (Modification of Award), which prohibits the redetermination of the merits of a claim once the hearing has been closed. Given that the parties have the power under AAA Rule R-1 (a) to vary the AAA rules, there appears to be no need to amend Rule 46, since any reversal by the Appellate Arbitrator would not alter the factual findings in the original award.

The proposed 20 days' notice of intent to appeal is consistent with the time requirement in Rule 46 governing requests for modification of an award. In its totality, the proposed arbitration clause would likely achieve a fair, expeditious and cost-effective arbitration with the ability to appeal issues of law.

Conclusion

A properly drafted arbitration clause could provide for an appeal of alleged errors of law in an award to an Appellate Arbitrator. If the clause outlined the appellate procedures to be followed, I believe the appeal could be heard under the existing AAA rules.

The ability to appeal to an Appellate Arbitrator could eliminate (or at least reduce) attorneys' resistance to arbitration based on the finality of awards. It seems sensible to expect arbitral institutions to support an optional arbitral appeals process as a response to reasonable objections to arbitration and make it more attractive to attorneys.

Some may argue that allowing appeals to an Appellate Arbitrator also would undermine the conclusiveness of awards and send a signal to legislators and courts that they should expand the grounds for vacatur. But the reality is that courts are already expanding these grounds by fashioning common law doctrines permitting vacatur—such as for manifest disregard of the law, conflicts with public policy, and denial of fundamental fairness—where they perceive a need. I believe that if there is an arbitral appeals process, courts will have fewer reasons to stake out yet additional grounds to vacate awards and the U.S. Supreme Court will have little reason to perceive a need to accept a case for review that raises such grounds. ■

ENDNOTES

[1] 935 F.2d 1501, 1505 (7th Cir. 1991).

[2] Clearly, the appellate mechanism discussed in this article isn't for every transaction. I do not advocate it for disputes under standard form contracts raising commonly encountered issues unique to a particular business (e.g., credit card, insurance and securities disputes), or for disputes that are notoriously fact-based and usually decided by specialized panels (e.g., construction, elections, employment, labor and patent disputes, to name a few).

[3] See Paul Bennett Marrow, "The Unconscionability of a Liquidated Damage Clause: A Practical Application of Behavioral Decision Theory," 22 *Pace L. Rev.* 29, 32-53 (2001).

[4] Contractual limitations on liability for negligence are usually enforceable unless: (a) there is a special relationship between the parties, (b) a statute or public policy imposes liability, or (c) the party seeking enforcement has caused damages by acts of gross negligence. See, e.g., *Sommer v. Federal Signal Corp.*, 79 N.Y.2d 540 (1992); *Peluso v. Tauscher Cronacher Prof'l Eng'rs*, 270 A.D.2d 325 (N.Y. App. Div. 2d Dept. 2000). See also Restatement (2nd) Contracts § 195(1).

[5] Robert Scott, "The Lawlessness of Arbitration," 9 *Conn. Ins. L.J.* 355 (2002/2003); Rex P. Perschbacher & Debra Lyn Bassett, "The End of Law," 84 *B.U.L. Rev.* 1, 28-32 (2004).

[6] Challenges based on the applicability and interpretation of law must be distinguished from challenges that an arbitrator evidenced a manifest disregard for the law. The doctrine of manifest disregard for the law is a recognized common law ground for vacatur in the federal courts. See *Hoeft v. MVL Group*, 343 F.3rd 57, 64 (2d Cir. 2003). For a general review of the doctrine, see Noah Robins, "Manifest Disregard of the Law" and "Vacatur of Arbitral Awards in the United States," 12 *Am. Rev. Int'l Arb.* 363 (2001). For a discussion of the applicability of the manifest disregard doctrine under state law, see Paul Turner, "Preemption: The United States Arbitration Act, the Manifest Disregard of the Law Test for Vacating an Arbitration Award, and State Courts," 26 *Pepp. L. Rev.* 519 (1999). A mere error or misunderstanding of the law does not constitute manifest disre-

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gard of the law. One decision by the 2nd Circuit said that manifest disregard requires an arbitrator to identify the applicable law and then completely ignore it. *Hoeft, supra.*

[7] FAA § 2 provides:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

UAA § 1 (1955) provides:

> A written agreement to submit any existing controversy to arbitration or a provision in a written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable, save upon such grounds as exist at law or in equity for the revocation of any contract. This act also applies to arbitration agreements between employers and employees or between their respective representatives [unless otherwise provided in the agreement].

UAA § 6 (a) (2000) provides:

> An agreement contained in a record to submit to arbitration any existing or subsequent controversy arising between the parties to the agreement is valid, enforceable, and irrevocable except upon a ground that exists at law or in equity for the revocation of a contract.

[8] One court aptly observed that "short of authorizing trial by battle or ordeal or, more doubtfully, by a panel of three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes; parties are as free to specify idiosyncratic terms of arbitration as they are to specify any other terms in their contract." *Baravati v. Josephthal, Lyons & Ross*, 28 F.3d 704, 709 (7th Cir 1994).

[9] Much has been written on this topic, so there is no need to repeat the various arguments. See D.P. Wood, "Brave New World of Arbitration," 31 *Cap. U. L. Rev.* 383 (2003); Lee Goldman, "Contractually Expanded Review of Arbitration Awards," 8 *Harv. Negotiation L. Rev.* 171 (2003); William H. Knull III & Noah D. Rubins, "Betting the Farm on International Arbitration: Is it Time to Offer an Appeal Option?," 11 *Am. Rev. Int'l Arb.* 531 (2000); Michael H. LeRoy & Peter Feuille, "The Revolving Door of Justice: Arbitration Agreements that Expand Court Review of an Award," 19 *Ohio St. J. Disp. Resol.* 861 (2004); Richard C. Solomon, "Appeals of Arbitration Awards by Agreement: Why They Should be Allowed," 58 *Disp. Resol. J.* 58 (2003); Margaret Moses, "Party Agreements to Expand Judicial Review of Arbitral Awards," 20 *J. Int'l Arb.* 315 (2003); James B. Hamlin, "Defining the Scope of Judicial Review by Agreement of the Parties," 13 *Mealey's Int'l Arb. Rep. 25* (1998); Stephen Hayford & Ralph Peeples, "Commercial Arbitration Evolution: An Assessment and Call for Dialogue," 10 *Ohio St. J. Disp. Resol.* 343 (1995).

[10] The 4th and 5th Circuits are prepared to recognize such contracts. *Syncor Int'l Corp. v. McLeland*, 120 F.3d 262 (4th Cir 1997); *Gateway Technologies v. MCI Telecom. Corp.*, 64 F.3d 993 (5th Cir 1995); see also *New England Utilities v. Hydro-Quebec*, 10 F. Supp. 2d 53 (D. Mass. 1998).

The 7th, 8th and 10th Circuits have refused to recognize contractual provisions for expanded judicial review. *Chicago Typographical Union, supra* n. 1; *UHC Mgmt. Co. v. Computer Sci. Corp.*, 148 F.3d 992 (8th Cir 1998); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925, 935 (10th Cir 2001).

[11] Compare *Crowell v. Downey Community Hosp. Found.*, 95 Cal. App. 4th 730 (2d Dist. 2002) (interpreting the California Arbitration Act); *In Re County of Chemung*, 277 A.D.2d 792 (N.Y. App. Div. 3rd Dept. 2000) (interpreting N.Y. C.P.L.R. art. 75); *Dick v. Dick*, 534 N.W.2d 185 (Mich. Ct. App. 1994) (interpreting Michigan's Arbitration Act); *Chicago, Southshore & South Bend R.R. v. Northern Ind. Commuter Transp. Dept.*, 682 N.E.2d 156 (Ill. App. 1997) *rev'd other grounds*, 184 Ill. 151 (1998) (interpreting the Illinois Arbitration Act) with *Primerica Fin. Serv. v. Wise*, 217 Ga. App. 36 (1995) (interpreting the FAA).

[12] International Institute for Conflict Prevention and Resolution Arbitration Appeal Procedure available at www.cpradr.org/.

[13] JAMS Optional Arbitration Appeal Procedure (2003), available at www.jamsadr.com/.

[14] Officially called the Code of Procedure (2003), available at www.arbitration-forum.com/.

[15] See also Rule 43(D): "An award is reviewable by a court of competent jurisdiction as provided by applicable law."

[16] UAA § 201(b) (2000), Reporter's Notes B(B)(5).

[17] All is not lost if the AAA were to decline to administer the appeal. Rule 1.1 of the CPR Arbitration Appeals Procedure suggests that CPR would facilitate an appeal from an award granted pursuant to the rules of another facilitator.

[18] AAA Rule R-1 (b) gives parties the option of employing the Expedited Procedures in situations of their choosing. It provides in part: "Unless the parties or the AAA determines otherwise, the Expedited Procedures shall apply in any case in which no disclosed claim or counterclaim exceeds $75,000, exclusive of interest and arbitration fees and cost. Parties may also agree to use these procedures in larger cases...."

[19] AAA Expedited Procedure E-3 (Serving of Notices), allows notice as provided by Section R-39(b), and telephone notice subsequently confirmed in writing to the parties. E-3 states that "[s]hould there be a failure to confirm in writing any such oral notice, the proceeding shall nevertheless be valid if notice has, in fact, been given by telephone."

[20] AAA Expedited Procedure E-4 (Appointment and Qualifications of Arbitrator) describes a "list procedure" for the appointment of the arbitrator. First, the AAA sends each party a list of five proposed arbitrators. The parties are supposed to agree on one, but if they can't agree, they are to use the "strike" method of selection. This means each party may strike two names from the list. If the arbitrator can't be appointed from the list, the AAA will make the appointment. The parties can object to the appointment of an arbitrator for cause.

If the parties wish to have three arbitrators selected under the procedure in E-4, they must so provide in their contract.

[21] AAA Expedited Procedure E-9 states with respect to timing:

> Unless otherwise agreed by the parties, the award shall be rendered "not later than 14 days from the date of the closing of the hearing or, if oral hearings have been waived, from the date of the AAA's transmittal to the arbitrator." Because there are no statements or proofs on an appeal, the clause would have to indicate an intention by the parties that in the place and stead of statements and proofs, the parties intend "final briefs and the relevant portions of the hearing transcript, if there is one....

[22] E-10. Arbitrator's Compensation provides that arbitrators will receive compensation at a rate to be suggested by the AAA regional office.