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Post-Prop. 64 UCL Actions
page 39

Los Angeles lawyers (l. to r.) Robert C. Brandt, Geoffrey Murry, and Howard S. Klein examine undue influence claims in family law and probate matters page 30

Under the Influence

PLUS

Using Effective Contract Language in Arbitration Agreements

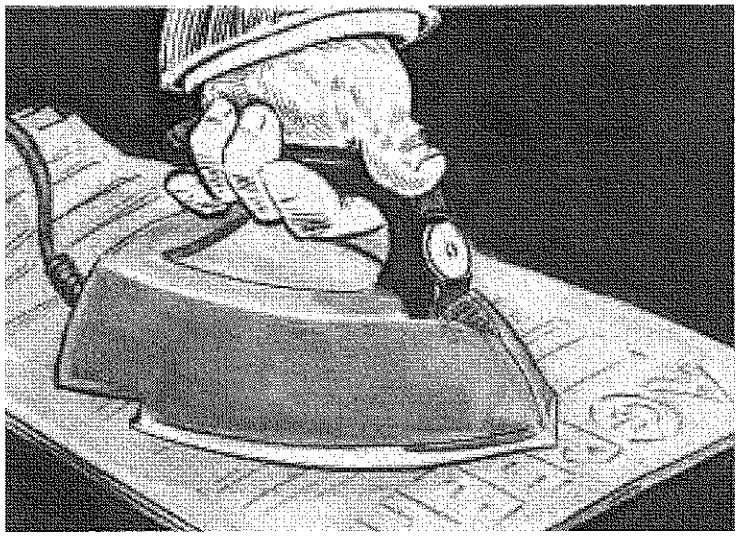
THE MAJORITY OF ATTORNEYS may get through three years of law school and complete the bar exam without ever having encountered the term "arbitration," but the fact is that arbitration is almost inevitably going to be encountered in any legal practice. Mandatory binding arbitration clauses appear in almost every type of contract, from joint venture agreements between business partners to cell phone contracts. Except in the very rare instance in which the arbitration provision in a contract, or the entire contract, can be found unenforceable due to its basic unconscionability, an arbitration provision is mandatory, and a court will enforce it.[1]

In addition to being mandatory, the typical arbitration provision leads to a result that is more or less unreviewable by a court. This immediate finality is commonly perceived as one of the great benefits to arbitration, in that litigation and appeals are completely avoided. The question still remains, however, how unreviewable the decision of an arbitrator actually is. This is important for business attorneys drafting contracts that incorporate a mandatory binding arbitration provision because they need to ensure that the benefits of arbitration that they seek are actually realized. Likewise, a litigator faced with an arbitration decision that the client insists was erroneous and unjustified also needs to be able to explain to that client whether an appeal of that decision to a court of law would be a worthwhile exercise or a waste of time and money.

It is well known and often repeated in case law that an arbitrator is free to be wrong. A merely erroneous decision on the facts of the matter will not be reversed by a court.[2] The chance that an arbitrator may simply just get it wrong is a risk inherent in the arbitration process, and the reason why time and effort is well spent by attorneys in choosing their arbitrator or arbitration panel.[3] But it is also essential to remember that arbitration is itself a contract.[4] While an arbitrator is free to decide the matter presented, however rightly or wrongly, the arbitrator must not stray outside the limitations of the arbitration contract. A court will look only to the language of the arbitration agreement and will use that language to make all determinations about the propriety and reviewability of the outcome.

Because the outcome of an arbitration is unreviewable, lawyers must craft their agreements to arbitrate to limit or control the outcome so that review becomes unnecessary. This is easily accomplished—and can only be accomplished—in the language of the arbitration contract. Parties can limit the powers or arbitrators to specific questions or require the application of specific law.[5] For example, a franchise agreement may require submission of any dispute to binding arbitration, require the application of the American Arbitration Association's commercial arbitration rules, and limit the arbitrator's discretion by specifically proving "in no event may the material provisions of this agreement be modified or changed by the arbitrator at any arbitration hearing."

This was the issue in the franchise agreement litigation presented in *Gueyffier v. Ann Summers, Ltd.*, an opinion of the California Supreme Court.[6] This case demonstrates that even when arbitrators



RICHARD EWING

seem to go beyond the limits of their authority as defined by the contract, their decision is still likely to be found unreviewable.

In *Gueyffier,* the arbitrator was bound to apply the provisions of the contract to the dispute in question and was expressly prohibited from modifying or changing any element of the contractual requirements. The arbitrator, however, found that compliance with the contractual provisions was excused and therefore the mandatory provisions did not need to be applied to the dispute. The losing party immediately took the arbitration decision to court, insisting that this was a violation of the arbitrator's powers. The supreme court disagreed and made the important distinction that excuse of a contractual term is not the same as a modification of a contractual term.

The Franchise Contract

The *Gueyffier* opinion concerned a dispute over a franchise agreement between Celine Gueyffier and Ann Summers, Ltd., a British company that franchised lingerie and adult novelty stores throughout the United Kingdom. Ann Summers entered into the franchise agreement with Gueyffier in an attempt to open the first American Ann Summers store. Ann Summers and Gueyffier signed a franchise agreement under which Gueyffier was to open an Ann Summers location in Beverly Hills. Ultimately, Gueyffier opened her store, but the opening was a total failure, as the store was greeted with open hostility. Gueyffier was quickly forced to close the store.

Disputes almost immediately arose regarding whether each party had performed its obligations under the contract. Gueyffier claimed that Ann Summers had violated the franchise agreement by failing to properly provide training and support as it was obliged to do under

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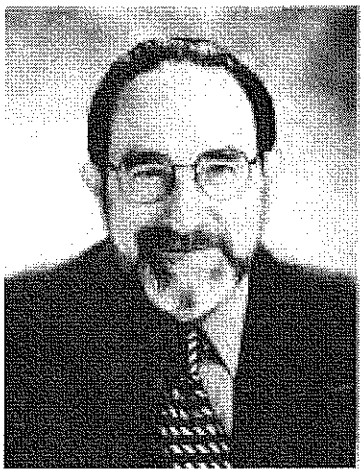

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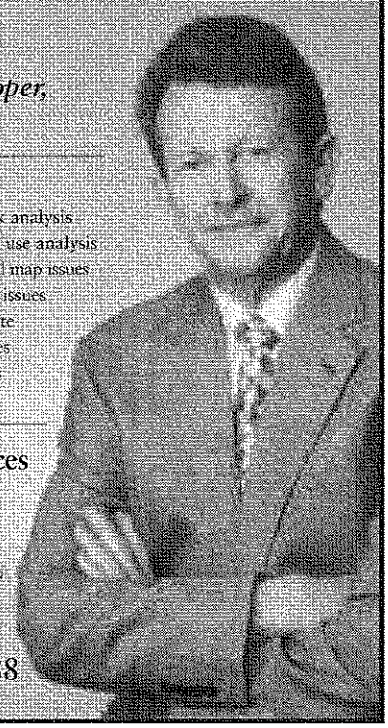

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the contract. Ann Summers countered that the contract had a notice-and-cure provision that would have required Gueyffier to first provide notice of the problem to Ann Summers and give the company a 60-day opportunity to cure this problem prior to closure of the store and declaration of breach. Ann Summers claimed that Gueyffier should have immediately notified the company when she realized that it was not fulfilling its training and support obligations. Because Gueyffier failed to give this notice, Ann Summers alleged that Gueyffier was, in fact, the party in breach.

The franchise agreement contained an arbitration clause providing for mandatory arbitration in the event of a dispute between the parties. It specifically limited the arbitrator's discretion, explicitly stating: "In no event may the material provisions of this Agreement...be modified or changed by the arbitrator at any arbitration hearing."[7]

The dispute accordingly went to arbitration. The arbitrator ultimately found that the breach by Ann Summers in failing to provide the necessary training and support for Gueyffier was incurable. Because the breach was incurable, the notice-and-cure provision was necessarily mooted due to impossibility. Therefore, the arbitrator concluded, Gueyffier's breach of the notice-and-cure provision was excused by Ann Summers's own breach of that same contract.

On appeal to the trial court, the question became: Was the equitable principle of excuse within the arbitrator's powers to grant? After all, under the terms of the contract, the arbitrator was limited by the contract from modifying or changing any provision. By excusing Gueyffier's failure to comply with one of the provisions, was the arbitrator in fact changing that provision and adding an "impossibility of cure" defense?

The arbitrator did not provide a lengthy written justification for the award. Under the contract to arbitrate, this was perfectly acceptable. A reasoned decision by the arbitrator was neither required under the arbitration provision nor requested by the parties. This was not an unusual situation. Due to the usually unreviewable nature of arbitration decisions, there is little need to require something akin to a trial court order and reasons for judgment. Litigators should know, however, that if clients see arbitration as merely a first step toward eventual litigation, written decisions should be required and requested. Otherwise, the arbitrator's reasons for reaching the decision that he or she did are inscrutable and are extremely unlikely to be reversed.

The *Gueyffier* arbitrator did write a final award in which he expressly stated that he found that the notice-and-cure provision of the contract had been rendered moot by Ann

Summers's actions. Gueyffier was awarded over $650,000 in damages. Ann Summers immediately appealed to the trial court, which in due course affirmed the arbitrator's award. Ann Summers then appealed further to the California Court of Appeal, which surprised many by reversing the trial court and finding that the arbitrator had in fact exceeded his authority.[8]

Simply put, the appellate court decided that the "no modification or change" provision in the arbitration agreement prevented the arbitrator from finding that a contractual obligation did not have to be complied with. In making this finding, the appellate court relied heavily on *O'Flaherty v. Belgum*.[9] In *O'Flaherty*, the court of appeal also reversed an arbitration award by concluding that an arbitrator exceeded his powers under the contract. In that case, the contract limited the arbitrator in his choice of remedies (he was only allowed to award remedies available either under the terms of the contract itself or in a court of law). The *O'Flaherty* court decided that the arbitrator's decision was not supported by either the terms of the contract or California case law and, therefore, the award represented an act that fell outside the arbitrator's power.

The problem was that the *O'Flaherty* and *Gueyffier* appellate court opinions both appear to contradict or at least severely constrain the supreme court's prior rulings, including *Moshonov v. Walsh*, that deferred to the decisions and interpretations of arbitrators about the scope of their powers under the arbitration agreement. In the *Moshonov* opinion, for example, the supreme court affirmed an arbitrator's decision not to award attorney's fees to the prevailing party. The contract in question called for an award of attorney's fees to the prevailing party. The arbitrator, however, determined that this provision did not apply to the award in question, and accordingly refused to award attorney's fees. The supreme court upheld this decision, noting: "Interpretation of the contract underlying this dispute being within the matter submitted to arbitration, such an interpretation could amount, at most, to an error of law on a submitted issue, which we have held is not in excess of the arbitrator's powers...."[10] This raises a question: Is an arbitrator able to employ equitable principles when determining whether otherwise controlling contractual provisions apply to the facts at hand? *Moshonov* suggests the answer is yes, but *O'Flaherty* and the court of appeal's *Gueyffier* opinion indicate that no, this is not an option.

Seeking resolution of this issue, Gueyffier appealed to the state supreme court, which sided with the arbitrator and the trial court and reversed the court of appeal. The supreme court found that the excuse of a contractual

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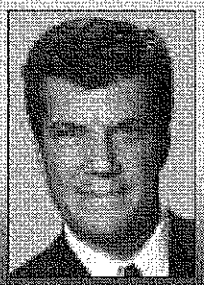

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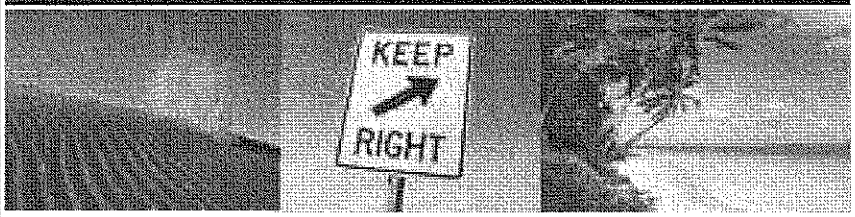

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obligation is inherently different from a change in that obligation. The no-modification clause did not work to bar the arbitrator from deciding that the notice-and-cure provision was simply inapplicable on the facts of the case as he found them. "The arbitrator was empowered to interpret and apply the parties' agreement to the facts he found to exist; included therein was the power to decide when particular clauses of the contract applied."[11] The supreme court insisted that an actual change in a clause by the arbitrator would have been erroneous. For example, they noted that if the notice-and-cure requirement had been changed by the arbitrator from 60 days to 30 days, this would constitute a change of a term. But excusing the entire notice-and-cure provision altogether was not actually a change.

According to this opinion, a change or modification of contract terms only transpires if express, definite terms of the contract are altered to read something else. Arbitrators must apply the terms of the contract as they are presented, no matter how bizarre or egregiously one-sided those terms may prove to be. As the *Gueyffier* opinion recognizes, arbitrators are not merely fact finders. This, in fact, is likely what the court of appeal in *Gueyffier* and in *O'Flaherty* got wrong. These opinions suggest that there is no room in arbitration for an arbitrator to do anything other than apply the facts to the terms of the contract. This is an oversimplification of an arbitrator's role. The supreme court in *Gueyffier* recognized that simple application of factual scenarios to contract terms is not the only thing that arbitrators are faced with. There will be instances in which a contract cannot or should not be applied as written.[12] In those situations, unless the arbitration provision expressly prohibits it, an arbitrator is automatically granted a reasonable amount of discretion and equitable power. Of course, parties can contract to limit or eliminate even that, but unless such limitation is specifically mentioned in the arbitration agreement, the courts will allow a decision based on that discretion or equitable remedy to stand.

As the supreme court itself noted, this entire debacle could have been avoided had the arbitration provision simply limited the scope of the arbitrator's powers so that he could not base his decision on an excuse of any contractual term. When parties fail to make an explicit limitation of the equitable powers of arbitrators, the supreme court has directed that the arbitrator can and will move beyond simple application of the facts in dispute to the terms of the contract.

Careful Drafting

Gueyffier is a lesson in careful writing of the arbitration agreement. The supreme court in

fact made a lesson out of *Gueyffier,* noting that the entire dispute could have been avoided had the arbitration provision included one more clause. That is, instead of simply limiting the arbitrator from modifying or changing any term of the contract, the parties could have agreed in advance to prevent the arbitrator from "modifying, changing, or *excusing performance*" of any material term of that contract. With those two additional words in the contract, the outcome of the matter would have been entirely different.

The *Gueyffier* arbitrator was able to use his own judgment as a sort of on-off switch that he alone controlled. "The arbitrator was empowered to interpret and apply the parties' agreement to the facts he found to exist; included therein was the power to decide when particular clauses of the contract applied."[13] In essence, once the contract was switched on, all of its provisions and demands had to be met. However, if the relevant contract provision was turned off, the parties' compliance with or breach of this provision was irrelevant to the arbitrator's decision. And the arbitrator was holding the switch.

Gueyffier offers clear insight on how courts will treat arbitration decisions as well as how important it is to craft an arbitration agreement. At the onset of a dispute, courts may allow parties to avoid arbitration,[14] but once arbitration is invoked, courts are extremely loathe to reverse or even scrutinize the decisions of arbitrators. If there is any way for an arbitrator to have reached his or her decision while somehow complying with the limitations of authority as set forth in the arbitration agreement, the court will defer to this decision and will not reverse it for either factual misunderstandings or clear legal error.

Construction of an arbitration provision is vitally important. If, for example, parties to a contract must absolutely depend on the fulfillment of certain obligations, an arbitration provision must not allow for the excuse of such provisions, in any situation, even in those where equity would normally excuse performance. On the other hand, if clients hope to protect themselves from bizarre or unforeseen circumstances that make fulfillment of contractual obligations impossible, the ability of an arbitrator to turn to equitable principles should be incorporated into the arbitration provision that sets out the scope and limits of the arbitrator's authority.

Little can be done in litigation once an arbitration decision is rendered. The decisive steps occur when the arbitration provision is drafted and when the arbitrators are chosen. Unlike litigation, which to a certain extent is always under the control of the higher courts, arbitration can really only be effectively directed from the ground up. Parties who agree to binding arbitration are ceding their constitutional rights to a jury trial and appeal. Once attorneys have to begin to search for a means to overturn an arbitration decision, the battle may already have been lost.

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[1] *See, e.g.,* Abramson v. Juniper Networks, Inc., 115 Cal. App. 4th 638, 662-63 (2004).
[2] *See, e.g.,* Moshonov v. Walsh, 22 Cal. 4th 771, 775-76 (2000).
[3] *See* Azteca Const., Inc. v. ADR Consulting, Inc., 121 Cal. App. 4th 1156, 1168 (2004).
[4] CODE CIV. PROC. §§1281, 1281.2(b).
[5] *See* Advanced Micro Advances, Inc. v. Intel Corp., 9 Cal. 4th 362, 372-75 (1994).
[6] Gueyffier v. Ann Summers, Ltd., 43 Cal. 4th 1179 (2008).
[7] *Id.* at 1183.
[8] Gueyffier v. Ann Summers, Ltd., 144 Cal. App. 4th 166 (2006).
[9] O'Flaherty v. Belgum, 115 Cal. App. 4th 1044 (2004).
[10] *See* Moshonov v. Walsh, 22 Cal. 4th 771, 779 (2000).
[11] Gueyffier, 43 Cal. 4th at 1185.
[12] This is recognized in case law that allows for equitable excuse of contract obligations. *See, e.g.,* O'Morrow v. Borad, 27 Cal. 2d 794, 800 (1946); Root v. American Equity Specialty Ins. Co., 130 Cal. App. 4th 926, 939 (2005); Russell v. Johns Manville Co., 20 Cal. App. 3d 405, 413 (1971).
[13] Gueyffier, 43 Cal. 4th at 1185.
[14] *See, e.g.,* Gatton v. T-Mobile USA, Inc., 152 Cal. App. 4th 571, 579 (2007).