CPR International Institute for Conflict Prevention & Resolution

Alternatives

TO THE HIGH COST OF LITIGATION

INTERNATIONAL INSTITUTE FOR CONFLICT PREVENTION & RESOLUTION VOL. 24 NO. 3 MARCH 2006

Alternatives to the High Cost of Litigation (Print ISSN 1549-4373, Online ISSN 1549-4381) is a newsletter published 11 times a year by the International Institute for Conflict Prevention & Resolution and Wiley Periodicals, Inc., a Wiley Company, at Jossey-Bass. Jossey-Bass is a registered trademark of John Wiley & Sons, Inc.

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Eliminating Unconscionability in Assessing Mandatory Clauses by Deploying the 'Vantage Point of Public Policy'

BY PAUL BENNETT MARROW

In a recent article ("Squeezing Subjectivity from the Doctrine of Unconscionability," 53 *Cleveland State L. Rev.* 187 (2005)), this author proposed a method for containing, if not eliminating judicial subjectivity from, determinations about substantive unconscionability. I argued that courts should abandon the inquiry into the impact of a suspect term on the parties themselves, in favor of an examination of the impact enforcement might have on the integrity of our contracting system.

I pointed out that the resulting decisions should be useful as precedent, an outcome that isn't likely when the focus is on the impact of a term on specific parties.

Let's see how this approach applies to clauses mandating arbitration that are challenged as unconscionable.

A common objection to a mandatory arbitration clause is that it is "unconscionable." Surprisingly, there is little concrete guidance as to what it is about mandatory arbitration that provokes this claim. Clearly, it isn't that mandatory arbitration is per se unconscionable because the public policy of all U.S. jurisdictions is to favor alternative dispute resolution through arbitration, provided that the parties mutually agree to such a system. So is it about specific terms?

The answer is supposed to come from courts on a case-by-case basis. If you are advising a client or attempting to pass on the clause's validity as an arbitrator, you should be able to rely on judicial determinations considering the correctness of a given arbitration scheme.

For example, if terms requiring confidentiality are found conscionable provided a specified criterion is met, the advocate or arbitrator should feel comfortable matching a suspect clause against that criterion. Errors should be minimal because each clause is tested against the specific criterion.

That makes sense. And it should follow that if a number of different courts in different states all apply the same state law

to test the identical clause, the results should be uniform. Simple.

Well, maybe not.

Determinations about unconscionability are cut from a special cloth. By statute and by common law, these determinations are characterized as findings of law. Findings of law have value as precedent because of their universal nature. But a finding of law based on an analysis of subjective factors involving the litigants is really a finding that by definition can't have value as precedent.

Subjective factors work to mold the resulting determination into an idiosyncratic finding. This shouldn't be a surprise if subjective" is defined as "based on or influenced by personal feelings, tastes, or opinions," or "dependent on the mind for existence." Compact Oxford English Dictionary (2005).

The result is a standard that lacks a definition. With different judges, there is a good possibility there will be different results. It's like the famous statement by U.S. Supreme Court Associate Justice Potter Stewart in *Jacobellis v. Ohio,* 378 U.S. 184, 197 (1964). The justice was trying to nail down a definition for pornography: "I could never succeed in intelligibly doing so. But I know it when I see it. . . ."

But is this any way to run a system of jurisprudence?

Consider a clause that provides for a panel of arbitrators composed of individuals, all of whom have an interest in the contract. Is such a provision unfair on the grounds that a fair hearing can't be had should a dispute arise? That was the issue presented by a clause used by a major U.S. accounting firm in its partnership agreement. The BDO Seidman clause is as follows:

> Any controversy or dispute relating to this agreement or to the Partnership and its affairs shall be resolved and disposed of in accordance with this section, except that any accounting provided for in this agreement, to be conclusive, shall not be subject to this procedure, but shall be conclusive upon the Partners and the Partners agree and accept to be bound by any such accounting. *Any dispute or controversy shall be considered and decided by an arbitration panel consisting of two (2) members of the Board of Directors (other than the Chairman and Chief Executive Partner) selected by the Board of Directors and three (3) Partners from the Partnership's practice offices who are not members of the Board of Directors.* The members of the arbitration panel shall be mutually agreed to by the Board of Directors and the parties to the controversy or dispute, provided that no member of the panel shall be from an office in which any complaining Partner was located at the time of the filing of the complaint, nor be otherwise involved in the controversy or dispute. The arbitration panel shall be selected as soon as possible after notice to the Partnership by any Partner that such a controversy or dispute exists. The conduct of the arbitration shall be in accordance with such procedures as the Board of Directors adopts and communicates to the Partners. The vote of a majority of the arbitration

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Published online in Wiley InterScience (www.interscience.wiley.com).
Alternatives DOI: 10.1002/alt

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> panel shall determine the resolution and disposition of any such dispute or controversy. The determination of such arbitration panel shall be conclusive and binding on all the Partners, and shall not be subject to further determination in any type of proceeding within or without the Partnership. . . . [T]his agreement, its validity, construction, administration and effect, shall be governed by and construed in accordance with the laws of the State of New York. (Emphasis added.)

Common sense would suggest that if all courts apply the rules of construction recognized by New York law, the clause would be uniformly found to be either enforceable or unenforceable. And yet, as we'll see, this clause has been found to be both enforceable and unenforceable by 12 different courts, sitting in many jurisdictions through out the United States, and all applying the rules of construction recognized by New York law.

These dozen decisions turn on one of two theories: (a) whether the clause was substantively unconscionable because of its operation on the parties, or (b) whether the clause violates public policy because of an apparent denial of a fair hearing and thus due process. Only four of the courts saw the problem as involving unconscionability. Three of these upheld the clause. The results were identical among the courts that applied the alternative theory, i.e., six of the eight upheld the clause.

RESOLVING COMPETING THEORIES

But how do we account for the fact that there are two theories in the first place and given the results does it matter? Perhaps the answer has to do with subjectivity. Let's take a careful look at the opinions that have been spawned by the BDO Seidman clause and see if subjectivity in fact played a role. And assuming that it does, let's then try to answer the question about the present system's efficacy.

Here's the list of decisions enforcing the clause [available by E-mail from the author upon request]:

Reported—

1. *Hottle v. BDO Seidman LLP,* 268 Conn. 694 (2004).
2. *BDO Seidman LLP v. Bloom,* 2004 N.Y. Slip Op 51419U (Sup Ct N.Y. Cty. 2005).
3. *Greenwald v. Weisbaum et al.,* 785 N.Y.S. 2d 664 (Sup Ct. N.Y. Cty 2004).

Not reported—

1. *Sowan v. BDO Seidman LLP,* No. DV99-2676-B (Tex Dist. Ct 1999).
2. *Waite v. BDO Seidman LLP,* No. 01-4009-C (Mass Sup. Ct. 2002).
3. *Jehle v. BDO Seidman LLP,* No. 012-10118 (Mo. Cir. Ct. 2002).

Concerns about partners on the arbitration panel were found unwarranted, because the parties knew the reality when they signed the clause.

4. *Brown v. Seidman,* File No. 919343-NO (Mich. Cir. Ct. 1992).
5. *Pioso v. Abernathy, L.C.* No. 90-CV-002739 (Wis. Ct. Appeals, 1990).
6. *Selznick v. BDO Seidman LLP,* Index No. 507/95 (Sup. Ct Westchester Cty.).

Here's the list of decisions refusing to enforce the clause:

Reported—

1. *BDO Seidman LLP v. Miller,* 949 S.W. 2d 858 (Tex. Ct of App 1997).
2. *Behrer v. BDO Seidman LLP,* 2003 Mass. Super. LEXIS 235 (Superior Ct 2003).

Not reported—

1. *Romer v. BDO Seidman LLP,* Index No.1995-7807 (Sup Ct. Erie Cty).

All of the cases involved share these common factual elements:

- All arose because of challenges to the legality of the BDO Seidman clause.
- All involved the same business arrangement, i.e., the BDO Seidman partnership agreement, a business arrangement.
- In every case the partner litigant voluntarily executed the agreement and to some degree benefited from the relationship.
- In every case the complaining partner was well educated and capable of understanding the terms being accepted.

The only substantive difference was the *situs* for the challenge.

UNCONSCIONABILITY DISMANTLED

The lead decision finding the clause enforceable and conscionable is the Connecticut Supreme Court's *Hottle*. There the court dismissed the claim that the clause was grossly unfair and one-sided since it gave BDO Seidman exclusive control over the arbitration panel's selection and the arbitral process. Rather, it found that the clause contained measures designed to maintain a level playing field citing the ability of all parties to select a panel from the same pool, albeit one composed of partners of the firm.

"[T]he clause expressly requires that the arbitrators 'shall be mutually agreed to' by the board of directors and the parties to the dispute. As an additional safeguard, the arbitration clause further provides that 'no member of the panel shall be from an office in which any complaining Partner was located at the time of the filing of the complaint, nor be otherwise involved in the controversy or dispute.'" 268 Conn. at 721.

Nor was the court willing to accept the proposition that the clause vested one party with complete control over the arbitral process. "We do not believe that this express language of the arbitration clause,

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Alternatives DOI: 10.1002/alt

alone, is so imbalanced in the defendant's favor as to render the clause substantively unconscionable and to require this court to interfere with the freely made agreement of the parties. Cf. *Hooters of America Inc.* v. *Phillips*, 173 F.3d 939 (4th Cir. 1999) (unfair arbitration rules provided employer with exclusive right to modify rules 'in whole or in part,' whenever it wished and 'without notice' to the employee)." 268 Conn. at 721-22.

Bloom and *Greenwald* are companion cases upholding the clause. They were decided at the same time by New York State Supreme Court Justice Bernard J. Fried. In both, the unconscionability claim was tied to the provision allowing for an arbitration panel consisting entirely of individuals possibly partial to BDO Seidman—individuals who were in reality real parties in interest.

What was the point raised by the one court that found the clause unconscionable? In *Behrer*, the court saw an uneven playing field established by an apparent conflict of interest for the members of the panel: ". . . Use of such arbitrators, who owe a fiduciary duty to one party, creates an 'inherent inequity of having [a party] serve as its own arbitrator to determine matters' under the contract. *Id.* Indeed, the financial interests of the arbitrators are identical to those of the defendant; this is clearly inequitable and unjust. It is beyond question that 'to allow a party to act as its own judge necessarily taints the process and is repugnant to a proper sense of justice.' Id., citing *Cross & Brown*, 167 N.Y.S.2d 573, 575 [(N.Y. App. Div. 1957)]" 2003 Mass. Super. Lexis at 10-11.

Do the decisions upholding the clause show anything more than a callused disregard or unwarranted dismissiveness? Is it that the *Behrer* decision is all about compassion for the underdog?

Public policy isn't violated if a mandatory arbitration clause permits a disputing party's employee to adjudicate disputes.

The court reasoned that since the clause itself required a panel of both non-board members and partners not from the same office as the complaining partner, sufficient precaution had been taken to ensure a fair hearing. "Additionally, since every partner of BDO may be compelled in the future to arbitrate a dispute before such a panel, this dramatically illustrates that there is certainly a reasonable expectation that the arbitration will not be unfair." *Greenwald*, 785 N.Y.S. 2d at 670-71.

Moreover, the concern about the standing of the partners on the panel was found unwarranted because of the reality that the parties knew this factor when they accepted the clause. *Bloom*, 2004 NY Slip Op 51419U at 9-10.

Either way it seems that these decisions speak to judicial attitudes about the parties and their respective circumstances, and not about the public's interest in a system for contracting that supports alternative dispute resolution through arbitration. The result is four decisions that are of little far-reaching value because they are tainted by subjectivity.

THE PUBLIC POLICY APPROACH

The remaining eight cases were resolved using an analysis stressing public policy and concerns about the denial of due process. (*Sowan* and *Pioso* were decided without a written opinion.) For these courts, the issue was whether the propriety of an arrangement that confers on a contracting party the power to adjudicate disputes arising under the contract would pass muster under New York's public policy. (*Jehle* and *Brown* were decided without reference to specific New York case law but the public policy analysis was the same).

These courts weighed the clause against the rules announced in *Westinghouse Electric Corp. v. New York City Transit Authority*, 82 N.Y. 2d 47 (1993), and *Cross & Brown v. Nelson*, 167 N.Y.S.2d 573 (N.Y. App. Div. 1957). The courts that followed *Westinghouse* found the clause acceptable. The courts following *Cross & Brown* found the clause violated New York's public policy.

Westinghouse stands for the proposition that public policy isn't violated if a mandatory arbitration clause permits a disputing party's employee to adjudicate disputes. The case involved an arbitration clause in a construction contract. It provided that the superintendent in charge of the job—one of the defendant's employees—would resolve any disputes. The superintendent's determination would be final subject to judicial review limited to whether or not his determination "is arbitrary, capricious or grossly erroneous to evidence bad faith."

The court held that such an arrangement passed muster for three reasons: (a) The Plaintiff chose "with its business eyes open" and knew what it was getting into when it accepted the term; (b) Allowing a party to such an arrangement a "get out of jail free card" would have a destabilizing effect on the state's commercial law; and (c) Public policy would not be transgressed because of the contracts provision for judicial review. 82 N.Y. 2d at 47-48.

Cross & Brown stands for the proposition that members of a corporate contracting party's board aren't disinterested in the outcome. The case states that public policy is violated when a clause designating board members as the dispute resolution panel is enforced. The clause involved was remarkably similar to the BDO-Seidman clause, providing:

10. It is further agreed between the

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Alternatives DOI: 10.1002/alt

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> respective parties hereto that any dispute or difference as to any matter in this contract contained shall be settled by submitting the same to arbitration to the Board of Directors of the party of the first part (the employer), whose decision shall be final.

The court rejected the clause citing public policy concerns:

> A well recognized principle of "natural justice" is that a man may not be a judge in his own cause. Irrespective of any proof of actual bias or prejudice, the law presumes that a party to a dispute cannot have that disinterestedness and impartiality necessary to act in a judicial or quasi-judicial capacity regarding that controversy. This absolute disqualification to act rests upon sound public policy. Any other rule would be repugnant to a proper sense of justice.
>
> …
>
> What we do hold is that no party to a contract, or someone so identified with the party as to be in fact, even though not in name, the party, can be designated as an arbitrator to decide disputes under it. Apart from outraging public policy, such an agreement is illusory; for while in form it provides for arbitration, in substance it yields the power to an adverse party to decide disputes under the contract. 4 A.D. 2d at 501-02.

The *Cross & Brown* clause has never been reviewed by the New York Court of Appeals, which is the state's top court, and the *Cross & Brown* decision has never been directly reversed or overruled.

Six of the eight courts involved with BDO Seidman favored the *Westinghouse* approach. *Selznick*, a decision by a lower New York court is an example:

> It is the expressed public policy of this State to encourage the use of arbitration as an alternative means of dispute resolution (see *Westinghouse Elec. Corp. v. NYC Transit Auth.*, 82 N.Y. 2d 47 [(N.Y. 1993)]) and the powers of the Court to intervene before an award is made are narrowly circumscribed. On the other hand, it is the duty of this Court to give effect to the terms and conditions of a party's contract rather than rewrite the contract with terms palatable to the Court.
>
> Upon review of the arbitration provision of the partnership agreement and the arbitration procedures adopted by BDO, the Court holds that they do not violate the public policy of this State or petitioner's right to a fair hearing."

Romer, also a decision by a lower New York court, follows the logic of *Cross & Brown*:

> . . . [*Cross & Brown*] . . . is more directly in point than maybe any other case. In *Cross*, the Board of Directors was the complete arbitration panel. The Board of Directors was deemed to be the party and therefore the arbitration panel was not sustained. In this case Defendant would have the inclusion of three "disinterested" partners, not from the "Policy Group," raise the panel to some independent tribunal. To buy into that argument would be to close our eyes to the financial reality of who stands to gain from the outcome. It would also require a quantum leap of faith that the Defendant would and could agree to three of its own partners acting as mutually selected panel members without an expectation that the Defendant's partners would not look out for the financial interests of themselves as partners.

The unconscionability decisions were uniformly subjective and of questionable value as precedent.

The differences notwithstanding, all of these decisions have value as precedent because they involve a discussion of New York's public policy and the consequences that result from enforcing clauses that potentially can undermine the stability of New York's commercial law.

WHAT'S REALLY GOING ON?

No matter the theory employed, the results were the same—75% of the rulings found the clause enforceable. But this shouldn't be seen simply as proof that the same result can be obtained no matter the method of analysis used. The real significance is that the unconscionability theory resulted in decisions that have no widespread value, while those that employed a public policy test have some long-term value.

Note that the courts that resolved the dispute from the unconscionability perspective did so basing their opinions on observations about the clause's operation on the party claiming it to be unconscionable, with no mention—except *Hottle*—about the clause's impact, if enforced, on the stability of the contracting system. These decisions were uniformly subjective and of questionable value as precedent.

By contrast, all the courts that tied the result to concerns about public policy viewed the clause from the perspective of whether enforcement would or wouldn't

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Alternatives DOI: 10.1002/alt

undermine the stability of our system for evaluating contracts. For these courts, what controlled was what was good for the system of law without concern for the litigants. These decisions have value as precedent.

How can we test this conclusion about the long-term value of these decisions? Determinations made "as a matter of law" require the possibility of global application without determinations as to the case's unique facts. A clause that requires the parties to do "A" is either enforceable or unenforceable, notwithstanding the surrounding circumstances.

Therefore, a party wishing to enforce the clause should be able to move for summary judgment based on the rules of construction applicable to a given type of clause or term, assuming the absence of a dispute about performance.

But in the case of determinations involving unconscionability, if the court is permitted to make a factual determination as to the clause's operation, the resulting ruling goes beyond the rules of construction and is based on unique facts, and therefore limited in scope. It follows that a ruling in any of the four unconscionability cases discussed above—being focused on unique facts and circumstances—are therefore of little or no global application.

Contrast this reasoning to the results reached by the eight courts that measured the clause from the public policy viewpoint. A determination by the New York Court of Appeals in any of these situations would yield a rule that clauses of this type are either enforceable or unenforceable, and such a ruling would be global and thus useful to a party seeking summary judgment.

GO FOR THE ALTERNATIVE

What this suggests is that when possible it is best to avoid an unconscionability analysis when an alternative theory for analysis is available. Setting aside terminology, the investigation enjoining analysis in the first place is the same: What is and what isn't fair and just?

The unconscionability analysis stresses fair and just as measured against factors such as oppression, surprise and unequal bargaining powers, while the analysis about public policy stresses the stability of the contracting system. But either way, the goal is the determination of what is fair and just.

Seen in this light it can be said that both approaches are in fact different sides of the same coin. This conclusion is further supported by the *Hottle* decision. There, the court determined that the clause not only passed muster when tested for unconscionability, but that it also was acceptable when considered using a public policy analysis.

The opinion gave three reasons supporting the supposition that the clause wasn't illusory or in violation of New York's public policy: (a) The panel wasn't a party to the dispute since the claim was asserted against the partnership itself and the individual partners sitting on the panel did not "share the same legal identity as the partnership for the purposes of the partnership agreement." 268 Conn. at 714-716; (b) *Westinghouse* establishes that in New York an employee can make determinations where his or her employer is a party to the subject contract; and (c) None of the partners on the panel were either a party to the contract dispute or "someone so identified with the party as to effectively be that party. . . ." 268 Conn. at 718.

* * *

Dealing with the appropriateness of a mandatory arbitration clause from the view that it is possibly unconscionable leads only to uncertainty because each clause must be tested against a subjective standard. When unconscionability is that standard, the decision must be made as a matter of law but as we have seen this isn't possible because subjectivity inevitably comes into play. But things change, and they change for the better, when public policy is brought to bear on the problem.

What this suggests is that the New York Court of Appeals will need to resolve the legal conflict between *Westinghouse* and *Cross & Brown*. That decision will yield a global rule of law about the propriety of the BDO-Seidman clause from the vantage point of public policy. And what results will be a rule of law that has widespread application.

DOI 10.1002/alt.20117
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