Litigation

Don't Ignore the Details of the Arbitration Agreement

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Often the alternative dispute resolution provisions in a contract are considered only after a lengthy and complex negotiation involving the substantive aspects of a transaction. As a result, the parties, weary and eager to complete their task, fail to give sufficient attention to the details of the procedures binding them in the event of disagreement. Only too late do they appreciate that they may have submitted to a process that will be unfair and put them at a significant disadvantage should arbitration be required.

A recent case from the U.S. District Court for the Northern District of Texas, Dallas Division—*AVIC International USA v. Tang Energy Group*, Civil Action No. 3:14-CV-2815-K, February 5, 2015—reflects a situation in which plaintiffs found themselves in just such an uncomfortable position.

In 2008, the two plaintiffs had entered into a limited liability company agreement with the five defendants. The agreement contained a provision under which all disputes were to be resolved by binding arbitration. The agreement provided that any "disputing member" could initiate arbitration by notifying all of the other "disputing members" and providing a demand for arbitration, a statement of the matter in controversy, and "the name of the arbitrator appointed by the disputing member." A disputing member was "each member that is a party to such dispute."

The agreement then provided that each disputing party receiving notice of the dispute should name an arbitrator. Once all of the party-appointed arbitrators were selected, they were to select an additional arbitrator. Finally, "In the event that there

are more than two disputing members to the dispute … the arbitrators selected by

the disputing members shall cause the appointment of either one or two arbitrators as necessary to constitute an odd number of total arbitrators hearing the dispute."

In 2014, the two plaintiffs contended that there had been a breach of the agreement by the other five members to it and demanded arbitration. Under the terms of the arbitration agreement, each of the plaintiffs was entitled to select an arbitrator for a total of two, and each the five defendants was entitled to select an arbitrator for a total of five, resulting in a total of seven arbitrators. The seven arbitrators then selected two additional arbitrators so that, in accordance with the agreement, there would be an odd number of arbitrators.

Ultimately, the plaintiffs recognized that they were at a serious numerical disadvantage as the five arbitrator appointees of the defendants alone constituted a majority of the arbitration panel, and they presumably selected the two additional arbitrators as well.

Accordingly, the plaintiffs sought a declaratory judgment from the court claiming that the arbitrator selection process in which they had engaged "deviates" from the selection provisions in the agreement; they further argued that it should be construed as authorizing the plaintiffs to select one arbitrator for their side and the defendants to select one arbitrator for their side. The two arbitrators so selected would then select the third arbitrator. Otherwise, the, plaintiffs argued, "the current panel fails to comply with the constitutional requirement that disputes be resolved by an impartial decision-maker because the 'deck is stacked' against plaintiffs."

Contending that the arbitration panel as currently comprised is "inherently unfair and not neutral," they requested that the court order the reconstitution of the panel according to the "correct" process authorized by their interpretation of the arbitration provision.

The defendants moved to dismiss the plaintiffs' lawsuit on the ground that the courts have very limited jurisdiction to intervene in the arbitral process and, in particular, under the Federal Arbitration Act (FAA) may not consider the plaintiffs' claims until after an arbitration award had been issued.

In its considerations, the court noted Congress' liberal policy favoring arbitration and the enforcement of arbitration agreements. It further recognized that the FAA "expressly favors the selection of arbitrators by parties rather than the courts" and that a court's jurisdiction to intervene is very limited under the FAA. On the other hand, "judicial intervention may be required to achieve the goal of moving parties out of the courts and into arbitration promptly and efficiently."

Thus, to assist the arbitration process, the court under the FAA may intervene if there is a breakdown in the process of naming the arbitrators. This may involve an agreement that does not provide a method for selecting arbitrators, a party that refuses or fails to follow the method provided or "if there is a lapse in the naming of an arbitrator or arbitrators." Such a lapse might involve the passage of time or the filling of a vacancy in the arbitration panel. Absent such a "lapse," the parties "must adhere to their contractual arbitration selection procedure if one exists."

Based on these principles the court granted the defendants' motion to dismiss the plaintiffs' action on the ground that it had no jurisdiction. It specifically rejected the plaintiffs' contentions that the "impasse" created by their refusal to arbitrate before the current panel "where the deck was stacked against them," giving "the appearance of bias, violating their constitutional right to an impartial decision-maker," created a "lapse" warranting the court's intervention.

The court pointed out that each party had appointed its arbitrator with no delay strictly in accordance with the terms of the agreement. Moreover, a "lapse" cannot be deemed to have been created under either the FAA or case law merely because one of the parties refuses to participate in the arbitration.

Similarly, the court does not gain jurisdiction based on a contention that constitutional rights were being violated because of the alleged unfairness resulting from the imbalance in the numbers of arbitrators on each side resulting from adherence to the provision in the arbitration provision itself. This argument relates only to the fairness of the selection process in the arbitration provision. Whether a selection process is fair, however, goes to the procedure of arbitration, an issue that is initially is for the arbitrator(s) to decide. (Of course, in this case, this is the very alleged unfairness that the plaintiffs feared.).

Eventually, the court will be in a position to consider bias and vacatur, but only after the arbitration has been completed and an award has been made.

The lesson from the above scenario should be clear. In drafting dispute resolution provisions, counsel must be continually alert to pitfalls lurking in provisions that on their face are perfectly fair. Here, the language of the arbitrator selection provision allowing each party to select an arbitrator may have appeared to be even-handed, although as a practical matter, it offered a significant advantage to the defendants.

To undo this perceived unfairness, the plaintiffs will be required to arbitrate the entire matter before they have the opportunity to present their bias argument to a court. Moreover, the likelihood of vacatur based on bias will be highly unlikely as the arbitrators were apparently selected in strict compliance with the language of the agreement itself in which the plaintiffs had joined. Closer attention to the arbitrator selection process initially would, in all likelihood, have eliminated the danger to which

the plaintiffs were ultimately exposed.