*The Arbitration Newsletter*

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*The Arbitration Newsletter* is published periodically by Whitaker, Chalk, Swindle and Sawyer, L.L.P., Fort Worth, Texas to explore the rapidly developing law and practice of commercial arbitration both in the U.S. and other countries.[1]

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## ARBITRABILITY AND UNCONSCIONABILITY OF CONSUMER ARBITRATION AGREEMENT

### *Bess v. DirecTV, Inc.*, 2007 Ill. App. LEXIS 757 (2007).

In November 2000, Charlotte Bess filed suit against DirecTV alleging that a $5 administrative late fee charged by the company violated Illinois law.[2] DirecTV moved to stay the proceedings and to compel arbitration pursuant to the dispute-resolution clause in DirecTV's Customer Agreement.[3] However, the circuit court of St. Clair County denied DirecTV's motion, finding that the arbitration agreement was procedurally and substantively unconscionable and, therefore, unenforceable.[4]

DirecTV filed an interlocutory appeal, first arguing that the unconscionability of the Customer Agreement as a whole was a matter to be determined by the arbitrator, not the court.[5] The Illinois appellate court disagreed, stating that where a party challenges the validity of the arbitration provision itself and not the contract as a whole, the issue of unconscionability is an issue for the court to decide, not the arbitrator.[6]

Next, the court turned to the conscionability of the arbitration clause, noting that ordinary state contract laws and principles are applicable in determining whether the parties in a dispute actually agreed to arbitrate.[7] The court held that, under the circumstances, the arbitration provision was procedurally unconscionable[8] and therefore unenforceable.[9] First, because Bess was a consumer dealing with a "nationwide provider of satellite television services," the parties were in disparate bargaining positions.[10] Second, the Customer Agreement that contained the arbitration provision was a preprinted form contract, which the court deemed an adhesion contract because "Bess had no hand in drafting it but, instead, had to 'take it or leave it' as

DirecTV drafted it."[11] Finally, the arbitration provision "was printed in single-spaced lines of very small font on the last two panels of a multipaneled pamphlet,"[12] and DirecTV first provided the agreement to Bess with her first monthly bill which was "after Bess had already purchased [the] satellite television equipment and contracted to receive DirecTV service."[13] Thus, Bess could not have seen the arbitration provision before entering into the DirecTV contract.[14] In light of these facts, the court concluded that the contract was unconscionable, and therefore unenforceable, because Bess was deprived of a "meaningful choice" in deciding whether to enter into the contract.[15]

## *RES JUDICATA* AND COLLATERAL ESTOPPEL FOR ARBITRATION

### *Collins v. D.R. Horton, Inc.*, 2007 U.S. App. LEXIS 22613 (9th Cir. 2007).

The Ninth Circuit in extensive *dicta* has recently observed that "'[a]rbitrators are not free to ignore the preclusive effect of prior judgments under the doctrines of res judicata and collateral estoppel, although they generally are entitled to determine in the first instance whether to give the prior judicial determination preclusive effect.'"[16] The Court addressed "whether arbitrators possess the same broad discretion that district courts possess to determine when to apply offensive non-mutual collateral estoppel," and concluded that arbitrators do.[17]

Three executive employees of D.R. Horton, Inc. ("Horton") filed separate but almost identical lawsuits against Horton in Arizona federal court. One case resulted in a jury verdict and judgment for one of the three employees. The second case, filed by the other two employees, was sent to arbitration. The arbitration resulted in an award for the other two employees except for one cause of action on which the litigation employee had been successful.[18] The arbitration employees asked the arbitrators to apply "offensive non-mutual collateral estoppel" in support of their unsuccessful cause of action, but the arbitrators refused.[19]

The arbitration employees asked the trial court to vacate the arbitration award based on "manifest disregard of the law." Both the trial court and the Ninth Circuit refused to vacate the award explaining that because an arbitrators' discretion to apply res judicata and collateral estoppel had never been addressed in any of the federal circuits, the arbitrators had not manifestly disregarded the law.[20] The Ninth Circuit also noted that 9 U.S.C. §10 "does not sanction judicial review of the merits of arbitration awards."[21] The arbitrators did not ignore "well defined, explicit, and clearly applicable" governing law when they chose not to apply "offensive non-mutual estoppel" in this arbitration.[22] Both the prior judgment on appeal and "the FAA's narrow scope of review limit[] the ability of an arbitration defendant to overturn a collateral estoppel-based arbitration award in the event the [prior] judgment upon which [the award] is based is

vacated or reversed on appeal."[23] The arbitrators, therefore, applied their broad discretion in choosing not to apply "offensive non-mutual estoppel" in this arbitration.

The Ninth Circuit, in this otherwise straightforward application of "manifest disregard of the law," chose to give arbitrators three guiding principles for the exercise of their broad discretion when faced with res judicata and collateral estoppel claims– whether offensively or defensively.[24]

1. "'[A]rbitrators are not free to ignore the preclusive effect of prior judgments under the doctrines of res judicata and collateral estoppel...'";[25]

2. "[A]rbitrators are entitled to determine in the first instance whether the prerequisites for collateral estoppel are satisfied...";[26] and

3. "[A]rbitrators possess broad discretion to determine when they should apply offensive non-mutual collateral estoppel."[27]

**Our Lessons from *Collins v. D.R. Horton, Inc.***

1. As an advocate, don't dismiss the importance of res judicata and collateral estoppel if applicable to your arbitration facts. As with dispositive motions, there is a myth among practitioners that such doctrines are inapplicable.

2. As an arbitrator, recognize your responsibility to apply the doctrines of res judicata and collateral estoppel (if the law of your federal circuit permits).

3. As an arbitrator confronted with these doctrines, especially offensive use of these doctrines, recognize your broad discretion to make sure that no unfairness is worked on the parties by the application of these doctrines.

4. We will watch for further developments in other circuits of an arbitrator's discretionary use of res judicata and collateral estoppel.

## EXPANDED JUDICIAL REVIEW OF ARBITRAL AWARDS:[28] SUMMARY OF BRIEF OF AMICUS CURIAE AMERICAN ARBITRATION ASSOCIATION IN

***Hall Street Associates, L.L.C. v. Mattel, Inc.*, 127 S. Ct. 2875 (2007) (No. 06-989).[29]**

AAA is opposed to expanded judicial review of arbitral proceedings because allowing parties to contract for judicial review would fundamentally undermine the expediency, economy, flexibility, and finality of arbitral proceedings;[30] contravene Congress's intent to separate the arbitral and judicial processes and to protect the finality of arbitral awards;[31] involve an unconstitutional delegation of the Congress's legislative power over the conduct of courts;[32] and conflict with the respect for finality embraced by the international arbitration community.[33]

## A Subversion of the Arbitral Process

Expanded judicial review would fundamentally undermine the arbitral process.[34] The bedrock of arbitration is expediency, economy, flexibility, and finality.[35] Arbitration reduces the burden on courts, allows parties to choose an experienced arbitrator, reduces the costs of resolving disputes, decreases the time in which disputes are resolved, and permits flexibility in the manner in which disputes are resolved.[36] If parties are able to demand court review of arbitral decisions, the benefits of arbitration will be minimized and arbitration will look more like litigation– not a substitute for it.[37] Judicial review of arbitral proceedings will necessarily increase the amount of time and money that it takes to resolve disputes; countermine the reduced burdens on courts; and encourage arbitrators to engage in more formal procedures relating to discovery, record-keeping, and decisionmaking, thereby reducing the flexibility and informality of the arbitration process.[38] Moreover, the contractual provisions that expand judicial review would themselves invite additional litigation and court involvement, further prolonging the arbitration process.[39]

## A Threat to Congress's Intent in Drafting the FAA

Expanded judicial review would threaten Congress's intent to separate the arbitral and judicial processes and to protect the finality of arbitral awards.[40] Under the FAA, a court's role in an arbitral proceeding is strictly limited.[41] A court may issue a stay of litigation pending an arbitral decision, compel arbitration if the parties have agreed to arbitration in a written contract, appoint arbitrators if not already specified in the parties' agreement, and compel witnesses to attend arbitral proceedings.[42]

Once an award is rendered, the court's role is limited even further. The court must grant an order confirming an arbitral award except in rare circumstances.[43] An award cannot be vacated unless the award was procured by corruption, fraud or undue means; there was evident partiality or corruption in the arbitrator; the arbitrator was guilty of misconduct in refusing to postpone the hearing or refusing to hear certain evidence, or guilty of other misconduct that prejudiced the proceeding; or the arbitrator exceeded his or her powers.[44] While some lower courts have permitted vacatur on the common-law ground of "manifest disregard" of the law, this judicially-created exception to the FAA is still "qualitatively different from party-created standards of review, which would be infinite, inconsistent, and more difficult to apply."[45]

## Not an Issue of Party Autonomy

Party autonomy in determining arbitral procedures is one of the benefits of arbitration; however, party autonomy applies to parties' ability to formulate an arbitration agreement that addresses arbitral rules and procedures, and applies only to the extent that contracted-for rules do not violate the FAA's objectives of expediency, economy, flexibility and finality.[46] Party autonomy does not apply to judicial rules and procedures that come into play after an arbitral award has been rendered.[47]

Expanded judicial review also would involve an unconstitutional delegation of congressional power.[48] Congress's power to legislate how federal courts conduct themselves does not encompass delegating to private parties the power to regulate courts by contracting to alter standards of judicial review.[49]

While party autonomy does not extend to expanded judicial review, parties who wish to contract for appellate review of an arbitral award have other alternatives. For example, parties are free to contract for review by an arbitral panel.[50] In fact, AAA has drafted a clause for use by parties who wish to provide for arbitral appellate review in an arbitration agreement.[51] Moreover, the parties can contract to have a judge appointed as one of the appellate arbitrators,[52] and establish the standard of review that will be applied by the appellate panel.[53]

## At Odds with the International Arbitral Community

Expanded judicial review would put the United States at odds with the international arbitration community whose "arbitral mechanisms reflect a strong belief in the finality of arbitral awards."[54] Like the FAA, the statutes of most countries strongly favor a limited role of courts in arbitration.[55] No country permits parties to contractually create their own standards of judicial review of arbitral awards.[56] In fact, the international arbitral community discourages court involvement in arbitral proceedings and instead emphasizes the final and binding nature of arbitral awards and the limited grounds on which awards are subject to court review.[57]

## Conclusion

AAA's opposition to expanded judicial review of arbitral proceedings is grounded on its respect for the expediency, economy, flexibility, and finality of arbitral proceedings[58] and its belief that increasing judicial involvement in arbitral proceedings would belie Congress's intent to make arbitration a substitute for litigation.[59] In addition, AAA believes that allowing parties to contract for judicial review of arbitral awards would be an unconstitutional delegation of Congress's legislative power[60] and conflict with the international community's respect for finality in arbitral proceedings.[61]

**Endnotes**

1. Nothing in *The Arbitration Newsletter* is presented as or should be relied on as legal advice to clients or prospective clients. The sole purpose of *The Arbitration Newsletter* is to inform generally. The application of the comments in *The Arbitration Newsletter* to specific questions and cases should be discussed with the reader's legal counsel.

2. *Bess v. DirecTV, Inc.*, 2007 Ill. App. LEXIS 757, *6 (2007).

3. *Id.*

4. *Id.* at *7.

5. *Id.* at *7, *10.

6. *Id.* at *10, *12.

7. *Id.* at *9. "The Supreme Court has confirmed that 'generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening [the FAA ].'" *Id.* at *10 (quoting *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 687 (1996)).

8. "'Procedural unconscionability refers to a situation where a term is so difficult to find, read, or understand that the plaintiff cannot fairly be said to have been aware he was agreeing to it.'" *Id.* at *13-14 (quoting *Razor v. Hyundai Motor America*, 854 N.E.2d 607, 622 (Ill. 2006)). "'Courts are more likely to find [procedural] unconscionability when a consumer is involved, when there is a disparity in bargaining power, and when the consequential damages clause is on a pre-printed form.'" *Razor,* 854 N.E.2d at 622-23 (quoting *Pierce v. Catalina Yachts, Inc.*, 2 P.3d 618, 623 (Alaska 2000)).

9. *Bess,* 2007 Ill. App. LEXIS at *20. The court noted that it did not need to address the issue of whether the arbitration provision was substantively unconscionable: "because we find that the arbitration provision is procedurally unconscionable and that the procedural unconscionability is sufficient to invalidate the arbitration provision, we need not address the issue of whether the arbitration provision is also substantively unconscionable." *Id.* at *22-23 (citing *Kinkel v. Cingular Wireless*, LLC, 857 N.E.2d 250, 263 (Ill. 2006) ("A finding of unconscionability may be based on either procedural or substantive unconscionability, or a combination of both.")).

10. *Id.* at *20.

11. *Id.* "'While the fact that a contract is offered in a form contract on a take-it-or-leave-it basis does not automatically render a contract term procedurally unconscionable.... [However,] courts have long found provisions offered on a take-it-or-leave-it basis and also hidden in a maze of fine print to be procedurally unconscionable.'" *Id.* at *15-16 (quoting *Kinkel*, 828 N.E.2d at 818-19).

12. *Id.*

13. *Id.* at *21.

14. *Id.*

15. *Id.*

16. *Collins v. D. R. Horton, Inc.*, 2007 U.S. App. LEXIS 22613, *13 (9th Cir. 2007) (quoting *Aircraft Braking Sys. Corp. v. Local 856*, 97 F.3d 155, 159 (6th Cir. 1996)).

17. *Id. See Parklane Hosiery Co. v. Shore*, 493 U.S. 322, 326 (1979), for definitions of res judicata, collateral estoppel, and offensive (and defensive) non-mutual collateral estoppel. *See also Appling v. State Farm Mut. Auto. Ins. Co.*, 340 F.3d 769, 775 (9th Cir. 2003) (citing *Parklane Hosiery*, 439 U.S. at 326).

18. *Collins*, 2007 U.S. App. LEXIS at *8.

19. *Id.* at *7.

20. *Id.* at *10, *24.

21. *Id.* at *10-11.

22. *Id.* at *24 (citing *Carter v. Health Net of Cal., Inc.*, 374 F.3d 830, 838 (9th Cir. 2004)).

23. *Id.* at *22 (citing *Collins v. D.R. Horton*, Inc., 361 F.Supp.2d 1085, 1089-90 (D. Ariz. 2005)).

24. *Id.* at *20.

25. *Id.* (quoting *Aircraft Braking*, 97 F.3d at 159).

26. *Id*. (citing *Aircraft Braking*, 97 F.3d at 159).

27. *Id*. (citing *Parklane Hosiery*, 439 U.S. at 331).

28. The federal circuits are split on whether parties can contractually expand judicial review of arbitration awards. Cases in which a federal circuit court has refused to allow expanded judicial review include *Kyocera Corp. v. Prudential-Bache Trade Servs, Inc.*, 341 F.3d 987 (**9th Cir**. 2003) ("Congress has specified the exclusive standard by which federal courts may review an arbitrator's decision" under the FAA and "private parties may not contractually impose their own standard on the courts"); *Hoeft v. MVL Group, Inc.*, 343 F.3d 57, 65 (**2d Cir.** 2003) (suggesting that the court would not permit expanded judicial review: "[j]udicial standards of review, like judicial precedents, are not the property of private litigants."); *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925 (**10th Cir.** 2001) (holding that private parties may not contract for a standard of review more expansive than that stated in the Federal Arbitration Act); *UHC Mgmt. Co. v. Computer Scis. Corp.*, 148 F.3d 992, 997 (**8th Cir.** 1998) (suggesting that it would refuse to permit expanded judicial review, but not finally deciding the issue because the contract language was insufficient to indicate the parties' intent); *Chi. Typographical Union No. 16 v. Chi. Sun-Times, Inc.*, 935 F.2d 1501, 1505 (**7th Cir.** 1991) ("If the parties want, they can contract for an appellate arbitration panel to review the arbitrator's award[;] [b]ut they cannot contract for judicial review of that award.").

    Cases in which a federal circuit court has held that parties may contract to displace the FAA standards of review include *P.R. Tel. Co. v. U.S. Phone Mfg. Corp.*, 427 F.3d 21, 31 (**1st Cir.** 2005) ("We agree... that the parties can by contract displace the FAA standard of review, but that displacement can be achieved only by clear contractual language."); *Harris v. Parker College of Chiropractic*, 286 F.3d 790, 793 (**5th Cir.** 2002) ("[P]arties may contractually modify the standard of review of an arbitration award."); *Roadway Package Sys., Inc. v. Kayser*, 257 F.3d 287, 288-89 (**3rd Cir.** 2001) (stating that "parties [may] contract for vacatur standards other than the ones provided in the FAA; ... [the] rule is simply that courts must enforce the terms of private arbitration agreements."), *cert. denied*, 534 U.S. 1020 (2001).

29. Certiorari has been granted in this appeal from the 9th Circuit. *Hall St. Assocs., L.L.C. v. Mattel, Inc.*, 2006 U.S. App. LEXIS 19527 (9th Cir. 2006), *cert. granted*, 127 S. Ct. 2875 (2007) (No. 06-989). American Arbitration Association ("AAA") has filed its *amicus curiae* brief in this matter and is summarized by Rebecca K. Eaton of our law firm in this issue of *The Arbitration Newsletter*. AAA opposes expanded judicial review of arbitration awards.

30. Brief of Amicus Curiae American Arbitration Association at 6, Hall Street Associates, L.L.C. v. Mattel, Inc., 127 S. Ct. 2875 (2007) (No. 06-989).

31. *Id.* at 12.

32. *Id.* at 18.

33. *Id.* at 24.

34. *Id.* at 6.

35. *Id.* at 7-8.

36. *Id.*

37. *See id.* at 9.

38. *Id.*

39. *Id.* at 10.

40. *Id.* at 12.

41. *Id.* at 14.

42. *Id.* at 14 n.2.

43. *Id.* at 14.

44. *Id.* at 15 n.3.

45. *Id.* at 17.

46. *Id.* at 19 (citing *Volt Info. Sciences, Inc. v. Bd. of Trustees of the Leland Stanford Junior Univ.*, 489 U.S. 468, 475-76 (1989)).

47. *Id.* at 18.

48. *Id.* at 20-21.

49. *Id.*

50. *Id.* at 21.

51. *Id.* at 22.

52. *Id.* at 21-22.

53. *Id.* at 22.

54. *Id.* at 26.

55. *Id.* at 24.

56. *Id.*

57. *Id.*

58. *Id.* at 6.

59. *Id.* at 12.

60. *Id.* at 18.

61. *Id.* at 24.