PITFALLS IN DRAFTING ARBITRATION CLAUSES

By David Loewenstein

Based on my experience litigating arbitration clauses, I have recognized some important issues that should be considered at the drafting stage, rather than when the time comes to enforce them. The last thing you want to do is draft an ambiguous clause that will require litigation to enforce, when the reason for the clause in the first instance was to avoid litigation, and to streamline dispute resolution.

For example, imprecise language about the scope and duration of the arbitration clause can lead to a complex and costly dispute concerning the arbitrability of the claim. I set out below some suggestions for avoiding these problems.

I. WAR STORY

One case I litigated involved a supply agreement between a large established company and a small start-up, which included various patent licenses. The start-up initially faced financial difficulties and the underlying agreement, which had a broad arbitration provision, was terminated, but the arbitration provision survived termination. The start-up’s financial difficulties were resolved; it later prospered, and several years later it was sued for patent infringement based on the patents that had been licensed. The question was whether the parties were obligated to arbitrate their differences. It was a close call, which was not resolved, but the problem, and the significant costs involved in briefing the issue and participating in the suit while the motion was pending, could have been avoided had the parties considered in more

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detail the language used in the arbitration provision, rather than seemingly relying on “boilerplate.”

In some jurisdictions, the case will proceed even if a motion to dismiss has been filed. Therefore, the parties’ underlying objective (or at least one of the party’s objectives), relatively inexpensive arbitration is thwarted if the arbitration provision is unclear. The dispute, at least in the beginning stages, will be litigated, probably costing considerably more than arbitration, and almost certainly delaying the resolution.

II. STRONG POLICY TO ENFORCE ARBITRATION CLAUSE

To begin with, it is well understood that there is an overriding federal policy embodied in the Federal Arbitration Act (“FAA”) favoring arbitration requiring Courts to “rigorously enforce” arbitration provisions. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985). At least half a dozen Supreme Court decisions have emphasized the strong federal policy favoring arbitration created by the FAA.² Section 2 of the FAA states in relevant part (emphasis added):

A written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.


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The Supreme Court in *Mitsubishi*, reiterated the long-standing principle embodied in the FAA:

*The Bremen*[^1^] and *Scherk* establish a strong presumption in favor of enforcement of freely negotiated contractual choice-of-forum provisions. Here, as in *Scherk*, that presumption is reinforced by the emphatic federal policy in favor of arbitral dispute resolution.

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‘[T]he preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered,’ a concern which ‘requires that we rigorously enforce agreements to arbitrate.’ *Mitsubishi* at 631 and 625-26 (citation omitted).

Where there is ambiguity or doubt regarding the arbitration provision, arbitration will be favored and “only the most forceful evidence of a purpose to exclude the claim from arbitration can prevail.” *Nestle*, 505 F.3d at 503 (emphasis added) (quoting *AT&T Techs., Inc. v. Commc'ns Workers of Am.*, 475 U.S. 643, 650, 106 S.Ct. 1415, 89 L. Ed. 2d 648 (1986)). Because of the federal policy favoring arbitration, in *Neal* the Fifth Circuit held:

> [A]rbitration should not be denied ‘unless it can be said with positive assurance that the arbitration clause is not susceptible of an interpretation which would cover the dispute at issue.’

*Neal v. Hardee’s Food Systems, Inc.*, 918 F.2d 34, 37 (5th Cir. 1990); accord *Safer v. Nelson Financial Group, Inc.*, 422 F.3d 289, 294 (5th Cir. 2005).

However, the primary purpose of the Arbitration Act is to enforce private arbitration agreements not judicial efficiency or expeditious dispute resolution[^4^]. “Arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed to submit.” *Mediterranean Enterprises, Inc. v. Ssangyong Corp.*, 708 F.2d 1458,

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[^4^]: *Dean Witter supra*, 470 U.S. 213.
Although, this federal policy exists, it is not a panacea. It must be reconciled with the specific contract language, which will ultimately determine arbitrability.

In the case mentioned above, the presumption certainly was in play, but the agreement’s language was needed to help the Court resolve the ambiguity.

III. SUBJECT MATTER JURISDICTION

Where there is a binding arbitration provision, there is no judiciable controversy and the Court consequently lacks subject matter jurisdiction. As explained in the footnote, Courts have dismissed cases based on arbitration provisions under Federal Rules 12(b)(1), (b)(3), (b)(6), as well as Rule 56.  

Taking into consideration the strong federal policy in favor of enforcing arbitration agreements, Courts generally review arbitration provisions with a limited two-step inquiry:

‘(1) whether there is a valid agreement to arbitrate between the parties; and (2) whether the dispute in question falls within the scope of that arbitration agreement.’

Safer, supra, 422 F.3d at 293 (citations omitted); see also Mitsubishi at 628.
Under AAA rules, the arbitrator will decide in the first instance if the case should be arbitrated. “One of those rules states that ‘the arbitrator shall have the power to determine the existence or validity of a contract of which an arbitration clause forms a part.’” *Preston* at 361 (citing AAA Commercial Arbitration Rule 7(b)); see also *Buckeye*, *supra*, 546 U.S. at 446 and 449 (“[A] challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator.”). The threshold question of arbitrability is also for the arbitrator under AAA rule 7(a), which states:

> The arbitrator shall have the power to rule on his or her jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement.


When the parties cede the decision concerning arbitrability to the arbitrator, the Court’s role considering this issue is significantly circumscribed. In this situation, the Court can consider only whether the claim for arbitrability is “wholly groundless.”

> Because any inquiry beyond a ‘wholly groundless’ test would invade the province of the arbitrator, whose arbitrability judgment the parties agreed to abide by in the 2001 Agreement, the district court need not, and should not, determine whether Nokia’s defenses are in fact arbitrable.

*Qualcomm Inc. v. Nokia Corp.*, 466 F.3d 1366, 1374 (Fed. Cir. 2006).

Any ambiguity in the scope of an arbitration provision, in conjunction with the presumption of arbitrability, requires the matter to be submitted to the arbitrator:

> The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.

*Moses Cone* at 24-25.
Incorporation of the AAA Rules within the dispute provision “clearly and unmistakably shows the parties’ intent to delegate the issue of determining arbitrability to an arbitrator.” *Qualcomm* at 1373-74. This rule has been followed by courts in at least the following circuits: Federal, 1st, 2nd, 7th, 10th and 11th 6 -- and in California:

[T]he Court is persuaded that the prevailing rule across jurisdictions is that incorporation by reference of rules granting the arbitrator the authority to decide questions of arbitrability -- especially the AAA rules -- is clear and unmistakable evidence that the parties agreed to submit arbitrability questions to the arbitrators.


Therefore, it may save considerable resources later if the drafters incorporate an organization’s arbitration rules, specifically state that any disputes about arbitrability should be determined by the arbitrator, and perhaps include a provision stating that while the arbitrator is considering the issue any Court action should be stayed. There is a substantial possibility for inefficiency, if a Court, for example, determines that arbitrability is a question in the first instance for the arbitrator, who then determines that the issue is not arbitrable, and returns dispute back to Court.

Considering the issue in advance, therefore, may avoid costly motion practice and associated delay.

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IV. **THE OPERATIVE CLAUSE**

The scope of the arbitration provision is determined by the specific language used within the clause articulating the subject matter intended to be arbitrated. There is a spectrum of possible language: “arising hereunder” or “arising out of” and “arising out of or relating to.”

For example, use of the phrase “arising hereunder” narrows the scope of the arbitration provision to primarily issues of contract interpretation and performance, as well as formation in certain circuits. In *Mediterranean Enterprises*, the Ninth Circuit interpreted “‘arising hereunder’ as synonymous with ‘arising under the Agreement’… ‘relatively narrow as arbitration clauses go.’” *Mediterranean Enterprises* at 1464 (quoting *Sinva, Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 364 (S.D.N.Y. 1966)). The Court was persuaded by a line of cases from the Second Circuit including, *In re Kinoshita & Co.*, 287 F.2d 951, 953 (2d Cir. 1961) holding that when an arbitration clause “refers to disputes or controversies ’under’ or ‘arising out of’ the contract,” arbitration is restricted to “disputes and controversies relating to the interpretation of the contract and matters of performance.” The Ninth Circuit adopted Second Circuit’s view that determined the omission of ‘relating to’ the agreement within the arbitration clause as significant. The Ninth Circuit reaffirmed its holding from *Mediterranean Enterprises* in *Tracer Research Corp. v. Nat'l Envtl. Servs. Co.*, 42 F.3d 1292 (9th Cir. Ariz. 1994), whereas the Second Circuit has confined the holding of *Kinoshita* to its facts: “We reaffirm that this Court's decision in *In re Kinoshita & Co.*, concluding that the use of the phrase "arising under" results in a narrow arbitration clause, has been *limited to its precise facts.*” *ACE Capital Re Overseas Ltd. v. Cent. United Life Ins. Co.*, 307 F.3d 24, 26 (2d Cir. N.Y. 2002) (emphasis added; citation omitted). Most federal circuits, in deference to the strong policy

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in favor of arbitration, have since moved away from the Ninth Circuit’s strict view that “arising under” relates only to issues of contract interpretation and performance and broadened the scope of such language to also include disputes of contract formation.  

In *Prima Paint*, the Supreme Court held that “any controversy or claim *arising out of or relating to* this Agreement” to be a broad arbitration clause. *Prima Paint* at 398 (emphasis added). Furthermore, “arising out of or relating to” is the standard language recommended by the AAA.  

The breadth of subject matter “arising under” versus “arising out of or relating to” the agreement is quite different. A substantial and preventable drafting error is the interchangeable use of one phrase for the other and not explicitly stating the intended scope of the arbitration provision.  

V. **DURATION**  

Another common drafting pitfall relates to the survival of the arbitration clause upon termination of an agreement. Parties often intend to allow the arbitration clause to survive termination. Termination of an agreement where arbitration is not explicitly included in a

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8 “Other circuits have declined to follow *Kinoshita* because of the strong federal policy in favor of arbitration. See, e.g., *Battaglia v. McKendry*, 233 F.3d 720, 727 (3d Cir. 2000) ("[W]hen phrases such as 'arising under' and 'arising out of' appear in arbitration provisions, they are normally given broad construction, and are generally construed to encompass claims going to the formation of the underlying agreements."); *Gregory v. Electro-Mech. Corp.*, 83 F.3d 382, 386 (11th Cir. 1996) (arbitration clause covering "any dispute . . . which may arise hereunder" was sufficiently broad to encompass a fraudulent inducement claim); see also *Highlands Wellmont Health Network v. John Deere Health Plan*, 350 F.3d 568, 578 (6th Cir. 2003) (holding "that 'arising out of' is broad enough to include a claim of fraudulent inducement of a contract"); *Sweet Dreams Unlimited, Inc. v. Dial-A-Mattress Int'l, Ltd.*, 1 F.3d 639, 642 (7th Cir. 1993) (noting that "arising out of" covers all disputes "having their origin or genesis in the contract, whether or not they implicate interpretation or performance of the contract per se"); *Mar-Len of Louisiana, Inc. v. Parsons-Gilbane*, 773 F.2d 633, 637 (5th Cir. 1985) (recognizing that *Kinoshita* is inconsistent with federal policy favoring arbitration). The case law that we have examined suggests that the Ninth Circuit is the only federal circuit that continues to strictly adhere to the analysis in *Kinoshita.*” *Dialysis Access Ctr., LLC v. RMS Lifeline, Inc.*, 638 F.3d 367, 380-381 (1st Cir. P.R. 2011)  

9 *Mediterranean* at 1464; *In re Kinoshita & Co.*, 287 F.2d 951, 953 (2d Cir. 1961).
survival clause raises the issue of whether an arbitration clause will survive termination. Again, if the parties’ intent is unclear, the issue will be litigated, in the first stance in Court, before the arbitrator, or both. This emphasizes the importance of expressly stating the parties’ intent regarding the survival of the arbitration clause.

Courts have held that simply claiming an agreement has terminated, or trying to “plead around it,” cannot divest a party of its fundamental right to arbitrate because an arbitrator must resolve the question of termination.\(^\text{10}\)

In *Litton*, the Supreme Court recognized a “presumption in favor of postexpiration arbitration of matters unless negated expressly or by clear implication [for] matters and disputes arising out of the relationship governed by contract.” *Litton Financial Printing Division v. NLRB*, 501 U.S. 190, 204 (1991). The Court further held that the presumption favoring arbitration cannot apply wholesale to expired agreements, but rather a nexus is required between post-termination conduct (i.e., a continued relationship) and agreement content.

An issue of first impression among the circuit courts, whether the strong presumption in favor of arbitration applies where arbitration is not included in the survival clause, was recently addressed in *Huffman v. Hilltop Cos., LLC*, 747 F.3d 391 (6th Cir. 2014). The Court held that the arbitration clause survived post-expiration because the intent of the parties was unclear whether arbitration would survive coupled with the strong presumption in favor of arbitration. Omitting arbitration in the survival clause did not clearly imply a lack of

\(^{10}\) *Memphis Publishing Co. v. Newspaper Guild*, 2006 U.S. Dist. LEXIS 10539 at * 11 (W.D. Tenn. Feb 15, 2006); *see also Qualcomm* at 1373-74; (district court in *Qualcomm* on remand held the question of what products covered by the arbitration provision is for the arbitrator). *See also Electrolux Home Products, Inc. v. Mid-South Elec.*, 2008 U.S. Dist. LEXIS 61416 at * 12 (E.D. Ky. Aug. 11, 2008) (“A party cannot avoid arbitration simply by renaming its claims so that they appear facially outside the scope of the arbitration agreement.”).
post-expiration effect. The strong presumption in favor of arbitration controlled, because reading the contract as a whole the Court could not say with certainty that there was no intent for the arbitration clause to survive. Furthermore, the survival clause in *Huffman* did not raise other important provisions intended to survive expiration such as non-compete, severability, and integration clauses. The Sixth Circuit’s decision in *Huffman* indicates that Courts are likely to find arbitration clauses to survive termination unless expressly provided otherwise.

To preempt questions of survival, drafters should explicitly state the intended duration of an arbitration provision post-expiration by including arbitration in the survival clause or survival in the arbitration clause (if not both).

Keep in mind that the combination of survival and a broad arbitration clause means, potentially anyway, that any dispute the parties have *forever*, will go to arbitration. That may not be a bad outcome, if that is really what the parties intended, but forever is a long time and almost no one wants to be bound to an agreement indefinitely.

VI. CONCLUSION

As in many other endeavors, thinking ahead and considering the breadth of the issues the arbitration provision is intended to cover should be discussed and set out in the agreement. The same is true about the duration and who makes the call on arbitration. Also, parties might consider cost shifting to deter delay. For example, if a party challenges arbitrability and loses, it should pay for that diversion.