# North Carolina Arbitration Law: Selected Topics

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W. Mark C. Weidemaier Institute of Government University of North Carolina at Chapel Hill In 2000, the National Commissioners on Uniform State Laws (NCCUSL) adopted the Revised Uniform Arbitration Act (RUAA). With slight modifications, the North Carolina General Assembly enacted the RUAA in 2003 as Article 45C of Chapter 1, repealing former Article 45A. The RUAA applies to specified agreements to arbitrate made on or after January 1, 2004, or by consent of the parties to agreements made before that date.

## Some significant Revised Uniform Arbitration Act provisions/changes

#### A. Arbitrator disclosures (G.S. § 1-569.12)

- 1. An arbitrator has a continuing duty, beginning before he or she accepts the appointment, to make a reasonable inquiry and to disclose facts that a reasonable person would consider likely to affect the arbitrator's impartiality, including:
  - financial or personal interest in the proceeding, and
  - existing or past relationship with any party to the agreement or to the proceeding, their counsel or representatives, witnesses, or other arbitrators.
- 2. Failure to disclose may be a basis for vacating the award, as may continued service after disclosure, when a party objects to the appointment or continued service. If the relevant arbitration organization's rules establish procedures for challenging an arbitrator, a party must substantially comply with these procedures to preserve the right to ask the court to vacate the award.
- 3. A neutral arbitrator who does not disclose a known, direct, and material interest in the outcome of the arbitration, or a known, existing, and substantial relationship to a party, is presumed to act with evident partiality under G.S. § 1-569.23(a)(2).
- 4. The parties may not, before a controversy arises, agree to unreasonably restrict these disclosure obligations. G.S. § 1-569.4(b)(3).
- 5. Substantial compliance with any agreed-upon procedures for challenging an arbitrator (i.e., procedures specified in the contract or authorized by rule of the chosen ADR provider) is a condition precedent to a motion to vacate.
- B. Additional grounds for vacating award (G.S. § 1-569.23(a)(6)
  - 1. Provisions governing vacatur of award have been restructured and a new basis for vacatur added:
    - Court shall vacate the award if the arbitration was conducted without proper notice (see G.S. § 1-569.9) of its initiation so as to prejudice substantially the rights of a party.

#### C. Remedy provisions (G.S. § 1-569.21)

#### 1. Punitive damages or other exemplary relief

- Arbitrators may award punitive damages if (1) the arbitration agreement provides for such an award; (2) such an award is authorized by law in a civil action involving the same claim; and (3) the evidence at the hearing justifies the award under the legal standards otherwise applicable to the claim.
- Note: If punitive/exemplary damages would be available if the identical dispute had been brought in court, the Federal Arbitration Act, 9 U.S.C. § 1 et seq. (FAA), arguably preempts a requirement that the arbitration agreement specifically "provide for" an arbitral award of punitive damages. See The Federal Arbitration Act: Federal Preemption of State Law Regulating Arbitration, Administration of Justice Bulletin No. 2005/05 at 14 (August 2005).

#### 2. Attorney fees

- Arbitrators may award attorney fees if (1) the arbitration agreement provides for such an award and (2) such an award is authorized by law in a civil action involving the same claim.
- As with the limit on punitive/exemplary damages, the FAA arguably preempts
  the requirement that the arbitration agreement "provide for" attorneys fees,
  where fees could be awarded in a judicial proceeding without such contractual
  authorization.

## D. Judicial award of attorney fees (G.S. § 1-569.25)

- 1. Upon motion by a prevailing party to a *contested judicial* proceeding seeking to confirm, vacate, or modify an award, the court may award reasonable attorney fees or other reasonable litigation expenses incurred in a judicial proceeding after the award is made. Fees/expenses to be included in judgment confirming, vacating without directing a rehearing, modifying, or correcting an award.
- 2. The court may allow reasonable costs of the motion and subsequent judicial proceedings.

#### E. Venue (1-569.27)

- 1. Applications for judicial relief are heard by motion (G.S. § 1-569.5) made in the county in which the agreement to arbitrate specifies the arbitration hearing is to be held.
- 2. Otherwise, the motion may be made in any county in which any adverse party resides or has a place of business or, if no adverse party has a residence or place of business in the state, the motion may be made in any county.

#### F. Provisional remedies (G.S. § 1-569.8)

- 1. Before an arbitrator is appointed and is authorized and able to act, the court may, upon motion and for good cause shown, grant preliminary relief to protect the effectiveness of the arbitral proceeding to the same extent and under the same circumstances as if the controversy were the subject of a civil action.
- 2. After the arbitrator is appointed and is authorized and able to act, the arbitrator may grant any provisional remedy necessary to protect the effectiveness of the arbitral proceeding and to promote the fair and expeditious resolution of the controversy.
  - If the matter is urgent and the arbitrator is not able to act in a timely manner or cannot provide an adequate remedy, a party may move the court for provisional relief
  - RUAA establishes an expedited process for confirming the arbitrator's provisional remedy. *See* G.S. § 1-569.18.

#### G. Consolidation (G.S. § 1-569.10)

- 1. Upon motion, court may consolidate separate arbitration proceedings, as to all or some claims, if:
  - There are separate arbitration agreements or proceedings between the same persons, or one of them is a party to a separate arbitration agreement or proceeding with a third person;
  - The claims subject to the arbitration agreements arise in substantial part from the same transaction or series of related transactions;
  - The existence of a common issue of law or fact creates the possibility of conflicting decisions in the separate arbitration proceedings; and
  - Prejudice resulting from a failure to consolidate is not outweighed by the risk
    of undue delay or prejudice to the rights of, or hardship to, parties opposing
    consolidation.
- 2. The court shall not order consolidation of the claims of a party to an arbitration agreement if the agreement prohibits consolidation.

#### Selected issues:

#### A. Federal Arbitration Act preemption

1. Although litigants frequently neglect to raise the issue, the Federal Arbitration Act ("FAA") applies to the significant majority of arbitration clauses and will preempt any conflicting state law.

- 2. Section 2 of the FAA, 9 U.S.C. § 2, provides that a written arbitration provision "in any maritime transaction or a contract evidencing a transaction involving commerce . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." According to the U.S. Supreme Court, section 2 establishes a "national policy favoring arbitration" that applies in both state and federal courts. *Southland Corp. v. Keating*, 465 U.S. 1, 10 (1984). State law that conflicts with this policy is preempted.
- 3. These materials do not discuss federal preemption of state arbitration law in detail. Readers interested in such a discussion should consult *The Federal Arbitration Act: Federal Preemption of State Law Regulating Arbitration*, Administration of Justice Bulletin No. 2005/05 (August 2005) (available on-line at <a href="http://php.unc.edu/sogcart/books.php?cat=26">http://php.unc.edu/sogcart/books.php?cat=26</a>). Nevertheless, a diagram of the FAA preemption analysis is appended to these materials.

#### B. Validity and scope of arbitration agreement

- 1. When faced with a motion to compel arbitration, courts apply a two-pronged analysis: (1) whether the parties have a valid agreement to arbitrate, and (2) whether the specific dispute is covered by the substantive scope of the agreement. See Ellen v. A.C. Schultes, \_\_ N.C. App. \_\_, 615 S.E.2d 729 (2005); Moose v. Versailles Condominium Ass'n, \_\_ N.C. App. \_\_, 614 S.E.2d 418 (2005).
- 2. The party seeking to compel arbitration has the burden of establishing these elements. *See Routh v. Snap-On Tools Corp.*, 108 N.C. App. 268, 271-72, 423 S.E.2d 791, 794 (1992).

# C. May third parties (i.e. nonsignatories) invoke protections of the arbitration clause, or be bound by the clause?

1. Generally speaking, nonsignatories to an arbitration agreement are not entitled to demand that claims against them be arbitrated and are not required to arbitrate their own claims.

#### 2. 3 possible exceptions:

- Nonsignatory may invoke the arbitration clause if the contract parties intended to permit the nonsignatory to do so.
- Nonsignatory may sometimes invoke the arbitration clause on an agency theory.
- Nonsignatory may invoke, or be bound by, arbitration clause under equitable estoppel theory.
- 3. First, a nonsignatory may invoke the arbitration clause as a third-party beneficiary of the agreement. Whether he or she may invoke the clause depends on the

wording of the clause at issue and whether the contracting parties intended to permit the third party to invoke the clause. Such an intent is likely to be rare where the agreement does not expressly identify third parties who may invoke the arbitration clause.

- 4. Second, a third party might invoke the arbitration clause under an agency theory. For example, an employee of a corporate defendant may attempt to invoke the arbitration clause contained in the agreement between the plaintiff and the corporate employer.
  - Brown v. Centex Homes, \_\_\_, N.C. App. \_\_\_\_, 615 S.E.2d 86 (2005): Buyers of home sued seller and seller's agent based on agent's alleged representations about future plans for adjacent property. Trial court granted seller's motion to compel arbitration based on arbitration clause in purchase agreement, but denied motion by agent, who was not a party to agreement. The Court of Appeals reversed, holding that buyers were required to arbitrate claims against seller's agent. According to the Court, the agent's status as an agent for the seller entitled her to invoke the arbitration clause, because "the basis for plaintiffs' claims derive from [her] representation as an agent." Plaintiffs' claims against the corporation were based exclusively on the agent's conduct, and plaintiffs would have to prove that the agent was acting in furtherance of the corporation's business goals. Under the circumstances, suing the agent was merely an attempt to circumvent the arbitration clause with the seller.
- 5. Third, a nonsignatory might be equitably estopped from denying the applicability of an arbitration clause. Typically, this occurs where the nonsignatory asserts a claim based on the contract against a contract party.
  - Doctrine "recognizes that a party may be estopped from asserting that the lack of his signature on a written contract precludes enforcement of the contract's arbitration clause when he has consistently maintained that other provisions of the same contract should be enforced to benefit him. See Ellen v. A.C. Schultes, \_\_ N.C. App. \_\_, 615 S.E.2d 729, 732 (2005).
  - A nonsignatory may be estopped from refusing to comply with an arbitration clause when it seeks or receives a direct benefit from the contract containing the clause. *Ellen v. A.C. Schultes*, \_\_ N.C. App. \_\_, 615 S.E.2d 729 (2005) (quoting *Int'l Paper v. Schwabedissen Maschinen & Anlagen*, 206 F.3d 411, 416-17 (4th Cir.2000)). In *Ellen*, the Court of Appeals held that shareholders of a subcontractor were not required to arbitrate their claims against the general contractor and its principals, even though the shareholders had signed, in their official capacities and on behalf of the subcontractor, a series of subcontracts containing arbitration clauses. Plaintiffs asserted claims for unfair and deceptive trade practices and tortious interference with prospective business advantage, based on alleged misconduct by defendants after one plaintiff refused amorous advances by defendant. According to the Court, the

- plaintiffs were not seeking a direct benefit under the contracts and were not asserting any rights under the contracts.
- In any case, whether to apply the doctrine of equitable estoppel is in the court's discretion.

## D. <u>Unconscionability</u>

- 1. Section 2 of the FAA mandates the enforcement of written arbitration provisions in any maritime transaction or any contract evidencing a transaction involving commerce "save upon such grounds as exist at law or in equity for the revocation of any contract."
- 2. This "savings" clause allows courts to apply "generally applicable contract defenses, such as fraud, duress, or unconscionability" to invalidate arbitration agreements. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996) (emphasis added).

## 3. But courts may not:

- Invalidate an arbitration agreement under state laws applicable *only* to arbitration provisions. *See id.* at 687.
- Invalidate an arbitration agreement under a "state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue." *Perry v. Thomas*, 482 U.S. 483, 492 n.9 (1987).
- When evaluating the enforceability of an arbitration agreement, construe the agreement "in a manner different from that in which [the court] otherwise construes nonarbitration agreements under state law." *Id*.
- Rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable. *See id*.

#### 4. The doctrine of unconscionability:

- Uniform Commercial Code (U.C.C.) § 2-302: "If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result." G.S. § 25-2-302(1). The U.C.C. does not define the term unconscionability.
- Classic description: "Unconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." Williams v. Walker-Thomas Furniture Co, 350 F.2d 445, 449 (D.C.

Cir. 1965). North Carolina cases adopt a similar definition, stating that a contract is unconscionable if "the inequality of the bargain is so manifest as to shock the judgment of a person of common sense, and where the terms are so oppressive that no reasonable person would make them on the one hand, and no honest and fair person would accept them on the other." *Brenner v. Little Red School House, Ltd.*, 302 N.C. 207, 213, 274 S.E.2d 206, 210 (1981).

- Courts sometimes divide unconscionability into procedural and substantive components. *See Sidden v. Mailman*, 137 N.C. App. 669, 675, 529 S.E.2d 266, 271(2000). "Procedural unconscionability involves fraud, coercion, duress, undue influence, inadequate disclosure, and misrepresentation in the formation of the contract. Substantive unconscionability involves harsh, one-sided, and oppressive terms of a contract" sufficient to satisfy the definition in *Brenner*, above.
- 5. Note, however, that in cases governed by the FAA, the arbitrator, not the court, must resolve claims that an entire contract is unenforceable due to unconscionability or fraud. *See Keel v. Private Business, Inc.*, 163 N.C. App. 703, 594 S.E.2d 796 (2004).

#### E. Waiver of the right to arbitrate

- 1. Party opposing arbitration on basis of waiver must demonstrate that it was prejudiced by its adversary's delay, or by actions of its adversary that were inconsistent with arbitration. *See Sullivan v. Bright*, 129 N.C. App. 84, 86-87, 497 S.E.2d 118, 120 (1998).
- 2. Examples of prejudice include (1) being forced to bear the expenses of a long trial; (2) loss of helpful evidence; (3) having to take steps in the litigation, or incur significant expenses in the litigation; (4) the opponent's use of discovery procedures that would have been unavailable in arbitration. *See id.* Note, the RUAA has expanded the scope of discovery available in arbitration, so (4) may be a weaker basis for finding a waiver in cases governed by the RUAA.
  - Sears Roebuck & Co. v. Avery, 163 N.C. App. 207, 593 S.E.2d 424 (2004): Applying Arizona law; creditor waived right to compel arbitration by filing suit in district court for the same relief it could have obtained in arbitration (even though arbitration clause excepted from arbitration actions filed in small claims court and amount in controversy was less than \$4000).
  - Moose v. Versailles Condominium Ass'n, \_\_ N.C. App. \_\_, 614 S.E.2d 418 (2005): By taking depositions that would not have been available in arbitration (because former law only allowed depositions of witnesses who could not be subpoenaed or were unable to attend the arbitration hearing), then by demanding arbitration to cut off ongoing discovery by plaintiff, defendant had waived right to compel arbitration. Evidence also showed that plaintiff had spent almost \$33,000 in legal fees and costs in the lawsuit, much

- of which had been spent providing information to defendant that would not have been provided in arbitration.
- Sullivan v. Bright, 129 N.C. App. 84, 86-87, 497 S.E.2d 118, 120 (1998): Trial court erred in finding a waiver of the right to arbitrate where, before demanding arbitration, plaintiff took two depositions. The record did not contain evidence about whether the witnesses could have been deposed in arbitration, nor did it contain evidence of substantial expenditures in litigation by party opposing arbitration.

## F. Standards for vacating arbitration award

- G.S. § 1-569.23(a) provides that the court shall vacate an award, upon motion, if:
  - (1) The award was procured by corruption, fraud, or other undue means;
  - (2) There was:
    - a. Evident partiality by an arbitrator appointed as a neutral arbitrator;
    - b. Corruption by an arbitrator; or
    - c. Misconduct by an arbitrator prejudicing the rights of a party to the arbitration proceeding;
  - (3) An arbitrator refused to postpone the hearing upon a showing of sufficient cause for postponement, refused to consider evidence material to the controversy, or otherwise conducted the hearing contrary to <u>G.S. 1-569.15</u> so as to prejudice substantially the rights of a party to the arbitration proceeding;
  - (4) An arbitrator exceeded the arbitrator's powers;
  - (5) There was no agreement to arbitrate, unless the person participated in the arbitration proceeding without raising the objection under <u>G.S. 1-569.15(c)</u> no later than the beginning of the arbitration hearing; or
  - (6) The arbitration was conducted without proper notice of the initiation of an arbitration as required in <u>G.S. 1-569.9</u> so as to prejudice substantially the rights of a party to the arbitration proceeding.
  - 1. G.S. § 1-569.23(a)(6) is a new basis for vacatur. Otherwise, these standards are similar to former law.
  - 2. Cases under prior law emphasized the narrowness of judicial review of arbitral awards: "Our Supreme Court has recognized that arbitration also poses disadvantages in that parties to arbitration enjoy limited appellate review, and have no recourse when an arbitrator makes a mistake. Because an arbitrator is not bound by substantive law or rules of evidence, an award may not be vacated merely because the arbitrator erred as to law or fact. Where an arbitrator makes such a mistake, 'it is the misfortune of the party.'" *Sholar Bus. Assocs., Inc. v. Davis*, 138 N.C. App. 298, 301, 531 S.E.2d 236, 239

(2000) (quoting and citing *Patton v. Garrett*, 116 N.C. 847, 858, 21 S.E. 679, 682 (1895)) (other citations omitted).

- 3. Possible additional grounds for vacatur/Manifest disregard of the law
  - Interpreting the FAA, some courts have indicated that arbitral awards may be vacated for "manifest disregard of the law." This basis for vacatur requires more than a mere error or misunderstanding of the law. Although different courts phrase the test in different ways, they generally require (1) that the result be clearly inconsistent with governing law and (2) that the arbitrator understood, but intentionally chose not to apply, that law. For sample cases see *Apex Plumbing Supply, Inc. v. U.S. Supply Co., Inc.*, 142 F.3d 188, 193 & n.5 (1998); *Carte Blanche (Singapore) PTE Ltd. v. Carte Blanche Int'l.*, 888 F.2d 260, 265 (2d Cir. 1989); and *M&C Corp. v. Erwin Behr & Co.*, 87 F.3d 844, 851 (6th Cir. 1996).
  - North Carolina courts have also applied this standard to cases governed by the FAA. *See Pinnacle Group, Inc. v. Shrader*, 105 N.C. App. 168, 170-71, 412 S.E.2d 117, 120 (1992) ("[T]he award may be vacated where the arbitrators acted in manifest disregard of the law to such an extent as to deny a party a fair hearing when the record is viewed as a whole."). It is not clear whether some variant of this standard exists under North Carolina law.
  - In drafting the RUAA, the NCCUSL considered including "manifest disregard" as a basis for vacatur, but ultimately rejected a proposal to include "manifest disregard" as an express basis for vacatur. See RUAA comment to § 23 (<a href="http://www.law.upenn.edu/bll/ulc/uarba/arbitrat1213.htm">http://www.law.upenn.edu/bll/ulc/uarba/arbitrat1213.htm</a>). The drafters reasoned that the Supreme Court had never expressly approved the "manifest disregard" standard under the FAA and concluded that, if the Court ultimately rejected that standard, its ruling might preempt state law applying that standard to cases governed by the FAA. It is not clear whether, in enacting the RUAA, the General Assembly intended to disapprove the practice of reviewing awards for "manifest disregard" of the law.

#### 4. Awards that violate public policy

• Although there appear to be no pertinent North Carolina cases, some courts have approved the vacatur of arbitral awards that violate public policy. Like the manifest disregard standard, this exception is a narrow one. For example, courts may limit this basis for vacatur to situations where the arbitrator's award effectively requires a party to violate a well-defined and dominant state policy or law. See, e.g., George Watts & Son, Inc. v. Tiffany & Co., 248 F.3d 577, 580 (7th Cir. 2001) (discussion in context of "manifest disregard"); PaineWebber, Inc. v. Argon, 49 F.3d 347

(8th Cir. 1995); *Brown v. Rauscher Pierce Refnses, Inc.*, 994 F.2d 775 (11th Cir. 1994).

• The same concerns about FAA preemption led the drafters of the RUAA to omit a public policy basis for vacatur.

# **Analysis of FAA preemption issues**

The following chart is taken from *The Federal Arbitration Act: Federal Preemption of State Law Regulating Arbitration*, Administration of Justice Bulletin No. 2005/05 (August 2005) (<a href="http://php.unc.edu/sogcart/books.php?cat=26">http://php.unc.edu/sogcart/books.php?cat=26</a>), which contains a detailed discussion of FAA preemption.

