

Drafting Arbitration Provisions for LLC Agreements **The Devil Is in the Details**

By Dominick T. Gattuso

Freedom of contract is an express fundamental principle set forth in the limited liability company (LLC) and limited partnership (LP) statutes of Delaware, Arkansas, Maine, Georgia, and New Mexico, among others. The LLC and LP statutes of these states afford business partners broad latitude in structuring their business dealings and provide gap fillers where the parties' agreement is silent on a particular issue. This "freedom" to contract comes at a price, however—the "duty to scriven with precision"—as Delaware Vice Chancellor Leo E. Strine Jr. noted in *Willie Gary, LLC v. James & Jackson LLC*, 2006 WL 75309 (Del. Ch. Jan. 10, 2006). Apparently, this duty has gone unmet often enough to lead several judges to comment publicly on the growing number of inarticulately worded agreements flowing through their courts.

While the reasons for the inartful drafting are legion, the solution is devilishly simple: Know the deal. Understand the expectations of the

parties. Be cognizant of the changes (and proposed changes) to the applicable law. Eschew the form agreement in favor of a carefully drafted agreement that fits the deal and satisfies the parties' expectations. And have a litigator familiar with the transaction review the agreement. Why? In *Men Are from Mars and Women Are from Venus*, the author, John Grey, posits that men and women have markedly different approaches to the world around them. Like the "Martians" and "Venusians" Mr. Grey writes about, deal (i.e., transactional) lawyers and business litigators frequently have a different view of the world around them. To put a finer point on it, deal lawyers are focused on the "before"—papering the deal, often in record time. Out of necessity, deal lawyers are focused on the forest, rather than on a particular branch of a specific tree in a forest full of trees. Business litigators, by contrast, are focused on the "after." They are looking for the loophole, the defect in the agreement. Thus, the business litigator can provide invaluable assistance if he or she is brought into the deal at the outset by reviewing the terms of the draft agreement and analyzing those terms that might play out in litigation.

With these thoughts in mind, I turn to the drafting of arbitration clauses in operating agreements and partnership agreements. Arbitration clauses, along with exculpatory clauses, buyout provisions, and clauses dealing with the

elimination or restriction of fiduciary duties, are being litigated with increasing frequency. This trend likely will continue for the foreseeable future, given the growing use of LLCs and LPs.

The decision to include an arbitration clause often is based on the perception (though some would say misperception) that arbitration is a cheaper, faster dispute resolution mechanism than litigation. The reality, however, is that the economy and efficiency of arbitration depend largely on the clarity of the arbitration provision. Poorly drafted arbitration clauses can, and often do, result in unnecessary litigation, thereby reducing, or even eliminating, the cost savings frequently associated with arbitration.

The Scope of the Arbitration Clause

Arbitration is a matter of contract. Parties to an operating agreement or partnership agreement cannot be forced to commit a dispute to arbitration unless they have agreed to do so. Accordingly, the draftsman should state clearly in the agreement what disputes will be subject to arbitration, including whether the question of arbitrability will be decided by a court or an arbitrator.

The Arbitration Clause: Broad Versus Narrow. Generally speaking, arbitration clauses are referred to as being "broad" or "narrow." Typically, broad arbitration clauses encompass all of the parties' disputes arising out of their

Gattuso is special counsel with Proctor Heyman LLP, in Wilmington, Delaware, and practices in the areas of corporate, alternative entity, and commercial litigation. His e-mail is dgattuso@proctorheyman.com. The views expressed herein do not necessarily represent the views of Proctor Heyman LLP or its clients.

agreement, whereas narrow clauses are intended to limit the disputes that are referred to arbitration. Courts will not presume that the parties agreed to refer all of their disputes to arbitration unless the arbitration clause contains broad enabling language evidencing that intent. For instance, in *Parfi Holding AB v. Mirror Image Internet, Inc.*, 817 A.2d 149 (Del. 2002), the parties agreed to arbitrate any dispute “arising out of or in connection with” their agreement. The Delaware Supreme Court held that the parties had “signaled an intent to arbitrate all possible claims that touch on the rights set forth in their contract.” Language such

the exclusive dispute resolution mechanism under the latter two operating agreements, citing the obvious ambiguity in the clause. Indeed, the court stated that “[a]t bottom, this is a poorly worded arbitration provision . . .” Interestingly, similarly worded arbitration provisions turned up in two other undated opinions in California, demonstrating that such provisions were fodder for litigation.

Additionally, the wording of the arbitration clause should be consistent internally and operate in harmony with other provisions of the agreement. In *Green v. Short*, 2007 WL 2570821 (N.C. Super. Ct. 2007), the parties’

followed and (2) the arbitration clause is broadly worded, subjecting all of the parties’ controversies to arbitration. This is so because Rule R-7(a) of the AAA rules grants arbitrators the power to rule on their own jurisdiction.

Thus, under the rules espoused in *Willie Gary*, incorporation of the AAA rules alone is insufficient to establish that the parties intended to submit questions of arbitrability to the arbitrator, where the scope of the arbitration clause is narrow. Something more is required to evidence such intent, as the Delaware Court of Chancery explained in *Brown v. T-Link, LLC*, 2007 WL 4302594 (Del. Ch. 2007). In *Brown*, the arbitration clause was narrow, referring only those disputes “concerning the enforcement or interpretation of the [operating] Agreement” to arbitration. The parties’ operating agreement also contained a more broadly worded clause, waiving the right to a jury trial. The court did not find the reference to the AAA rules persuasive evidence of the parties’ intent to refer the question of arbitrability to the arbitrator. Comparing the narrowly worded arbitration clause with the jury waiver clause, the court reasoned that had the parties intended to refer all of their disputes to arbitration, including the issue of arbitrability, they clearly understood what language was necessary to achieve that intent.

Thus, once the parties have agreed on the scope of the arbitration provision, it is incumbent on the draftsman to employ clear, precise language to draft an arbitration clause that evidences the parties’ intent regarding who rules on arbitrability. The drafting exercise need not, and should not, end there, however.

Procedural Issues in Arbitration

Though often overlooked, other provisions may be added to the arbitration clause, or elsewhere in the parties’ agreement, to assist in taking full advantage of the efficiencies often associated with arbitration.

The Choice of Law. When considering the choice of law in an operating agreement or partnership agreement, the

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as “all disputes arising out of the operating agreement are subject to arbitration” or “any dispute or controversy arising under this operating agreement shall be submitted to binding arbitration” is equally effective in evincing the parties’ intent to submit all of their disputes to arbitration. The American Arbitration Association (AAA) and the National Arbitration Forum (NAF) provide sample broad arbitration clauses on their Web sites.

Both broad and narrow arbitration clauses often suffer from the same drafting errors. Though a seemingly obvious point, care should be taken to avoid ambiguous language. For instance, in *Segal v. Silberstein*, 67 Cal. Rptr. 3d 426 (Cal. App. Ct. 2007), the operating agreement of one of the three LLCs at issue provided that “[a]rbitration shall be the exclusive dispute resolution process in the State of California, but arbitration shall be a nonexclusive process elsewhere.” The arbitration clauses in the operating agreements of the two remaining LLCs contained almost identical language, except the clause in each agreement stated that arbitration would be the exclusive dispute resolution process in Texas and optional elsewhere. The California appellate court ruled that arbitration in California was not

operating agreement contained a broad arbitration clause. A separate clause in the agreement referred generally to the remedy of judicial dissolution, leading to a dispute whether a claim for judicial dissolution could be brought in a court. Relying on the broad arbitration clause and the absence of language “mandat[ing] a judicial determination of the [dissolution] issue,” the court ruled that the dissolution claim was subject to arbitration. The Delaware Court of Chancery reached a similar conclusion in *Terex Corp. v. STV USA, Inc.*, 2005 WL 2810717 (Del. Ch. 2005).

Who Shall Decide the Question of Arbitrability? A drafting question closely related to the broad versus narrow decision is who should decide the question of arbitrability, the court or the arbitrator? All too frequently, the agreement does not contain clear language addressing this issue, forcing courts to divine the parties’ intent. Recently, in *James & Jackson, LLC v. Willie Gary, LLC*, 906 A.2d 76 (Del. 2006), the Delaware Supreme Court adopted the majority rule, holding that parties have manifested a clear and unmistakable intent to have an arbitrator decide issues of arbitrability where the agreement expressly states that (1) the rules of the American Arbitration Association (AAA) shall be

draftsperson should expressly identify the procedural law that will govern the arbitration clause, and the substantive law that will govern the parties' underlying dispute.

Where the parties' agreement involves interstate commerce, as is virtually always the case, the Federal Arbitration Act (FAA) preempts state law and will govern the arbitration. The parties may displace the default federal standard in favor of a state arbitration act, provided there is clear evidence of such intent in the parties' agreement. Inclusion of a generic choice of law provision in the operating agreement standing alone is not adequate evidence of the parties' intent to displace the FAA. That intent may be established by an express statement in the parties' agreement, preferably in the arbitration clause, that a particular state arbitration act, rather than the FAA, shall govern.

To the extent the parties' agreement contains a choice of law clause, that clause should be in harmony with the language in the arbitration clause. For example, if the parties' choice of law clause provides for application of Delaware law, and their preference is to have the Delaware Uniform Arbitration Act govern arbitration, the choice of law clause should state clearly that Delaware law shall apply to the underlying dispute and reiterate that the Delaware Uniform Arbitration Act shall apply to the arbitration.

The Manner of Selecting an Arbitrator. The parties may specify the number of arbitrators that will preside over the arbitration (e.g., a panel of three arbitrators), establish criteria for the selection of arbitrators (e.g., number of years in practice, knowledge base in specific practice areas, etc.), and set the manner of selecting arbitrators. For example, it is common in high-value commercial disputes for parties to agree in advance that the panel will consist of three arbitrators. Typically, each party will choose one arbitrator, with the arbitrators selecting the third arbitrator. Occasionally, the parties retain the right to agree on the appointment of the third arbitrator. Because a risk of deadlock exists under either scenario,

The following guidelines should be considered when drafting an arbitration clause:

- Decide whether the arbitration clause will be "broad" or "narrow."
- If a narrow arbitration clause is intended, or the parties intend to carve out certain disputes from an otherwise broad arbitration clause, those disputes should be clearly identified in the arbitration clause, and the arbitration clause should state expressly that the enumerated disputes are subject to civil judicial proceedings, not arbitration.
- The arbitration clause should not contain internal inconsistencies, and the arbitration clause should operate in harmony with the other provisions of the parties' agreement.
- The arbitration clause should state in unambiguous language whether a court or the arbitrator shall decide questions of arbitrability.
- Irrespective of whether the arbitration clause is broad or narrow, use appropriate enabling language to make clear the parties' intent as it relates to the scope of the arbitration provision.
- Consider customizing the arbitration clause further by incorporating procedural rules governing the choice of law, discovery, the manner of selecting an arbitrator, and the methods for judicial review and/or enforcement of an arbitration award.

the agreement should incorporate a mechanism to break a deadlock. For instance, the parties could agree to surrender the decision to the AAA, the NAF, or a similar independent body.

Discovery in Arbitration. The AAA rules provide for limited discovery. However, the parties may alter these rules by including appropriate language in the arbitration clause. For example, the AAA's discovery rules may be revised to (1) expand (or restrict) the use of written discovery, including making changes to the scope of document exchange; (2) permit the taking of depositions; and (3) permit the making of dispositive motions as well as the manner and length of the hearing on the motion, the form of an award, and a mechanism to enforce the award. Such procedural alterations may enhance the efficiency of the arbitration process while avoiding the costs typically associated with full-blown litigation.

Enforcement of the Arbitration Award.

Because a party typically is required to have the arbitration award confirmed and entered as a judgment, it makes sense to include in the arbitration clause a procedure for confirming and enforcing the arbitration award. The provision should identify the court that will confirm the arbitration award as well as the time period in which a party must move to confirm the award. Litigators familiar with the relevant courts should be consulted to assist in selecting the most appropriate forum for confirmation of the award.

Judicial Review of an Arbitration Award. Arbitration awards are subject to limited judicial review under the FAA as well as most state arbitration acts. Though parties can, and often do, agree to a heightened standard of judicial review of arbitration awards, *Hall Street Assoc., LLC v. Mattel, Inc.*, 128 S. Ct. 1396 (2008) has ended that practice at least as it relates to

agreements governed by the FAA. In *Hall*, the U.S. Supreme Court ruled that the grounds for vacating or modifying an arbitration award under the FAA are exclusive. Although parties can no longer contract for heightened judicial review under the FAA, they can guard against the risk of legal error by agreeing in their arbitration clause that the arbitrator must comply with Rule 20(D) of the National Arbitration Forum *Code of Procedure*, which says that “[a]n Arbitrator shall follow the applicable substantive law and may grant any legal, equitable or other remedy or relief provided by law in deciding a Claim, Response or Request properly submitted by a Party under this Code. Claims, Responses, remedies or relief cannot be unlawfully restricted.” Accordingly, the arbitration award is subject to vacatur under Rule 20(D) where the arbitrator ignores the law or fails to apply the law correctly and, thereby, exceeds his or her powers. Section 5714(a)(3) of the Delaware

Uniform Arbitration Act provides parties with similar protection. As the Court of Chancery explained in *Wier v. Manerchia*, 1997 WL 74651 (Del. Ch. 1997), a court may vacate an arbitration award under section 5714(a)(3) upon a finding that “the arbitrators, in ‘manifest disregard’ of the law, were cognizant of the controlling law but clearly chose to ignore it in reaching their decision.”

Other Provisions of Interest

There are a number of other provisions the draftsman may consider adding to an arbitration clause in an operating agreement or partnership agreement, including a location for holding the arbitration; procedures for emergency relief, such as those set forth in section O of the AAA rules; the timing for selecting arbitrators and holding the arbitration; a requirement that the arbitrator provide a written opinion establishing the basis for his or her award; and a so-called step-

provision, whereby the parties can opt to negotiate or mediate their dispute before proceeding to arbitration. The parties also may consider a clause to compel arbitration with an appropriate penalty in the event a party resists arbitration. Indeed, these provisions are suitable for inclusion in an arbitration clause in virtually any agreement.

The foregoing is not to say that an arbitration clause should overtake the remainder of the operating agreement in complexity, breadth, or detail. Nor is it an indictment of illusory compromises. Such compromises are a business reality, particularly where parties are unable or unwilling to agree on certain provisions. After all, a written operating agreement with an illusory arbitration clause may be preferable to not having a written operating agreement. However, where the parties are able to reach agreement on the specifics of arbitration, a clearly drafted arbitration clause will insure the parties' expectations are met should a dispute arise.