Litigation Considerations in Leasing: Arbitration vs. Litigation

Janice Mac Avoy
Fried, Frank, Harris, Shriver & Jacobson LLP

Danielle C. Lesser
Morrison Cohen LLP

I. ARBITRATION VS. LITIGATION

A. Advantages and disadvantages of arbitration: Arbitration can be quicker than a plenary action in Supreme Court – arbitration has limited, more streamlined discovery (or no discovery if lease so provides), but may take longer than a summary proceeding in Civil Court. Arbitrators can be selected based on specialized knowledge or can be pre-selected in the lease itself.

1. Carefully consider the qualifications of the arbitrator and whether there will be qualified arbitrators available.

2. Consider whether some or all disputes will be arbitrated:

   (a) Just FMV resets?

   (b) All disputes?

B. Will you be better served by imposing the higher costs of litigation on the other side?

C. Consider the tendency of arbitrators to "split the baby." This can be minimized by using a baseball provision -- where the arbitrator selects only one party's determination, whichever is closer to correct.

D. Certain types of disputes are better suited to submission to arbitration before arbitrators with specialized knowledge, such as fair market rent re-sets, where arbitrators are typically appraisers with specialized knowledge of market value, or construction disputes that arise during major tenant improvement construction work, which must be decided quickly and benefit from an arbitrator with construction-related expertise.

1. For matters that will only arise in the initial stages of the lease, such as disputes over construction or tenant build-outs, considerthat pre-selecting arbitrators can quickly rule.

2. Consult with a litigator before setting pre-determined time periods for an expedited arbitration. While certain disputes must be resolved quickly, you want to provide time for your litigators to be able to

adequately prepare their case.

E. Arbitration clauses typically provide for either a single arbitrator or a panel of three arbitrators. If a panel of three is chosen, the lease should specify that:

1. Party-appointed arbitrators are non-neutral, and each party may have *ex parte* communications with their party-appointed arbitrator.

2. The role of party-appointed arbitrators – whether they can cross-examine witnesses, provide testimony, what is their role in deliberations?

3. Baseball arbitration (arbitrator may select only landlord or tenant's determination, may not make his/her own determination) vs. majority decision vs. unanimous decision: baseball arbitration keeps the parties honest and will require them to make a reasonable submission to the arbitrators, making settlement more likely. Requiring a unanimous decision creates the possibility of deadlock, whereas a simple majority decision creates the possibility that the arbitrators will "split the baby" – a common complaint about arbitration.

4. Consider the cost and effectiveness of a panel of three versus the unpredictability of a single arbitrator.

F. The arbitration clause may provide expressly whether a court or the arbitrator should decide threshold questions of arbitrability in the first instance. In the absence of such an express provisions, the courts will presume that the parties intended for the court to decide the threshold question of whether or not the dispute is arbitrable. *First Options of Chi v. Kaplan*, 514 U.S. 938, 943 (1995). However, if the arbitration clause provides that AAA rules apply, the arbitrator will decide the question of arbitrability in the first instance, pursuant to AAA rules. *See* AAA Commercial Arbitration Rules, R-7(a) (effective Oct. 1, 2013) ("The arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim."). Thus, by incorporating the AAA Arbitration Rules, the Parties agreed to delegate any questions of arbitrability to the arbitral tribunal. *See Life Receivables Tr. v. Goshawk Syndicate 102 at Lloyd's*, 66 A.D.3d 495, 495-96 (1st Dep't 2009) ("Although the question of arbitrability is generally an issue for judicial determination, when the

parties' agreement specifically incorporates by reference the AAA rules, which provide that '[t]he tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement,' and employs language referring 'all disputes' to arbitration, courts will 'leave the question of arbitrability to the arbitrators….'") (citation omitted), *aff'd*, 14 N.Y.3d 850 (2010).

G. If there is a challenge to the validity of the arbitration clause itself, however, that challenge must be decided by a court, not the arbitrator. *Matter of Teleserve Sys., Inc. (MCI Telecommuns. Corp.)*, 230 A.D.2d 585, 592-93, 659, N.Y.S.2d 659, 664 (4th Dep't 1997). But "courts look only to whether the arbitration clause itself was induced by fraud or duress; the question of whether the overall agreement is invalid is for the arbitrators" to decide. *Zurich Ins. Co. v. R. Elec., Inc.*, 5 A.D.3d 338, 339, 773 N.Y.S.2d 560, 560 (1st Dep't 2004). If a court concludes, however, that "the alleged fraud was part of a grand scheme that permeated the entire contract, including the arbitration provision, the arbitration provision should fall with the rest of the contract." *Weinrott v. Carp*, 32 N.Y.2d 190, 197, 344 N.Y.S.2d 848, 855(1973).

H. Under New York law, an arbitration award is conclusive and binding on the parties absent fraud, illegality or undisclosed bias. The parties may not challenge the arbitration award simply on the basis that the arbitrator wrongly decided the law or the facts. See *DigiTelCom v. Telez Sverige*, 2012 WL 3065345 (S.D.N.Y. July 25, 2012) (sanctioning law firm for frivolous challenge to arbitration award: "Plaintiff's challenge to the Award amounts to little more than an [improper] assault on the Tribunal's fact finding and contratual interpretation rather than on its actual authority"). *But see LJL 33rd Street Associates, LLC v. Pit Cairn Properties, Inc.*, 11 Civ. 6399 (JSR) (S.D.N.Y. Feb. 15, 2012) (arbitrator's valuation overturned for improperly excluding evidence relating to the fair market value of the property). In addition, courts have set aside arbitration awards when the arbitrator exceeded his or her authority. *N.Y. by Off. of Mun. Labor Rel. v. Davis*, 146 A.D.2d 480, 482-83 (1st Dep't 1989) (finding that the arbitrator violated a provision in the agreement that he "shall not add to, subtract from or modify any contract" when he cited nonexistent provisions and relied on matters outside of the agreement).

I. Consider that arbitration is private and confidential vs. a case filed in court, where all papers filed are publicly available.