Stiffing the Arbitrators and the Respondents

Arbitration Rule Changes Are Needed to Combat the Pay-Only-If-I’m-Winning Strategy of Claimants

By Howard E. Levin

Consider the following scenario: After years of failed negotiations, Gen Corp files for arbitration against your client over a license dispute. The license agreement includes an arbitration clause that requires both parties to pay half the arbitrator fees and costs. A year into the arbitration, it becomes clear that Gen Corp will not be able to recover any damages from your client because its claims have no merit. Your client tells you that she is very happy and is looking forward to finally resolving the dispute.

But then you receive a letter from the arbitration administrator informing you that Gen Corp is breach­­ing the license agreement and refusing to pay its $50,000 share of fees and costs owed to the three-member arbitrator panel. The letter includes a request that infuriates your client: “At this time we are kindly asking if you are willing to front the balance for Gen Corp so that this matter can proceed. You may apply to recover the funds in the final arbitration award.”
Your client cannot believe that the arbitration rules permit Gen Corp, the party that dragged your client into arbitration, to halt the proceeding by refusing to pay after it becomes clear that Gen Corp is going to lose. To make matters worse, if your client begrudgingly agrees to front her adversary’s $50,000 share, the arbitration administrator will not guarantee that she will be entitled to reimbursement at the end of the arbitration. Having already spent significant time and money on the arbitration, your client wants it to proceed so that the dispute can finally be resolved. But paying Gen Corp’s fees will put a big dent in her litigation budget. She likens the arbitration to a hostage situation and the request to pay Gen Corp’s share, with no guarantee of repayment, to a ransom. If she decides not to pay Gen Corp’s share, the arbitration will be terminated without resolution. And if the arbitration is terminated, she has lost the incentive to pay her own company’s $50,000 share of the cost, increasing the likelihood that the arbitrators will get stiffed for $100,000 in unpaid fees and costs, and everyone will have spent time, money, and energy on a process that accomplished nothing.

Unfortunately, the current rules of arbitral institutions such as the American Arbitration Association (AAA) and the International Centre for Dispute Resolution (ICDR) allow claimants to engage in a pay-only-if-I’m-winning strategy that can result in arbitrators not getting paid and the arbitration being terminated. With the growth of contingency-fee representation and third-party funding arrangements, the strategy will only become more common. Some basic rule changes, however, could greatly reduce the impact of this unfair system. But first, some background concepts are explored.

Arbitrator Fees and Costs

Unlike court proceedings administered by the government with funding from taxpayers, arbitrations are typically administered by private arbitral institutions and funded entirely by the parties involved in the arbitrated dispute. The main difference between arbitration and litigation in terms of out-of-pocket costs is compensation for the arbitrators. Unlike judges (who are paid by the publicly funded court system) and juries (who receive no pay from the parties), arbitrators who preside over arbitrations and determine the outcome are paid by the parties themselves.1

Arbitrators are typically experienced attorneys who charge an hourly rate for time spent on the arbitration.2 They also typically charge for travel and other costs associated with the arbitration.3 Depending on the complexity of the issues addressed, the travel requirements, and the length of the proceeding, arbitrator fees and costs can be substantial. According to statistics provided by the AAA for arbitrations between 2012 and 2015 involving awards of $1 million or more, the median arbitrator fees for a three-member panel were $295,946 for intellectual property disputes and $124,029 for business disputes.4 If the dispute involves complex technology or specialized legal issues, the arbitrators may rely on experts, which drives costs even higher.

Cost Sharing

Arbitration is a creature of contract,5 and the contract clauses that require disputes to be resolved in arbitration may specify the share of arbitrator fees and costs that each party is obligated to pay should arbitration be needed. Although any desired fee-sharing arrangement can be negotiated, a common approach is to specify that the parties are responsible for an equal share of arbitrator fees and costs. If the contract has an arbitration clause that does not specify the breakdown, the fees and costs will typically be shared equally under default rules of arbitral institutions.6 Another common approach is to specify a three-person arbitration panel with the fees divided according to the selected arbitrators — one arbitrator is appointed by each party, and the third arbitrator is selected by mutual agreement of the two appointed arbitrators. Arbitration clauses requiring a three-person panel may specify that each party is responsible for the fees of its appointed arbitrator and half the fees and costs for the third arbitrator. Although

The main difference between arbitration and litigation in terms of out-of-pocket costs is compensation for the arbitrators.
the parties may not have control over the costs of the third arbitrator, they have complete control over the hourly rate of their respective appointed arbitrator.

**Arbitrator Fee Deposits**

Under the rules of various arbitral institutions, arbitration cannot begin until each party has paid a deposit on its respective share of the projected fees and costs.\(^7\) As the arbitration progresses through discovery, briefing, and hearings, the arbitrators periodically provide bills to the arbitral institution, and the institution pays the arbitrators from the deposits. Because predicting fees and costs is difficult, the initial deposits are often too small to cover all the fees, and the arbitral institution typically requires the parties to make additional payments\(^8\) before the final award is issued.

**Refusing to Pay**

Respondents (the parties who have been sued) often follow a well-known strategy to avoid liability in arbitration: they refuse to pay their share of the initial deposit at the beginning of the arbitration.\(^9\) According to the rules of arbitral institutions, once the respondent has indicated its refusal to pay, the arbitration can begin only if the claimant (the party who initiated the arbitration) agrees to front the respondent’s share of the deposit.\(^10\)

Various commentators have identified this problem, explained how unfair it is to the party who wants to resolve a dispute in arbitration, and noted that existing arbitration rules actually provide incentives to “game the system” and reward the strategic behavior of the non-paying party.\(^11\) But these commentators
HOT TOPICS

focus on the unfairness of a respondent’s failure to pay at the outset of arbitration, before time and money have been invested in resolving the dispute. They do not address cases such as Gen Corp, in which the claimant, the party who initiated the arbitration, refuses to pay after the arbitration has started, when it has become clear that the claimant is going to lose.

Claimants Refusing to Pay in the Midst of Arbitration

Several events can make the pay-only-if-I’m-winning strategy attractive to a claimant and result in the claimant refusing to pay its share of fees in the midst of arbitration: the discovery of harmful evidence or testimony; a preliminary ruling by the arbitration panel (e.g., a partial final award) that hurts the claimant’s case; a finding against the claimant in a parallel proceeding on a related issue; and the claimant’s determination that the potential amount owed for a pending counterclaim may outweigh the potential recovery from its original claim.

Once an arbitration has begun, existing rules are adequate to protect a respondent who does not want to continue. Under these rules, the claimant’s own claims are deemed withdrawn if the claimant refuses to pay the required balances or supplemental deposits. But the rules do not protect the arbitrators who have not been paid for their time or respondents who want the arbitration to proceed according to the terms of the fee-sharing clause in the arbitration agreement. As in the case of Gen Corp, unless the respondent agrees to pay the complainant’s share of fees and costs, the claimant’s refusal to pay may leave the dispute in limbo. If the respondent decides not to front its adversary’s share, the arbitrators will not get paid and all the time and money spent arbitrating will have been wasted.

Contingency fee representation and third-party funding in litigation and arbitration have grown significantly over the past decade.

Investor Arrangements

Contingency fee representation and third-party funding in litigation and arbitration have grown significantly over the past decade. These investor arrangements allow claimants who cannot otherwise afford the upfront costs to arbitrate their claims. They also allow claimants who can afford the costs to offset the risks of uncertain outcomes and control budgets by bringing in an investor who funds the arbitration and assumes a portion of the risk.

Under an investor arrangement, the investor provides funding for the dispute in exchange for a percentage of the potential monetary damages awarded to the claimant. Under a typical third-party funding arrangement, the investor pays for a claimant’s attorney fees and the arbitrator fees and costs. The third-party funder recoups his or her investment from any recovery obtained in the arbitration and also receives a percentage of the recovery beyond costs to compensate the funder for risk. Under a typical contingency-fee arrangement, counsel representing the complainant in the arbitration is both the investor and the advocate. Counsel does not charge any attorney fees for the time spent on legal representation and pays the arbitrator fees and costs. Similar to the third-party funder, the contingency-fee counsel expects to recoup fronted arbitrator fees and costs from any recovery made and gets a percentage of the recovery beyond out-of-pocket costs.

Although the benefits of these investor arrangements are apparent for claimants who are unable to afford arbitration without funding and those who prefer to shift the risk of losing to third parties, such arrangements may be detrimental to respondents and arbitrators because they create an incentive for the investor behind the complainant to engage in the pay-only-if-I’m-winning strategy. When it becomes likely that the claimant will lose (or not be able to recover a monetary award large enough to cover the ongoing costs and fees of arbitration), the investor may bail out and cut his or her losses. Because the investor’s contractual obligation to pay the claimant’s share of fees and costs is outside the scope of the arbitration and generally unknown to anyone other than the claimant and investor, existing rules allow the investor to get out of the arbitration without repercussion.
If the respondent agrees to pay the arbitrator fees and costs owed by the claimant so that the arbitration can proceed, the arbitrators get paid, but the respondent has no guarantee that he or she will get reimbursed for paying its adversary’s share of fees. As the letter to Gen Corp’s respondent noted, the respondent must “apply” to get reimbursed at the end of the arbitration, and reimbursement is at the arbitration panel’s discretion. Even if the arbitration panel orders the complainant to reimburse the respondent for the fronted fees and costs in the final arbitration award, if the claimant does not have the funds to pay, the respondent cannot recover. While it would seem fair to allow the respondent to pursue reimbursement of the claimant’s share from the third-party funder or contingency-fee counsel, the arbitration rules include no mechanism to do so. The current rules do not require disclosure of investors in the arbitration, which means that the arbitrators or the respondent may need to file a separate lawsuit to find out about any investor arrangement.

Proposed Rule Changes

Although no silver bullet can prevent a claimant or its investor from using the pay-only-if-I’m-winning strategy after the arbitration has begun, just knowing that the strategy is a possibility is helpful. One of the advantages of arbitration is that it is flexible, and the parties, along with the arbitrators, can determine the structure of the arbitration based on efficiency and the particular characteristics of the dispute. If the respondent suspects that the complainant may resort to the pay-only-if-I’m-winning strategy, the arbitration can be structured in a way that protects the respondent and the arbitrators.

One clear way to provide this protection is to require the complainant (or its investor) to pay a large and comprehensive initial deposit as a condition for starting the arbitration. A less obvious tactic is to structure the arbitration such that all issues, including threshold issues, are decided by the arbitration panel at the same time, after all balances have been paid. While taking a staggered approach to deciding issues and payments may be more efficient under normal circumstances, each intermediate determination that goes against the complainant may result in the complainant’s bailing out of the process.

Three basic rule changes could significantly reduce the ability of a claimant to game the system. The first two are intended to provide notice to the arbitrators and respondent of the likelihood that the claimant may use the pay-only-if-I’m-winning strategy and the third is intended to provide predictability when the claimant refuses to pay its share of fees.

1. Mandate Disclosure of Investor Arrangements

The arbitration rules should be changed to require the claimant to disclose the existence of third-party funding or contingency-fee arrangements. Similar changes have already been proposed by commentators seeking to prevent conflicts of interest between arbitrators and undisclosed funders. Rules requiring disclosure of the identity of third-party funders at the beginning of the arbitration may address the conflicts-of-interest problem, but they do not go far enough to address the problems caused by the pay-only-if-I’m-winning strategy. New disclosure rules should apply to both types of investors (third-party funders and contingency counsel) and should also require the claimant to identify who is contractually responsible for paying the arbitrator fees and costs (the claimant or the investor) and any rights or circumstances that would allow the investor to discontinue fronting funds during the arbitration under the investor agreement. Once the funding arrangement details have been disclosed, the respondent, the arbitrators, and the arbitral institution will all be able to assess the likelihood of the investor ceasing payments during the arbitration and adjust the structure of the arbitration and the amount of initial deposits accordingly.

Complainants may be reluctant to disclose information about their funding arrangements, but as long as these details, like any other confidential information
disclosed in arbitration, are protected, there does not seem to be any good reason for withholding the information. At the very least, information about who is responsible for paying the arbitrator fees and costs should be disclosed to the arbitral institution for in-camera review. The administrator from the arbitral institution can then make an assessment of the potential risks before deciding whether to disclose the information to the arbitrators and the respondent.

2. Require any Investor to Certify Whether He or She Will Join the Arbitration and Assume the Complainant’s Obligation to Pay Arbitrator Fees and Costs

If an investor is not a party to the arbitration agreement, the arbitration panel has no authority to issue awards against him or her for failure to pay the complainant’s share of fees and costs. Once an investor arrangement has been identified, the rules should require the investor to join the arbitration and certify that it will assume the claimant’s obligations for arbitrator fees and costs, at least for claims asserted by the claimant, or certify that it reserves the right to refuse to fund the claimant’s share. These certifications by the investor will provide useful information about the investor’s level of accountability in situations where the complainant does not have sufficient funds to arbitrate. If the investor refuses to agree to be on the hook for the claimant’s share, then the arbitrators and the respondent are on notice that the investor is more likely to use the pay-only-if-I’m-winning strategy and stiff the arbitrators. Accordingly, larger initial deposits should be required and the arbitration should be structured to protect against the bailout strategy.

If the investor certifies that it will join the arbitration and assume the obligation to pay claimant’s share, the arbitrator panel can hold the investor accountable for any unpaid fees in the final award, and the respondent and the arbitrators will have the opportunity to go after the investor for any breaches of the fee-sharing agreement in post-arbitration collection proceedings. In situations where the complainant has deeper pockets than the investor, it may be beneficial to require a certification that the complainant and investor will be jointly liable for complainant’s share of arbitrator fees and costs.

3. Award Fees to Respondent by Default If the Respondent Has to Pay Complainant’s Share

When an arbitral institution sends a letter requesting that a party front its adversary’s share of arbitrator fees and costs, the first question that comes to mind is whether the party who is breaching the fee-sharing agreement will be held liable for its breach at the end of the arbitration. The answer is typically “probably, but there is no guarantee.” Final apportionment of fees and costs is at the discretion of the arbitrators, and the paying party must apply for reimbursement of fronted fees. The uncertainty caused by the existing rules over the treatment of fronted fees and costs is a disincentive for the respondent to front the complainant’s share. If the arbitral institution wants the arbitrators to get paid, it should remove this uncertainty. The rules should be changed to provide the respondent with a monetary award for any fronted fees and costs by default at the end of the arbitration.

It is difficult to imagine a scenario that would justify penalizing the respondent for going beyond its contractual obligations and fronting its adversary’s share and rewarding the complainant for its breach of the fee-sharing agreement. If such a scenario exists, the breaching complainant should have the burden of applying to overturn the default monetary award that accounts for the breach. The proposed rule change that provides a default monetary award in favor of the paying party for fronted fees and costs should apply in all circumstances where one party is asked to front the other party’s share.

The pay-only-if-I’m-winning strategy is unfair — to the respondent as well as the arbitrators — and needs to be constrained. These three basic, easily implemented rule changes will give the respondent, the arbitrators, and the arbitral institution enough information to tailor the process to reduce the chances that a claimant will bail out — and to ensure that time, energy, and money are all well spent.
Endnotes

5. Eiseman & Farkas, supra note 2, at 1.
7. ICDR International Dispute Resolution Procedures, Article 36(1); AAA Commercial Arbitration Rules and Mediation Procedures, R-56(a).
8. ICDR International Dispute Resolution Procedures, Article 36(2); AAA Commercial Arbitration Rules and Mediation Procedures, R-56(a).
9. Eiseman & Farkas, supra note 2, at 1; Steven C. Bennett, What to Do When a Party Fails to Pay Its Portion of Arbitration Fees, Practical Lawyer, at 58.
12. Eiseman & Farkas, supra note 2, at 19; Dewitt & Dewitt, supra note 11 at 571, Bennett, supra note 9 at 58.
13. The strategy may also be attractive to a respondent who determines that the chances of winning have become diminished during the arbitration.
14. ICDR International Dispute Resolution Procedures, Article 36(4); AAA Commercial Arbitration Rules and Mediation Procedure, R-57(b).
15. ICDR International Dispute Resolution Procedures, Articles 32(2), 36(3); AAA Commercial Arbitration Rules and Mediation Procedures, R-57 (e,f).

Howard E. Levin is a partner with Haynes Boone in Chicago. His practice focuses on patent litigation and arbitration, strategic patent portfolio management, patent acquisitions, inter partes review (IPR), and counseling. He has represented foreign and domestic clients in patent matters before the International Trade Commission, the International Centre for Dispute Resolution, and federal district courts across the United States. He can be reached at howard.levin@haynesboone.com.

18. Drahozal, supra note 1, at 732.
19. Because third-party investors and contingency-fee counsel risk losing their entire investment if the claimant loses in arbitration, they should perform in-depth pre-filing investigations that identify the strengths and weaknesses of the claims and any expected counterclaims from the respondent. If the potential rewards significantly outweigh the risks of losing, the arbitration may be a good investment. But robust analysis of the risks and rewards may be time-consuming, and outcomes are difficult to predict. Thus, alternative fee arrangements are inherently risky for the investor and contingency fee counsel even if a significant amount of time is spent evaluating the merits of the case.
20. ICDR International Dispute Resolution Procedures, Article 34; AAA Commercial Arbitration Rules and Mediation Procedures, R-47(c).
22. ICDR International Dispute Resolution Procedures, Article 37; AAA Commercial Arbitration Rules and Mediation Procedures, R-23(a).
23. Under the Federal Arbitration Act, arbitration applies only to parties who have agreed to arbitration in a written contract. 9 U.S.C.A. § 2. “Arbitration is strictly a matter of contract. If a party has not agreed to arbitrate, the courts have no authority to mandate that he do so.” United Steelworkers of Am. v. Warrior & Gulf Navigation Co., 363 U.S. 574, 582, 80 S.Ct. 1347 (1960). However, a non-signatory can be bound by an arbitration clause under common law principles of “1) incorporation by reference; 2) assumption; 3) agency; 4) veil-piercing/alter ego; and 5) estoppel.” Thomson–CSF, S.A. v. American Arbitration Ass’n, 64 F.3d 776 (2d Cir.1995). Although it is theoretically possible, no US court decisions have been identified that support binding non-signatory third party funders or contingency fee counsel to the complainant’s arbitration agreement under common law principles of contract. One of the few grounds available to vacate an arbitration award is “where the arbitrators exceeded their powers.” 9 U.S.C.A. §10(a)(4). Any arbitration award that attempted to bind a non-signatory investor involuntarily would be subject to challenge.