ETHICS WATCH

Enforceability of Arbitration Clauses in Engagement Agreements

By Nathan M. Crystal

The engagement agreement is the most important document in the attorney-client relationship. Properly drafted engagements clarify roles, responsibilities, and expectations; minimize disputes; and protect lawyers from liability to the maximum extent possible. Provisions on fees and expenses are, of course, fundamental, but lawyers should consider a wide range of other topics, such as scope of engagement, authority of counsel, client responsibilities and cooperation, attorney liens, file preservation and storage, use of technology in handling cases, and withdrawal and termination. In this article I will consider one important topic: whether lawyers should include arbitration provisions in their engagement agreements?

Rules of Professional Conduct and the Fee Disputes Resolution Board

Comment 9 to SCRPC 1.5 provides that when the bar has established a mandatory procedure for resolution of fee disputes, "the lawyer must comply with the procedure when it is mandatory." South Carolina has a fee dispute resolution system, SCACR 416. The system is "client option," i.e. if the client consents in writing to be bound by the decision of the Resolution of Fee Disputes Board, then the attorney is also bound and the jurisdiction of the Board is exclusive. See Rule 9 of SCACR 416. Of course, an attorney can suggest to a client the use of the system for resolution of a fee dispute, but there is no requirement that the lawyer's engagement include a reference to fee arbitration. (By contrast, New York requires engagements to include notice of the client's right to fee arbitration.) The jurisdiction of the Board is limited to disputes less than $50,000. Rule 2 of 416. As used in the rules the term "fee" includes "costs of litigation and disbursements." Id. Proceedings before the Board are confidential except to the extent of any appeals. See Rule 21 of 416. The Board does not handle claims of malpractice or professional misconduct except to the extent that they relate to fee disputes.

What is the effect of Rule 416 on the use of arbitration provisions in engagement agreements? Rule 416 is not dependent on an arbitration provision in an engagement agreement. Since the rule is mandatory for lawyers at the election of the client, in my opinion it would preempt any arbitration provision in an engagement agreement but only to the extent that the arbitration provision was inconsistent with Rule 416. See *Schatz v. Allen Matkins Leck Gamble & Mallory LLP,* 198 P.3d 1109 (Cal. 2009) (arbitration provision in engagement agreement found not to be inconsistent with California Mandatory Fee Arbitration Act). Therefore, if an engagement agreement included an arbitration provision, Rule 416 would still govern fee disputes within the jurisdiction of the Board. However, Rule 416 would not preclude arbitration provisions that did not conflict with Rule 416, such as arbitration provisions covering malpractice claims and other client disputes that were not fee disputes (for example, dispute over the client's file); arbitration provisions covering fee disputes of $50,000 or more; and arbitration of fee disputes less than $50,000 where the client does not choose to use Rule 416 or where Rule 416 is unavailable (for example, when the claim is more than three years old, Rule 2 of 416). Would an arbitration provision in an engagement agreement covering disputes not within the jurisdiction of the Fee Disputes Resolution Board be enforceable?

ABA Formal Opinion 02-045

In *Formal Opinion* #02-425—Retainer Agreement Requiring the Arbitration of Fee Disputes and Malpractice Claims—the ABA Committee on Ethics and Professional Responsibility advised that it was ethically permissible for lawyers to enter into engagement agreements in which clients agreed to binding arbitration of fee disputes and malpractice claims subject to certain limitations. First, the arbitration provision would be improper if "it insulates the lawyer from liability or limits the liability to which she otherwise would be exposed under common or statutory law." For example, if the agreement precluded the award of punitive damages or attempted to limit the statute of limitations for claims against the attorney, it would be an impermissible prospective limitation on liability under SCRPC 1.8(h)(1).

Second, the lawyer must fully disclose to the client the risks and benefits of mandatory arbitration. See SCACR 1.4(b) (communication). It terms of benefits, arbitration can be faster, less expensive, and more private than dispute resolution by litigation, although this is not necessarily the case,

particularly with regard to expense. However, lawyers must disclose to clients the risks of arbitration:

> [T]he lawyer should make clear that arbitration typically results in the client's waiver of significant rights, such as the waiver of the right to a jury trial, the possible waiver of broad discovery, and the loss of the right to appeal. The lawyer also might explain that the case will be decided by an individual arbitrator or panel of arbitrators and inform the client of any obligation that the lawyer or client may have to pay the fees and costs of arbitration. Formal Opinion 02-425 at 2.

Therefore, if an arbitration provision in an engagement agreement complies with the requirements set forth in the ABA opinion, it should be ethically proper and enforceable, provided it complies with other law.

The South Carolina Arbitration Act (SCA) and the Federal Arbitration Act (FAA)

Attorneys considering including arbitration provisions in their engagement agreements must consider the possible application of the SCA, S.C. Code §15-48-10. Subsection (b) of the Act states:

> This chapter shall not apply to:
>
> (3) A pre-agreement entered into when the relationship of the contracting parties is such that of lawyer-client or doctor-patient …

While this provision at first glance may appear to preclude arbitration provisions in engagement agreements, there are several possible limitations on this provision. First, the provision could be applied literally, in which case it would not apply to the standard arbitration clauses found in engagement agreements between lawyers and clients because these do not amount to "pre-agreement" arbitration—they are part of the agreement. As Professor Freeman has pointed out, the term "pre-agreement" is "gibberish." *Caveat on arbitration clauses in retainer agreements,* Ethics Watch (January 2003). However, the drafters almost certainly meant "pre-dispute," and it is likely that the provision would be interpreted that way.

Second, and more substantively, the provision actually does not invalidate arbitration agreements between lawyer and client; instead, it provides that such agreements are <u>not subject to the SCA.</u> This interpretation of the exclusion could be justified on the ground that agreements between lawyer and client raise ethical issues that should be decided by the Supreme Court, not the legislature. Read this way, the exemption is a deference to Supreme Court regulation of lawyers rather than an invalidation of arbitration clauses. If the Act does not apply to arbitration agreements between lawyer and client, a court could enforce such an agreement based on common law contract principles. This reading would be consistent with the overall purpose of the SCA, which was to validate rather than nullify arbitration. Indeed, section (b)(1) seems to contemplate common law arbitration stating that the chapter does not apply to "[a] agreement or provision to arbitrate in which it is stipulated that this chapter shall not apply or to any arbitration or award thereunder." Given the increasing use and validity of arbitration since the passage of the SCA in 1978, and the validation of attorney-client arbitration given by the ABA Opinion, this narrow interpretation of the lawyer-client exclusion from the SCA would be sound as a matter of policy.

Third, the South Carolina Act does not apply if the FAA, 9 U.S.C. §1, preempts the state law. *Lucey v. Meyer,* 401 S.C. 122, 2012 S.C. App. Lexis 402 (2012), while not dealing specifically with attorney-client contracts, is illustrative of the relationship between the SCA and the FAA. In *Lucey,* the court of appeals dealt with an employment contract between the Justin Lucey Law Firm and attorney Meyer that contained an arbitration clause. The contract specifically referred to certain cases that Meyer would be working on. These cases involved interstate commerce. In one case that Meyer handled, she traveled frequently outside of South Carolina. When a dispute developed between the parties, the Law Firm sought to compel arbitration. The court of appeals agreed with the Law Firm that the contract involved interstate commerce and accordingly it was subject to the Federal Arbitration Act. If the SCA had applied, the arbitration agreement would have been unenforceable because it did not satisfy the requirement of conspicuous notice of arbitration under the SCA. S.C. Code §15-48-10(a). The court in *Lucey* discussed a number of South Carolina cases finding that contracts involved interstate commerce and were therefore subject to the FAA. One case, *Timms v. Greene*, 310 S.C. 469, 427 S.E.2d 642 (1993), held that a contract between a nursing home and patient was not subject to FAA even though the home was a division of a Delaware partnership, marketed outside the state, and purchased most of its equipment and supplies outside the state. However, *Timms* was overruled by *Dean v. Heritage Healthcare of Ridgeway, LLC*, 408 S.C. 371, 759 S.E.2d 727 (2014), with the court citing the expansive view of interstate commerce applied by the Supreme Court in cases involving the FAA.

Based on *Lucey* and the overruling of *Timms* it would appear that an engagement agreement with an arbitration clause between a South Carolina firm and a client from another state for litigation or transactional services in South Carolina or elsewhere should be subject to the FAA. Similarly, a contract between a South Carolina firm and a South Carolinian for lit-

igation in another state should also be subject to the FAA. It might be questionable whether an engagement agreement between a South Carolina law firm and a South Carolinian for legal services to be rendered only in South Carolina would be subject to the FAA, but perhaps it would. For example, the contract probably involves research or data storage services offered by companies out-of-state. In addition, it might require out-of-state travel by lawyers involved in the case.

The significance of the engagement being subject to the FAA is that the engagement would not be subject to the restrictive provision of the SCA, although as discussed above, in my opinion S.C. Code §15-48-10(b)(3) should be narrowly construed only to prevent the application of the SCA to arbitration clauses in engagement agreements, but not to prohibit as a matter of common law an attorney and client from entering into an engagement with an arbitration clause, even if the FAA does not apply. The interpretation of the SCA I suggest would also promote uniformity in treatment of arbitration clauses in engagement agreements of South Carolina lawyers—all such clauses would be enforceable either under the FAA or common law of contract provided they complied with ethical requirements such as those set forth in ABA Formal Opinion 02-045.

Recent significant arbitration cases

If a law firm decides to include an arbitration clause in an engagement agreement, drafting can be tricky as shown by two recent appellate decisions. In *Rice v. Down,* 2016 Cal. App. LEXIS 529 (Cal. App. 2016), the California Court of Appeals held that an arbitration clause in a partnership agreement between a lawyer and client did not cover tort claims including malpractice claims because the arbitration stated that it applied to "any controversy … arising out of this agreement." The appellate court reasoned that the clause was too narrowly written to cover tort claims. Instead, it should have provided for arbitration of "any controversy or claim arising out of or relating to this agreement."

In *Tillman v. Rheingold*, 2016 U.S. App. LEXIS 10818 (9th Cir. 2016), the Ninth Circuit Court of Appeals held that when a client was unable (not just unwilling) to pay the required amount of her deposit with the arbitrator ($18,562 in that case), resulting in dismissal of the arbitration, the client could still proceed civilly despite the binding arbitration clause in the engagement agreement. Lessons: arbitration clauses should not result in a denial of justice for the client. Choose carefully the arbitration system so as to not unduly burden clients, particularly clients with modest means. In addition, consider including in the arbitration provision an option for the firm to pay the fees if the client can establish inability to do so. It may be worthwhile to pay the fees in large cases. ⚖

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