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Arbitration Discovery Has Its Limits

Law360, New York (February 18, 2009) -- Arbitration continues to grow in popularity as a means for resolving disputes because of the many features it can offer instead of litigation, including the more streamlined and cost-effective discovery process typical in arbitrations.

While a limited scope to discovery has its benefits, there are situations in which parties will need more extensive discovery to frame their side of a disputed matter.

A November 2008 federal appellate decision has clarified that parties to arbitrations cannot compel pre-hearing document discovery from non-parties.

This decision may cause parties to certain agreements to consider whether arbitration provisions will provide enough protection if a dispute emerges.

Court's Ruling in Life Receivables Trust

The Court of Appeals for the Second Circuit recently held that the Federal Arbitration Act (FAA) does not authorize arbitrators to compel pre-hearing document discovery from persons or entities who are not parties to the arbitration proceeding.

At issue in Life Receivables Trust v. Syndicate 102 at Lloyd's of London[1] was Section 7 of the FAA, which grants arbitrators the ability to "summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document or paper which may be deemed material."[2]

The statute also allows for enforcement of arbitral subpoenas in federal district court, just as with subpoenas in federal litigations.

The Second Circuit seized on the rule's express provision that persons could be summoned "to attend before them or any of them as a witness" and concluded that a non-party could be summoned only to attend a hearing.[3]

The court held that the explicit limitation of Section 7 did not allow for any other subpoenas to non-parties – including a subpoena for documents to be produced separate from any hearings.

Under the court's decision, a non-party can only compelled to produce documents if the summons requires attendance at a hearing before the arbitral panel.

Given this reading, the Second Circuit reversed the district court's enforcement of an arbitration subpoena demanding that a non-party produce documents during the pre-hearing discovery phase.

In reaching its decision, the court addressed three different approaches taken by other appellate courts on whether the power under Section 7 was limited to subpoenas for hearings.

The Second Circuit agreed with a 2004 decision of the Third Circuit (authored by then-Circuit Judge Samuel Alito) that concluded that the express language and legislative history of Section 7 did not empower arbitrators to compel pre-hearing document discovery from non-parties.[4]

The Second Circuit found that this interpretation reflected the "emerging rule," as several district courts in the last few years have accorded with the limited reading of Section 7.[5]

In reaching this view, the court rejected earlier decisions by the Eighth and Fourth Circuits that held that arbitrators had implicit powers to compel pre-hearing discovery to further efficiency or to respond to a showing of special need or hardship, respectively.[6]

The court noted that the FAA was enacted before the Federal Rules of Civil Procedure created more expansive discovery vehicles, but declined to assume that Congress intended those devices to be available in federal arbitrations.[7]

Sympathetic to the practical burdens imposed by the FAA, the court suggested that parties could seek to obtain discovery from non-parties by requesting that the arbitration tribunal hold hearings and issue subpoenas for the limited purpose of obtaining documents – and if needed, authenticating testimony – from non-parties.

But because the availability of this possible path is within the arbitrator's discretion and, in any event, could prove expensive, it may be too risky for a party who feels it will absolutely need pre-hearing, non-party discovery. Arbitrators may decline to hold hearings, particularly where documents are sought from multiple non-parties.

Indeed, the Second Circuit recognized that the presence requirement of Section 7 forces the parties and arbitrators to consider whether non-party discovery is really necessary,[8] and a panel may decide that it is not needed.

Further, when arbitrators do hold hearings, they charge for their time. The rigmarole of repetitive hearings and requests for hearings, therefore, might not be cost-effective. This problem is compounded when there are multiple arbitrators on a panel.

In light of the Second Circuit's holding, it would be risky for a party to an arbitration to assume that the panel will grant requests for hearings just for the purpose of getting documents from non-parties before the merits are tried – especially because a hallmark of arbitration is more expedited and narrow discovery than most litigations.

As a result, parties should consider the potential need for non-party discovery before agreeing to arbitrate.

Practical Impact of Second Circuit's Decision

The Life Receivables Trust decision has special implications for parties to certain contracts who might be more likely to need documents from non-parties and would want to obtain them before a merits hearing.

Here are just a few examples where parties to a dispute would deem non-party documents essential to developing a legal strategy.

As one example, in an arbitration between a property casualty insurer and insured, either party might seek fire or safety records from government agencies for their relevance to liability under the policy. Without these records, each party would have a more difficult time in establishing fault or lack of fault.

Another example comes from the world of protective covenants between an employer and an employee.

If the employee left the employer, began soliciting the employer's clients in violation of the protective covenant, and diverted the employer's business, the employer might want to obtain the diverted clients' records of communications with the former employee to prove that the employee violated the protective covenant.

If the parties had agreed to arbitrate this type of dispute, the employer, under the Second Circuit's ruling, would not be able to compel the diverted clients to produce their records without a hearing. The employer, therefore, might miss the opportunity to obtain favorable documents before a final hearing.

Conversely, if the non-party documents would have reflected the absence of any prohibited contact, the employer might not learn this fact until a hearing.

An additional hypothetical comes from the world of television advertising contracts. Frequently, an advertiser will contract with an ad buyer, who acts as an intermediary in placing television commercials on a variety of stations and programs.

The ad buyer secures commercial slots and relies on both the individual stations to verify that they ran the contracted commercials and rating services to determine the number of viewers, which impacts the prices paid under the ad-buy agreement.

If the ad buyer and advertiser get into a dispute over the money to be paid, the ad buyer might need to compel documents from both the television stations and rating services to establish its right to payment. In an arbitration, the ad buyer could not count on getting those documents before a final hearing.

The Court's Rationale Might Limit the Availability of Depositions

The Second Circuit's adherence to the strict textual limits of Section 7 should provide a warning to parties who take for granted that many common discovery devices will be available to them in arbitrations, including depositions.

Neither Section 7, nor any other provision of the FAA, contains a mechanism by which non-parties can be compelled to submit to depositions.

Non-party depositions were not at issue in Life Receivables Trust, so the Second Circuit did not take a position on whether Section 7 could be invoked to compel pre-hearing depositions, and has not previously taken one.[9]

Several district courts have held that non-parties could not be compelled to give depositions in an arbitration,[10] and the rationale of Life Receivables Trust gives non-parties a strong argument against being forced to appear at a deposition, should a party convince an arbitrator to issue a subpoena for one.

Therefore, parties to arbitrations should not assume that depositions of non-parties will be available.

Conclusion

Life Receivables Trust serves as a reminder to contract drafters, including insurers, that by agreeing to proceed with arbitration, they may have to forego discovery vehicles that are sometimes taken for granted – non-party document discovery and, depending on the tribunal, non-party depositions.

Many companies opt for arbitration because of its cost-effective discovery procedures. But for some disputes, streamlined discovery may act more as a detriment than a benefit, especially where documents from non-parties are deemed essential.

In light of the holding of Life Receivables Trust, arbitrating parties may find it considerably more difficult in an arbitration to get the discovery desired from a non-party than in a litigation.

Before agreeing to arbitrate, contracting parties should assess the likelihood the discovery from non-parties may be critical if a dispute arose so they can determine whether arbitration is the best way to resolve a potential dispute.

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[1] 549 F.3d 210 (2d Cir. 2008).

[2] 9 U.S.C. 7 (2009).

[3] 549 F.3d at 216-17.

[4] Id. at 215 (citing Hay Group Inc. v. E.B.S. Acquisition Corp., 360 F.3d 404, 407 (3d Cir. 2004)).

[5] 549 F.3d at 216.

[6] 549 F.3d at 215 (citing In re Arbitration Between Sec. Life Ins. Co. of Am., 228 F.3d 865, 870-71 (8th Cir. 2000) and Comsat Corp. v. Nat'l Sci. Found., 190 F.3d 269, 275 (4th Cir. 1999)).

[7] 549 F.3d at 216.

[8] Id. at 218.

[9] Id. at 215.

[10] See, e.g., Matria Healthcare LLC v. Duthie, 584 F. Supp. 2d 1078, 1080 (N.D. Ill. 2008); Odjfell ASA v. Celanese AG, 328 F. Supp. 2d 505, 507, n.1 (S.D.N.Y. 2004) (and cases cited therein).