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by Kurt L. Schmalz

A Fee Change

A recent California Supreme Court decision has eviscerated the effectiveness of the Mandatory Fee Arbitration Act

For more than 30 years, attorneys and clients in California have resolved disputes over legal fees and costs through the Mandatory Fee Arbitration Act (MFAA).[1] Under the MFAA, local bar associations conduct nonbinding arbitrations for the disputants, and parties dissatisfied with the result of an arbitration can move for a trial de novo in superior court. But the days of the MFAA appear to be numbered. A recent California Supreme Court case, *Schatz v. Allen Matkins Leck Gamble & Malloy LLP*,[2] has eviscerated the MFAA and, if that were not enough, cases construing the Federal Arbitration Act have created authority that threatens to preempt what little remains of the MFAA.

The unraveling of the MFAA has been sudden, but it should not have been unexpected. In 2004, the California Supreme Court in *Aguilar v. Lerner*[3] found that the binding arbitration clause in an attorney-client fee agreement was not superseded by the MFAA, but the majority opinion narrowly based the decision on the client's waiver of the MFAA. Justice Chin, in a concurring opinion joined in by two other justices, advocated overruling *Alternative Systems, Inc. v. Carey*,[4] a 1998 decision in which the court of appeal held that the MFAA displaced agreements between attorneys and clients for binding arbitration of their fee disputes. Indeed, until *Schatz* in January 2009, the prevailing view was that the MFAA had implicitly repealed the older California Arbitration Act (CAA)[5] as it pertained to binding arbitration agreements between attorneys and clients over fee disputes.

Although *Alternative Systems* and the MFAA survived the *Aguilar* decision, Justice Chin and his colleagues exposed significant cracks in the MFAA edifice regarding its support of California's strong public policy promoting a single binding arbitration pursuant to the CAA. In *Schatz*, a unanimous court upheld binding arbitration clauses, enforceable under the CAA, as being complementary to—and not in conflict with—MFAA arbitration.

In 1976, the State Bar of California Board of Governors found that attorney-client fee disputes "were the most serious problem between members of the bar and the public."[6]

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The State Bar proposed the creation of a consumer-oriented arbitration system that would counteract the perceived disparity in bargaining power between attorneys and clients.[7] In enacting the MFAA, the California Legislature opted to devise an arbitration scheme that was separate and distinct from the previously established CAA. Under the MFAA, the State Bar Board of Governors was tasked with setting up a system and procedure for the arbitration of disputes over fees charged for professional services by members of the California bar or by members of the bar of other jurisdictions.[8]

The MFAA offers a dispute resolution scheme that includes arbitration, mediation, and ultimately (if either party rejects the arbitration award) a trial in superior court. The MFAA's dispute resolution procedure is limited to disputes between attorneys and clients over attorney's fees and costs and is specifically inapplicable to "claims for affirmative relief against the attorney for damages or otherwise based upon alleged malpractice or professional misconduct."[9] The MFAA system that has developed over the past 30 years involves arbitrations conducted through local bar association programs that are subject to review by the State Bar Board of Governors.[10]

An MFAA arbitration usually is triggered when an attorney sends a client a written notice of the client's right to arbitrate under the MFAA. If the client fails to initiate an MFAA arbitration before a local bar association within 30 days following receipt of this notice, the client waives the right to arbitration under the MFAA, and the attorney is entitled to sue the client in court for fees or, if appropriate, to initiate a private arbitration outside the MFAA.[11] The client can also waive the right to an MFAA arbitration by seeking judicial resolution of the fee dispute or suing the attorney for legal malpractice or other affirmative relief.[12] If the attorney files a lawsuit or other legal proceeding against the client to collect fees (including a private arbitration) without giving the client written notice of the right to MFAA arbitration, the client can stay the legal proceedings by serving and timely filing a request for arbitration, pursuant to the MFAA, or ask the court to dismiss the legal proceeding brought by the attorney.[13]

The MFAA, designed to be consumer friendly, allows the client to participate in the MFAA arbitration without having to hire a second attorney. Indeed, the MFAA system is voluntary for the client but mandatory for the attorney, if the arbitration procedure is properly initiated by the client.[14] However, unlike arbitration under the CAA, the award in an MFAA arbitration is only binding if neither the attorney nor the client rejects the award and seeks a trial in superior court no later than 30 days after service of the award on the parties.[15]

Significantly, the ability of the parties to reject an MFAA award and proceed to trial in court is in conflict with California's strong policy that parties who agree to resolve their disputes in private arbitration should be allowed to do so in a single binding arbitration. Moreover, the MFAA is a "closed system" of special arbitration before local bar associations, not a binding arbitration in a private forum like the American Arbitration Association or similar organizations.[16] The hybrid nature of the MFAA system—a combination of nonbinding arbitration and judicial proceedings—clearly clashes with the core concept of arbitration, which is the private resolution of a dispute in a single proceeding outside of court.

State and National Public Policy

The CAA, which was enacted in 1961, "represents a comprehensive statutory scheme regulating private arbitration in California."[17] The CAA emphasizes private arbitration as a favored procedure for "speedy and relatively inexpensive means of dispute resolution."[18] In enacting the CAA, the legislature expressed a "strong public policy" in favor of private arbitration when the parties to a contract have agreed to arbitrate their disputes.[19] The CAA sets forth procedures for the enforcement of agreements to arbitrate;[20] establishes rules for conducting arbitration proceedings, but the parties may otherwise agree to their own;[21] describes the circumstances in which the awards of arbitrators may be judicially vacated, corrected, confirmed, and enforced;[22] and specifies where, when, and how court proceedings that relate to arbitration matters will take place.[23]

Private arbitration is a policy priority not only in California. The Federal Arbitration Act (FAA) makes agreements to arbitrate disputes a national policy priority as well.[24] Moreover, a growing body of case law cites the federal preemption doctrine to invalidate state laws that interfere with contracts between parties to resolve disputes through a single binding arbitration.[25]

Thus the interplay between the MFAA, on the one hand, and the FAA's strong public policy in favor of the contractual arbitration of disputes, on the other, does not bode well for the continued viability of the MFAA. In the FAA, not only did Congress declare "a national policy favoring arbitration,"[26] but it also used its authority to regulate interstate commerce to withdraw the power of the states to require a judicial forum for the resolution of claims that the contracting parties agreed to resolve by arbitration.[27]

The FAA applies to arbitration provisions in written maritime contracts or contracts "evidencing a transaction involving commerce."[28] The courts have found the FAA to apply when a contract facilitates interstate commercial transactions or directly or indirectly affects commerce between the states.[29] Given the wide scope of what constitutes a transaction involving or affecting commerce, few commercial transactions, including those between attorneys and clients, would fall outside the ambit of the FAA. Even a garden variety sale of residential property in California was held to be a transaction involving interstate commerce when the purchase of the property was financed by a Federal Housing Administration loan and the parties used the forms copyrighted by the National Association of Realtors in the transaction.[30] Accordingly, a large number of attorney-client fee agreements in California could involve commerce sufficient to invoke the FAA—even agreements between a California attorney and a California-based client.

The FAA establishes an obligation to arbitrate notwithstanding any state substantive or procedural policy to the contrary.[31] The national policy in favor of arbitration applies in state as well as federal courts and "forecloses state legislative attempts to undercut the enforceability of arbitration agreements."[32] Thus, when parties agree to arbitrate all issues arising under a contract, "state laws lodging primary jurisdiction in another forum, whether judicial or administrative, are superseded by the FAA."[33]

The Impact of *Schatz*

The MFAA scheme clearly is fundamentally different from binding arbitration under the CAA or FAA. Until *Schatz*, the prevailing view was that if an attorney and his or her client specified in their initial fee agreement that all disputes would be resolved by binding arbitration, the MFAA system displaced binding arbitration for a fee dispute. In *Schatz*, however, the California Supreme Court tried to harmonize the MFAA's nonbinding arbitration with the binding arbitration provided for by the standard arbitration clause in attorney-client fee agreements enforceable under the CAA.

As a follow-up to Justice Chin's concurring opinion in *Aguilar*, the *Schatz* court found that the MFAA's right to a trial de novo was not intended to override a contractual obligation to arbitrate disputes pursuant to the CAA. In examining the statutory language of the MFAA and the CAA and "the strong public policy in favor of binding arbitration as a means of resolving disputes," the court found that after completion of the nonbinding arbitration under the MFAA, the dissatisfied party could seek a trial de novo "unless the parties had agreed to binding arbitration."[34] In that situation, according to

the court, the parties would move to a binding arbitration, as they had agreed, and not to a trial in court.[35] The justices rejected the contention, adopted by the court of appeal reviewing *Schatz*, that the MFAA had implicitly repealed a portion of the CAA as it related to attorney-client fee disputes:

> It would be illogical, and contrary to the purpose behind both the MFAA and the CAA, for the Legislature to permit attorneys to evade their agreement to arbitrate if, but only if, the client invokes the MFAA.…[A]n adoption of Schatz's position of implied repeal would result in a statutory scheme that is quite illogical. Giving effect to both the MFAA and the CAA, on the other hand, would be consistent with the distinct purposes behind both of those statutory schemes.[36]

Despite the court's efforts to harmonize the MFAA system with CAA binding arbitration, after *Schatz* it is hard to tell what is really left of the MFAA. Why would clients opt for a nonbinding MFAA arbitration when they had agreed to binding arbitration in the first place? Are two arbitrations—one under the MFAA and the other under the CAA—something that furthers a client's interest in an efficient and relatively inexpensive resolution of an attorney's fee dispute? A nonbinding arbitration—with its significant filing fees of up to $5,000 as well as other expenses and burdens on the client—seems to be pointless.[37] The client would be better off skipping the nonbinding MFAA arbitration and adjudicating all claims against the attorney in a single binding arbitration or, if the arbitration clause is waived or challenged, in court. Two arbitrations to solve one attorney-client fee dispute is not the consumer-oriented, cost-efficient system that the MFAA was supposed to create.

Before *Schatz*, clients could use the MFAA system to avoid binding arbitration agreements they had signed, using the trial de novo provision to get a jury trial. *Schatz* closed the door on that strategy in those circumstances when a valid arbitration agreement exists between attorney and client.

Thus, there seems to be little upside for clients to invoke the MFAA following *Schatz*. The next step may be for the legislature to clarify whether it actually intended for the MFAA to modify the CAA for attorney's fee disputes. Alternatively, it may be time to repeal the MFAA and have fee disputes governed by the CAA when attorneys and clients have agreed to binding arbitration in their initial fee agreements.

Federal Preemption Analysis

In crafting a response to *Schatz*, the legislature should be mindful that the current MFAA system does not fare well under a federal preemption analysis involving the FAA. To date, the issue of whether an arbitration under the FAA supersedes the MFAA system has not been squarely addressed in a published decision by either the California state or federal courts.[38] However, after *Schatz*, the likelihood is high that a state or federal court will soon address the issue of whether the MFAA is preempted by the FAA.

At first glance, an argument could be made that an agreement between a California-licensed lawyer and a California resident for a legal matter arising in California does not evidence "a transaction involving [interstate] commerce." Several unpublished California cases have reached this conclusion and rejected the FAA's applicability to attorney-client disputes.[39] One recent published court of appeal decision, in dictum, noted that when parties have a California choice of law provision in their agreement and choose to arbitrate in accordance with California law, preemption under the FAA would not occur.[40]

However, the preemption analysis employed by federal courts, and a few California courts, supports the argument that a fee agreement between a California attorney and a California client could evidence a transaction involving commerce or an activity that directly or indirectly affects commerce.[41] The U.S. Supreme Court has stated repeatedly that the practice of law is important to the national economy and, in the aggregate, the activities of lawyers have a significant effect on interstate commerce.[42] Thus, even though a specific attorney-client agreement at issue may not actually reflect a transaction in interstate commerce, the cumulative effect of this legal activity creates an impact sufficient to affect commerce and trigger the FAA.

Moreover, what might first appear to be a completely intra-state transaction between a California attorney and a California resident could affect interstate commerce if either the lawyer or client had offices outside California or if significant meetings or depositions in the case were expected to take place outside California. Similarly, if lawyers touted themselves to clients as having a reputation for representing clients or handling matters outside California, a court may find that the representation probably evidences interstate commerce. Also, if all or some of the defense costs of an engagement are being paid by an insurance company located outside California, the effect on interstate commerce from the payment of insurance money should be sufficient to trigger the applicability of the FAA to a dispute between the attorney and the client when there is a signed arbitration agreement between them.

Given the apparent resistance of some California courts to apply federal preemption to state-mandated proceedings in conflict with the FAA, attorneys who want their arbitration clauses to be enforceable should make sure that their fee agreements include recitations of the interstate aspects of their engagement. For example, the fee agreement containing the binding arbitration clause should include language about the interstate nature of the legal profession and its impact on the national economy. If out-of-state meetings or depositions are contemplated or out-of-state experts or consultants are expected to be retained, those facts also should be referenced in the agreement, along with a statement that the arbitration will be conducted pursuant to the FAA.

Of course, mere recitals will not create an effect on interstate commerce where none exists. Still, the marshaling of facts in the fee agreement to show the transaction's effect on commerce could be the difference between

an enforceable binding arbitration clause and one that opens the door to state-mandated administrative or judicial proceedings. As the U.S. Supreme Court has stated: "[A]ny doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability."[43]

While these precautions could make the difference, ultimately practitioners will gain further guidance from the inevitable head-on clash between the FAA and the MFAA. Recently, in *Preston v. Ferrer*, the U.S. Supreme Court held that the FAA preempts the administrative review provisions of the California Talent Agencies Act.[44] In 1984, the Supreme Court invalidated the arbitration preclusion provisions of California's Franchise Investment Law on the basis of FAA preemption.[45] The MFAA is likely to meet a similar fate once the FAA preemption issue is properly raised in court.

Even after the California Supreme Court held in *Schatz* that binding arbitration could replace the trial de novo option when the parties had agreed to binding arbitration, the nonbinding arbitration component of the MFAA would probably conflict with the FAA. As the U.S. Supreme Court noted in *Preston*, "A prime objective of an agreement to arbitrate is to achieve 'streamlined proceedings and expeditious results.'"[46] The *Preston* Court rejected the argument that an administrative proceeding that merely postponed the arbitration did not conflict with the FAA. According to the Court, the initial proceeding would delay the binding arbitration in contravention of the intent of Congress to move parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible.[47]

Accordingly, if the state legislature decides to review the MFAA post-*Schatz*, it may want to consider repealing the MFAA and letting the CAA control fee disputes when the parties have agreed to binding arbitration. Having attorney-client disputes for fees and other issues, including legal malpractice, resolved in a single binding arbitration rather than multiple arbitrations or other proceedings could be a more efficient and inexpensive alternative to the present system.

Another legislative alternative would be to keep the MFAA initial arbitration in place but make that arbitration binding only on the attorney. The client could reject the arbitration award and thereafter seek a trial de novo or go to binding arbitration if the parties had agreed to binding arbitration in the fee agreement. The lawyer, however, would have to accept the results of the MFAA arbitration. Although many lawyers would object to such an arrangement as being unfair, this change in the MFAA by the legislature would be consistent with its original consumer-oriented purpose.[48] Moreover, the client would have an incentive to use the MFAA, whereas after *Schatz* the initial arbitration—which either party could reject—would probably be a waste of the client's money. Clearly the MFAA, without legislative resuscitation, has reached the end of its useful life as an efficient dispute resolution system. ■

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[1] Bus. & Prof. Code §§6200 *et seq*.
[2] Schatz v. Allen Matkins Leck Gamble & Malloy LLP, 45 Cal. 4th 557, 87 Cal. Rptr. 3d 700 (2009). The court has extended the date for finalizing its opinion until March 27, 2009, pending a decision on Schatz's request for modification of the opinion.
[3] Aguilar v. Lerner, 32 Cal. 4th 974 (2004).
[4] Alternative Sys., Inc. v. Carey, 67 Cal. App. 4th 1034, 1042 (1998).
[5] The California Arbitration Act, Code Civ. Proc. §§1280 *et seq*.
[6] Aguilar, 32 Cal. 4th at 983 (discusses background of the MFAA and contrasts the MFAA dispute resolution system with the CAA procedures).
[7] *Id*.
[8] *Id*.
[9] Bus. & Prof. Code §6200(a), (b)(2).
[10] Bus. & Prof. Code §6200(d).
[11] Bus. & Prof. Code §6201(a); *see also* Ervin, Cohen & Jessup, LLP v. Kassel, 147 Cal. App. 4th 821, 828-29 (2007) (Binding arbitration clause in an attorney fee agreement is applicable when the client fails to invoke MFAA arbitration within 30 days after written notice.).
[12] Bus. & Prof. Code §6201(d); *see also* Aguilar, 32 Cal. 4th at 988-89.
[13] Bus. & Prof. Code §6201(b), (c); *see also* Alternative Sys., Inc. v. Carey, 67 Cal. App. 4th 1034, 1042 (1998).
[14] Bus. & Prof. Code §6200(c).
[15] Bus. & Prof. Code §6204(b), (c). In addition, the parties can agree in writing that the MFAA award shall be binding, provided that the agreement is made after the fee dispute arises. Bus. & Prof. Code §6204(a).
[16] Aguilar, 32 Cal. 4th at 984.
[17] Moncharsh v. Heily & Blase, 3 Cal. 4th 1, 9 (1992).
[18] *Id*.
[19] *Id*.
[20] Code Civ. Proc. §§1281.2–1281.95.
[21] Code Civ. Proc. §§1282–1284.2.
[22] Code Civ. Proc. §§1285–1288.8.
[23] Code Civ. Proc. §§1290–1294.2.
[24] 9 U.S.C. §§1 *et seq*.
[25] Federal preemption is based upon the Supremacy Clause in the U.S. Constitution, which provides: "This Constitution, and the Laws of the United States…shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding." U.S. Const. art. 6, cl. 2.
[26] Southland Corp. v. Keating, 465 U.S. 1, 10 (1984).
[27] *Id*.
[28] *Id*. at 10; *see also* 9 U.S.C. §2.
[29] Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 401-02 (1967).
[30] Hedges v. Carrigan, 117 Cal. App. 4th 578, 586-87 (2004) (FAA preempted Code of Civil Procedure §1298 requirements for type size and warnings in arbitration contracts.).
[31] Southland Corp., 465 U.S. at 10.
[32] *Id*. at 16.
[33] Preston v. Ferrer, ___ U.S. ___, 128 S. Ct. 978, 981 (2008).
[34] Schatz v. Allen Matkins Leck Gamble & Malloy, LLP, 45 Cal. 4th 557, 87 Cal. Rptr. 3d 700, 712-13 (2009).
[35] *Id*.
[36] *Id*. at 713-14.
[37] According to the current fee arbitration schedule for the Los Angeles County Bar Association, administered through Dispute Resolution Services, Inc., the filing fee for a client is 7% of the amount in dispute when the total dispute is $20,000 or more, with a $5,000 maximum. Thus, for a $75,000 fee dispute, a client pays a $5,000 filing fee to initiate the nonbinding arbitration. As of January 1, 2009, the filing fee for an unlimited jurisdiction civil action in Los Angeles Superior Court was $350. For a commercial claim over $10,000 but not exceeding $75,000, the American Arbitration Association charges a filing fee of $950. Also, the AAA charges a case service fee of $300, payable after the first hearing. Ironically, the cost to the client to initiate a nonbinding MFAA arbitration is significantly more than the other supposedly less consumer-friendly alternatives.
[38] In a footnote in *Aguilar*, the California Supreme Court declined "to address any issue concerning the Federal Arbitration Act" because the parties had not raised the issue. Aguilar v. Lerner, 32 Cal. 4th 974, 991, n.8 (2004). Justice Moreno's concurring opinion also notes that the court was not addressing "whether a state statute that precludes binding predispute arbitration agreements of legal fees would be preempted by the Federal Arbitration Act." *Id*. at 994.
[39] *See*, *e.g*., Goodrich, Goodyear & Hinds v. Conkle & Olesten, 2002 WL 2005678 (Cal. App. 4th Dist. 2002) (unpublished); Soni v. Sheldon & Mak, Inc., 2003 WL 23019405 (Cal. App. 2d Dist. 2003) (unpublished); Gemmel Pharmacies, Inc. v. Vienna, 2003 WL 22865624 (Cal. App. 2d Dist. 2003) (unpublished). *But see* Mitchell, Silberberg & Knupp v. McDonald & Co. Invs., 2002 WL 253920 (Cal. App. 2d Dist. 2002) (unpublished). The court states in dictum that an attorney-client fee agreement between a California law firm and a California client involved "commerce."
[40] Duffens v. Valenti, 161 Cal. App. 4th 434, 452 (2008) (Parties failure to properly develop facts relating to interstate commerce rendered analysis of FAA preemption "speculative.").
[41] Reber v. Provident Life & Accident Ins. Co., 93 F. Supp. 2d 995, 1009-10 (S.D. Ind. 2000) ("There can be no doubt that the practice of law in the aggregate significantly affects commerce."); Miller v. Travelers Ins. Co., 723 F. Supp. 1345, 1346 (E.D. Mo. 1989) (The extent of interstate communication, travel, and commerce necessarily involved in the practice of law today is evidence that practice of law is an activity "affecting commerce."). Reber and Miller involved ERISA jurisdiction, not the FAA, but the commerce analysis appears to be similar under the two statutes.
[42] Supreme Court of N.H. v. Piper, 470 U.S. 274, 281 (1985); Goldfarb v. Virginia State Bar, 421 U.S. 773, 788 (1975).
[43] Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626 (1985).
[44] Preston v. Ferrer, ___ U.S. ___, 128 S. Ct. 978, 989 (2008) (FAA preempts Labor Code §1700.44(a), a provision of the California Talent Agencies Act.).
[45] Southland Corp. v. Keating, 465 U.S. 1, 16 (1984) ("We hold that §31512 of the California Franchise Investment law violated the Supremacy Clause.").
[46] Preston, 128 S. Ct. at 986 (citations omitted).
[47] *Id*.
[48] This amendment would still face potential preemption under the FAA. However, with the amendment in place, a party could argue that the initial arbitration does not directly conflict with the FAA because it promotes binding arbitration consistent with the FAA and the CAA.