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Arbitration and Beyond: Avoiding Pitfalls in Drafting Dispute Resolution Clauses in Employment Contracts

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You've just helped a mid-sized company, Allwell Corp., to reach a settlement in an action brought by a disgruntled former employee. The CEO turns to you and says, "Even though I still believe that we didn't do anything wrong, I'm glad this lawsuit is over. I can't believe how much money and time we've wasted in defending ourselves. Now, how can we keep this from happening in the future? I've been reading about companies putting arbitration clauses in all kinds of contracts. I want to know whether we can require our employees to arbitrate—and maybe even require them to attempt mediation before arbitration—rather than sue us." The CEO tells you to report back by the end of the week.

You know that labor contracts often include provisions for arbitration and mediation of grievances. Even though Allwell has a non-union shop, can you just find a clause in a labor contract and cut and paste it into the company's personnel policy?

Well, no. If you want to be sure that your proposed "dispute resolution clause" is enforceable, you will need to be more careful in your drafting. This article is designed to warn you about some of the pitfalls you can and should avoid in developing dispute resolution clauses. Because the guidance is clearer for arbitration clauses, we will begin there. The article will then discuss drafting pitfalls applicable to clauses that provide for the use of other dispute resolution processes.

Federal Arbitration Act

Congress and the Supreme Court have combined to send strong signals encouraging parties to insert arbitration clauses into all sorts of contracts. In 1925, Congress passed the Federal Arbitration Act (FAA). Commercial arbitration is grounded in this statute.¹ Section 2 of the FAA specifically provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole

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or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

The FAA definitely is not a model of drafting clarity but, through a series of decisions, the Supreme Court has interpreted the above-quoted language in order to make its main message clear. First, the Supreme Court concluded that with the passage of the FAA, the Congress had declared a national policy favoring binding arbitration. Second, the Supreme Court ruled that the FAA preempted the states' power to force parties to use the courts when the parties had entered into agreements providing for binding arbitration. Then, in a series of opinions, the Supreme Court made it clear that if parties entered into agreements to use arbitration to resolve disputes, the courts would enforce those agreements.

If that were the entire story, there would be no need to be careful in drafting arbitration clauses. Not surprisingly, however, there are exceptions to the general rule established by the FAA and the Supreme Court's decisions. The language of Section 2 of the FAA is the source of many of those exceptions. This leads to our discussion of drafting pitfalls for arbitration clauses.

Drafting “pitfalls” for arbitration clauses

Pitfall #1: You assume that the FAA does not apply to your arbitration clause because it will be part of an employment agreement, not a maritime contract or a contract involving a “commercial” transaction.

If you read the quoted language carefully, you noticed that the FAA does not apply unless an arbitration clause is “part of a maritime contract or a contract evidencing a transaction involving commerce.” Which contracts “evidence a transaction involving commerce?” Did the Congress use this language as a means to place some limits on the reach of the FAA? Or, does every contract evidence a transaction involving commerce?

For a while, courts differed in their answers to these questions. This was significant because the answer determined the preemptive reach of the FAA. If the FAA were interpreted as applying to only a narrow class of contracts, states would be able to place substantial limits on the enforcement of arbitration clauses in the majority of contracts. If the FAA were interpreted broadly, states would largely be preempted from placing limits on contractual arbitration.

In two relatively recent decisions, the Supreme Court affirmed the expansive in-
terpretation of the FAA in invalidating states' efforts to place special limits on arbitration agreements. This has led various commentators to conclude that the FAA governs "virtually all arbitration in the United States, in state as well as in federal courts." What does this mean for you? Simply, you will need to be guided by the FAA as you write the arbitration clause for Allwell's employment contract.

Pitfall #2: You assume that an arbitration clause will be enforceable regardless of the types of employees covered by the clause.

Section 1 of the FAA specifically provides: "Nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce." What does this mean? In today's global economy, most workers have some involvement in interstate or foreign commerce. Does this mean that the FAA does not apply to arbitration clauses in agreements between any of these employees and their employers?

Despite the language of the FAA quoted above, the FAA has been applied to individual employment contracts in a wide variety of situations. In addition, several federal circuit courts have held that only workers in transportation industries are excluded from FAA coverage. Beyond this, some courts have held that only the workers who are directly involved in transportation or in the actual movement of goods are excluded. However, it is worth noting that case law interpreting this provision in Section 1 of the FAA is not totally consistent.

So let's imagine that Allwell is a mid-sized trucking company that ships products and materials across the country. Half of the employees are truck drivers while the remainder work in the office or in the warehouse. Allwell's CEO wants the arbitration clause to apply to all employees.

You can be quite confident that the FAA will not apply to the truck drivers and thus the FAA will not ensure the enforcement of your arbitration clause as it applies to these employees. On the other hand, assuming that your arbitration clause satisfies all of the other requirements of the FAA, it appears relatively likely that it will be enforced as it applies to the office and warehouse workers.

Pitfall #3: You assume that your arbitration clause will apply to all claims arising out of the employment relationship.

Section 2 of the FAA, which is quoted above, provides that arbitration clauses will be enforceable "save upon such grounds as exist at law or in equity for the revocation of any contract." Guided by this language, courts have refused to require arbitration if they find that the parties did not intend the arbitration clause to encompass certain claims or issues. Importantly, however, courts generally resolve questions concerning the
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Avoiding pitfalls in drafting dispute resolution clauses in favor of arbitration. And in the case of broadly worded arbitration clauses, the presumption favoring arbitration is applied with even greater force. (For instance, arbitration clauses covering “any disputes” or any “other disputes” in an employment contract generally have been found broad enough to encompass statutory claims, such as those made pursuant to Title VII.)

However, courts sometimes have invalidated the application of arbitration clauses to particular statutory claims, even when the employment contract contains broad language indicating that the clause is meant to apply to all disputes arising out of the employment relationship. Why?

An arbitration clause may not apply to a federal statutory claim if Congress has expressed an explicit and specific intent either to make such statutory claims unarbitrable, or to limit the ability of private parties to enter into a contract waiving the federal statute's protections. Under these circumstances, a court may find that Congress has “trumped” the FAA with another federal statute. For example, the Ninth Circuit Court of Appeals recently found that the Civil Rights Act of 1991 precludes the compulsory arbitration of civil rights claims and that employees cannot be required to waive their right to bring Title VII claims in court as a condition of employment.

If you want the arbitration clause in Allwell's personnel policy to apply to all disputes arising out of the employment relationship, not just those explicitly arising out of the policy itself, you should use broad language that conveys this intent. In addition, to be on the safe side, you may consider specifying that arbitration will be used to resolve federal statutory claims arising out of the employment relationship as well.

Pitfall #4: You assume that you can limit the remedies that are available to your employees.

Since Allwell can require its employees to arbitrate all disputes arising out of the employment relationship, can the company also limit their remedies? For example, can the arbitration clause provide that employees will be able to recover only for breach of contract claims? Can the clause provide that employees cannot recover punitive damages?

Quite simply, the answer is no. Allwell can restrict its employees to a particular forum, but the company cannot require them to waive substantive relief and remedies. Doing so will endanger the enforceability of the arbitration clause.

Pitfall #5: You assume that all of the administrative terms of your clause will be enforceable.
Of course, your clause will provide that all disputes arising out of an individual's employment at Allwell will be resolved through arbitration. However, it is very possible that your clause will go further, specifying the organization that will supply the arbitrators, how individual arbitrators will be selected, how much the arbitrators will be paid, and who will be responsible for paying them. There are good administrative reasons for defining these terms up front, rather than waiting until the first dispute arises to figure them out.

It is possible that a court could decide to enforce Allwell's arbitration clause generally, but invalidate one of these more detailed administrative matters for the same reasons described in Pitfall #3. For example, at least one lower court has found that Title VII of the Civil Rights Act of 1964 partially trumps the FAA by affording employees a nonwaivable right of reasonable access to a neutral forum. As a result, the court concluded that an employer compelling arbitration must pay the arbitrator's fee.  

Pitfall #6: You assume that the enforceability of your arbitration clause will not be affected by the fact that it is part of an employment agreement.

Based on the language in Section 2 of the FAA, courts also have invalidated arbitration clauses based on generally applicable contract defenses such as fraud, duress, and unconscionability. Courts have been more likely to deem arbitration clauses unconscionable when these clauses are found in "contracts of adhesion." These are contracts imposed by the party with superior bargaining strength in situations where the other party has no effective opportunity to reject the contract and the contract terms unreasonably favor the party with the bargaining strength.

The fact that the circumstances surrounding contract formation may affect enforceability is especially important in the employment context. Employees have argued that in certain situations (for example, if the employer adds new, more restrictive terms to an existing personnel policy and the new terms now apply to a long-time employee) employment contracts should be considered contracts of adhesion.

In several recent cases, the Supreme Court has upheld the enforcement of arbitration clauses in contracts that could be considered adhesive—including employment contracts. This obviously is significant. However, lower courts have not always been as supportive of arbitration clauses if they find them in contracts they consider adhesive. These courts have been willing to find specific terms contained in an arbitration clause to be outside the "reasonable expectations" of the weaker or adhering party, or unduly oppressive or unconscionable pursuant to a "principle of equity applicable to all contracts generally." For example:

- A California court found an arbitration clause in an employment contract to be unconscionable where the employee's statutory remedies were greatly curtailed, the employer's remedies were embellished, and the agreement was presented as a standard employment contract after the employee had commenced her employment.
- An Ohio court found an arbitration clause to be unconscionable because it required a party of limited means to pay an "exorbitant" filing fee to institute arbitration and the party had unknowingly agreed to the clause.
- The California Supreme Court found an arbitration clause unconscionable because the arbitrator was presumptively biased when the clause named a particular organization as the arbitrator and the more powerful party was a member of the named organization.
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The California Court of Appeals refused to enforce an arbitration clause in a small finance contract, finding it unconscionable due to such terms as selection of a distant forum and required payment of additional fees.24

The United States Court of Appeals for the Fourth Circuit refused to require arbitration where the process was “egregiously unfair” and “utterly lacking in the rudiments of even-handedness.”25

On the other hand, a federal district court in Minnesota enforced an arbitration policy that had been added to a company’s employee manual, finding that the policy language was sufficiently definite in form; the employee received a copy of the provision at the time it became effective; the employee continued his employment with knowledge of the changed condition; and there had been no showing that the arbitration clause was inherently unfair.26

What does all of this mean as you draft the arbitration clause for Allwell’s employment contract? Because an employment contract may be found to be a contract of adhesion, be certain that you:

1. Provide clear notice to employees regarding the arbitration clause and thus provide an opportunity for the knowing, voluntary waiver of rights.
2. Are clear regarding the scope of issues to be resolved through arbitration. Do you want arbitration to be used to resolve all controversies arising “under the employment contract” or all controversies arising “within the employment relationship?” If you want to exempt certain issues from arbitration, be specific.
3. Specify the use of clearly impartial arbitrators or provide for an impartial selection process, as well as thorough conflict disclosure procedures.
4. Avoid requiring employees to pay fees or costs that could be considered excessive and could be interpreted as inhibiting their access to the arbitration process.
5. Plan to hold the arbitrations in locations convenient for your employees.

Drafting pitfalls for other ADR processes

Pitfall #7: You assume that if a court would enforce an arbitration clause, it would be just as likely to enforce a clause providing for a different ADR process.

You’ve had a lot of good experience with mediation of employment disputes. You decide to follow the CEO’s lead and write a “dispute resolution clause” that provides for the use of a two-step process, med-arb. First, the company and the employee will attempt to reach resolution of the dispute through mediation. If the dispute is resolved at this stage, there will be no need to proceed to the second step. On the other hand, if mediation does not
resolve the matter, then the company and the employee will enter the second step, binding arbitration.

You plan to give the employees plenty of notice, use unquestionably impartial mediators and arbitrators, and provide the processes at no charge to the employees. You have no concerns that the clause will be considered unconscionable. Because a court would likely enforce a binding arbitration clause under these circumstances, it will be just as ready to enforce the mediation portion of your med-arb provision, right? Or wrong?

The answer is not absolutely clear at this time. It is important to remember that the courts' general willingness to enforce arbitration clauses is the direct result of Congress' endorsement of binding arbitration as described in the FAA. The FAA, however, does not reference mediation, med-arb, or any other ADR process besides binding arbitration. And without the direction provided by the FAA, it is up to the courts to decide whether it is fair and just to enforce clauses providing for the use of non-binding ADR ("non-binding ADR clauses").

Courts currently are employing a rather confusing array of tests as they try to determine whether to enforce non-binding ADR clauses. Upon examination, three general strands of analysis emerge from the cases—and sometimes all three strands are found in a single case.

**FAA analysis.** First, a court may ground its analysis in the FAA, even though the FAA does not apply to non-binding ADR clauses. The courts using this approach have focused on the language in Section 2 of the FAA, which provides for enforcement of "[a] written provision ... to settle [a controversy] by arbitration...." (Emphasis added.) Obviously, binding arbitration is certain to settle a controversy while non-binding ADR processes do not guarantee settlement.

This has led some courts to try to determine whether the ADR process written into a contract is likely to settle the controversy. If the process does appear likely to settle the controversy, courts have been willing to enforce the clause. On the other hand, when courts have concluded that nothing will be gained by forcing one of the parties to use a non-binding ADR process, they have refused to compel the performance of such "a futile or ineffective act."28

**Public policy.** Second, a court may find that public policy favors enforcement of all ADR clauses, not just binding arbitration. In the cases reflecting this strand of analysis, the courts appear to view binding arbitration as the "pioneer" ADR process, blazing the trail for all of its procedural cousins to follow.29

**Contract law.** Last, a court may analyze a non-binding ADR clause purely in terms of contract law. The courts using this approach have begun by determining whether the parties intended to enter into a non-binding ADR clause.30 If they did, the only remaining question has been whether or not the parties intended the clause to cover the particular dispute that has been brought to the court. When courts have determined that the dispute falls within the intended scope of the non-binding ADR clause, they have enforced the clause.31

As part of this analysis, some courts have invoked exhaustion principles, requiring that the complaining party exhaust the non-binding ADR procedures agreed to under the contract, before he or she can sue based on alleged breach of the same contract.32 Other courts also appear more comfortable enforcing non-binding ADR clauses where participation in the ADR process is simply
a condition precedent to bringing suit or entering into a binding ADR process.\textsuperscript{33}

For courts using the pure contract approach to determine the enforceability of these clauses, the generally applicable contract defenses described earlier will apply. Interestingly, courts have not found clauses providing for non-binding ADR unconscionable—yet.\textsuperscript{34} It is likely only a matter of time before non-binding ADR clauses are found unconscionable for the same reasons that have occasionally afflicted arbitration clauses.

So, what does all of this suggest as you draft your med-arb clause? First, don't forget all of the tips for drafting binding arbitration clauses. They apply to these clauses as well. In addition:

1. Be clear about the process that you are using. You may want to describe the process, rather than merely name it.
2. Indicate that you intend to use the process to “settle” controversies arising under the contract.
3. Build in procedural safeguards that make it more likely the process will result in settlement—e.g., trusted, impartial neutrals whose facilitation skills and/or evaluations are likely to be taken seriously, and adequate time for an employee to prepare for and participate in the process.
4. If you want to guarantee that the process will result in settlement, make the non-binding process a condition precedent to a binding ADR process.

Including ADR clauses in employment contracts is one of the most effective means of mainstreaming ADR.

\section*{Conclusion}

It can be exciting and fulfilling to find ways to “mainstream” the use of ADR into the employment arena. Including ADR clauses in employment contracts is one of the most effective means of mainstreaming ADR. However, poorly conceived or poorly introduced clauses can create unnecessary disputes and can keep employers and employees from achieving the full potential of ADR. ◆
Endnotes

Labor arbitration, meanwhile, is grounded in Section 301 of the Taft-Hartley Act, which was interpreted in 1957 as authorizing enforcement of agreements to arbitrate labor-management contract disputes. Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957).


Doctor’s Associates, Inc. v. Casarotto, 517 U.S. 681 (1996) (preempting a Montana statute requiring contracts containing arbitration clauses to include a statement on the first page that arbitration is required) and Perry v. Thomas, 482 U.S. 483 (1987) (preempting California’s prohibition against arbitration to resolve actions for collection of wages).

Macneil et al., Federal Arbitration Law § 9.5.3, text accompanying n. 46. This has been cause for concern among some legal commentators. See, e.g., Stemlight, Jean, Rethinking the Constitutionality of the Supreme Court’s Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns, 72 Tul. Rev. 1, 47 (1997).


See, e.g., Rojas v. TK Communications, Inc., 87 F.3d 745 (5th Cir. 1996).


See Rojas v. TK Communications, Inc., 87 F.3d 745 (5th Cir. 1996), Miller v. Public Storage Management, Inc. 121 F.3d 215 (5th Cir. 1997).


Duffield v. Robertson Stephens & Co., 144 F.3d 1182 (9th Cir. 1998) but see Seus v. Nuveen & Co., 146 F.3d 175 (3rd Cir. 1998). See also, Knepp v. Credit Acceptance Corporation, et al., 229 B.R. 821 (N.D. Ala. 1999) (court found an inherent conflict between the FAA and the Bankruptcy Code, that creditors’ interests would be affected by granting motion to compel arbitration, and that monies used to pay for arbitration “mean less money to fund the plan and pay creditors”); Wilson v. Waverlee Homes, Inc., 954 F.Supp. 1530 (M.D. Ala. 1997), aff’d 127 F.3d 40 (11th Cir. 1997) (court examined language of Magnuson-Moss Act, legislative history, and regulations adopted pursuant to Act and concluded that the Act does not allow for binding, non-judicial dispute resolution).


Cole v. Burns Int’l Sec. Servs., 105 F.3d at 1482. See also, Paladino v. Avent Computer Techs., Inc., 134 F.3d 1054 (11th Cir. 1998) (in suit for alleged violation of Title VII, court found arbitration clause in employee handbook unenforceable because it barred arbitrator from awarding damages except for breach of contract and thus defeated Title VII’s remedial purpose).


See cases cited supra note 4.


arbitration clause would be "to deny the resisting party a fair opportunity to present his position.")


And there are still plenty of courts that would prefer not to enforce arbitration agreements in certain contexts. See, e.g., Knepp v. Credit Acceptance Corporation et al., 229 B.R. at 827-828 ("The reality that the average consumer frequently loses his/her constitutional rights and right of access to the court when he/she buys a car, household appliances, insurance policy, receives medical attention or gets a job rises as a putrid odor which is overwhelming to the body politic. . . . When introduced as a method to control soil erosion, kudzu was hailed as an asset to agriculture, but it has become a creeping monster. Arbitration was innocuous when limited to negotiated commercial contracts, but it developed sinister characteristics when it became ubiquitous.")

28 Shade, Joseph, The Oil & Gas Lease and ADR, 30 Tulsa L.J. 599, 647 (1995). See, e.g., AMF Inc. v. Brunswick Corp., 621 F. Supp. 456, 460 (S.D. N.Y. 1985) (federal district court enforced an agreement between competitors to submit advertising conflicts to a neutral arbitrator who would render a non-binding advisory opinion, observing that the clause specified a neutral arbitrator who specialized in advertising claims and had at least as much expertise as a court and that the clause should be enforced if "viewed in the light of reasonable commercial expectations, the dispute will be settled by this arbitration."); Kelley v. Benchmark Homes, Inc., 550 N.W.2d 640 (Neb. 1996) (court found non-binding arbitration clause as condition precedent to commencement of litigation enforceable under the FAA); Harrison v. Nissan Motor Corp., 111 F.3d 343, 350 (3d Cir. 1997) (Better Business Bureau auto line created by automobile manufacturers for informal dispute resolution of consumers' complaints not within FAA's enforcement mandate because, based on auto line's history, there was "no reasonable commercial expectation that disputes will be resolved."); Brennan v. King, 139 F.3d 258 (1st Cir. 1998) (clause requiring submission of disputed tenure recommendations to "binding" arbitration not within FAA because arbitration decision not truly binding and thus would not provide final resolution of controversy). See also, CB Richard Ellis, Inc. supra note 9 (court enforced mediation clause in a Master Independent Contractor's Agreement between the parties, noting that parties agreed that the FAA governed court's analysis and that the mediation was intended to "settle" the controversies arising under the agreement).

29 See, e.g., Annapolis Professional Firefighters Local 1926 v. City of Annapolis, 100 Md. App. 714 (Ct. Spec. App. 1994) (court found that Maryland common law and public policy favored enforcement of an agreement to use mediation and that agreement to use ADR should be enforced "at least to the extent that it would be enforced if the chosen method were arbitration."); Citibank N.A. v. Bankers Trust Co., 633 N.Y.S.2d 314 (App. Div. 1995) (ADR agreement to defer litigation, to secure a non-binding determination and permit suit to enforce discovery provisions upheld by court under New York public policy favoring enforcement of arbitration and other ADR agreements).

30 See, e.g., Citibank N.A., 633 N.Y.S.2d at 314 (noting that ADR agreements should be enforced "where they 'reflect the informed negotiation and endorsement of the parties' ") (quoting Westinghouse Elec. Corp. v. New York City Transit Auth., 603 N.Y.S. 2d 404, 407 (1993)).

31 See, e.g., CB Richard Ellis, Inc., supra note 9 (court enforced mediation clause, finding that allegations related, "broadly speaking," to waste removal and therefore "touch[ed] matters covered by the agreement between the parties"); Ellsworth v. Ellisworth, No. C-970916, 1998 WL 892139 (Ohio App. 1 Dist. Dec. 24, 1998) (court found that parties' shared parenting plan required consultation, and mediation and arbitration if necessary, regarding schooling of children, that the mother had invoked the mediation/arbitration clause, and that the trial court was acting pursuant to its inherent power to enforce the provisions of its decree when it ordered the parties to arbitrate this issue pursuant to the plan); Cecala v. Moore, 982 F. Supp. 609 (N.D. Ill. 1997) (in case involving alleged failure to disclose material defect and knowing disclosure of false information regarding flooding in basement of home, court found that dispute fell within scope of mediation clause in contract between parties and enforced clause); AMF Inc., supra note 27; Kelley, supra note 27; Brennan, supra note 27.

32 See, e.g., Brennan, 139 F.2d at 269-270 (dismissing breach of contract claim for failure to follow arbitral grievance procedure contained in same contract; court refused to require the parties to use the procedure for claims which did not specifically arise out of the contract).

33 See, e.g., DeValk Lincoln Mercury, Inc. v. Ford Motor Co., 811 F.2d 366 (7th Cir. 1987) (court granted summary judgment for defendants where plaintiff failed to "mediate" under provision specifically requiring resort to Policy Board as a condition precedent to pursuit of other remedies), Kelley, supra note 27.

34 Actually, there is one example of a non-binding ADR clause being found unconscionable, but the circumstances are so unusual that it does not merit more than a footnote. In Reed v. Farmers Ins. Group, 685 N.E.2d 385 (Ill.App.Ct.1997), an uninsured motorist carrier included an arbitration clause in its insurance policy as required by state statute. The statute mandated that an arbitration clause be included in automobile insurance policies to resolve uninsured motorist claims. Further, the statute required that the clause be structured to provide for binding arbitration of awards up to the financial liability limits of the Illinois Vehicle Code, while awards in excess of those limits were subject to trial de novo. The court found this ADR clause unconscionable because its "language allowed[ed] the insurer to avoid a high award while binding the insured to a low award." The court also found the statute violated the right to contract.