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Anatomy of an arbitration disaster

Amanda Bronstad / Staff reporter

LOS ANGELES — A Los Angeles Superior Court judge on May 28 affirmed an arbitration award of more than $4.1 billion, sending shockwaves through the labor and employment bar in California.

The award went to Paul Thomas Chester, a former executive at iFreedom Communications Inc., who brought a wrongful termination suit against his former employer, its affiliated businesses and the founder, Timothy Ringgenberg.

The case ended up before an arbitrator, William F. McDonald, a retired supervising judge of the Orange County, Calif., Superior Court's complex civil litigation panel, who now works at JAMS.

Michael D. Young, a partner in the Los Angeles office of Atlanta's Alston & Bird, wrote about the award on his firm's labor and employment blog, "Who's the Boss?" Young spoke to The National Law Journal about the lessons that employment lawyers and their clients could learn from the outcome in this case regarding arbitration agreements and the arbitration process.

Young also broke down the award, to explain how the arbitrator came up with such an astronomically high number.

NLJ: Have you ever seen an arbitration award of this amount before?

MY: No, even in California I've never seen a $4.1 billion award for a single plaintiff in a wrongful termination case — not even a jury verdict, which tend to be even more outlandish.

NLJ: What message does this award send to employers about their arbitration agreements?

MY: Arbitration is real. The parties need to understand that arbitrations are just as powerful and important as a regular trial. And the consequences are going to be the same. Once we get into the details of this one, you'll see the defendant in this case didn't treat this as if it were a binding dispute resolution process.

NLJ: How did this award get so big?

MY: It got this way because the defendant, the employer, first of all, apparently had terminated a high-level employee without cause. He [the ousted executive] then sued, and the defendant, who at that time had a lawyer, moved to compel arbitration.

At that point, the defendant made some mistakes. It appears the defendant neglected to, or decided not to, participate in discovery and withheld financial information not only asked for in discovery requests but ordered by the arbitrator.

A little bit later, the defendant fired his lawyers. The individual who owns the defendant companies, Timothy Ringgenberg, substituted himself in to represent all the parties. That's something you cannot do in court because corporations have to be represented by counsel. The individual then represented himself and his companies for the remainder of the arbitration.

And what happened next is really the telling part: The [retired] judge set the hearing for the arbitration, and the defendant wrote a letter to the arbitrator saying, "I'm not going to show up." When there wasn't any information forthcoming from the defendant, what the arbitrator did was look at what information was available about the financial situation of the company and applied adverse inferences against the defendant, essentially filling in the gaps in the story presuming it would come out in favor of the plaintiff. That was really where the numbers started to scale.

NLJ: So this isn't a typical case?

MY: It does happen sometimes because there are a lot of defaults taken in court and presumably they happen in arbitration, as well. But usually the numbers don't get this big because the fact pattern doesn't give rise to these gigantic numbers. This was a combination of both a defendant giving up and not appearing, and an executive compensation agreement that allowed for these numbers to grow like this.

NLJ: What was special about this executive compensation agreement?

MY: This agreement said that the employee was going to be paid a commission structure of 5% of gross sales. What was significant about this one is that the agreement provided that if he is terminated without cause he is entitled to receive his commissions on an ongoing and permanent basis. It's not unusual for employers, especially startups, to try to incentivize good people to work for them by giving an equity stake in the company to build some protections. In this case, though, they provided [that] he would be entitled to a commission forever if he's fired without cause.

NLJ: What other factors led to this award?

MY: One big factor was trying to figure out what those gross sales were going to be. Because the defendant didn't provide any financial information, the arbitrator and plaintiffs didn't have a lot to go with in trying to predict where the company was going to go. They looked at a letter the defendant sent to shareholders talking about revenue in one month being $535,000 and then talking about the expected growth rates of 20% or 10% per month. It's not a realistic rate [that] the company really would grow 10% per month in perpetuity, but because the defendant didn't come forward with any evidence, because they didn't provide anything in discovery, these adverse inferences were then applied and the arbitrator essentially assumed that those figures were going to be correct. If you have a commission structure based on those kinds of growth numbers, you get up to the $1 billion pretty quickly. The punitive damage award was brought in at essentially triple the commission award. It's unusual you would triple a $1 billion award, but clearly the arbitrator was going to make a point.

NLJ: Do you still think that arbitrations are more predictable than jury verdicts, given this award?

MY: I do. This is an interesting story, but I don't think it is representative of employment arbitrations anywhere, let alone California. And once you dig into it a little bit, you see the mistakes that were made by the defendants, both in the development of their executive compensation agreement and their refusal or failure to defend themselves.

But because of potentials like this — maybe not this egregious — many arbitration agreements now call for appellate rights. They could be private appellate rights, where parties will agree on another retired judge to review the ruling of the initial arbitrator, or could allow for a review by the courts. One main concern is to prevent, or at least review, awards like the one we're talking about.

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