DISPUTE RESOLUTION JOURNAL®

AMERICAN ARBITRATION ASSOCIATION®
INTERNATIONAL CENTRE FOR DISPUTE RESOLUTION®
AAA Mediation.org

NOVEMBER 2020 | VOLUME 75 | NUMBER 2

Best Practices for Statutory Cost-Shifting Offers in Arbitration

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I. Introduction

Parties to arbitration have another issue to consider after the California Supreme Court decision in *Heimlich v. Shivji*, 7 Cal. 5th 350 (2019) ("*Heimlich*"). In *Heimlich*, the would-be prevailing party was actually the loser because of a catch-22 created by the arbitration process. This article discusses the potential pitfall and how to assure the benefits of fee- and cost-shifting statutory settlement offers are preserved by parties to arbitration. Although this article focuses on California Code of Civil Procedure Section 998, it is applicable to similar fee- and cost-shifting statutes such as Rule 68 under the Federal Rules of Civil Procedure.

Under California Code of Civil Procedure Section 998 ("Section 998"), the California offer to compromise statute, a prevailing party in arbitration who obtains a more favorable result than its rejected Section 998 offer ("998

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offer") is entitled to recover its post-offer costs, which often include attorneys' fees, experts' fees, and arbitrator fees, generally referred to as "costs" in this article. The catch-22 discussed in *Heimlich* is failure to inform the arbitrator of the existence of a fee- or cost-shifting statute until after a final award is issued, at which stage the arbitrator is generally divested of jurisdiction.

The best practice when California law applies, which has equal application under other controlling law with similar cost-shifting statutes, is to require the arbitrator to decide the parties' substantive claims in an interim award followed by subsequent consideration of the prevailing party for purposes of an award of fees and costs. The prevailing party can subsequently submit a request for costs to the arbitrator and the interim award can either become final or be modified to include costs before it becomes the final award. This solution promotes both the underlying pro-settlement purpose of Section 998, because parties are not prejudiced by presenting a 998 offer as evidence during arbitration, and the judicial policy favoring arbitral finality, because parties will not look to courts to amend arbitration awards to include costs.

This article provides an overview of Section 998 and *Heimlich*, a brief summary of other states' cost-shifting statutes and the federal cost-shifting counterpart, and a recommended practice arbitrators and parties can adopt to ensure parties in arbitration are afforded the same opportunities to recover costs after arbitration as litigants in civil actions.

II. Background

A. 998 Offers in California Arbitration

1. California Code of Civil Procedure Section 998

In California, the general rule regarding recovery of costs incurred during a civil proceeding, including arbitration, is "a prevailing party is entitled as a matter of right to recover costs."[1] However, Section 998 is an exception to this general rule. Section 998 provides, in relevant part:

[1]Cal. Civ. Proc. Code § 1032(b).

- "Not less than 10 days prior to commencement of trial or arbitration . . . any party may serve an offer in writing upon any other party to the action to allow judgment to be taken or an award to be entered in accordance with the terms and conditions" of the offer.[2]

- "If an offer made by a defendant is not accepted and the plaintiff fails to obtain a more favorable judgment or award, the plaintiff shall not recover his or her postoffer costs and shall pay the defendant's costs from the time of the offer" and the costs from the time of the offer shall be deducted from any damages awarded in favor of plaintiff.[3]

- "If an offer made by a plaintiff is not accepted and the defendant fails to obtain a more favorable judgment or award . . . the court or arbitrator, in its discretion, may require the defendant to pay a reasonable sum to cover postoffer costs of expert witnesses."[4]

Section 998 is meant to "encourage settlement by providing a strong financial disincentive to a party—whether it be a plaintiff or a defendant—who fails to achieve a better result than that party could have achieved by accepting his or her opponent's settlement offer."[5] In furtherance of Section 998's pro-settlement purpose, a rejected 998 offer "cannot be given in evidence upon the trial or arbitration."[6] Section 998 recognizes "that if a court or jury is informed of a settlement offer [amount] before determining liability, the offering party may be prejudiced in its ability to obtain any outcome better than that which it had previously expressed a willingness to accept. That reality could chill the making of reasonable offers and undermine the policy favoring settlement."[7] Thus, Section 998's limit on the admissibility of 998 offers protects the parties from this potential unfairness.

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[2]Cal. Civ. Proc. Code § 998(b).

[3]*Id.* § 998(c)(1), (e).

[4]*Id.* § 998(d).

[5]*Bank of San Pedro v. Superior Court*, 3 Cal. 4th 797, 804 (1992).

[6]Cal. Civ. Proc. Code § 998(b)(2); *Heimlich v. Shivji*, 7 Cal. 5th 350, 361 (2019) (citing *White v. W. Title Ins. Co.*, 40 Cal. 3d 870, 889 (1985)).

[7]*Heimlich v. Shivji*, 7 Cal. 5th at 361.

2. Summary of Heimlich v.Shivji

In *Heimlich*, Heimlich, an attorney, filed suit against his client, Shivji, to recover unpaid fees.[8] The parties proceeded to arbitration, which resulted in no recovery to either party.[9] Six days after the issuance of the arbitrator's final award, which indicated, "[e]ach side will bear their own attorneys' fees and costs," Shivji requested the arbitrator award him costs under Section 998 because Heimlich's recovery was less favorable than a 998 offer Shivji served on him prior to arbitration.[10] After the arbitrator responded that he no longer had jurisdiction to hear Shivji's cost request, Shivji asked the trial court to confirm the arbitration award and also award him costs under Section 998.[11] The trial court confirmed the arbitrator's award but denied costs.[12] Shivji appealed and the appellate court reversed the trial court's decision because it concluded the arbitrator should have reached the merits of Shivji's post-award Section 998 costs.[13]

In deciding the proper procedure for a party to request Section 998 costs after arbitration, the appellate court balanced the pro-settlement purpose of Section 998 and the "strong judicial policy favoring arbitral finality."[14] The court held, "a party's section 998 request should be deferred until after the arbitration award is made. If and when a party makes a section 998 post-award request, an AAA arbitrator is empowered to recharacterize the award as interim, interlocutory, or partial and proceed to resolve the section 998 request by a subsequent award."[15] Accordingly, the appellate court partially vacated the arbitration award and ordered a hearing on Shivji's request for costs before the same arbitrator.[16]

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[8] *Heimlich v. Shivji*, 12 Cal. App. 5th 152, 155 (Ct. App. 2017).

[9] *Id.*

[10] *Id.* at 155, 158.

[11] *Id.* at 156.

[12] *Id.* at 169, 174.

[13] *Id.* at 177.

[14] *Id.* at 174.

[15] *Id.* at 173-74.

[16] *Id.* at 177.

However, the California Supreme Court subsequently reversed the appellate court's decision and held the arbitrator's refusal to hear evidence regarding Shivji's rejected 998 offer was not grounds for vacation of the arbitration award.[17] In an attempt to resolve any potential prejudice resulting from Section 998 admissibility restrictions, the Court held a request for Section 998 costs can be submitted to the arbitrator during arbitration without violating Section 998, subdivision (b)(2) [inadmissibility], so long as it is not being used to prove liability, or within 15 days after the issuance of the final award.[18]

However, "most legal errors in arbitration are not reviewable."[19] "An arbitration award may be vacated only for fraud, corruption, misconduct, an undisclosed conflict, or with the fairness of the arbitration process. Otherwise, judicial corrections are limited to remedying 'obvious and easily correctable mistake[s],' 'technical problem[s],' and actions in excess of authority so long as the correction leaves the merits of the decision unaffected."[20] Further, vacation of an award for refusal to hear evidence material to the controversy must rest on more than a simple error in applying the rules of evidence.[21] "Most specifically, error in failing to award costs to a qualifying party under section 998 is not grounds for relief."[22] Therefore, the Court could not review or vacate the arbitrator's decision to deny Shivji's request for costs. Notably, the Court explained Shivji, "chose to wait until shortly after the arbitrator's merits award to raise the issue. While Shivji was legally entitled to do so, he ran the risk that the arbitrator would erroneously refuse to award costs, leaving him without recourse under the narrow grounds for vacation or correction contained in the statutory scheme. It is within the power of the arbitrator to make a mistake either legally or factually."[23] Accordingly, the California Supreme Court confirmed the arbitrator's award

[17] *Heimlich v. Shivji*, 7 Cal. 5th 350, 371 (2019).

[18] *Id.* at 359-60.

[19] *Id.* at 367.

[20] *Id.* at 367 (citing *Moncharsh v. Heily & Blase*, 3 Cal. 4th 1, 12-13 (1992)).

[21] *Id.* at 368.

[22] *Id.* at 367.

[23] *Id.* at 370.

and Shivji was left with no recourse to recover his costs pursuant to Section 998.

Notably, this predicament could have been avoided by disclosing to the arbitrator the fact that one or more 998 offers had been made in the case and requesting an interim award after which any applicable 998 offer could be considered.[24]

B. Cost-Shifting Statutes in Other Jurisdictions

1. Nevada

Nevada Rule of Civil Procedure, Rule 68 ("Nevada Rule 68"), the Nevada offer of judgment statute, is substantially similar to California's Section 998 offer to compromise. Nevada Rule 68 provides:

- "At any time more than 21 days before trial, any party may serve an offer in writing to allow judgment to be taken in accordance with its terms and conditions . . . ."[25]
- If "the offeree rejects an offer and fails to obtain a more favorable judgment . . . the offeree must pay the offeror's post-offer costs and expenses . . . ."[26]

Although not expressly provided for in the statute, *WPH Architecture, Inc. v. Vegas VP, LP* ("*WPH Architecture*"), a recent Nevada Supreme Court decision, held Nevada Rule 68 also applies in arbitration proceedings.[27] However, similar to California, Nevada Rule 68 currently does not provide recourse for a party that obtained a more favorable outcome at arbitration than its rejected pre-arbitration offer, if a final arbitration decision has already been rendered.

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[24] *See, e.g.*, American Arbitration Association Commercial Arbitration Rules, Rules R-37, R-47; American Arbitration Association Construction Industry Arbitration Rules, Rules R-38, R-48.

[25] Nev. R. Civ. Proc. 68.

[26] *Id.*

[27] *WPH Architecture, Inc. v. Vegas VP, LP*, 131 Nev. 884, 889 (2015).

In *WPH Architecture*, a panel of arbitrators ruled in favor of WPH.[28] The award stated that each party would bear its own costs and fees.[29] WPH subsequently filed a post-award motion for costs pursuant to Nevada Rule 68.[30] The arbitration panel denied the motion because at that point, there was no case law to support the application of Nevada Rule 68 in arbitration proceedings.[31] WHP filed a motion with the court to modify or correct the award to include recovery of WPH's fees and costs.[32] The court denied WPH's motion and the Nevada Supreme Court affirmed.[33] The Nevada Supreme Court held although Nevada Rule 68 applies to arbitration proceedings, the arbitration panel was not obligated to hear WPH's post-award motion or award WPH its fees and costs.[34] Therefore, because the arbitration panel did not "manifestly disregard" Nevada law, the court could not modify or correct the arbitration award.[35] WPH was left with no recourse to recover its post-offer costs simply because the case was decided in arbitration rather than trial where clear post-trial cost motion practice exists. Had the case been decided at a trial, Nevada Rule 68 would clearly apply and WPH would have had the opportunity to recover costs with a post-trial motion. As in California, Nevada's offer of judgment statute does not adequately place parties in arbitration on equal footing with litigants in civil actions. Therefore, the same practice should be followed in arbitration proceedings where Nevada law applies, as in California: disclose the existence of one or more statutory offers and request an interim award so the arbitrator considers the offer.

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[28] *Id.* at 886.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.* at 891.

[34] *Id.*

[35] *Id.*

2. Arizona

Similarly, Arizona Rule of Civil Procedure Rule 68 ("Arizona Rule 68") is the Arizona counterpart offer of judgment statute. Although Arizona Rule 68 is procedurally different from California and Nevada's cost-shifting statutes, it is substantively similar. Arizona Rule 68, which expressly applies in arbitration proceedings, provides:

- "Any party may serve on any other party an offer to allow judgment to be entered in the action . . . . A party who rejects an offer, but does not obtain a more favorable judgment, must pay as a sanction . . . the offeror's reasonable expert witness fees and double the taxable costs" and prejudgment interest.[36]

- However, "[t]o determine whether to impose a sanction after an arbitration hearing, the court must compare the offer to the final judgment entered" on the arbitration award.[37]

- Because "[a]n arbitration award alone, in the absence of an affirmative act by the court to enter judgment, is not a judgment," a party must apply for entry of judgment on the arbitration award before the offer of judgment can be compared to the judgment.[38]

Therefore, in Arizona, court involvement is necessarily required after arbitration to recover costs pursuant to an offer of judgment. Nonetheless, Arizona provides for recovery of costs for a party who obtains a better result at trial or arbitration than its rejected offer of judgment, and this article's recommended best practice could apply under Arizona Rule 68 to provide fairness to parties in arbitration.

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[36] Ariz. R. Civ. Proc. 68(a), (g)(1).

[37] Ariz. R. Civ. Proc. 68(g)(3).

[38] *Sw. Barricades, L.L.C. v. Traffic Mgmt., Inc.*, 240 Ariz. 139, 141 (Ct. App. 2016).

3. Federal Rules of Civil Procedure

a. Federal Offer of Judgment Rule

Federal Rules of Civil Procedure Rule 68 ("Federal Rule 68") also includes a cost-shifting offer of judgment rule.[39] However, Federal Rule 68 provides the cost-shifting benefits to defendants only, and provides:

- "At least 14 days before the date set for trial, a party defending against a claim may serve on an opposing party an offer to allow judgment on specified terms, with the costs then accrued . . . ."[40]
- If the judgment that the offeree finally obtains is not more favorable than the unaccepted offer, the offeree must pay the costs incurred after the offer was made.[41]

Evidence of an unaccepted offer is not admissible except in a proceeding to determine costs.[42] Therefore, the penalties for a plaintiff who fails to obtain a better result at trial than a Federal Rule 68 offer it rejected are similar to the penalties imposed by states' cost-shifting statutes. Further, the purpose of Federal Rule 68, to encourage settlement, is consistent with the pro-settlement goal of states' counterparts to Federal Rule 68.[43] As such, the same recommended practice can be followed where Federal Rule 68 applies to assure defendants using it receive its benefit.

b. Application of State Law

Although the Federal Rules of Civil Procedure include a cost-shifting rule, federal courts with diversity jurisdiction may also apply a state counterpart to Federal Rule 68 in some circumstances under the *Erie* doctrine.[44] In

[39] Fed. R. Civ. Proc. 68.

[40] Fed. R. Civ. Proc. 68(a).

[41] Fed. R. Civ. Proc. 68(d).

[42] Fed. R. Civ. Proc. 68(b).

[43] *See Goldberg v. Pac. Indem. Co.*, 627 F.3d 752, 757 (9th Cir. 2010).

[44] *Zamani v. Carnes*, No. C-03-00852-RMW, 2009 WL 2710108, at *2 (N.D. Cal. Aug. 25, 2009) ("offer of judgment rules appear to be substantive for *Erie* purposes." (citing *Jones v. United Space All., L.L.C.*, 494 F.3d 1306, 1309 (11th Cir. 2007)).

determining whether the state statutory offer applies, courts look to whether the "federal rules are sufficiently coextensive with the asserted purposes of the state rule to indicate that the federal rule occupies the state rule's field of operation."[45] "[T]he question of whether there is a direct conflict with its state law counterparts depends, at least in part, on the scope of the relevant state rule and the circumstances under which it would be applied in the particular case."[46]

For example, in *S.A. Healy Co. v. Milwaukee Metro. Sewerage Dist.*, the plaintiff made an offer of judgment under the Wisconsin Rule 68 equivalent, won at trial, and then sought to collect its costs.[47] The district court denied Plaintiff's motion for costs on the ground that the Federal Rule 68 occupies the field of settlement offers and precludes the application of state rules dealing with the subject—even when the substantive rules of decision are state rather than federal.[48] The court based this decision largely on the fact that Wisconsin Rule 68 allows plaintiff demands, whereas Federal Rule 68 does not.[49] As there is a "conflict" between the rules, the Federal rule controls. However, on appeal, the Seventh Circuit applied a simple two-part test to determine whether to apply the state rule or Federal Rule 68.[50] Under this test, the court must:

> [A]sk two questions: Is the [state] rule so likely to dictate outcomes that it will cause a lot of forum shopping (or, if forum shopping is somehow infeasible, cause like cases to be decided differently) unless it is made applicable to diversity cases and so ceases to be a factor in the choice between state and federal court? Is it so entwined with procedures prescribed by the federal rules that it is likely to impair the integrity of federal procedure if it is applied in diversity cases? If the answer to the

[45] *Goldberg*, 627 F.3d at 755-56.

[46] *Id.* at 756.

[47] *See S.A. Healy Co. v. Milwaukee Metro. Sewerage Dist.*, 60 F.3d 305, 307 (7th Cir. 1995).

[48] *Id.* at 311-12.

[49] *Id.* at 312.

[50] *Id.* at 310-11.

> first question is "yes" and to the second "no," then we can be reasonably confident that application of the [state] rule in diversity cases would be consistent with the principles of *Erie* and the Rules Enabling Act. Those in fact are our answers . . . .[51]

Consequently, the appellate court held Wisconsin's Rule 68 counterpart applied and reversed the District court's denial of costs.[52]

The Tenth Circuit decided similarly in *Scottsdale Ins. Co. v. Tolliver*, where the plaintiff made an offer under both Federal Rule 68 and the Oklahoma state law equivalent.[53] The defendant rejected the offer and subsequently lost at trial.[54] The district court granted the plaintiff's request for fees and the defendant appealed on the basis that the federal and state rules "collided" because the state rule required the offer to be filed with the court at the time it was made, whereas the federal rules do not.[55] The appellate court affirmed the fee award, reasoning "if [Oklahoma's Rule 68] were to apply in state but not federal court, a state court defendant would have an advantage that is unavailable to a defendant with an identical claim in federal court under diversity jurisdiction. This result makes [Oklahoma's Rule 68] substantive. As a result, we apply Oklahoma substantive law, specifically [Oklahoma's Rule 68], to the matter before us . . . . To do otherwise would undoubtedly result in an 'inequitable administration of the laws' and be contrary to the twin aims of *Erie*."[56]

Although the Federal Rules of Civil Procedure include a cost-shifting procedure, federal courts sitting in diversity jurisdiction will apply state substantive settlement law depending on the particular facts of the case and the relationship between the state and federal statutes, as explained above. Therefore, the application and effect of state offer of judgment and offer of compromise statutes can substantially affect parties' right to recover

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[51] *Id.*

[52] *Id.* at 312.

[53] *Scottsdale Ins. Co. v. Tolliver*, 636 F.3d 1273 (10th Cir. 2011).

[54] *Id.* at 1276.

[55] *Id.*

[56] *Id.* at 1280 (citing *Hanna v. Plumer*, 380 U.S. 460, 468 (1965)).

costs in both state and federal courts. As to arbitration, the controlling law is typically for the arbitrator to decide, and the parties in arbitration under the governing law of these jurisdictions can benefit by the practice recommended in this article.

III. Recommended Practice to Preserve Benefits of Cost-Shifting Statutes

As noted by the California Supreme Court in *Heimlich*, "[w]hen the Legislature amended section 998 to encompass arbitrations, it sought to place parties in arbitration on equal footing with parties to civil actions."[57] However, in *Heimlich*, although Shivji achieved a better result at arbitration than a 998 offer it served on Heimlich, Shivji was unable to recover costs pursuant to Section 998 because the arbitrator concluded his jurisdiction terminated after the issuance of the final award, which indicated each party would bear its own costs and fees. This left Shivji with no recourse because the arbitrator's decision not to award costs was not reviewable by the Court.

Further, parties who disclose a rejected 998 offer during arbitration risk the inherent potential for prejudice as noted by the California Supreme Court as, "if a court or jury is informed of a settlement offer before determining liability, the offering party may be prejudiced in its ability to obtain any outcome better than that which it had previously expressed a willingness to accept."[58] Thus, only the existence of a statutory offer, and not its terms or the offering party, should be disclosed to the arbitrator with a request for an interim award.

After an interim award is issued, the arbitrator can hear evidence of statutory offers and the prevailing party's request for costs and fees. After the arbitrator decides the prevailing party's request for costs, the interim award can either become final or be modified to include costs and fees before it becomes the final award. This practice will ensure the judicial policy of arbitral finality and the legislative purpose of Section 998 and similar statutes are furthered.

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[57] *Heimlich v. Shivji*, 7 Cal. 5th 350, 361 (2019).

[58] *Id.*

First, this interim award procedure promotes arbitral finality because it minimizes court involvement in vacation or modification of arbitration awards. Parties, arbitrators, and courts can be assured all final arbitration awards resolve the parties' claims and include recovery of any prevailing party costs pursuant to Section 998. This eliminates the risk of an arbitrator refusing to hear a party's request for Section 998 costs, as in *Heimlich*, because arbitrators will not be faced with amending a final award to include costs. Rather, all final awards will necessarily include the arbitrator's decision on a prevailing party's request for costs.

Further, issuing interim awards removes the current tension between disclosing a 998 offer too early and potentially affecting the arbitrator's judgment and disclosing an offer too late and being left with no procedure to amend the final award to recover costs. Parties would be encouraged to serve 998 offers and pursue settlement if the opportunity to request Section 998 costs after the conclusion of arbitration, and have the request be substantively decided by the arbitrator, is preserved.

This recommended best practice applies equally to other governing law, including the state and federal rules discussed above. Although some states' cost-shifting statutes vary in procedure and substance from California's Section 998, application of this recommended practice in other jurisdictions would also effectively promote efficient resolution of arbitrations, arbitral finality, and encourage settlement.

IV. Conclusion

The solution to the catch-22 faced in *Heimlich* is for the arbitrator and the parties to implement a practice for arbitration awards to be issued as interim awards to allow time for the prevailing party's request for costs to be heard and decided by the arbitrator before the award becomes final. This practice, which has broad application to substantive law similar to Section 998, furthers the legislative intent behind Section 998 and arbitral finality.