



CASES OF INTEREST

The Shifting Landscape of Arbitration

*The world is changing – the global climate, the national economy, local and national politics, the balance of trade, the international balance of power – everything seems to be shifting all at once. Just as the larger world changes, so does the smaller world of arbitration. In this edition of the **Alert**, we focus in on three important cases that are reshaping the way the world of judges and appellate courts relate to the semi-private world of commercial dispute resolution.*

1. *Hall Street v. Mattel*: The Right Result the Wrong Way?

By **Hiro N. Aragaki**

Although the losing party to a lawsuit generally has an automatic right of appeal, the main purpose of which is to correct legal errors made by the trial court, the losing party to a private arbitration has no such right. Under the Federal Arbitration Act (“FAA”), the grounds on which courts of law may review arbitral awards are extremely limited – they have more to do with correcting fundamental injustices than correcting an arbitrator’s erroneous decision on the merits.

Until the U.S. Supreme Court decided *Hall Street Associates v. Mattel*, 128 S.Ct. 644 (Mar. 25, 2008), few knew whether private parties were able to contract to expand the FAA grounds to allow courts to review arbitral awards with the same scrutiny that applies to appeals from lower courts. *Hall Street* provided the answer: The FAA’s narrow grounds for judicial review of arbitral awards are the exclusive grounds.

In this article, I explore the background and implications of the *Hall Street* decision.

Background of the Case

The dispute in *Hall Street* involved a commercial lease between Mattel and its predecessors, as lessees, and Hall Street and its predecessors, as lessors. In 2000, Hall Street sued Mattel claiming that Mattel had improperly (1) terminated the lease and (2) failed to comply with applicable environmental laws during the lease term.

The case proceeded to a bench trial on the termination issue, and Mattel prevailed. The parties then asked the court to refer the second issue to arbitration. They entered into an agreement to arbitrate that was unique in the following respects:

- It called for the court to review any legal errors in the arbitral award under a “*de novo*” standard—a far more searching level of judicial review than what the FAA provides.
- Unlike the vast majority of arbitration agreements, which are contained in private contracts negotiated well in advance of an eventual dispute, it was entered into *after* Hall Street and Mattel were already waging their battle in court.
- It was approved of by the trial judge and entered as an order of the court.

According to *Hall Street*, the *de novo* review provision “was crucial to the parties’ willingness to arbitrate the remainder of their dispute because of the high stakes at issue.”

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his principal to a contract with an arbitration clause; or whether a contracting party had the mental capacity to form a contract at all.

The Potential for the Misuse of an Arbitrability Defense

There are serious implications to this line of cases. What if, for example, you as a litigator have a client who wants to delay the day of reckoning and, in addition, has a colorable argument that his agent who signed the agreement with the arbitration clause was not authorized to do so; or whether your client has another argument that he never agreed to arbitrate at all? If you preserve your rights in the arbitration (and that, it seems, takes relatively little effort—nothing more than a protest that the arbitrator should not be deciding the issue), you may well be entitled (at least in the Third Circuit) to a second bite of the apple at the enforcement stage by arguing that a court must determine whether your client agreed to arbitrate in the first place.

This defense could also exist in cases where an arbitrator purports to order a non-signatory to arbitrate, or allows an arbitration to proceed at the behest of a non-signatory.

These are situations that have the potential for delays that arbitration was supposed to avoid. Indeed, the desire to keep arbitration efficient was undoubtedly one of the motivating forces guiding the Supreme Court in 1967 when it decided the *Prima Paint* case. In *Prima Paint* the claimant in the arbitration resisted arbitration alleging that he was fraudulently induced to enter into a contract that happened to contain an arbitration clause. Thus, reasoned the claimant, he should be entitled to a trial in court on the threshold issue of whether the contract was void because it was induced by fraud. After all, if the contract itself was void, then the arbitration clause falls with it. The Supreme Court decided that—absent a specific attack on the arbitration clause itself—the issue of fraudulent inducement was a question for the arbitrators and not a threshold question for the courts. If one thinks about it, this is the only rational decision if you believe that arbitration is worth saving. Absent a so-called “severability” or “separability” doctrine, one

of the hallmarks of the process, to wit, speed, would be severely compromised. There are not many enterprising lawyers who – seeking to delay a final determination – would not raise a “fraud in the inducement” defense in a contract action if the mere raising of that defense would ensure a years-long court process as a prelude to arbitration. This was recognized long before the Supreme Court did the right thing in *Prima Paint*. Virtually all of the rules of the major arbitration provider organizations, both domestic and international, have the severability doctrine embedded in their rules. See, e.g., JAMS Comprehensive Rule 11(c).

Thus far, the case reports have not disclosed a substantial number of cases in which challenges to arbitrability – such as those described in the Supreme Court’s footnote in *Buckeye Check Cashing* – have been used with any degree of frequency to slow down or scuttle arbitration proceedings, but the potential is there. Only time will tell whether the ability to raise such threshold defenses will enable reluctant litigants to buy time either via applications to stay arbitration or applications to vacate at the enforcement stage.

Mr. Davidson is a full-time arbitrator and mediator and the Executive Director of JAMS Arbitration Practice. This article is based upon a paper prepared for the Second Annual Conference on International Arbitration and Mediation held at Fordham University Law School on June 18-19, 2007. The paper and the other Conference Papers were published by Martinus Nijhoff Publishers in June 2008 under the title “Contemporary Issues in International Arbitration and Mediation.” The Fordham Papers 2007, Arthur W. Rovine, Editor.

3. Classwide Arbitration Waivers in California – The Effects of *Gentry*

By Hon. Lawrence C. Waddington (Ret.)

In four sentences, the California Supreme Court summarized its decision precluding waiver of classwide arbitration agreements included in employment contracts. That Court held, “[i]n some cases prohibition of classwide relief would undermine vindication of employees’ unwaivable statutory rights.” Accordingly,

such "class arbitration waivers should not be enforced... if the trial court finds classwide arbitration ineffective to vindicate statutory rights." *Gentry v. Sup.Ct.*, 42 Cal.4th 443 (2007); Lab. Code 1194.

To which the dissent replied, "...there is more than one way courts can show hostility to arbitration as a simpler, cheaper, and less formal alternative to litigation. They can simply refuse to enforce the parties' agreement. Or, more subtly they can alter the arbitral terms to which the parties agreed ..."

Although the California Supreme Court had endorsed classwide arbitration in *Keating v. Sup.Ct.*, 31 Cal.3d 584 (1982) – a case reversed by the United States Supreme Court on other grounds in the famous case of *Southland Corp. v. Keating*, 465 U.S. 1 (1984) – several federal courts had refused to consolidate multiple arbitrable claims. But in *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 1029 (2003) a splintered Supreme Court majority apparently approved classwide arbitration if state courts or legislatures either permitted consolidation or did not prohibit class wide arbitration. Employers, service providers and franchisors seeking to impose a format for individual arbitration claims wrote classwide arbitration waivers into contract clauses of employees, consumers and franchisees as exemplified in *Gentry*.

The majority opinion in *Gentry* does not find the classwide arbitration waiver signed by the employee automatically unenforceable but remands the case to the trial court with instructions to determine whether the specific terms of the arbitration agreement in question enables an employee to vindicate statutory rights as outlined in the Labor Code. The *Gentry* court instructs the

trial court to consider several factors in reaching its conclusion: the modest size of the potential recovery; employer retaliation against class members; inability to inform absent class members of their rights; other real world obstacles to vindication of alleged Labor Code violations through individual arbitration.

According to the *Gentry* court, this analysis coincides with rules applicable to class actions in general, i.e., predominant questions of law and fact; typical claims of class members; numerous class members; adequate representation of absent and non-class members. The *Gentry* majority requires trial courts to compare classwide arbitration with alternative individual arbitration clauses offered by the employer in specific cases instead of merely comparing individual arbitration with classwide litigation in general.

Gentry also challenges the arbitrability of the arbitration agreement as procedurally unconscionable despite an "opt-out" agreement for employees. The court notes the agreement accelerates time lines to file employee claims, contradicts the conventional statute of limitations, limits damages (back pay),

eliminates punitive damages, and allocates costs and fees. These conditions are deemed potentially unconscionable, leaving the ultimate decision about unconscionability for trial court resolution.

The list of factors cited in *Gentry* a court should consider in determining whether to prohibit classwide arbitration waivers, or in the alternative, a finding of unconscionability of the arbitration agreement, guarantees an analytic framework that draws no "bright lines" and assures more litigation.

Gentry is joined by the ruling in *Discover Bank v. Sup.Ct.*, 36 Cal.4th 148 (2005), an earlier California Supreme Court case invalidating waiver of classwide arbitration in consumer cases. Together, these cases open the door, albeit slightly, to permit class action waivers "in some cases." The majority in *Discover Bank* explained that

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"...the law in California is that class action waivers in consumer contracts of adhesion are unenforceable under some circumstances." If an adhesive consumer contract is unconscionable, or the complaint alleges a small amount of damages incurred by a scheme to cheat large numbers of consumers and disabling them from vindicating statutory rights, the classwide arbitration waiver becomes potentially vulnerable; Civ. Code 1688; 1670.5.

Gentry and *Discover Bank* are superficially synonymous in linking the right of employees and consumers to vindicating their statutory rights. In both cases the contracts are adhesive and usually involve a small amount of damages but the theoretical basis for treating them similarly ignores the legal relationship between the parties. Employee and employer relationships are personal – in the sense each person signs a contract to perform services for another person or entity (although there is clearly disproportionate bargaining power). Service provider – consumer relationships are impersonal. Selling a product or providing service to a consumer is typically a single transaction involving exchange of money with little to no ongoing interaction between parties, and each party has low cost alternatives to agreement. The consumer can continue to shop elsewhere and the service provider can insulate itself in the awareness that the small amount of damages involved in a typical dispute will diminish incentives to pursue a contested case.

Consistent with its *Discover Bank* decision, the court majority in *Gentry* puts California in a minority position among federal and state court decisions upholding classwide arbitration waivers in consumer cases. The Justices in *Gentry* cited only a handful of U.S. District Court decisions in support of its position. The dissent identifies numerous state and federal Circuit Courts of Appeal employment decisions conflicting with the *Gentry* majority.

In state court cases removed to federal court on grounds of diversity jurisdiction, employers and service providers also filed motions to compel arbitration of individual claims citing the classwide waiver in contracts of employees or consumers. A federal court applying

state contract law as required under the Federal Arbitration Act could refuse to enforce classwide arbitration waiver on the grounds that the adhesive nature of the contractual clause fails to vindicate statutory rights or is unconscionable, but in such instances, severance of the unenforceable clause is a viable (and indeed encouraged) option. *Kristian v. Comcast Corp.*, 446 F.3d 251 (1st Cir. 2006).

The Ninth Circuit, historically unsympathetic to arbitration of employment cases until reversed by the Supreme Court in *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105 (2001), had previously held classwide arbitration waivers in adhesive employment contracts unconscionable in *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165 (9th Cir. 2003) and in consumer contracts. *Ting v. AT & T*, 319 F.3d 1126 (9th Cir. 2003). Citing *Gentry*, the Ninth Circuit panel in *Shroyer v. New Cingular Wireless Services, Inc.*, 498 F.3d 976 (9th Cir. 2007) also refused to enforce a classwide arbitration waiver in a consumer contract on grounds the adhesive contract was unconscionable but without the *Gentry* caveat of possible exceptions.

Despite that holding, the Ninth Circuit panel endorsed classwide arbitration in principle as an alternative to litigation enabling arbitrators to resolve contractual disputes by introducing resolution techniques unavailable in federal trial courts.

Shroyer discusses the effect of the Consumers Legal Remedies Act (CRLA), a California consumer based statute that defines an unconscionable provision in a contract as an unlawful business practice and unenforceable. Civ.Code 1770 (a) (19). Although the pleadings in *Shroyer* had alleged an unlawful business practice, the trial court had certified a national class citing invalidity of the classwide arbitration waiver. For a federal court to certify a national class based on the innumerable laws of multiple jurisdictions on classwide waiver would defeat the purpose of Rule 23 (FRCP) requiring procedural superiority prior to class certification.

The First Circuit has confronted challenges to classwide arbitration waivers in a trilogy of cases illustrating the difficulty of conforming to Supreme Court insistence on eliminating previous judicial hostility to arbitration.

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In *Kristian*, the classwide waiver of arbitration clause included a remedy stripping provision precluding a party from collecting statutorily mandated damages for violation of federal anti trust law. That court held that the classwide arbitration waiver disabled the plaintiff from vindicating their federal statutory rights to obtain treble damages. Yet the court salvaged arbitration by severing the unenforceable damages clause and permitting classwide arbitration pursuant to a "savings clause" in the contract.

In *Anderson v. Comcast Corp.*, 500 F.3d 66 (1st Cir. 2007) the court was unsympathetic to an argument against a classwide arbitration bar based on a state statute permitting class actions. Citing its decision in *Kristian*, the court held that as long as the state permits class actions, or inferentially class arbitration, the parties can agree to waive that right. But this decision is not for the court to resolve, the clause not involving formation of the contract; or in the language of arbitration, not a judicial question of "arbitrability."

In *Skirchak v. Dynamics Corp.*, the First Circuit commented that the classwide arbitration bar is arguably unconscionable but also severable. In an interesting jurisdictional question, the parties solicited the court rather than the arbitrator to decide issues of unconscionability or inability to vindicate statutory rights. The court confirmed its jurisdiction conferred by the parties.

In contrast to the First Circuit, California, the *Gentry* court majority and the Ninth Circuit have cloaked a policy position in legal garments by refusing to enforce waivers of classwide arbitration in employment and consumer contracts, in each case on different grounds, but paradoxically endorsing the process per se.

What lies ahead? It appears that a major issue will involve the expanding role of arbitrators in classwide arbitration. When a case is decided involving that issue, you can look forward to another update.

Judge Waddington is a full-time arbitrator and mediator with JAMS. Prior to joining JAMS, he served on the Los Angeles Superior Court for 15 years.



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