

Expanding Judicial Review of Arbitration Awards: The Uncertainty Continues for Drafters of Arbitration Agreements

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How the California Supreme Court
muddied the waters with its
decision upholding expanded review
in *Cable Connection v. DIRECTV*.

Much of the arbitration community heaved a sigh of relief when the U.S. Supreme Court held earlier this year in *Hall Street Associates, L.L.C. v. Mattel, Inc.* (128 S. Ct. 1396, 2008) that the grounds to vacate or modify an arbitration award in the Federal Arbitration Act (FAA) are exclusive; thus, parties cannot agree to allow judicial review of an award for errors or law made by the arbitrator. The decision resolved a split

in the federal circuit courts, which have struggled with this issue for more than a decade. But did it finally resolve a drafting problem that has vexed lawyers?

Well, not quite. Five months after the Supreme Court ruled that parties cannot obtain judicial review of the merits of an arbitration award by express agreement, the California Supreme Court ruled in *Cable Connection v. DIRECTV* (2008 WL 3891556, Aug. 25, 2008) that they could, even when they also agree that their arbitration is governed by the FAA.

The split between federal and California state courts creates risks and opportunities for clients who arbitrate in California. And the tension between these conflicting positions underscores the importance of drafting detailed choice-of-law provisions with compatible forum-selection clauses.

Hall Street Limits Review

In ruling in *Hall Street* that the FAA prevents parties from contracting for expanded judicial review of arbitral awards, the Supreme Court said that this reading of the FAA was necessary to curtail the “full-bore legal and evidentiary appeals” that often followed a contentious arbitration, which severely undercut arbitration’s “essential virtue” of providing a final resolution quickly and efficiently.

The plaintiff in the case, Hall Street, was Mattel’s landlord. After years of use by Mattel and prior tenants, the leased property showed high levels of pollutants when environmental tests were conducted. Mattel, the manufacturer of such popular toys as “Hot Wheels” and “Barbie,” notified Hall Street that it would be terminating its lease and vacating the premises. Hall Street sued, claiming that Mattel could not terminate its lease. It also sought indemnification under the terms of the lease for the looming environmental cleanup costs. At trial, the court found for Mattel on the issue of termination. The parties agreed to mediate the separate issue of indemnification, but the mediation effort failed. They agreed to arbitrate that issue and so notified the court. Then they drafted an arbitration agreement, which they submitted to the court for approval. Among other things, the arbi-

tration agreement provided that the U.S. district court “shall vacate, modify or correct the arbitration award: (1) either where the arbitrator’s findings of fact are not supported by substantial evidence, or (2) where the arbitrator’s conclusions of law are erroneous.” The court approved the arbitration agreement and entered it as an order.

The arbitrator initially ruled in Mattel’s favor, but the award was hardly final since the result was a long succession of appeals, reversals, remands, and then review by the Supreme Court.

As noted above, the Supreme Court concluded that the judicial review clause was unenforceable under the FAA. The decision echoed many of the policies championed by the American Arbitration Association (AAA) in its *amicus brief*. The AAA argued that eliminating expanded judicial review would be consistent with international trends, which favor reduced judicial intervention. Most importantly, the AAA stressed that to allow expanded judicial review by contract would “eviscerate the principle of finality” in arbitration, and would “likely transform arbitration into traditional litigation.” Rather than providing efficient dispute resolution while avoiding the courtroom, arbitration might become just another step in the lengthy litigation process.

Underlying the Court’s decision was the concern that arbitration agreements providing for expanded judicial review had resulted in awards that resolved nothing and generated years of protracted proceedings. For example, *Kyocera Corp. v. Prudential-Bache Trade Securities* (341 F.3d 987, 9th Cir. 2003) involved a series of judicial appeals lasting almost nine years. *Hall Street* followed this pattern. After the arbitrator’s ruling, the parties spent almost seven years litigating and arbitrating before the case was ultimately resolved.

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California Allows Expanded Review

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Supreme Court jumped into the debate and reached the opposite result under the California Arbitration Act. It reasoned that allowing parties to agree to expanded judicial review actually encourages the use of arbitration.

The arbitration in *Cable Connection* involved DIRECTV and the retail dealers of its satellite television equipment. The dealers, acting on behalf of a class, alleged that DIRECTV had wrongfully withheld commissions and assessed improper charges. Following procedures adopted by the AAA after the Supreme Court's decision in *Green Tree Financial Corp. v. Bazzle* (539 U.S. 444, 2003), the arbitrators first addressed whether the parties' agreement, which was silent on the issue of classwide arbitration, permitted such arbitration. They concluded that classwide arbitration was permitted by the contract and authorized by California case law. But the arbitrators

strength from the agreement of the parties. It further explained that "policies favoring the efficiency of private arbitration as a means of dispute resolution must sometimes yield to its fundamentally contractual nature, and to the attendant requirements that arbitration shall proceed as the parties themselves have agreed."

The California Supreme Court went on to emphasize the public benefits of allowing parties to set their own rules for resolving disputes. "The judicial system reaps little benefit from forcing parties to choose between the risk of an erroneous arbitration award and the burden of litigating their dispute entirely in court. Enforcing contract provisions for review of awards on the merits relieves pressure on congested trial court dockets," the court said.

Supporters of the *Cable Connection* ruling observe that by giving parties confidence that

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reserved decision as to whether classwide arbitration should be ordered in this case. DIRECTV petitioned a state trial court to vacate the award, arguing that the arbitrators had exceeded their authority and made errors of law in violation of the parties' arbitration agreement, which provided: "The arbitrators shall not have the power to commit errors of law or legal reasoning, and the award may be vacated or corrected on appeal to a court of competent jurisdiction for any such error." The agreement further provided that the arbitrators shall apply California substantive law to the proceeding. It also provided that the agreement itself and any arbitration conducted thereunder shall be governed by the FAA.

The trial court vacated the award, accepting essentially all of DIRECTV's arguments. The California Court of Appeal reversed, concluding that the provision for judicial review was unenforceable. That is how the issue of whether California law allows for expanded judicial review where the parties explicitly provide for it ended up before the California Supreme Court.

Ultimately, the decision in *Cable Connection* is an affirmation of party autonomy and the freedom of parties to structure a dispute resolution proceeding that fits their needs. Responding to the objection that expanded judicial review is incompatible with the goal of finality, the court pointed out that the policy of finality draws its

they have some protection from errors of law, arbitration becomes a less risky alternative. The California court gave a nod to this argument when it acknowledged that expanded judicial review is "a product of increasingly 'judicialized' arbitration settings, with many of the attributes of court proceedings."

The court expanded on how this has come about, saying, "The desire for the protection afforded by review for legal error has evidently developed from the experience of sophisticated parties in high stakes cases, where the arbitrators' awards deviated from the parties' expectations in startling ways."

As a result, in California, expanded judicial review is an important tool parties can use to mitigate risk in arbitration. In this respect it is similar to requiring a reasoned award or having a panel of three, rather than a single, arbitrator.

California is the first state court to weigh in (favorably) on the issue of expanded review since *Hall Street*. New Jersey also has a favorable attitude since it allows parties to agree to expanded judicial review by statute.

The Importance of Choice of Law and Venue

At the core of the *Hall Street* and *Cable Connection* litigations are drafting issues that are separate and distinct from the decision to provide for arbitration of disputes—namely, the parties'

choice of law and venue.

In *Cable Connection*, the parties explicitly provided that the FAA would govern their agreement to arbitrate. At first glance this would seem to invoke the *Hall Street* rule prohibiting expanded judicial review. But it didn't. The reason is that the parties in *Cable Connection* also agreed that the decision of the arbitrators "may be enforced as a final judgment in any court of competent jurisdiction." They did not restrict enforcement proceedings to federal courts. This meant that the FAA would not apply if the parties elected to proceed in state court. Why? Because, by its terms, the FAA's provisions on judicial review (Sections 10 and 11) apply to federal courts alone. The converse would also likely hold true: parties who choose California substantive law but fail to include a forum-selection clause that specifies

Expanded judicial review of arbitral awards, a powerful tool for certain high-stakes disputes, is available in California state court, but not in the federal courts.

jurisdiction of the California state courts and that "any proceeding relating to the interpretation, enforcement, or validity of this agreement, including proceedings relating to any award, shall be heard in the Superior Court of the State of California." ■

California state courts are unlikely to reap the benefits of the expanded judicial review provided for in *Cable Connection*.

Thus, when the parties to a contract want expanded judicial review of arbitration awards, they must draft compatible choice-of-law and forum-selection clauses in order to ensure that the judicial review provision will be enforceable. The choice-of-law clause should state that California law applies, including the California Arbitration Act, while the forum-selection clause should provide that the parties consent to the