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May the Parties to an Arbitration Agreement Agree that a Court May Modify the Award because of Legal or Factual Error?

by Jay E. Grenig

PREVIEW of United States Supreme Court Cases, pages 81–85. © 2007 American Bar Association.

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ISSUE

May the parties to an arbitration agreement provide that a court may review an arbitration award for legal or factual error despite the Federal Arbitration Act's provision that a court "must grant an order" confirming an award except on specified grounds that do not include legal or factual error?

FACTS

Hall Street Associates is the owner of property in Beaverton, Oregon. Mattel, Inc., and its predecessors have leased the property for over 20 years. As a result of a series of mergers and assignments, Mattel became the tenant in 1997. The lease between Mattel and Hall Street did not contain an agreement to arbitrate disputes; it preserved both parties' right to have all claims arising under the lease resolved by court adjudication.

The parties' lease required Mattel to comply with all federal, state, and local environmental laws and regulations in its use of the leased prop-

erty. The lease required Mattel to assume liability "for the use of presence in the Building materials on or about the Premises of any hazardous waste" and responsibility for investigation and cleanup of "any such release or presence or use." The lease provided that Mattel would "indemnify and defend Landlord" for "all losses, costs, damages, expenses (including environmental abatement costs[]) or liability directly or indirectly resulting or arising from any such release or presence or use of hazardous building materials." The lease included an exception to the tenant's obligation to indemnify the landlord, "[t]o the extent Tenant has been in compliance with applicable environmental laws, ... Tenant shall not be held liable following the expiration of this Lease term for the following the removal and disposal of any hazardous waste on the Premises, the presence of use of which hazardous waste has not been caused directly or indirectly by the acts of the tenant."

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HALL STREET ASSOCIATES, L.L.C.
v. MATTEL, INC.
DOCKET NO. 06-989

ARGUMENT DATE:
NOVEMBER 7, 2007
FROM: THE NINTH CIRCUIT

Case at a Glance

The Federal Arbitration Act provides specific grounds, not including legal or factual error, for vacating arbitration awards. The Supreme Court is now asked to determine whether the parties to an arbitration agreement may confer upon a court the power to vacate or modify an arbitration award on the ground of legal or factual error.

The Oregon Drinking Water Quality Act required regular testing of the well water on the leased property for environmental contaminants. Mattel and its predecessors did not test the well water for trichloroethylene (TCE), a chemical used by a predecessor of Mattel to degrease metal parts.

After Hall Street tested the well water on the property in 1998, Hall Street discovered the well water contained levels of TCE significantly above federal limits. A subsequent investigation showed that other types of contaminants were present. In early 2000, Mattel notified Hall Street that it intended to terminate the lease. After spending more than \$1 million on repairs and inspections, Mattel surrendered the property to Hall Street in May 2001. During this time, Hall Street filed a complaint in Oregon state court for a declaratory judgment that Mattel's termination of the lease was not permissible and that the lease obligated Mattel to indemnify Hall Street for costs related to environmental cleanup and third-party lawsuits. Mattel removed the case to the United States District Court for the District of Oregon based on the diversity of the parties.

In the district court, the parties conducted a court on one issue in the case involving Mattel's termination of the lease. 145 F.Supp.2d 1211 (D.Or. 2001). After the district court decided that issue and after an unsuccessful attempt to settle the entire case through mediation, the parties proposed to the district court that they arbitrate the remaining issues in the case. The proposed arbitration agreement allowed either party to seek district court review of the arbitral decision for substantial evidence and errors of law.

The parties' arbitration agreement contained several provisions relating

to the district court's review of the arbitration award. First, to facilitate that review, Paragraph 1 of the arbitration agreement specified the "arbitrator shall prepare written findings of fact and conclusions of law that may be reviewed" by the district court at the request of either party. The arbitration agreement also specified the standard of review of the arbitration award:

The arbitrator shall decide the matters submitted based upon the evidence presented and the applicable law. The arbitrator shall issue a written decision which shall state the basis of the decision and include specific findings of fact and conclusions of law. The United States District Court for the District of Oregon may enter judgment upon any award, either by confirming the award, or by vacating, modifying or correcting the award. The Court shall vacate, modify or correct any award: (i) where the arbitrator's findings of facts are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous.

A provision in the arbitration agreement entitled "Confirmation of Award by Judgment" conditioned confirmation of the arbitration award on the district court's first reviewing the arbitration award for substantial evidence of legal error at the request of either party. Following the district court's approval of the agreement, the parties proceeded to arbitration to resolve the remaining issues in the case.

In January 2002, the arbitrator issued an award determining that the lease contained a broad indemnification clause requiring Mattel to "indemnify Hall Street for all activities with respect to the premises whether or not they occurred before

the date of the original lease." The arbitrator determined the only exception to Mattel's obligation to indemnify Hall Street for all activities with respect to the premises was if Mattel (1) complied with all applicable federal, state, and local environmental laws; and (2) did not directly or indirectly contribute to the presence or use of hazardous waste on the property.

The arbitrator found that Mattel and its predecessor had failed to comply with the Oregon Drinking Water Quality Act during the approximately 18 years they occupied the property. However, the arbitrator concluded that Mattel's failure to comply with the Act was not a violation of any "applicable environmental law" because the statute sought to protect human health and was "not designed to protect landowners from having their property protected from environmental contamination." Based on that conclusion, the arbitrator ruled Mattel was entitled to the contractual exception to the broad indemnification requirements of the lease.

Hall Street then filed a motion with the district court seeking review of the arbitrator's decisions. Hall Street argued that the arbitrator had committed legal error in concluding that Mattel's violation of the Oregon Drinking Water Quality Act was not a violation of an "applicable environmental law." Granting Hall Street's motion to vacate the award, the district court held that the arbitrator had erred in concluding the Oregon Drinking Water Quality Act was not an "applicable environmental law." The district court said the arbitrator's conclusion that the Act was not an applicable environmental statute "defies logic" and remanded the matter to the arbitrator.

On remand, the arbitrator entered an amended decision based on the

district court's ruling that the Oregon Drinking Water Quality Act qualified as an applicable environmental law. Ruling that no exceptions to Mattel's indemnification agreement applied, the arbitrator awarded Hall Street \$583,971.60 and also awarded declaratory relief against Mattel for all future costs that Hall Street might be required to pay relating to the environmental cleanup of the property.

Both parties then sought review of the arbitrator's amended decision. The district court upheld the arbitrator's amended award, except for a correction of the arbitrator's computation of prejudgment interest. The judgment against Mattel totaled \$810,107.49 with 6 percent post-judgment interest. Both sides then appealed to the U.S. Court of Appeals for the Ninth Circuit.

Reversing the district court, a three-judge panel of the Ninth Circuit declared that, under *Kyocera Corp. v. Prudential-Bache Trade Services, Inc.*, 341 F.3d 987 (9th Cir. 2003) (en banc), the Federal Arbitration Act precluded the parties from modifying the statutory grounds for vacatur of arbitral awards to authorize judicial review of an arbitration award for legal error. Also relying on *Kyocera*, the court held that evidence the parties intended that the entire arbitration agreement should fail in the event that the expanded standard of review provision failed was not strong enough to distinguish the case from *Kyocera*. 113 Fed.Appx. 272 (9th Cir. 2004).

According to the Ninth Circuit, *Kyocera* compelled it to vacate the district court's judgment based on the arbitration agreement and returned the case to the district court. On remand, the district court was directed to return to the original arbitration award (not the subsequent award revised after rever-

sal), and confirm that award unless the district court determines the award should be vacated on the grounds allowable under 9 U.S.C. § 10, or modified or corrected under the grounds allowable under 9 U.S.C. § 11.

On remand, the district court again failed to enforce the arbitration award—this time finding the award was “implausible.” On appeal from that decision, a divided three-judge panel of the Ninth Circuit once again reversed the district court's decision holding that implausibility is not a valid ground for avoiding an arbitration award under either 9 U.S.C. § 10 or 11. 196 Fed.Appx. 476 (9th Cir. 2006). Acknowledging that the arbitrator's assessment of the merits in the case contained possible errors of law, the court held those errors were not a sufficient basis for a federal court to overrule an arbitration award. In addition, the majority found it cannot be said that the arbitrator's decision was completely irrational.

The court remanded the case to the district court with instructions to enforce the original arbitration award and declare Mattel the prevailing party. Hall Street sought review of this decision by the U.S. Supreme Court, and the Supreme Court granted certiorari. 127 S.Ct. 2875 (2007).

CASE ANALYSIS

The right or duty to arbitrate normally arises from an agreement to arbitrate a future or existing dispute. The arbitration agreement determines and limits the issues to be decided. In *Volt Information Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 479 (1989), the Supreme Court held that “[j]ust as [private parties] may limit by contract the issues which they will arbitrate, so too may they specify by contract the rules under which that

arbitration will be conducted.” An arbitration agreement may include such matters as the governing substantive law, the procedure for initiating arbitration, the procedure for selecting the arbitrator or arbitrators, the place of the arbitration hearing, and whether the decision should include the arbitrator's reasons for the award.

The Federal Arbitration Act, 9 U.S.C. §§ 1-16, enumerates limited grounds on which a federal court may vacate, modify, or correct an arbitral award. In addition to these statutory grounds for vacating an award, courts have applied the non-statutory grounds of manifest disregard of the law, conflict with public policy, complete irrationality, and failure of the award to draw its essence from the parties' underlying contract.

It is Hall Street's position that, at the time the parties made their proposal to arbitrate, the parties and the district court were bound by the decision of the Ninth Circuit in *LaPine Tech. Corp. v. Kyocera Corp.*, 130 F.3d 884 (9th Cir. 1997), *vacated sub nom. Kyocera Corp. v. Prudential-Bache Trade Services, Inc.*, 341 F.3d 987 (9th Cir. 2003) (en banc), *petition for cert. dismissed*, 540 U.S. 1098 (2004). In *LaPine*, the Ninth Circuit held that nothing in the Federal Arbitration Act precludes parties from agreeing to deviate from the statutory grounds for vacatur and agreeing to allow federal courts to review an arbitration award for legal error. Based on *LaPine*, the district court approved the parties' agreement to arbitrate the remaining issues and agreed to confirm the arbitration award only if it was free from legal error.

Quoting *Volt Information Sciences, Inc. v. Board of Trustees*, 489 U.S.

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468, 479 (1989), Hall Street argues that the primary purpose of the Federal Arbitration Act is to ensure that “private agreements to arbitrate are enforced according to their terms.” Hall Street asserts that the Supreme Court has held repeatedly that private agreements to arbitrate must be rigorously enforced according to their terms, even if those terms deviate from the Federal Arbitration Act’s statutory provisions.

Mattel responds that the Federal Arbitration Act’s limited grounds for vacatur, modification, or correction of an award reflect a deliberate choice made by Congress in 1925 to reject an alternative approach of certain contemporaneous arbitration laws in some states, in particular Illinois, that permitted vacatur of arbitration awards for legal error. Mattel says Congress followed the New York Arbitration Act of 1920, which had been uniformly interpreted not to permit review of an arbitrator’s conclusions of law or findings of fact.

Hall Street points out that that Section 9 of the Federal Arbitration Act authorizes “parties in their agreement” to determine whether “a judgment of the court shall be entered upon the award made pursuant to the arbitration....” It explains that, by deferring to the parties’ agreement on whether a judgment shall be entered, Section 9 necessarily allows parties to specify in their agreement the circumstances under which a judgment shall not be entered on an arbitration award. Hall Street notes that the Supreme Court has recognized judicially created exceptions to the statutory grounds for vacating arbitration awards, including manifest disregard of the law.

With respect to manifest disregard of the law as a ground for vacating

an arbitration award, Mattel contends that Court’s reference to that in *Wilko v. Swan*, 346 U.S. 427 (1953) was dicta going to the scope of the statutory grounds in Section 10. Mattel claims that such dicta did not establish a nonstatutory ground for vacatur. Mattel also asserts that *Volt Information Systems* is inapplicable here because it relied on principles of preemption and looked to the test of Section 4 of the Federal Arbitration Act, neither of which is relevant here according to Mattel.

Hall Street reasons that an arbitration agreement entered into in the middle of an ongoing federal litigation, which clearly and unmistakably preserves the court’s ability to correct an arbitrator’s erroneous legal conclusion, does not offend the goals and policies of the Federal Arbitration Act or unduly burden the federal judiciary. Hall Street says the parties’ arbitration agreement does not usurp any congressional power or dictate to the court how to conduct its judicial proceedings. It points out the district court fully endorsed the parties’ agreement and entered it as an order of the court.

Mattel disagrees, asserting that Section 2 of the Federal Arbitration Act makes the Act applicable to agreements to “settle” a controversy “by arbitration.” If the parties to an arbitration agreement can agree a court will refuse to confirm an award if the award contains an error of law or lacks substantial evidence supporting facts, Mattel argues that arbitration becomes only a prelude to judicial review and there is no agreement that arbitration will “settle” the controversy.

Mattel notes the parties can protect themselves against the risk of an anomalous decision by an arbitrator through the use of appellate arbitra-

tion. Appellate arbitration allows parties to provide for a second review by arbitrators of an award under whatever standards the parties wish. According to Mattel, what parties cannot do is require a court to apply standards of review and grounds for judicial vacatur, modification, or correction of an arbitration award that the parties customize for their particular cause of action in court, but which Congress did not authorize in the Federal Arbitration Act.

Hall Street stresses that the parties’ agreement did not purport to confer federal jurisdiction. It points out that the Federal Arbitration Act is not a jurisdictional statute and that any case before a federal district court under the Federal Arbitration Act must have an independent jurisdictional basis.

Mattel responds that, under Hall Street’s view, a court would be bound by the grounds drafted by the parties for confirmation, vacatur, modification, or correction, rather than by the grounds stated by Congress. Mattel asserts that Section 9 of the Federal Arbitration Act unequivocally directs that a court “must grant” an application for an order forming an arbitration award unless “the award is vacated, modified or corrected as prescribed in sections 10 and 11” of the Act. Mattel claims that Sections 10 and 11 do not authorize a court to vacate, modify, or correct an award based merely on an error of law or fact. Mattel reasons that Section 9 is not a default standard subject to the parties’ alteration.

SIGNIFICANCE

Given the rapid growth of the use of arbitration to resolve commercial and consumer disputes, this case will have a significant impact on how arbitration agreements are drafted and applied. There is a defi-

nite split among the circuits with respect to whether the parties may contract for more expansive judicial review of arbitration awards. The Tenth Circuit has agreed with the Ninth Circuit that the parties do not have such power. *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925 (10th Cir. 2001). *Cf. UHC Mgt. Co. v. Computer Sciences Corp.*, 148 F.3d 992 (8th Cir. 1998) (stating it is not clear that parties have any say in how a federal court will review an arbitration award, when Congress has ordained a specific, self-limiting procedure for how such review is to occur).

The Third and Fifth Circuits disagree with the Ninth and Tenth Circuits, holding that parties who voluntarily agree to arbitration may provide for more expansive judicial review of an arbitration award than that provided in the Federal Arbitration Act. They emphasize the purpose of the Federal Arbitration Act is to enforce the terms of private arbitration agreements including terms specifying the scope of review of arbitration decisions. See *Roadway Package Systems, Inc. v. Kayser*, 257 F.3d 287 (3d Cir.), *cert. denied*, 534 U.S. 1020 (2001); *Gateway Technologies, Inc. v. MCI Telecommunications Corp.*, 64 F.3d 993 (5th Cir. 1995).

The Supreme Court has the opportunity to decide whether parties may include standard-of-review clauses in arbitration agreements or if substantive review of arbitration awards may only be had under the narrow standards of the Federal Arbitration Act.

It is suggested that a decision permitting parties to include a standard-of-review clause in arbitration agreements promotes arbitration by appealing to parties who otherwise would be reluctant to arbitrate for fear of a legally erroneous award

without a chance for meaningful review. Others disagree, suggesting that permitting parties to agree on nonstatutory grounds for judicial vacatur, modification, or correction of arbitration awards based on errors of law would create havoc for arbitrators and courts, resulting in arbitration becoming like court proceedings. Such a decision may force arbitrators to adopt explicit limits on the scope of the record, rulings on evidentiary objections, and formal findings. Some argue that this would seriously undermine the time and cost savings arbitration is supposed to yield.

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