

Freedom of Contract v. Efficient Dispute Resolution: The Supreme Court to Decide Primary Policy Underlying the Federal Arbitration Act

By Susan C. Levy and Joelle Blomquist

There are two primary public policies underlying the American arbitration system: freedom of contract allowing parties to bypass the traditional civil litigation system and cost-efficient resolution of private disputes. In most arbitrations under the Federal Arbitration Act (FAA), these two policies are in complete accord. However, when parties' contracts provide for more expansive judicial review than that provided for under the FAA and common law, these two policies collide. The Circuit Courts of Appeal that have addressed which one of the two policies should take precedence have reached conflicting decisions. On May 29, 2007, the U.S. Supreme Court granted a petition for a writ of certiorari in *Hall Street Associates, L.L.C. v. Mattel, Inc.*, ___ U.S. ___, 127 S.Ct. 2875 (2007), to address the foregoing split of authority.

Judicial Review of Arbitration Awards Under the FAA

The FAA constitutes a body of substantive federal law governing the enforcement and review of arbitration agreements and awards.¹ Consistent with the provisions thereof, reviewing courts give an arbitrator's factual and legal findings great deference.² Specifically, under the FAA, an arbitral award must be confirmed unless: (1) one of the statutory exemptions listed in 9 U.S.C. § 10 applies; (2) the arbitrators acted in manifest disregard of the law; or (3) the arbitral award is incomplete, ambiguous, or contradictory.³ Furthermore, the confirmation of an arbitration award generally is a summary proceeding that makes what is already a final arbitration award an enforceable judgment of the court.

Given this deference to arbitration awards, a party seeking to vacate an arbitral award bears the heavy burden of showing that the award falls within the very narrow set of exceptions to enforcement established by the FAA and common law. The FAA provides that an arbitration award may be vacated only if: (1) the award was procured by corruption, fraud or undue means; (2) the arbitrators exhibited "evident partiality" or "corruption"; (3) the arbitrators were guilty of misconduct; or (4) the arbitrators exceeded their power.⁴ Courts will also vacate an arbitration award if it is based upon a manifest disregard of the law. Manifest disregard of the law is "a doctrine of last resort" limited to "those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent, but where none of the provisions of the FAA apply."⁵ Accordingly, courts will enforce an arbitrator's award, despite disagreement with it on the merits, "if there is a **barely colorable justification** for the outcome reached."⁶

This limited standard of review furthers one of the primary goals of arbitration, settling disputes efficiently and avoiding long and expensive litigation. As the Second Circuit observed in *Matter of Arbitration between Andros Compania Maritima S.A. and Marc Rich & Co.*, 579 F.2d 691, 703 (2d Cir. 1973) (quoting *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 599):

Justice Douglas' opinion concludes with a clear warning to all disappointed parties to arbitral proceedings who may be tempted to relitigate the merits in federal court: "The question of interpretation of the . . . agreement is a question for the arbitrator. It is the arbitrator's construction which was bargained for; and so far as the arbitrator's decision concerns construction of the contract, the courts have no business overruling him because their interpretation of the contract is different from his."

The First, Third, Fourth, Fifth, and Sixth Circuits have found that enforcing contractual provisions expanding the scope of judicial review is in line with the right to freedom of contract implicit in the arbitration process.

In recent years, seven Federal Circuit Courts of Appeal have addressed whether the limited standard of review prescribed by the FAA, in addition to the judicially-created standard of review for manifest disregard of the law, are the only grounds upon which arbitration awards can be reviewed by the courts. A split in the Circuits has developed. Five Circuits have held that freedom of contract supports enforcing clearly articulated contractual provisions establishing additional grounds for judicial review. Two Circuits have expressly disagreed, holding that the FAA's underlying policies of efficient and cost-effective dispute resolution necessitate that contractual provisions allowing for expanded review of arbitration awards not be enforced. Three additional Circuits have found, in similar contexts, that freedom of contract does not allow parties to

contractually alter federal judicial review or undermine the policies underlying the FAA.

This spring, the Supreme Court granted certiorari in *Hall Street Associates v. Mattel, Inc.* to address the permissibility of contractual expansion of judicial review of arbitration awards. In deciding this issue, the Supreme Court will reconcile the conflicting policies underlying the American arbitration system.

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The Case for Certiorari: *Hall Street Associates v. Mattel, Inc.*

Due to the circumstances under which the parties negotiated the arbitration agreement allowing for expanded judicial review of any subsequent arbitration award, the *Hall Street* case presents an excellent opportunity for the Supreme Court to resolve the conflict regarding the FAA's underlying policies and the permissible scope of review of final arbitration awards. In *Hall Street*, the underlying dispute concerns a property leased by Mattel from Hall Street.⁷ The lease did not contain an arbitration agreement.⁸ Contamination of well water on the property led to the filing of an action by Hall Street in Oregon state court asserting several claims for injunctive and declaratory relief, in addition to other damages. Ultimately, the case was removed to the United States District Court for the District of Oregon.

The case proceeded to trial on one of the claims asserted by Hall Street, the claim was decided, and the parties engaged in unsuccessful attempts to settle the remaining claims. Instead of engaging in a lengthy and expensive civil lawsuit, however, the parties notified the district court that they would negotiate an agreement to arbitrate the remaining issues and would seek the district court's approval of the arbitration agreement. Even though the FAA does not allow review of an arbitrator's factual or legal findings, the agreement the parties reached contained language allowing the district court to review the arbitrator's factual findings for substantial evidence and the arbitrator's legal findings for legal error.

The district court approved the parties' arbitration agreement, including the provision allowing for expanded judicial review. In so doing, the district court relied on a prior ruling of the Ninth Circuit, *LaPine Technology Corp. v.*

Kyocera Corp., 130 F.3d 884 (9th Cir. 1997), which enforced a similar provision.

An arbitration hearing was conducted before a single arbitrator on the remaining issues. Once the arbitration was completed, the arbitrator issued Findings of Fact and Conclusions of Law, and found in favor of Mattel, the lessee. Hall Street sought to vacate the arbitration award in the District Court of Oregon. The district court enforced the expanded judicial review provision of the parties' arbitration agreement and vacated the award based upon a finding of legal error in the construction of the applicable Oregon environmental statute. The matter was remanded back to the arbitrator, who revised his award based on the district court's interpretation of the Oregon environmental statute. Unsatisfied with the revised arbitration award, both parties sought review by the district court. This time, the district court upheld the award.

Both sides appealed the district court's decision. Significantly, by this time, the Ninth Circuit had reversed *LaPine*, and had instead adopted the position that parties could not contractually expand the scope of judicial review of an arbitration award beyond the grounds enumerated in the FAA.⁹ Consistent therewith, on appeal, the Ninth Circuit reversed the district court's original *vacatur* of the arbitration award due to an alleged error of law on the basis that the expanded judicial review provision could not be enforced.¹⁰ The Ninth Circuit remanded the case to the district court and directed that the motion to vacate be considered under the limited standard of review set forth in the FAA.

Once again, the district court vacated the award, this time by allegedly applying the FAA standard of review and finding that the arbitrator had exceeded his authority by basing his award on an "implausible" interpretation of a contract. Mattel appealed a second time.

The Ninth Circuit again reversed the district court, finding that being "implausible" was not a grounds for *vacatur* under the FAA, and that, even though "the arbitrator's assessment of the merits in this case contains possible errors of law,

The Second, Seventh, and Eighth Circuits have not explicitly ruled on this issue.

those errors are not a sufficient basis for a federal court to overrule an arbitration award."¹¹ Hall Street petitioned the United States Supreme Court for a writ of *certiorari*, requesting that the Court resolve the split among the Federal Circuit Courts of Appeal concerning the enforceability of contractual provisions expanding the standard of review of arbitration awards under the FAA. On May 29, 2007, the Supreme Court granted *certiorari*.¹²

The Split in the Circuits: The FAA's Competing Policies

The split in the Federal Circuit Courts of Appeal is founded on the competing policies underlying the FAA -- freedom of contract versus efficient and cost-effective dispute resolution. The First, Third, Fourth, Fifth, and Sixth Circuits have found that enforcing contractual provisions expanding the scope of judicial review is in line with the right to freedom of contract implicit in the arbitration process.¹³ These Circuit Courts based their decisions on **Mastrobuono v. Shearson Lehman Hutton, Inc.**, 514 U.S. 52, 115 S. Ct. 1212 (1995), which construed a contractual choice-of-law provision to allow for punitive damages in arbitration; and **Volt Information Sciences, Inc. v. Board of Trustees**, 489 U.S. 468, 109 S. Ct. 1248 (1989), which held that the FAA did not preempt the parties' agreement to abide by state rules of arbitration. In both cases, the Supreme Court stated that Congress enacted the FAA for the "central purpose" of ensuring that private agreements to arbitrate are enforced according to their terms.¹⁴

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For example, in **Gateway Technologies, Inc. v. MCI Telecommunications Corp.**, 64 F.3d 993 (5th Cir. 1995), the contract provision at issue allowed for judicial review for mere errors of law. The Fifth Circuit recognized that the provision expanded the narrow review allowed by the FAA, but held that such expansion was acceptable because arbitration is a creature of contract.¹⁵ The court concluded that the FAA's limited standard of review was the "default standard of review" applicable when the arbitration agreement was silent on judicial review of the award, but that "the FAA does not prohibit parties who voluntarily agree to arbitration from providing contractually for more expansive judicial review of the award."¹⁶ The court relied on the Supreme Court's holding in **Volt**, which held that the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.¹⁷ Based upon this precedent, the court held that refusal to enforce the parties' provision allowing for review of errors of law "would be quite inimical to the FAA's purpose of ensuring that private agreements to arbitrate are enforced according to their terms."¹⁸ The First, Third, Fourth, and

Sixth Circuits thereafter followed **Gateway**, showing a clear intent to allow for expanded judicial review of arbitration awards beyond the standard of review established by the FAA.¹⁹

Two Circuits explicitly have ruled to the contrary. Specifically, the Ninth and Tenth Circuits have refused to enforce provisions expanding judicial review of arbitration awards, finding that private parties have no power to alter or expand the FAA's grounds for review of arbitration awards, and that contractual provisions purporting to do so are legally unenforceable.²⁰ These Circuits have found that enforcing such provisions would undermine the public policy favoring efficient and cost-effective dispute resolution upon which the FAA, and the arbitration system, is founded.

The Tenth Circuit was the first to hold that provisions expanding judicial review of arbitration awards are not enforceable. In **Bowen v. Amoco Pipeline Co.**, 254 F.3d 925 (10th Cir. 2001), the parties agreed that they could challenge an arbitration award on the grounds that the award was not supported by the evidence, which is not one of the grounds for review under the FAA or common law. In holding that that provision was not enforceable, the court found that **Volt** not only did not support a contrary result, but rather, actually dictated this result. **Volt** held that parties may agree to state procedural rules because the federal policy favoring arbitration does not favor arbitration under a particular set of procedural rules.²¹ The Tenth Circuit found that, unlike any particular set of procedural rules, however, enforcing contractual provisions expanding judicial review would undermine the policies underlying the FAA and would therefore be preempted.²² The court reasoned that, by consenting to arbitration, parties trade the procedures and opportunities offered by the courtroom for the simplicity, informality, cost-effectiveness, and expedition of arbitration.²³ The court concluded: "Contractually expanded standards, . . . clearly threaten to undermine the independence of the arbitration process and dilute the finality of arbitration awards because, in order for arbitration awards to be effective, courts must not only enforce the agreements to arbitrate but also enforce the resulting arbitration awards."²⁴

For similar reasons, in **Kyocera Corp. v. Prudential-Bache Trade Services, Inc.**, 341 F.3d 987 (9th Cir. 2003), the Ninth Circuit rejected an agreement that provided for more expansive judicial review. "Broad judicial review of arbitration decisions could well jeopardize the very benefits of arbitration, rendering informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process."²⁵

The Second, Seventh, and Eighth Circuits have not explicitly ruled on this issue. However, their opinions in analogous contexts suggest that they would likely follow the Ninth and Tenth Circuits. In **Hoelt v. MVL Group, Inc.**, 343 F.3d 57 (2d Cir. 2003), the Second Circuit held that an arbitration

clause that purported to preclude any judicial review whatsoever of an arbitration award was unenforceable. The court held that private parties cannot tell a federal court when to enter a judgment enforcing an arbitration award because judicial standards of review, like judicial precedents, “are not the property of private litigants.”²⁶ Similarly, in *Chicago Typographical Union v. Chicago Sun-Times, Inc.*, 935 F.2d 1501, 1504-5 (7th Cir. 1991), the Seventh Circuit addressed the limitations on a Federal court in reviewing an arbitration award:

Federal courts do not review the soundness of arbitration awards. An agreement to submit a dispute . . . to arbitration is a contractual commitment to abide by the arbitrator’s interpretation. . . . But [the parties] cannot contract for *judicial* review of that award; federal jurisdiction cannot be created by contract. . . . The court is forbidden to substitute its own interpretation even if convinced that the arbitrator’s interpretation was not only wrong, but plainly wrong.

And, in *UHC Management Company, Inc. v. Computer Sciences Corp.*, 148 F.3d 992, 997-98 (8th Cir. 1998), the Eighth Circuit stated that the ability to contract for a heightened standard of review is “not yet a foregone conclusion.” The court reasoned that allowing expanded judicial review appeared to be at odds with the plain language of Section 9 of the FAA, which provides that federal courts “must grant” an order confirming an arbitration award “unless the award is vacated, modified, or corrected as prescribed in sections 10 or 11 of this title.”²⁷

Conclusion

The split in the Federal Courts of Appeals has created conflicting outcomes regarding the scope of judicial review of arbitral awards. By granting certiorari in *Hall Street Associates v. Mattel, Inc.*, the Supreme Court has an opportunity to bring predictability and uniformity back to the federal law of arbitration and definitively to establish whether freedom of contract or the maintenance of an efficient and cost-effective alternative system of dispute resolution is the primary public policy underlying the FAA.



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- ¹ *Allied-Bruce Terminix Co., Inc. v. Dobson*, 513 U.S. 265, 270-72, 115 S. Ct. 834 (1995).
- ² *Wallace v. Buttar*, 378 F.3d 182, 189 (2d Cir. 2004); *Duferco Int’l Steel Trading v. T. Klaveness Shipping A/S*, 333 F.3d 383, 388 (2d Cir. 2003).
- ³ See 9 U.S.C. §§ 9-10; see also *Matter of Arbitration between Carina Int’l Shipping Corp. and Adam Maritime Corp.*, 961 F. Supp. 559, 563 (S.D.N.Y. 1997).
- ⁴ 9 U.S.C. § 10.
- ⁵ *Wallace*, 378 F.3d at 189; *Duferco*, 333 F.3d at 389.
- ⁶ *Wallace*, 378 F.3d at 190.
- ⁷ See *Petition for Writ of Certiorari, Hall Street Associates, LLC v. Mattel, Inc.*, ___ U.S. ___, 127 S. Ct. 2875 (2007) (No. 06-989).
- ⁸ See *Petition for Writ of Certiorari, Hall Street Associates, LLC v. Mattel, Inc.*, ___ U.S. ___, 127 S. Ct. 2875 (2007) (No. 06-989).
- ⁹ See *Kyocera Corp. v. Prudential-Bache Trade Servs., Inc.*, 341 F.3d 987 (9th Cir. 2003).
- ¹⁰ *Hall Street Assoc., LLC v. Mattel Inc.*, 113 Fed. Appx. 272 (9th Cir. 2004).
- ¹¹ *Hall Street Assoc., LLC v. Mattel Inc.*, 196 Fed. Appx. 476 (9th Cir. 2006).
- ¹² *Hall Street Assoc., LLC v. Mattel, Inc.*, ___ U.S. ___, 127 S. Ct. 2875 (2007).
- ¹³ See *Gateway Techs., Inc. v. MCI Telecomm. Corp.*, 64 F.3d 993 (5th Cir. 1995); *Syncor Int’l Corp. v. McLeland*, No. 96-2261, 1997 U.S. App. LEXIS 21248 (4th Cir., Aug. 11, 1997); *Roadway Package Sys., Inc. v. Kayser*, 257 F.3d 287 (3d Cir. 2001); *Jacada, Ltd. v. Int’l Mktg. Strategies, Inc.*, 401 F.3d 701 (6th Cir. 2005); *Puerto Rico Tel. Co., Inc. v. U.S. Phone Mfg. Corp.*, 427 F.3d 21 (1st Cir. 2005).
- ¹⁴ *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 53-54, 115 S. Ct. 1212 (1995); see also *Volt Info. Sci., Inc. v. Board of Trustees*, 489 U.S. 468, 478-79, 109 S. Ct. 1248 (1989).
- ¹⁵ *Gateway*, 64 F.3d at 996.
- ¹⁶ *Id.* at 997.
- ¹⁷ *Volt*, 489 U.S. at 478.
- ¹⁸ *Gateway*, 64 F.3d at 996.
- ¹⁹ *Puerto Rico Telephone*, 427 F.3d at 30-31; *Syncor*, 1997 U.S. App. Lexis at *17; *Roadway Package System*, 257 F.3d at 292-93; *Jacada*, 401 F.3d at 709-11.
- ²⁰ See *Kyocera Corp.*, 341 F.3d at 1000 (9th Cir. 2003) (“We agree with the Seventh, Eighth, and Tenth Circuits that private parties have no power to determine the rules by which federal courts proceed, especially when Congress has explicitly prescribed those standards.”); see also *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925 (10th Cir. 2001).
- ²¹ *Volt*, 489 U.S. at 478-79.
- ²² *Bowen*, 254 F.3d at 934-35.
- ²³ *Id.* at 932.
- ²⁴ *Id.* at 935.
- ²⁵ *Kyocera*, 341 F.3d at 998.
- ²⁶ *Hoelt v. MVL Group, Inc.*, 343 F.3d 57, 65 (2d Cir. 2003). In *Fils et Cables D’Acier de Lens v. Midland Metals Corp.*, 584 F. Supp. 240, 243-44 (S.D.N.Y. 1984), the Southern District of New York held that parties can expand judicial review of an arbitration award by contract. In *Hoelt*, when the Second Circuit addressed this analogous issue, it ignored the Southern District of New York’s holding in *Fils et Cables*.
- ²⁷ *UHC Mgmt.*, 148 F.3d at 997-98.

Editors’ note: oral argument before the Supreme Court of the United States on *Hall Street Associates, L.L.C. v. Mattel, Inc.*, is set for November 7, 2007.