

# Client Alert

A report  
for clients  
and friends  
of the Firm     April 2008

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## Divided Supreme Court Rules That the Scope of Judicial Review to Confirm Arbitral Awards May Not Be Expanded by Agreement

On March 25, 2008, the United States Supreme Court issued a 6-3 ruling which resolved a long-standing Circuit split concerning whether parties to an arbitration agreement can agree to expand the scope of judicial review of an arbitration award, beyond the relatively narrow review provided by the Federal Arbitration Act ("FAA"), 9 U.S.C. § 1 *et seq.* In *Hall Street Associates, L.L.C. v. Mattel, Inc.*, No. 06-989, 552 U.S. \_\_\_\_ (2008), the Supreme Court ruled that the grounds set forth in the FAA for vacating or modifying an arbitration award are exclusive, and that parties to binding arbitration under the FAA cannot, by agreement, expand or otherwise modify the scope of judicial review. Given the wide reach and broad applicability of the FAA, with its governance over the review of awards concerning matters "involving commerce," 9 U.S.C. § 2, the Court's ruling could significantly affect the ways in which parties approach agreements to arbitrate, regardless of whether a potential dispute has a domestic or international scope and regardless of the commercial or industrial context in which a dispute might arise.

### Background

This case arose out of a property lease between landlord Hall Street Associates, L.L.C. ("Hall Street") and Mattel, Inc. ("Mattel"). The property in question was used for decades by Mattel and its predecessors as a manufacturing site. When, after some years, it was discovered that well water on the property had been contaminated, Mattel and one of its predecessors entered into a Consent Order with the Oregon Department of Environmental Quality, providing for cleanup of the site. The lease specifically required Mattel to "indemnify and defend" Hall Street for all costs arising out of a failure by Mattel to comply with applicable environmental laws while using the premises.

In 2001, Mattel gave notice of its intent to terminate the lease, prompting Hall Street to file suit, in which it both contested Mattel's right to vacate the premises and claimed a right to indemnification for costs arising out of the site's cleanup. Mattel prevailed on the termination issue, and the parties proposed to submit the indemnification claim to arbitration, entering into an arbitration agreement, which the United States District Court for the District of Oregon subsequently entered as an Order. The agreement specified, among other things, the scope of judicial review against which to test any resulting arbitration award. Specifically, the parties' agreement provided that:

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.

The arbitrator found that, under the lease, Hall Street was not entitled to indemnification because the lease did not obligate Mattel to comply with the testing requirements of the Oregon Drinking Water Quality Act, which the arbitrator characterized as relating to public health rather than environmental contamination.

Hall Street sought review of the decision, asserting that the arbitrator's failure to treat the Drinking Water Quality Act as an applicable environmental law under the lease constituted legal error. The District Court vacated the award and remanded for further consideration, expressly relying upon the provision in the parties' agreement that allowed review "where the arbitrator's conclusions of law are erroneous." The arbitrator amended the decision accordingly, and both parties filed motions in the District of Oregon to modify the decision. The District Court again applied the standard of review set forth in the parties' agreement and upheld the award, correcting only the arbitrator's calculation of interest.

Both parties appealed to the Court of Appeals for the Ninth Circuit. On appeal and for the first time, Mattel argued that, under the Ninth Circuit's *en banc* decision in *Kyocera Corp. v. Prudential-Bache Servs., Inc.*, 341 F.3d 987 (9th Cir. 2003), overruling *Lapine Tech. Corp. v. Kyocera Corp.*, 130 F.3d 884 (9th Cir. 1997), the arbitration agreement's provision providing for an agreed-upon form of judicial review for legal error was invalid and unenforceable. The Ninth Circuit agreed, remanding the matter to the District Court with instructions to confirm the original arbitration award unless the award should be vacated, modified, or corrected according to the grounds allowable under the FAA, 9 U.S.C. §§ 10-11. On remand, the District Court reasoned that the arbitration award rested on an implausible interpretation of the lease, in violation of the arbitrator's powers, and vacated the award under 9 U.S.C. § 10. On appeal, the Ninth Circuit again reversed.

The Supreme Court granted certiorari to resolve the question of whether the grounds specified in 9 U.S.C. §§ 10-11 on which a Court may vacate, modify or correct an arbitration award are exclusive (*i.e.*, those grounds cannot be expanded or supplemented, by agreement of the parties). The Circuit Courts have been sharply divided over this question. Compare *Kyocera Corp. v. Prudential-Bache Servs., Inc.*, 341 F.3d at 1000; *Bowen v. Amoco Pipeline Co.*, 254 F.3d 925, 936 (10th Cir. 2001); *UHC Mgmt. Co. v. Computer Sciences Corp.*, 148 F.3d 992, 997-98 (8th Cir. 1998) with *Puerto Rico Tel. Co. v. U.S. Phone Mfg. Corp.*, 427 F.3d 21, 31 (1st Cir. 2005); *Jacada (Europe), Ltd. v. Int'l Mktg. Strategies, Inc.*, 401 F.3d 701, 710 (6th Cir. 2005); *Roadway Package Sys., Inc. v. Kayser*, 257 F.3d 287, 288 (3d Cir. 2001); *Syncor Int'l Corp. v. McLeland*, 120 F.3d 262 (4th Cir. 1997).

## The Supreme Court's Decision

In *Hall Street*, the Supreme Court sided with the Ninth Circuit, holding that the grounds set forth in Sections 10 and 11 of the FAA are the exclusive grounds on which an arbitration award may be reviewed. The majority reasoned that the text of Section 9 directs that courts must confirm an arbitration award "unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11." Sections 10 and 11 limit judicial review of arbitration awards to circumstances where an award was procured by corruption, fraud, or undue means; where there was evident partiality or corruption in the arbitrator; where the arbitrator was guilty of misconduct in not postponing the arbitration or refusing to hear evidence; or where "the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made."

In reaching its conclusion, the Supreme Court reasoned, among other things, that the inflexibility of that language establishes that Congress intended the grounds set forth in Sections 10 and 11 exclusive, absent which all arbitration awards *must* be confirmed. The majority added that its interpretation furthered the policy objectives behind the FAA, noting that:

[I]t makes more sense to see the three provisions, §§9–11, as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. Any other reading opens the door to the full-bore legal and evidentiary appeals that can render informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process...

The majority also addressed the principle, acknowledged in *Wilko v. Swan*, 346 U.S. 427 (1953), that courts may vacate or modify arbitration awards that are in "manifest disregard" of the law. The "manifest disregard" standard has been widely adopted, either expressly or impliedly, since *Wilko*. And although the *Hall Street* opinion did not expressly preempt or abolish that standard, the Court suggested that "manifest disregard" may simply refer generally to some or all of the grounds set forth in Section 10.

## What Does This Ruling Mean For Arbitration?

For parties to binding arbitration provisions governed by the FAA, *Hall Street* makes clear that the narrow grounds for judicial review of an arbitral award under the FAA are the only grounds available for such review. In short, the decision precludes negotiation of an expanded or otherwise modified scope of judicial review where one or both parties seek to vacate or modify an award. As noted above, prior to *Hall Street*, several federal circuit courts previously had

allowed a negotiated expansion of the scope of review. After *Hall Street*, however, this flexibility is gone. The arbitration award will be confirmed unless there were fairly egregious flaws in the arbitration proceeding.

It is commonly understood that, as compared with judicial resolution in litigation, arbitration can offer a more efficient, prompt, and less costly method for resolving disputes. In addition, the overall “binding” nature of arbitration, afforded by statutes such as the FAA, guarantees a valuable “finality,” for better or worse. At the same time, however, the perceived flexibility of arbitrating parties to tailor certain aspects of the arbitral proceeding, such as selecting an arbitrator, certainly has contributed greatly to the use and popularity of arbitration generally.

*Hall Street* arguably has placed a notable limitation on the ability of contracting parties to design a dispute-resolution mechanism that meets their mutual real or perceived need. To the extent the question previously was unclear, agreements expanding the scope of judicial review of an arbitration decision are now clearly no longer enforceable under the FAA.

In reaching this conclusion, the Court made certain observations that ultimately may have more reaching effects on arbitration, however. For example, the Court’s suggestion that the “manifest disregard” of the law standard equates with the grounds set forth in Section 10 may be the first step along a path that narrows that standard along the lines of Section 10 of the FAA. In addition, the Court’s passing reference to other avenues for judicial review (e.g., pursuant to state statutory common law) raises questions concerning the larger issue of the scope of the FAA’s application generally.

Time will tell whether the Court’s ruling in *Hall Street* will make much of a difference. Indeed, the parties – along with their respective *amici* – were sharply divided over the potential implications of the Court’s ruling. *Hall Street* submitted that, if expanded judicial review were foreclosed, parties will shy away from arbitration. Mattel, by contrast, maintained that the chilling effect would largely fall on the courts, because the finality of arbitration would make judicial resolution the preferred form of dispute resolution. In the end, however, the majority declined to weigh in on the anticipated consequences of its ruling. It is difficult, of course, to assess with any degree of certainty whether a limitation on the scope of judicial review of arbitral awards will have an appreciable effect on parties’ willingness to arbitrate more generally. At a minimum, however, *Hall Street* should be taken into account by parties who find themselves at the negotiating and drafting stages of the arbitral process.

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