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Ninth Circuit Splits From the Second, Third and Fourth Circuits in "Brain Twister" Arbitration Case

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Arbitration provisions are common features of commercial agreements. Arbitration is often touted as a cost-effective alternative to litigation that provides contract parties the freedom to decide everything from what law the arbitrator should apply, to what issues the arbitrator should resolve. The parties can even delegate to the arbitrator the issue of what should and should not be arbitrated (also known as arbitrability issues) by incorporating a delegation clause in their arbitration agreement.

Arbitration, however, does have limits. One such limit is that arbitration agreements are invalid if they would cause a party to lose the right to bring a federal statutory claim – also known as the "prospective waiver" doctrine. This could occur, for example, if a contract has a choice-of-law clause that precludes the application of federal law.

An interesting puzzle arises when a contract contains both of these elements: a choice-of-law clause precluding the arbitrator from applying federal law, and a delegation clause requiring the arbitrator to resolve disputes relating to arbitrability. In such a case, there is an unresolved order-of-analysis issue: Does a court first look at the delegation clause and send the case to arbitration? Or does the court look first at whether the arbitration agreement would result in prospective waiver due to the choice-of-law clause?

On September 17, 2021 in a 2-1 decision, the Ninth Circuit split with the Second, Third, and Fourth Circuit on this question, holding that unless the delegation clause itself is invalid, the arbitrator must decide the prospective waiver issue, even if a choice-of-law clause in the arbitration agreement may cause a party to waive federal rights.

The case arose out of loans that the borrowers argued were usurious under federal and California law. Plaintiffs obtained the loans from certain tribal lending entities under agreements that required disputes to be resolved under "Tribal Law." The agreements expressly waived application of federal (and state) law with two exceptions: the arbitrator could apply the law of the (1) Federal Arbitration Act, and (2) the Indian Commerce Clause of the Constitution of the United States.

Plaintiffs resisted arbitration on the ground that the arbitration agreement and the delegation clause were invalid, because the arbitrator's application of Tribal Law denied them the opportunity to sue under, among other things, the RICO statute. Defendants argued that the arbitrator had to decide the issue due to the delegation clause.

Circuit Judge Forrest authored the majority opinion (joined by Judge VanDyke), and characterized the issue as a "brain twister." The majority explained that if there is a valid delegation clause, whether or not arbitration would result in waiver of federal rights "is not for us—nor anyone else wearing a black robe—to decide." To the extent the Second, Third, and Fourth Circuits reached a different conclusion, the majority suggested they had conflated the question of whether the delegation clause was valid with the question of whether the arbitration agreement was valid. Because plaintiffs had not shown that the delegation clause was invalid, the arbitrator, and not the court, had to decide if the arbitration agreement was invalid under the prospective waiver doctrine.

Circuit Judge Fletcher dissented, arguing that the delegation clause was invalid, because the choice-of-law clause prohibited the arbitrator from applying federal law with (narrow exceptions), including the prospective waiver doctrine. As Judge Fletcher put it: "the choice-of-law provisions prospectively waive the prospective waiver rule" itself.

The practical effect of the decision is that parties resisting arbitration in federal courts in the Ninth Circuit will now need to challenge the delegation clause itself as invalid, rather than the arbitration agreement as a whole. If they fail and the arbitrator decides against them, the battle to vacate an award would appear to be even more challenging. As the majority acknowledged, a court's review of an arbitration award is "limited and highly deferential."

Because the Ninth Circuit's holding has produced a split among the circuits, this issue is likely to develop further. Stay tuned for more on this and other legal brain twisters.

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