Drafting Arbitration Clauses that Permit Expanded Judicial Review of Awards

January 1, 0001

Many parties prefer arbitration as a method of dispute resolution due to its touted benefits of speed and finality, which result in part from the limited judicial review afforded to arbitral awards. Under U.S. law, for example, courts may vacate arbitral awards only on very narrow grounds, such as corruption or bias in the arbitrators, gross procedural irregularities in the course of the arbitration, or conduct by the arbitrators outside the scope of their authority.[1]

Some parties selecting arbitration, however, are prepared to sacrifice speed and finality by granting courts the power to review arbitral awards on the merits. For many years, the U.S. Circuit Courts of Appeal were split over whether arbitration clauses that expressly authorized the courts to review awards for legal or factual error were enforceable. The U.S. Supreme Court resolved this issue in 2008, deciding in Hall Street Associates, LLC v. Mattel, Inc.[2] that the Federal Arbitration Act (the “FAA”) did not permit parties to expand the scope of judicial review by contract. By contrast, the California Supreme Court subsequently decided in Cable Connection, Inc. v. DirectTV, Inc.[3] that parties could contract for expanded review under the California Arbitration Act (the “CAA”). Notwithstanding these divergent opinions, parties may still be capable of contracting for expanded judicial review by specifying that enforcement of any arbitral award will be governed by California law.

Hall Street Associates
In *Hall Street Associates*, the U.S. Supreme Court held that parties may not contractually agree to expand judicial review of arbitral awards beyond the grounds set forth in the FAA. The arbitration agreement in that case provided the court with authority to vacate any award in which the conclusions of law were erroneous or the factual findings were not supported by substantial evidence. Hall Street made two principal arguments in support of its position that the court was required to apply the parties’ contractual standards of review. First, Hall Street contended that if courts could expand review through judicially-created doctrines such as “manifest disregard of the law” then parties could expand review through their contract. Second, Hall Street argued that the statutory grounds set forth in the FAA were merely default rules that the parties could agree to modify or expand. The Court rejected both arguments, holding that the FAA provides the exclusive grounds for vacating an arbitral award. As a result, the decision in *Hall Street Associates* forecloses expanded judicial review of awards governed by the FAA.

**Cable Connection**

In *Cable Connection*, the California Supreme Court came to the opposite conclusion with respect to the CAA, even though the CAA provides for substantially the same grounds for vacating awards as those set forth in the FAA. The arbitration clause at issue in *Cable Connection* provided, in pertinent part, that 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.” Reviewing prior case precedent and the legislative history of the CAA, the Court concluded that the CAA does not limit the ability of parties to contract for expanded judicial review of awards in this manner. The Court concluded that “the drafters of the CAA established the statutory grounds for judicial review with the expectation that arbitration awards are ordinarily final and subject to a restricted scope of review, but that parties may limit the arbitrators’ authority by providing for review of the merits in the arbitration agreement.”

In reaching this decision, the Court noted that the CAA expressly provides for vacatur of an arbitral award where the arbitrators “exceeded their powers” and that “the merits of an award may come within the ambit of the statutory grounds for review for excess of the arbitrators’ powers.” The Court advised that “to take themselves out of the general rule that the merits of an award are not subject to judicial review, the parties must clearly agree that legal errors are an excess of arbitral authority that is reviewable by the courts.” The Court further cautioned that “parties seeking to allow judicial review of the merits, and to avoid an additional dispute over the scope of review, would be well advised to provide for that review explicitly and unambiguously.” Asserting that its decision was fully consistent with the strong public policy in favor of arbitration, the Court noted that 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
Finally, the Court rejected the argument that its decision would be pre-empted by the FAA, as it was fully consistent with the FAA policy guaranteeing the enforcement of private contractual arrangements. The Court also noted that Hall Street Associates had specifically left open the possibility that parties could contract for “other possible avenues for judicial enforcement of arbitration awards,” such as via state statute or common law. Indeed, the U.S. Supreme Court’s decision in Hall Street Associates itself suggests the possibility of some merits review under the FAA – the decision acknowledged, without affirming, the long line of cases in which the FAA provision authorizing vacatur where the arbitrators “exceeded their powers” was found to encompass a limitation on the arbitrators’ power to rule in manifest disregard of the law.

**Drafting Arbitration Clauses for Expanded Judicial Review**

After Hall Street Associates and Cable Connection, parties may still contract for expanded review of arbitral awards if they carefully draft the arbitration clause and ensure that it will be governed by the CAA. First, parties will need to take heed of the California Supreme Court’s admonition that they explicitly and unambiguously provide for expanded judicial review. As with the arbitration clause in Cable Connection, parties should clearly specify that the arbitrators shall not have the power to commit errors of law and that the award may be vacated for any such legal error. Likewise, if the parties wish to provide for review of the arbitrators’ factual conclusions, they should clearly specify that the arbitrators shall not have the power to reach factual conclusions unsupported by substantial evidence and that the award may be vacated for any such factual error.

Second, parties will need to ensure that judicial review of the award is governed by the CAA rather than the FAA. To do so, they must include a choice-of-law clause in their contract – and preferably in the arbitration clause itself – clearly stating that the arbitration and the enforcement of any resulting award shall be governed by the CAA. The U.S. Supreme Court has previously recognized the ability of parties to select which law governs their arbitration. In Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University,[4] the Court recognized that when parties “have agreed to abide by state rules of arbitration, enforcing those rules according to the terms of the agreement is fully consistent with the goals of the FAA.” The Court reasoned that there was “no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.” Thus, enforcing a choice-of-law provision requiring application of state rules of arbitration is permissible under the FAA.

Nevertheless, drafting an effective arbitration clause that incorporates California arbitration law is not without obstacles. Subsequent to its decision in Volt, the U.S. Supreme Court returned to the relationship
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Many parties prefer arbitration as a method of dispute resolution due to its touted benefits of speed and finality, which result in part from the limited transaction requirements. However, arbitration is not without its drawbacks. Among the most significant drawbacks is the limited ability of courts to review arbitration awards. The Federal Arbitration Act ("FAA") was passed as a means to fill this void by giving parties an option to have arbitration awards reviewed by federal court. The availability of judicial review under the FAA may help to clarify ambiguities in the parties' agreement, correct 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. In reaching this decision, the Court noted that the FAA expressly provides that "the arbitrators 'shall not have the power to commit any error 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."

In addition, where a basis for federal court jurisdiction exists, the enforcement action could end up in federal court, where the parties face the risk that the court would hold that the FAA preempts expanded review under the CAA.[7] To increase the likelihood that California arbitration law is applied, parties should therefore consider including a forum-selection clause requiring that any action to enforce the award be brought in California state court.

International Arbitration Clauses

The issue, however, becomes much more complicated when parties are drafting international arbitration agreements that will be governed by the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "Convention").[8] Expanded judicial review under the CAA has not yet been tested in a case governed by the Convention. It is therefore difficult to predict whether courts will enforce such provisions and thereby allow merits-based review of international arbitral awards.

Courts of signatory countries must enforce foreign arbitral awards governed by the Convention unless certain narrow exceptions are met. One of those exceptions is where the award "has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made."[9] This exception has been interpreted to mean that actions to set aside awards can only be brought in the jurisdiction in which the arbitration was held and only on the grounds for vacatur provided by the domestic law of that jurisdiction.[10] Although it is theoretically possible for parties to designate an arbitration law other than that of the jurisdiction in which the arbitration is to be held, such an option is rarely if ever used and would potentially lead to "inextricable complications."[11]

Where an arbitration governed by the Convention takes place in the U.S., a so-called "non-domestic" arbitration, there is a greater likelihood that U.S. courts would enforce an arbitration clause stating that the enforcement of any resulting award is governed by the CAA. It is possible, however, that a federal court could hold that resort to expanded review under state...
arbitration law is incompatible with the enforcement regime mandated by the Convention. For parties seeking expanded judicial review for an international arbitration seated in the U.S., the most promising course appears to be to include a California forum-selection clause and an explicit waiver of any right to remove the action to federal court. Although each transaction requires its own independent analysis, such provisions may help ensure that any motion to vacate is heard in California state court. However, since forum-selection clauses are also subject to challenge, this option is more likely to succeed where the arbitration takes place in California or there is some other reasonable connection to California.[12]

[7] Although California courts have repeatedly held that the FAA does not preempt the vacatur provisions of the CAA, see, e.g., SWAB Financial v. E*Trade Securities, 150 Cal. App. 4th 1181, 1195 (2007) (citing cases), very few federal court decisions have addressed whether the FAA preempts state grounds for vacatur. Compare Penn Virginia Oil & Gas Corp. v. CNX Gas Co., LLC, 2007 WL 593578, at *6 (W.D. Va. 2007) (holding that the FAA did not preempt state vacatur grounds) with M&L Power Services, Inc. v. American Networks Int’l, 44 F. Supp. 2d 134, 142 (D.R.I. 1999) (holding that state law permitting arbitration award to be vacated on ground of complete irrationality was preempted by the FAA). Note, however, that these cases did not involve a choice-of-law clause designating that state arbitration law applied. The argument in favor of preemption would likely be weaker where there is an express choice-of-law provision.
[10] See, e.g., Karaha Bodas Co. v. Perusahaan Pertambangan Minyak
Many parties prefer arbitration as a method of dispute resolution due to its speed and finality by granting courts the power to review arbitral awards on "FAA". The New York Arbitration Convention of 1958 (the "Convention") did not permit parties to expand the scope of judicial review by contract. By contrast, the California Supreme Court subsequently decided "FAA") did not permit parties to expand the scope of judicial review by contract. Instead, parties still need to contractually agree to expand judicial review of arbitral awards beyond the CAA. To increase the likelihood that California arbitration law is incorporated California law did not incorporate California law); 711 (2002) (generic choice-of-law provision designating California law did not incorporate California arbitration law) with the risk of an erroneous arbitral award and the burden of litigating their intent to incorporate state arbitration law.

To help avoid such difficulties, parties should clearly state in the arbitration clause itself that the intended to incorporate state rules of arbitration, enforcing those resulting award shall be governed by the CAA. The U.S. Supreme Court concluded that the CAA does not limit the ability of parties to contractually agree to expand judicial review of arbitral awards beyond the FAA. In Volt v. Phoenix Mut. Life Ins. Co., 386 U.S. 449 (1967) (holding that the FAA did not preempt state vacatur grounds), the U.S. Supreme Court returned to the relationship between the FAA and state arbitration laws. Nevertheless, drafting an effective arbitration clause that incorporates California law governed by the Convention unless certain narrow exceptions are met. One Courts of signatory countries must enforce foreign arbitral awards governed by the Convention unless certain narrow exceptions are met. One problem is that courts may be reluctant to enforce foreign arbitral awards in California unless they are procured freely and voluntarily, with the place chosen having some foreign cases).


[12] See, e.g., America Online, Inc. v. Superior Court, 90 Cal. App. 4th 1, 12 (2001) ("Our law favors forum selection agreements only so long as they are procured freely and voluntarily, with the place chosen having some logical nexus to one of the parties or the dispute . . ."); CQL Original Products, Inc. v. National Hockey League Players Ass’n, 39 Cal. App. 4th 1347, 1354 (1995) ("in determining reasonability, the choice of forum requirement must have some rational basis in light of the facts underlying the dispute").