

Pennsylvania/New Jersey – Legal Service Providers

Arbitration And Freedom Of Contract: What Are The Limits In Pennsylvania And New Jersey?

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Over the past few decades, as arbitration has evolved from niche status into an all-purpose means of dispute resolution, parties have increasingly shaped the process to meet their expectations – either by defining the process in the arbitration agreement itself or by adopting arbitration rules that fulfill their desire for just and efficient dispute resolution.

Amidst this evolution, courts have struggled to define the extent to which parties to an arbitration agreement enjoy freedom of contract. This question touches several aspects of arbitration, but during the past year in Pennsylvania and New Jersey, the question has arisen in two contexts of particular interest to corporate counsel.

The first is whether parties can contract for heightened judicial review of arbitration awards. Last summer, the Pennsylvania Superior Court said no to a provision for *de novo* review. This holding should not overly concern corporate counsel in Pennsylvania because the United States Supreme Court recently granted *certiorari* on this very question. Moreover, even if a contractual provision for heightened judicial review is unenforceable, counsel can ensure just and efficient dispute resolution by selecting an arbitration provider that requires its arbitrators to follow the law.

The second is whether parties can agree that arbitration must proceed on an individual basis, thereby avoiding the complexity and formality of class-wide proceedings. Last year, both the New Jersey Supreme Court and the Pennsylvania Superior Court addressed this issue and concluded that a bar on class-wide proceedings may sometimes be unenforceable. As those cases demonstrate, corporate counsel who prefer one-on-one arbitration can minimize enforceability concerns by including a suitable choice-of-law provision.

Heightened Judicial Review

Ordinarily, judicial review of arbitration awards is extremely deferential. There are two distinct principles underlying this deference. First, the efficiency of arbitration derives partly from its finality, and deferential review promotes finality by precluding courts from revisiting the questions of fact and law that attend an arbitrable dispute. Second, unless the parties have agreed otherwise, arbitrators are not bound by the law and may instead guide their decisions by principles of equity and fairness.

The Federal Arbitration Act (“FAA”) and state arbitration laws implement this deferential standard of review by limiting the grounds for vacating or modifying an arbitration award. The doctrine of deferential review is so well entrenched that courts across the country have wrestled with the question of whether parties to an arbitration agreement can contract for heightened judicial review.

Last summer, *Trombetta v. Raymond*

James Financial Services, Inc., 907 A.2d 550 (Pa. Super. Ct. 2006), addressed that question. In *Trombetta*, an investor and his broker were parties to an arbitration agreement that provided for *de novo* review of any arbitration award where the amount in controversy exceeded \$100,000.

When his account suffered substantial losses, the investor filed an arbitration claim seeking damages in excess of \$2 million. After a nine-day hearing, the arbitrators issued an award denying all of the investor’s claims. The investor subsequently filed a petition for vacatur in a Pennsylvania trial court, requesting *de novo* review of the arbitration award. The trial court denied *de novo* review and confirmed the award.

On appeal, the issue before the Pennsylvania Superior Court was the enforceability of the provision for *de novo* review. Since there was no Pennsylvania law directly on point, the court relied on policy considerations and authority from outside jurisdictions in holding that a contractual provision for *de novo* review is unenforceable under Pennsylvania law.

The court identified two significant policy considerations to support its holding. First, the court reasoned that the enforcement of *de novo* review provisions would “provide a disincentive for entering into arbitration agreements” because arbitration “would be a meaningless gesture that could result in a time consuming and cost absorbing preliminary review that would then be followed by an even more expensive *de novo* trial.” Second, the court reiterated the trial court’s concern that there are no established procedures for conducting *de novo* review of an arbitration award.

Less than a year after it was issued, the *Trombetta* decision has already come under criticism by a member of the Pennsylvania Superior Court. In *Bucks Orthopaedic Surgery Associates, P.C. v. Ruth*, No. 1182-EDA-2006, 2007 WL 1544649 (Pa. Super. Ct. May 30, 2007), the court upheld an arbitration agreement that permitted an aggrieved party to seek a trial *de novo*. The court distinguished *Trombetta* on the ground that the parties were “preserving their right to a judicial forum” rather than “prescribing a standard of review” for the trial court.

In a concurring opinion, Judge Klein agreed that *Trombetta* was distinguishable but stated his view that “the holding in *Trombetta* is incorrect and calls for further clarification by either an *en banc* panel of [the Pennsylvania Superior Court] or the Pennsylvania Supreme Court.” Specifically, Judge Klein objected to *Trombetta* on the ground that “[p]recluding parties from crafting an arbitration clause to allow *de novo* appeal frustrates the purpose of alternative dispute resolution and contradicts the principle that parties to an arbitration clause can contract for their remedy.”

There is another recent development that may portend *Trombetta*’s demise. In *Hall Street Associates, L.L.C. v. Mattel, Inc.*, No. 06-989, 2007 WL 142533 (May 29, 2007), the United States Supreme Court has granted *certiorari* to resolve a circuit split on the question of whether the FAA precludes federal courts from enforcing a contractual provision for heightened judicial review.

Regardless of *Trombetta*’s fate, Pennsylvania counsel can still ensure legally sound arbitration awards by drafting arbitration agreements that reject the traditional model of arbitration in favor of arbitration rules that require the arbitrator to follow the law. For example, under the National Arbitration Forum *Code of Procedure*, arbitrators are required to follow the applicable substantive law.¹

By adopting arbitration rules that require the arbitrator to follow the law, parties can enjoy the procedural efficiencies of arbitration while also obtaining the benefits of the rule of law – namely, assurance that one’s conduct will be gauged by a discernible body of law rather than the whimsy of the arbitrator. Moreover, the requirement has teeth because arbitration awards may be vacated whenever the arbitrator exceeds his powers,² and if the arbitrator disregards the law despite the parties’ agreement that the arbitrator must follow the law, the arbitrator has exceeded his powers.³

Class Action Waivers

There is inherent tension between arbitration’s streamlined procedures and the unique complexity of class-wide proceedings. Some parties obviate this tension by agreeing that arbitration must be on an individual basis, thereby avoiding the complexity and formality of class-wide proceedings. This type of arbitration agreement is frequently described as a class action waiver.⁴

Class action waivers are typically deemed enforceable on the principle that the omission of “certain litigation devices,” such as class-wide proceedings, “is part and parcel of arbitration’s ability to offer ‘simplicity, informality, and expedition,’ characteristics that generally make arbitration an attractive vehicle for the resolution of low-value claims.”⁵

However, there has been a recent string of cases holding that a class action waiver may be unenforceable if it functions as an exculpatory clause. During the past year, both the New Jersey Supreme Court and the Pennsylvania Superior Court stepped into this fray.

In *Muhammad v. County Bank of Rehoboth Beach, Delaware*, 912 A.2d 88 (N.J. 2006), the New Jersey Supreme Court held that a class action waiver in a payday loan agreement was unconscionable and therefore unenforceable. In reaching its holding, the court reasoned that “class-action waivers can functionally exculpate wrongful conduct by reducing the possibility of attracting competent counsel to advance the cause of action.”

The court was careful to limit the reach of its holding, noting that class action waivers are not “*per se* unenforceable” and framing its holding by reference to both the small amount of damages and the difficulty of proving the borrower’s case. In fact, the court upheld a class action waiver in a separate case decided the same day.⁶

There was another aspect of the *Muhammad* decision that may change the result in future New Jersey cases. In addition to the class action waiver, the loan agreement also contained a choice-of-law provision that called for the application of Delaware law. Under Delaware law, class

action waivers are enforceable,⁷ but according to the intermediate appellate court, the lender waived any argument that Delaware law should apply.

The choice-of-law issue has already removed at least one case from the rule set forth in *Muhammad*. In *Homa v. American Express Co.*, No. 06-2985, 2007 WL 1585168 (D.N.J. May 31, 2007), a New Jersey credit card holder filed a putative class action against the card issuer. The cardmember agreement contained a class action waiver and a Utah choice-of-law provision. In upholding the waiver under Utah law, the court reasoned that the application of Utah law would not violate a fundamental policy of New Jersey because *Muhammad*’s case-by-case approach to unconscionability did not establish a fundamental public policy against class action waivers.

The Pennsylvania Supreme Court has never addressed the enforceability of class action waivers, but late last year, in *Thibodeau v. Comcast Corp.*, 912 A.2d 874 (Pa. Super. Ct. 2006), the Pennsylvania Superior Court relied on its own precedent in refusing to enforce a class action waiver in a cable television service agreement. The court was unswayed by a Massachusetts choice-of-law provision, reasoning that the outcome would be no different under Massachusetts law.

As these cases demonstrate, the enforceability of a class action waiver may depend on whether the underlying contract contains a choice-of-law provision and, if so, whether that provision has been properly invoked. The challenge for corporate counsel is choosing a suitable choice-of-law provision so that the patchwork of state laws does not make the cost of doing business even more unpredictable.

Conclusion

Both of these issues light the way for corporate counsel to minimize the uncertainty inherent in dispute resolution. First, to ensure that disputes are resolved efficiently and according to a discernible body of law, counsel should choose an arbitration provider that requires its arbitrators to follow the law. Second, to avoid the disarray of 51 separate bodies of law, counsel should choose a single body of law to govern each business relationship by including a choice-of-law provision in the underlying contract.

¹ See Rule 20(D) of the National Arbitration Forum Code of Procedure (available at www.adrforum.com).
² See 9 U.S.C.A. § 10(a)(4).

³ See, e.g., KeyClick Outsourcing, Inc. v. Ochsner Health Plan, Inc., 946 So.2d 174, 178 (La. Ct. App. 2006) (holding that arbitrator exceeded his powers by misapplying the law where the arbitration agreement provided that “the arbitrator shall have no authority to make material errors of law”).

⁴ The term is arguably a misnomer because waiver generally denotes the relinquishment of a right. However, the right to seek class-wide relief is merely procedural, see, e.g., Deposit Guaranty Nat’l Bank, Jackson, Miss. v. Roper, 445 U.S. 326, 332, 100 S.Ct. 1166 (1980), and a party necessarily relinquishes that right when they agree to arbitrate.

⁵ See, e.g., Iberia Credit Bureau, Inc. v. Cingular Wireless LLC, 379 F.3d 159, 174 (5th Cir. 2004) (citation omitted).

⁶ Delta Funding Corp. v. Harris, 912 A.2d 104, 115 (N.J. 2006) (distinguishing *Muhammad* based on the disparity in potential damages).

⁷ See Lloyd v. MBNA America Bank, N.A., 27 Fed.Appx. 82, 84 (3rd Cir. 2002) (unpublished); Discover Bank v. Superior Court, 36 Cal. Rptr. 3d 456, 462 (Cal. Ct. App. 2005).

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