

THIS ISSUE

Supreme Court Reaffirms Two Key Arbitration Holdings.....	1
Did You Know?.....	2
Fourth Circuit Upholds Arbitration of Employment Claims	3
Contracting for Increased Scrutiny of Arbitral Errors.....	3
Customer Service Representative Not Within FAA's Transportation Worker Exception.....	4

Supreme Court Reaffirms Two Key Arbitration Holdings

Contract Validity Issues are Arbitrable and the Federal Arbitration Act Binds State Courts

Whether brought in federal or state court, a challenge to the validity of a contract as a whole, rather than just to the arbitration clause, must be referred to arbitration, according to the Supreme Court of the United States.

In ***Buckeye Check Cashing, Inc. v. Cardegna***, No. 04-1264 (Feb. 21, 2006), Cardegna brought a putative class action alleging that Buckeye charged usurious interest rates in connection with check cashing loans, and that Buckeye's loan agreements violated several Florida lending and consumer protection laws.

Buckeye moved to compel arbitration based upon the arbitration clause contained in the loan agreements. Cardegna argued that the entire contract was illegal and void, and that the arbitration clause was therefore also void.

The Florida Supreme Court sided with Cardegna, holding that enforcing agreements to arbitrate in a contract challenged as unlawful "could breathe life into a contract that not only violates state law, but also is criminal in nature."

On grant of certiorari, the Supreme Court of the United States reversed, holding that Cardegna's challenge to the contract "must go to the arbitrator." Writing for a seven justice majority, Justice Scalia reaffirmed ***Prima Paint Corp. v. Flood & Conklin Mfg. Co.***, 388 U.S. 395 (1967), noting that ***Prima Paint*** and its progeny established three propositions.

"[U]nless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator...."

—JUSTICE SCALIA
(WRITING FOR THE MAJORITY)

"[S]ubstantive federal arbitration...law applies in state as well as federal courts."

—JUSTICE SCALIA
(WRITING FOR THE MAJORITY)

First, an arbitration provision is severable from the rest of the contract. *Id.* Second, unless the challenge is to the arbitration clause itself, the validity of a contract is for the arbitrator to decide. *Id.* And finally, substantive federal arbitration law applies in both state and federal courts. ***Southland Corp. v. Keating***, 465 U. S. 1, 12 (1984).

CONTINUED ON PAGE 2

CONTINUED FROM PAGE 1

Scalia rejected the Florida court's distinction between void and voidable contracts. Under Florida law, parts of a contract cannot be severed from a void contract. But the Supreme Court concluded that, because *Prima Paint* rejected the application of state severability rules to arbitration agreements, Florida state law is irrelevant.

Cardegna also argued that the Federal Arbitration Act (FAA) only applies to contracts; void contracts under state law are not contracts; and therefore the FAA does not apply. The Court disagreed, pointing to the final clause of Section 2 of the FAA, which permits a challenge to an arbitration clause "upon such grounds as exist at law or in equity for the revocation of any contract." (emphasis in original)

"There can be no doubt," according to the majority, "that 'contract' as used this last time must include contracts that later prove to be void." Otherwise, an arbitration agreement could implausibly be challenged as voidable but not void. Therefore, the Court held, the FAA applies to contracts that might later turn out to be void.

This piece of the Court's analysis is important because it clarifies that the basis of *Prima Paint* is in Section 2 of the FAA, the section that the Court has explicitly stated is binding on state courts.

Justice Scalia went on to explain why the Court could not agree with Cardegna:

It is true, as respondents assert, that the *Prima Paint* rule permits a court to enforce an arbitration agreement in a contract that the arbitrator later finds to be void. But it is equally true that respondents' approach permits a court to deny effect to an arbitration provision in a contract that the court later finds to be perfectly enforceable.

The Court distinguished contract validity challenges, which are now clearly reserved for the arbitrator, from arguments that the agreement was never concluded. Only the latter are the types of "gateway" issues appropriate for court decision. Justice Scalia listed lack of a contract signature, insufficient agent authority to bind a principle, and signor mental capacity as examples.

In this way, *Buckeye* replaces a murky arbitrability doctrine potentially reliant on relatively arbitrary distinctions from contract validity law with a bright-line test based upon contract formation. After *Buckeye*, validity questions go to arbitration and formation questions are for the court.

In addition to reaffirming the core arbitration holdings in *Prima Paint* and *Southland*, the case should also

be seen as a continuation of the recent Supreme Court trend of respecting and expanding arbitrator authority.

PacifiCare Health Systems, Inc. v. Book, 538 U.S. 401 (2003), held that arbitrators, rather than courts, have the power to determine the meaning of contractual damages provisions. *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), emphasized that matters of contract

[T]he case should also be seen as a continuation of the recent Supreme Court trend of respecting and expanding arbitrator authority.

interpretation "should be for the arbitrator, not the courts, to decide."

Adding *Buckeye* to this mix, and reading it in this context, further strengthens its message: whether the challenge is brought in state or federal court, challenges to a contract's validity must go to the arbitrator.

Did you know?

The Federal Arbitration Act (FAA):

- governs a vast collection of arbitration agreements in contracts "involving commerce,"¹
- applies to contracts fitting within the "broadest permissible exercise"² of Congress' Commerce Clause Power, and
- creates a federal law duty to enforce arbitration agreements and confirm arbitration awards as written.

However, the FAA does not, in itself, create federal question jurisdiction allowing parties to compel arbitration or confirm awards in federal court. In this regard, it is "something of an anomaly in the field of federal-court jurisdiction."³ Instead, the transaction underlying the arbitration agreement or award must independently qualify for federal subject matter jurisdiction either on diversity or federal question grounds for an action to be heard in federal court.

The rights conferred by the FAA are fully enforceable in state as well as federal court.⁴

¹ 9 U.S.C. § 2.

² *Citizens Bank v. Alafabca, Inc.*, 539 U.S. 52, 56 (2003).

³ *Moses H. Cone Memorial Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, 26, n.32 (1983).

⁴ *Id.* at 24.

Fourth Circuit Upholds Arbitration of Employment Claims

Employment arbitration agreements are not unconscionable under West Virginia law, and the Federal Arbitration Act (FAA) preempts state laws that specifically invalidate arbitration provisions, according to the Fourth Circuit Court of Appeals.

In *American General Life & Accident Insurance Co. v. Wood*, No. 04-2252 (4th Cir. 2005), American General filed suit in federal court to compel arbitration of sex discrimination and wage law violation claims Wood had filed in state court. The district court granted American General's motion and Wood appealed.

During Wood's employment, American General instituted an Employee Dispute Resolution Program and provided all employees with a packet describing the Program which stated

that "continued employment after the effective date constitutes consent" to the program's terms. In addition, Wood assented by signing an Acknowledgement and Agreement Form.

Wood contended the Arbitration Agreement was an unenforceable adhesion contract that abrogated his state constitutional right to a judicial forum and to trial by jury. The court disagreed, concluding that—even if the agreement was adhesive and procedurally unconscionable—it contained no substantively unfair terms because Wood could seek to vindicate his claims in arbitration.

Waiving the right to a particular forum does not, in and of itself, extinguish substantive legal rights or remedies to which a party is entitled by statute.

See *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991).

The court also invoked the preemptive force of the FAA to override any state-created rights that frustrate arbitration. Even if West Virginia precedent could be construed to hold that state law claims are not arbitrable, such an interpretation "cannot contravene the FAA."

The court recognized the long established principle that arbitration provides employees with a fair and appropriate avenue in which to pursue their legal rights and remedies. Spurious attacks reflecting "general hostility" toward arbitration are ineffective in the face of the FAA and the strong federal policy of enforcing agreements to arbitrate.

Contracting for Increased Scrutiny of Arbitral Errors

Circuits Split on Attempts to Permit Appellate Review for Errors of Law

In *Puerto Rico Telephone Co. v. U.S. Phone Manufacturing Corp.*, 427 F.3d 21 (1st Cir. 2005), Puerto Rico Telephone Co. Inc. (PRTC) and U.S. Phone Manufacturing Corp. (US Phone) arbitrated a breach of contract dispute and the arbitration panel awarded US Phone over \$2.5 million in damages. PRTC sought to vacate the award.

The Federal Arbitration Act (FAA) permits vacatur only for corruption, fraud, arbitrator partiality or misconduct, or an arbitrator exceeding his or her powers. 9 U.S.C. § 10. PRTC contended the parties chose to apply Puerto Rican law, which permits courts to review arbitral awards for errors of law.

The 1st Circuit concluded that a general choice of law provision does not displace the limited federal grounds upon which awards can be vacated. The court noted, however, that parties may explicitly agree to replace the FAA standards as long as the new standards are stated with precision.

The 3rd, 5th, and 6th Circuits align with the 1st in reasoning that the ultimate purpose of the FAA is to

enforce arbitration agreement terms, including allowing enhanced appellate review.

The 7th, 8th, 9th and 10th Circuits have reasoned otherwise, concluding that federal jurisdiction cannot be created by contract.

In light of this split, contracting parties seeking enhanced appellate review of future arbitration awards across jurisdictions have some options. First, the contract can specify appellate review for errors of law conducted by a second-level arbitration panel rather than a court. See, e.g., National Arbitration Forum Code of Procedure Rule 1(D). The court can then confirm or vacate the second-level panel's decision under the FAA standards of review.

Second, parties can draft arbitration agreements that require arbitrators to follow the applicable substantive law that governs the dispute. See FORUM Rule 20(D). Aggrieved parties may then attempt to vacate an award for failure to follow the applicable law based upon the FAA ground that the arbitrators "exceeded their powers" under the agreement. 9 U.S.C. §10(a)(4).

THIS ISSUE

- Supreme Court Reaffirms Two Key Arbitration Holdings
- Did You Know?
- Fourth Circuit Upholds Arbitration of Employment Claims
- Contracting for Increased Scrutiny of Arbitral Errors
- Customer Service Representative Not Within FAA's Transportation Worker Exception

Customer Service Representative Not Within FAA's Transportation Worker Exception

The limited exception to the Federal Arbitration Act (FAA) for transportation workers only applies to those workers actually engaged in the movement of goods in interstate commerce, according to the Eighth Circuit Court of Appeals.

In *Lenz v. Yellow Transportation Inc.*, No. 05-1641, (8th Cir. 2005), customer service representative Lenz sued Yellow after he was terminated. Yellow moved to compel arbitration.

Lenz argued the FAA did not preempt Iowa laws preventing arbitration of the dispute because his status as a customer service representative for a transportation company fit within the FAA's transportation worker exception. 9 U.S.C. § 1.

The court disagreed and found that, although Lenz worked in the transportation industry, his duties only tangentially related to the transport of goods. He neither worked directly with goods in interstate commerce nor directly supervised transportation workers.

"Lenz's central task was to answer the questions of and provide information to Yellow customers, not to supervise packages moving in interstate commerce."

Courts are reluctant to override the strong federal policy in favor of arbitration. While this exception is narrow, transportation industry employers should be careful to understand which employees may not be eligible for arbitration under the FAA.

FREE WEEKLY ADR UPDATES

We invite you to subscribe to the *ADR Law & Policy Update* today.

The *ADR Law & Policy Update* is a free weekly e-newsletter from the FORUM that will keep you up-to-date on all important case law, legislation and regulation in dispute resolution.

To subscribe, simply visit our website at www.adrforum.com and look for the *ADR Law & Policy* icon.

