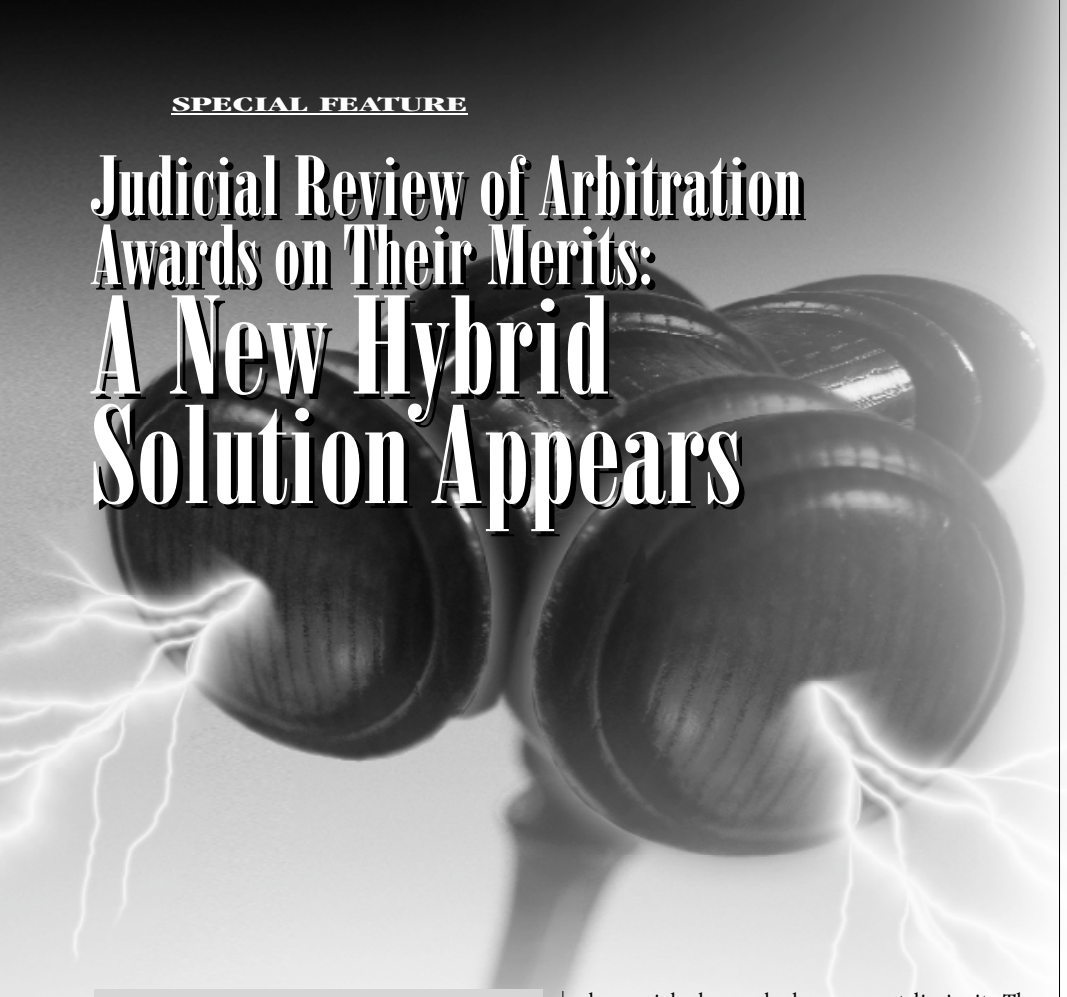
SPECIAL FEATURE

# Judicial Review of Arbitration Awards on Their Merits: A New Hybrid Solution Appears





***by Frank Cronin***

**A maxim of arbitration** has always been that an arbitrator's award is "final and binding." Traditionally, courts will not review an arbitrator's award for errors of law, for insufficient evidence to support the decision or even for awarding damages which are inconsistent with law. (*Moncharsh v. Heily & Blase*, 3 Cal. 4th 1 (1992); *Adv. Micro Devices, Inc. v. Intel Corp.*, 9 Cal. 4th 362 (1994).) This doctrine of arbitral finality is the *quid pro quo* for the benefits of a faster, more informal and less expensive method of dispute resolution. But what if the parties want to have the courts available to review the merits of an arbitration award, to protect against serious errors or other manifest disregard of the law? Can parties take advantage of the arbitration process and also demand the benefit of judicial review of the arbitration award?

Until recently, the answer has been a fairly consistent "No," on the theory that once you have picked your bed, you must lie in it. The courts would not disturb an arbitration award except for the most egregious misconduct by the arbitrator, usually involving corruption, fraud, refusing to hear material evidence or obvious overreaching, such as exceeding the powers delegated to the arbitrator by the parties. (*Cf.* Cal. Code Civ. Proc. § 1286.2 and the Federal Arbitration Act, 9 U.S.C. § 10(a) ("FAA").) Judicial review for "mere" errors of law was simply not permitted. Whether the arbitrator was right or wrong, the award was final and unreviewable on the merits.

But last year, the California Supreme Court ruled that judicial review of arbitration awards will be allowed when the parties to the arbitration agreement have clearly stated their intention to allow appeal to the courts. In a significant change of course, the Court held: "The California rule is that the parties may obtain judicial review of the merits by express agreement." (*Cable Connection, Inc. v. Direct TV, Inc.*, 44 Cal. 4th 1334, 1340 (2008) ("*Direct TV*").) This is a major change which has implications in drafting arbitration clauses, in preparing and presenting cases in arbitration and in the preparation of awards by arbitrators. From a practitioner's perspective, it makes arbitration hearings more like bench trials and much less like the informal, cheap and quick method of getting a dispute to a conclusion that arbitration has traditionally provided. The impact of this change of law is limited, however, to situations where the parties have expressly agreed to allow judicial review. So the parties to an arbitration agreement and their attorneys have another decision to make: do they want to proceed on the traditional "final and binding" track or the new "judicial review" track? Perhaps the first question is whether they want to use arbitration at all, since the new option so closely resembles a bench trial, which civil litigants can always elect once litigation commences.

Surprisingly, the first step in this evolution of the law came from the U.S. Supreme Court earlier in 2008, which held that parties could *not* enforce contractual agreements which required courts to review arbitration awards on their merits. In *Hall St. Assoc., LLC v. Mattel, Inc.*, (128 S. Ct. 1396 (2008) ("*Hall Street*"), the U.S. Supreme Court firmly rejected the notion that parties to an arbitration agreement could mandate court review on the merits of arbitration awards by the terms of their agreement. Applying a narrow reading of the Federal Arbitration Act (FAA), the court held that there was no basis for expanded review of an arbitrator's rulings other than arbitrator misconduct or exceeding the jurisdiction conferred upon the arbitrator by the parties, as set out by statute. (*Id.* at 1406.) Thus, the Supreme Court disapproved some federal circuits which had attempted to reach the merits of arbitrator's rulings under the rubric of correcting serious or egregious errors where the arbitrator had acted in "manifest disregard" of the applicable law. (*Id.* at 1403.)

Despite the fact that the parties in *Hall Street* had specifically contracted for a heightened judicial review by a clause in the arbitration agreement, the U.S. Supreme Court firmly rejected that tactic, holding that private parties may not contractually impose their own standards on the courts because the FAA provided the exclusive and very narrow standards by which federal courts could review an arbitrator's decision. (*Id.* at 1406.) The Supreme Court pointed out in *dicta*, however, that this ruling applied only to cases which were governed solely by the FAA, and hinted broadly that a "more searching review" might be available "under state statutory or common law," whereas the FAA permitted only "the limited review needed to maintain arbitration's essential virtue of resolving dis-

putes straightaway." (*Id*. at 1405-1406.)

Just five months later, on August 25, 2008, the California Supreme Court leapt through the loophole provided in *Hall Street* which suggested that different rules might apply under state arbitration statutes. In *Direct TV, supra*, the California Court held that the California Arbitration Act, C.C.P. 1280 *et seq*. ("CAA"), allowed private parties to provide for expanded scope of judicial review of arbitration decisions and that the courts must review arbitration awards pursuant to those private agreements. The California Supreme Court held that "while the statutory grounds for correction and vacation of arbitration awards do not ordinarily include errors of law, contractual limitations on the arbitrators' powers can alter the usual scope of review." (*Direct TV*, *supra*, 44 Cal. 4th at 1356.) The Court distinguished the CAA from the FAA, finding indications in the California statute that the "parties' expectations as embodied in their agreement" could expand the scope of judicial review beyond the narrow list of rationales for modification stated in the CAA itself. (*Id.* at 1358.) Since the language of the CAA is modeled upon and is almost identical to the FAA, this reading is a direct refutation of the U.S. Supreme Court's interpretation. The California Court disposed of the federal preemption issue by simply finding that *Hall Street* did not intend to preempt state law and left open the option for states to allow more expansive review than what is permitted by the FAA. (*Id.* at 1351-1352.)

As a condition to judicial review of arbitration awards, the California Supreme Court emphasized that the parties must *expressly* provide for an expanded scope of review in their arbitration agreement. Offering guidelines on draftsmanship, the court recommended 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 in excess of arbitral authority that is reviewable by the courts." (*Id*. at 1361.)

The court found that the parties had met that standard by including the following clause in their agreement: "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." (*Id.* at 1340, 1341, fn. 3.) While approving this particular language, the Court declined to decide whether "one or the other of these clauses alone, or some different formulation, would be sufficient to confer an expanded scope of review." (*Id.* at 1361.) However, the court emphasized that the parties who desired judicial review "would be well advised to provide for that review explicitly and unambiguously." (*Id*.)

To reach this ruling, the California Supreme Court had to disapprove a line of earlier California appellate decisions which had refused to enforce arbitration clauses providing for judicial review. The Court found that the objections raised in these prior cases are "…outweighed by the freedom of contract that is fundamental to arbitration, by the availability of an expanded scope of review in other contexts, and by the considerable public and private benefits that such a review can provide." (*Id.*) The Court also found that the California Arbitration Act, which permits a court to vacate arbitration awards where the arbitrator has exceeded his powers, CCP 1286.2 (4), provided the "textual hook" for its rationale. If the parties say that the arbitrator is not empowered to make errors of law, then the arbitrator has *ipso facto* exceeded his powers. (*Id.* at 1370.) This rather glib (and entirely novel) interpretation of the state statute is—as noted—flatly contrary to the U.S. Supreme Court's interpretation of nearly identical language in the Federal Arbitration Act.

The *Direct TV* majority thus gave its unambiguous approval to a new hybrid system of dispute resolution, where the parties can agree to initiate the dispute in a private forum and then bring it to the public court system for appellate review. In justifying this change in law, the Court argued that "[t]he judicial system reaps little benefit from forcing parties to choose between the risk of an erroneous arbitration award and the burden of litigating their dispute entirely in court. Enforcing contract provisions for reviewable awards on the merits relieves pressure on congested trial court dockets…[C]ourts are spared not only the burden of conducting a trial, but also the complication of discovery disputes and other trial proceedings." (*Id.* at 1363.) The Court argued that this approach "…preserves the utility of arbitration as a way to obtain expert factual determinations without delay, while allowing the parties to protect themselves from perhaps the weakest aspect of the arbitral process, its handling of disputed rules of law." (*Id.*) The court also pointed out that there are "…significant benefits to the development of common law when arbitration awards are made subject to merits review by the parties' agreement. (*Id.*)

The majority briefly addressed the "apprehension that permitting review on the merits would open the door to contracts imposing unfamiliar standards of review." (*Id.* at 1362.) They pointed out that historically, and in the instant action, the agreement simply called for review "in traditional fashion," and declined to speculate about provisions that might call for "bizarre modes of decision," such as flipping a coin. (*Id*. at 1362.) But the Court stopped short of declaring exactly what standards of review the parties might select and left this issue open for future development.

In a concurring and dissenting opinion, Justice Moreno pointed out some countervailing policy implications of the new hybrid system: "The majority decision would allow parties to fundamentally refashion arbitration from being a means of binding dispute resolution to being essentially a preliminary fact finding procedure." (*Id.* at 1374.) Justice Moreno expressed concern about burdening the courts "with a minutiae of arbitration disputes" and uncertainty as to the standard of review that should be applied. (*Id.*) Do trial courts review arbitration awards only for clear legal error? Do they address mixed questions of law and facts? Should they apply the substantial evidence test to arbitration awards? None of these secondary questions are clear in the majority decision and there is no statutory guidance on these points. As Justice Moreno succinctly concludes, the CAA does not give the parties to an arbitration agreement the power "…to conscript courts to serve as appellate arbitration tribunals, with all the attended costs and burdens." (*Id.* at 1375.)

Both the novelty and uncertainty of the California Supreme Court's ruling quickly became apparent in reported and unreported appellate decisions immediately subsequent to August 2008. For example, in *Erreca's, Inc. v. Safeco Ins. Co. Of Am.*, (2009 Cal. App. UnPub. LEXIS 1750 at *2 (Cal. App. 4th Dist. Mar. 3, 2009)), the Fourth District Court of Appeal, Division 1, reversed and remanded a trial court's decision to confirm an arbitration award in which the trial court declined to review the award for errors of law despite an arbitration clause which expressly provided for such court review. In this commercial dispute between an engineering contactor and a builder regarding $7,000,000 for grading work on a large residential development project, the parties had agreed to arbitrate pursuant to an agreement

which stated that the arbitrators would apply the law of California, "…as though acting as a court in a civil action in California. (*Id.*) The arbitrators shall not have the power to commit errors of law or legal reasoning and the award may be vacated or corrected pursuant to CCP sections 1286.2 or 1286.6 for any such error…." (*Id.* at *3.) After an 18-day hearing before three retired judges with 25 witnesses and hundreds of exhibits, the arbitration panel issued a 33-page final award with a net award to the defendant company of $2,000,000. (*Id.* at *4-*5.) Illustrating Justice Moreno's concerns about burdening the trial courts, Erreca's petition to vacate the award included the 4,661 page arbitration transcript and 390 documentary exhibits. (*Id.* at *6.) Relying on the *Crowell* line of cases (which were subsequently disapproved in *Cable Connection*), the trial court ruled that it had no statutory authority to review the merits of the binding arbitration award. (*Id.*) *Direct TV* was decided during the appeal process, so the Court of Appeal ruled that the trial court had erred in refusing to review the legal merits of the arbitration award. (*Id.* at *6-*7.) In a classic understatement, the Court of Appeal acknowledged that the review by the trial court "…may require a review and/or understanding of the voluminous factual record." (*Id.* at *10.) Thus, petitions to vacate or confirm arbitration awards, which hitherto consisted of a Judicial Council form, plus a copy of the award, will now resemble the record on appeal, with full transcripts and all its attendant baggage. And the trial courts must review and/or understand the entire case history and record to grant or deny these petitions.

Even before the California Supreme Court gave its blessing to reviewing arbitration awards on the merits, some courts have demonstrated an irresistible impulse to find reasons to reverse arbitration rulings where they see something obnoxious to their sense of fairness in the arbitrator's decision.

One recent example of this urge is seen in *Burlage v. Super. Ct. of Ventura Co*., (2009 Cal. App. LEXIS 1692 (Cal. App. 2d Dist. Oct. 20, 2009).) In this 2-1 decision, the majority begins by acknowledging that it is rare indeed for an appellate court to affirm a trial court's vacation of an arbitration award. (*Id.* at *1.) They then cite *Moncharsh, supra*, for the proposition that an arbitration award is not subject to judicial review even when an error of law is apparent and even when the error causes substantial injustice. (*Id*. at *1-*2.) They next acknowledge the ruling in *Direct TV*, but admit it does not govern in this case because the parties had not agreed to judicial review. (*Id*. at *2.) The majority then fashions a new standard which will guide them in this case: "…arbitrators have a great deal of power, but not absolute power…." (*Id*.) Stating that arbitrators are known to be fallible, and that the parties have accepted that possibility when agreeing to arbitrate, the majority stakes out another principle for their action: "But tolerance for fallibility has its limits." (*Id.* at *3.)

From this loose footing, the majority proceeds to show that the arbitrator excluded certain evidence from consideration, the absence of which led to a $1.5 million judgment. (*Id.* at *9.) The majority acknowledged that the arbitrator's exclusion of the evidence was based on a legal ruling he had made regarding the date upon which damages must be measured. (*Id.* at *8.) Although this was a legal ruling which was arguably incorrect (and not correctable by the courts), the majority proceeded to reverse the arbitration award on the theory that the arbitrator had not considered "material evidence" and hence the arbitration award could be reversed based on CCP sec. 1286.2 (a) (5), one of the narrow, traditional grounds for vacating arbitration awards ["The rights of the party were substantially prejudiced by the refusal of the arbitrators to postpone the hearing…or by the refusal…to hear evidence material to the controversy…."]. (*Id.* at *7-*8.)

The spirited dissent pointed out that virtually any ruling on a legal issue by either an arbitrator or a court results in limiting admissibility of evidence in some manner. "Right or wrong, it was a legal ruling which, under both *Monsharsh* and *Cable Connection*, precludes judicial review." (*Id.* at *12.) The dissent argues that "…great mischief can and will result from the majority's ruling…" which "…cuts the heart out of *Moncharsh*." (*Id* at *18.) These strong sentiments seemed justified where an appellate court goes to such lengths to evade a well established rule prohibiting judicial intervention into arbitration awards, at least where the parties never bargained for such review.

From a practioner's viewpoint, *Direct TV* highlights a number of choices that parties and their lawyers must now make. First, do you want traditional "final and binding" arbitration, or judicial review? The traditional approach has the advantages of getting the dispute to an end more expeditiously in most cases. Without any appeal possible, there is less need for creating a record of the type that appellate courts favor. For example, there may be no need for a court reporter to prepare a hearing transcript—a substantial cost saving in most cases.

If appellate review is the choice, the language approved in *Direct TV,* which denies the arbitrators the power to err and also explicitly provides for review, is the obvious choice. It would be ill advised to draft an arbitration clause which is anything less than entirely explicit in light of the Court's emphatic position on that issue. But beyond the obvious, there may be circumstances in which the parties may want additional terms included, *e.g.,* defining the standard of review more clearly, identifying a particular venue for judicial review or even defining a trigger point to authorize review (for example, "…any award in an amount greater than $1 million, net of fees and costs"). Taking at face value the *Direct TV* majority's expressed deference to freedom of contract, there is no end to the ways that creative lawyers can craft unique judicial review clauses to suit their client's interest. Of course, the enforceability of those creative (or just poorly drafted) clauses will likely result in considerable litigation in itself.

As it does so often, a novel, policy-based ruling by the California Supreme Court will require a new way of looking at old questions. What had been a simple binary decision (arbitrate? yes/no) is now a more complicated question which starts with drafting an arbitration clause and may end in the state appellate courts, where you are defending or attacking an award made years earlier by an arbitrator who was not necessarily even an attorney, much less a judge. Now that parties have the power to elect either the traditional "final and binding" arbitration or the new judicial review variety, perhaps courts will become less eager to construct strained rationales, as in *Burlage*, to reverse arbitration awards where the parties freely contracted for no review. After all, there are now two very different beds to choose between when parties elect to arbitrate, and the courts may revert to the adage that you must lie in the bed you chose.

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