Hall Street Associates: Arbitration Results Are Final Despite Erroneous Legal Analysis

Freedom of contract in arbitration agreements?

There's a limit, says the Supreme Court.

By Joel Leeman

It would seem altogether ordinary. Two companies make an arm's-length agreement to submit their dispute to arbitration. They stipulate that the local federal court has the discretion to reject or modify the arbitrator's decision if it is not supported by substantial evidence or if it gets the law wrong. No one would look askance, you might think, at this homely safeguard against an arbitrator's blunder.

Not so. In *Hal Street Associates, L.L.C. v. Mattel, Inc.,* decided March 25, 2008, the U.S. Supreme Court insists that the grounds enumerated in the Federal Arbitration Act ("FAA") for setting aside or modifying an arbitrator's award are exclusive. The parties cannot provide, even by mutual agreement, for a heightened level of judicial review. As a result, the federal court cannot correct even a glaring error of law made by the arbitrator before confirming his award, as long as the arbitrator was not motivated by corruption or fraud.

The events preceding the ruling: Mattel had been renting property from Hall Street, but sought to terminate the lease after Oregon officials found pollutants in the property's well water. Hall Street filed suit in federal district court, challenging Mattel's right to terminate the lease and claiming that the toy manufacturer was obliged to indemnify Hall Street for cleanup costs. Mattel won at trial on the termination issue. The parties then agreed, with the district court's blessing, to arbitrate the indemnification issue. Their written arbitration clause empowered the district court to override any award if the arbitrator's factual findings award were "not supported by substantial evidence," or if his conclusions of law were "erroneous."

Mattel's lease required it to comply with all "environmental" laws, and to indemnify Hall Street from any harm if it did not comply. Hall Street argued that Mattel was obligated to pay cleanup costs because it violated the Oregon Drinking Water Quality Act. Quizzically, the arbitrator concluded that this Act was a human health law, not an environmental law as such, and decided for Mattel.

Relying on the arbitration clause, Hall Street pointed to what it labeled the arbitrator's erroneous conclusion of law and asked the district court judge to correct it. The judge wholeheartedly agreed, saying that the arbitrator's conclusion that the Water Quality Act was not an applicable environmental law "defies logic." The judge sent the matter back to the arbitrator, who followed the judge's ruling and amended the arbitration decision to favor Hall Street.

Mattel thereupon appealed to the Court of Appeals for the Ninth Circuit, arguing that the arbitration clause it had signed was not enforceable because it provided for judicial review of legal error. The appellate court agreed with Mattel, holding that the grounds listed in the FAA for vacating or modifying an arbitrator's decision were exclusive.

The ruling: The Supreme Court, in a split decision, agreed with the Ninth Circuit. The Court held that, under the FAA, an arbitration award may be set aside or corrected for the reasons listed in the FAA, but for no other reasons. Those recognized reasons are limited to egregious misbehavior in the nature of corruption, fraud, or obvious partiality, or instances of the arbitrator deciding a question that was not submitted to him. The FAA,

says the Supreme Court, provides no room "to supplement instances of outrageous conduct with review for just any legal error." The justices in the majority see in the FAA a national policy favoring arbitration with only so much review as serves arbitration's "essential virtue of resolving disputes straightaway."

The Court implicitly states that when freedom of contract butts up against statutory restrictions, the latter must prevail. Arbitration is chosen (or often imposed) because of its perceived advantages of greater speed and lower cost compared to litigation. The justices saw value in preserving the quick-and-dirty quality of arbitration and in protecting this alternative process against the thoroughgoing, and more expensive, appellate review that can follow litigation.

The Court was alert to the extraordinary fact that Hall Street and Mattel agreed, with the trial judge's acquiescence, to arbitrate part of their dispute in the midst of their litigation. This led the justices to muse whether some authority outside the FAA--for example, a trial court's inherent power to manage its cases--could provide a basis for heightened judicial review in such a circumstance. This issue was not addressed by Hall Street or Mattel in earlier proceedings, so the justices gave Hall Street permission to press the question on remand to the Ninth Circuit. The eventual answer may not, however, offer a path to enhanced review in the usual situation of a pre-dispute arbitration agreement.

Lessons learned: The *Hall Street* decision should stimulate companies who want heightened judicial review to re-evaluate their thinking about arbitration as an alternative to litigation. To be sure, arbitration offers certain advantages: The ease of tailoring the process to meet the specific needs of the parties; the freedom to choose a neutral decision-maker who is highly skilled in the technology at issue; and the enhanced capacity to maintain the confidentiality of documents and testimony. Moreover, as a less formal procedure than litigation, arbitration may be desirable when a company wishes to soften the damage that a dispute may pose to an important business relationship. Finally, if the parties adhere to the rules and timetable they take upon themselves, arbitration can be faster and cheaper than litigation.

In intellectual property disputes, however, especially ones involving patents, companies have often been wary about choosing arbitration, because the stated advantages are outweighed by two principal drawbacks of arbitration. First, the comprehensive search for evidence through the discovery process is invariably curtailed in arbitration. This is a good thing in some disputes, but when IP assets are a company's crown jewels, or where practicing the invention is essential to the business of the alleged infringer, one or both disputants may want to avoid the risks of limited discovery. To make its infringement claim stick, the patentee will want to search out, for example, every last relevant detail of the alleged infringer's manufacturing and sales activities. The alleged infringer, in turn, will seek from the patentee a comprehensive range of documents and testimony that might support any of a multitude of challenges to the patent's invalidity.

The second weighty drawback to arbitration, as we are now reminded by the Supreme Court, is that a decision based on mistakes of fact or law is largely insulated from review by the courts. In *Hall Street,* the Court tells us that parties may not contract this problem away by agreeing to a heightened level of judicial supervision. In a bet-the-business dispute, this may be one compromise too many.

Heightened judicial review is likely unavailable in state courts either. The Supreme Court has repeatedly ruled that FAA standards prevail in federal and state courts alike. Virtually all 50 states have passed a Uniform Arbitration Act, which contains the same limited grounds for setting aside or modifying an arbitrator's decision that the FAA enumerates. While the state legislation (like the FAA) does not explicitly forbid parties from contracting for additional grounds for review, the *Hall Street* decision will preempt any state law that

may provide for heightened review and thereby potentially interfere with federal arbitration policy as articulated by the Supreme Court.

Arbitration may sometimes commend itself as preferable to litigation; often, it is inescapable if the parties have agreed to arbitration long before a dispute arises. Since the decision of a well-intentioned but bumbling arbitrator is largely immune to correction, one simple piece of advice applies: Don't stint on the search for an arbitrator of superior judgment and reputation.

Hall Street Associates, L.L.C. v. Mattel, Inc. (U.S. Supreme Court March 25, 2008) is available at http://www.supremecourtus.gov/opinions/07pdf/06-989.pdf