ADR Study Group

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What Commercial Neutrals Need to Know Now: Important Recent Decisions and Statutes on Arbitration and Mediation

Notable Decisions, Statutes and Other Developments Affecting the Practice and Process of Arbitration, Mediation and Settlement

[Based on an earlier presentation to the Orange County Bar Association on March 26, 2018 and the Pepperdine / Straus American Inn of Court for Dispute Resolution on April 12, 2018]

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MEDIATION DEVELOPMENTS

1. Mediation Confidentiality – California Law

(a) *Background Statement*

California has long favored private negotiation and settlement of civil disputes. The state legislature has expressly stated that "[t]he peaceful resolution of disputes in a fair, timely, appropriate, and cost-effective manner is an essential function of the judicial branch of state government." Cal. C. Civ. Proc. § 1775(a). To effectuate this policy, the state legislature has expressly validated mediation as a process that "provides parties with a simplified and economical procedure for obtaining prompt and equitable resolution of their disputes and a great opportunity to participate directly in resolving those disputes." Cal. C. Civ. Proc. § 1775(c). Because mediation provides a simple, quick, and economical means of resolving disputes, and because it may also help reduce the court system's backlog of cases, California has recognized that the public has an interest in protecting not only the mediation participants, but the mediation process itself. *Rojas v. Superior Court*, 33 Cal. 4th 407, 415 (2004).

The starting point for California's mediation confidentiality scheme is Evidence Code Section 1115 which defines the processes that qualify for confidentiality protection. That protection extends to "mediations" and "mediation consultations." A "mediation consultation" is defined a "a communication between a person and a mediator for the purpose of initiating, considering, or reconvening a mediation or retaining the mediator." Cal. Evid. C. § 1115(c). A "mediation" is defined as a process in which "a neutral person or persons facilitate communication between the disputants to assist them in reaching a mutually acceptable agreement." Cal. Evid. C. § 1115(a). The comments to Section 1115 make it clear that what qualifies as a mediation is to be determined by "the nature of a proceeding, not its label," and that a proceeding might qualify as a mediation for purposes of the confidentiality protections "even though it is denominated differently." The fact that a court may use the terms "mediation" and "settlement" interchangeably when referring to the process taking place or that a judicial officer might be assigned to preside over the talks will not transform the proceeding into a mandatory settlement conference without a clear record that such a conference was ordered. *Doe I v. Superior Court*, 132 Cal. App. 4th 1160, 1166-1167 (2005) (the "*Archdiocese Case*") ("Except where the parties have expressly agreed otherwise, appellate courts should not seize on an occasional reference to 'settlement' as a means to frustrate the mediation confidentiality statutes." This is an important distinction because Evidence Code Section 1117(b)(2) provides that the confidentiality protections afforded communications in mediation do <u>not</u> apply to communications had during a mandatory settlement conference convened pursuant to Rule 3.1380 of the California Rules of Court.

Under California law, confidentiality protection is provided in the form of an evidence exclusion provision. It does not provide for an evidentiary privilege. Evidence Code Section 1119 bars – as evidence in a court or other adjudicatory proceeding – disclosures of (a) anything said or any admission made for the purpose of, in the course of, or pursuant to, a mediation or mediation consultation (Cal. Evid. C. § 1119(a)); (b) any writing prepared for the purpose of, in the course of, or pursuant to, a mediation or mediation consultation (Cal. Evid. C. § 1119(b)); and (c) all "communications, negotiations, or settlement discussions" by and between participants in the course of a mediation or mediation consultation (Cal. Evid. C. § 1119(c)). The California Supreme Court has confirmed on several occasions that the "any" and "all" provisions of Section 1119 are to be interpreted quite literally and made it clear that the scope of protection intended by the statute is unqualified, clear and absolute, and is not subject to judicially crafted exceptions or limitations. See, *Foxgate Homeowners Ass'n v. Bramalea Calif., Inc.*, 26 Cal. 4th 1, 14 (2001); *Rojas*, supra, 33 Cal. 4th at 424; *Fair v. Bakhtiari*, 40 Cal. 4th 189, 197 (2006); *Simmons v. Ghaderi*, 44 Cal. 4th 570, 588 (2008); *Cassel v. Superior Court*, 51 Cal. 4th 113, 124 (2011). The facts of the cases in which the California Supreme Court has been called upon to rule about the scope of protection afforded by Section 1119 have been somewhat extreme and serve to illustrate the breadth of what will be held as confidential if the communications (and sometimes conduct) occurred during a mediation.

Absent an agreement to the contrary, a mediation does not end until and unless "[f]or 10 calendar days, there is no communication between the mediator and any parties to the mediation relating to the dispute." Cal. Evid. Code § 1125(a)(5). Where the parties convene a mediation and commence settlement negotiations in that environment, their post-mediation negotiations will be protected for the ten-day period following the mediation. See, *Rodriquez v. United Nat'l Ins. Co.*, No. BC43004, 2012 WL 541512 (2d Dist., Feb. 6, 2012) (when a mediation ends is defined by statute and does not occur when one party walks out of the mediation). Mediation confidentiality does not extend to the date, location and attendants at the mediation, nor does it cover correspondence exchanged two months after the mediation was concluded. *Nazareth v. Malcolm & Cisneros*, No. RG13674746, 2016 WL 4491452 (1st Dist., Aug. 26, 2016).

An interesting side development concerning the mediation confidentiality protections available under California law concerns parties' efforts to avoid the consequences of a settlement by settling with their adversary and then suing their attorney for "settlement malpractice." In our inaugural Recent Developments program in 2013, we looked at *Filbin v. Fitzgerald*, 211 Cal. App. 4th 154 (2012) as an example of this developing trend of settle with your attorney and then sue your attorney for "negligent" or "inadequate" settlement. Following a bench trial, the trial court in this case entered judgment in plaintiffs' favor on the malpractice claim. The First District Court of Appeal reversed, explaining that in a "settle and sue" malpractice action, the plaintiff must prove that *but for* the malpractice she would *certainly* have received more money. Simply showing that the attorney erred is not enough. The Court noted that the requirement that a malpractice plaintiff prove damages to a "legal certainty" is difficult to meet in "settle and sue" cases because claims of inadequate

settlement are often inherently speculative since settlement involves a wide spectrum of considerations and broad discretion. Importantly, however, the Court did not flatly prohibit liability against former counsel for less favorable settlement, and simply concluded that based upon the facts before it, plaintiffs had failed to prove causation or damages as a matter of law.

It is even more difficult for parties to prove settlement malpractice when the settlement is the product of mediation, because there are the additional hurdles of (1) mediation confidentiality protection under Evidence Code section 1119 making inadmissible as evidence any communications, negotiations or discussions had during a mediation, and (2) that fact that there presently is no exception to the broad scope of confidentiality protection provided by Section 1119 for claims of fraud or professional malpractice during a mediation. *Cassel v Superior Court*, 51 Cal. 4th 113 (2011) is the landmark decision from the California Supreme Court and kicked off this issue in 2011, but we have looked at similar cases of alleged mediation or settlement malpractice each year since the ADR updates program was first presented in 2013. See, e.g., *Filbin v. Fitzgerald*, 211 Cal. App. 4th 154 (2012); *Roldan v. Callahan & Blaine*, 219 Cal. App. 4th 87 (2013); *Moua v. Pittullo Howington Barker Abernathy LLP*, 228 Cal. App. 4th 107 (2014); *Syers Properties III, Inc. v. Rankin*, No. RG10518323, 2014 WL 1761923 (1st Dist., May 5, 2014); *Amis v. Greenberg Taurig LLP*, 235 Cal. App. 4th 331 (2015).

Another interesting side development concerning mediation confidentiality protection under California law is that demonstrated in the unreported Fourth District decision in *Chodosh v. Trotter*, No. 30-2017-722371, 2017 WL 4020446 (4th Dist., Sep. 13, 2017), discussed in Section (c), below, where disgruntled plaintiffs who did not settle at mediation later sued the mediator and provider for alleged misconduct during the course of the mediation which they believe compromised their due process rights to an impartial judge when they returned to court for trial setting. The bottom line: I anticipate there will be more "process litigation" directed at mediation and its participants as mediation becomes further incorporated / annexed to the civil litigation process, and that resulting case law will continue to influence how the various participants (including mediators) view their roles, how the process should be administered and what constitute "best practices" in the realm of mediation.

(b) Statutory Exceptions to Mediation Confidentiality Moving Forward – Draft Legislation re Proposed Evidence Code § 1120.5

In 2011, the California Supreme Court decided *Cassel v. Superior Court*, 51 Cal. 4th 113 (2011), in which it upheld the broad, unconditional scope of the mediation confidentiality protections afforded by Evidence Code § 1119 in the context of an attorney-malpractice case. In an underlying litigation dispute, Cassel was the plaintiff and, during a mediation, agreed to settle his claims. He then sued his attorneys for malpractice and related claims, and asserted that they provided bad advice during the mediation and were both deceptive and coercive towards him during the mediation. The Supreme Court held that the trial

court properly granted motions in limine precluding Cassel from introducing any evidence which arose during the mediation, leaving Cassel with no evidence to prove his case.

The attorney-client context in which the scope of mediation confidentiality was tested not surprisingly invited a firestorm of negative publicity and public opinion. In response, Assemblyman Gorell introduced AB 2025 in 2012, which proposed to create an exception under Evidence Code § 1124 for "evidence of legal malpractice, breach of fiduciary duty or State Bar disciplinary action." As proposed, the bill still barred the attorney from introducing testimony by other participants (such as the adverse party and the mediator) to defend against the malpractice claims. As such, the attorney could not show that the ultimate settlement was the result of information obtained from the mediator or the adverse party because these communications remained inadmissible. AB 2025 passed the Assembly in 2012, but then stalled in the Senate Rules Committee. When Gorell was unsuccessful in negotiating a compromise bill in the Senate, the matter was referred to the California Law Revision Commission (CLRC) to analyze the issue and make a recommendation.

The CLRC conducted a study, commonly referred to as "Study K-402 – Relationship Between Mediation Confidentiality and Attorney Malpractice and Other Conduct," and conducted numerous public hearings where it received extensive comments in favor and against the proposed amendment. Those advocating for no exception to the broad confidentiality protection afforded by Evidence Code Section 1119, argued that the broad, blanket protection promotes candor, encourages the exchange of information and discussion about information, facilitates greater freedom in discussing possible settlement frameworks and terms, encourages parties to speak to each other directly in joint session, promotes finality / closure and discourages "buyer's remorse" and post-settlement litigation. Those advocating for the exception legislation argued that it would encourage better behavior by all during mediation, promote public confidence in the integrity of the mediation process, and encourage greater decision making responsibility on the part of the client / party. They also argued that mediated settlements should not be "super contracts," immune from attack on grounds of fraud, duress or coercion, and that attorneys should not be able to hide their incompetence or misconduct under the cloak of mediation confidentiality.

In November 2016, the CLRC proposed draft legislation in its "Memorandum 2016-58," providing for new Section 1120.5 to be added to the Evidence Code that would create an exception to mediation confidentiality protection for "alleged misconduct" of lawyers when representing clients in mediation. The CLRC then took additional public comment and held additional hearings on the proposed legislation. Following intense opposition and debate, in December 2017, the CLRC voted 4 to 1 to send proposed Section 1120.5 to the Legislature in the form of a sponsored bill. According to an article that appeared on the front page of the Daily Journal on December 5, 2017, "[s]trong opposition is expected, with plans by opponents to introduce their own gut-and-replace legislation." So, it would appear that (a) the debate is far from over, and (b) fate of the CLRC's proposed Section 1120.5 is anything but certain.

As drafted, the CLRC's proposed Section 1120.5 provides for an exception to mediation confidentiality that would allow disclosure / introduction of (1) evidence relevant to prove or disprove an allegation that a lawyer committed malpractice during a mediation, *if* (2) the evidence is sought or proffered in connection with resolving (a) a complaint against the lawyer under the State Bar Act (Business & Professions Code §§ 6000 et seq.) or (b) a claim of malpractice. The proposed new Section 1120.5 includes specific language allowing a court to use a variety of tools to limit the publication of what would otherwise be a confidential mediation communication – e.g., sealing order, protective order, redaction, in cameral hearing, etc. It also includes a provision requiring that a notice of complaint must be reasonably provided to all mediation participants (regardless of their status as parties to the complaint or action) so as to allow them to protect themselves from disclosures. Importantly, proposed Section 1120.5 does not change or affect Evidence Code Section 703.5, which provides that mediators are incompetent to testify as witnesses.

The text of the CLRC's proposed Section 1120.5 is set forth below:

Evid. Code § 1120.5 (added). Alleged misconduct of lawyer when representing client in mediation context

SEC. ____. Section 1120.5 is added to the Evidence Code to read:

1120.5. (a) A communication or a writing that is made or prepared for the purpose of, or in the course of, or pursuant to, a mediation or mediation consultation, is not made inadmissible, or protected from disclosure, by provisions of this chapter if both of the following requirements are satisfied:

(1) The evidence is relevant to prove or disprove an allegation that a lawyer breached a professional requirement when representing a client in the context of a mediation or a mediation consultation.

(2) The evidence is sought or proffered in connection with, and is used solely in resolving, one of the following:

(A) A complaint against the lawyer under the State Bar Act, Chapter 4 (commencing with Section 6000) of the Business and Professions Code, or a rule or regulation promulgated pursuant to the State Bar Act.

(B) A cause of action for damages against the lawyer based upon alleged malpractice.

(b) If a mediation communication or writing satisfies the requirements of subdivision (a), only the portion of it necessary for the application of subdivision (a) may be admitted or disclosed. Admission or disclosure of evidence under subdivision (a) does not render the evidence, or any other mediation communication or writing, admissible or discoverable for any other purpose.

(c) In applying this section, a court may, but is not required to, use a sealing order, a protective order, a redaction requirement, an in camera hearing, or a similar judicial technique to prevent public disclosure of mediation evidence, consistent with the requirements of the First Amendment to the United States Constitution, Sections 2 and 3 of Article I of the California Constitution, Section 124 of the Code of Civil Procedure, and other provisions of law.

(d) Upon filing a complaint or cross-complaint that includes a cause of action for damages against a lawyer based on alleged malpractice in the context of a mediation or a mediation consultation, the plaintiff or cross-complainant shall serve the complaint or cross-complaint by mail, in compliance with Sections 1013 and 1013a of the Code of Civil Procedure, on all of the mediation participants whose identities and addresses are reasonably ascertainable. This requirement is in addition to, not in lieu of, other requirements relating to service of the complaint or cross-complaint.

(e) Nothing in this section is intended to affect the extent to which a mediator is, or is not, immune from liability under existing law.

(c) An Alternative to Proposed Evidence Code § 1120.5 – SB 954 Which Would Add New Evidence Code § 1129 that Would Require Attorneys to Obtain Informed Consent from Their Clients re the Restrictions Attendant to Participating in a Mediation

As an alternative to the approach taken by the CLRC, Senator Wieckowski has proposed SB 954, which would amend the Evidence Code to add new Section 1129. The new Evidence code section would require an attorney representing a person participating in a mediation or a mediation consultation to inform his or her client of the confidentiality restrictions related to mediation, and to obtain informed written consent from the client that he or she understands the restrictions and opts to proceed with participating in a mediation or mediation consultation. The text of SB 954 is set forth below:

SECTION 1. Section 1129 is added to the Evidence Code to read:

1129. Before engaging in a mediation or a mediation consultation, an attorney representing a client participating in the mediation or a mediation consultation shall inform his or her client of the confidentiality restrictions as described in Section 1119, and obtain the client's written consent to the restrictions, in a form acknowledging that the client is informed of the restrictions and understands them.

SB 954 was introduced on January 30, 2018 and referred to Committee on February 8, 2018. It is eligible to be acted on after March 1, 2018.

(c) No Reported Cases in 2017 – But One Notable Unreported Case

- ***Chodosh v. Trotter*,** Case No. 30-2017-722371, 2017 WL 4020447 (4th Dist., Sep. 13, 2017) - Alleged statements made by the mediator for the ostensible purpose of coercing a settlement were inadmissible to support opposition to anti-SLAPP motion brought by the mediator and provider when sued by a mediation participant for alleged misconduct.

Plaintiffs were residents in a mobilehome park who got into a dispute with the mobilehome park's association over a special assessment. The judge to whom the matter was assigned – Judge Nancy Stock – encouraged the parties to try to settle the dispute with the help of a mediator at JAMS – Justice Trotter. In late 2013, the parties attended two separate mediation sessions with Justice Trotter – the first in October and the second in November - but the matter did not resolve. According to plaintiffs, when the parties' reached impasse at the second mediation in November, Justice Trotter allegedly told the plaintiffs that the association's settlement offer "was a gift and that he would personally tell 'Judge Nancy' that Plaintiffs refused to settle … and were the reason why settlement was not reached."

At the December 2013 trial setting conference, plaintiffs asked for a phased trial starting with a bench trial on legal issues, and the association asked for an unphased jury trial. Judge Stock agreed with the association and set the matter for an unphased jury trial. Judge Stock retired in January 2014 and soon thereafter joined JAMS. Plaintiffs then moved to disqualify Judge Stock retroactively and to void her order for the unphased jury trial alleging that Judge Stock had directed the parties to mediate with Justice Trotter while she was in discussions with JAMS about joining JAMS after her retirement and that neither disclosed this alleged conflict. Plaintiffs also alleged that Judge Stock's trial setting motion had been influenced by Justice Trotter carrying through on his threat to contact Judge Stock and tell her that plaintiffs (basically) did not participate in good faith in the mediation effort and turned down a reasonable (gift) offer. Plaintiffs' motion was denied and plaintiffs' petition for writ of mandate was denied.

Plaintiffs then filed a lawsuit against Justice Trotter and JAMS for breach of contract, fraudulent concealment, negligence, intentional and negligent infliction of emotional distress, intentional and negligent misrepresentation and unfair business practices. These claims were based on Justice Trotter's alleged threat during the November 2013 mediation the purported failure on the part of Justice Trotter and JAMS to disclose that Judge Stock was joining JAMS or in discussions to join JAMS after her impending retirement. In response to the lawsuit, JAMS and Justice Trotter filed a special motion to strike the complaint under the anti-SLAPP statute (CCP § 425.16) and argued that their alleged acts were protected litigation-related conduct and that plaintiffs could not establish a likelihood of prevailing due to mediation confidentiality, quasi-judicial immunity and the litigation privilege under Civil Code § 47. Plaintiffs opposed the motion and, in support of their

opposition, offered declarations in which they repeated Justice Trotter's alleged statements (threats) at the mediation session. Defendants objected to the declarations being considered as falling within the scope of Evidence Code § 1119.

The trial court granted defendants' anti-SLAPP motion, finding that the gravamen of plaintiffs' claims arise out of statements made in connection with an issue under consideration by a judicial body and in a mediation. In so ruling, the trial court held that plaintiffs did not meet their burden to present admissible evidence demonstrating a possibility of prevailing on their claims. First, the court found that the statements attributed to Justice Trotter were inadmissible "because they are protected by the mediation privilege" set forth in the Evidence Code. The court noted that the Evidence Code "sets forth an extensive statutory scheme protecting the confidentiality of mediation proceedings, with narrowly delineated exceptions" and prohibits participants and mediators alike from revealing mediation communications. The trial court further buttressed its ruling with findings that defendants were protected by quasi-judicial immunity and that the communications at issue were entitled to absolute protection under the litigation privilege.

On appeal to the Fourth District, the trial court's granting of defendants' anti-SLAPP motion was affirmed. The appellate court found that the trial court did not err in ruling that the alleged statements made by Justice Trotter were inadmissible under Evidence Code § 1119 and, as such, plaintiffs had no admissible evidence to establish a probability of prevailing at trial. In so ruling, the appellate court rejected plaintiffs' argument that mediation confidentiality should not apply because to do so would sanction conduct by which defendants "denied [them] due process by threatening to unlawfully taint their constitutional right to an impartial judge."

> "The issue is not whether defendants impeded plaintiffs' due process rights, but whether mediation confidentiality would do so. And even if their ability to pursue claims were limited by mediation confidentiality, *Cassel* confirms this scenario does not, without more, establish a due process violation…. 'Implicit in our decisions in *Foxgate, Rojas, Fair,* and *Simmons* is the premise that the mere loss of evidence pertinent to the prosecution of a lawsuit for civil damages does not implicate such a fundamental interest.'"

*7, citing *Cassel*, supra, 51 Cal. 4th at 135.

The appellate court also found unpersuasive plaintiffs' claim that use of the mediation statutes to protect mediator misconduct is an absurd result contrary to legislative intent.

> "The intent of the Evidence Code mediation provision is to encourage mediation. [Citations omitted.] This requires confidentiality, which means participants generally must forego claims arising from mediation conduct….

*8, citing *Cassel*, supra, 51 Cal. 4th at 133.

Finally, the appellate court declined plaintiffs' invitation to craft a judicial exception to Evidence Code § 1119, and noted that the issue of whether California law should provide rules to govern private mediator conduct was a matter for the Legislature.

Comment: An interesting thing about this decision is the introduction of the litigation privilege as an additional ground for immunizing from later litigation attack those who participate in the mediation of a litigated dispute. The significance of the litigation privilege is that it provides a complete defense / bar to litigation based upon a long-established and accepted common law doctrine dating back to jolly old England, whereas Evidence Code § 1119 simply provides a basis to present a defense on the merits because the only evidence the other side has is inadmissible as a matter of California law. As discussed below, federal law does not view mediation confidentiality the same way as California, so the common law doctrine of litigation privilege may actually provide greater protection for what is said and done in a mediation of a litigated dispute.

2. Mediation Confidentiality – Federal Law

(a) *Background Statement*

In opening a mediation session, it is fairly routine for the mediator to promise comprehensive confidentiality to the participants. While there are a number of statutes, rules, and cases that support confidentiality in mediation, a certain amount of skepticism and concern exists regarding the scope of protection that actually exists. The uncertainty about the nature and extent of what confidentiality protections exist for things said in mediation is especially apparent in federal court litigation disputes. See DWIGHT GOLANN, MEDIATING LEGAL DISPUTES 218-220 (2009); Dennis Sharp, *The Many Faces of Mediation Confidentiality*, *in* HANDBOOK ON MEDIATION 223-236 (2d ed. 2010). Both state and federal courts recognize that a theoretical component of mediation is confidentiality, but while California has express statutory provisions that provide for confidentiality protections, and numerous California Supreme Court decisions endorsing those protections, no similar protections are available under federal law. The scope of protection available under federal law is unclear and minimal at best. A detailed discussion of the statutory and case law governing mediation confidentiality protection under California law as compared to federal law can be found in Rebecca Callahan's recent article, *Mediation Confidentiality: For California Litigants, Why Should Mediation Confidentiality be a Function of the Court in Which the Litigation is Pending?* 12 Pepp. Disp. Resol. L.J. 63 (2012).

As a matter of federal common law, the Supreme Court has emphasized that testimonial privileges are not favored.

> "The common-law principles underlying the recognition of testimonial privileges can be stated simply. 'For more than three centuries it has now been recognized as a fundamental maxim that the public . . . has a right to every man's evidence. When we come to examine the various claims of

> exemption, we start with the primary assumption that there is a general duty to give what testimony one is capable of giving, and that any exemptions which may exist are distinctly exceptional, being so many derogations from a positive general rule.'"

Jaffee v. Redmond, 518 U.S. 1, 9 (1923), citing *United States v. Bryan*, 339 U.S. 323, 331 (1950). So, the starting place for understanding the federal perspective on mediation confidentiality is the common law rule that (a) the public is entitled to every person's evidence, and (b) testimonial privileges are disfavored. Fed. R. Evid. 408(b)(1)-(2).

There is no federal statute, rule of procedure, or rule of evidence that expressly recognizes or provides confidentiality protection for communications during or in connection with a mediation. The only express protection for settlement discussions is provided by Rule 408 of the Federal Rules of Evidence, which makes "conduct or statements made in compromise negotiations regarding the claim" inadmissible to prove liability. Thus, Rule 408 provides an admission standard for proof offered at trial to prove liability or invalidity of a claim and speaks in terms of *relevancy*. Its purpose is "to encourage the compromise and settlement of existing disputes," *Josephs v. Pac. Bell*, 443 F.3d 1050, 1064 (9th Cir. 2006), so as to avoid "the chilling effect" that potential disclosure might have on a party's willingness to make a compromise offer for fear of jeopardizing its case or defense if the matter is not settled. *Molina v. Lexmark Int'l, Inc.*, No. CV 08-04796 MMM (FMx), 2008 WL 4447678, at *11-12 (C.D. Cal. Sept. 30, 2008).

It is important to note that, by its terms, Rule 408(a) applies only to the *admissibility* of evidence at trial and does *not* apply to *discovery* of settlement negotiations or settlement terms. On this issue, the courts are split as to whether Rule 408 precludes discovery.[1] Moreover, Rule 408(b) expressly provides that exclusion is not required if the "offer and compromise" evidence is offered for a purpose that is not expressly prohibited by Rule 408(a). Fed. R. Evid. 408(b). Among the "permitted uses" delineated in Rule 408(b) are evidence of settlement and compromise negotiations offered (1) to prove bias or prejudice on the part of a witness; (2) to prove that an alleged wrong was committed during the negotiations (e.g., libel, assault, unfair labor practice, etc.); (3) to negate a claim of undue delay; or (4) to prove obstruction of a criminal investigation or prosecution. Additionally, a number of courts, including the Ninth Circuit, have concluded that Rule 408 does not make settlement offers inadmissible in the removal context where such offers represent evidence of the amount in controversy for the purpose of establishing the date on which such information was first made available to the defendant and thus started the thirty-day time period for removing a state court action to federal court. See, *Babasa v. LensCrafters, Inc.*, 498 F.3d 972 (9th Cir. 2007) (holding that a letter sent by plaintiffs estimating the amount alleged put defendant on notice of the amount in controversy); *Cohn v. Petsmart, Inc.*, 281 F.3d 837 (9th Cir. 2002) ("A settlement letter is relevant evidence of the amount in

[1] Compare *Bottaro v. Hatton Assocs.*, 96 F.R.D. 158, 160 (E.D.N.Y. 1982) (barring discovery of settlement terms), with *Bennett v. La Pere*, 112 F.R.D. 136, 139-40 (D.R.I. 1986) (allowing discovery of settlement discussions), and *NAACP Legal Def. & Educ. Fund, Inc. v. U.S. Dep't of Justice*, 612 F. Supp. 1143, 1146 (D.D.C. 1985) (allowing discovery if information is relevant to other issues in the pending action).

controversy if it appears to reflect a reasonable estimate of the plaintiff's claim."). Numerous district court decisions have used the settlement letter to establish the amount in controversy.[2]

In sum, Rule 408 is keenly focused on offers of compromise and negotiations involved in making, accepting, or rejecting such offers. As such, Rule 408 appears *not* to provide protection of any sort for prenegotiation communications or exchanges of information that parties might have with or through a mediator, even though the goal of those discussions is to open settlement dialogue.

The only other source of confidentiality protection in federal cases is Rule 501 of the Federal Rules of Evidence. Rule 501 empowers the holder of a recognized privilege to use the legal process to prevent others from disclosing protected communications. It also vests the holder with the right to refuse to produce otherwise relevant evidence. What qualifies as a "recognized privilege" is *not* detailed in Rule 501. In federal question cases under 28 U.S.C. § 1331, the extent to which a privilege exists is governed by federal common law[3] and may not be augmented by local court rules.[4] In diversity cases under 28 U.S.C. § 1332, where state law provides the rule of decision, the existence of a privilege is a matter of applicable state law. FED. R. EVID. 501. See also *Olam v. Cong. Mortg. Co.*, 68 F. Supp. 2d 1110, 1124-25 (N.D. Cal. 1999). That being said, federal law governs whether a case exceeds the amount in controversy requirement. See *Molina v. Lexmark Int'l, Inc.*, No. CV 08-04796 MMM (FMx), 2008 WL 4447678, at *6 (C.D. Cal. Sept. 30, 2008) (citing *Horton v. Liberty Mut. Ins. Co.*, 367 U.S. 348, 352 (1961)).

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[2] See *Munoz v. J.C. Penny Corp.*, No. CV09-0833 ODW (JTLx), 2009 WL 975846 (C.D. Cal. Apr. 9, 2009) (settlement proposal letter was admissible to establish that the jurisdictional amount in controversy had been met for purposes of removing the case to federal court); see also *Ray v. Am. Airlines, Inc.*, No. 08-5025, 2008 WL 3992644, *4 (W.D. Ark. Aug. 22, 2008) (settlement letter used to establish the amount in controversy); *Haydel v. State Farm Mut. Auto. Ins. Co.*, No. CIVA 07-939-C, 2008 WL 2781472, *8, n.8 (M.D. La. July 10, 2008); *Finnegan v. Wendy's Int'l, Inc.*, No. 2:08-cv-185, 2008 WL 2078068, *3 (S.D. Ohio May 13, 2008); *Sulit v. Slep-Tone Entm't*, No. C06-00045 MJJ, 2007 WL 4169762, *3, n.1 (N.D. Cal. Nov. 20, 2007); Turner v. Baker, No. 05-3298-CV-S-SWH, 2005 WL 3132325, *3 (W.D. Mo. Nov. 22, 2005); *LaPree v. Prudential Fin.*, 385 F. Supp. 2d 839, 849, n.9 (S.D. Iowa Aug. 17, 2005).

[3] Id. See also *Religious Tech. Ctr. v. Wollersheim*, 971 F.2d 364, 367, n.10 (9th Cir. 1992).

[4] See *Facebook, Inc. v. Pac. Nw. Software, Inc.*, 640 F.3d 1034, 1040-41 (9th Cir. 2011) ("A local rule, like any court order, can impose a duty of confidentiality as to any aspect of litigation, including mediation. . . . But privileges are created by federal common law.") In *Facebook*, the Winklevosses sought to avoid enforcement of the settlement agreement between ConnectU and Facebook which was negotiated and entered into during a private mediation. Id. at 1040. The Winklevosses proffered evidence of what was and was not said during the mediation. Id. The District Court for the Northern District of California excluded this evidence under its local rule that protected such communications as "confidential information," which the court read as creating a "privilege" for "evidence regarding the details of the parties' negotiations in their mediation." Id. at 1040. While the Ninth Circuit found that the district court's reason for excluding the evidence was wrong, it concluded that the court was nevertheless correct in excluding the proffered evidence because the parties had engaged with a private mediator and had signed an express written confidentiality agreement before the mediation commenced. Id. at 1041. Accordingly, the Ninth Circuit held that the confidentiality agreement signed by the Winklevosses precluded them from introducing "any evidence of what Facebook said, or did not say, during the mediation." Id.

Rule 501 raises a difficult question regarding which law shall apply in federal question cases with pendent state law claims. In the Ninth Circuit, that question has been resolved so that the law of privilege is governed by federal common law.[5] That being said, the Ninth Circuit has also held that "[i]n determining the federal law of privilege in a federal question case, absent a controlling statute, a federal court may consider state privilege law." See, *Lewis v. United States*, 517 F.2d 236, 237 (9th Cir. 1975) (citations omitted).

(b) 2017 Cases

- *Introductory Note*

The federal cases discussed in this section of the materials are a continuation of the dialogue being had in the federal courts in an effort to understand mediation as a dispute resolution process distinguishable from a settlement negotiation between the parties and a settlement conference presided over by the court. What we see is a growing appreciation of mediation, but resistance to the notion of blanket privilege or "protection" barring material evidence from being offered and heard by the decider of fact at trial. A case in point is *Milhouse v. Travelers Commercial Ins. Co.*, 982 F.Supp. 2d 1088 (C.D.Cal. 2013), where the trial court allowed testimony of what the plaintiffs' settlement demands were at mediation because to deem such evidence inadmissible at trial would violate the due process rights of defendant to provide a defense to its alleged liability for bad faith and punitive damages. "To exclude this crucial evidence would have been to deny Travelers of its due process right to present a defense." Id. at 1108. While the trial court's decision in *Milhouse* was affirmed on appeal, the Ninth Circuit declined to address the merits of this issue because it deemed the issue waived due to the fact that Milhouse's counsel failed to object to the proffered evidence on the basis of the mediation privilege, and did not alert the district court that he believed that California Evidence Code section 1119, not Federal Rule of Evidence 408, controlled the issue concerning the admission of evidence from mediation proceedings. "641 Fed. Appx. 714. "By failing to object on the basis of the mediation privilege at trial, the Milhouses did not preserve for appeal whether the district court erred when it admitted mediation statements." Id. at 717.

In the past couple of years, we have also looked at a number of district court decisions where the courts have shown their acceptance of confidentiality protection for communications had *during* the mediation under California Evidence Code § 1119, but have demonstrated a tendency to parse confidentiality issues more closely than their state court counterparts. For example, in *Haskins v. Employers Ins. of Wausau*, 2015 WL 369983 (N.D.

[5] Id. at n.10 (court refused to apply California litigation privilege in copyright action with pendent state law claims); *Folb v. Motion Picture Indus. Pension & Health Plans*, 16 F. Supp. 2d 1164, 1169-70 (C.D. Cal. 1998) (stating that the federal common law of privileges governs both federal and pendent state law claims in federal question cases); see also *Hancock v. Hobbs*, 967 F.2d 462, 467 (11th Cir. 1992) (per curiam) (the federal law of privilege is paramount in federal question cases even if the witness testimony is relevant to a pendent state law count which may be controlled by a contrary state law privilege); *Hancock v. Dodson*, 958 F.2d 1367, 1373 (6th Cir. 1992) (holding that the federal law of privilege is paramount to federal question cases).

Cal., Jan. 28, 2015), the court held that plaintiff's mediation brief was subject to discovery because it was prepared by or on behalf of fewer than all of the mediation participants and plaintiffs (through their counsel) had expressly agreed in writing to its disclosure via a letter written to counsel for plaintiffs' insurer, thus satisfying the express waiver requirements of Evidence Code §1122(a)(2). For another example, in *Doublevision Entertainment, LLC v. Navigators Specialty Ins. Co.*, No. C14-02848, 2015 WL 370111 (N.D. Cal., Jan. 28, 2015), the court held that California's mediation confidentiality protections provided grounds to grant a protective order for some – but not all – communications had during, before and after a mediation held in a related state court action: to wit, only two of five pre-mediation emails were protected because the other emails did not discuss mediation strategy and were not prepared for the upcoming mediation. To qualify for protection, the words "prepared for use in mediation" need to be stated or the substance has to refer to mediation strategy. Post-mediation memorandum were held to be protected because it recounted statements made during mediation. "The end of the mediation did not strip the privilege that attached to statements and communications made during the mediation." Post-mediation emails were held to not be protected because they were exchanged long after the end of the 10-day period prescribed by Evidence Code §1125(a)(5), did not recount anything from the earlier mediation, and could not be prepared for the purpose of or pursuant to a mediation because no subsequent mediation was scheduled, planned or under discussion.

Finally, we have seen the federal courts cut a straight and narrow path preferring the application of federal privilege law over California's statutory mediation confidentiality protections whenever the dispute involves both state and federal law claims - even when the federal claims have been dismissed. In *In re TFT-LCD (Flat Panel) Antitrust Litigation*, 835 F.3d 1155 (9th Cir. 2016), Sony and HannStar entered into a mediated settlement agreement that was effectuated through their respective attorneys' email exchanges with the mediator in which they accepted the "mediator's proposal" emailed by the mediator. When HannStar refused to pay, Sony sued in federal court to enforce the agreement. The district court denied Sony's motion for summary judgment on the ground that the emails by which HannStar accepted the mediator's proposal did not meet section 1123's conditions for admission.[6] Judgment was entered for HannStar and Sony appealed. On appeal to the Ninth Circuit, the judgment was reversed on the grounds that the district court should have applied the federal law of privilege even though Sony had dismissed its federal question claims and was proceeding in district court under the court's diversity jurisdiction to enforce a state law contract claim. The Ninth Circuit acknowledged that the general rule is that federal privilege law applies where there are federal question claims and pendent state law claims present, and that state law governs privilege when state law supplies the rule of decision, 635 F.3d at 1158, citing *Agster v. Maricopa County*, 422 F.3d 836, 839 (9th Cir. 2005) and Fed. R. Evid. 501. The Court held, however, that the rule was slightly different when the action was one to enforce a settlement of both federal and state

[6] California Evidence Code section 1123 provides that a written settlement agreement reached through mediation, which would otherwise be protected by the mediation privilege, is admissible in court if it is signed by the parties and meets one of the listed statutory conditions (e.g., an express statement to the effect that the settlement was intended to be enforceable or binding). There is no similar rule under federal law.

claims, as it had clarified in *Wilcox v. Arpaio*, 753 F.3d 872 (9th Cir. 2014).[7] Applying *Wilcox* to the case at hand, the Court found that the district court erred in applying California privilege law concerning mediation confidentiality because, at the time the parties engaged in mediation, their negotiations concerned (and the mediated settlement settled) both federal and state law claims.[8] As such, the Court concluded that federal privilege law applies, and remanded the matter for redetermination applying federal privilege law.

Against the foregoing backdrop, the following are a few interesting federal courts cases from 2017.

- ***Westport Ins. Corp. v. California Casual Management Co.***, 249 F.Supp. 3d 1164 (N.D.Cal., Apr. 17, 2017) - Communications had prior to mediation concerning attendance at the mediation are admissible and not protected by California Evidence Code § 1119.

School district's primary general liability insurer brought an action against the school administrators' excess insurer seeking declaratory relief and equitable contribution after it settled students' negligent supervision claims against the district and its administrators. The parties filed cross-motions for summary judgment. Before reaching the merits of those motions, the court was asked to rule on several evidentiary objections, including defendant's objection to plaintiff's reference to two letters exchanged prior to the mediation discussing who would attend the mediation. The district court ruled that while the letters were not important to its analysis in the case, they were admissible. In this regard, the court ruled that California Evidence Code § 1119 was inapplicable to the letters because they were not between the disputants in the mediation (which involved the students, the District and the Administrators), but were communications had outside of the mediation between counsel and only concerned who would attend the mediation. 249 F.Supp. 3d at 1172.

[7] In *Arpaio*, the Court held that although state contract law governed whether the parties had reached a settlement, the underlying action that was allegedly settled contained both federal and state claims. Accordingly, the Court held that federal privilege law applied because "the same evidence relates to both federal and state law claims."

[8] The Honorable Barbara M. G. Lynn, Chief District Judge for the Northern District of Texas, sitting by designation, filed a dissenting opinion in which she stated that the question of whether to apply *Arpaio* should be analyzed against the backdrop of the claims pending when the admission of evidence is sought, and noted that in this case, only state law claims remained at the time Sony sought to admit evidence of the email exchange in support of its motion for summary judgment to enforce the alleged settlement. Id. at 1159.

- ***Federal Deposit Ins. Corp. v. Nova Financial and Investment Corp.***, No. CV-15-00855, 2017 WL 956095 (D.Az., Jan. 10, 2017) - Mediator allowed to give a declaration in support of one party's proposed interpretation concerning the scope of the release included in the mediator's proposal that the parties accepted.

The FDIC and Nova Financial participated in a private mediation. After failing to come to an agreement in person, the parties reached an oral agreement during a telephone conference with the mediator had that same evening. The mediator then sent an e-mail to the parties to confirm the terms of the settlement that had been discussed. Neither party objected at that time to the mediator's description of the settlement terms and neither party later disputed that a settlement had been reached. However, within two days of the settlement, a number of disagreements arose when the parties attempted to reduce the settlement agreement to writing. The parties were able to resolve all disagreements except the scope of the release provision, which stated that the release was as to "Defendant and its respective heirs, executors, administrators, representatives, successors, and assigns." A lawsuit ensued to decide the scope of the release, with defendant contending that it was intended to be a "broad" release that included its employees, officers, directors, shareholders, subsidiaries, affiliates and agents. The mediator gave a declaration that supported defendant's position, stating that he (the mediator) believed that the release was broad and that the reference to "Nova" included defendant and any "related parties." The noted that while it had "great respect for the mediator, his legal acumen and his integrity," it did not find his interpretation – however commercially reasonable it might be – to be an objective assessment of the parties' agreement.

While it is surprising to see a mediator weigh in at all with respect to a controversy that later developed between the settling parties, with regard to mediation confidentiality under Arizona law, the court noted that the mediator's interpretation was based not on anything discussed during the mediation, but from his understanding of what is "typical in commercial disputes." On this point, the court noted in footnote 1 that "[i]f the mediator's assessment of what is typical in commercial disputes did not arise 'during a mediation,' he is not barred from sharing it…. To the extent the mediator's views are affected by his assessment of what occurred at the mediation, they are barred by statute." *3.

- ***Apelian v. Allstate Ins. Co.,*** No. CV16-4977, 2017 WL 6028742 (C.D.Cal. Mar. 9, 2017) - Defendant and its counsel sanctioned for not attending the court-facilitated mediation in good faith and not including in their mediation statement information required by the Magistrate Judge pursuant to his "settlement order."

This case illustrates how much more arm-twisting power a Magistrate Judge has over a court-assigned mediation than that of a panel mediator when confronted with recalcitrant parties and/or counsel who have been required to engage in some sort of alternative dispute resolution before being allowed to take up precious federal court time with a trial. *But* it raises the question of whether a settlement conference conducted under the auspices of FRCP 16 can properly be called a "mediation."

The case was referred to a Magistrate Judge for a settlement conference, which it appears was conducted as a "mediation" because the Magistrate Judge issued an order in which he listed the information required to be included in the parties' "mediation statements." That order put the parties and counsel on notice that their failure to strictly follow the order could result in an award of sanctions. Post-settlement conference, the Magistrate Judge ordered the defendant to pay $12,500 in attorney's fees to plaintiff's counsel and $500 to the Court Clerk. He also ordered defendant's counsel to pay $950 to the Court Clerk. The reason for the sanctions was defendant's failure to include seven of the eight required categories of information, the tardy submission of its mediation statement two days past the deadline and the Magistrate Judge's finding that defendant and its counsel had not attended the settlement conference in good faith.

On review, the district court judge to whom the case was assigned denied defendant's motion for review finding that the court had no "definite and firm conviction" that the Magistrate Judge's decision was reached in error or that it was contrary to law. With regard to the legal basis for awarding sanctions, the court noted that under FRCP 16(f), federal courts may impose sanctions, including attorney's fees, on a party that is "substantially unprepared to participate – or does not participate in good faith" in a Rule 16 settlement conference or who fails to comply with a Rule 16 settlement conference order.

Comment: While the Magistrate Judge's "settlement order" referred to a "mediation statement," it would seem to be more appropriate for that brief to be described as a settlement conference statement, especially since the order included a provision for sanctions under FRCP 16 if the order was not strictly adhered to. Moreover, if the settlement conference was truly a "mediation" covered by General Order No. 11-10, the Magistrate Judge - acting in the capacity as mediator - would be constrained with respect to how much he / she could report to the court about the mediation. Here, the sanctions order stated that defendant and its counsel had "engaged in a pretense" and had "paid no heed in connection with the requirements of Defendant's mediation statement, its timely

submission, etc." These are not statements that a panel mediator could include in his / her report to the court using the ADR-03 form.

3. Miscellaneous

(a) A development / different perspective regarding the use of "binding mediation" to resolve disputes – *Gerawan Farming, Inc. v. Agricultural Labor Relations Board*, 3 Cal. 5th 1118 (Cal. S.C., Nov. 27, 2017).

Introductory Statement

Mediation in the context of general, civil disputes has been defined as "the intervention in a negotiation . . . of an acceptable third party who has limited or no authoritative decision-making power, who assists the involved parties to voluntarily reach a mutually acceptable settlement of the issues in dispute." Christopher W. Moore, The Mediation Process / Practical Strategies for Resolving Conflict (3d ed. 2003), p. 15. There is thus an incongruity in coupling "mediation" with "binding." Nevertheless, the term "binding mediation" entered our vocabulary in 2006 when the mediator in *Lindsay v. Lewandowski*, 139 Cal. App. 4th 618 (2006) issued a "binding mediation ruling" that he said was a procedure he regularly used. Honorable Robert Polis (ret.), the mediator in question, defined the process as one where the parties "agreed in advance that in the event [they failed] to agree, I then decide [the] terms and conditions, typically by asking the parties to each submit . . . their final offers, accompanied by their oral argument as to why I should select their version over all others." Id. at 1621 The trial court's confirmation of the binding mediation award as a judgment was reversed by the Fourth District Court of Appeal as unenforceable – not on any procedural grounds (like lack of due process because the mediator's decision is made without benefit of evidence and is based on confidential information shared with only the mediator), but because the process as expressed by the parties in their agreement was ambiguous. Id. at 1624. In a concurring opinion, two Justices found the term "binding mediation" to be "deceptive and misleading" and the concept to be "oxymoronic" because mediations "are supposed to reflect a truly voluntary process" that, by definition, "reflect[s] the consent of the parties." Id. at 1625-1628.

When presented with a similar "binding mediation" situation in 2012, the Fourth District Court of Appeal took a different tact – because the facts were quite different from those presented in *Lindsay* – and affirmed the trial court's judgment on the mediator's binding mediation award. See, *Bowers v. Raymond J. Lucia Companies, Inc.*, 206 Cal. App. 4th 724 (2012). In *Bowers*, the parties submitted their dispute to binding arbitration. After several days of evidentiary hearing, the parties agreed to settle the dispute by defendant dismissing all claims asserted against plaintiffs in the arbitration proceeding and by plaintiffs submitting their claims in the state court lawsuit to "mediation/binding baseball arbitration." With regard to the latter process, the parties agreed to participate in a full day mediation, and if they were unable to reach agreement at the end of the mediation, they agreed that the mediator was empowered to set the amount of the judgment in favor of

plaintiffs and against defendant "at some amount between $100,000 and $5,000,000" based upon the parties' respective last and final offers, and that "mediator judgment" could then be entered as a judgment in the state court proceedings without objection of any party. As agreed, the parties participated in a full-day mediation, but were unable to reach an agreement. Plaintiffs' last and final demand was $5 million and defendant's last and final offer was $100,000. Ultimately, the mediator selected the $5 million number and plaintiffs petitioned to confirm the mediator's award as a judgment. The trial court declined to confirm the award as an arbitration award, but enforced the settlement agreement and mediator award under Code of Civil Procedure Section 664.6. The trial court explained:

> "Despite their use of undefined legal terms such as 'mediation with a binding arbitration component' and 'mediation/binding baseball arbitration,' the parties clearly agreed in writing that the mediator would decide the amount of the judgment with the 'binding mediator judgment to then be entered as a legally enforceable judgment . . . ."

The Court of Appeal affirmed the judgment entered by the trial court on the "mediator award," and rejected each of the three attacks waged by defendant. With regard to mutual consent, the Court of Appeal found that there was substantial evidence in the transcript of the arbitration agreement and the parties' written settlement agreement showing that the parties agreed to a full-day mediation, at the end of which the mediator could make a binding award if the mediation was not successful. Moreover, the Court of Appeal found that "most supportive of the trial court's finding" was the absence of any indication by the defendant or its counsel that they ever requested the arbitrator to conduct an arbitration after the full-day mediation ended.

With regard to defendant's contention that the settlement agreement was unenforceable because "binding mediation" is an inherently uncertain term, the Court of Appeal disagreed and found that the term was sufficiently certain to be specifically enforceable. Of critical importance to the court was the fact that the parties – both in their agreement and in recorded statements made on the record in the arbitration proceeding – had elaborated on what they meant by the alternative dispute resolution method they had chosen, as well as the fact that defendant never objected or insisted on a post-mediation arbitration hearing until after the mediator made an award in plaintiffs' favor.

With regard to defendant's contention that the settlement agreement was unenforceable because "binding mediation" was not among the constitutionally and statutorily permissible means of waiving jury trial rights, the Court of Appeal disagreed. Although "binding mediation"' is not among the methods listed in Code of Civil Procedure Section 631 for waiving a jury trial, the Court of Appeal found that that did not preclude enforcement of the settlement agreement because section 631 relates only to the manner in which a party to a pending court action can waive his right to a jury trial instead of a court trial. It does not prevent parties from avoiding jury trial by not submitting their controversy to a court of law in the first instance. Therefore, while section 631 applies to

the validity of a pre-dispute jury trial wavier in a judicial forum, it does not invalidate a post-dispute jury trial waiver in an agreement to settled in a non-judicial forum.

This year – 2017 – we have a decision by the California Supreme Court in which a "mandatory mediation and conciliation process" created by statute (the Agricultural Labor Relations Act) was validated and the Board's final order adopting the mediator's report was affirmed.

Case Note

The *Gerawan Farming* case offers up a unique factual context that probably does not have broad application in the general, civil context, but it is interesting nonetheless because it provides a glimpse at how "binding mediation" is used in the collective bargaining arena. In this context, "neutral state mediators" are brought in to assist the union and employer in negotiating a new contract and, if the parties cannot reach agreement on mutually acceptable terms, the mediator then has the power – under Labor Code § 1164, et seq. – to conduct a hearing on the disputed terms and submit a proposed contract to the Agricultural Labor Relations Board (Board). The Board can then order a new contract between the union and the employer based on the mediator's recommendation.

In this case, the United Farm Workers of American (UFW) filed a request for mandatory mediation and conciliation (MMC) with the Board after failing to reach a collective bargaining agreement with Gerawan Farming. When mediation failed to produce an agreement, the mediator submitted a proposed contract to the Board fixing the contract terms. The Board adopted the mediator's recommendation and issued a final order imposing the mediator's proposed contract on both parties. Gerawan Farming petitioned for review of the Board's order, contending, among other things, that the MMC statutory scheme was unconstitutional.

The Fifth District Court of Appeal agreed with Gerawan Farming and held that the MMC statute "on its face violates equal protection principles" and "improperly delegates legislative authority." In so holding, the Court of Appeal adopted the reasoning of the dissent in *Hess Collection Winery v. Agricultural Labor Relations Bd.*, 140 Cal. App. 4th 1584, 1611 (2006), in which the Third District Court of Appeal upheld the MMC statute against a similar constitutional challenge.

The *Gerawan Farming* case is significant because the California Supreme Court has resolved the split between the Third and Fifth Districts concerning the constitutionality of the "binding mediation" procedure utilized by the Board under the Labor Code. In reaching the constitutional issues, the Court made clear that the only challenge raised was a "facial attack on the MMC statute," and that the Gerawan Farming challenge did not articulate an as-applied challenge based on the specific terms of the contract imposed by the Board's final order.

Gerawan Farming's lead argument was that the MMC process is one that is actually known as "compulsory interest arbitration," in which the terms and conditions of employment are established by a final and binding decision of an arbitrator. Unlike "grievance arbitration," which focuses on construing the terms of an existing agreement and applying them to a particular set of facts, "compulsory interest arbitration" focuses on what the terms of a new agreement *should* be. The MMC process results in "quasi-legislative action" by which the terms of a union contract governing an employer and its employees is imposed by force of law. While "compulsory interest arbitration" is common in public sector labor relations at the federal, state and local levels, Gerawan Farming contended that such a system was "categorically impermissible" in the private sector because it violates substantive due process. In support of its argument, Gerawan Farming relied on a trilogy of cases from the 1920's that held unconstitutional a Kansas statute authorizing a three-judge industrial court to arbitrate employment disputes and impose wage and other terms of employment. The California Supreme Court found this argument unpersuasive because this "restrictive view of the police power" has been repudiated by later cases. Moreover, while the United States Supreme Court has interpreted the National Labor Relations Act (NLRA) to prohibit compulsory arbitration, the Court noted that the United States Supreme Court had resolved those NLRA decision on statutory grounds and said nothing about compulsory arbitration's constitutionality. "Contrary to what Gerawan contends, there is no indication in the high court's case law that compulsory arbitration in areas *not* covered by the NLRA, such as agricultural relations, would be unconstitutional." Seeing no authority to support Gerawan Farming's substantive due process challenge, the Court declined to rule that compulsory interest arbitration was categorically unconstitutional.

With regard to the equal protection challenge, Gerawan Farming's primary argument was not that the MMC statutory scheme treats classes of employers differently, but that it discriminates against each individual agricultural employer within the covered class of employers who have not entered into a first contract after their workforce has voted to unionize. The Fifth District Court of Appeal accepted this argument and concluded that the MCC program has the effect of imposing a "distinct, unequal, individualized set of rules" on the affected set of employers and that this is "the very antithesis of equal protection." While Gerawan Farming did not allege class-based discrimination, it claimed that it had been irrationally singled out as a "class of one" as recognized by the United States Supreme Court in *Engquist v. Oregon Dept. of Agriculture*, 553 U.S. 591 (2008). Central to its argument was the argument that because the MMC statute does not pass any judgments as to the specific terms that would foster collective bargaining and stability in the workforce, a mediator could consider one employer's wages with relation to comparable employers and choose to impose a wage increase, a wage decrease, or no change at all. Three different mediators dealing with three similarly situated employers could impose collective bargaining agreements with different terms - resulting in different wage structures - thus creating a situation where those similarly situated employers could suffer different impacts on their gross profit margins.

The California Supreme Court found Gerawan Farming's equal protection challenge unpersuasive. The Court held that the purpose of the MMC statute is "to promote collective bargaining and ensure stability in the agricultural labor force," and that the statute accomplishes this purpose "by empowering mediators to make individualized determinations regarding the terms of particular collective bargaining agreements." The Court went on to hold that these individualized determinations "are rationally related to the Legislature's legitimate interest in ensuring that collective bargaining agreements are tailored to the unique circumstances of each employer." The Court rejected as "hypothetical" the argument that three similarly situated employers could be treated differently under the MMC statute, and held that "it is not enough to show that *some* hypothetical applications of the MMC statute might result in arbitrary or discriminatory treatment. Instead, Gerawan must show that the statute 'inevitably pose[s] a present total and fatal conflict' with equal protection principles" or "that the statute violates equal protection 'in the generality or great majority of cases.'"

Comment: This decision offers up a lot of interesting issues for discussion, including:

1. *Can you call it mediation if, in practice, the neutral mediator imposes / decides the negotiated resolution whenever the parties cannot agree?*

2. *Can you call it arbitration when there is no writing between the parties agreeing to submit their disputes to binding arbitration as required by the FAA (9 U.S.C. § 2) and the California Arbitration Act (CCP § 1281)?*

3. *One has to assume that the MMC mediator provides some type of "report" to the Board regarding the mediation as the backdrop for his recommended contract terms. Why is this program exempt from mediation confidentiality?*

4. *Given that employee wages and associated payroll tax liabilities constitute one of the largest expenses in "cost of goods sold," which determines a company's gross profit, what happens to the concept of "private sector" and "free competition" if the state or federal government has the power to effectively dictate and set employee wages and benefits? And what happens if similarly situated / competing farmers are ordered to accept different pay rates and benefits packages, thereby giving one a healthier profit margin and thus a competitive advantage over the other?*

5. *To the extent that one gets to pick their "neutral mediator" in the MMC program, this decision strongly suggests that the parties pick carefully!*

(b) Motion for sanctions for party's alleged failure to appear at mediation denied – *Drop Stop LLC v. Zhu*, Case No. CV-16-07916-AG (SSX), 2017 WL 3433695 (C.D.Cal. Jun. 30, 2017)

Plaintiff Drop Stop sued defendants for alleged patent infringement, and defendants asserted various counterclaims. In accordance with its power under FRCP Rule 16(c)(1) to order parties to attend and participate in a pretrial settlement conferences. Under the court's local rules, the parties must participate in at least one "ADR procedure" prior to trial. In this case, Judge Guilford ordered the parties to participate in an ADR procedure and the parties chose mediation with a court panel mediator. When the parties went to mediation, all but one of the defendants appeared and the mediator's report to the court so indicated. The present parties mediated, but did not reach a settlement agreement at the mediation, and the mediator's report so indicated. After the mediation, Drop Stop filed a motion seeking sanctions against the missing defendant for failing to appear at the mediation. In opposition, the defendants claimed that one of the individuals present at the mediation had settlement authority for more than one of the defendants and that there was simply confusion about that point. In a Solomon-like manner, Judge Guilford noted that while it was "concerning" about the represented facts concerning who appeared and said or did not say what concerning their capacity, the court had not ordered the parties to mediate by a certain date and, as such, the missing defendant technically had not violated the court's scheduling order and would not be in violation of that order so long as it engages in another mediation before the pretrial conference. Apparently appreciating that the parties had exhausted their "free" mediation with the court's panel through the earlier failed mediation, Judge Guilford told the parties that they were "welcome to stipulate to a no-cost mediation before a Magistrate Judge," clearly try to make amends for the offending / missing party by not penalizing them through a "fee-based" do-over.

CONTRACT ARBITRATION DEVELOPMENTS

1. Statutory Developments

(a) ***Labor Code § 925*** **–effective Jan. 1, 2017** – Addition to the California Labor Code prohibiting an employer from requiring an employee who primarily resides and works in California to agree, as a condition of employment, to a provision that would either require the employee to litigate or arbitrate employment disputes (1) outside of California, or (2) under the laws of another state.

For companies with headquarters outside of California and with a work force in California, as well as other states, forum-selection and choice-of-law provisions are were a common practice. Some would say that the practice is in an effort to have uniformity and consistency in administering litigated disputes with employees. Others would say that the practice is aimed at avoiding California courts and dodging California employment law, such as California's prohibition of covenants not to compete. Whatever the case, with the passage of SB 1241 and the addition of Section 925 to the California Labor Code, an employer is prohibited from requiring an employee who resides and works primarily in California to agree, as a condition of employment, to out-of-state choice of law and/or forum selection clauses, except in the case where the clause has been negotiated with an employee "individually represented by legal counsel." New Section 925 does not affect employment agreements already in effect. It also does not affect post-employment agreements such as severance agreements or agreements in existence as of January 1, 2017. By its terms, the new law applies only to contracts entered into, modified, or extended on or after January 1, 2017.

The enactment of SB 1241 followed Governor Brown's veto of AB 465 in 2015. AB 465 attempted to ban mandatory employment arbitration agreements. Governor Brown's veto message explained that purported employment abuses "should be specified and solved by targeted legislation, and not a blanket prohibition." New Section 925 is one such piece of targeted legislation, attacking contractual provisions that are hostile to California law, whether they appear in an arbitration clause or elsewhere within an employment agreement required as a condition of employment.

Section 925 in a nut shell:

- Applies to all employers with employees who reside or work primarily in California, regardless of where they are located

- Does not apply to an agreement with an employee who is "in fact individually represented" if his/her lawyer is involved in negotiating the terms of the contract applicable to employment disputes

- Does not apply to voluntary agreements that are not a condition of employment – e.g., a severance agreement

- Applies to claims and controversies "arising in California"

- Applies to disputes arising in arbitration or litigation

- Any provision of an agreement that violates § 925 is voidable by the employee. If an employee requests that a provision be rendered void, the dispute over whether the provision is voidable will be litigated in California under California law.

- Does not apply to agreements existing as of 1-1-2017 that remain unchanged.

But see the Ninth Circuit's February 3, 2017 rulings in *Poublon v. C. H. Robinson*, 846 F.3d 1251 (9th Cir. 2017) (discussed at page 107), in which the Court did not find out-of-state forum selection clauses to be substantively unconscionable for purposes of defeating the enforceability of an arbitration clause included in an employment adhesion contract – relying on its October 13, 2016 decision in *Tompkins v. 23andMe, Inc.*, 840 F.3d 1016 (9th Cir. 2016) (discussed at page 104), in which the Court addressed the validity / conscionability of including an out-of-state forum selection clause in the arbitration provisions of an online consumer contract (i.e., making no distinction or adjustment for adhesion contracts required in the employment vs. consumer context).

(b) ***Code of Civil Procedure § 1282.5*** **– effective Jan. 1, 2017** - Addition to the California Arbitration Act creating a right to have a certified shorthand reporter transcribe any deposition, proceeding or hearing in an arbitration

New Code of Civil Procedure § 1282.5 specifies that a party to arbitration has the right to have a certified shorthand reporter transcribe any deposition, proceeding or hearing. The request for a reporter must be made either in a demand, response, answer, or counterclaim related to the arbitration, or at a pre-hearing scheduling conference. If the arbitration agreement does not provide for a court reporter, the cost of the reporter is borne by the parting requesting the reporter (except in the case of an indigent consumer in a consumer arbitration). A party whose request for a reporter is refused may petition the court for an order to compel the arbitrator to grant the party's request. The Court may stay any hearing, deposition or proceeding in the arbitration pending the decision on the petition for a court reporter.

Practice Note:

It is fairly common place for the court reporter issue to be included on the agenda for the initial preliminary hearing. The agenda description looks something like the following as pertains to the evidentiary hearing:

5. Court Reporter

5.1 Does any party want a Court Reporter at the evidentiary hearing?

Requested by Claimant? YES ☐ NO ☐
Requested by Respondent? YES ☐ NO ☐

[Note: If requested, the Court Reporter must be arranged and paid for by the requesting party or jointly if all parties agree.]

5.2 If yes, will the Reporter's transcript be the official record of the proceeding?

YES ☐ NO ☐

[Note: The Reporter's transcript will not be the official record of the proceeding unless all parties so stipulate and the Arbitrator so orders, in which case, the Arbitrator is to be provided with a copy of the transcript in the same manner as provided to the parties (e.g., hard copy, disk, CD). If real time transcripts are provided to the parties at the evidentiary hearing, they shall also be provided to the Arbitrator.]

At the time of the initial preliminary hearing, parties frequently have not made a decision with regard to whether or not to have a court reporter at the evidentiary hearing. It is fairly common place for the court reporter issue to nevertheless be included in the Scheduling Order with a provision along the following lines:

3.8 *Stenographic or Other Official Record*. If any party wishes to utilize a court reporter for the evidentiary hearing or any other proceeding, the responsibility for making arrangements to have the court reporter present rests with that party – and not with the Case Manager, the AAA or the Arbitrator. To avoid having multiple court reporters present for the same proceeding, any party wishing to have a stenographic record must advise all other parties at least seven days prior to the commencement of the evidentiary hearing. The Arbitrator has no preference regarding the use (or non-use) of a court reporter. If a court reporter is present, both sides must be given the opportunity to purchase a transcript according to the same pricing schedule.

(c) ***Code of Civil Procedure § 1281.2*** **– effective Jan. 1, 2018** – Banks cannot use predispute arbitration agreement contained in documents pertaining to a legitimate accounts as the basis for compelling arbitration of fraud and identity theft disputes pertaining to bogus accounts opened in the customer's name without the customer's knowledge or consent.

Wells Fargo, like many financial institutions, requires customers to give up their right to sue in court and to sue in a representative or class capacity when they sign up for personal accounts and other services. In 2013, it was revealed that at least 3,500 Wells Fargo employees had opened approximately 1.5 million bank accounts and over 500,000 credit card accounts using existing customers' names and personal identification information, and that they had done so without the account holders' knowledge or consent. Investigations revealed that the targets of this conduct were often young adults opening their first bank account, small businesses, non-English speaking immigrants and the unsophisticated or infirm elderly. When customers attempted to sue over fees and other damages incurred as a result of the bank's conduct concerning these unauthorized accounts, Wells Fargo successfully argued in state and federal courts across the country that the private arbitration agreements contained in the agreements pertaining to the customers' legitimate accounts were applicable to their claims arising from the fraudulently created accounts. Consumer advocates and others believed that by forcing these matters into arbitration, Wells Fargo was able to (a) keep the scandal out of the public view, (b) allow the fraud to be further perpetrated, and (c) enable the bank to continue profiting from the fraudulent accounts.

In response to the disclosure of the bogus account scheme and Wells Fargo's strategic use of arbitration to keep this problem out of public view, Senator Bill Dodd (D-Napa) and California Treasurer John Chiang proposed SB 33 to amend Code of Civil Procedure section 1281.2 to preclude forced arbitration in lawsuits against financial institutions for claims arising out of accounts created by fraudulent, illegal or otherwise surreptitious means.

The proposed amendment became law in October 2017 and becomes effective January 1, 2018. As amended, Code of Civil Procedure § 1281.2 allows a court to deny enforcement of an arbitration agreement if it determines that the petitioning party is a state or federally chartered depository institution seeking to apply a consensual arbitration agreement to a purported contractual relationship with the respondent consumer that was "created by the petitioner fraudulently without the respondent consumer's consent and by unlawfully using the respondent consumer's personal identifying information…."

Several bank and business trade groups opposed SB 33, arguing that the FAA preempts state laws that single out arbitration agreements for special treatment and that SB 33 is such a law. Given the currently popularity of arbitration in many state and federal courts of appeal, it is anticipated that there will be litigation concerning the amended statute in the near future, but it will probably several years to receive a definitive statement from the United States Supreme Court, if at all.

2. Arbitrator Disclosures and Disqualification Under the FAA

When an arbitrator fails to disclose at the front-end of the arbitration process an interest or relationship that amounts to "evident partiality" under 9 U.S.C. §10(a)(2), the FAA requires vacatur. As demonstrated by the cases discussed below, there is no clear consensus among the federal circuits on what constitutes "evident partiality" for purposes of vacating an arbitration award. Rather, on a fact driven basis, the courts have fashioned similar, yet different, tests for analyzing whether an arbitrator's existing or prior relationships are sufficient to support vacatur on the grounds of "evident partiality."

(a) *"Evident Partiality" in the Context of Disclosed Conflicts*

"Evident partiality" may exist where there is actual bias on the part of the arbitrator, or where an arbitrator's failure to disclose information gives the impression of bias in favor of one party. See *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145, 149 (1968); *Schmitz v. Zilveti*, 20 F.3d 1043, 1045 (9th Cir. 1994); *Ventress v. Japan Airlines*, 603 F.3d 676, 679 (9th Cir. 2010).

In actual bias cases, the integrity of the arbitrator's decision is directly at issue. See *Schmitz v. Zilveti*, supra, 20 F.3d at 1045; *Woods v. Saturn Distribution Corp.*, 78 F.3d 424, 427 (9th Cir. 1996); *Ventress v. Japan Airlines*, supra, 603 F.3d at 679.

"The appearance of impropriety, standing alone, is insufficient" because a reasonable impression of partiality does not necessarily mean that the award was the product of impropriety. See *Sheet Metal Workers Int'l Ass'n Local 420 v. Kinney Air Conditioning Co.*, 756 F.2d 742, 746 (9th Cir. 1985); *Schmitz v. Zilveti*, 20 F.3d 1043, 1047 (9th Cir. 1994); *Woods v. Saturn Distribution Corp.*, 78 F.3d 424, 427 (9th Cir. 1996); *Ventress v. Japan Airlines*, 603 F.3d 676, 679 (9th Cir. 2010).

The party alleging evident partiality in an actual bias (known conflict) case must establish specific facts which indicate improper motive on the part of the arbitrator. *Sheet Metal Workers Int'l Ass'n Local 420 v. Kinney Air Conditioning Co.*, supra, 756 F.2d at 746. An example of such a circumstance is provided by *Morelite Const'n Corp. v. New York City Dist. Council, Etc.,* 748 F.2d 79 (2d Cir. 1984). In this case, the arbitrator was the son of the president of an international labor union, which was a party to the arbitration. The Court noted that "[e]xactly what constitutes 'evident partiality' by an arbitrator is a troublesome question." Id. at 82. Acknowledging that the standard of "appearance of bias" is too low for the invocation of Section 10, and "proof of actual bias" is too high, it settled on a "reasonable person" standard, meaning that "evident partiality" will be found "where a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration." Id. at 84. While there was no evidence concerning the specifics of the arbitrator's relationship with his father, the court nevertheless concluded that "sons are more often than not loyal to their fathers, partial to their fathers, and biased on behalf of

their fathers," and thus inferred that the awarded was grounded in "unfairness," and was thus properly subject to vacatur. Id.

On the flip side, the Fourth Circuit took a different tact in *Consolidation Coal Co. v. Local 1643, Etc.*, 48 F.3d 125 (4th Cir. 1995), when presented with the circumstance where the arbitrator's brother was an employee of an international labor union not directly involved in the matter at hand. The district court granted vacatur based upon the finding that the sibling relationship was "strong evidence of partiality by [the arbitrator]" because it was analogous to the father-son relationship that led to vacatur in the *Morelite* case. Id. at 129. On appeal, the Fourth Circuit disagreed and reversed, finding that, without any further evidence, a court should not assume the same degree of loyalty and partiality in a sibling relationship that it can assume in a father-son relationship; that a finding of partiality based solely on the existence of the sibling relationship was "at best remote, uncertain and speculative;" that through his relationship with his brother, the arbitrator had only an indirect relationship to a party in the arbitration and that relationship had no connection with the issues submitted to the arbitrator for decision. Id. at 129-130, citing with approval *Hobet Mining, Inc. v. International Union, UMWA*, 877 F.Supp. 1011, 1021 (S.D.W.Va. 1994) (setting forth a four-factor test to assist in determining evident partiality: (1) any personal interest, pecuniary or otherwise, the arbitrator has in the proceeding; (2) the directness of the relationship between the arbitrator and the party he is alleged to favor; (3) the connection of the relationship to the arbitration; and (4) the proximity in time between the relationship and the arbitration proceeding).

A more difficult situation is presented when there are disclosures of a relationship or conflict circumstance, but those disclosures are later discovered to be incomplete or understated. The issue then becomes one of inquiry notice and constructive knowledge. Several courts have held that where a party has only constructive knowledge of an arbitrator's potential conflicts, the losing party's failure to object to the arbitrator before an award is issued will not waive that party's right to seek vacatur on the grounds of evident partiality unless it is shown that the facts being argued to support vacatur were known at the time the grievance was submitted. See, e.g., *Apperson v. Fleet Carrier Corp.*, 879 F.2d 1344, 1359 (6th Cir. 1989); *Early v. Eastern Transfer*, 699 F.2d 552, 558 (1st Cir. 1983). Other courts have invoked the waiver principle, finding that the complaining party was put on inquiry notice and (1) should have known of the facts indicating partiality of an arbitrator, and (2) should have raised an objection prior to the arbitration decision being rendered. See, e.g., *JCI Communications, Inc. v. Int'l Brotherhood of Electrical Workers, Etc.*, 324 F.3d 42, 52 (1st Cir. 2003); *Kiernan v. Piper Jaffray Cos., Inc.* 137 F.3d 588, 593 (9th Cir. 1998); *Fidelity Federal Bank v. Durga Ma Corp.*, 386 F.3d 1306, 1313 (9th Cir. 2004). In these cases, the challenging party's failure to object to the arbitrator until after the award was issued, was deemed a waiver of that party's right to challenge the award based on evident partiality. As one court explained, the application of the waiver doctrine is consistent with the court's policies favoring the finality of arbitration awards and the speedy and cost-effective resolution of disputes. See *Fidelity Federal Bank v. Durga Ma Corp.*, supra, 386 F.3d at 1313.

(b) *"Evident Partiality" in the Context of Nondisclosure*

The FAA does not specifically address the matter of what disclosures an arbitrator must make prior to his or her appointment. It is only after an award has been issued, if a party moves to vacate the award on the grounds of alleged bias by the arbitrator, that the court examines whether the arbitrator had existing or pre-existing relationships or other conflicts that should have been disclosed, and whether the award must be set aside due to the taint of bias. See, e.g., *Michael v. Mariforum Shipping, S.A.*, 624 F.2d 411, 414 n. 4 (2d Cir. 1980) ("[I]t is well established that a district court cannot entertain an attack upon the qualifications or partiality of arbitrators until after the conclusion of the arbitration and the rendition of an award."); accord *Gulf Guaranty Life Ins. Co. v. Connecticut General Life Ins. Co.*, 304 F.3d 476, 490 (5th Cir. 2002).

A recent Ninth Circuit decision has left open for discussion whether there might be extreme circumstances warranting midstream judicial intervention to remove an arbitrator for evident partiality prior to that arbitrator's issuance of a final award. See, *In re Sussex*, 781 F.3d 1065 (9th Cir. 2015), cert. denied, 136 S.Ct. 156 (2015). The undisclosed facts prompting the charge of evident partiality concerned the arbitrator's efforts to start a company to attract investors for litigation financing because the claimants and their counsel were the arbitrator's target market. The district court concluded that these facts qualified as a circumstance that would taint any award he might later make, and that it made no sense to require the parties to proceed through the arbitration to final award, only to have to go through the whole process again if the arbitrator was then disqualified; that that course would only promote delay and waste in time and resources. *Sussex v. Turnberry/MGM Grand Towers, LLC,* No. 2:08-cv-00773. 2013 WL 6895845, *3 (D.Nev. Dec. 31, 2013).[9] The Ninth Circuit disagreed with the district court that midstream intervention was warranted because it concluded that the trial court had *misapplied* the legal standard for "evident partiality." [T]he financial relationship in this case is contingent, attenuated, and merely potential (citations) and would not give a court grounds to vacate an award for evident partiality." 776 F.3d at 1101. *Importantly, the Ninth Circuit did <u>not</u> take issue with the district court's midstream intervention – just the standard it had applied for determining the arbitrator's "evident partiality"!*

On its face, "evident partiality" conveys a stern standard. Partiality means bias, while "evident" is defined as "clear to the vision or understanding" and is synonymous with manifest, obvious, and apparent. See *Webster's Ninth New Collegiate Dictionary* 430 (1985); 9 U.S.C. § 10(a)(2). Although linguistically facile, in application the phrase "evident partiality" has proven problematic for the courts, especially when the question involves an arbitrator's failure to disclose existing or prior relationships, dealings or conflicting

[9] On the issue of stepping in pre-award, the district court noted that while Section 10(a)(2) of the FAA does not expressly address a district court's ability to remove an arbitrator for evident partiality prior to the entry of a final award, it felt that the Ninth Circuit in *Aerojet-General Corp. v. American Arbitration Ass'n*, 478 F.2d 248 (9th Cir. 1973) had left open the possibility that a district court could consider such pre-award challenges in "extreme cases."

interests. In its only decision to date interpreting the "evident partiality" standard in the nondisclosure context, the Supreme Court in *Commonwealth Coatings v. Continental Casualty Co.*, 393 U.S. 145 (1968), attempted to provide guidance on this critical issue. However, the result of that decision has invited disagreement among the circuits, and has resulted in anything but clarity with respect to what types of relationships mandate disclosure and disqualification.

In *Commonwealth,* the arbitrator was a leading and respected consulting engineer who had performed services for most of the prime contractors in Puerto Rico, where the project and dispute were venued. The arbitrator was well known to the subcontractor's counsel and they were personal friends. While the subcontractor's counsel knew the arbitrator and knew of his reputation and business ties in the community, he was not aware of the fact that the arbitrator had performed services for the prime contractor whose bond was in issue, and that fact was not made known to claimant by the arbitrator or anyone else until after the award had been made. When the award came out against the subcontractor and in favor of the contractor, the subcontractor complained that the arbitrator's undisclosed, past business relationship with the prime contractor created an impression of bias. The district court refused to set aside the award because there was no charge that the arbitrator was guilty of actual bias in deciding the case. The court of appeal affirmed.

On further review by the United States Supreme Court, the confirmation of the award was reversed and the award vacated because the arbitrator's past business relationships created an impression of possible bias. The Justices who decided *Commonwealth* expressed two different views on the ethical standard governing arbitrator disclosures. Those views were – literally – Black and White. Justice Black, writing for the plurality, appeared to impose upon arbitrators the same lofty ethical standards required of Article III judges, suggesting that "we should, if anything, be even more scrupulous to safeguard the impartiality of arbitrators than judges, since the former have completely free rein to decide the law as well as the facts and are not subject to appellate review." 393 U.S. at 149. Using language that has since been seized upon by unsuccessful parties to arbitration, Justice Black concluded by writing that arbitrators, like judges, must avoid even the "appearance of bias." Id. In Justice Black's view, "evident partiality" in the FAA meant that an arbitrator must not only be unbiased, but must also avoid the appearance of possible bias. Id. at 150.

Justice White, joined by Justice Marshall, stated that he was "glad to join" Justice Black, and wrote additional remarks, emphasizing that the Court was not deciding that arbitrators are to be held to the same standards as Article III judges. Id. ("The Court does not decide today that arbitrators are to be held to the standards of judicial decorum of Article III judges, or indeed of any judges.") According to Justice White, because arbitrators are "men of affairs, not apart from, but of, the marketplace," they should not be "automatically disqualified by a business relationship with the parties before them." Id. For Justice White, such relationships are acceptable so long as the parties "are informed of the relationship in advance, or if they are unaware of the facts but the relationship is trivial." Id. Justice White's concurrence required arbitrators to disclose only those relationships that would lead a "reasonable person [to] … conclude that an arbitrator was partial," but offered no

guidance with respect to what types of relationships will be deemed significant versus trivial for purposes of defining where an arbitrator's disclosure obligation begins and where it leaves off. Justice White's opinion fully envisions upholding awards when arbitrators fail to disclose insubstantial relationships, offering that "where the arbitrator has a substantial interest in a firm which has done more than trivial business with a party, that fact must be disclosed," but an arbitrator "cannot be expected to provide the parties with his complete and unexpurgated business biography." Id. at 151-152.

Because there was no majority opinion in *Commonwealth*, some federal circuits have taken the position that the vote of Justice White or Justice Marshall was necessary for the formation of a majority for reversal. Because Justices White and Marshall concurred with reasoning on grounds slightly different from that set forth in the plurality opinion written by Justice Black, the resulting decision is a "plurality" opinion, leaving it to the circuits to pick between the two expressed views. See, e.g., *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 681 (7th Cir. 1983), cert denied, 464 U.S. 1009, as amended, 728 F.2d 943 (1984) (noting that *Commonwealth* "provides little guidance because of the inability of a majority of the Justices to agree on anything but the result"); *Morelite Const'n Corp. v. New York City Dist. Council, Etc.*, 748 F.2d 79, 83 n. 3 (2d Cir. 1984) ("Because the two opinions are impossible to reconcile, however, we must narrow the holding to that subscribed by both Justices White and Black"); *ANR Coal Co., Inc. v. Cogentrix of North Carolina, Inc.*, 173 F.3d 493, 499-500 (4th Cir. 1999) (noting that courts have given Justice White's concurrent particular weight); *Nationwide Mutual Ins. Co. v. Home Ins. Co.*, 429 F.3d 640, 644 n.5 (6th Cir. 2005). This has led some commentators and courts to refer to a "split among the circuits," and to refer to a "majority" view (Justice White) or a "minority" view (Justice Black) when applying *Commonwealth* to determine whether "evident partiality" exists on the part of the arbitrator so as to warrant vacatur of his or her award. See, e.g., *Montez v. Prudential Securities, Inc.*, 260 F.3d 980, 983 (8th Cir. 2001); Howard S. Suskin & Suzanne J. Prysak, "New Developments on the Standard for Finding "Evident Partiality" (2006) https://jenner.comhttps://jenner.com/system/assets/publications/7677/original/Bloomberg_Law_Reports_Securities_Arbitration.pdf?1323206353; Susan A. Stone & Jen C. Won, "Arbitrator Impartiality in the Context of a Tripartite Tribunal" (2013) http://www.americanbar.org/content/dam/aba/administrative/litigation/materials/2013_corporate_counselcleseminar/9_2_arbitration_impartiality_in_context.authcheckdam.pdf.

What has been described as the "majority" view is that which is attributed to Justice White's concurring opinion. The courts applying this standard have followed Justice White's reasoning that arbitrators are not subject to the same standards of impartiality as Article III judges. Finding the standard of "appearance of bias" too low and proof of "actual bias" too high, these courts have held that "evident partiality" within the meaning of Section 10 of the FAA will be found where "a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration." See *Applied Industrial Materials Corp. v. Ovalar Makin Ticaret Ve Sanayi, A.S.*, 492 F.3d 132, 137 (2d Cir. 2007), quoting *Morelite Const'n Corp. v. New York City Dist. Council, Etc.*, supra, 748 F.2d at 84. Unlike a judge, who can be disqualified "in any proceeding in which his impartiality *might* reasonably be questioned," *Apple v. Jewish Hospital & Medical Center*, 829 F.2d 326, 332-

333 (2d Cir. 1987), an arbitrator is disqualified only when a reasonable person, considering all of the circumstances, "would *have* to conclude" that an arbitrator was partial to one side. *Morelite Const'n Corp. v. New York City Dist. Council, Etc.*, supra;; see also *Gianelli Money Purchase Plan & Trust v. ADM Investor Services, Inc.*, 146 F.3d 1309, 1312 (11th Cir. 1998); *Olson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 51 F.3d 157, 159 (8th Cir. 1995); *ANR Coal Co. v. Cogentrix of North Carolina, Inc.*, supra, 173 F.3d at 500; *Gianelli Money Purchase Plan & Trust v. ADM Investor Services, Inc.*, 173 F.3d 493 (4th Cir. 1999). The courts that apply this standard sometimes talk about the need for evidence of bias or interest that is direct, definite and capable of demonstration, rather than remote, uncertain or speculative. See, e.g., *Ormsbee Development Co. v. Grace*, 668 F.2d 1140, 1147 (10th Cir. 1982); *Consolidation Coal Co. v. Local 1643, Etc.*, 48 F.3d 125, 129 (4th Cir. 1995); *Andersons, Inc. v. Horton Farms, Inc.*, 166 F.3d 308, 329 (6th Cir. 1998).

In contrast, the Ninth Circuit has adopted the "appearance of bias" standard, which has been attributed to Justice Black's plurality opinion, and has held that "evident partiality" exists when "undisclosed facts show a reasonable impression of partiality." See, e.g., *Schmitz v. Zilveti*, 20 F.3d 1043, 1046 (9th Cir. 1994); *Middlesex Mutual Ins. Co. v. Levine*, 675 F.2d 1197, 1201 (11th Cir. 1982). In applying this standard, the courts sometimes talk about "evident partiality" being established by the circumstance where an arbitrator fails to disclose relationships or dealings that "might create an impression of possible bias." See, e.g., *Crow Const'n v. Jeffrey M. Brown Associates, Inc.*, 264 F.Supp. 2d 217, 220 (E.D.Pa. 1003) ("evident partiality" established when an arbitrator failed to disclose "any dealings that might create an impression of possible bias."). The focus here is on the fact of nondisclosure and the perceived relationship between that which was not disclosed and the particulars of or parties to the arbitration. As demonstrated by the cases discussed in Sections (c) and (d), below, in application, this standard also looks for something of significance about an existing or prior relationship that has not been disclosed before a finding of "evident partiality" will be made.

The difference between what qualifies as "evident partiality" under the "reasonable person" standard, as distinguished from the "appearance of bias" standard, is difficult to articulate. Indeed, one court has commented that "it is difficult to extract from the cases [applying *Commonwealth*] more than a mood," and the mood "is one of reluctance to set aside arbitration awards for failure of the arbitrator to disclose a relationship with a party. *Merit Ins. Co. v. Leatherby Ins. Co.*, supra, 714 F.2d at 682. *Commonwealth* reflects the ideal that arbitration functions best when arbitrators do not have an apparent reason to be partial to a given party. There is no clear consensus among the federal circuits on what constitutes "evident partiality" for purposes of vacating an arbitration award, except perhaps with regard to there being greater tolerance for relationships and overlapping engagements for party-appointed, as opposed to neutral, arbitrators. Rather, on a fact driven basis, the courts have fashioned similar, yet different, tests for analyzing whether an arbitrator's relationships or other interests are sufficient to support vacatur on the grounds of "evident partiality."

(c) *Notable Historical Cases Granting Vacatur Based Upon Nondisclosure*

Regardless of which standard is applied, it is the rare case where a challenge to an award based upon "evident partiality" is successful. As demonstrated by the cases discussed in this section, where vacatur is granted, most would agree that either test could have been applied to reach the same result. As a result, there is some guidance at the extreme outer edges with regard to disclosures arbitrators should make so as to give parties an opportunity to object before they render a decision, but there is no clear guidance for arbitrators operating under the FAA with regard to what types of existing or prior relationships constitute "conflicts" requiring disclosure and / or investigation by the arbitrator. The following are a few notable case examples.

Schmitz v. Zilveti, 20 F.3d 1043 (9th Cir. 1994) - This is a nondisclosure case involving an arbitrator who had no actual knowledge of the fact that his law firm had represented the parent company of a party "in at least nineteen cases during a period of 35 years" with the most recent representation ending less than two years before the arbitration was submitted. The Ninth Circuit held that an arbitrator's failure to investigate potential conflicts of interest may result in a "reasonable impression of partiality" under *Commonwealth.* In reaching its holding, the Court rejected the argument that the arbitrator's lack of knowledge precluded a finding of evident partiality. Based on *Commonwealth*, the Ninth Circuit concluded that the legal standard for evident partiality is whether there are "facts showing a 'reasonable impression of partiality.'" Id. at 1048. The Court explained that this legal standard can be satisfied even where an arbitrator is unaware of the facts showing a reasonable impression of bias because an arbitrator "may have a duty to investigate independent of [his] … duty to disclose." Id. Under the NASD Code, the arbitrator had a duty to investigate. Because an actual conflict relationship existed due to the arbitrator's firm's representation of the parent company of a party, the court found that the arbitrator had violated his duty to investigate under the NASD Code, and that the resulting nondisclosure created a reasonable impression of partiality to support vacatur for "evident partiality" under Section 10 of the FAA. Id.

Olson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 51 F.3d 157 (8th Cir. 1995) - The Eighth Circuit reversed the district court's order confirming an arbitration award because the arbitrator had failed to disclose his job title and the fact that his employer had ongoing business relationships with one of the parties. The arbitrator disclosed only that he was employed by a securities firm. He did not disclose that his firm did a substantial amount of business with Merrill Lynch in which they were co-underwriters on numerous bond issues. Because his firm had more than a trivial business relationship with a party and because the arbitrator was viewed as having a substantial interest in his firm by virtue of his high ranking officer positions (e.g., chief financial officer, compliance officer and vice president), the court concluded that these were matters that the arbitrator had a duty to disclose. Id. at 159. The nondisclosure of what amounted to a significant business relationship with a party to the arbitration was deemed a sufficient basis to find evident partiality warranting vacatur of the award. The Eighth Circuit noted that while there is some uncertainty among

the circuits as to whether the Justice White opinion in *Commonwealth* provides for a narrower standard than that presented in the majority opinion written by Justice Black, the court said that it did not need to sort out this uncertainty to decide the present case; that evident partiality was established under either view. Id.

Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S., 492 F.3d 132 (2d Cir. 2007) - The Second Circuit held that an arbitration award should be vacated for evident partiality where one of three arbitrators who was the chairperson, president and CEO of a "multi-billion dollar company with 50 offices in 30 countries" failed to either investigate what he knew to be a potential business relationship between his company and the parent company of a party to the arbitration or to inform the parties that he had erected a Chinese Wall that prevented him from learning more. Id. at 134-135. The court began with the proposition that where an arbitrator knows of a material relationship with a party and fails to disclose it, "[a] reasonable person would have to conclude that the arbitrator was evidently partial." Id. at 137. That "material" relationship in this case was a commercial relationship that existed between the arbitrator's company and the parent of Applied Industrial that had generated approximately $275,000 in revenue for the arbitrator's company. Id. at 135. Quoting from Justice White's opinion in which he stated that arbitrators are not automatically disqualified by an undisclosed business relationship if the relationship is "trivial," the court ruled that where an arbitrator has reason to believe that a nontrivial conflict of interest might exist, the arbitrator must either investigate the circumstance or disclose his or her decision to not investigate. Id. at 138. In this case, the arbitrator confirmed that he had been informed that one branch of his company was negotiating with one of Applied Industrial's subsidiaries to enter into a business relationship. The court found that at this moment in time, the arbitrator "knew, at a minimum, that a potential conflict existed." Id. The court held that the arbitrator's decision to not investigate and his concomitant failure to so inform the parties that he had erected a so-called "Chinese Wall," was sufficient to establish evident partiality for purposes of vacating the arbitrator's award.

HSMV Corp. v. ADI Ltd., 72 F.Supp. 2d 1122 (C.D.Cal. 1999) - The arbitrator's law firm represented the parent company of a party to the arbitration. That attorney-client relationship began prior to the arbitration and continued during the proceeding. The court found that the arbitrator, as a lawyer, had a duty to investigate whether a conflict relationship might exist prior to accepting his engagement as the sole "neutral" arbitrator in this dispute. Id. at 1129. Citing the Ninth Circuit's decision in *Schmitz*, the court noted that precedent had been established to the effect that an arbitrator who is also a lawyer may have an independent duty to investigate possible conflicts and, failing to do so, opens the door to vacatur of any award he or she renders if such an undisclosed relationship is later revealed that could have been discovered by a simple conflicts check.[10] Id. at 1129-1130.

[10] The *Schmitz* court cited *Close v. Motorists Mutual Ins. Co.*, 21 Ohio App. 3d 228, 486 N.E.2d 1275 (1985) as an example of a case where "the parties can expect a lawyer/arbitrator to investigate and disclose conflict." 20 F.3d at 1048. In *Close*, the Ohio Court of Appeals vacated an arbitration award on the ground that evident partiality existed where the lawyer/arbitrator failed to disclose his law firm's ongoing representation of one

New Regency Productions, Inc. v. Nippon Herald Films, Inc., 501 F.3d 1101 (9th Cir. 2007) - The arbitrator made a number of disclosures to the parties who had jointly selected him: e.g., that he had previously arbitrated a case where one of the parties' counsel had represented a party; that he had negotiated deals with various executives of New Regency before they became executives at New Regency; and that he expected to be called as a witness in an unrelated litigation matter where an attorney from the firm representing Nippon Herald in the current arbitration was representing a party. What the arbitrator did not disclose was the fact that during the course of the arbitration, he was recruited and accepted a high-level executive position with a film company that "[was doing] more than trivial business closely connected to a party to the arbitration." Id. at 1107. As it did in *Schmitz v. Zilveti*, 20 F.3d 1043 (9th Cir. 1994), the Ninth Circuit again rejected the argument that evident partiality could not be established if the arbitrator does not have actual knowledge of the facts he or she failed to disclose. "[L]ack of knowledge of actual knowledge of the presence of a conflict does not excuse non-disclosure where the arbitrator had a duty to investigate, and thus had constructive knowledge of, the conflict." Id., citing *Schmitz*, 20 F.3d at 1048. In this case, the court reasoned that the arbitrator had a duty to investigate because "the parties could reasonably have expected [him] to investigate potential conflicts when, during the pendency of the arbitration, he took a job, the duties of which included overseeing the legal department of another film company." Id. at 1109. The court held that the arbitrator's decision to accept a high-level executive position a company in the same industry as the parties to the arbitration was precisely the type of situation where an arbitrator should have reason to investigate to determine the existence of potential conflicts requiring disclosure to the parties. Id. at 1109, citing *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S.*, 492 F.3d 132 (2d Cir. 2007).

Thomas Kincaid Company v. White, 711 F.3d 719 (6th Cir. 2010) - The court was presented with strategic gamesmanship gone awry. Against the backdrop of a tortured set of facts representing the penultimate in gamesmanship aimed at currying the arbitrator's favor, the serious issue of "evident partiality" was missed by both the arbitrator and the provider organization, and thus had to be corrected by the courts. The case involved a dispute between the Thomas Kinkade Company and one of its dealers. The company claimed that the dealers had not paid for artwork worth hundreds of thousands of dollars, and the dealers counterclaimed that they had been fraudulently induced to enter into the dealer agreements with the company. The entire case is worth a read because, as noted by the Sixth Circuit, it presents "a model of how not to conduct [an arbitration]." Id. at 720. After nearly 5 years and 50 days of hearing (with the arbitration still not complete), the dealers and persons associated with the dealers began showering the arbitrator's law firm with new business directed to various of the arbitrator's partners on matters where the fees for the engagements were expected to be substantial. The arbitrator disclosed the fact

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of the parties. The court was not persuaded that there could be no evident partiality where the arbitrator had no knowledge of the conflict, noting that lawyers routinely conduct conflicts checks as part of the process of taking on new clients. The *Close* court held that "the same duty is owed to the parties to an arbitration." 21 Ohio App. 3d at 230.

of these engagements to the parties. Not surprisingly, in response, the Thomas Kinkade Company objected to these concurrent engagements in a letter directed to the provider organization (the AAA). The arbitrator was re-confirmed after his partner declined one representation and the partner on the other representation left the firm. The Thomas Kinkade Company renewed its request for disqualification, which both the provider and the arbitrator denied. The arbitrator then proceeded to continue with the arbitration in a manner that allowed the dealers several opportunities to correct errors and put documents into evidence they had failed to exchange as ordered. At the end of the arbitration, the arbitrator issued a $1.4 million award in favor the dealers. The Thomas Kinkade Company then petitioned the district court for vacatur under Section 10(a)(2) of the FAA, which the court granted and the Sixth Circuit affirmed.

The Sixth Circuit held that the Thomas Kinkade Company had established "a convergence of undisputed facts that, considered together, show a motive for [the arbitrator] to favor the [dealers] and multiple concrete actions in which he appeared actually to favor them. To begin with the motive: nearly five years into this arbitration, and in the space of eight weeks, the purportedly neutral arbitrator's law firm – of all the law firms that practice commercial litigation in Michigan – was hired by one party's arbitrator-advocate . . . and then again by that same party . . . for engagements that by all appearances would be substantial." Id. at 724. On the issue of the arbitrator's disclosure of the engagements to the parties, the Sixth Circuit noted that "'[w]hen the neutral arbitrator engages in or attempts to engage in mid-arbitration business relationships with non-neutral participants, it jeopardizes what is supposed to be a party-structured dispute resolution process." Id. What also appears to have swayed the Sixth Circuit was the "dilemma" the arbitrator's mid-arbitration disclosures created for the Thomas Kinkade Company because it was forced to raise the issue of arbitrator bias to the arbitrator during the course of evidentiary proceedings. The Sixth Circuit concluded that a party who has paid a neutral arbitrator to prepare for and sit through nearly 50 days of hearings over a five-year period, "deserve[d] better treatment than this." Id. at 724-725.

(d) *Notable Historical Cases Denying Vacatur Despite Missing or Incomplete Disclosures*

When courts deny vacatur, they usually do so after conducting their own case-by-case factual analysis to determine whether an undisclosed relationship rises to the level of a conflict sufficient to create an impression of possible bias. While the cases purport to be applying the Justice White or the Justice Black standard as set forth in the *Commonwealth* decision, it is hard to discern a bright line of demarcation as to what relationships, interests or other conflicts are trivial or unsubstantial and thus do not prompt a duty on the part of the arbitrator to investigate further or make disclosure to the parties. The following are a few notable case examples.

Sanko S.S. Co. v. Cook Industries, 495 F.2d 1260 (2d Cir. 1978) - At the commencement of arbitration, the arbitrator disclosed that he owned a grain company and had had dealings with one of the parties (also a grain company) "of a spot nature." After the arbitrator ruled

against Sanko, it conducted an investigation and found that in fact the business dealings between the two grain companies were extensive; that while the companies were technically competitors, they arranged "swaps" and "sales" between themselves or their affiliates running into the millions of dollars. The trial court stated that it would forego an evidentiary hearing and accept Sanko's version of contested facts regarding the arbitrator's prior dealings with the opposing party. Nevertheless, the trial court made findings at variance with Sanko's position and concluded that the arbitration award should not be vacated. The Second Circuit reversed and remanded, concluding that an evidentiary hearing was necessary to determine the full extent and nature of the relationships at issue so that the district court would be in a better position to follow the dictates of *Commonwealth*. Id. at 1263.

ANR Coal Co. v. Cogentrix of North Carolina, Inc., 173 F.3d 493 (4th Cir. 1999) - The dispute arose from a coal sales contract between ANR Coal and Cogentrix. Cogentrix purchased coal from ANR, which it used to generate electric power in its North Carolina facility that, in turn, was sold to Carolina Power & Light Co. Ten years prior to the arbitration dispute, the arbitrator was a member of a law firm that merged with the firm representing Cogentrix. That merger lasted only one year and during the time of the merged law firm's operations, the arbitrator was ill with leukemia and not actively practicing law or otherwise involved with the law firm. The arbitrator disclosed the fact of his affiliation with the temporary merged law firm and stated that it was through that affiliation that he was acquainted with Congentrix's counsel in the arbitration. What the arbitrator did not disclose, and what ANR Coal learned after an award was issued in favor of Cogentrix, was that the merged law firm had represented Cogentrix and that certain attorneys at the firm had loaned money to Cogentrix in consideration for stock warrants in the company. Based upon this showing, the district court granted ANR's vacatur petition. On appeal, the Fourth District reversed, finding that ANR had failed to show that the arbitrator had any personal interest in the arbitration or any real connection between the arbitrator and Cogentrix. Applying the Justice White standard in *Commonwealth*, the court found that all of the facts proffered by ANR, alone or taken together, would not permit a reasonable person to assume that the arbitrator was partial to Cogentrix; that the facts demonstrated nothing more than a trivial relationship between the arbitrator and the prevailing party. Id. at 501-502.

Lucent Technologies Inc. v. Tatung Co., 379 F.3d 24 (2d Cir. 2004) - One member of a three-member panel had been a paid patent license expert for Lucent in a matter pending concurrently with the subject arbitration. That same member had shared ownership of an airplane with another arbitrator on the panel from more than a dozen years prior to the arbitration. The first circumstance was disclosed, but Tatung claimed to have not received the disclosure form. The airplane ownership relationship was not disclosed by either arbitrator. After Tatung lost at arbitration, it petitioned for vacatur on the grounds of evident partiality for nondisclosure. With regard to the arbitrator's engagement as an expert witness for Lucent, the court found that the arbitrator had complied with his obligation to make disclosures by completing the AAA form and returning it to the provider; that Tatung knew of the AAA rules requiring disclosure by arbitrators and had

received disclosure forms for the other two arbitrators, so there was no persuasive reason for Tatung to have assumed that the third arbitrator had not submitted a similar form. With regard to the arbitrators' co-ownership of an airplane from 1974 to 1990, the court rejected the notion that *Commonwealth* established a per se rule requiring vacatur of an award whenever any type of undisclosed relationship is discovered. Rather, the court noted that the Supreme Court in *Commonwealth* had directly observed that some "undisclosed relationships … are too insubstantial to warrant vacating the award." Id. at 30, citing *Commonwealth*, 393 U.S. at 152. The court specifically did not decide whether an undisclosed relationship between arbitrators could be cause for vacatur under certain circumstances, but it found that the arbitrators' relationship of co-ownership of a plane more than a decade in the past was simply "too insubstantial to require vacatur." Id. at 31.

Positive Software Solutions, Inc. v. New Century Mortgage Corp., 476 F.3d 278 (5th Cir. 2007) - After losing in the arbitration, Positive Software conducted a detailed investigation of one of the arbitrator's background and discovered that several years earlier he and his former law firm had represented the same party as New Century's counsel in a major patent litigation matter involving Intel and Cyrix. That litigation had involved six different lawsuits in the early 1990's in which Intel was represented by seven law firms and at least 34 lawyers, including the arbitrator and New Century's counsel in the arbitration. Positive then moved the district court for an order vacating the award. That motion was granted based upon the district court's finding that the arbitrator had failed to disclose "a significant prior relationship with New Century's counsel," thus creating an appearance of partiality requiring vacatur.[11] On appeal, and after rehearing en banc, the Fifth Circuit reversed, holding that awarding vacatur "based on a mere appearance of bias for nondisclosure would hold arbitrators to a higher ethical standard than Article III judges." The court went on to note that had the same relationship occurred between an Article III judge and an attorney in a case pending before him or her, "neither disclosure nor disqualification would have been forced or even suggested." Id at 285, citing *Chitimacha Tribe of La. v. Harry L. Laws Co.*, 690 F.2d 1157, 1166 (5th Cir. 1982) (rejecting a finding of judicial bias where the federal judge had represented a party to the case in an unrelated matter at least six years prior). In final analysis, the court concluded that the prior case relationship between the arbitrator and New Century's counsel was trivial, and noted that it had been unable to find a case vacating an arbitration award "for nondisclosure of such a slender connection between the arbitrator and a party's counsel." Id. at 284, citing *Montez v. Prudential Securities, Inc.*, 260 F.3d 980, 982 (8th Cir. 2001); *ANR Coal Co., Inc. v. Cogentrix of N.C., Inc.*, 173 F.3d 493, 495-496 (4th Cir. 1999); *Al-Harbi v. Citibank, N.A.*, 85 F.3d 680, 682 (D.C.Cir. 1996); *Lifecare Int'l, Inc. v. CD Med., Inc.*, 68 F.3d 429, 432-434 (11th Cir. 1995); *Health Services Management Corp. v. Hughes*, 975 F.2d 1253, 1255 (7th Cir. 1992); *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 677 and 680 (7th Cir. 1983); *Ormsbee Dev. Co. v. Grace*, 668 F.2d 1140 1149-1150 (10th Cir. 1982). The court reasoned that requiring vacatur on facts such as those presented in the instant case would result in the loss of expert decision makers acting as arbitrators "because the best lawyers and professionals, who normally have the longest lists of potential connections to disclose, have

[11] *Positive Software Solutions, Inc. v. New Century Mortgage Corp.*, 337 F.Supp. 2d 862, 865 (N.D.Tex. 2004).

no need to risk blemishes on their reputations from post-arbitration lawsuits attacking them as biased." Id.

Lagstein v. Certain Underwriters at Lloyds, London, 607 F.3d 634 (9th Cir.), cert. den., 131 S.Ct. 832 (2010) - The Ninth Circuit narrowly construed an arbitrator's required disclosures to relationships and dealings with the current arbitration participants. In *Lagstein*, a three-arbitrator panel concluded that Lloyds had breached an insurance contract and acted unreasonably with regard to the handling of the insured's claims, but the panel split on the amount of damages to be awarded. The majority concluded that Lagstein (the insured) should be awarded the full value of his policy ($900,000), plus $1.5 Million for emotional distress. The dissenting arbitrator would have awarded Lagstein only $11,000 and would not have awarded emotional distress damages. Subsequent to the initial award, proceedings were held on the request for punitive damages. Again, the majority awarded Lagstein punitive damages in the amount of $4 Million, whereas the dissenting arbitrator argued that the panel lacked jurisdiction and, even if it had jurisdiction, the award should be limited to $50,000. Following the panel's awards, Lloyds investigated the backgrounds of the arbitrators and discovered that the arbitrators forming the majority had been involved in an ethics controversy over a decade earlier. Lloyds then filed a motion to vacate the arbitration award on several grounds, including the arbitrators' failure to disclose their involvement in the prior ethics controversy. The district court granted vacatur, but not on the ground of "evident partiality." On appeal, the district court's vacatur was reversed and remanded with instructions. However, with regard to the "evident partiality" challenge, the Ninth Circuit agreed with the district court that Lloyds had not established the existence of "an inappropriate relationship or contact" between the two arbitrators or a failure to disclose "information that would warrant vacating the award." Id. at 645. To show "evident partiality" in an arbitrator, the court held that the moving party "must establish specific facts indicating actual bias toward or against a party or show that [the arbitrator] failed to disclose to the parties information that creates '[a] reasonable impression of bias.'" Id. at 645-646, citing *Woods v. Saturn*, 78 F.3d at 427. The court held that vacatur of an arbitration award is not required under Section 10(a)(2) of the FAA simply because an arbitrator fails to disclose a matter that might be of some interest to a party. Instead, an arbitrator is required to disclose "only facts indicating that he 'might reasonably be thought biased against one litigant and favorable to another.'" Id. at 646, citing *Commonwealth*, 393 U.S. at 150. Here, the Ninth Circuit found that Lloyds had failed to show any connection between the parties to the present arbitration and any of the majority arbitrator's past difficulties that would give rise to a reasonable impression of partiality toward Lagstein. Indeed, the court found that the majority arbitrator's alleged misconduct occurred more than a decade before the subject arbitration and concerned neither of the parties to the current case. Id., citing *Paine-Webber Group, Inc. v. Zinsmeyer Trusts P'ship*, 187 F.3d 988, 995 (9th Cir. 1999) (characterizing a claim of evident partiality as "border[ing] on frivolous" where there was no alleged relationship between the parties and the arbitrators, and "there [was] no evidence the arbitrators had any financial or personal interest in the outcome of the arbitration").

In re Sussex, 781 F.3d 1065 (9th Cir. 2015), cert. denied, 136 S.Ct. 156 (2015) - Plaintiffs were purchasers of condominium units in a luxury condominium project seeking rescission of their purchase agreements or money damages arising from a wide range of fraud and other claims. Pursuant to the arbitration clause contained in the purchase and sale agreement, the dispute was submitted to arbitration in 2011. At about the same time as his appointment, the arbitrator founded a company that "invests in high-value, high-probability legal claims and litigations." In connection with that business venture, the arbitrator participated as a panelist in a couple of litigation finance and investment seminars and created a website to attract investors to his new firm. The arbitrator did not disclose his litigation finance business venture, but at some point in time the defendants learned of it and asked the AAA to disqualify the arbitrator from further service in the matter. That request was denied. Defendants then petitioned the district court, and that request was granted even though no arbitration award had yet been issued. The district court found that the arbitrator's founding of a company that intends to profit from funding large, potentially profitable litigations of the kind that he was overseeing was likely to give rise to justifiable doubt regarding his impartiality, particularly since he failed to disclose his new pursuit. In this regard, the Court noted that the arbitrator stood to profit from a business that funds plaintiffs in high-value cases such as the one before him; that the business pursuit he failed to disclose was substantial and his failure to disclose it created a reasonable impression of partiality that would likely lead to vacatur of any award he might eventually make.[12] On appeal, the Ninth Circuit reversed, finding that the undisclosed facts regarding the arbitrator's "modest efforts" to start a company to attract investors for litigation financing did not give rise to a reasonable impression that the arbitrator would be partial to either party. The court noted the lack of any relationship between the arbitrator and any party to the dispute, and thus reasoned that the arbitrator's potential ability to profit from a large award in favor of the plaintiffs "can best be described as 'attenuated and insubstantial,'" citing *New Regency Productions, Inc. v. Nippon Herald Films, Inc.*, 501 F.3d 1101, 1110 (9th Cir. 2007).

***Move, Inc. v. Citigroup Global Markets, Inc.*,** 840 F.3d 1152 (9th Cir. 2016) – This case is discussed in further detail at pages 148-149, below, but deserves a mention here because the nondisclosure facts are so extreme. Online real estate company Move Inc. sued Citigroup Global Markets, Inc. for mismanagement of $131 million of its funds that were invested in speculative auction rate securities. While there was a "Client Agreement" between Move Inc. and Citigroup that contained an arbitration clause covering "all claims or controversies," before initiating the FINRA arbitration proceedings, FINRA required Move Inc. and Citigroup to sign a submission agreement. The matter then proceeded to arbitration, and FINRA provided the parties with a list of 30 proposed arbitrators and their employment histories, including ten proposed arbitrators from FINRA's chairperson roster. Because the dispute involved a complex securities issue, it was important to Move Inc. that the chairperson be an experienced attorney. Move, Inc. ranked "James H. Frank" first who, according to the FINRA arbitrator disclosure report, was a licensed attorney in California,

[12] See *Sussex v. Turnberry/MGM Grand Towers, LLC*, 2:08-cv-00773, 2013 WL 6895845 (D.Nev. Dec. 31, 2013) (Slip Opinion).

New York and Florida. According to his bio, Mr. Frank had sat on 50 panels during the course of his 15 years as a FINRA arbitrator. This latter information was true, but Mr. Frank was not and never had been an attorney licensed to practice in any state and his purported experience as a securities attorney was a total and complete fabrication. The falsity of this information did not come to light until several years after the issuance of an award – long after the three-month deadline for seeking vacatur under Section 12 of the FAA. As discussed below, the Ninth Circuit squarely decided that the FAA is subject to the established doctrine of equitable tolling so as to allow the court to step in an order vacatur of the award issued in this case.

(e) 2017 Cases re Incomplete or Missing Disclosures Under the FAA

No cases to report.

3. Arbitrator Disclosures and Disqualification Under California Law

(a) *California's Ethics Standards for Neutral Arbitrators Serving in Commercial Arbitrations*

As has been true with many other aspects of arbitration, California's approach to arbitrator disclosures and disqualification differs markedly from how those matters are handled under the FAA. Commercial arbitrators serving as neutral arbitrators are required to make a number of advance disclosures and must recuse themselves if any party timely objects after receipt of the arbitrator's disclosures. Standard 6 of California's Ethics Standards for Neutral Arbitrators in Contractual Arbitration (the "Ethics Rules") squarely places the responsibility on the arbitrator to assess his or her ability to be impartial and to decline an appointment if he or she is unable to be so "notwithstanding any contrary request, consent or waiver by the parties." The Ethics Rules are found at the end of the California Rules of Court and are incorporated by reference into the California Arbitration Act at Sections 1281.85(a) and 1281.9(a)(1) of the California Code of Civil Procedure.

As a matter of common law, California courts historically held that arbitration awards shall be vacated if it is shown that the arbitrator failed to disclose facts creating a reasonable impression of possible bias. See *Britz v. Alfa-Laval Food & Dairy Co.*, 34 Cal. App. 4th 1085 (1995); *Betz v. Pankow*, 31 Cal. App. 4th 1503 (1995). As a matter of statute, neutral arbitrators are required to disclose "all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial." Cal. Code of Civ. Proc. § 1281.9(a). Included within those disclosure obligations are six specific disclosures concerning relationships the arbitrator or any member of his or her immediate family has or had with any party or lawyer for a party in the current arbitration proceeding.

- Whether the arbitrator has a current arrangement concerning prospective employment or other compensated service as a dispute resolution neutral with any party or attorney to the current matter. Cal. Code of Civ. Proc. § 1281.9(a)(1).

- Whether the arbitrator is, or within the last two years has, participated in discussions regarding prospective employment or other compensated service with any party or attorney to the current matter. Cal. Code of Civ. Proc. § 1281.9(a)(1).

- Whether the arbitrator is serving or has previously served as a party-appointed arbitrator for any party. Cal. Code of Civ. Proc. § 1281.9(a)(3).

- Whether the arbitrator is serving or has previously served as a neutral arbitrator for any party. Cal. Code of Civ. Proc. § 1281.9(a)(4).
- Whether the arbitrator has or had an attorney-client relationship with any party or lawyer for a party in the current matter. Cal. Code of Civ. Proc. § 1281.9(a)(5).

- Whether the arbitrator or any member of his immediate family has or had any professional or significant personal relationship with any party or lawyer for a party in the current matter. Cal. Code of Civ. Proc. § 1281.9(a)(6).

An even more detailed and extensive list of required disclosures is contained in Standard 7 of the Ethics Rules. Among other matters, the Ethics Rules require disclosure generally of (1) any matter that might cause a person aware of the facts to reasonably entertain a doubt that the arbitrator would be able to be impartial and, more specifically, (2) any interest that could be substantially affected by the outcome of the arbitration." Ethics Rules, Standards 7(d)(14) and (d)(11).

The Ethics Standards provide that arbitrators have an obligation to inform themselves about matters that need to be disclosed, Ethics Rules, Standard 9(a), and that an arbitrator's duty of disclosure is a continuing duty. Ethics Rules, Standard 7(f).Thus, if something arises in the course of an arbitration that triggers a need to make a supplemental disclosure, the arbitrator must disclose the added information within 10 calendar days and parties have 15 calendar days after the disclosure within which to disqualify the arbitrator. Ethics Rules, Standard 10(a)(3).[13]

[13] Due to the peremptory nature of the parties' disqualification rights under the California Arbitration Act and Ethics Standards, midstream disclosures should be carefully considered. The cases have made clear that relationships that are trivial scope or remote in time do not quality as significant personal or professional relationships requiring disclosure. With regard to midstream disclosures, there is the counter-balance need to protect the integrity of the process, and that includes not opening up the process unnecessarily to

Disqualification based on disclosures is an absolute right of the parties, and can occur at the outset of the process or at any time during the process if new disclosures are provided by the arbitrator. See, *Azteca Construction, Inc. v. ADR Consulting, Inc.*, 121 Cal. App. 4th 1156, 1163 (2005); *Ovitz v. Schulman*, 133 Cal. App. 4th 830, 840 (2005). In this regard, parties not only have an absolute right to disqualify an arbitrator for failing to serve a disclosure statement as required, but nondisclosure also grants an objecting party the absolute right to have an arbitration award vacated without a showing of actual bias or evident partiality. Id. It is the simple fact of the failed disclosure or the failure of the arbitrator to recuse himself or herself after receipt of a timely objection after making disclosures that serves as grounds for vacatur. Cal. Code Civ. Proc. § 1286.2(a)(6). Under Section 1281.9(b) of the California Code of Civil Procedure, disqualification is mandatory; operates as a peremptory challenge; and takes effect when a party timely serves a notice of disqualification.

Under Section 1281.91(b), there is no limit on the number of times a party may challenge a proposed arbitrator. For the recalcitrant party trying to avoid binding arbitration, an obvious tactic would be to serve a notice of disqualification within 15 days of each proposed arbitrator's disclosures. The only way to limit the number of peremptory challenges a party may assert is by seeking court intervention via a motion that asks the court to appoint the arbitrator as provided by Code of Civil Procedure section 1281.91. Section 1281.91(a)(2) then provides that a party shall have the right to disqualify one court-appointed arbitrator without cause in any single arbitration and, beyond that, may petition the court to disqualify a subsequent appointee "only upon a showing of cause."

Code of Civil Procedure section 1286.2 provides the "strong-arm" mechanism for enforcing arbitrator disclosures – namely, vacatur. As amended, Section 1286.2 mandates that a court "shall" vacate an arbitration award if the arbitrator making the award (a) failed to disclose a ground for disqualification of which the arbitrator was aware, or (b) was subject to disqualification upon grounds specified in Section 1281.9 but failed to disqualify himself or herself after receipt of a timely notice of disqualification. At least one court has commented that, on its face, "the statute leaves no room for discretion. If a statutory ground vacating an award exists, the trial court must vacate the award." See, *Ovitz v. Schulman*, 133 Cal. App. 4th 830, 845; accord, *International Alliance of Theatrical Stage Employees, etc. v. Laughton*, 118 Cal. App. 4th 1380, 1386 (2004).

Despite the breadth and detail of the Ethics Rules, the California Supreme Court has previously made clear that the statutory disclosure requirements are intended to ensure the impartiality of the arbitrator, not mandate disclosure of "all matters that a party might wish to consider in deciding whether to oppose or accept the selection of an arbitrator." *Haworth v. Superior Court*, 50 Cal. 4th 372, 393 (2010). In this regard, the Supreme Court cautioned against construing the governing standard too broadly. "An impression of possible bias in the arbitration context

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gamesmanship. If an arbitrator makes a midstream disclosure is made, that act suggests that the arbitrator views the relationship or circumstance as carrying some significance and, once made, gives the parties the absolute right to object to his or her appointment and demand that the arbitrator voluntarily recuse himself or herself. The failure to do so will expose any later award to vacatur.

means that one could reasonably form a belief that an arbitrator was biased *for or against a party for a particular reason.*" Id. at 389 (italics in the original). In this regard, one California Court of Appeal has construed the Ethics Rules so that "'ordinary and insubstantial business' arising from participation in the business or legal community do not necessarily require disclosure." *Luce, Forward, Hamilton & Scripps, LLP v. Koch*, 162 Cal. App. 4th 720, 723 (2008), quoting *Guseinov v. Burns*, 145 Cal. App. 4th 944, 959 (2006). As evidenced by the decision of the California Court of Appeal in *Mt. Holyoke Homes, L.P. v. Jeffer Mangels Butler & Mitchell*, 219 Cal. App. 4th 1299 (2013), the issue of what type of relationships require disclosure on penalty of vacatur is still under discussion and development in the courts, and involve similar, fact-driven decisions versus any clear line of demarcation as to what personal or professional relationships rise to the level of being "substantial" or "meaningful" or otherwise provocative for purposes of mandating a disclosure.

(b) Notable Historical Cases re What Does and Does not Constitute a Required Disclosure Under California's Ethics Standards

Azteca Construction, Inc. v. ADR Consulting, Inc., 121 Cal. App. 4th 1156 (2004) – Disqualification based upon an arbitrator's disclosures is an absolute right of the parties and is "essential to ensuring the integrity of the arbitration process." The provisions in the CAA relating to arbitrator disqualification cannot be waived because they were "enacted primarily for a public purpose." Upon objection of a party based upon the arbitrator's disclosures, disqualification is not subject to review or determination by the provider institution or other higher outside authority.

Ovitz v. Schulman, 133 Cal. App. 4th 830, 840 (2005). Under Code of Civil Procedure section 1281.91(b), disqualification is mandatory; operates as a peremptory challenge; and takes effect when a party timely serves a notice of disqualification. The failure of the arbitrator to recuse himself / herself will result in vacatur of any award he / she thereafter makes. "[T]he statute leaves no room for discretion. If a statutory ground vacating an award exists, the trial court must vacate the award."

Guseinov v. Burns, 145 Cal. App. 4th 944 (2006) – The arbitrator having acted as an uncompensated mediator in prior matters where lawyer for a party to the arbitration represented a party unrelated to the current arbitration was insufficient to constitute a professional relationship within the meaning of the statute, and was not a required disclosure.

Hayden v. Superior Court, 150 Cal. App. 4th 360 (2007) – No grounds to vacate the arbitration award for conflict of interest where the alleged conflict relation was the mid-arbitration acquisition of a party to the arbitration by an entity that had previously looked to the arbitrator and his provider organization for private dispute resolution services. The acquisition did not make the acquiring entity a party to the dispute for disclosure or conflict disqualification purposes.

Advantage Medical Services, LLC v. Hoffman*,* 160 Cal. App. 4th 806 (2008) – After claims were referred to arbitration and an interim award for the LLC was issued, the arbitrator was asked to disqualify himself after the founding member of the LLC discovered that the arbitrator was "correspondent counsel" for marine entities who procured reinsurance from the London insurance market association. On petition to the court, the interim award was vacated because the arbitrator had failed to make a required disclosure when counsel for Lloyds of London entered an appearance in the case as the LLC's insurer in the matter. Affirmed.

Dornbirer v. Kaiser Foundation Health Plan, Inc., 160 Cal. App. 4th 831 (2008) - The statutory scheme does not require an arbitration award to be vacated "when the arbitrator has generally disclosed the grounds for disqualification, i.e., his or her relationships and prior interactions with the parties to the arbitration and/or their attorneys, but has not provided all of the specific details required … and despite the omissions, the parties agreed to go forward with the arbitration."

Casden Park La Brea Retail LLC v. Ross Dress for Less, Inc., 162 Cal. App. 4th 468 (2008) – Only significant or substantial business relationships between a neutral arbitrator and a party or its representative must be disclosed to avoid the appearance of impropriety, but ordinary and insubstantial business dealings do not necessarily require disclosure. Arbitrator had no duty to disclose a $500 contribution to the mayoral campaign of one party's arbitrator more than five years before the arbitration. The campaign contribution was ordinary and insubstantial. Arbitrators are not expected to be entirely without business contacts.

Luce, Forward, Hamilton & Scripps LLP v. Koch, 162 Cal. App. 4th 720 (2008) – Under California law, persons serving as neutral arbitrators must disclose "all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial." Cal. Code Civ. Proc. § 1982.9(a). While not exclusive, the statute sets forth six enumerated matters that must be disclosed, including "[a]ny professional or significant personal relationship the proposed neutral arbitrator … has or has had with any party to the arbitration proceeding or lawyer for a party." Cal. Code Civ. Proc. § 1281.9(a)(6). In this case, the Court of Appeal addressed the extent to which disclosure about relationships through professional organizations are legally required or, even if not required, will nevertheless confer upon the parties an automatic right to disqualify a neutral arbitrator once made. At the outset of the case, the neutral arbitrator in this case disclosed that he had previously acted as mediator in three cases where Luce Forward was a party, but that none of the mediations concerned the issues in the present case and the attorneys involved in the present case did not participate in those earlier mediations. Neither party sought to disqualify the arbitrator based upon these disclosures. Later, in the course of preparing for the evidentiary hearing, the arbitrator learned that a Luce Forward partner with whom he had served on the board of the ABTLA was listed as counsel on the opening brief. The arbitrator then supplemented his disclosures to apprise the parties that he had served on the ABTLA board and on the board of the American Inns of Court with the Luce Forward partner whose name appeared on the brief. In response to

these disclosures, Koch moved to disqualify the arbitrator, which motion was denied. The hearing went forward as scheduled, and the arbitrator issued a final award in favor of Luce Forward. Koch then moved to vacate the award on the grounds that the arbitrator was disqualified based on his disclosures, which petition was also denied. The trial court was affirmed on appeal, which concluded that while the neutral's candor was "commendable," he was not legally required to disclose the board service relationships because they did not involve close personal or business relationships or close friendships, but only "slight or attenuated" contacts. The court noted that "arbitrators cannot sever all their ties with the business world" and the same is true of professional obligations involving service to the legal community and the public, continuing education for bar members and mentoring for new lawyers." Also significant was the court's holding that while parties to an arbitration have an unqualified right under the California arbitration statutes to disqualify a neutral arbitrator based upon any disclosure that is required by law, the court refused to interpret these statutes to grant an absolute right of disqualification where a disclosure is not legally required but is instead made out of an abundance of caution or "commendable" candor on the part of the neutral. [Note: The California Supreme Court declined to follow the *Luce Forward* reasoning in *Haworth*.]

Haworth v. Superior Court, 50 Cal. 4th 372 (2010) - Despite the breadth and detail of the Ethics Rules, the California Supreme Court has made clear that the disclosure requirements are intended to ensure the impartiality of the arbitrator, not mandate disclosure of "all matters that a party might wish to consider in deciding whether to oppose or accept the selection of an arbitrator." In this case, the fact that the arbitrator, a retired judge, had disclosed the fact of judicial discipline many years in the past. The Supreme Court cautioned against construing the governing standard too broadly. "An impression of possible bias in the arbitration context means that one could reasonably form a belief that an arbitrator was biased *for or against a party for a particular reason.*"

Rebmann v. Rohde, 196 Cal. App. 4th 1283 (2011) – A judge or arbitrator's impartiality should never be questioned simply because of who they are. Jewish arbitrator did not have a duty to disclose his family background and associations just because one party (the losing party) was of German decent. There was nothing in the arbitrator's professional record that indicated bias toward German's. The arbitrator's background was entirely irrelevant to the commercial dispute before him and the losing party's family background was unknown to the arbitrator at the time of the arbitration.

Gay v. Chiu, 212 Cal. App. 4th 1355 (2013) – Vacatur granted where the arbitrator failed to disclose that one of the attorneys for one of the parties had become associated as a neutral on the arbitrator's provider panel.

Mt. Holyoke Homes, L.P. v. Jeffer Mangels Butler & Mitchell, 219 Cal. App. 4th 1299 (2013) - The Arbitrator's failure to disclose that the managing partner in defendant law firm had been listed as a reference on his resume required vacatur of the award. The connection between the undisclosed fact of the arbitrator's naming an attorney as a reference on his resume and the subject matter of the arbitration, a legal malpractice action against the law

firm in which the same attorney is a party, was sufficiently close that a person reasonably could entertain a doubt that the arbitrator could be impartial. An objective observer reasonably could conclude that an arbitrator listing a prominent litigator as a reference on his resume would be reluctant to rule against the law firm in which that attorney is a party as a defendant in a legal malpractice action. "To entertain a doubt as to whether the arbitrator's interest in maintaining the attorney's high opinion of him could color his judgment in these circumstances is reasonable, is by no means hypersensitive, and requires no reliance on speculation."

United Health Centers v. Superior Court, 229 Cal. App. 4th 63 (2014) - Not every omission of information that is required to be disclosed pursuant to CCP §1281.9 and the Ethics Rules constitutes a ground for disqualification. A party may forfeit his / her ability to vacate an arbitration award if the party had knowledge of the omitted or incomplete disclosures and took no action. In this case, plaintiff – the petitioning party – was charged with knowledge that the arbitrator previously had conducted an arbitration in which plaintiff's attorneys were involved, and yet took no action to either disqualify the arbitrator or request more information. The forfeiture principle set forth in *Dornbirer v. Kaiser Foundation Health Plan, Inc.*, 106 Cal. App. 4th 831 (2008) remains viable.

(c) *2017 Cases re Failed Disclosures Under California Law*

- ***ECC Capital v. Manatt Phelps & Phillips,*** 9 Cal. App. 5th 885 (2d Dist. Mar. 15 2017) – Arbitration award valid despite arbitrator's failure to disclose connection to attorney from defendant law firm prior to UDRP proceeding because the arbitrator was unaware of the connection.

ECC Capital Corporation (ECC) sued Manatt Phelps & Phillips (Manatt) for legal malpractice stemming from an asset purchase agreement ECC had entered into with Bear Stearns. Pursuant to the arbitration provision contained in its engagement with ECC, Manatt successful compelled arbitration of the dispute. The arbitrator issued his interim decision in favor of Manatt and instructed Manatt to submit its application for attorney's fees and costs. Before Manatt filed its application for fees and costs, ECC requested that the arbitrator disqualify himself from the matter, noting that a Manatt attorney had represented a party in a Uniform Domain Name Dispute Resolution Policy (UDRP) proceeding in which the presiding arbitrator had served as a panelist. The arbitrator responded that he was unaware that a Manatt attorney was involved in the prior UDRP; that all of the UDRP arbitrations he handed were uncontested, documents only proceedings in which he has access to a limited set of documents, has no contact or communication with any party's counsel, and frequently does not know the names of the party's representatives or attorneys.[14] Because the arbitrator had no knowledge that a Manatt attorney was

[14] Note: Section 7(d)(4) of the Ethics Standards creates a mandatory disclosure obligation if a neutral arbitrator has served as an arbitrator within the previous 5 years in a matter involving a party or attorney for a party to the current proceeding.

counsel for a party to the prior UDRP proceeding, he did not disqualify himself (and the AAA did not require his disqualification). The arbitrator then proceeded to award Manatt nearly $7 million in fees and costs.

ECC filed a petition to vacate the award on the grounds that the arbitrator had violated his mandatory disclosure obligations, and that was the meaty issue on appeal. The Court of Appeal said "no," because Code of Civil Procedure section 1286.2(a)(6)(A) provides grounds for vacatur where the arbitrator fails to disclose a ground for disqualification "of which the arbitrator was then aware." The court held that constructive knowledge does not suffice. Since the parties did not dispute that at the time of his disclosures, the arbitrator was not aware that a former Manatt attorney had participated in the UDRP matter. For good measure, the court pointed out that as a factual matter, it was not unreasonable for the arbitrator to fail to disclose the UDRP matter because he had participated in hundreds of such desk-arbitration matters and such matters may not even qualify as genuine arbitrations since they typically involve no in-person or telephonic contact, no hearings, no witnesses, and no contact with the panelist.

Comment: Arbitrator disclosure issues tend to lose traction when raised late in the game. Courts like to emphasize that arbitration is final, binding and cost-effective. As stated in Casden Park La Brea Retail LLC v. Ross Dress for Less, Inc., 162 Cal. App. 4th 468 (2009), the Legislature intended "to prevent the undoing of an arbitration award based upon an arbitrator's unknowing failure to disclose information." Interestingly, Casden Park successfully convinced the trial court to vacate an arbitration award on the basis that the arbitrator had failed to disclose prior business relationships. The Court of Appeal reversed, finding that a neutral arbitrator who has no pecuniary interest in profits generated by his employer's business relationship with a party or a party's representative "has no substantial business relationship … and, therefore, no duty to disclose such transactions." Manatt represented Casden Park in that appeal.

4. Class Arbitration and the Status of Waivers and Contract Silence

(a) *Background Statement*

Over the past five or six years, we have looked at a string of major case law developments at both the state and federal levels concerning class arbitration and the enforceability of arbitration agreements in the consumer and employment context where those agreements include provisions limiting employees and consumers to individual arbitration of their claims and waivers of class action rights. What we have seen thus far is the U.S. Supreme Court taking a fairly firm stand in favor of enforcing arbitration agreements, even those waiving class action rights or limiting the parties to individual arbitration of claims, and the California Supreme Court issuing what some have called "pro-employee" and "pro-consumer" decisions by limiting the scope of arbitration to exclude PAGA claims[15] and denying enforcement to arbitration agreements whose provisions include waivers of a

[15] See, *Iskanian v. CLS Transp. Los Angeles LLC*, 59 Cal. 4th 348 (20140, cert. den., 131 S.Ct. 1155 (2015).

consumer's right to seek public injunctive relief on the grounds that such provisions are against California public policy and have nothing to do with arbitration at all.[16]

In 2010, the United States Supreme Court said that consent to class arbitration may not be "read into" agreements covered by the Federal Arbitration Act because requiring class arbitration on a nonconsensual basis would interfere with the Congressional intent behind the Federal Arbitration Act (FAA). *Stolt-Nielsen v. Animal Feeds Int'l Corp.* (2010) 130 S.Ct. 1262 (2010). If an arbitration agreement is silent on whether a class arbitration can be brought under its terms, and there is no evidence that the parties intended to include class actions in the agreement, then a party may not be compelled under the FAA to submit to class arbitration.

In 2011, the Supreme Court expanded on the *Stolt-Nielsen* decision and held that the FAA's overarching purpose is to "ensure the enforcement of arbitration agreements according to their terms." *AT & T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011). The arbitration agreement in that case included a class-action waiver in a consumer contract that required the parties to arbitrate only in their "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding." The arbitration agreement also prohibited the arbitrator from consolidating the claims of more than one person, or from presiding over any form of representative class proceeding. In the lower court proceedings before both the district court and the Ninth Circuit, defendant's motion to compel individual arbitration and stay the class action proceedings was denied based on application of the "Discover Bank Rule" announced by the California Supreme Court in 2005: namely, that when a class action waiver is included in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, such waivers are unconscionable as a matter of law, making the arbitration agreement unenforceable. See, *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 162 (2005). The Supreme Court reversed the Ninth Circuit, finding that because it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress (citation), California's *Discover Bank* rule is preempted by the FAA." 131 S.Ct. 1753.

The majority of federal appeals and district court decisions have followed *Concepcion*. See, e.g., *Cruz v. Cingular Wireless LLC*, 648 F.3d 1205 (11th Cir. 2011) (the FAA preempts a remedial consumer statute on the same grounds that it preempts the *Discover Bank* rule); *Litman v. Cellco Partnership*, 655 F.3d 225 (3rd Cir. 2011) (New Jersey law requiring the availability of class wide arbitration "creates a scheme inconsistent with the FAA" and therefore the district court properly enforced the class arbitration waiver by compelling individual arbitration); *Green v. Super Shuttle Int'l, Inc.*, 653 F.3d 766 (8th Cir. 2011) (in a class action alleging violations of Minnesota's overtime law, the court held that the *Concepcion* decision foreclosed a state law challenge to the enforcement of class action waivers).

[16] See, *McGill v. Citibank*, 2 Cal. 5th 945 (2017).

Up until 2014, there was uncertainty in California with regard to the enforceability of class action waivers in general and with regard to the application of such waiver provisions to "representative actions" brought under California's Private Attorney General Act ("PAGA"). In *Brown v. Ralph's Grocery, Inc.*, 197 Cal. App. 4th 489 (2011), the Second District Court of Appeal held that *Concepcion* did not apply to PAGA claims and suggested that the four-factor test established by *Gentry v. Superior Court*, 42 Cal. 4th 443 (2007) governed that determination.[17] That being said, the *Brown* majority did not reach the issue regarding the invalidity of the class action waiver because it found that the plaintiff had failed to satisfy *Gentry's* four-factor test. On the flip side, several California federal courts have held that *Concepcion* overruled *Gentry*. See, *Steele v. American Mortg. Management Servs.*, 2012 WL 5349511 (E.D.Cal. Oct. 26, 2012); *Sanders v. Swift Transp. Co. of Ariz., LLC*, 834 F.2d 1033 (N.D.Cal. 2012); *Lewis v. UBS Fin. Servs*, 818 F.2d 1161 (N.D.Cal. 2011); *Valle v. Lowe's HIW, Inc.*, 2011 WL 3667441 (N.D.Cal. Aug. 22, 2011); Murphy v. DIRETV, Inc., 2011 WL 3319574 (C.D.Cal. Aug. 2, 2011). And at least two California federal courts have questioned the *Brown* court's holding that the right to bring a PAGA claim cannot be waived in an arbitration agreement. See, *Quevedo v. Macy's, Inc.*, 798 F.Supp. 2d 1122 (C.D.Cal. 2011); *Grabowski v. C.H. Robinson Co.*, 817 F.Supp. 2d 1159 (S.D.Cal. 2011).

In 2014, the California Supreme Court revisited the viability of *Gentry* after *Concepcion* and held that it is no longer good law, thereby eliminating the ability of California courts to invalidate class action waiver provisions contained in employment agreements on what amounted to "public policy" grounds in the labor setting. *Iskanian v. CLS Transp. Los Angeles LLC*, 59 Cal. 4th 348 (2014). While the demise of *Gentry* and *Discover Bank* is a boon to employers wishing to avoid class actions by including class action waivers in their arbitration provisions of their employment agreements, the California Supreme Court specifically held in *Iskanian* that waivers of PAGA claims are <u>not</u> enforceable. While one would think that forbidding the enforcement of PAGA claim waivers would, like prohibiting class action waivers, run up against FAA preemption, the California Supreme Court said otherwise:

> "Simply put, a PAGA claim lies outside the FAA's coverage because it is not a dispute between an employer and an employee arising out of their contractual relationship. It is a dispute between an employer and the state, which alleges directly or through its agents – either the Labor and Workforce Development Agency or aggrieved employees – that the employer has violated the Labor Code."

59 Cal. 4th at 386-387.

[17] *Gentry* directed trial courts to consider four factors in deciding whether to enforce class action waivers in wage and hour cases: "[1] the modest size of the potential individual recovery, [2] the potential retaliation against members of the class, [3] the fact that absent members of the class may be ill informed about their rights, and [4] other real world obstacles to the vindication of class members' right to overtime pay through individual arbitration." *Gentry* then directed trial courts to invalidate class arbitration waivers if they found that a class arbitration was likely to be significantly more effective in vindicating employee rights than an individual arbitration or litigation, and if disallowing class arbitration would likely lead to less comprehensive enforcement of overtime laws.

CLS Transportation petitioned for review by the United States Supreme Court with respect to the determination that PAGA claim waivers remained enforceable in light of the FAA and the holding in *Concepcion*. The legal community expected that certiorari would be granted because, in the months after *Iskanian*, several federal district courts in California issued decisions rejecting *Iskanian*.[18] In essence, these decisions found that while California is entitled to interpret California statutes, such as PAGA, such decisions are not binding on federal courts who, likewise, have jurisdiction to interpret and apply state law. While federal courts typically defer to state supreme court decisions interpreting state laws, that is not what is going on in these decisions. Both state and federal courts were determining whether PAGA is preempted by the FAA (determined by *Southland* to be substantive law), and both were necessarily interpreting federal law to do so. This has resulted in an unusual split of authority because the California Supreme Court is not required to give deference to the federal court decisions, nor are the federal courts required to give deference to the California Supreme Court decision. It was thus a surprise when, on January 20, 2015, the Supreme Court denied certiorari to decide this issue. It was an even greater surprise when, a few months later, the Ninth Circuit issued a reported decision *following* the rule announced by the California Supreme Court in *Iskanian*: namely, that PAGA waivers included in arbitration clauses contained in employment agreements are unenforceable. See, *Sakkab v. Luxottica Retail North America, Inc.*, 803 F.3d 425 (9th Cir. 2015). Before this decision, the federal district courts were disinclined to follow *Iskanian* and instead were applying *Concepcion*.

(b) *Notable Historical Cases*

Discover Bank v. Superior Court, 36 Cal. 4th 148 (2005) – Some class action waivers are unconscionable and thus unenforceable. The "Discover Bank Rule" was rejected by the U.S. Supreme Court in 2011 in *Conception.*

Gentry v. Superior Court, 42 Cal. 4th 443 (2007) – Some class action waivers found in adhesion employment agreements are unenforceable. The "Gentry Rule" was disapproved by the California Supreme Court in 2014 in *Iskanian.*

[18] See, e.g., *Lucero v. Sears Holdings Mgmt. Corp.*, No. 14-cv-1620, 2014 WL 6984220 (S.D.Cal., Dec. 2, 2014); *Mill v. Kmart Corp.*, No. 14-cv-02749, 2014 WL 6706017 (N.D.Cal., Nov. 26, 2014); *Langston v. 20/20 Companies, Inc.*, No. 14-cv-1360, 2014 WL 5335734 (C.D.Cal., Oct 17, 2014) (concluding that the FAA preempts California's rule against arbitration agreements that waive an employee's right to bring representative PAGA claims and that the reasoning in *Iskanian* is inconsistent); *Chico v. Hilton Worldwide, Inc.*, No. 14-cv-5750, 2014 WL 5088240 (C.D.Cal., Oct 7, 2014) (noting that "numerous federal courts have determined that the FAA preempts California's rule prohibiting waiver of representative PAGA claims" and "agree[ing] and adopt[ing] the reasoning of these cases"); *Ortiz v. Hobby Lobby Stores, Inc.*, 52 F.Supp. 3d 1070 (E.D.Cal. 2014) ("It is clear that the majority of federal district courts find that PAGA action waivers are enforceable because a rule stating otherwise is preempted by the FAA and *Conception."); Fardig v. Hobby Lobby Stores*, No. 14-cv-00561, 2014 WL 4782618 (C.D.Cal., Aug. 11, 2014) ("Even in light of *Iskanian*, the Court continues to hold that the ruling making PAGA waivers unenforceable is preempted by the FAA).

Stolt-Nielsen v. Animal Feeds Int'l Corp., 559 U.S. 662 (2010) – Consent to class arbitration may not be "read into" agreements covered by the Federal Arbitration Act because requiring class arbitration on a nonconsensual basis would interfere with the Congressional intent behind the Federal Arbitration Act (FAA). If an arbitration agreement is silent on whether a class arbitration can be brought under its terms, and there is no evidence that the parties intended to include class actions in the agreement, then a party may not be compelled under the FAA to submit to class arbitration.

AT & T Mobility LLC v. Concepcion, 563 U.S. 333 (2011) – The Supreme Court expanded on the *Stolt-Nielsen* decision and held that the FAA's overarching purpose is to "ensure the enforcement of arbitration agreements according to their terms." The arbitration agreement in that case included a class-action waiver in a consumer contract that required the parties to arbitrate only in their "individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding." The arbitration agreement also prohibited the arbitrator from consolidating the claims of more than one person, or from presiding over any form of representative class proceeding. Defendant's motion to compel individual arbitration and stay the class action proceedings was denied based on application of the "Discover Bank Rule" announced by the California Supreme Court in 2005: namely, that when a class action waiver is included in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, such waivers are unconscionable as a matter of law, making the arbitration agreement unenforceable. See, *Discover Bank v. Superior Court* (2005) 36 Cal. 4th 148. The Supreme Court reversed the Ninth Circuit, finding that because it California's *Discover Bank* rule "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," it is preempted by the FAA. (5-4 decision)

Oxford Health Plans v Sutter, 569 U.S. 564 (2013) – In the arbitration, the parties agreed to submit to the arbitrator the issue of whether the parties' contract authorized class arbitration. The arbitrator concluded that it did. Noting that the question turned on "construction of the parties' arbitration agreement," the arbitrator reasoned that the clause sent to arbitration "the same universal class of disputes" that it barred the parties from bringing as civil actions in court; that the intent of the clause was "to vest in the arbitration process everything that is prohibited from the court process." The arbitrator further reasoned that a class action "is plainly one of the possible forms of civil action that could be brought in a court" absent the agreement. Accordingly, the arbitrator concluded that the arbitration clause expressed the parties' agreement to class arbitration. The Supreme Court granted certiorari and affirmed. In an opinion by Justice Kagan, the Court reasoned that FAA section 10(a)(4) limits a court's ability to overturn an arbitrator's decision where it is arguably based on an interpretation of the parties' agreement. While the Court conceded that the parties' agreement did not contain any language authorizing class arbitration, it noted that the arbitrator found the arbitration clause "unambiguously evinced an intention to allow class arbitration" based on construing "the arbitration clause in the ordinary way to glean the parties' intent." Tacitly acknowledging the arbitrator's potentially erroneous interpretation, the Court again made clear that section 10(a)(4) provides that the

"arbitrator's construction holds, however good, bad, or ugly." Citing *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2008), the Court stated that the issue would have been different had Oxford Health challenged the availability of class arbitration as a "question of arbitrability." Such questions include preliminary matters such as whether the parties have a valid agreement and are presumptively decided by the courts. Instead, Oxford Health challenged the decision as a matter within the arbitrator's discretion to decide. Consequently, the Court did not inquire into whether class arbitration is a question of arbitrability.

American Express Co. v. Italian Colors Restaurant, 570 U.S. 228 (2013)– Class action waiver clause held to be enforceable even though it would be uneconomical for plaintiff to pursue federal statutory claim on an individual basis. The FAA does not permit courts to invalidate a contractual waiver of class arbitration on the ground that the plaintiff's cost of individually arbitrating a federal statutory claim exceeds the potential recovery. Even claims alleging the violation of a federal statute are subject to binding arbitration unless the FAA's mandate has been "overridden by a contrary congressional commend," citing *CompuCredit Corp. v. Greenwood* 565 U.S. 95 (2012).

Ferguson v. Corinthian Colleges, 733 F.3d 928 (9th Cir. 2013) – *Concepcion* preempts the *Broughton-Cruz* rule that arbitration may not be compelled when a plaintiff, acting as a private attorney general, seeks a "public injunction" to enjoin future deceptive practices for the benefit of the general public. The Ninth Circuit the argument that because an injunction is technically a remedy rather than a cause of action, the *Broughton-Cruz* rule is insulated from the FAA. As stated by the Supreme Court in *Concepcion* in 2011 and reiterated in 2012 in *Marmet Health Care Center, Inc. v. Brown*, 565 U.S. 530 (2012) "[w]hen state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA." Recognizing that its decision overruled an important aspect of consumer protection in California, the Ninth Circuit offered some hints about how plaintiffs might proceed in the future, but withheld judgment about the success of those possible procedures. "We decline to resolve in advance the question of what, if any, court remedy Plaintiffs might be entitled to should the arbitrator determine that it lacks the authority to issue the requested injunction. That is beyond the scope of this appeal. If the arbitrator comes to that conclusion, Plaintiffs may return to the district court to seek their public injunctive relief. We express no opinion on any question that might arise at that time. Similarly, we decline to resolve now questions that could arise or a motion is brought in court to confirm an arbitration award that includes injunctive relief, or whether it might be necessary for a court to enforce a public injunction awarded by an arbitrator. Those questions can be better addressed in the context of an actual case, with arguments directed more specifically to the questions raised in that case."

Iskanian v. CLS Transp. Los Angeles LLC, 59 Cal. 4th 348 (2014), cert. den., 131 S.Ct. 1155 (2015) - The California Supreme Court held that after the U.S. Supreme Court's ruling in *Concepcion*, class action waivers are generally valid and enforceable – even in employment contracts. However, with regard to PAGA claim waivers, the Court held that such waivers are not enforceable because a PAGA claim lies outside the FAA's coverage. The Court explained that a PAGA claim is not a dispute between an employer and employee arising out of their contractual relationship but, rather, is a dispute between an employer and the State concerning alleged violations of the Labor Code. The employer filed a petition for writ of certiorari with the U.S. Supreme Court. That petition was denied on January 20, 2015, thereby leaving intact the California high court's decision requiring that representative actions brought under PAGA proceed on a representative basis in some forum – whether it be in court or an arbitration. On remand from the California Supreme Court, Judge Robert L. Hess ruled on November 25, 2015 (L.A. Superior Court Case No. BC35621) that the individual claims subject to arbitration must be resolved before the trial court would address the PAGA claims.

DirecTV v. Imburgia, ___ U.S. ___, 136 S.Ct. 463 (2015) - Justices of the U.S. Supreme Court had scorching criticism for a California court's refusal to enforce an arbitration agreement. In this case, two customers who objected to the company's early termination fees sought to represent a class of people in the same situation by filing a class action lawsuit in 2008. After *Concepcion*, DirecTV asked a state court judge to dismiss the lawsuit and require arbitration. The case turned on an odd provision in the company's contract that forbid class arbitration, but made the entire arbitration provision unenforceable if "the law of your state" barred class arbitration waivers. Applying to the law as it existed at the time the lawsuit was filed, the request for arbitration was denied and the matter was allowed to proceed in court as a class action. Justice Breyer, writing for the majority, said that the state court failed to take into account the Court's 2011 decision in *Concepcion*, which allowed companies to avoid class actions by insisting on individual arbitrations. He went on to say that the right way to read the contract was to assume that it referred to *valid* California laws and not to ones displaced by the 2011 decision.

Sakkab v. Luxottica Retail North America, Inc., 803 F.3d 425 (9th Cir. 2015) - PAGA claims cannot be waived in employment arbitration agreements, following the rule announced by the California Supreme Court in *Iskanian*. With this 2-1 ruling, the Ninth Circuit majority found that the *Iskanian* rule barring PAGA waivers is not preempted by the FAA. The majority rejected the preemption argument, holding that "[f]ollowing the logic of *Concepcion* … the *Iskanian* rule is a 'generally applicable' contract defense that may be preserved by [the FAA's] savings clause" because "the *Iskanian* Rule does not conflict with the FAA's purposes." The court found here that the waived PAGA claims did not mandate procedures that interfere with arbitration, as the class action claims in *Concepcion* did.

Sanchez v. Valencia Holding Co., LLC, 61 Cal. 4th 899 (2015) - Car buyer brought class action against dealer alleging violations of the CLRA and other consumer protection laws. The CLRA provides for a right to file a class action and also provides that such right is unwaivable. The Court held that the anti-waiver provision was unenforceable under the U.S. Supreme Court's decision in *Concepcion* and thus the class waiver provision was enforceable. The Court also held that that conclusion did not limit the unconscionability rules applicable to other provisions of the arbitration agreement, and affirmed the lower court's denial of arbitration on that grounds.

Securitas Security Services USA, Inc. v. Superior Court, 234 Cal. App. 4th 1109 (2015) - The trial court ruled that a PAGA claim waiver was unenforceable, but issued an order compelling arbitration of all claims – including the PAGA claim. The Court of Appeal reversed, holding that the PAGA waiver rendered the entire arbitration agreement unenforceable due to the existence of a non-severability provision that immediately followed the class action and representative action waiver provisions. The court stated that "Notwithstanding any other clause in this Agreement, the proceeding sentence shall not be severable from this Agreement in any case in which the dispute to be arbitrated is brought as a class, collective or representative action." The court held that the non-severability provision essentially turned the arbitration agreement into an all-or-nothing proposition: If the class or representative action waivers are not enforceable, the entire agreement to arbitrate is unenforceable, and all dispute must be resolved in court.

Mohamed v. Uber Technologies, Inc., 848 F.3d 1201 (9th Cir. Dec. 21, 2016) – This case illustrates the importance of including a severance provision in the arbitration clause (not just the agreement as a whole). While this decision adds to the list of decisions holding that PAGA waivers are invalid, it also holds such a provision is severable so that the balance of the arbitration agreement may be enforced and the individual claims sent to arbitration. As discussed with respect to the California Supreme Court's decision in *McGill v. Citibank*, 2 Cal. 5th 945 (2017), the application of the common law doctrine of severance has become a central issue when dealing with challenges to the validity and enforceability of adhesion arbitration agreements that contain class action waivers, forum selection and other provisions perceived as being one-sided in favor of the party requiring the arbitration agreement as a condition to doing business (typically in the consume or employment context).

In this case, the Ninth Circuit delivered a significant victory to Uber by reversing a district court's denials of Uber's motions to compel arbitration in companion class action lawsuits brought by former drivers in Massachusetts and California. In one case, *Mohamed v. Uber Technologies, Inc.*, a Massachusetts driver sued Uber for violations of the Fair Credit Reporting Act and related state laws. He claimed that Uber's involuntary termination of his business relationship with the company based on consumer credit background information it obtained about him, violated various federal and state laws. In a related case, *Gillette v. Uber Technologies, Inc.*, other drivers made similar claims related to alleged improper

background checks. In this case, the class action lawsuit also pursued PAGA claims, alleging that drivers were improperly classified as independent contractors rather than employees. In addressing the PAGA waivers contained in the two agreements, the Court found that the 2013 agreement expressly required the court - not the arbitrator - to decide all challenges to the enforceability of the PAGA waiver. Relying on *Iskanian v. CLS Transportation L.A., Inc.*, 59 Cal. 4th 348 (2014), the Court ruled that the PAGA waiver was invalid but severable because the contract contained a severance provision. With respect to the 2014 agreement, the court relied on the broad scope of arbitration provision and left the determination of that issue to the arbitrator.

(c) *2017 Cases*

- ***Morris v. Ernst & Young LLP***, 834 F. 3d 975 (9th Cir. 2016), cert. granted, 137 S.Ct. 809 (2017) – The Ninth Circuit joins the Seventh Circuit in favor of non-enforcement of arbitration agreements that require employees to bring claims in "separate proceedings" (thereby prohibiting class and collective actions), finding that such agreements are illegal under the NLRA and thus unenforceable.

This is a significant case because it further deepened the split among the Circuits concerning the intersection of the FAA and the long line of cases promoting the enforcement of arbitration agreements by their terms, including class action waivers, on the one hand, and a developing trend of cases flowing from administrative decisions of the National Labor Relations Board (NLRB) denying enforcement of arbitration clauses that include class action waivers in employment contracts because they impair the collective action rights of employees under the National Labor Relations Act (NLRA) to prosecute collective action complaints against employers for violations of the Fair Labor Standards Act (FSLA), on the other. It was thus news that the United States Supreme Court accepted review of this case in January 2017, along with the Seventh Circuit's decision in Lewis v. Epic Systems Corp., 823 F.3d 1147 (7th Cir. 2016), and the Fifth Circuit's decision in NLRB v. Murphy Oil USA, Inc., 808 F.3d 1013 (5th Cir. 2015). This case was argued to the newly constituted Supreme Court in October 2017, and will most likely be decided in 2018. Stay tuned!

Prior to 2016, four Circuit Courts of Appeal had denied enforcement of NLRB rulings declining to enforce arbitration agreements that contained class action waivers, thereby rejecting the argument that an employee's right to prosecute a collective action under the FSLA is a non-waivable substantive right. See, e.g., *Murphy Oil U.S.A., Inc. v. NLRB*, 808 F.3d 1013 (5th Cir. 2015); *Walthour v. Chipio Windshield Repair*, 745 F.3d 1326 (11th Cir.), cert denied, 134 S.Ct. 2886 (2014); *D.R. Horton, Inc. v. NLRB,* 737 F.3d 344 (5th Cir. 2013); *Sutherland v. Ernst & Young LLP,* 726 F.3d 290 (2d Cir. 2013); *Owen v. Bristol Care, Inc.*, 702 F.3d 1050 (8th Cir. 2013); *Cellular Sales of Missouri, LLC v. NLRB*, No. 15-1620, 2016 WL 3093363 (8th Cir. June 2, 2016).

In 2016, the Seventh Circuit became the first Court of Appeal to adopt the NLRB's position and strike down class waivers in employment contracts. See, *Lewis v. Epic Systems Corp.*, 823 F.3d 1147 (7th Cir. 2016). The court in *Epic Systems* opined that there is nothing quite so "concerted" as a piece of class action litigation, where employees band together to collectively assert a legal challenge to a workplace practice. A few months later, the Ninth Circuit followed suit and echoed the Seventh Circuit's reasoning in *Morris v. Ernst & Young LLP*.

In this case, the plaintiff worked for the accounting firm, Ernst & Young, and like all new hires, he was required to sign an arbitration agreement at the outset of his employment as a condition to employment. The arbitration agreement contained a class action waiver and expressly required "covered disputes" to be heard in "separate proceedings." Despite the existence of this provision, plaintiff brought a class and collective action against his employer in federal court, alleging that he and others had been misclassified as exempt from overtime under the FLSA. Ernst & Young moved to compel individual arbitration. Plaintiff opposed, challenging the "concerted action waiver" and arguing that it violated the NLRA by interfering with the right of employees to pursue work-related legal claims together. The trial court granted Ernst & Young's motion and ordered the plaintiff and all others who felt aggrieved to pursue individual arbitration claims, and dismissed the case. Plaintiffs appealed.

Dismissing contrary holdings by the Second, Fifth and Eighth Circuits, as well as the California Supreme Court, the Ninth Circuit joined the Seventh Circuit and held that the "concerted action waiver" violated the NLRA. The Ninth Circuit reversed the decision and struck down the class waiver provisions. Just as the Seventh Circuit ruled in *Epic Systems*, the Ninth Circuit held that employers interfere with the right of all employees – not just those unionized – to engage in concerted activity under the NLRA by requiring them to pursue claims in separate proceedings. The Court noted that Section 7 of the NLRA provides a statutory right to employees to engage in concerted activities for their mutual aid or protection, and determined that this included class action litigation.

Although the employer defended its position by pointing out that the Federal Arbitration Act (FAA) mandates a liberal policy in favor of upholding arbitration agreements, the Ninth Circuit was not persuaded. "The problem with the contract at issue is not that it requires arbitration, it is that the contract term defeats a substantive federal right to pursue concerted work-related legal claims." By concluding that the rights established under the NLRA are substantive in nature and not just procedural, the Court ruled that these rights could never be waived via a standard, mandatory arbitration agreement, thus adopting the view of the currently constituted NLRB.

- ***Valdez v. Terminix Int'l Co. Ltd. Ptnrshp.*,** 681 Fed. Appx. 592 (9th Cir. Mar. 3, 2017) – While under *Iskanian* a PAGA waiver is invalid and unenforceable, such a provision can be severed and then the question is whether or not a PAGA claim falls within the scope of the remaining arbitration clause. If it is a covered dispute, it must be submitted to binding arbitration.

This case demonstrates just how differently different courts are approaching some of the PAGA issues left open after *Iskanian*.

In this case, a former employee brought an action against his former employer complaining that the employer did not allow its employees to take rest and meal breaks as required by California law. The district court denied the employer's motion to compel arbitration and the employer appealed. The Ninth Circuit reversed the district court, holding that the former employee's claims feel within the scope of the arbitration clause at issue. The arbitration provision covered all disputes relating to Valdez's employment with the company and arising under state employment laws. The Ninth Circuit held that PAGA claims are eligible for arbitration if they fall within the scope of the arbitration clause. The Court noted that the arbitration agreement at issue in this case included a severance provision. The Court reasoned that once the offending PAGA waiver was severed, the remaining provisions were in full force and effect. Because the Court found that the employee's PAGA claims fell within the scope of the arbitration clause, the district court erred in denying the employer's motion. The matter was remanded for the district court to decide whether to stay or dismiss the action pending arbitration.

Note: Several recent decisions by California courts of appeal have decided the issue concerning the arbitrability of PAGA claims differently. Relying on the rationale of *Iskanian*, they have concluded that an employer cannot compel an employee to arbitrate representative PAGA claims through a predispute arbitration agreement. See, e.g., *Tanguilig v. Bloomingdale's, Inc.*, 5 Cal. App. 5th 665 (2016),[19] *Betancourt v. Prudential Overall Supply*,

[19] In *Tanguilig*, the court said that because the state controls PAGA actions, "a PAGA claim, individual or collective, cannot be arbitrated pursuant to a predispute arbitration agreement without the state's consent." 5 Cal. App. 5th at 678.

9 Cal. App. 5th 439 (2017);[20] *Montano v. Wet Seal Retail Inc.*, 7 Cal. App. 5th 1248 (2015);[21] *Julian v. Glenair, Inc.*, 17 Cal. App. 5th 853 (2017).[22]

- ***Betancourt v. Prudential Overall Supply*,** 9 Cal. App. 5th 439 (4th Dist., Mar. 7, 2017), cert. denied, 138 S.Ct 556 (Dec. 11, 2017) – The Fourth District takes a different approach than the Fifth District and holds that a motion to compel arbitration is not the proper procedural vehicle for addressing the civil penalties limitation for a non-arbitrable PAGA claim.

Like the employee plaintiff in *Esparza v. KS Industries, LP*, 13 Cal. App. 5th 1228 (2017), discussed at p. 80, below, the employee plaintiff in this case brought a single cause of action under PAGA in which he complained about violations of California's wage and hour laws. Also like the employee plaintiff in *Esparza*, the employee plaintiff in this case sought unpaid wages, interest, attorney's fees and costs, in addition to civil penalties. Because Betancourt signed an arbitration agreement in which he agreed to submit to final and binding arbitration any and all claims and disputes related to his employment and to "forego any right to bring claims on a representative or class member basis, Prudential brought a motion to compel arbitration. In support of its motion, Prudential argued that Betancourt was attempting to evade arbitration by labeling garden-variety wage and hour claims as a single PAGA claim. Prudential argued that Betancourt's action was – in substance – a standard wage and hour case as evidenced by the prayer for relief, which sought recovery of unpaid wages, business expenses, interest, attorney's fees and costs, remedies that do not fall within a PAGA claim. The trial court denied the employer's motion and the employer appealed.

In affirming the trial court's denial of Prudential's motion to compel, the Fourth District took a very different approach from the Fifth District in *Esparza* by treating the overbreadth of relief sought by plaintiff's PAGA claim as a matter of pleading (i.e., form) and not a matter of arbitrability (i.e., substance). The Fourth District ruled that Prudential's motion to compel arbitration was not the "proper procedural vehicle for sorting through alleged defects" in Betancourt's complaint; that if Prudential believed that Betancourt was attempting an "end run" around arbitration by mislabeling his single cause of action, the

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[20] In *Betancourt*, the court said that "[t]he state is not bound by Betancourt's predispute agreement to arbitrate," and that "Betancourt is suing on behalf of the state," so that the employer cannot rely on the predispute agreement with Betencourt to compel arbitration" of the PAGA claims being asserted by Betancourt in his representative capacity. 9 Cal. App. 5th at 446.

[21] In *Montano*, the court acknowledged that several federal district courts within California had found PAGA waivers to be enforceable under the FAA. However, the court went on to state that decision of lower federal courts are not binding on state courts and that, therefore, until the United States Supreme Court resolves the issue, they are bound to follow the California Supreme Court's decision in *Iskanian* (as to which the United State Supreme Court denied cert). 7 Cal. App. 5th at 1257-1258.

[22] Under the principles and public policy considerations set forth in *Iskanian*, the classification of an agreement as "predispute" or "postdispute" must be made by reference to the point in time at which an individual employee acquires the status of the state's agent in relation to the creation of the agreement to arbitrate. 17 Cal. App. 5th at 860, 870.

proper course was for Prudential to challenge the complaint with a demurrer or motion to strike. Based on this perspective of the situation, the Court stated that it appeared to it "that Prudential may be attempting to make an 'end run' around a demurrer or motion to strike, by trying to roll a challenge to the pleadings into a motion to compel arbitration." 9 Cal. App. 5th at 349.

As noted above, the United States Supreme Court denied Prudential petition for certiorari on December 11, 2017, thereby maintaining its streak of rejecting cert petitions based on PAGA issues, and has left open for another day / case whether the Court will adopt or reject the more limited application of the *Iskanian* rule as utilized by the Fifth Circuit in *Esparza*.

- ***McGill v. Citibank*,** 2 Cal. 5th 945 (Apr. 6, 2017) - Arbitration agreement that required credit card holders (consumers) to waive their right to seek public injunctive relief available under various consumer protection laws was deemed unenforceable as against California public policy.

In 2001, McGill opened a Citibank credit card account and purchased the Credit Protector Plan. At that time, the credit card agreement did not include an arbitration provision. In October 2001, Citibank sent McGill a notice regarding a change in the terms of her credit card agreement, which terms added a binding arbitration provision stating as follows:

> "Either you or we may, without the other's consent, elect mandatory, binding arbitration for any claim, dispute, or controversy between you and us (called "Claims")…. All Claims relating to your account or a prior related account, or our relationship are subject to arbitration, including Claims regarding the application, enforceability, or interpretation of this Agreement and this arbitration provision. All claims are subject to arbitration, no matter what legal theory they are based on or what remedy (damages, or injunctive or declaratory relief) they seek. This includes Claims based on contract, tort (including intentional tort), fraud, agency, your or our negligence, statutory or regulatory provisions, or any other sources of law; … and Claims made independently or with other clams …. Claims and remedies sought as part of a class action, private attorney general or other representative action are subject to arbitration on an individual (non-class, non-representative) basis. The arbitrator will not award relief for or against anyone who is not a party. <u>If you or we require arbitration of Claims, neither you, we, nor any other person may pursue the Claim in arbitration as a class action, private attorney general action or other representative action, nor may such claim be pursued on your or our behalf in any litigation in any court</u>." *[Emphasis added to highlight the "waiver" language, effectively foreclosing McGill from bringing a PAGA claim in court.]*

McGill lost her job in 2008 and made a claim under the Credit Protector Plan she had purchased. In 2011, McGill filed a class action based on Citibank's marketing of the Credit

Protector Plan and the manner in which Citibank had administered her claim under the plan. The complaint included claims for violation of California's unfair competition law ("UCL"), violation of the false advertising law ("FAL"), violation of the Consumer Legal Remedies Act ("CLRA"), and improper sale of insurance. The relief McGill sought included injunctive relief enjoining Citibank from continuing to engage in its allegedly illegal and deceptive practices.

Citibank moved to compel arbitration of McGill's claims on an individual basis as required by the arbitration agreement included in the Credit Protector Plan. The trial court that motion in part and denied it in part. Specifically, the trial court severed and stayed the claims for injunctive relief under the UCL, FAL and CLRA, and ordered McGill or arbitrate all other claims, including claims for restitution and damages under the aforementioned statutes. The trial court refused to order arbitration of the injunctive relief claims based on the *Broughton-Cruz* rule. Under that rule, arbitration provisions are unenforceable as against public policy if they require arbitration of UCL, FAL or CLRA injunctive relief claims brought for the public's benefit.

On appeal to the Fourth District Court of Appeal, the court reversed the trial court's order refusing to compel arbitration of McGill's injunctive relief claims and remanded for the trial court to order McGill to arbitrate all of her clams. The Fourth District's opinion was in line with several federal court decisions in concluding that the FAA preempts the *Broughton-Cruz* rule based on the United States Supreme Court holding in *Concepcion*.[23] The Fourth District reasoned that the *Broughton-Cruz* rule fell pretty to the sweeping directive in *Concepcion* because it is a state-law rule that prohibits arbitration of UCL, FAL and CLRA injunctive relief claims brought for the public's benefit. *McGill v. Citibank, N.A.,* Case No. G049838, 2017 WL 4382034 (4th Dist., Oct. 3, 2017), *2.

The California Supreme Court granted review and issued an opinion on April 6, 2017 reversing the Fourth District's judgment and striking another blow in its contentious battled with the United States Supreme Court concerning the enforceability of arbitration clauses included in consumer contracts subject to the FAA. The California Supreme Court held that the arbitration clause in Citibank's Credit Protector Plan purported to waive McGill's right to seek public injunctive relief in any forum and was thus unenforceable as against California public policy. The Court further held that, notwithstanding the U.S. Supreme Court's decisions on the subject, including *Concepcion*, the FAA did not preempt California's policy. During oral argument in December 2016, as reported by the Daily Journal, Justice Liu asked a number of tough questions and at one point flatly said, "This is very different from *Concepcion*," and "isn't about arbitration at all." According to the article, Justice Liu "hammered home his point … that even the Federal Arbitration Act, citing *Concepcion*, does not allow Citibank to take away the statutory rights of credit card holders just because the language is found in an arbitration agreement."

[23] In *Concepcion*, the court declare the FAA preempts all state-law rules that prohibit arbitration of a particular type of claim because an outright ban, no matter how laudable the purpose, interferes with the FAA's objective of enforcing arbitration agreements according to their terms.

As discussed above, the basis upon which the Fourth District had reversed the trial court's ruling was its conclusion that the *Broughton/Cruz* rule was preempted by the FAA. The California Supreme Court side-stepped this issue and, instead, focused on the arbitration clause's unusual language purporting to prevent plaintiff from seeking public injunctive relief *in any forum* (court or arbitration). Relying on the "savings clause" of the FAA, which "permits arbitration agreements to be declared unenforceable 'upon such grounds as exist at law or in equity for the revocation of any contract[,]'" the Court reached three conclusions.

First: It determined that California Civil Code §3513—which provides that "a law established for a public reason cannot be contravened by a private agreement"— was a state law providing for revocation of any contract and thus within the savings clause. Notably, the Court cited no case law applying section 3513 to revoke a contract other than an arbitration agreement—and very little exists—but nevertheless concluded that the statute applies to "*any* contract—even a contract that has no arbitration provision—that purports to waive, in all fora, the statutory right to seek public injunctive relief ….." Id. at 16.

Second: The Court deemed a public injunction to be a "substantive statutory remedy" and not a procedural device like a class action. Such a right, it concluded, could not be waived as part of an arbitration clause or otherwise. Reasoning that Congress' purpose in enacting the FAA "'was to make arbitration agreements as enforceable as other contracts, *but no more so*[,]'" the Court held that Citibank's arbitration clause was unenforceable. Id. at 15 (quoting *Prima Paint v. Flood & Conklin*, 388 U.S. 395, 404 n.12 (1967) (emphasis added)).

Third: The Court dismissed Citibank's concerns about piecemeal litigation if plaintiff's individual claim were arbitrated while her public injunction claim waited for later resolution by a court.

All three conclusions appear to be inconsistent with U.S. Supreme Court decisions holding that the scope of arbitration under the FAA is broad, that federal policy favors the enforcement of arbitration agreements, and that state laws and policies must not place arbitration agreements on weaker footing than other types of contracts. As recently explained by the United States Supreme Court in *Kindred Nursing Centers, L.P. v. Clark* (discussed below at page 96), state courts and legislatures cannot fashion rules of contract on the pretense that they apply to "any contract" when, in practice, they are arbitration focused and merely encompass hypothetical contracts or "black swans."

Note: The McGill case also raises the issue of severance and the differing views of the federal and state courts. 2 Cal. 5th at 966-967. Why not just strike the "offending" provision? The state court rule of thumb appears to be that if an agreement contains more than one substantively unconscionable term, then it is deemed to be so "permeated with unconscionability" that it is not eligible for application of the severance doctrine to save the enforceability of the arbitration agreement. See, e.g., Murphy v. Check 'N Go Calif., Inc., 156

Cal. App. 4th 138, 149 (2007); Carbajal, v. CWPSC, Inc., 245 Cal. App. 4th 227 (4th Dist., Feb. 26, 2016). Whereas, the federal courts appear to be more willing to apply the doctrine of severance and enforce an arbitration agreement even in the face of several substantively unconscionable terms. See, e.g., Poublon v. C.H. Robinson, 846 F.3d 1251 (9th Cir. Feb. 3, 2017). In 2015, the United States Supreme Court granted certiorari to review the Ninth Circuit's decision in Zaborowski v. MHN Government Services, 601 Fed. Appx. 461 (9th Cir. 2014), and address whether California's "two strikes and you're out" severability rule as applied to arbitration agreements disfavors such agreements and places them on unequal footing with other contracts in violation of the FAA. The Court's answer to that question will have to wait because the case was dismissed shortly before oral argument due to the parties' settlement. 136 S.Ct. 1539 (2016).

- ***Esparza v. KS Industries, LP*,** 13 Cal. App. 5th 1228 (5th Dist., Aug. 2, 2017) – Court of Appeal holds that victim-specific relief seeking unpaid wages are not "civil penalties" under the *Iskanian* rule and thus are subject to compelled arbitration under the terms of the parties' arbitration agreement and the FAA.

This is an important decision – the first of its kind in terms of reported decisions – to drill down on the California Supreme Court's decision in *Iskanian v. CLS Transp. Los Angeles LLC*, 59 Cal. 4th 348 (2014) concerning the scope of what qualifies as a non-arbitrable PAGA claim.

In *Esparza*, a former employee brought a single cause of action under PAGA in which he sought unpaid wages, civil penalties, interest, attorney's fees and costs on behalf of himself and other employees for the employer's alleged failure to provide meal and rest breaks, to pay wages in a timely manner, to provide accurate wage statements and to reimburse business expenses. When KS Industries moved to compel arbitration, the employee responded that a claim for civil penalties under PAGA cannot be forced to arbitration and that such a claim includes claims seeking recovery of wages. The trial court denied the employer's motion and KS Industries appealed.

Against the backdrop of the liberal federal policy favoring arbitration, the Court of Appeal considered the *Iskanian* holding, as well as the language of PAGA and Labor Code section 558. In *Esparza*, the employee maintained that the statutory damages recoverable under Labor Code section 558 constituted a "civil penalty" within the meaning of Labor Code section 2699(a) and for purposes of the non-arbitrability. The Court of Appeal disagreed, and characterized the employee's argument as one "based on semantics and not substance." The Court found that one substantive aspect of a wage claim under Labor Code section 558 is "the financial reality that 100 percent of the 'amount sufficient to recover underpaid wages' is paid to the affected employee." 13 Cal. App. 5th at 1245. Citing *Iskanian*, the court found that the goal was to consider substance in determining the scope of representative claims that can be pursued outside arbitration without violating the FAA and the liberal federal policy favoring arbitration.

The Court of Appeal concluded that the employee's attempt to recover unpaid wages under Labor Code section 558 was, for purposes of the FAA, a private dispute arising out of his employment contract with KS Industries because it could be pursued by the employee in his own right. Recognizing that private disputes can overlap with claims that could be pursued by state labor law enforcement agencies, the Court held that such claim retained their private nature and continued to be covered by the FAA.

> "To hold otherwise would allow a rule of state law to erode or restrict the scope of the Federal Arbitration Act – a result that cannot withstand scrutiny under federal preemption doctrine. Therefore, we conclude preventing arbitration of a claim for unpaid wages would interfere with the Federal Arbitration Act's goal of promoting arbitration as a forum for private dispute resolution. (See *Iskanian*, *supra*, 59 Cal. 4th at p. 389).

Id. at 1246.

The Court also found that the employee's claim on behalf of "other aggrieved employees" also involved "victim-specific relief," was a private dispute and subject to arbitration. In this regard, the Court declared that the *Iskanian* rule – as stated by the California Supreme Court – is limited to representative claims for civil penalties in which the state has a direct financial interest:

> "The rule of nonarbitrability adopted in *Iskanian* is limited to claims 'that can *only* be brought by the state or is representatives, where any resulting judgment is binding on the state and any monetary penalties largely go to state coffers.' (*Iskanian*, *supra*, 59 Cal. 4th at p. 388, italics added). Those limitations are not met by the claims for unpaid wages owed to other aggrieved employees because (1) those employees could pursue recovery of the unpaid wages in their own right and (2) the unpaid wages recovered would not go to state coffers."

Id.

Because the Court of Appeal could not discern the former employee's true position from the record below, it remanded the case so that the employee could indicate whether he wished to pursue claims for unpaid wages and other individual relief and, if so, those claims would be ordered to arbitration. If the former employee elected to pursue only the PAGA representative claims, then those limited claims would continue in court.

- ***Julian v. Glenair, Inc.***, 17 Cal. App. 5th 853 (2d Dist., Nov. 27, 2017) – Under the principles and public policy considerations set forth in *Iskanian*, the classification of an agreement as "predispute" or "postdispute" must be made by reference to the point in time at which an individual employee acquires the status of the state's agent in relation to the creation of the agreement to arbitrate.

California's Private Attorney General Act (PAGA) permits employees to represent the State of California and other aggrieved employees for purposes of recovering civil penalties for violations of the California Labor Code. In 2014, the California Supreme Court determined in *Iskanian v. SLC Transportation Los Angeles, LLC*, 59 Cal. 4th 348 (2014), that pre-dispute waivers of the right to bring class or representative actions were unenforceable as against public policy.[24] This decision was significant for employers who routinely include arbitration clauses with class and representative action waiver provisions in their new-hire materials, employee handbooks and employment agreements. There are several issues that the *Iskanian* case did not decide, including: (a) whether an employer could compel an employee to arbitrate representative PAGA claims, and (b) whether an employee might be able to enter into an enforceable post-dispute agreement to arbitrate PAGA claims.

As to the first question, several recent appellate court decisions have relied on the rationale of *Iskanian* to reach the conclusion that an employer cannot compel an employee to arbitrate representative PAGA claims. See, e.g., *Tanguilig v. Bloomingdale's, Inc.*, 5 Cal. App. 5th 665 (2016),[25] *Betancourt v. Prudential Overall Supply*, 9 Cal. App. 5th 439 (2017);[26] *Montano v. Wet Seal Retail Inc.*, 7 Cal. App. 5th 1248 (2017).[27]

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[24] In examining the extent to which the right to assert a PAGA claim may be waived in advance of such a claim coming into existence, the Court relied on California Civil Code section 1668, which invalidates contracts that exempt their parties from "violation[s] of law," and California Civil Code section 3513, which invalidates private contracts that contravene "a law established for a public reason…" 59 Cal. 4th at 382-382. Applying these statutes, the Court determined that a waiver of the right to assert a PAGA claim in any forum "disable[d] one of the primary mechanisms for enforcing the Labor Code" and thus harmed the state's interests in enforcing that code. Id. at 383.

[25] In *Tanguilig*, the court said that because the state controls PAGA actions, "a PAGA claim, individual or collective, cannot be arbitrated pursuant to a predispute arbitration agreement without the state's consent." 5 Cal. App. 5th at 678.

[26] In *Betancourt*, the court said that "[t]he state is not bound by Betancourt's predispute agreement to arbitrate," and that "Betancourt is suing on behalf of the state," so that the employer cannot rely on the predispute agreement with Betencourt to compel arbitration" of the PAGA claims being asserted by Betancourt in his representative capacity. 9 Cal. App. 5th at 446.

[27] In *Montano*, the court acknowledged that several federal district courts within California had found PAGA waivers to be enforceable under the FAA. However, the court went on to state that decision of lower federal courts are not binding on state courts and that, therefore, until the United States Supreme Court resolves the issue, they are bound to follow the California Supreme Court's decision in *Iskanian* (as to which the United State Supreme Court denied cert). 7 Cal. App. 5th at 1257-1258.

Because *Iskanian* clearly limited its holding to pre-dispute arbitration agreements, the issue was left open as to whether and when an employer and employee might agree to arbitrate PAGA claims after such a dispute arises. In *Julian v. Glenair, Inc.*, 17 Cal. App. 5th 853 (2017), in a decision authored by Justice Nora M. Manella, the Second District Court of Appeal has answered precisely that question.

The arbitration agreement at issue in *Julian* was entered into after an earlier PAGA case had been filed in 2013 (commonly referred to as "the *Rojas* action"). In July 2014, Glenair provided its hourly employees with a proposed arbitration agreement entitled the "Glenair Dispute Resolution Program." The proposed agreement provided employees with a 30-day opt-out right and informed employees that if they did not opt out, their continued employment with Glenair would manifest their consent to mandatory arbitration of a broad range of claims, including "past, present and future claims." In this regard, the proposed agreement provided that employees who did not opt out would not be able to participate in any class or collective action, including the Rojas action. The proposed agreement included a description of the claims then asserted in the *Rojas* action, including the PAGA claim.

In January 2015, the Julians' employment with Glenair was terminated. In April 2015, a proposed fourth amended complaint was circulated in the *Rojas* action identifying the Julians as additional named plaintiffs and including a PAGA claim. That amended complaint was never filed. Instead, in October 2015, the Julians initiated their own lawsuit against Glenair. Their complaint contained a single claim under PAGA for civil penalties "on behalf of themselves and other current and former non-exempt employees. The complaint alleges that the Julians are "aggrieved employees" for purposes of prosecuting a representative action under PAGA, and that they complied with the requirements for commencing a representative action under PAGA. Glenair filed a petition to compel arbitration of the Julians' claim, arguing that the arbitration agreement was enforceable under *Iskanian* because it was a voluntary postdispute arbitration agreement. The trial court and Court of Appeal both disagreed and denied Glenair's petition.

In this case, the record was undisputed that Glenair distributed the proposed arbitration agreement to the Julians and other employees in July 2014, and that the Julians first initiated the procedure for becoming the state's agents in April 2015 by submitting notice of Labor Code violations to the LWDA. Glenair maintained that the July 2014 arbitration agreement was an enforceable post-dispute agreement because (a) it came into existence after the *Rojas* action was commenced, (b) it specifically referenced and included the Labor Code violations and PAGA claim alleged in the *Rojas* action, (c) the Julians' 2015 action asserted a PAGA claim that was essentially similar to that asserted in the *Rojas* action. The crux of Glenair's argument was that after the *Rojas* plaintiff was authorized to assert a PAGA claim against Glenair and Glenair's employees received notice of that fact, the pre-dispute / post-dispute boundary was crossed with respect to all other employees relating to any similar PAGA claim that might be asserted by them. The Court of Appeal held that although the two PAGA cases were similar, they were not the same. More importantly, the Court of Appeal held that the classification of an arbitration agreement as "pre-dispute" or

"post-dispute" must be made by reference to the point when the complaining employee acquires the status of "state agent" in relationship to the creation of the agreement to arbitrate. It was clear from the record in this case that the Julians did not acquire "state agent" status until 2015 and thus were no in a position in 2014 to know which alleged Labor Code violations – if any – they were authorized to assert on behalf of the LWDA or to enter into an informed waiver of their statutory right to pursue a PAGA claim in court by agreeing to arbitration of such claim. "We hold that an agreement to arbitrate a PAGA claim, entered into before an employee is statutorily authorized to bring such a claim on behalf of the state, is an unenforceable predispute waiver."[28] 17 Cal. App. 5th 860.

> "Generally, a waiver of a statutory right is not enforceable unless – at minimum – 'it appears that the party executing it ha[s] been fully informed of the existence of that right, its meaning, [and] the effect of the "waiver" presented to him' [Citations] Only after employees have satisfied the statutory requirements for commencing a PAGA action are they in a position 'to determine what trade-offs between arbitral efficiency and formal procedural protections best safeguard their statutory rights.' [Citations] Prior to that point, the employees either have submitted no allegations of Labor Code violations to LWDA, or have done so, but await LWDA's determination regarding the extent to which LWDA itself will resolve the allegations …. Accordingly, before meeting the statutory requirements for commencing a PAGA action, employees do not know which alleged violations – if any – they are authorized to assert in the action. Enforcing a waiver secured at that time would effectively dictate a choice of forum the employee did not knowingly make."

Id. at 870.

The *Julian* decision reinforces that it will remain exceedingly difficult – if not impossible – for employers to enforce any agreements requiring arbitration of PAGA claims. It seems highly unlikely that an employee – who would most likely be represented by counsel – would agree to arbitration of PAGA claims after he or she has exhausted the statutory requirements for filing his or her own PAGA claim.

[28] The Court's conclusion that a "dispute" begins coterminously with attainment by a would-be PAGA plaintiff of a "right to sue" was drawn from the California Supreme Court's decision in *Iskanian* and two Court of appeal opinions applying wording in that case to arbitration agreements. E.g., The Supreme Court held that

- ***Muro v. Cornerstone Staffing Solutions, Inc.***, 20 Cal. App. 5th 784 (4th Dist. Feb. 23, 2018) – Having concluded that the FAA was not applicable to the arbitration agreement at issue, the court held that the appropriate test under California law to determine whether the "class action waiver" provision is enforceable is the four-part *Gentry* test. Trial court properly denied motion to compel individual arbitration and correctly found that a class proceeding would be a significantly more effective way of permitting the subject employees to enforce their statutory rights.

Muro entered into an employment contract with Cornerstone (a staffing agency) to work as an interstate truck driver for Team Campbell (client of the staffing agency), a company that ships products from California to places throughout the country. The contract had an arbitration clause and included a class action waiver provision. In response to Muro's complaint, which was styled as a proposed class action, Cornerstone moved to compel individual arbitration and to dismiss Muro's class claims. Muro opposed the petition, claiming that because he was a "transportation worker" within the ambit of the "exemption" provision of the FAA (9 U.S.C. § 1), the FAA did not govern the court's determination of Cornerstone's petition to compel arbitration, and, because the FAA did not apply, California law as expressed in *Gentry v. Superior Court*, 42 Cal. 4th 443 (2007) was controlling law. Muro argued that because he satisfied the *Gentry* factors, the class waiver provision was unenforceable and his claims should be permitted to proceed in the current court action.

Relying heavily on *Garrido v. Air Liquide Industrial, U.S. LP*, 241 Cal. App. 4th 833 (2015), the trial court concluded that the arbitration agreement in question was exempt from the operation of the FAA through Section 1, and was instead governed by California law. The trial court agreed with Muro that the California Supreme Court's decision in *Gentry* (overruled on other grounds in *Iskanian v. CLS Transportation, Los Angeles, LLC*), 59 Cal. 4th 348 (2014) was still good law and provided the relevant framework for evaluating whether a class action waiver provision was enforceable under California law. Applying the *Gentry* factors, the trial court found that Muro had carried his burden of establishing the existence of the four factors[29] and that a class proceeding would be a significantly more effect way of permitting employees to enforce their statutory rights. Because Cornerstone's petition sought exclusively individual – rather than class – arbitration, and neither party had indicated a willingness to engage in class arbitration – the petition to compel arbitration was denied.

[29] As a refresher, the Court in *Gentry* held that a party opposing enforcement of an express class action waiver must make a factual showing under a four-part test, which requires the trial court to consider: (1) the modest size of the potential individual recovery, (2) the potential for retaliation against members of the class, (3) the fact that absent members of the class may be ill informed about their rights, and (4) other real world obstacles to the vindication of class members' rights through arbitration. *Gentry* held that a trial court may decline to enforce a class action waiver if it concludes, based on these factors, that class arbitration is "likely to be a significantly more effective practical means of vindicating right of affected employees than individual litigation or arbitration," and that there would be a "less comprehensive enforcement" of the applicable laws if the class action device is disallowed. 42 Cal. 4th at 463.

On appeal, the Fourth District Court of Appeal affirmed finding that the trial court was correct in all of its conclusions. Based on the trial court's finding that the class waiver constituted an unlawful exculpatory clause, the court held that the trial court had properly denied the petition to compel individual arbitration.

5. Arbitrability and Who Decides the Issue

(a) *Background Statement*

In civil litigation, the power of the court over the parties and the subject matter of the dispute are both discussed under the general topic of "jurisdiction." In arbitration, "jurisdiction" is generally used to discuss the power of the arbitrator over the parties and "arbitrability" is used to discuss the power of the arbitrator to hear and decide particular issues or claims in a dispute. A challenge to arbitrability raises the question of whether the claim is within the scope of disputes the parties agreed to have determined through arbitration. Arbitration is a matter of contract and, as such, the parties may freely delineate the area of its application. *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Jr. Univ.*, 489 U.S. 468, 478 (1989). An arbitrator's authority over the parties and the subject matter of the dispute is consensual and must find its source in the parties' agreement. *Steelworkers v. Warrier & Gulf Nav. Co.*, 363 U.S. 574, 582 (1060). Accordingly, as a preliminary matter, before parties are ordered to arbitration, a valid agreement to arbitrate must exist and the particular dispute must fall within the scope of the agreement. *Volt*, supra, 489 U.S. at 479; *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 943 (1995); see also *Trippe Mfg Co. v. Niles Audio Corp.*, 401 F.3d 529, 532 (3d Cir. 2005).

In construing the parties' agreement to determine arbitrability, the law requires that questions of arbitrability "be addressed with a healthy regard for the federal policy favoring arbitration," and that "any doubts concerning . . . scope . . . be resolved in favor of arbitration." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 631 (1985); *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983); *Moses H. Cone*, supra, 460 U.S. at 24-25. Under the FAA, the issue of whether the parties have a valid arbitration agreement is to be decided by the courts, unless the parties' contract contains a clear and unmistakable delegation of such issues to the arbitrator. *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995); *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003). The general rule is that courts presume that the parties intend courts – not arbitrators – to decide arbitrability unless the parties clearly and unmistakably agree otherwise. Likewise, the courts presume that the parties intend for arbitrators – not the courts – to decide disputes about the meaning and application of particular procedural preconditions for the use of arbitration. *BG Group, PLC v. Republic of Argentina*, ___ U.S. ___, 134 S.Ct. 1198 (2014). At least one court has held that the reference to the AAA Rules in the arbitration provision was sufficient to constitute clear and unmistakable evidence that the parties intended to delegate to the arbitrator the determination of arbitrability of the dispute. See *Brennan v. Opus Bank*, 796 F.3d 1125 (9th Cir. 2005).

(b) *Separability Doctrine*

Section 2 of the FAA specifically provides that arbitration provisions in written agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract. 9 U.S.C. § 2. Because arbitration provisions are treated like other contracts, they can be invalidated and held to be unenforceable under "generally applicable contract defenses, such as fraud, duress, or unconscionability." *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996). In reliance on this exception, some parties have tried to avoid arbitration by attacking the existence or validity of the contract containing the arbitration clause. The reasoning behind these attacks is that because arbitration is purely a creature of contract, there can be no obligation to arbitrate if the contract containing the arbitration clause was induced by fraud, has been repudiated or is otherwise unenforceable. This line of attack is directly contrary to the separability doctrine established by the Supreme Court in *Prima Paint.*[1]

In *Prima Paint*, the Supreme Court held that when parties commit to arbitrate their disputes, it is a mainstay of the FAA's substantive law that attacks on the validity of the contract, as distinct from attacks on the validity of the arbitration clause itself, are to be resolved by the arbitrator in the first instance, and not by a federal or state court. The court reasoned that an arbitration agreement is a separate contract from the contract in which it is imbedded for purposes of all contract defenses. Thus, an attack on the contract as a whole is not an attack on or defense to the validity or enforceability of the arbitration agreement, so the defense to the contract must be decided by the arbitrator and not the court. 388 U.S. at 403-404; *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440-445 (2006).

The Court later explained in *Buckeye Check Cashing*,

> "Challenges to the validity of arbitration agreement upon such grounds as exist at law or in equity for the revocation of any contract can be divided into two types. One type challenges specifically the validity of the agreement to arbitrate. The other challenges the contract as a whole, either on a ground that directly affects the entire agreement … or on the ground that the illegality of one of the contract's provisions renders the whole contract invalid … Regardless of whether the challenge is brought in state or federal court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator."

Id. at 444.

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[1] 388 U.S. 395 (1967). The doctrine of separability is different from the general rule of contracts that, if a court finds that a provision in a contract is unconscionable or illegal, the court may refuse to enforce the entire contract *or* it may sever the offending provision(s) and enforce the remainder of the contract. See, e.g., California Civil Code § 1670.5; *Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal. 4th 83 (2000); *Marathon Entertainment, Inc. v. Blasi*, 42 Cal. 4th 974 (2008).

(c) *Notable Historical Cases*

Sandquist v. Lebo Automotive, Inc., 228 Cal. App. 4th 65 (2014), *affirmed* 1 Cal. 5th 233 (Jul. 28, 2016) – As a matter of state contract law, the question of whether class arbitration is available is for the arbitrator, not the court, to decide. The trial court's error in deciding the issue was not reviewable for harmless error, but rather was reversible per se. The trial court compelled arbitration based on the broad arbitration provisions contained in the documents plaintiff was required to sign as a condition of employment. The trial court also dismissed plaintiff's class claims on the grounds that the agreements did not permit class arbitration. Plaintiff took an appeal. The Second District Court of Appeal reversed, finding that the trial court erred in deciding the arbitrability of the class action issue. The trial court was ordered to vacate its order dismissing the class claims and to enter a new order submitting to the arbitrator the issue of whether the parties had agreed to class arbitration. In making its decision, the appellate court looked at a number of recent lower court decisions that have decided the "who decides" question of class arbitrability and found that those courts "have reached conflicting conclusions," with most concluding that the question of class arbitration is for the arbitrator. The court was particularly impressed with the reasoning of two district court cases, one out of the Central District of California – *Lee v. JP Morgan Chase & Co.*, 982 F.Supp. 2d 1109 (C.D.Cal. 2013)– and one out of the Eastern District of New York - *Guida v. Home Savings of America, Inc.*, 793 F.Supp. 2d 611 (E.D.N.Y. 2011). In the *Guida* case, the court stated that in light of the Supreme Court's decisions in *Stolt-Nielsen* and *Bazzle*, "the ability of a class to arbitrate a dispute where the parties contest whether the agreement to arbitrate is silent or ambiguous on the issue is a procedural question that is for the arbitrator to decide."

In July 2016, a divided California Supreme Court affirmed the Court of Appeal's decision. Justice Werdegar, writing for the majority, was joined by Chief Justice Cantil-Sakauye and Justices Liu and Cuellar. The Court first held that there is no hard and fast rule to determine whether the issue of class arbitrability is decided by the arbitrator or the court, but that the matter must be resolved under state law based on the language of the parties' arbitration agreement. Here, the arbitration agreement language was extremely broad, which the Court suggested, but did not conclusively establish, that the arbitrability of class claims must be resolved by the arbitrator. Because the arbitration agreement at issue in this case applied to all claims related to employment, the Court held that its silence about who should decide the issue meant that the presumption in favor of arbitration meant that the arbitrator – not the court – should decide the issue.

Justice Kruger dissented, reasoning that in recent years, the U.S. Supreme Court has disavowed any notion that the *Bazzle* decision had decided that the classwide arbitrability question was a procedural matter and, instead, gave every indication short of an outright holding that the issue of classwide arbitrability is a gateway question for the courts rather than a subsidiary one, citing *Reed Elsevier, Inc. v. Crockett,* 734 F.3d 594, 598 (6th Cir. 2013), cert. denied 134 S.Ct. 2991 (2014). Justice Kruger also noted that "every federal court of appeals to consider the issue on the merits has concluded – in contrast to the

majority's holding today – that whether an arbitration agreement permits class arbitration is presumptively a question for the court, rather than the arbitrator."

Martin v. Yasuda, 829 F.3d 1118 (9th Cir. 2016) **–** Waiver by litigation conduct is a gateway issue for the court – not the arbitrator – to decide. In October 2013, cosmetology school students sought to bring a collective action under the Fair Labor Standards Act (FSLA) against defendant school and its owner and president, alleging violation of overtime and minimum wage requirements. Between October 2013 and March 2014, over 70 individuals opted to join the action. The complaint was served on defendants in February 2014, and counsel for defendants filed a notice of appearance in March 2014. Thereafter, the parties stipulated that there should be discovery and an opportunity for the court to resolve the question whether the plaintiffs were employees of defendant under wage laws before any effort to certify the class because the lawsuit presented "unique legal claims." The court granted the parties' joint stipulation motion. Over the course of the next six months, plaintiffs amended their complaint twice, the parties filed a joint Rule 26(f) report and the district court conducted a scheduling conference. At the scheduling conference, the district court asked defendants' counsel whether defendants intended to file a motion to compel arbitration, and counsel responded that a decision had not yet been made. A scheduling order was issued and the parties commenced discovery, including a protective order issued by the court per the parties' stipulation. It was not until 17 months after the start of the case that defendants moved to compel individual arbitration. Plaintiffs opposed the motion, arguing that the defendants had waived to right to compel through their litigation conduct. The district court denied defendants' motion, finding that (1) it was indisputable that the defendants had knowledge of their existing right to compel arbitration, (2) the defendants had engaged in conduct inconsistent with the right to compel arbitration by delaying their motion to compel and by actively participating in the litigation for 17 months, and (3) granting the motion to compel would result in prejudice to the plaintiffs.

Defendants appealed arguing that (1) an arbitrator, rather than the court, should decide whether the defendants had waived their right to arbitration through litigation conduct, and (2) even if the district court was correct to decide the issue, it had erred by finding waiver. On appeal, the Ninth Circuit affirmed.

On the first issue, the Ninth Circuit held that it had previously made clear in *Cox v. Ocean View Hotel Corp.*, 533 F.3d 1114, 1120-1121 (9th Cir. 2008), that waiver by litigation conduct is a gateway issue for the court – not the arbitrator to decide. The Court noted that "[e]very circuit that has addressed this issue – whether a district court or an arbitrator should decide if a party waived its right to arbitrate through litigation conducted before the district court – has reached the same conclusion." Id. at 1123, citing *Marie v. Allied Home Mortg. Corp.*, 402 F.3d 1, 14 (1st Cir. 2005); *Ehleiter v. Grapetree Shores, Inc.*, 482 F.3d 207, 217-218 (3d Cir. 2007); *JPD, Inc. v. Chronimed Holdings, Inc.*, 539 F.3d 388, 394 (6th Cir. 2008); *Grigsby & Associates, Inc. v. M Sec Inv.*, 664 F.3d 1350, 1353 (11th Cir. 2011); see also *Hong et al v. CJ CGV Am. Holdings, Inc.*, 222 Cal. App. 4th 240, 256-258 (2013) (finding that the First, Third, Sixth and Eleventh Circuits, as well as the Supreme Courts of Colorado,

Nebraska, Texas and Alabama allow courts to decide the waiver by litigation conduct issue).

On the second issue, the Ninth Circuit noted that because waiver of the right to arbitration is disfavored, the party arguing waiver bears a heavy burden of proof. Id. at 1124, citing *Belke v. Merrill Lynch, Pierce, Fenner & Smith*, 693 F.3d 1023, 125 (11th Cir. 1982). As such, the party seeking to provide waiver of a right to arbitration must demonstrate: (1) knowledge of an existing right to compel arbitration, (2) acts inconsistent with that existing right, and (3) prejudice to the party opposing arbitration resulting from such inconsistent acts. The Court found that all three requirements were satisfied. Defendants conceded that they had knowledge of the right to compel arbitration. The records showed that defendants had spent 17 months litigating the case and, 14 months into the litigation, had told the district court that they were likely "better off" in federal court versus seeking to compel arbitration. With regard to prejudice, that element is established when a party has expended considerable time, effort and money on the federal court litigation, including conferring with opposing counsel regarding how to conduct the case on the merits, analyzing how to approach discovery and class certification, and contesting the defendant's motion to dismiss on the merits.

Nguyen v. Applied Medical Resources Corporation, 4 Cal. App. 5th 232 (2016) – Based on broadly worded arbitration provision, it is the arbitrator, not the court, who must decide whether class claims may be asserted in arbitration. Former employee brought a putative class action against former employer, alleging causes of action under the Labor Code, the Unlawful Competition Law, and the Private Attorney General Act (PAGA). That action sought unpaid overtime, meal and rest period compensation, penalties, and other equitable relief. Defendant moved to compel arbitration of the individual claims, strike the class allegations, and stay the PAGA cause of action. The trial court granted defendant's motion in all regards.

On appeal, the court vacated the portion of the trial court's order dismissing the class claims to allow the arbitrator to decide whether the arbitration clause permits arbitration on a class-wide basis. The Court of Appeal applied the holding in *Sandquist v. Lebo Automotive, Inc.*, 1 Cal. 5th 233 (2016) (discussed above), to a similarly broadly worded arbitration provision, which called for arbitration of "all disputes and claims arising out of or relating to the submission of [Plaintiff's employment] application" and "all disputes which might arise out of or relate to [Plaintiff's] employment with the [Defendant]." Like the Court in *Sandquist*, the Court of Appeal held that under this sort of broad language, the question of whether or not class claims may be arbitrated is, itself, a question for the arbitrator.

(d) *2017 Cases*

- ***Laymon v. J. Rockcliff, Inc.***, 12 Cal. App. 5th 812 (1st Dist. May 23, 2017) – Denial of motion to compel arbitration overturned where arbitration agreements covered the claims asserted.

Two sets of plaintiff home buyers (*Laymon* and *Hernandez*) filed two materially identical class action lawsuits against several real estate brokers, a group of title companies and other service providers (collectively, Defendants), in connection with Defendants' failure to disclose alleged kickbacks associated with their use of "TransactionPoint" software. Defendants moved to compel arbitration based on three separate agreements containing arbitration clauses: the Residential Listing Agreement (RLA), the 2007 Residential Purchase Agreement (RPA), and the 2010 RPA. Each plaintiff executed at least one of those agreements. The trial court concluded that the arbitration clauses in the RLA and the 2007 RPA did not cover the claims by the Laymons in the *Laymon* action and the Himpler and McCants groups in the *Hernandez* action, and therefore denied defendants' motion to compel arbitration. In contrast, the court granted to the motion to compel arbitration as to the plaintiffs who signed the 2010 RPA (the Hernandez group in the *Hernandez* action). Defendants appealed the court's order denying arbitration as to the Laymons and the Himpler and McCants groups, while the plaintiffs appealed the order to requiring them to arbitrate the Hernandez group's claims in the *Hernandez* action.

On appeal, the trial court's order denying arbitration was reversed and remanded with instructions to the trial court to enter an order compelling all plaintiffs to arbitration. The Court of Appeal cited the long-established rule that although California policy strongly favors arbitration, there is no policy compelling persons to accept arbitration of disputes which they have not agreed to arbitrate. The Court found that the RLA required arbitration between a client and a broker of disputes "regarding the obligation to pay compensation under this Agreement." The Court noted that among other things, plaintiffs' allegations appeared, on the surface, to implicate this obligation, as did their disgorgement claim. As such, plaintiffs who executed the RLA should be required to arbitrate. The Court likewise overturned the trial court's decision as to the 2007 RPA and dismissed the Hernandez group's appeal because an order compelling arbitration is not appealable.

- ***United States and Nevada ex rel. Welch v. My Left Foot Childrens Therapy, LLC***, 871 F.3d 791 (9th Cir. Sep. 11, 2017) - "Arise out of" and "relate to" defines a broad scope of claims subject to arbitration, but that scope is not unlimited. Ninth Circuit adopts the reasoning of the Fifth and Eleventh Circuits disputes "arising out of" or "relating to" a contractual or employment relationship cannot properly be construed as encompassing any claim related to the other party or any incident that may have happened during the course of the contractual or employment relationship.

This case is a good illustration of how very important simple, clear and consistent drafting is when dealing with arbitration clauses and the need to always bear in mind the black letter rules governing the creation and enforcement of contracts in general.

The backdrop for this case is the False Claims Act (FCA), which establishes a scheme that permits either the Attorney General, 31 U.S.C. § 3730(a), or a private party, 31 U.S.C. § 3730(b), to maintain a civil action against "any person" who "knowingly presents, or causes to be presented, a false or fraudulent claim for payment" to the United States government. 31 U.S.C. § 3729(a). When brought by a private party, an enforcement action under the FCA is called a *qui tam* action, and the private party is referred to as the "relator." When a relator initiates an FCA action, the United States has the right to intervene in the case. 31 U.S.C. § 3730(b)(2), (4). When the government intervenes, it assumes responsibility for prosecuting the action and is not bound by any act of the relator. 31 U.S.C. § 3730(c)(1). When the government does not intervene, it is not a party to the action, but still retains its status as the "real party in interest." *United States ex rel. Eisenstein v. City of New York*, 556 U.S. 928, 930 (2009).

Welch, a former employee of My Left Foot Childrens Therapy LLC (MLF), brought an action against her former employer alleging that it had presented fraudulent Medicaid and Tricare claims in violation of the FCA and Nevada's state law equivalent. Neither the United States government nor the state of Nevada opted to intervene in the case. MLF then moved to compel arbitration of the *qui tam* claims based upon an arbitration agreement Welch signed at the outset of her employment. The district court denied MLF's motion because it found that the FCA claims belonged to the government and neither the United States nor Nevada had agreed to arbitrate their claims. Accordingly, the district court reasoned that sending the dispute to arbitration would improperly bind them to a pre-dispute arbitration agreement that they did not agree to.

The Ninth Circuit affirmed the district court's ruling, but did so on alternative grounds based on what it termed to be the "textual requirements" of the arbitration agreement at issue. "Though the question of the enforceability of a relator's agreement to arbitrate FCA claims is interesting, our holding rests on a rather unremarkable textual analysis." 871 F.3d at 794. Based on the discussion of the case that follows, I think you will find that the Ninth

Circuit's reasoning is remarkable because it holds that words that have typically been used in drafting arbitration agreements to define a broad scope of arbitrability – i.e., "arising out of" or "relating to" – should properly be construed as setting "a boundary by indicating some direct relationship" because to do otherwise would allow the term to "stretch to the horizon" and that would result in a meaningless and empty term because relations would then stop nowhere. Id, citing *New York State Conference, Etc. v. Travelers Ins. Co.*, 514 U.S. 645, 655 (1995). In this regard, the court acknowledged that it has interpreted "relating to" as being broader in scope than "arising out of" or "arising under," that there is a difference between a clause being "broad" versus "unlimited." Id. at 798, citing *N. Cal. Newspaper Guild Local 52 v. Sacramento Union*, 856 F.2d 1381, 1383 (9th Cir. 1988). The court went on to conclude that the FCA suit had no direct connection with Welch's employment with MLF because even if she had never been employed by MLF, she would still have been eligible to act as a relator in bringing suit against MLF for presenting false claims to the government. Id. at 799.

Looking at the text of the arbitration agreement in question, the court found that it contained "two key sections." The first section was titled "Agreement" and stated three iterations of the contractual duty to arbitrate: (1) "all dispute that may arise out of the employment context;" (2) any claim, dispute and/or controversy that [Welch] may have against the Company … or the Company may have against [Welch], arising from, related to, or having any relationship or connection whatsoever with [Welch] seeking employment by, or employment or other association with the Company;" and (3) any claim between the Company and Employee arising out of or related to the employment relationship." The second section was titled "Included Claims" and stated that minus limited exceptions not applicable to Welch or her lawsuit, the scope of the arbitration agreement included "all disputes, whether they be based on the state employment statutes, Title VII of the Civil Rights Act of 1964 … or any other state or federal law or regulation." On appeal, MLF argued that the two sections must be read together and that the breadth of the "Included Claims" section clearly covered Welch's FCA claims. The Ninth Circuit said "no" and provided somewhat circular reasoning for doing so after acknowledging that the "Included Claims" section provides that "all disputes," including those based on "any … federal law" fall within the scope of the arbitration agreement. Id. at 797. Ultimately, what seems to have driven the Ninth Circuit's decision that the scope of the arbitration agreement was defined solely by the text in the "Agreement" section was its reasoning that had the parties intended to arbitrate every conceivable dispute that might arise, as encompassed in the "Included Claims" section they could have worded the scope of arbitration in the "Agreement" section as "any and all disputes whatsoever." Id. Having chosen to include language in the "Agreement" section that imposed a "textual limitation" that, to be arbitrable, the dispute must arise from, relate to, or be connected with Welch's employment with MLF, the court found that it was bound to define the scope of the arbitration agreement by those stated limitations under two "cardinal rules" of contract interpretation: First, that the specific governs the general and, in this case, the "Agreement" section was held to be more specific than the "Included Claims" section. Second, that if possible, every word and every provisions is to be given effect and, in this case, if the language about arising out of and relating to employment did not limit the scope of the arbitration agreement, then those provisions would have no purpose. Id. at 798.

In a nutshell, this is a fact-specific case in which the Ninth Circuit drilled down on the language used in the arbitration agreement. The employer's arbitration clause was found to have not been phrased broadly enough to encompass FCA claims. As such, this decision does not stand for any general proposition regarding the arbitrability of FCA claims.

6. Enforceability and Challenges to Enforcement

(a) *Background Statement*

While defenses directed to the underlying contract as a whole will not defeat arbitral jurisdiction, other "end-run strategies" are available to the party wishing to avoid arbitration.[2] Because the right to compel arbitration is a matter of contract, arbitration agreements are subject to the same defenses to formation and enforcement as other contracts.

The most common end-run strategy is to attack the enforceability of the arbitration clause on the grounds that it is unconscionable. While parties are generally free to structure their contracts how they please and to practice the "art of advantage," there is a limit as to how much advantage-taking will be tolerated when there is 1. significant disparity in the parties' respective bargaining power or 2. the contract is one of adhesion (meaning non-negotiable), frequently seen in the consumer and employment context.

Under California law, the unconscionability defense has both a procedural and substantive element, the former focusing on oppression or surprise due to unequal bargaining power, the latter focusing on overly harsh, one-sided or unilateral results. *Sanchez v. Valencia Holding Co., LLC*, 61 Cal. 4th 899, 910-911 (2015); see also *Harper v. Ultimo*, 113 Cal. App. 4th 1402 (2003). Both procedural and substantive unconscionability must be present in order for an arbitration agreement to be deemed unconscionable and unenforceable, but they need not be present to the same degree. *Armendariz v. Found. Health Psychcare Services, Inc.*, 24 Cal. 4th 83, 114 (2000). The central idea behind the unconscionability doctrine is that the terms of the agreement are "unreasonably favorable to the more powerful party." *Sonic-Calabasas A. Inc., v. Moreno*, 57 Cal. 4th 1109, 1145 (2013). As demonstrated by the Ninth Circuit's recent decision in *Mohamed v. Uber Technologies, Inc.*, 848 F.3d 1201 (9th Cir. 2016), the terms of the challenged arbitration agreement must be *both* procedurally and substantively unconscionable for the agreement to be denied enforcement on this grounds. An opt-out provision will render an adhesive arbitration agreement procedurally conscionable, thus ending the inquiry with respect to the substantive unconscionability of an arbitration agreement. From a drafting point of you, this decision is quite significant for employers and companies that sell goods and services to consumers.

[2] This is the phrase coined by Ben H. Sheppard, Jr., Distinguished Lecturer at University of Houston Law Center and retired partner from Vinson & Elkins LLP, in his work on Pre-Arbitration, set forth in Chapter 17 of the course materials for the 27th Advanced Annual Civil Trial Course presented by the State Bar of Texas in 2004.

Other defenses frequently raised are lack of assent, non-signatory, waiver by conduct, and preemption of certain types of statutory claims making them non-arbitrable. Another tactic to circumvent an arbitration agreement is to file suit on behalf of or against a non-signatory party that the other side will want or need to have included in the global resolution of the dispute. That circumstance might lead the party who would otherwise prefer to be in arbitration to forego that right so as to avoid piecemeal litigation and the expense of litigating in two forums, keeping in mind that only parties who have agreed to arbitrate can be ordered to arbitration.[3]

(b) ***Arbitration Agreements Must be Placed on Equal Footing with Other Contracts for Purposes of Enforcement and Available Defenses -*** *Kindred Nursing Centers, L.P. v. Clark*, ___ U.S. ___, 137 S.Ct. 1421 (May 15, 2017)

In 2009, the executors of the estates of the late Joe Wellner and Olive Clark separately sued Kindred Nursing Centers in Kentucky state court, alleging that Kindred had delivered substandard care to Joe and Olive, causing their deaths. Kindred moved to dismiss based on the fact that the executors had each signed – pursuant to a power of attorney – contracts that contained mandatory arbitration provisions as a condition to Joe and Olive being allowed to move into one of Kindred's nursing homes. The trial court denied Kindred's motion.

On appeal, the Kentucky Supreme Court consolidated the cases and affirmed the trial court, holding that because the right to a jury trial under the Kentucky Constitution is "inviolate" and "sacred" — a "divine God-given right" — "the power to waive generally such fundamental constitutional rights must be *unambiguously expressed* in the text of the power-of-attorney document in order for that authority to be vested in the attorney-in-fact."

Put another way, the Kentucky Supreme Court said that a principal must expressly give its agent the specific authority to bind the principal to an arbitration agreement for that agreement to be valid and enforceable.

On appeal to the United States Supreme Court, the Court reaffirmed that the FAA preempts state laws placing agreements to arbitrate on weaker footing than other types of contracts, and found that Kentucky's "clear statement rule," though facially neutral, was really an attempt to target and disfavor arbitration agreements. The Court therefore refused to enforce the rule and held that the arbitration agreements at issue must be enforced. In an opinion written by Justice Kagan, the Court held that the Kentucky Supreme Court's "clear-

[3] It is a cardinal principle that arbitration "is a matter of consent, not coercion." *Volt Info. Sciences v. Leland Stanford Jr. University*, supra, 489 U.S. at 479. Thus, "'a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit.'" *AT&T Technologies v. Communications Workers*, supra, 475 U.S. at 648; *Cromus Investments, Inc. v. Concierge Services*, 35 Cal. 4th 376, 384-385 (2005).

statement rule" — which required "an explicit statement before an attorney-in-fact with broad powers could relinquish [the right to a jury trial] on another's behalf"— violated the FAA's "equal-treatment principle." In other words, Kentucky's "clear-statement rule" was "too tailor-made to arbitration agreements — subjecting them, by virtue of their defining trait, to uncommon barriers."

The Court criticized the Kentucky Supreme Court for using a "black swan"[4] defense as the basis for denying enforcement of an otherwise valid arbitration agreement, reinforcing the long-standing federal policy under the FAA of requiring state and federal courts (a) to recognize the validity and enforceability of arbitration agreements, and (b) to treat such agreements the same as contracts in general. On May 15, 2017, the Supreme Court of the United States reaffirmed that the Federal Arbitration Act (the "FAA") preempts state laws placing agreements to arbitrate on weaker footing than other types of contracts. The Court found that while the state-court rule (the so-called "clear-statement rule") was facially neutral, in application it was an ill-disguised attempt to target and disfavor arbitration agreements. The Court thus struck down the rule and held that the arbitration agreements at issue must be enforced.

The Supreme Court's decision is notable for three reasons:

First, this case garnered a 7 to 1 majority, notwithstanding the Roberts Court's stark division on other decisions involving the FAA. See, e.g., *AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011) (5-4 split); *American Exp. Co. v. Italian Colors Restaurant*, ___ U.S. ___, 137 S.Ct. 2301 (2013) (5-3 split); *DirecTV, Inc. v. Imburgia*, ___ U.S. ___, 136 S.Ct. 468 (2015) (6-3 split). The near-unanimous agreement in *Kindred* is likely due more to the case fitting "well within the confines of … present well-established law" than to any realignment of the Justices' positions on matters of arbitration. It is worth nothing that in *Concepcion* in 2011, the Court hypothesized that states may attempt an end-run around the FAA by "classifying as unconscionable arbitration agreements … that disallow an ultimate disposition by a jury." That is exactly what appears to have happened in *Kindred*!

Second, the Supreme court indicated that it will look past the surface-level justification of state courts in order to protect the reach of the FAA. The Kentucky Supreme Court attempted to frame its rule as a broad one that rejected the ability of attorneys-in-fact to find their principals to *any* contracts affecting "fundamental … liberties," and offered as examples contracts that "waive the principal's civil rights; or the principal's right to worship freely; put her child up for adoption; consent to abort a pregnancy; consent to an arranged marriage; or bind the principal to personal servitude." The Supreme Court rejected the Kentucky Supreme Court's invocation of these "patently objectionable and utterly fanciful contracts" to justify its decision. Accordingly, state courts cannot properly invoke the FAA's saving clause by simply broadening an otherwise arbitration-focused rule or encompass other merely hypothetical contracts or "black swans," as the Court called them.

[4] A metaphor used to describe an event that comes as a surprise, has a major effect, and is often inappropriately rationalized after the fact with the benefit of hindsight.

Third, in light of *Kindred*, attorneys should note the Court's visceral reaction against common-law rules and arguments that effectively act as back-handed ways to discriminate against arbitration agreements. While the Supreme Court acknowledged that traditional common law defenses to contract formation – like mutual mistake, duress, unconscionability, and the like – may potentially serve as a basis to invalidate an arbitration agreement, the Court was clear that rules and arguments that target arbitration's effect on "fundamental liberties," such as the right to a jury trial, are unlikely to succeed. Put most simply, *Kindred* reemphasizes the principle that arbitration agreements must be placed on an equal footing with other contracts.

(c) *2016 and 2017 Cases re the Unconscionability Defense*

- ***Baltazar v. Forever 21, Inc.***, 62 Cal. 4th 1237 (2016) – Mutual injunctive relief carve-out in an adhesion contract was not unfairly one-sided and thus did not amount to a substantively unconscionable term warranting denial of enforcement of the arbitration agreement.

In connection with her employment by Forever 21, plaintiff initially refused to sign an arbitration agreement. Defendant employer told her that she was required to sign the arbitration agreement or she would not get the job. Plaintiff signed. Later, plaintiff sued for wrongful termination and for discrimination based upon her race and gender. Defendant moved to compel arbitration, and the trial court denied the motion on the basis that the agreement was unconscionable and thus unenforceable. Defendant appealed. The Court of Appeal for the Second District reversed, and the California Supreme Court affirmed.

While the Supreme Court acknowledged that contracts of adhesion contain a degree of procedural unconscionability even without any notable surprises, and invite the possibility of oppression and overreaching, the prevailing view is that procedural and substantive unconscionability must *both* be present in order for a court to exercise its direction to refuse to enforce a contract or clause under the doctrine of unconscionability. 62 Cal. 4th at 1243-1244, citing *Armendariz v. Foundation Health Psychcare Services, Inc.*, 24 Cal. 4th^{h} 83, 114 (2000). The Court went on to note that "the unconscionability doctrine is concerned not with a 'simple old-fashioned bad bargain' … but with terms that are 'unreasonable favorable to the more powerful party'." Id. at 1244, citing *Sonic-Calabasas A, Inc. v. Moreno*, 57 Cal. 4th 1109, 1145 (2013).

In affirming the Court of Appeal's reversal of the trial court's ruling denying arbitration, the Supreme Court rejected a panoply of arguments attacking the subject arbitration agreement, including findings that: (1) the failure to attach the arbitration provider's rules to the agreement did not in and of itself create procedural unconscionability unless the employee was challenging some element of the rules themselves; (2) that carve-out allowing the parties to seek temporary restraining orders and injunctive relief in the courts was not substantively unconscionable because it applied mutually to both parties; (3) listing employee claims as examples of claims subject to the agreement did not make

the agreement one-sided or unfair; and (4) including a provision providing for protection of the employer's confidential information (but not the employee's) was not unfairly one-sided because the employee did not dispute the legitimate commercial need for the agreement to address the employer's valuable trade secrets and proprietary information.

- ***Carbajal v. CWPSC, Inc.***, 245 Cal. App. 4th 227 (2016) – Applying the California Arbitration Act (versus the FAA), motion to compel arbitration was denied based on the court's finding that the contract had both a moderate level of procedural and substantive unconscionability. The court found that the presence of three substantively unconscionable provisions supported the conclusion that the agreement was "permeated with unconscionability," and thus the trial court did not abuse its discretion in refusing to sever the unconscionable terms from the agreement.

Plaintiff filed a putative wage and hour class action against her former employer. Relying on an arbitration agreement with a class action waiver, the employer moved to compel plaintiff to arbitrate her individual claims. The trial court denied the motion, holding that the arbitration agreement was procedurally and substantively unconscionable. The employer appealed, claiming that the trial court had abused its discretion in denying its motion.

One of the issues raised on appeal was whether the FAA applied to the contract, which was silent on the subject. The FAA applies to contracts containing arbitration provisions if those contracts evidence transactions involving interstate commerce. Plaintiff's job was to solicit customers for defendant's painting business. The issue posed was whether strictly intrastate use of phone lines supplied the requisite connection to interstate commerce for FAA purposes when the subject matter of the contract containing the arbitration clause did not involve a channel or instrumentality of interstate commerce. The court of appeal concluded that the party asserting FAA preemption bears the burden of presenting evidence to show the requisite connection to interstate commerce. The only evidence was that plaintiff used telephones in the conduct of its business, but that evidence also showed that plaintiff's use of the phone lines was entirely intrastate and was thus, at most, "a trivial connection to interstate commerce." So, the trial court concluded that the FAA did not apply to the arbitration clause at issue in this case.

The court of appeal agreed with the trial court that the arbitration agreement was procedurally unconscionable because it was a contract of adhesion and did not state which set of AAA rules would apply to any arbitration conducted pursuant to the clause.

The court of appeal also agreed with the trial court that the arbitration agreement was substantively unconscionable in three regards: (1) It required plaintiff to bring all claims in arbitration, but unilaterally authorized the employer to seek any type of injunctive relief in court. (2) It contained a provision waiving the requirement that the employer post a bond in order to obtain injunctive relief in court. (3) It provided that each party would bear its

own fees, which provision would interfere with plaintiff's statutory right to recover attorney's fees if she prevailed on her Labor Code claims. Perhaps most significant to the court of appeal's ruling was its determination that the presence of three substantively unconscionable provisions supported the conclusion that the agreement was "permeated with unconscionability," such that the trial court did not abuse its discretion in refusing to sever the unconscionable terms from the agreement so that the individual claims could be ordered to arbitration.

Comment: The decision in *Carbajal* is an example of what has been referred to as California's "arbitration-only severability rule" as applied to the enforceability of arbitration agreements. Under this special rule, courts are given discretion to invalidate an arbitration agreement with more than one unconscionable provisions (because it is permeated with unconscionability) or to sever the unconscionable terms and enforce the remainder of the agreement. In 2015, the United States Supreme Court granted certiorari to review the Ninth Circuit's decision in *Zaborowski v. MHN Government Services*, 601 Fed. Appx. 461 (9th Cir. 2014). 136 S.Ct. 27 (2015). The question before the Court was whether California's severability rule, which affords courts the discretion to invalidate an arbitration agreement with more than one unconscionable term or to sever the unconscionable terms and enforce the remainder of the agreement, disfavors arbitration agreements and thus does not place them on equal footing with other contracts. The Court's answer to that question will have to wait for another day because the case was dismissed shortly before oral argument due to the parties' settlement. 136 S.Ct. 1539 (2016).

- ***Merkin v. Vonage America, Inc.***, 639 Fed. Appx. 481 (9th Cir. 2016) – Trial court reversed in denying motion to compel arbitration. While plaintiffs identified several provisions in the arbitration agreement as being substantively unconscionable in the district court proceedings, they only identified a single provision in the appeal, and that one provision was easily severable without affecting the remainder of the arbitration agreement.

The district court refused to compel arbitration by applying *Armendariz* to hold that the arbitration agreement was too one-sided because it excluded from arbitration those types of disputes more likely to be brought by the stronger party. The Ninth Circuit reversed with directions to grant the motion. The Court rejected defendant's argument that the district court should have referred to the arbitrator the plaintiff's contention that the arbitration provision was unconscionable, reciting the general rule that when a challenge is made to the enforceability of a contract as a whole, the arbitrator decides the validity of the contract, but when a challenge is made to the enforceability of the arbitration agreement, that is a question for the courts to decide. Id. at *1, citing *Bridge Fund Capital Corp. v. Fastbucks Franchise Corp.* (9th Cir. 2010). In this case, the Court found that plaintiff's challenge was clearly directed at the arbitration provision. The Ninth Circuit agreed with the district court that the arbitration agreement was procedurally unconscionable because it was a contract of adhesion. Id. However, with regard to substantive unconscionability,

the Court noted that while plaintiffs had identified several provisions in the arbitration agreement as being substantively unconscionable in the district court proceedings, they had only identified a single provision in the appeal. As to that one provision, the Court found that it could be easily severed without affecting the remainder of the arbitration agreement and held that that was the proper course in this case. Id., citing *Dotson v. Amgen,Inc.*, 181 Cal. App. 4th 975 (2010).

- ***Magno v. The College Network, Inc.***, 1 Cal. App. 5th 277 (2016) – Indiana venue clause and one-sided arbitrator selection clause rendered arbitration agreement unconscionable and thus unenforceable.

Defendant The College Network, Inc. (TCN) is an Indiana-based company with customers nationwide. Plaintiffs were Licensed Vocational Nurses (LVNs) who were sold a program by TCN. The program allowed plaintiffs to take Registered Nurse classes online through Indiana State University (ISU) and clinical programs through California State University (CSU). The contract plaintiffs were required to sign was a two-sided, preprinted purchase agreement that included an arbitration clause that required binding arbitration in Marion County, Indiana, before a neutral arbitrator selected by TCN.

After signing the purchase agreement and enrolling in the Registered Nurse B.S. program, plaintiffs discovered that ISU had suspended enrollment into its LVN to B.S. nursing program. Plaintiffs filed suit against TCN for fraud and breach of contract, alleging that TCN had wrongfully concealed this information and misrepresented that by enrolling in the program plaintiffs would qualify for entrance into ISU's nursing degree program. TCN moved to compel arbitration. The trial court denied TCN's motion, and the Court of Appeal affirmed, holding that there was procedural and substantive unconscionability that invalidated the arbitration clause. The Court of Appeal held that there was procedural unconscionability due to the rush nature of the negotiation, the unequal bargaining power and the use of a pre-printed form contract drafted by TCN. The Court found that substantive unconscionability existed because arbitration in Indiana would not have been within the young, college-age students' reasonable expectations, and would put them at a disadvantage in any arbitration. Additionally, the agreement had unilateral provisions beneficial only to TCN, such as providing for TCN to select the neutral arbitrator and for a shortened statute of limitations period applicable only to plaintiffs' claims.

- ***Penilla v. Westmont Corp.***, 3 Cal. App. 5th 205 (2016) – A mobile home park's arbitration provision was unconscionable and unenforceable because it was given to Spanish-speaking residents in an English-only adhesion contract and required residents to advance half of the cost of a three-person JAMS arbitration, restricted the remedies the arbitrators could award, and imposed a shortened one-year limitations period for asserting claims.

Westmont rents land to low-income mobile home owners. Forty-six mobile home owners who entered into rental agreements with Westmont sued the company on various contract, tort, and statutory claims. Westmont, citing the arbitration provision within its rental agreements, moved to compel arbitration. The mobile home owners opposed the motion, arguing that the arbitration provision was both procedurally and substantively unconscionable.

The mobile home owners said the arbitration provision was procedurally unconscionable because it (1) was a contract of adhesion, (2) was not provided or explained in Spanish for the one-third of the mobile home owners who spoke little English, and (3) was signed under severe economic pressure.

The mobile home owners said the arbitration agreement was also substantively unconscionability, because the agreement (1) required a three-arbitrator panel at JAMS, and required claimants to advance half of the costs associated with the arbitration (which could easily amount to more than the park residents could afford and even exceed the amount of the dispute), (2) contained a shortened one-year limitations period for asserting claims, and (3) limited the recovery of punitive damages.

Although the trial court found that a valid rental contract existed between Westmont and the mobile home owners, it did not compel arbitration, because the arbitration provision was both procedurally and substantively unconscionable. The trial court found that the mobile home owners were under economic pressure to enter into the rental agreements since they already were paying for mobile homes and could not afford other housing, and were not informed that the expense of a JAMS arbitrator ranged from $500 to $800 per hour and $5,000 to $10,000 per day per arbitrator. Westmont appealed this ruling.

The Court of Appeal affirmed the trial court's ruling and reasons for denying the petition to compel arbitration. It also articulated additional grounds for finding the subject arbitration provision to be unconscionable and thus unenforceable. Although an arbitration agreement is not rendered unenforceable merely it is contained in a contract of adhesion, the Court of Appeal noted that the California Supreme Court has specifically opined that the "immobility of the mobile home, the investment of the mobile home owner, and restriction on mobile home spaces" heightens "an economic imbalance of power in favor of mobile home park owners." As applied to Westmont's arbitration provision, the Court of Appeal concluded

that the evidence showed that the mobile home owner plaintiffs had no real practical choice but to agree to the rental agreements containing the arbitration provision.

The Court of Appeal also faulted Westmont's managers who explained in Spanish that the rental agreement was required, but did not explain the arbitration provision's terms to the one-third of mobile home owners who were not proficient in English. More importantly, the Court of Appeal explained that, even for the English-proficient mobile home owners, the arbitration provision was "confusing and sometimes contradictory," reflected a "tenuous grasp of grammar and syntax," and would be incomprehensible, deceptive, or surprising to a layperson—in English or Spanish.

The Court of Appeal then found that the failure to explain to mobile home owners that arbitration fees could be up to $5,000 per day was significant. In addition to the deterrent effect noted by the trial court, the Court of Appeal emphasized the failure in light of the arbitration provision's imposition of a default judgment on parties who failed to advance their arbitration fees and the provision's failure to either limit the amount of arbitration fees, or provide any means of reducing fees (e.g., permitting claims in small claims court or consolidation of claims to permit splitting arbitration fees with others).

Finally, the Court of Appeal noted that the arbitration provision's shortened arbitral limitations period, and limitations on available remedies, also raised concerns of substantive unconscionability. Specifically, the rental agreement created a limitations period for claims of one year—although the claims asserted in the plaintiffs' lawsuit generally were subject to a limitations period of three or four years—and also limited awards of punitive damages to two percent of the owner's equity.

- ***Nguyen v. Applied Medical Resources Corp.***, 4 Cal. App. 5th 232 (2016) – "I agree" phrases did not destroy the bilateral nature of the arbitration agreement, so the agreement was enforceable.

Former employee brought a putative class action against former employer, alleging causes of action under the Labor Code, the Unlawful Competition Law, and the Private Attorney General Act (PAGA). That action sought unpaid overtime, meal and rest period compensation, penalties, and other equitable relief. Defendant moved to compel arbitration of the individual claims, strike the class allegations, and stay the PAGA cause of action. The trial court granted defendant's motion in all regards and over the plaintiff employee's objection that the employment agreement was unconscionable. Plaintiff's argument in this regard was that the agreement was peppered with "I agree" phases and, thus, was clearly one-side and intended to require the employee only to submit disputes to binding arbitration.[5] The agreement also expressly stated that it applied to "all disputes and claims arising out of or relating to the submission of [the employment application]," and "all disputes that cannot be resolved by informal internal resolution which might arise out of or relate to my employment

[5] The agreement contained many sentences beginning with one-sided words like, "I agree," "I further agree," and "I hereby agree." 4 Cal. App. 5th at 251.

with the company." The court found that these latter terms were sufficient to establish mutuality, and declined to find that the mere inclusion of the words "I agree" by one party in an otherwise mutual arbitration agreement destroys the bilateral nature of the agreement. 4 Cal. App. 5th at 252.

- ***Tompkins v. 23andMe, Inc.***, 840 F.3d 1016 (9th Cir. 2016) – Prevailing party clause, forum selection clause, and the exclusion of intellectual property disputes did not render the arbitration provision in an on-line consumer contract substantively unconscionable.

Plaintiffs were customers of personal genetics company 23andMe who purchased DNA test kits on-line. The company filed a motion to compel arbitration based upon the arbitration provisions contained in the terms of use posted on its website. Plaintiffs challenged the enforceability of the arbitration provisions on the grounds that it contained several substantively unconscionable terms. The district court concluded that although the arbitration provision was procedurally unconscionable, it was not substantively unconscionable and therefore was enforceable under California law. Plaintiffs appealed.

The Ninth Circuit affirmed the district court decision. The Court began its opinion by recognizing that Section 2 of the FAA "is a congressional declaration of a liberal federal policy favoring arbitration agreements." Any doubts about the scope of arbitrable issues, including applicable contract defenses, are to be resolved in favor of arbitration. *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983). The Court noted that the "savings clause" of Section 2 authorizes a court to strike or limit an arbitration provision only in instances involving generally applicable contract defenses, such as fraud, duress, or unconscionability. It held that a federal court must look to relevant state law in deciding whether an arbitration provision is unconscionable. For this reason, the Ninth Circuit examined California authorities to decide whether provisions of the arbitration clause in the instant case were unconscionable.

The Ninth Circuit first examined the provision in the arbitration clause stating "arbitration costs and reasonable documented attorneys' costs of both parties will be borne by the party that ultimately loses." Plaintiffs contended that if they lost, the arbitrators' charge of $1,500 per day and 23andMe's "top tier" lawyers' fees would be unreasonable, overly burdensome, and unfair. The Ninth Circuit panel reviewed relevant California authorities and found that a number of courts had enforced prevailing party clauses in the non-arbitration context. While several California appellate courts had held cost-shifting clauses to be unconscionable in the context of arbitration agreements, those cases all involved unilateral, rather than bilateral, fee-shifting provisions. The court noted that plaintiffs had not produced any case where a bilateral clause awarding attorney fees and costs to the prevailing party was held to be unconscionable. Indeed, the Court noted that California Civil Code section 1717 appears to approve bilateral prevailing party clauses, since it requires courts to treat all unilateral prevailing party clauses as if they were bilateral clauses. The Court noted that in the present case, the prevailing party clause was expressly bilateral, providing that either party could request binding arbitration, and the arbitration costs and reasonable documented attorney fees of both parties were to be borne by the

party that ultimately loses. Because the standard of unconscionability must be the same for arbitration and nonarbitration agreements, coupled with the general rule that parties may validly agree to a bilateral prevailing party clause, the Ninth Circuit concluded that the prevailing party clause at issue in this case was not unconscionable. 840 F.3d at 1026, citing *Sanchez v. Valencia Holding Co., LLC*, 61 Cal. 4th 899, 911 (2015); *Santisas v. Goodin*, 17 Cal. 4th 599, 608 (1998).

Next, the Ninth Circuit addressed plaintiffs' claim that the designation of San Francisco as the forum for arbitration was unconscionable as a matter of California law. The Ninth Court noted that in its 2015 decision in *Sanchez*, the California Supreme Court had indicated that its decision in *Valentino & Smith, Inc. v. Superior Court*, 17 Cal. 3d 491 (1976) (en banc) exemplified California's unconscionability doctrine with respect to forum selection clauses; that the "modern trend" favors enforceability of forum selection clauses, and that forum selection clauses "are valid and may be given effect, in the court's discretion and in the absence of a showing that enforcement … would be unreasonable." 17 Cal. 3d at 495-496. The Ninth Circuit looked at cases following *Valentino & Smith*, and found that California courts have generally expressed a policy approving forum selection clauses because they "play an important role in both national and international commerce … and provide a degree of certainty both for businesses and their customers, that contractual disputes will be resolved in a particular forum." 840 F.3d at 1028, citing *Lu v. Dryclean-U.S.A. of California, Inc.*, 11 Cal. App. 4th 1490, 1493 (1992); *Net2Phone, Inc. v. Superior Court*, 109 Cal. App. 4th 583, 588 (2003). Ultimately, the Ninth Circuit concluded that the designation of San Francisco as the choice of forum was not an unreasonable choice because San Francisco is 23andMe's principal place of business and thus has sufficient nexus to the contracts in issue; there was adequate notice to consumers about the forum selection clause; seven of the plaintiffs reside in California; and six of the nine actions were filed in California. Additionally, plaintiffs failed to submit affidavits explaining why the expense of traveling to the San Francisco venue would be too burdensome.

The final arbitration clause provision discussed by the Ninth Circuit was the one excluding from mandatory arbitration "any disputes relating to intellectual property rights, obligations, or any infringement claims." Plaintiffs argued that this clause was substantively unconscionable because 23andMe was more likely to bring intellectual property claims against its customers than vice versa, and therefore 23andMe had reserved for itself the advantages of a judicial forum, while forcing its customers to use an arbitral forum. The Ninth Circuit rejected plaintiffs' argument, noting that under the terms of service, customers retained certain intellectual property rights including rights in user-generated content and genetic information. As such, customers would be able to bring these claims in court. Conversely, the Court found that plaintiffs had not identified any intellectual property rights claims that 23andM3 might be likely to bring against its customers. The Court concluded that the intellectual property claims carve-out had more than a "modicum of bilaterality" and that plaintiffs therefore had not carried their burden of demonstrating that the clause was unconscionable. Id. at 1031.

- ***Mohamed v. Uber Technologies, Inc.***, 848 F.3d 1201 (9th Cir. 2016) – If an arbitration clause contained in an adhesion employment agreement includes a meaningful opt-out provision, the existence of the opt-out provisions will render the arbitration clause procedurally conscionable as a matter of law and eliminate the need to inquire further with respect to substantive unconscionability.

The Ninth Circuit delivered a significant victory to Uber by reversing a district court's denials of Uber's motions to compel arbitration in companion class action lawsuits brought by former drivers in Massachusetts and California.

In one case, *Mohamed v. Uber Technologies, Inc.*, a Massachusetts driver sued Uber for violations of the Fair Credit Reporting Act and related state laws. He claimed that Uber's involuntary termination of his business relationship with the company based on consumer credit background information it obtained about him, violated various federal and state laws.

In a related case, *Gillette v. Uber Technologies, Inc.*, other drivers made similar claims related to alleged improper background checks. In this case, the class action lawsuit also pursued PAGA claims, alleging that drivers were improperly classified as independent contractors rather than employees.

In both the Mohamed and Gillette cases, Uber moved to compel arbitration based upon a 2013 agreement signed by Gillette and a 2014 agreement signed by Mohamed. The 2013 and 2014 agreements were similar in that they both required arbitration of all claims and also both provided that all disputes as to arbitrability (i.e., whether the arbitration agreement was enforceable) were to be decided by the arbitrator and not the court. Both agreements also provided that the drivers waived their rights to bring any claim on a class or collective basis, meaning that their cases could only proceed on an individual basis in arbitration. Finally, both agreements included an opt-out provision. The 2013 agreement required drivers to opt-out in person at Uber's San Francisco office or by overnight mail. The 2014 agreement added options for drivers to opt-out by email or regular mail. The district court denied Uber's motion to compel based on a finding that the delegation clauses in both agreements were (1) ineffective because they were not clear and unmistakable, and (2) even if clear and unmistakable, were unenforceable because they were unconscionable. With regard to unconscionability, the district court ruled that the agreements were procedurally unconscionable because there was no meaningful opportunity for the driver to reject the 2013 agreement and because the 2014 agreement failed to notify drivers that a drawback of the delegation clause was that drivers might be required to pay considerable forum fees to arbitrate arbitrability.

The Ninth Circuit rejected the district court's reasoning. The Court relied on *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1281 (9th Cir. 2006) (en banc) for the proposition that the threshold inquiry in California unconscionability analysis is whether the agreement is adhesive." The Court ruled that both arbitration clauses include a "meaningful right to opt out" and the existence of the opt-out provisions "renders the arbitration clause … procedurally conscionable as a matter of law." *6, citing *Circuit City Stores, Inc. v. Ahmed*, 283 F.3d 1198, 1199 (9th Cir. 2002); *Kilgore v. KeyBank, N.A.*, 718 F.3d 1052, 1059 (9th Cir. 2013) (en banc). Because the Court found that the agreements were not procedurally unconscionable, and because both procedural and substantive unconscionability must be present in order for an agreement to be unenforceable on unconscionability grounds under *Armendariz*, the Court held that it "need not reach the question whether the agreements here were substantively unconscionable," and that the district court should have ordered the parties to arbitrate their dispute over arbitrability and remanded with instructions for the district court to do so.

The Ninth Circuit also addressed the PAGA waivers contained in the two agreements. The 2013 agreement expressly required the court, not the arbitrator, to decide all challenges to the enforceability of the PAGA waiver. Relying on *Iskanian v. CLS Transportation L.A., Inc.*, 59 Cal. 4th 348 (2014), the Court ruled that the PAGA waiver was invalid but severable because the contract contained a severance provision. With respect to the 2014 agreement, the court relied on the broad scope of arbitration provision and left the determination of that issue to the arbitrator.

- ***Poublon v. C. H. Robinson***, 846 F.3d 1251 (9th Cir. Feb. 3, 2017) – Despite the finding that two aspects of an arbitration clause were unconscionable / unenforceable, those provisions could be severed, allowing the rest of the arbitration clause to be enforced.

A former employee brought a putative class action against her former employee alleging that the employer had misclassified the class of employees as exempt from overtime pay and asserted a PAGA claim. While employed by C. H. Robinson, plaintiff signed an agreement titled "Incentive Bonus Agreement" in order to be eligible to receive a financial bonus. That agreement included an arbitration provision which provided that "neither You nor the Company may bring any Claim combined with or on behalf of any other person or entity, whether on a collective, representative, or class action basis." It included a severability clause, providing that if any part of the arbitration agreement was invalid, the rest of it would be enforced. The employer moved to compel arbitration and dismiss the class or representative claims. The district court found that the arbitration clause was procedurally and substantively unconscionable and denied the employer's motion. The district court took issue with the adhesive nature of the contract, as well as several provisions that it viewed as unilaterally favoring the employer. The district court was reversed on appeal to the Ninth Circuit.

The Ninth Circuit reversed the district court's determination that the Incentive Bonus Agreement was procedurally unconscionable to a high degree, noting that the adhesive nature of a contract, without more, only gave rise to a low degree of procedural unconscionability, and there was no evidence of any other indications of oppression or surprise to support a conclusion that the degree of procedural unconscionability was high.

With regard to substantive unconscionability, the Ninth Circuit disagreed with the district court that an out-of-state venue provision was unconscionable. The venue provision provided for Hennepin County, Minnesota to be the place of the arbitration hearing. Citing its recent decision in *Tompkins v. 23andMe, Inc.*, 840 F.3d 1016 (9th Cir. 2016) (discussed above), the Court restated its position that courts must enforce a forum selection clause unless there is evidence that "the forum selected would be unavailable or unable to accomplish substantial justice;" that inconvenience and expense associated with the forum alone are not sufficient grounds to deny enforcement. Moreover, the Court noted that the venue provision allowed the parties to agree on a different venue, and allowed the arbitrator to select a different venue for "good reason." The Court reasoned that an arbitrator would have good reason to change the venue if plaintiff could demonstrate that Minnesota would be "so gravely difficult and inconvenient" that she would be deprived of her day in court for all practical purposes.

The Ninth Circuit also disagreed with the district court and found that a confidentiality provision, a sanctions provision, a unilateral modification provision, and a provision imposing limitations on discovery were *not* substantively unconscionable.

In final analysis, the Ninth Circuit found that only two aspects of the arbitration clause were unconscionable / unenforceable – the PAGA waiver and a unilateral provision that allowed only the employer to go to court for injunctive or equitable relief. As to those provisions, the Court found that they could be severed so that the rest of the arbitration agreement could be enforced.

- ***Farrar v. Direct Commerce, Inc.***, 9 Cal. App. 5th 1257 (1st Dist. Mar. 23, 2017) – One-sided claim exclusion contained in an arbitration clause included in an adhesion employment contract was held to be substantively unconscionable. However, because it was the only unconscionable provision in the arbitration agreement, it could be severed and the balance of the agreement enforced.

Plaintiff worked for defendant for four years as its vice president of business development pursuant to the terms of a negotiated employment contract. When defendant fired plaintiff, she sued for alleged breach of contract, wrongful termination and various wage and hour claims. The defendant employer moved to compel arbitration. Plaintiff employee opposed the motion on the grounds that the arbitration clause contained in her employment agreement was unconscionable and thus unenforceable. The trial court denied the employer's motion based on its finding that the arbitration provision was both procedurally and substantively unconscionable. It ruled that the provision was

procedurally unconscionable because plaintiff "had no meaningful choice whether or not to accept the arbitration agreement," and that plaintiff was "surprised" by the arbitration provision because it differed from the provision contained in the original offer letter in that it changed the name of the arbitration provider and did not attach the provider rules which were to govern the arbitration. The trial court ruled that the arbitration provision was substantively unconscionable because it contained a one-sided carve out for trade secret claims (which were the sort of claims that only the employer would bring).

The First District Court of Appeal reversed. Noting that under California law, a court may refuse to enforce an agreement when it is both procedurally and substantively unconscionable, and that it may sever certain provisions to prevent an unconscionable result under Civil Code § 1670.5, the court held that there was only a small degree of procedural unconscionability in the facts presented in this case, and the one-side carve out could be cured by simply severing that provision and enforcing the balance of the agreement. The Court of Appeal held that severance was appropriate because the carve-out was the only substantively unconscionable term and did not permeate the entire agreement. The court distinguished prior cases where severance was found to not be appropriate (and thus the arbitration agreement deemed unenforceable) because the provision to be severed was more expansive than the one involved in this case and/or there were multiple unconscionable terms (where here there was only one).

Comment. This is an interesting case because it illustrates the application of the unconscionability defense in the context of a negotiated employment agreement involving an executive-level employee. Under California law, a court may refuse to enforce an agreement when it is both procedurally and substantively unconscionable, with the understanding that these characteristics need not be present in the same degree. Baltazar v. Forever 21, Inc., 62 Cal. 4th 1237, 1243 (2016). The more substantively oppressive a contract term is, the less evidence of procedural unconscionability is required for a court to conclude that the challenged agreement is unenforceable and vice versa. Pinnacle Museum Tower Assn. v. Pinnacle Market Development (US), LLC, 55 Cal. 4th 223, 247 (2012). As to the procedural unconscionability prong of the analysis, it is interesting that the employer in this did not really contest this issue. Plaintiff averred that while she was able to negotiate the economic terms of her employment, she could not negotiate other terms, including the arbitration provision. The result might have been different at the trial level had procedural unconscionability been contested by the employer.

- ***Baxter v. Genworth North America Corp***, 16 Cal. App. 5th 713 (1st Dist. Oct. 26, 2017) – Take-it-or-leave-it employment agreement with an arbitration clause containing multiple one-sided terms favoring the employer was unconscionable and unenforceable.

Maya Baxter ("Baxter") was employed by AssetMark Investment Services, Inc. ("AssetMark") from 2001 to 2006. Genworth North America Corporation ("Genworth) acquired AssetMark in 2006 and Baxter became an employee of Genworth. As a continue of her employment with Genworth, Baxter was required to sign a "Conditions of Employment Acknowledgment" in which she agreed to resolve any employment related disputes through binding arbitration and in accordance with the company's dispute resolution program called "Resolve." When Baxter was fired in 2013, she sued Genworth for wrongful termination, alleging that she was fired because of racial discrimination and retaliation for taking a leave under CFRA to care for her ill mother. Genworth filed a motion to compel arbitration. The trial court denied the motion, finding that it was both procedurally and substantively unconscionable. The First District Court of Appeal affirmed.

With regard to procedural unconscionability, the court noted the obvious: the acknowledgment was presented to Baxter as a condition of continued employment, with no opportunity to negotiate its terms and without any meaningful choice in the matter.

With regard to substantive unconscionability, the court concluded that the acknowledged was substantively unconscionable because it continued numerous one-sided terms that south to unfairly skew the arbitration process in favor of the employer. The offending terms included provisions (1) prohibiting communications with other employees by the employee, (2) limiting discovery in a factually complex case to an extent that would be inadequate to permit the employee to fairly pursue her claims, (3) shortening the limitations period and leaving insufficient time to protect the employee's right to vindicate her statutory rights, and (4) depriving the employee of her right to have an administrative investigation conducted before the employee was required to pursue statutory FEHA claims in an arbitration.

It is worth noting that the court held that the provisions concerning the timeline for commencing and concluding the arbitration and limiting the length of the arbitration hearing, "while short, were not per se unconscionable." The court of appeal parted ways with the trial court with regard to the "saving" provided by the provision giving the arbitrator discretion to extend the timelines upon a merely showing of good cause. The court held that because it must presume "that the arbitrator will act reasonably in conformity with the law," it could not say that an arbitrator would "feel compelled to deny a reasonable request to extend the Resolve arbitration timelines in a complex employment dispute." The court acknowledged that the short, default timelines set forth in the arbitration provisions gave it "cause for concern," but not enough to justify an inference of "a modest degree of unconscionability in light of the arbitrator's discretion to extend them." 16 Cal. App. 5th at 736.

(d) *2016 and 2017 Cases re Waiver Defense*

- ***Martin v. Yasuda,*** 829 F.3d 1118 (9th Cir. 2016) – Defendants engaged in acts inconsistent with the right to arbitrate by choosing to delay their right to compel arbitration by actively litigating the dispute and taking advantage of procedures available in a court setting.

This is an employment dispute in which cosmetology students, required to complete 1600 hours of technical instruction and practical training by performing services to the college's paying customers, sued the school for its failure to pay minimum hourly wages and overtime or to provide meal and rest breaks. Despite the fact that the Enrollment Agreement the students signed contained an arbitration clause, defendants delayed almost 17 months after the start of the case before moving to compel arbitration. The district court denied defendants' motion to compel arbitration, and defendants appealed.

The Ninth Circuit affirmed, and started its analysis by noting that the right to arbitration, like other contractual rights, can be waived. 829 F.3d at 1124, citing *United States v. Park Place Assocs., Ltd.*, 563 F.3d 907, 921 (9th Cir. 2009). While the party arguing waiver bears a heavy burden of proof, where it is shown that a party has engaged in acts that are inconsistent with its right to arbitrate – including such things as actively litigating its case and taking advantage of procedures available in a court setting – that burden will be deemed satisfied. Id. at 1125, citing *Van Ness Townhouses v. Mar Indus. Corp.*, 862 F.2d 754, 759 (9th Cir. 1988) (finding waiver when a party answered complaints, moved to dismiss the action, and did not claim a right to arbitrate in any of its pleadings), *Kelly v. Pub. Util. Dist., No. 2*, 552 Fed. Appx. 663, 664 (9th Cir. 2014) (finding this element satisfied when the parties conducted discovery and litigated motions, including a preliminary injunction and motion to dismiss), and *Plows v. Rockwell Collins, Inc.*, 812 F.Supp. 2d 1063, 1067 (C.D.Cal. 2011) (finding this element satisfied when the defendant actively litigated the case by removing it to federal court, seeking a venue transfer, participating in meetings and scheduling conferences, negotiating and entering into a protective order, and participating in discovery that would not have been available under the arbitration agreement).

In this case, the Ninth Circuit found that the defendants had participated in the preparation of a joint stipulation that dealt with the most resourceful and efficient manner in which to approach discovery and class certification motions, had filed a motion to dismiss on key merits issues, had entered into a protective order, had answered discovery, and had participated in depositions. While the defendants raised the issue of their right to arbitration at a scheduling conference, that was a year into the litigation, and they then waited another year before filing their motion to compel arbitration.

Another factor motivating the Court's decision was the fact that defendants had raised issues going to the merits of the case in a motion to dismiss, which they had lost. The Court found that plaintiffs would be prejudiced if the case were ordered to arbitration because they would be forced to relitigate a key legal issue on which the district court had ruled in their favor, essentially giving the defendants "a mulligan on a legal issue it chose to litigate in court and lost." Id. at 1128.

- ***Freeney v. Bank of America,*** Case No. 15-cv-02376 (C.D.Cal. Aug. 8, 2016) – Despite the fact that defendant stated in its multiple motions to dismiss that it intended to move to compel arbitration, when it finally made such a motion, the court concluded – following *Yasuda* – that defendant's repeated attacks on the merits of plaintiff's claim were acts inconsistent with the right to compel arbitration, and it would be inequitable to allow defendants a second bite of the apple after they tried and failed to obtain dismissal in a court setting.

This dispute involves Colts and Chargers defensive end and seven-time Pro Bowler Dwight Freeney and Bank of America. In a highly publicized lawsuit, Freeney sued Bank of America Corporation (BAC), Bank of America, N.A. (BANA). Merrill Lynch Pierce Fenner & Smith, Inc. (MLPFS), and Michael Bock, a former employee and financial advisor at MLPFS who handled Freeney's account, Freeney's claim was that he was the victim of an elaborate fraud scheme after entrusting the bank's wealth management division with his assets, suffered damages in excess of $20 million. While there was no disputing the fact that Freeney was defrauded – the two primary culprits (Eva Weinberg and Michael Stern) were criminally indicted and sentenced pursuant to plea agreements given in exchange for their guilty pleas [6] – this action raised the question of who should be held legally accountable to Freeney for the damages caused by the fraud.

As originally filed, Freeney alleged that Bank of America "participated in and aided and abetted" in an elaborate, malicious scheme and that truthful disclosure would have dissuaded him from agreeing to become a "BofA client or to entrust the management of his assets, investments and income to BofA." Bank of America, on the other hand, said that Stern, the primary wrongdoer, never worked for the bank or any of its affiliates, and that Weinberg committed her criminal conduct after leaving Merrill Lynch (a subsidiary of BofA). In July and November 2015, U.S. District Judge Margaret Morrow granted defendants' motions to dismiss the racketeering and aiding and abetting claims, but allowed Freeney leave to amend. Defendants then filed a motion to compel arbitration and, after Freeney filed his third amended complaint, they then filed a further motion to dismiss. On August 4, 2016, U.S. District Judge Jesus Bernal granted dismissal with prejudice of the

[6] Stern and Weinberg were charged in 2012 by federal prosecutors in Los Angeles with fraud and other offenses. After reaching plea agreements, Stern was sentenced to five years in prison, while Weinberg got six months.

racketeering and aiding and abetting charges with prejudice, but denied arbitration finding that through its aggressive litigation in the federal court case, defendants had acted inconsistently with asserting their right to compel arbitration and had thus waived that right.

With regard to the prejudice visited upon plaintiff as a result of defendants' delay in filing their motion to compel arbitration, the Court took issue with defendants' filing "two voluminous rounds of motions to dismiss, and a motion to relitigate one of the motions to dismiss, forcing Plaintiff to incur significant legal expenses that would be wasted if this case were now sent to arbitration." Citing, *Kelly v. Pub. Util. Dist. No. 2, Etc.*, 552 Fed. Appx. 663, 664 (9th Cir. 2014); *Hoffman Const. Co. of Oregon v. Active Erectors & Installers, Inc.*, 969 F.2d 796, 799 (9th Cir. 1992); *Morgan Stanley & Co., LLC v. Couch*, 134 F.Supp. 3d 1215, 1231-1232 (E.D. Cal. 2015); *Plows v. Rockwell Collins, Inc.*, 812 F.Supp. 2d 1063, 1068 (C.D.Cal. 2011); *Steiner v. Horizon Moving Sys., Inc.*, No. EDCV 08-682-VAP (CTx), 2008 WL 4822774 (C.D.Cal. Oct. 30, 2008); *In re Toyota Motor Corp. Hybrid Brake Mktg., Sales, Practices & Products Liab. Litig.*, 828 F.Supp. 2d 1150, 1165 (C.D.Cal.. 2011), aff'd sub nom. *Kramer v. Toyota Motor Corp.*, 705 F.3d 1122 (9th Cir. 2013).

- **Oto*, LLC v. Kho,*** 14 Cal. App. 5th 691 (1st Dist. Aug. 21, 2017) – Denial of employer's petition to compel arbitration of employee's wage and hour claims reversed. Arbitration provision provided an affordable and accessible forum and thus was not substantively unconscionable and was effective to waive the employee's right to a Berman hearing.

Kho was employed as an auto mechanic for OTO, LLC, doing business as One Toyota of Oakland. Approximately three years into his employment, One Toyota required Kho to sign an arbitration agreement, which he executed without any explanation. Following his termination, Kho filed a claim with the California Labor Commissioner against one Toyota for unpaid wages. After settlement efforts failed, One Toyota filed a petition to compel arbitration. The trial court denied the petition, concluding that the arbitration agreement was unconscionable because it did not meet the standard set forth in *Sonic-Calabasas A, Inc. v. Moreno*, 57 Cal. 4th[h] 1109 (2013) ("*Sonic II*").[7] After *Sonic II*, the waiver of the right to a

[7] In *Sonic-Calabasas A, Inc. v. Moreno*, 51 Cal. 4th 659 (2011) ("*Sonic I*"), the legal issue presented was whether an employer, as a condition of employment, could require an employee to waive the right to a Berman hearing (a dispute resolution procedure/administrative forum established by the Legislature to assist employees in recovering unpaid wages. In *Sonic I*, the California Supreme Court established a per se rule of unconscionability where an employer to required an employee to waive the right to a Berman hearing as part of a pre-dispute arbitration agreement. In *Sonic I*, the Court held that its rule prohibiting waiver of the right to Berman hearing does not discriminate against arbitration agreements, and is therefore not preempted by the FAA, because any party dissatisfied with the result of the Berman hearing could then move to compel arbitration of the wage dispute consistent with the arbitration agreement, just as a dissatisfied party could obtain a trial in court absent an agreement to arbitrate.

The United States Supreme Court granted certiorari in *Sonic I*, vacated the judgment and remanded the case to the California Supreme Court for consideration in light of the Court's decision in *Concepcion*, where it clarified the limitations that the FAA imposes on a state's capacity to enforce its rules of unconscionability on

Berman hearing as part of a pre-dispute arbitration agreement is not per se substantively unconscionable. Rather, the inquiry is whether the arbitration agreement provides the employee with an accessible and affordable arbitral forum for resolving wage disputes. As with any contract, "the unconscionability inquiry requires a court to examine the totality of the agreement's substantive terms as well as the circumstances of its formation to determine whether the overall bargain was unreasonably one-sided." 57 Cal. 4th at 1146.

In this case, on appeal to the First District Court of Appeal, the court reversed and remanded. Starting with the defense doctrine of unconscionability - in the context of arbitration agreements - the court noted that the California Supreme Court recently summarized that doctrine in *Sanchez v. Valencia Holding Co., LLC*, 61 Cal. 4th 899 (2015).

> "One common formulation of unconscionability is that it refers to 'an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party…. As that formulation implicitly recognizes, the doctrine of unconscionability has both a procedural and a substantive element, the former focusing on oppression or surprise due to unequal bargaining power, the latter on overly harsh or one-sided results…
>
> The prevailing view is that [procedural and substantive unconscionability] must *both* be present in order for a court to exercise is discretion to refuse to enforce a contract or clause under the doctrine of unconscionability…. But they need not be present in the same degree. 'Essentially a sliding scale is invoked which disregards the regularity of the procedural process of the contract formation, that create the terms, in proportion to the greater harshness or unreasonableness of the substantive terms themselves.' In other words, the more substantively oppressive the contract terms, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa. Courts may find a contract as a whole 'or any clause of the contract' to be unconscionable."

61 Cal. 4th at 910-911.

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parties to arbitration agreements. On remand to the California Supreme Court, the Court concluded that because compelling the parties to undergo a Berman hearing would impose significant delays in the commencement of arbitration, the approach it took in *Sonic I* was inconsistent with the FAA. Accordingly, the Court held that, contrary to *Sonic I*, the FAA preempts a state-law rule categorically prohibiting waiver of a Berman hearing in a predispute arbitration agreement imposed on an employee as a condition of employment. At the same time, the Court concluded that the state court may continue to enforce unconscionability rules that do not interfere with fundamental attributes of arbitration. 57 Cal. 4th at 1124, citing *Concepcion*, 131 S.Ct. 1740, 1748.

As applied to this case, the court of appeal found that the circumstances surrounding Kho's execution of the arbitration agreement established that the degree of procedural unconscionability was "extraordinarily high," but that was not enough to deny enforcement because the court found that the substance of the agreement was not substantively unconscionable. Under *Sonic II*, an arbitration agreement is substantively unconscionable only if it does not provide the employee with "an affordable and accessible alternative forum" to the courts. Here, the court found that the agreement in question was not substantively unconscionable because Kho was not required to pay any costs of arbitration not required by the civil courts. It also found that the arbitration proceeding was not inaccessible because it was similar to civil litigation and thus no more complex than a proceeding under the Labor Code's "Berman" hearing procedure. Accordingly, the court of appeal found that the trial court erred in not granting ne Toyota's motion to compel and reversed with instructions to enter a new order granting the petition to compel arbitration.

- ***Sprunk v. Prisma LLC,*** 14 Cal. App. 5th 785 (2d Dist. Aug. 23, 2017) – Withdrawal of motion to compel individual arbitration and opposition to class certification constitutes a waiver of the right to later seek to compel class arbitration.

An exotic dancer brought a wage and hour action against her employer alleging that she and other dancers were misclassified as independent contractors rather than employees and, consequently, denied various benefits. The defendant employer filed a motion to compel individual arbitration of the plaintiff's claims, despite the fact that her complaint included class allegations, and did so based upon the United States Supreme Court's recent decisions in *Concepion* and *Stolt-Nielsen* requiring courts to grant motions compelling arbitration of individual claims despite the existence of class allegations. Plaintiff filed opposition to the motion to compel in which she argued, among other things, that the extremely broad language of the arbitration clause that she signed as part of her employment permitted arbitration of class claims. For that reason, plaintiff claimed that the court must decide whether or not to order arbitration of all individual and class claims or, in the alternative, deny defendant's motion on the ground that it seeks to limit the arbitration to only individual claims even though class claims are included within the scope of arbitrable claims under the contract. Defendant withdrew its motion, and proceeded to participate in the litigation by doing such things as filing an answer to plaintiff's complaint filing a cross-complaint, filing a demurrer to plaintiff's complaint, taking plaintiff's deposition, and engaging in other discovery efforts.

When plaintiff moved for class certification, defendant opposed the motion with an argument that it still had a right to seek to compel individual arbitration of the class members because all of them had signed arbitration agreements and defendant could not have moved to compel arbitration until the class members were brought into the action through certification. The trial court rejected this argument, certified the class and found that defendant had waived the right to arbitrate at least as to the claims being asserted by plaintiff because it had delayed in seeking arbitration and taken advantage of the court's processes. The Second District Court of Appeal agreed, holding that the trial court did not

have to ignore the practical realities of the litigation when deciding the waiver issue. Based on the sequence of events, it appears that the defendant had abandoned its initial motion to compel arbitration in the hopes that it could defeat the action by opposing class certification. The court explained that "[a]n attempt to gain a strategic advantage through litigation in court before seeking to compel arbitration is a paradigm of conduct that is inconsistent with the right to arbitrate." 14 Cal. App. 5th at 798. In this case, the court found that there was substantial evidence to support the conclusion that defendant's delay in moving to compel arbitration until after a ruling on class certification was a strategic decision to attempt to win the case by defeating the class before seeking to arbitrate – keeping in mind that plaintiff had teed up the issue of class arbitration for the court to decide. Id. at 799.

The court of appeal also rejected the defendant's argument that a motion to compel arbitration as to plaintiff only was futile at the time due to authority in California that class-action waivers in arbitration agreements were unenforceable. In 2011, with its decision in *Concepcion*, the United States Supreme Court rejected California's "Discover Bank Rule" to the effect that some class action waivers were unconscionable and thus unenforceable. However, California courts continued to invalidate class action waiver provisions contained in employment contract on "public policy" grounds and the "Gentry Rule" until 2014 when the California Supreme Court held in *Iskanian* that the "Gentry Rule" was no longer good law and that class action waivers, to be distinguished from PAGA waivers, were valid and enforceable. The defendant had argued that a motion to compel arbitration against plaintiff would have been futile until 2014 when the California Supreme Court decided *Iskanian.* The court of appeal rejected this argument and noted that defendant's motion was not brought for over a year after *Iskanian* was decided, further supporting the notion that defendant made a strategic decision to oppose class certification in the trial court and thereby engaged in court litigation conduct that was inconsistent with and thus constituted a waiver of the right to arbitrate.

(e) 2016 and 2017 Cases re No Consent to Arbitration Defense

- ***Monschke v. Timber Ridge Assisted Living, LLC***, 244 Cal. App. 4th 583 (2016) – Motion to compel arbitration denied because plaintiff's wrongful death claim against nursing home belonged to her – not her mother or her mother's estate – and was thus not subject to the arbitration clause contained in the nursing home contract that plaintiff signed as her mother's agent under a general power of attorney.

Decedent had three daughters, one of whom is the plaintiff. When decedent began suffering from dementia, plaintiff enrolled decedent in one of defendant's assisted living facilities because it had a memory care unit. Acting as power of attorney for decedent, plaintiff executed a residency agreement allowing defendant to provide core living services for decedent. The residency agreement contained an arbitration clause providing for "any and all claims and disputes arising from or related to this Agreement or to your residency, care or services" to be resolved by binding arbitration and stated that it was binding on all parties to the agreement and their "heirs, representatives, executors, administrators, successor, and assigns."

While in defendant's care, decedent suffered a fall while left unattended and eventually died of her injuries. Plaintiff brought an action against the operator of the assisted living facility for wrongful death and elder abuse. Defendant petitioned the court to compel binding arbitration as to all of plaintiff's claims. The court denied the petition, and defendant appealed. The Court of Appeal affirmed. As personal representative, plaintiff sued on behalf of decedent's heirs – not the decedent. Although the arbitration clause in the agreement purported to bind "all parties" and "heirs, representatives, administrators, successors and assigns," only a party to an arbitration agreement may be bound by it. Since plaintiff signed the residency agreement in her capacity as decedent's attorney in fact, under a general power of attorney, and not in her personal capacity, the only parties to the residency agreement were the decedent and the defendant. The successors and assigns clause did not bind plaintiff or decedent's heirs with respect to their personal claims.

- ***Casa del Caffe Vergnano S.P.A. v. Italflavors, LLC***, 816 F.3d 1208 (9th Cir. 2016) – Arbitration denied where parties concurrently executed two agreements, the first containing an arbitration clause and the second containing a provision stating that the first was not intended to be binding or effective on the parties.

If two companies sign a document purporting to be a contract, and later during the very same day sign a separate contract that recites that the previously executed document "does not have any validity or effectiveness between the parties," then is the first document a "contract" at all? Did the first document ever constitute an enforceable contract? To put it differently, could one of the parties enforce any of the provisions of the first document

against its counter-party? These were the questions presented to the Ninth Circuit in this case.

This case involved two documents related to an alleged franchise for an Italian-style coffee shop located in San Diego, executed by the purported franchisor (Caffe Vergnano) and the purported franchisee (ItalFlavors). Both documents were signed in Italy on the same day. The first document signed (referred to in the opinion as the "Commercial Contract") set forth the commercial terms surrounding the franchise relationship. The second document signed (referred to as the "Hold Harmless Agreement") recited that the Commercial Contract was entered into for the purpose of allowing one of the principals of ItalFlavors to submit a copy of it to the relevant authorities in order for him to gain an entry visa to work in the United States. The Hold Harmless Agreement stated that the Commercial Contract did "not produce any effect between the parties," and agreed to "sign a future contract which will regulate their commercial relationship as soon as it is prepared in accordance with the federal and national laws of the United States of America."

The parties offered varying explanations to the Court for the rationale behind the Hold Harmless Agreement. Caffe Vergnano took the view that the Hold Harmless Agreement was not meant to render the Commercial Contract void, but instead was meant to protect Caffe Vergnano in the event of any liability arising from ItalFlavors' use of the Commercial Contract in connection with U.S. immigration laws. Thus, Caffe Vergnano argued that an arbitration provision in the Commercial Contract should be enforced. ItalFlavors, on the other hand, submitted that the Hold Harmless Agreement was executed because Caffe Vergnano had concerns over whether the Commercial Contract conformed with U.S. franchise laws.

ItalFlavors subsequently went ahead and established the franchise location in San Diego, but the coffee shop closed within a year. The "future contract" governing the commercial relationship of the parties contemplated by the Hold Harmless Agreement apparently was never executed. ItalFlavors then brought a lawsuit against Caffe Vergnano alleging violations of California's Franchise Investment Law and Business and Professions Code blaming the failure of the venture on Caffe Vergnano's alleged failure to provide promised support. Caffe Vergnano sought to enforce the clause in the Commercial Contract which provided for arbitration of disputes. The district court granted Caffe Vergnano's petition and ordered the matter to arbitration. ItalFlavors appealed.

Applying general principles of federal common law, the Ninth Circuit noted that "the formation of a contract requires a bargain in which there is a manifestation of mutual assent…" and that "where all the parties to what would otherwise be a bargain manifest an intention that the transaction is not to be taken seriously, there is no such manifestation of assent…" (quoting the Restatement (Second) of Contracts). The Court then looked to the "external expressions of intent" of the parties, most notably the statements in the Hold Harmless Agreement that the Commercial Contract did not have any "effectiveness" and that the parties expressly contemplated executing a future contract governing their commercial relationship. Relying on those statements, the Court concluded that the Commercial Contract was nothing more than a "sham" designed as a ploy to aid with the

visa application, and thus the Commercial Contract, including the arbitration provision contained therein, was not enforceable.

As shown by this case, mutual intention to be bound by an agreement is a *sine qua non* of a legally enforceable contract, and a court may look to external expressions of intent, such as other contemporaneous agreements entered into by the parties, when determining whether a binding and enforceable contract has been created.

- ***Long v. Provide Commerce, Inc.***, 245 Cal. App. 4th 855 (2016) – Inconspicuous link to "terms of use" does not create a binding agreement to arbitrate.

A consumer brought a class action against an internet flower retailer, claiming violations of the California Consumer Legal Remedies Act and Unfair Competition Law. Defendant moved to compel arbitration based on a provision contained in the company's "Terms of Use," which were viewable via a hyperlink displayed at the bottom of each page on the ProFlowers.com website – commonly referred to as a "browsewrap" agreement. Unlike the other common form of Internet contract – known as a "clickwrap" agreement – browsewrap agreements do not require users to affirmatively click a button to confirm their assent to the agreement's terms. Instead, a user's assent is inferred from his or her use of the website. Because assent must be inferred, the determination of whether a binding agreement has been formed depends on whether the user had actual or constructive knowledge of the website's terms and conditions. Plaintiff opposed the motion to compel arbitration on the ground that he was never prompted to assent to the "Terms of Use," nor did he actually read them prior to placing his order using the ProFlowers.com website. The trial court denied defendant's motion, concluding that the "Terms of Use" hyperlinks were too inconspicuous to impose constructive knowledge on plaintiff. Defendant appealed.

On appeal, the Court of Appeal examined the "placement, color, size and other qualities" of the "Terms of Use" hyperlink, and decided that the overall design of the ProFlowers.com website would not have put a reasonably prudent Internet user on notice of defendant's "Terms of Use." Therefore, plaintiff could not be deemed to have unambiguously assented to the subject arbitration provision simply by placing an order using the ProFlowers.com website. In reaching this conclusion, the Court noted that under both federal and state law, the threshold question by a petition to compel arbitration is whether there is an agreement to arbitrate; that this threshold inquiry stems from the basic premise that arbitration is consensual in nature and may be invoked as an alternative to the judicial process "'solely by reason of an exercise of choice by [all] parties.'" 245 Cal. App. 4th at 861, citing *Wheeler v. St. Joseph Hospital*, 63 Cal. App. 3d 345, 355 (1976). The Court of Appeal went on to note that while Internet commerce has exposed courts to many new situations, it has not fundamentally changed the requirement that "'[m]utual manifestation of assent, whether by written or spoken word or by conduct, is the touchstone of contract.'" Id. at 862.

While the Court of Appeal held that the inconspicuous placement of the "Terms of Use" on the website was sufficient alone to negate the enforceability of the arbitration provisions

contained therein based on general contract principles, it stated that its analysis was largely guided by two federal cases from the Second and Ninth Circuits, each of which considered the enforceability of a browsewrap agreement applying the objective manifestation of assent analysis dictated by California law, and declined enforcement. Id. at 863-864, citing *Specht v. Netscape Communs. Corp.*, 306 F.3d 17 (2d Cir. 2002).

- ***Harris v. Tap Worldwide, LLC***, 248 Cal. App. 4th 373 (2016) – Arbitration agreement attached to employee handbook is impliedly consented to by the employee's continued employment.

The plaintiff employee sued his former employer, alleging wrongful termination and other causes of action. The defendant employer moved to compel arbitration on the basis that the plaintiff had agreed to the arbitration agreement that was attached as Appendix A to the Employee Handbook. The plaintiff argued that the arbitration agreement was unenforceable because he did not read or sign the agreement, but merely acknowledged having received it. The trial court denied defendant employer's motion.

On appeal, the Court of Appeal. While plaintiff never signed the arbitration agreement, he did acknowledge in a signed writing before he started working that he had received both the Employee Handbook and the attached arbitration agreement. The arbitration agreement stated in paragraph 10, "If Employee voluntarily continues his / her employment … after the effective date of this Policy, Employee will be deemed to have knowingly and voluntarily consented to and accepted all of the terms and conditions set forth herein without exception." The Employee Handbook provided, "If for any reason, an applicant fails to execute the Agreement to Arbitrate yet begins employment, that employee will be deemed to have consented to the Agreement to Arbitrate by virtue of receipt of this Handbook." Based on the uncontroverted language in the Employee Handbook and the arbitration agreement, and plaintiff's admitted receipt of both, plaintiff employee was held to have consented to arbitration by commencing employment. The Court of Appeal further held that it was legally irrelevant whether or not he chose to actually read the handbook and arbitration agreement.

- ***Esparza v. Sand & Sea, Inc.***, 2 Cal. App. 5th 781 (2016) – Arbitration provision in employee handbook is *not* enforceable, despite signed acknowledgment of receipt.

The Court of Appeal for the Second District was faced with a situation similar to that presented in *Harris v. TAP Worldwide, LLC* (above), but reached the opposite conclusion – thus illustrating the fact-intensive nature of the cases decided in this area. *Note: Harris* was decided by Division 5 of the Second District. *Esparza* was decided by Division 4 of the Second District. In *Esparza*, the trial court's denial of the employer's motion to compel arbitration was based on lack of a mutual consent. That decision was affirmed on appeal.

There were several key factual differences between the cases. First, unlike the arbitration agreement in *Harris*, neither the employee handbook nor the arbitration agreement in *Esparza* expressly stated that the employee would be deemed to have agreed to arbitration by voluntarily continuing her employment after the acknowledged receipt. Second, in *Esparza*, the introduction to the employee handbook expressly stated that the handbook was not intended to create any legally enforceable obligations between the company and any employee. Third, while the plaintiff in *Esparza* signed a statement acknowledging that she had received a copy of the handbook, that acknowledgment contained no statement indicating that she agreed to be bound by its terms. Under these facts and circumstances, the Court of Appeal refused to create a binding legal agreement where the parties had not, and affirmed the trial court's decision to not compel arbitration.

- ***Mohamed v. Uber Technologies, Inc.***, 848 F.3d 1201 (9th Cir. 2016) – The Ninth Circuit rejects the bid by a co-defendant who was not a party to the arbitration agreement to join in compelling arbitration.

Along with Uber, the company that performed consumer credit background checks for Uber – Hirease LLC – was also sued. When Uber sought to compel arbitration pursuant to the arbitration agreements it had with its drives (discussed above), Hirease joined in Uber's motion arguing that it should be covered by the arbitration agreement because (1) it was alleged to have an agency relationship with Uber, see, e.g., *Murphy v. DirecTV, Inc.*, 724 F.3d 1218 (9th Cir. 2013); (2) it shared an "identity of interest" with Uber, see, e.g., *Jones v. Jacobson*, 195 Cal. App. 4th 1 (2011); and (3) the cause of action alleged against it was "intimately founded in and intertwined with" the underlying contract obligations, see e.g., *Kramer v. Toyota Motor Corp.*, 705 F.3d 1122 (9th Cir. 2013). The district court rejected all of Hirease's arguments and the Ninth Circuit agreed, noting that unlike the situation where parties and non-parties are sued under theories and claims seeking to impose joint and several liability resulted from the same underlying transactions and events, Hirease was only sued on one of many causes of action and those claims were based on its own alleged failure to act. The Court distinguished this fact circumstance from other cases where plaintiffs who have signed arbitration agreements with one defendant but not others, bring cases against multiple defendants "that are based on the same facts and are inherently inseparable from the arbitral claims."

- ***Norcia v. Samsung Telecommunications America LLC***, 845 F.3d 1279 (9th Cir. Jan. 19, 2017), cert. denied, 138 S.Ct. 203 (Oct. 2, 2017) - The 9th Circuit decides an issue of first impression and joins several other circuits in deciding that Section 16 of the FAA permits appellate review of vacatur orders that remand for a new arbitration.

While public policy favors contractual arbitration as a means of resolving disputes, one must be a party to the arbitration agreement (1) to be bound by it or (2) to invoke it. *This strong public policy in favor of arbitration does not extend to those who are not parties to the agreement. Arbitration is a consensual alternative dispute resolution process!* This case illustrates the general rule that silence or inaction does not constitute acceptance of an offer.

Plaintiff purchased a Samsung smartphone at a Verizon store. The phone was in a box, the back of which contained a notice that the box contained a "product safety and warranty brochure." The brochure contained an arbitration agreement. The plaintiff subsequently concluded that Samsung had misrepresented the storage capacity of the phone and had rigged it to operate at a higher speed when it was being tested. He filed a class action against Samsung alleging fraud and violation of various consumer protection statutes. Based upon the arbitration clause contained in the brochure, Samsung moved to compel arbitration. The district court denied the motion, finding that an arbitration agreement was not formed simply by plaintiff's receipt of the brochure. Samsung appealed.

The Ninth Circuit affirmed the district court's ruling that silence – under the circumstances of this case – would not be treated as consent to a contract because the party to be bound reasonably did not know that an offer of contract had been made. For example, where Samsung included an arbitration clause in its product safety and warranty information brochure contained in the package in which the phone was sold, the fact that the purchaser opened the box and kept the phone could not be construed as consent because there was no notice on the outside of the box advising the consumer that opening the box would be considered an agreement to the terms set forth in the company's in-box brochure.

The general rule is that a document that does not appear to be a contract and does not call to the attention of the recipient that acceptance of the goods or services will not constitute acceptance of the seller's terms. See *Windsor Mills, Inc. v. Collins & Aikman Corp.*, 25 Cal. App. 3d 987 (1972) (small print terms on the reverse side of seller's acknowledgment of buyer's purchase order because the contract provisions were inconspicuous and the document was not one whose contractual nature was obvious).

However, an offeree's silence may be deemed to be consent when the offeree has a duty to respond to the offer and fails to act in the face of this duty or when the party retains the benefit offered. See, *Golden Eagle Co. v. Foremost Ins. Co.*, 20 Cal. 4th 1372, 1386 (1993) (Where a couple received a renewal certificate from their insurance company, and retained the benefit of the renewed insurance policy, the couple's retention of the renewal

certificate was sufficient evidence of acceptance of the renewal policy and all of its terms and conditions, including the agreement to arbitrate.)

This exception has been held to apply to "shrink wrap" agreements where, by opening the package, a court can reasonably conclude that the user has a duty to act in order to negate the conclusion that the consumer accepted the terms of the "in the box" agreement. See *Wall Data Inc. v. L.A. County Sheriff's Department*, 447 F.3d 769 (9th Cir. 2006). The Court rejected this argument because, unlike the "shrink wrap" and "in the box" agreement cases – where the outside of the box puts the user on notice that by opening the box and keeping the contents, the user agrees to the seller's / licenser's terms – the Samsung box did not notify the consumer that opening the box would be considered agreement to the terms set forth in the product brochure. Accordingly, California's general rule that silence or inaction does not constitute acceptance was the rule of law that controlled the decision on Samsung's motion.

- ***Garcia v. Pexco, LLC.***, 11 Cal. App. 5th 782 (4th Dist. Apr. 24, 2017) – Employer can compel arbitration under arbitration clause contained in the agreement between staffing agency and its temporary worker where the worker alleges that the employer and staffing agency were "joint employers."

While public policy favors contractual arbitration as a means of resolving disputes, one must be a party to the arbitration agreement to be bound by it or to invoke it. The strong public policy in favor of arbitration does not extend to those who are not parties to the agreement. *Westra v. Marcus & Millichap Real Estate Investment Brokerage Co., Inc.*, 129 Cal. App. 4th 759, 763 (2005). This is another way of stating the general rule that one must be a party to an arbitration agreement to be bound by it. There are four exceptions to this general rule: (1) an agent can bind a principal, (2) spouses can bind each other, (3) a parent can bind a minor child, and (4) equitable estoppel may bring a non-signatory / non-party within its fold where the claims against it are intimately intertwined with the claims against another party who is governed by an arbitration agreement. This case demonstrates application of the latter exception.

In this case, an employee of a temporary staffing company asserted claims for wage and hour violations against the staffing company (who was his employer) and the staffing company's customer (for whom the employee worked on a temporary basis). In connection with his employment by the staffing company, plaintiff was required to sign an employment agreement that included a broad arbitration clause and class action waiver. Both Real Time (the staffing company) and Pexco (the customer) moved to compel individual arbitration of the employee's claims based upon the arbitration agreement plaintiff had signed with Real Time. Pexco was not a signatory to the arbitration agreement. The trial court granted the defendants' motion and dismissed the class claims from the lawsuit, leaving only the employee's individual claims to be adjudicated in arbitration. Plaintiff employee conceded that he was required to arbitrate his claims against Real Time, but appealed the trial court's order as to Pexco, arguing that, as a non-signatory to the arbitration agreement, Pexco had no right to compel arbitration with Garcia.

The Court of Appeal affirmed the trial court's order relying on two exceptions to the general rule that a non-signatory to an arbitration agreement has no standing to compel arbitration: (1) equitable estoppel, and (2) agency.

The Court of Appeal first looked at equitable estopel and held that it would be unfair for Garcia to allege that Pexco was Real Time's agent – for purposes of pleading "joint employer" liability in an effort to hold Pexco liable for Real Time's alleged wage and hour violations – while, at the same time, arguing that the arbitration provision exclusively applied to Real Time and not Pexco.

> "Garcia agreed to arbitrate his wage and hour claims against his employer, and Garcia alleges Pexco and Real Time were his joint employers. Because the arbitration agreement controls Garcia's employment, he is equitably estopped from refusing to arbitrate his claims with Pexco."

Id. At 796-797.

With regard to the "agency exception." The Court held that it applies "when a plaintiff alleges a defendant acted as an agent of a party to an arbitration agreement." Here, the complaint alleged that Real Time and Pexco were acting as agents of one another and every cause of action alleged identical claims against "All Defendants" without any distinction. Accordingly, the Court concluded that Pexco had standing to enforce the arbitration agreement the same as its alleged principal – Real Time.

- ***Baker v. Italian Maple Holdings, LLC***, 13 Cal. App. 5th 1152 (4th Dist. Jul. 31, 2017) – The Fourth District disagrees with the Fifth District with respect to the enforceability of a mandatory arbitration clause contained in a nursing home contract where the signatory dies during the 30-day "cooling off" period provided by CCP § 1295. The Fourth District says the arbitration agreement is enforceable if the signatory did not exercise her statutory right to rescind before she died.

In this case, a decedent's heirs sued the defendant nursing home for wrongful death, and the defendant moved to compel arbitration based upon a mandatory arbitration clause contained in the nursing home contract which the decedent signed one week before her death. The trial court denied the motion on the ground that CCP §1295(c) – which governs arbitration agreements contained in medical services contracts – provides a 30-day "cooling off" period for a signer to rescind the arbitration agreement, and that time period had not yet expired when the decedent died. The trial court relied on the decision of the Fifth District Court of Appeal in *Rodriguez v. Superior Court*, 176 Cal. App. 4th 1462 (2009) to conclude that the arbitration provisions were not enforceable unless and until the 30-day "cooling off" period had expired. The Fourth District Court of Appeal reversed, holding that under CCP § 1295(c), the arbitration agreement was enforceable "unless or until

rescinded." In this regard, the court noted that the Supreme Court has said that the purpose of section 1295 "is to encourage and facilitate arbitration of medical malpractice disputes," and that the provisions of section 1295 "are to be construed liberally" in support of that legislative purpose. 13 Cal. App. 5th at 1158, citing *Reigelsperger v. Siller*, 40 Cal. 4th 574, 578 (2007). The Fourth District acknowledged that its decision was contrary to the Fifth District's decision in *Rodriguez*, but stated that it "respectfully disagrees" with that opinion.

- ***State Farm General Ins. Co. v. Watts Regulator Co.***, 17 Cal. App. 5th 1093 (2d Dist. Nov. 30, 2017) - Parties to an agreement to submit disputes to an arbitration service provider in accordance with its rules are bound by unilateral changes made by the provider if given notice and an opportunity to withdraw, and neither party withdraws within the designated time period. The amended arbitration agreement is then controlling on the parties for disputes arising after the stated effective date of the amendment.

This case involves rather unusual facts, but the decision is premised on general contract law principles concerning the manifestation of consent as pertains to agreeing to arbitration.

In this case, the plaintiff and defendant did not contract with each other to resolve disputes in an arbitral forum. Rather, both parties are members of the Arbitration Forums, Inc. ("AF"), a nonprofit organization providing arbitration services to its members. In becoming members of AF, the parties agreed to submit to binding arbitration with AF a set of disputes defined by AF.

Plaintiff and defendant became members of AF and signatories to the AF arbitration agreement several years before the 2012 water loss damage to the home of one of plaintiff's insureds. The damage is alleged to have been caused by a defect in a supply line manufactured by defendant. In 2012, when the loss occurred, arbitral claims included product liability claims. In November 2014, AF issued a notice advising its members that effective January 1, 2015, product liability claims would be excluded from compulsory arbitration. That notice provided that member parties could still consent to resolve product liability claims on a per-case basis after January 1, 2015, and gave members the right to withdraw from the amended agreement upon 60 days notice. Significant to the court, neither plaintiff nor defendant withdrew from the AF arbitration agreement after receiving notice of the intended amendment and its effective date.

In March 2015, State Farm filed a complaint in the superior court seeking subrogation for its payments to its insured in connection with the 2012 water damage incident. The complaint alleged causes of action for negligence, strict products liability and breach of implied warranties. Watts Regulator – a self-insured member of AF – then moved to compel arbitration, claiming that the pre-2015 arbitration agreement terms were the ones that controlled; once State Farm and it had "signed-on" to the AF arbitration agreement in existence when they became members, AF could not unilaterally amend the terms of that

agreement to exclude product liability claims that accrued before the effective date of the amendment. The trial court and the Second District Court of Appeal found no merit in Watts Regulator's argument that "retroactive" application of the amended arbitration agreement was unenforceable without its consent. Nothing in the original agreement or the amendment provided that the accrual date of a claim would control which arbitration agreement applied. Instead, the third-party arbitration provider – AF – was allowed to make "unilateral" changes under the terms of the original agreement with its members. Accordingly, the accrual of State Farm's subrogation claim in 2012 did not create a "vested right" in Watts Regulator to require arbitration pursuant to the terms of the agreement in place as of that date. The date a claim was actually asserted controlled which arbitration terms applied.

> "[T]he AF arbitration agreement is an industry program offered by a third party that has determined the terms under which it will provide arbitration services to companies who agree to bind themselves to the terms set by the third party. There is no legal basis for applying rules governing retroactivity, vested rights, or accrual of claims under these circumstances."

17 Cal. App. 5th at 1101.

- ***Jensen v. U-Haul of California***, 18 Cal. App. 5th 295 (4th Dist. Dec. 11, 2017) – Injured worker may not be compelled to arbitrate action against U-Haul based upon contract signed by his employer. He's a non-signatory and the exceptions for agency, estoppel and third-party beneficiary do not apply.

Virgil and Glenda Jensen filed a lawsuit against U-Haul of California after Virgil was allegedly injured when a U-Haul truck rented by his employer blew a tire while he was driving it. The Jensens alleged that they suffered damages because the truck was not properly maintained. U-Haul filed a motion to compel arbitration of the Jensen's claims, arguing that the Jensens were bound by the arbitration agreement contained in the rental agreement signed by Virgil's employer even though the couple were not signatories to the agreement. The arbitration clause at issue provided that "You and U-Haul agree that any and all Claims … between You and U-Haul relating in any way to your rental … from U-Haul shall be submitted to binding Arbitration…." It then defined "You" as including "Your respective agents, employees … [and] all authorized or unauthorized users of the U-Haul equipment. The trial court denied U-Haul's motion and motion appealed. The Fourth District Court of Appeal affirmed.

The court noted that there was no doubt that the Jensens' claims fell within the extremely broad scope of the arbitration provision at issue, and that it was undisputed that Virgil was a "user" of the U-Haul equipment and that the Jensens' claims arose from Virgil's use of that equipment. Nevertheless, the court concluded that irrespective of the breadth of the contractual language, the Jensens could only be forced to arbitrate their claims against U-Haul if they were bound by the arbitration agreement entered into by his employer as the

renter of the U-Haul equipment. In this regard, the court noted that individuals typically are not bound by an agreement entered into by a corporation simply because they are owners or employees of the corporation. Citing *Matthau v. Superior Court,* 151 Cal. App. 4th 593 (2007), the court stated that the general rule is that "the right to arbitration depends on a contract, and a party can be compelled to submit a dispute to arbitration only if the party has agreed in writing to do so. The court went on to recognize that there are exceptions to the general rule where person who have not signed an agreement to arbitrate are bound to do so. Among those exceptions are third-party beneficiary, agency and estoppel, all of which were rejected by the court.

With regard to the third-party beneficiary exception, the court held that Mr. Jensen was not a third-party beneficiary of the contract between his employer and U-Haul. The rental agreement at issue contemplated the possibility that the employer might authorize someone other than the person who signed on behalf of the employer to use the rented truck. Moreover, there was no language in the contract that pointed to any intent to benefit a third party, and the contract was for the benefit of Mr. Jensen's employer – not him.

The court of appeal also rejected U-Haul's argument that the agency exception applied. The court held that there was no evidence to demonstrate that the signatory for Mr. Jensen's employer had implicit authority to bind its employee to arbitration.

Finally, the court of appeal rejected U-Haul's argument that the estoppels exception applied. The court noted that this exception comes into play when the nonsignatory asserts claims that are "dependent upon, or inextricably intertwined with" the underlying contractual obligations of the agreement containing the arbitration clause. The court held that those circumstances did not exist here because the plaintiffs claims did not rely and were no dependent on the rental agreement between Mr. Jensen's employer and U-Haul.

Comment: Mr. Jensen was an agent of his employer for some purposes, but that did not mean that his employer had implicit authority to bind him to arbitration. This finding is very fact-specific and points up the fact-specific nature of exceptions to the signatory requirement. With regard to the agency exception, it illustrates that the focus is not on whether an agency relationship exists (e.g., employer-employee), but on whether the nature of that relationship included "implicit authority" by one party to bind the other to an agreement to arbitrate. Bottom Line: There is no bright line here, and the absence of a bright line may promote fairness at the same time that it engenders process litigation.

- ***Douglass v. Serenivision, Inc.***, 20 Cal. App. 5th 376, (2d Dist. Feb. 18, 2018) – A party can clearly and unmistakably consent to have an arbitrator decide his or her own jurisdiction by conduct during the course of the proceedings evidencing such consent.

In 2009, Vivera, a company, signed an Advertising Insertion purchase order with Serenivision, doings business as Pinnacle Dream Media, an internet advertising company. The purchase order incorporated by reference a Master Agreement that was not actually attached to the purchase order, but referenced through an internet weblink. Among other things, the Master Agreement provided that the parties "consent to have all disputes regarding this agreement resolved by binding arbitration" and that all payments "are personally guaranteed by the individual executing the [purchase order]." The order was "accepted" by Vivera with the printed name and signature of Clayton Douglass.

By 2014, Vivera was significantly in arrears on its account and Serenivision filed a demand for arbitration against Vivera and Douglass seeking over $800,000 in damages, plus late penalties and interest. Douglass filed an answer to the demand, in which he admitted that he had signed the purchase order as Vivera's representative, but denied that he had any personal liability for Vivera's debt and disputed that he was a guarantor because he did not sign the Master Agreement. Douglass also appeared at a preliminary hearing before the arbitrator, at which time her affirmed that he was appearing voluntarily and submitting to the jurisdiction of the arbitrator. Later, he wrote a letter to Serenivision's attorney in which he stated that he was "voluntarily" appearing in the arbitration because he was "trying to avoid the additional time and expense" of litigating the dispute in "a federal lawsuit," but then conditioned his continued involvement on Serenivision posting a bond to cover Douglass's attorney's fees if he was the prevailing party. When Douglass received no response to that request / demand, he wrote a letter to the arbitrator relaying his prior statements to Serenivision's counsel and advising that he thought the posting of the requested bond was necessary in order for the tribunal to exercise jurisdiction. The arbitrator construed Douglass's letter as an expedited request for an order requiring Serenivision to post a bond, which the arbitrator denied. A week before the evidentiary hearing, Douglass wrote a letter to the arbitrator "terminating his voluntary appearance" and advising that he would make no further appearance in the arbitration proceedings. The matter proceeded to evidentiary hearing and, true to his word, Douglass did not appear. Serenivision presented its case and issued an award in which he found that Douglass was a guarantor of Vivera's debt. With interest, penalties and attorney's fees, the total award was over $1.7 million.

When Serenivision petitioned to confirm the award, Douglass counter-petitioned to vacate it on the grounds that the arbitrator did not have power to adjudicate any type of dispute as to him because he had not consented to arbitration. The trial court confirmed the award over Douglass's objection. Douglass then appealed, challenging the arbitrator's jurisdiction over him and arguing that such jurisdiction did not exist because he had not contracted for / consented to arbitrate the dispute.

The trial court was affirmed by the Second District, which held that a party's consent to arbitration is inferred from the party's "conduct of litigating an issue up to the point of submitting it for decision in the arbitral forum, at least if the party does so without objection." The court of appeal found that the record showed, through his conduct, that Douglass had clearly and unmistakably consented to arbitration because he did not object to arbitration, willingly participated in the arbitration proceedings, availed himself of the arbitrator's authority when he asked the arbitrator to issue an order requiring Serenivision to post a bond, and only tried to rescind his voluntary participation after the arbitrator ruled against him on the bond request. The court also held that Douglass's challenge to the arbitrator's jurisdiction was untimely (because he filed his petition for vacatur more than 100 days after the award was issued), and that his challenges to the arbitrator's assessment of his jurisdiction and to the ultimate award were without merit.

(f) 2016 and 2017 Cases re Statutory Claims Not Being Subject to Binding Arbitration

- ***EPD Investment Co. v. Rund (In re EPD Investment Co.)***, 821 F.3d 1146 (9th Cir. 2016) – With regard to core bankruptcy claims, the Ninth Circuit confirms its stance that the bankruptcy court has discretion to decline to enforce an otherwise valid arbitration agreement if arbitration of the dispute would conflict with the underlying purposes of the Bankruptcy Code.

In our inaugural recent updates program in 2013, we looked at two cases decided by the Ninth Circuit involving the intersection of the Bankruptcy Code with the FAA: *Continental Ins. Co. v. Thorpe Insulation Co. (In re Thorpe Insulation Co.)*, 671 F.3d 1011 (9th Cir. 2012) and *Ackerman v. Eber (In re Eber)*, 687 F.3d 1123 (9th Cir. 2012) (discussed below). While both cases recognized the strong federal policy favoring the enforcement of arbitration agreements, the Court found that the disputes involved "core" bankruptcy claims – meaning rights and claims premised on provisions in the Bankruptcy Code – and thus triggered the bankruptcy court's discretion to deny enforcement of an arbitration agreement if enforcement would result in conflict with bankruptcy law. This is a departure from long-established federal policy favoring arbitration agreements and requiring courts to rigorously enforce arbitration clauses.[8] There is no carve-out for bankruptcy courts. They too must enforce an arbitration clause even if arbitration may not be the most efficient forum.[9]

Given the recent spate of 2017 Chapter 11 bankruptcy filings by large retailers (discussed below), all seeking relief in the Delaware bankruptcy courts – not a particularly convenient forum for most creditors and typically not the place where the companies are headquartered or conduct most of their business – the value of a pre-dispute arbitration

[8] See *Moses H. Cone Memorial Hospital v. Mercury Const. Corp.*, 460 U.S. 1 (1983); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985).

[9] *In re Mor-Ben Ins. Mkts. Corp.*, 73 B.R. 644, 647 (9th Cir. BAP 1987)

clause looms large as a vehicle that might provide a basis to move the forum for dispute resolution to private arbitration in accordance with state arbitration laws. As one commentator recently wrote:

> "Arbitration clauses, and the opportunities they present, are too often overlooked amid the tangle of relief-from-stay motions, claim objections, adversary proceedings and other proceeding comprising a bankruptcy case. Clauses compelling arbitration in California will become particularly important as increasing numbers of large bankruptcy cases are filed in Delaware, New York and other distant fora. Mastery of the intersection of these two areas – arbitration and bankruptcy – will serve both bankruptcy and non-bankruptcy litigators well in the coming years."[10]

In 2016, the Ninth Circuit decided a third case - *EPD Investment Co. v. Rund* (discussed below) – which confirmed the Ninth Circuit's stance that the bankruptcy court has discretion to decline to enforce an otherwise valid arbitration agreement if arbitration of the dispute would conflict with the underlying purposes of the Bankruptcy Code. Before looking at the *EPD Investment* decision, let's first review the background concerning the intersection of the FAA with the Bankruptcy Code and the Court's earlier decisions in *Thorpe* and *Eber.*

Background Statement

Chapter 11 bankruptcy courts are true business courts in the sense that they do not have criminal, probate, juvenile or family dockets that compete for courtrooms, judges and hearing time, plus the nature of the disputes that the bankruptcy court routinely hears and decides is largely driven by commercial contracts that are in breach or being restructured.

Pursuant to 28 U.S.C. § 157(b)(1), bankruptcy judges are empowered to hear and determine all bankruptcy cases, as well as all core proceedings arising under the Bankruptcy Code ("arising under" jurisdiction) or arising in a bankruptcy case ("arising in" jurisdiction). Although beyond the scope of this discussion, it should be noted that the bankruptcy court's constitutional authority to enter final orders in core matters is subject to significant constitutional limits that are not reflected in the statute – keeping in mind that the bankruptcy courtsare Article I courts (created by the legislative branch), while the district courts are Article III courts (constitutionally empowered to exist and act by that section of the Constitution).

Suffice it to say that if a proceeding does not invoke a substantive right created by the Bankruptcy Code and is one that could exist outside of bankruptcy, it may not qualify as a "core" proceeding, which is significant in terms of where the courts draw the line between the enforcement and non-enforcement of pre-dispute arbitration clauses.

[10] Fernandez, Reno, "Enforcing Arbitration Agreements in Bankruptcy," 1 Cal. Lawyers Ass'n Bus. Law News 9, 16 (2018).

As demonstrated by the 2017 Chapter 11 bankruptcy filings of the Boston Herald, Sungevity and RadioShack, the preferred venue for many of the large retail bankruptcies has been Delaware (place of incorporation), which typically is not where the bulk of the debtor entity's creditors or operations are located. Litigation involving such debtors may be brought "home" to where the transaction was made or performed *if* the contract documents include an arbitration agreement with a choice of venue provision, and *if* the dispute can be characterized as non-core - meaning that its premise arises under non-bankruptcy law.

The 2012 Thorpe Decision. This case involved an issue of *first impression* in the Ninth Circuit concerning the enforceability of an arbitration agreement when the claims to be arbitrated arise under the Bankruptcy Code or otherwise involve or affect the administration of a bankruptcy case pursuant to the Bankruptcy Code. It is considered to be the controlling authority on compelling arbitration in bankruptcy in the Ninth Circuit. To understand the Ninth Circuit's holding, it is necessary to first review the background facts of the dispute that were presented to the bankruptcy court in the proceedings below.

Thorpe distributed and installed asbestos-containing products from 1948 to 1972. About 12,000 claims for asbestos-related injuries or deaths had been brought against Thorpe. Thorpe's insurers, including Continental, had paid more than $180 million defending and indemnifying Thorpe with respect to these claims. In 1985, Thorpe and its insurers entered into an omnibus insurance coverage and claims handling agreement. That agreement included an arbitration agreement for any coverage disputes. In 1998, Continental told Thorpe that it had exhausted its coverage under the Continental policies and ceased to indemnify Thorpe. Thorpe asserted a claim for "non-products" coverage, which Continental disputed and initiated arbitration under the omnibus agreement. The arbitrator rejected Thorpe's claim and found that Thorpe had no remaining coverage rights under the Continental policies. Thorpe appealed and in 2003, the parties entered in a settlement agreement. The settlement agreement released only Thorpe's claims against Continental. It did not refer to the direct action rights of individual asbestos claimants or to the contribution, indemnity or subrogation rights of other insurers. Those claims were not released. The settlement agreement included an arbitration agreement for any disputes regarding the settlement agreement and its terms.

In 2007, Thorpe filed a voluntary petition under Chapter 11 of the Bankruptcy Code. The primary purpose for the bankruptcy filing was to propose and confirm a plan of reorganization pursuant to Section 524(g) of the Bankruptcy Code, a unique provision in the Bankruptcy Code that provides a mechanism by which the asbestos-related assets and liabilities of a debtor are consolidated into a single trust for the benefit of present and future asbestos claimants. In this regard, Section 524(g) authorizes the bankruptcy court to enter a "channeling injunction" that channels all asbestos claims to a trust for administration and handling, and allows the debtor to continue operating without the continued disruption, expense and exposure of asbestos-claim litigation because, under the terms of such plans, asbestos claimants are enjoined from suing the debtor. The injunction may also be extended to bar actions against third parties, such as the debtor's insurers, if those third parties contribute to the trust in amounts that are commensurate with their

likely liability. In any event, in preparation for its bankruptcy, Thorpe negotiated with insurers other than Continental who agreed to fund the trust in consideration of Thorpe's filing for bankruptcy and seeking to confirm a "524 plan" that would result in a 524(g) injunction that would protect the insurers against asbestos-related claims arising out of policies issued to Thorpe. Additionally, these participating insurers agreed to assign their contribution, indemnification and subrogation rights against Thorpe's other insurers, including Continental, to the trust. As is not uncommon in a restructuring bankruptcy, before filing for bankruptcy, Thorpe collaborated with asbestos claimants to begin structuring a 524 plan. When Continental learned of Thorpe's pre-filing efforts to negotiate a 524 plan and prepare for bankruptcy, it claimed that such actions violated the 2003 settlement agreement. Continental also claimed that Thorpe had encouraged asbestos claimants to file direct actions against it and that that was also a violation of the 2003 settlement agreement. Pursuant to the arbitration clause contained in the 2003 settlement agreement, Continental made a demand for arbitration of this dispute. That arbitration was stayed when Thorpe filed bankruptcy in October 2007.

In the Thorpe bankruptcy case, Continental filed a claim for damages resulting from Thorpe's alleged violation of the 2003 settlement agreement (as discussed above). Thorpe objected to the claim, thereby commencing a "contested matter" proceeding in the bankruptcy court. Continental filed a motion in the bankruptcy court asking it to compel arbitration of the dispute. The bankruptcy court denied Continental's motion, and essentially held that the claims were not arbitral because (a) the resolution of Continental's claim had to be coordinated with the plan confirmation process because Continental's claim and its objection to plan confirmation overlapped factually, and (b) the remaining claims concerning Thorpe's alleged encouragement of direct actions against Continental involved Thorpe's exercise of its rights in bankruptcy and thus were within the "core" jurisdiction of the bankruptcy court and represented matters that should be decided only by a bankruptcy judge and not in a nonbankruptcy forum that might "end up adjudicating things that [it] has no business adjudicating" and result in violations of bankruptcy law and policy. 671 F.3d at 1019. Continental appealed to the district court, which affirmed, noting that Continental's claim regarding Thorpe's alleged encouragement of direct actions could have been separated out as a standalone claim for purposes of determining arbitrability, but Continental refused to separate that claim from the claims directed at Thorpe with respect to its invocation of its rights under the Bankruptcy Code to file and prepare for filing of a 524 plan. Continental appealed to the Ninth Circuit, which likewise affirmed.

In deciding the issue of whether the bankruptcy court erred in denying the motion to compel arbitration, the Ninth Circuit held that the threshold issue to determining arbitrability in the bankruptcy context is whether the dispute is a "core" or "non-core" proceeding.[11] Id. at 2010. In non-core proceedings, "the bankruptcy court generally does

[11] In so ruling, the Ninth Circuit referred to the earlier decisions on this issue made by several other circuits. See, *Whiting-Turner Contracting Co. v. Elec. Mach. Enters., Inc. (In re Elec. Mach. Enters., Inc.)*, 479 F.3d 791, 796 (11th Cir. 2007); *U.S. Lines, Inc. v. Am. S.S. Owners Mut. Prot. & Indem. Ass'n (In re U.S. Lines)*, 197 F.3d 631, 640 (2d Cir. 1999); *Ins. Co. v. N. Am. V. NGC Settlement Trust & Asbestos Claims Mgmt. Corp. (In re Nat'l Gypsum Co.)*, 118 F.3d 1056, 1066-69 (5th Cir. 1997).

not have discretion to deny enforcement of a valid prepetition arbitration agreement,"[12] meaning that such claims are arbitral. Id. at 1021. However, in core proceedings, the Ninth Circuit held that the bankruptcy court "has discretion to deny enforcement of an arbitration agreement" if such enforcement would conflict with bankruptcy law.[13] The court explained that "[t]he rationale for the core/non-core distinction, . . . is that non-core proceedings 'are unlikely to present a conflict sufficient to override by implication the presumption in favor of arbitration,' whereas core proceedings 'implicate more pressing bankruptcy concerns.'" Id. Importantly, in terms of leaving the door open for arbitration of "core" bankruptcy disputes, the Ninth Circuit held that "'not all core bankruptcy proceedings are premised on provisions of the Code that inherently conflict with the Federal Arbitration Act;' nor would arbitration of such proceedings necessarily jeopardize the objectives of the Bankruptcy Act." Id.

In affirming the bankruptcy court's decision to deny Continental's motion to compel arbitration of the claim objection dispute, the Ninth Circuit held that Continental's claim was a "core" matter in bankruptcy and that the bankruptcy court had discretion to deny Continental's motion to compel arbitration if it found that arbitration of the claim would conflict with the purposes and policies of the Bankruptcy Code. Because Continental's claim included a challenge to Thorpe's right to seek relief under Section 524(g) of the Bankruptcy Code by taking issue with Thorpe's activities in negotiating, proposing and confirming a plan under that section, the Ninth Circuit held that "[t]here was no error in the bankruptcy court concluding that such a claim must be resolved by a bankruptcy court and not an arbitrator." Id. at 1023. In so ruling, the Ninth Circuit noted that Continental's dispute in the case had heightened importance because the Continental's claim would need to be determined before payments could flow to Thorpe's creditors under the plan and as part of the plan confirmation process. Id. at 1023-24.

The 2012 Eber Decision. This case also concerns the arbitrability of bankruptcy claims, and was decided six months after the decision in *Thorpe* (discussed above). To appreciate the Ninth Circuit's holding, it is necessary to first review the background facts of the dispute that was presented to the bankruptcy court in the proceedings below.

Creditors commenced an arbitration proceeding against contract debtor seeking $3.3 million in damages for breach of contract related to the construction and operation of a hair salon in Las Vegas. Later, the contract debtor filed a voluntary bankruptcy petition under Chapter 7 of the Bankruptcy Code, which resulted in the automatic stay of the arbitration proceeding. In the bankruptcy case, creditors filed a complaint under Section 523 of the Bankruptcy Code seeking a determination that the debtor's liability to them was nondischargeable. Creditors filed a motion for relief from the automatic stay to allow them to proceed to determine the debtor's liability and to liquidate the amount of their claim in

[12] Again, in so ruling, the Ninth Circuit referred to the earlier decisions on this issue made by several other circuits. See, *In re Elec. Mach. Enters., Inc.*, supra, 479 F.3d at 796; *Cyrsen/Montenay Energy Co. v. Shell Oil Co. (In re Crysen/Montenay Energy Co.)*, 226 F.3d 160, 166 (2d Cir. 2000).

[13] See, *Phillips v. Congelton, LLC (In re White Mountain Mining Co.)*, 403 F.3d 164, 169 (4th Cir. 2005); *In re U.S. Lines*, supra, 197 F.3d at 640; *In re Nat'l Gypsum*, supra, 118 F.3d at 1067-68.

the pre-petition arbitration proceeding. That motion was denied. Creditors then filed a motion to vacate the bankruptcy court's decision denying relief from stay and, concurrently, filed a motion to seeking to compel arbitration of the statutory claims they had asserted under Section 523 of the Bankruptcy Code. Both motions were denied and creditors appealed. The first level of appeal was to the district court, which affirmed the bankruptcy court. The district court agreed with the bankruptcy court that because creditors' claims "go to the issue of dischargeability," arbitration of such claims "inherently conflicts with the goals of centralized resolution of bankruptcy issues . . . and the power of the bankruptcy court to enforce its own orders." Creditors then appealed to the Ninth Circuit, where the bankruptcy court's decision was affirmed.

The Ninth Circuit recognized that the claims the creditors proposed be submitted to arbitration were claims that arose under the Bankruptcy Code – specifically, Section 523(a)(2) (the fraud exception), (a)(4) (the breach of fiduciary duty exception) and (a)(6) (the intentional tort exception) – and were thus "core matter[s] which bankruptcy courts have special expertise to decide." The Ninth Circuit viewed the issue on appeal as one of reconciling the Federal Arbitration Act with the Bankruptcy Code, "and, more specifically, the bankruptcy court's jurisdiction to determine dischargeability." Id. at 1128. In this decision, the Ninth Circuit looked to the Supreme Court's decision in *Shearson/Am. Express, Inc. v . McMahon*, 482 U.S. 220 (1987) for guidance. "While the FAA establishes a federal policy of favoring arbitration,'[l]ike any other statutory directive, the Arbitration Act's mandate may be overridden by a contrary congressional command'" if the party opposing arbitration demonstrates that Congress intended to preclude a waiver of judicial remedies for the particular statutory claim at issue. Id. at 1129, citing *McMahon*, supra, 482 U.S. at 226-27.

In deciding the issue concerning the arbitrability of 523 claims, the Ninth Circuit applied the "*McMahon* factors,"[14] and noted that both the Ninth Circuit and its sister circuits have previously found "no evidence in the text of the Bankruptcy Code or in the legislative history suggesting that Congress intended to create an exception to the FAA in the Bankruptcy Code." Id. at 1129, citing *Thorpe*, supra, 671 F.3d at 1020. Applying the "*McMahon* facts" and Circuit precedent established by *Thorpe*, the Ninth Circuit held that the district court did not err when it affirmed the bankruptcy court's denial of the creditors' motion seeking to compel arbitration of their 523 claims. While the creditors attempted to characterize their claims as based on state law concerning breach of contract, fraud and breach of fiduciary duty, and thus non-core, arbitrable claims, the Ninth Circuit concluded that the object of the creditors' motion was to arbitrate dischargeability, "a core bankruptcy issue," meaning that the decision would be left to the discretion of the bankruptcy court. Here, the Ninth Circuit found that the bankruptcy court had not abused its discretion and agreed with the district court that allowing an arbitrator to decide

[14] In *McMahon*, the Supreme Court constructed a framework under which courts can analyze how the FAA and a particular statute interact for purposes of determining whether Congress intended to override the FAA's policy favoring arbitration with respect to claims brought under a particular statute. Under this framework, courts must examine: (1) the text of the statutes; (2) its legislative history; and (3) whether an inherent conflict between arbitration and the underlying purposes of the statute exist. 482 U.S. at 227.

dischargeability issues would conflict with the underlying purposes of the Bankruptcy Code. "When a bankruptcy court considers conflicting policies as the bankruptcy court did here, we acknowledge its exercise of discretion and defer to its determination that arbitration will jeopardize a core bankruptcy proceeding." Id. at 1131.

The 2016 EPD Decision. In this case, the Chapter 7 Trustee for the bankruptcy estate filed an adversary proceeding seeking to subordinate or disallow a creditor's claim against the estate (as presented through the filing of as proof of claim) and seeking to avoid (and recover) pre-petition payments that had been made to the defendant pursuant to the avoidance "strong arm" powers given to trustees under the Bankruptcy Code. The defendant/creditor moved to compel arbitration of the claims asserted in the Trustee's adversary proceeding based upon broad arbitration clauses contained in numerous investment and loan agreements executed with the debtor pre-petition. The bankruptcy court denied the motion, and defendant took an appeal to the district court.

The district court affirmed the bankruptcy court. First, the district court determined that the Trustee was not bound by the pre-petition arbitration agreements between the defendant/creditor and the debtor because the claims the Trustee was asserting either belonged to the estate's creditors or were for their benefit, and neither the Trustee nor any creditor was a party to any of the subject agreements. Second, the district court determined that arbitration of the subordination and disallowance of the defendant's claims and recovery or pre-petition transfers were matters submitted to the core jurisdiction of the bankruptcy court and would conflict with the underlying purposes of the Bankruptcy Code because resolution of those causes of action would require factual findings closely linked to the overall administration of the estate. Defendant then took a further appeal to the Ninth Circuit. [*Note: Because bankruptcy courts are Article I – not Article III – courts, the first level of appeal is to the District Court or the Bankruptcy Appellate Panel of the Ninth Circuit.*]

The Ninth Circuit affirmed, holding that the bankruptcy court had properly applied *Thorpe* to determine that the arbitration provisions at issue conflicted with the Bankruptcy Code purposes of having bankruptcy law issues decided by bankruptcy courts, of centralizing resolution of bankruptcy disputes with the bankruptcy court, and of protecting parties from piecemeal litigation. 821 F.3d at 1150, citing *Thorpe*, 671 F.3d at 1022-1023. In this regard, the Court noted that the bankruptcy court's analysis was supported by the record at the time of the ruling because the bankruptcy court had supervised the debtor's case for nearly three years, during which the Chapter 7 Trustee had filed more than 100 other adversary proceedings affecting the administration of the estate.

- ***Ziober v. BLB Resources, Inc.***, 839 F.3d 814 (9th Cir. 2016) – Claims brought under the Uniformed Services Employment and Reemployment Rights Act (USERRA) were arbitrable pursuant to the arbitration provision included within the plaintiff's employment contract.

The plaintiff signed an agreement with his employer requiring the arbitration of any legal disputes that might arise between them. Ziober later sued his employer for violation of the USERRA, claiming that he was fired from his job after providing notice of his deployment to Afghanistan in the United States Navy Reserve. The employer moved to compel arbitration and dismiss plaintiff's complaint based upon the arbitration clause contained in the employment contract. The district court granted the motion, and plaintiff appealed.

Despite the liberal federal policy favoring arbitration agreements, an exception to the FAA mandate exists when it is shown that Congress, in enacting a statutory scheme creating a civil right of action, intended to preclude a waiver of the judicial forum for claims falling within the statutory scheme. *CompuCredit Corp. v. Greenwood*, 565 U.S. 95 (2012). In this case, plaintiff argued that the plain text and legislative history of the USERRA revealed that Congress intended to preclude the compelled arbitration of claims arising under its provisions. The Ninth Circuit rejected plaintiff's argument, and joined its "sister circuits to have considered the question" in concluding that neither the text nor legislative history of the USERRA evinced such an intent. 839 F.3d at 817, citing *Landis v. Pinnacle Eye Care, LLC*, 537 F.3d 559 (6th Cir. 2008), *Garrett v. Circuit City Stores, Inc.*, 449 F.3d 672 (5th Cir. 2006), and *Bodine v. Cook's Pest Control Inc.*, 830 F.3d 1320 (11th^{h} Cir. 2016). The court reasoned that by agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights created by that statute; it only submits to their resolution in an arbitral, rather than judicial, forum. Id. at 818, citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985); *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 123 (2001).

- ***McGill v. Citibank, N.A.,*** 2 Cal. 5th 945 (Apr. 6, 2017) – A pre-dispute arbitration agreement that waives the right to seek public injunctive relief is contrary to public policy and thus unenforceable under California law.

The arbitration clause in issue was contained in a consumer credit card agreement that included provisions that purported to waive the consumer's right to seek public injunctive relief under various consumer protection laws.

McGill filed a putative class action lawsuit against Citibank related to its handling of a claim she made under the credit protector plan when she lost her job in 2008. The operative complaint alleged claims under California's Unfair Competition Law (UCL), the Consumer Legal Remedies Act (CLRA), and false advertising law, as well as under the California Insurance Code. The complaint sought, among other things, an injunction prohibiting Citibank from continuing to engage in its allegedly wrongful practices.

The trial court ordered McGill to arbitrate all claims other than those for injunctive relief under the UCL, the false advertising law, and the CLRA.[15] On appeal, McGill argued that the FAA does not preempt her claims and the arbitration provision is invalid and unenforceable because it waives her right to seek public injunctive relief. The Court of Appeal reversed and remanded for the trial court to order all of McGill's claims to arbitration, concluding that the FAA, as construed by the United States Supreme Court in *AT&T Mobility LLC v. Concepcion*, preempts prior California law that held that claims for public injunctive relief—i.e., injunctive relief that has the primary purpose and effect of prohibiting unlawful acts that threaten future injury to the general public—are not enforceable. The appellate court rejected plaintiff's argument that *Iskanian* had "reaffirmed" the *Broughton-Cruz* rule established in 1999 and 2003 respectively,[16] finding that the FAA's displacement of state laws that interfere with its purpose is well-established and has been repeatedly affirmed, citing *Preston v. Ferrer*, 552 U.S. 346 (2008). In this regard, the court noted that the purpose underlying a state statute or rule is irrelevant; that according to the United States Supreme Court's decision in *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011), if the state law interferes with the FAA's purpose of enforcing arbitration agreements according to their terms, the state law is preempted "no matter how laudable its objective."

The California Supreme Court granted review, and described the issue before it as whether the FAA, as interpreted in *Concepcion*, preempts the *Broughton-Cruz* rule that statutory claims for public injunction are not subject to compulsory private arbitration. The case was argued to the California Supreme Court on December 7, 2016 and, according to an article that appeared in the Daily Journal on December 8, 2016, Justice Liu asked a number of tough questions and at one point in the hearing, flatly said, "This is very different from *Concepcion*," and "isn't about arbitration at all." According to the article, Justice Liu "hammered home his point … that even the Federal Arbitration Act, citing *Concepcion*, does not allow Citibank to take away the statutory rights of credit card holders just because the language is found in an arbitration agreement."

[15] The trial court severed and stayed the claims for injunctive relief under California's unfair competition law, false advertising law and Consumer Legal Remedies Act. Despite finding that the arbitration agreement applied to all of plaintiff's claims, the trial court refused to order arbitration of the injunctive relief claims based upon the California Supreme Court's *Broughton-Cruz* rule prohibiting arbitration of injunctive relief claims brought under public-interest statutes.

[16] See, e.g., *Broughton v. Cigna Healthplans*, 21 Cal. 4th 1066 (1999) and *Cruz v. PacifiCare Health Systems, Inc.*, 30 Cal. 4th 303 (2003). Under the state-law rule created by these two case precedents, arbitrations provisions were unenforceable as against public policy if they required arbitration of injunctive relief claims brought for the public's benefit under California's unfair competition law, false advertising law and/or consumer legal remedies law. The central premise of the *Broughton-Cruz* rule is that "the judicial forum has significant institutional advantages over arbitration in administering a public injunctive remedy, which as a consequence will likely lead to the diminution or frustration of the public benefit if the remedy is entrusted to arbitrators."

On April 7, 2017, the California Supreme Court handed down its decision and reversed the appellate court in part, holding that the FAA does not preempt California law with respect to plaintiff's claim for public injunctive relief. The Court held that a pre-dispute arbitration agreement that waives the right to seek public injunctive relief is contrary to public policy and thus unenforceable under California law

The California Supreme Court reversed the appellate court in part, holding that the FAA does not preempt California law with respect to McGill's claim for public injunctive relief and the arbitration provision is unenforceable because its enforcement would violate public policy.

As a threshold matter, the court held that recent amendments to California law do not foreclose the standing of private plaintiffs who have suffered injury in-fact, like McGill alleges, to seek public injunctive relief under the UCL, false advertising law, and the CLRA. The court contrasted McGill's claims with claims where the plaintiff did not suffer an injury in-fact and the claims are brought solely on a representative basis.

The court then held the arbitration provision unenforceable under California law because its enforcement would violate public policy. As the court reasoned, a law established for a public reason cannot be waived by private agreement. Thus, because the purpose of public injunctive relief is to remedy a public wrong—not resolve a private dispute—waivers of a public injunction are unenforceable. While a public injunction may benefit the individual plaintiff, the court reasoned that any such individual benefit is incidental.

With respect to preemption, the court held that the FAA does not preempt relevant California law. The court reasoned that the FAA requires courts to place arbitration provisions on equal—not superior—footing with other contracts. Because other contracts would be unenforceable if they violated public policy, California law is not preempted by the FAA where arbitration agreements are held unenforceable for a reason that would make other contracts unenforceable.

The Court supported its decision with reference to *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985), in which the Supreme Court held that courts are not required to enforce an arbitration provision that forbids the assertion of statutory rights or eliminates a plaintiff's right to pursue a statutory remedy. Thus, the Court distinguished its holding from provisions in which parties agree on the *procedure* for resolving disputes – i.e., class action waivers. The Court explained that provisions that deal with the procedure by which parties resolve disputes may be enforceable because, while they may make pursuing a remedy not worth the expense, they do not foreclose the possibility of pursuing a statutory remedy. In contrast, waivers of public injunctive relief are not enforceable because they foreclose a substantive statutory remedy rather than a procedural path.

(g) 2017 Cases re California's "Third-Party Litigation Exception" Provision Under CCP § 1281.2(c) Allowing the Court to Deny a Motion to Compel and Order a Stay of Arbitration Pending the Outcome of a Court Action

Frequently in multi-party disputes, there are multiple related contracts, some with and some without arbitration clauses. When this circumstances exists, the parties must engage in a two-front war - one in arbitration and one in the courthouse – and are thus confronted with the specter of duplicative fees and costs and potentially contradictory outcomes where the matters require the determination of disputed factual and/or legal issues.

In response to this problem, California enacted Section 1281.2(c) of the California Arbitration Act (CCP §§ 1280, et seq.), which authorizes courts to refuse to enforce an arbitration agreement if the arbitration would threaten to produce a result that may conflict with the outcome of related litigation not subject to arbitration. It provides as follows:

> "On petition of a party to an arbitration agreement alleging the existence of a written agreement to arbitrate a controversy and that a party thereto refuses to arbitrate such controversy, the court shall order the petitioner and the respondent to arbitrate the controversy if it determines that an agreement to arbitrate the controversy exists, unless it determines that: …
>
> (c) A party to the arbitration agreement is also a party to a pending court action or special proceeding with a third party, arising out of the same transaction or series of related transactions and there is a possibility of conflicting rulings on a common issue of law or fact…."

In contrast, the Federal Arbitration Act (FAA) leaves no room for the exercise of such discretion by a district court, and instead mandates that district courts *shall* direct the parties to proceed to arbitration on all issues covered by their arbitration agreement and to order a stay of the court proceedings until the arbitration is completed. 9 U.S.C. §§ 3 and 4. The question is whether the procedural provisions of the FAA apply to a motion to compel arbitration in a California state court where the arbitration agreement is governed by the FAA (because it involves interstate commerce).

Before the United States Supreme Court's decision in *Volt Information Sciences v. Board of Trustees of Leland Stanford Jr. University*, 489 U.S. 468 (1989), the frequent assertion was that the FAA preempted CCP § 1281.2(c). However, in *Volt*, the Court squarely addressed that assertion and held that Section 1281.2(c) is not preempted by the FAA where the parties' contract includes a choice-of-law provision designating California law. The opinion was based on freedom of contract principles wherein parties may contract for whichever procedural rules they want, even if it means their arbitration will be joined with a court action or delayed indefinitely. "There is 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." Id. at 476.

At the state level, the California Supreme court has weighed in and held that the procedural aspects of the FAA do not apply in state court absent an express provision in the arbitration agreement that says so. See *Sanchez v. Valencia Holding Co. LLC*, 61 Cal. 4th 899, 922 (2015) (even where agreement specifies FAA governs any dispute, CAA still governs procedure); *Cronus Investments, Inc. v. Concierge Services*, 35 Cal. 4th 376, 394 (2005) ("We simply hold that the language of the arbitration clause in this case, calling for the application of the FAA 'if it would be applicable,' should not be read to preclude the application of § 1281.2(c), because it does not conflict with the applicable provisions of the FAA and does not undermine or frustrate the FAA's substantive policy favoring arbitration."). As discussed below, the Second and Fourth District Courts of Appeal have extended the principles discussed in *Cronus* and *Sanchez* to compel that California arbitration procedure (specifically Section 1281.2(c)) applies in California courts when the agreement is silent and there are no terms mentioning or alluding to the FAA, California law, or any other state law or rules of procedure. See, *Los Angeles Unified School District v. Safety National Casualty Corp.*, 13 Cal. App. 5th 471 (2017); *Avila v. Southern California Specialty Care, Inc.*, 20 Cal. App. 5th 835 (2018).

Although the *Volt* decision made clear that a generic California choice-of-law provision was enough to incorporate the CAA – and specifically Section 1281.2 – into an arbitration agreement for purposes of defining the governing procedural aspects for the parties' arbitration, the Ninth Circuit reached a contrary conclusion in *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205 (9th Cir. 1998), holding that the contract's generic choice-of-law provision was insufficient to incorporate the state's arbitration act provisions because it did not specifically reference the CAA or Section 1281.2. Id. at 1212-1213. In reaching this decision, the Court relied on *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995), in which the Supreme Court held that a generic choice-of-law clause incorporated only the chosen state's substantive law and not its procedural rules governing arbitration. While the California Supreme Court signaled its disapproval of *Wolsey* in *Cronus*, the federal district courts in California are bound by Ninth Circuit case law. In light of *Wolsey*, the federal court are more likely to find that Section 1281.2(c) does not apply if the contractual language permits such an interpretation. See, e.g., *Stone & Webster, Inc. v. Baker Process, Inc.*, 210 F.Supp. 2d 1177 (S.D.Cal. 2002). Consequently, the choice of state or federal court to enforce an arbitration agreement can influence, if not dictate, the governing procedural rules, bearing in mind that the substantive law aspects of the FAA and CAA are the same – i.e., arbitration agreements are valid and enforceable and are to be enforced by the courts to the same extent as other contracts.

While there is some level of discord as between the state and federal courts in California concerning what law governs the procedural aspects of an arbitration where the arbitration agreement is governed by the FAA, the simple lesson handed down by *Volt* is that parties are free to contract for any procedural rules they want. The best way to assure that a party's preferred arbitration rules will control is to state in clear and unmistakable

terms the particular procedural rules that will govern the arbitration – not just the agreement or the merits of any dispute.

- ***Los Angeles Unified School District v. Safety National Casualty Corp.***, 13 Cal. App. 5th 471 (2d Dist. Jul. 12, 2017) – Where the arbitration agreement is governed by the FAA, but has no choice-of-law provision and no provision expressly stating what procedural provisions are to govern the arbitration, the procedural aspects of the CAA – and specifically Section 1281.2(c) – apply in state court. Trial court did not abuse its discretion when it denied motion to compel and ordered a stay of the arbitration based upon the possibility of conflicting rulings in related litigation involving third parties.

Plaintiff school district sued 27 primary and excess liability insurers for refusing to provide coverage for third-party lawsuits filed against the school district alleging that due to the school district's negligence in hiring, retaining and supervising two teachers at an elementary school, hundreds of students were exposed to abuse for decades. The school district's complaint sought a declaration against all of the insurers that the third-party litigation constituted a single occurrence under the policies, and that all defense and indemnity sums incurred by or on behalf of the district in connection with the defense of the litigation resulted from that single occurrence. One of the defendant insurers moved to compel arbitration under a clause contained in its insurance policy. The trial court denied the motion on the grounds that rulings in the arbitration could conflict with rulings in the litigation against the remaining insurers. The defendant insurer appealed and argued that the FAA does not allow courts to refuse to compel arbitration based on the possibility of conflicting rulings. The Second District Court of Appeal affirmed the trial court and held that under the California Supreme Court's holding in *Cronus Investments, Inc. v . Concierge Services*, 35 Cal. 4th 376 (2005), California arbitration law concerning the procedural aspects of an arbitration apply absent an express invocation of the procedural provisions of the FAA. The court concluded that while the FAA applied with respect to the substantive law requiring that state and federal courts recognize the validity and enforceability of arbitration agreements, it was the CAA that controlled with respect to the procedural motion brought to compel arbitration because the parties' arbitration agreement did not contain an express clause requiring arbitration pursuant to the FAA's procedural rules.

In making this ruling, the court noted that the FAA simply requires state and federal courts to enforce privately negotiated arbitration agreements, like any other contract, in accordance with their terms. 13 Cal. App. 5th at 479, citing *Volt Information Sciences v. Leland Stanford Jr. University*, 489 U.S. 468 (1989). With regard to the procedural aspects of the arbitration the court went on to say that the FAA does not prevent the enforcement of arbitration agreements under different rules from those set forth in the FAA. Quoting from the *Volt* case, the court noted that "[w]here … the 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, even if the result is that arbitration is stayed where the [FAA] would otherwise permit it to go forward." Id. In this case, however, there was no

agreement to abide by state rules and no agreement to abide by FAA procedural rules. The parties' agreement was completely silent, with no terms mentioning or alluding to the FAA, the CAA or any other state law or rules of procedures. Under these circumstances – basically, contract silence on what procedural rules govern an arbitration – the court held that the principles discussed the *Cronus* case compel the conclusion that California procedure under the CAA applies in California state courts.

The CAA differs markedly from the FAA with respect to motions to compel. Under Sections 3 and 4 of the FAA, the court can compel arbitration and order a stay of court litigation. Under CCP §1281.2, the court can compel arbitration and order a stay of court litigation *or* deny a motion to compel and order a stay of the arbitration where the court determines that such action is necessary to avoid conflict rulings on common issues of fact and law amongst interrelated parties. At the center of the court's decision was its focus on the language of Sections 3 and 4 of the FAA which apply only in federal court proceedings and are not binding on state courts, provided that applicable state procedures do not defeat the substantive rights granted by Congress. 13 Cal. App. 5th at 481.

> "Our statutes do establish procedures for determining enforceability not applicable to contracts generally, but they do not thereby run afoul of the [FAA's] section 2, which sates the principle of equal enforceability, but does not dictate the procedures for determining enforceability."

Cronus, 35 Cal. 4th at 390.

Ultimately, the court held that CCP §1281.2(c) and (d) were procedural, rather than substantive, rules and that the trial court thus had discretion to refuse to compel arbitration in order to prevent inconsistent rulings in a matter that would proceed in court on the same issues with related parties. The court also held that under *Cronus*, CCP § 1281.2 was not preempted by the FAA because it did not violate the letter of that act or conflict with its policy of encouraging the validity and enforcement of arbitration agreements.

- ***Avila v. Southern California Specialty Services***, 20 Cal. App. 5th 835 (4th Dist. Feb. 26, 2018) – The procedural aspects of the FAA do not apply in state court absent an express provision in the arbitration agreement. The trial court had the discretion under CCP § 1281.2 not to enforce an arbitration agreement if a party to the agreement is also a party to a pending court action or special proceeding with a third party, arising out of the same transaction or series of related transactions, and there is a possibility of conflicting rulings on a common issue of law or fact.

Avila was his 87-year old father's power of attorney. Exercising that power, Avila checked his father into defendant's facility – a long-term acute care hospital – and signed admission paperwork that included an agreement to arbitrate any claims arising from his father's hospital stay and also purported to bind his father's heirs, family, spouse, etc. Five days after he was admitted, Avila's father died due to complications from a dislodged feeding tube. In his personal and representative capacity, Avila brought suit against the hospital for negligent care (medical malpractice), elder abuse and neglect and wrongful death. The hospital moved to compel arbitration based upon the arbitration agreement contained in the admission paperwork Avila signed in connection with his father's admission. The trial court denied that motion, finding that the hospital had failed to show that Avila, in his personal capacity or with respect to the elder abuse claims had agreed to arbitration.[17]

The issue raised on appeal was whether the trial court had abused its discretion under CCP § 1281.2(c). However, the court found that the trial court's discretion under Section 1281.2(c) "does not come into play until it is ascertained that the subdivision applies." Defendants argued that the FAA applied – and thus Sections 3 and 4 of the FAA controlled the issue and the trial court erred as a matter of law in applying Section 1281.2(c). Plaintiff argued that the CAA, and thus Section 1281.2(c), applied instead. The Court of Appeal held that defendants were incorrect. Noting that the FAA includes both procedural and substantive provisions, "[t]he procedural aspects of the FAA do not apply in state court absent an express provision in the arbitration agreement." 20 Cal. App. 5th at ___, citing *Volt*, *Sanchez* and *Cronus* (discussed above).

[17] California Code of Civil Procedure § 1295 contains certain requirements for arbitration agreements of "any dispute as to professional negligence of a health care provider." It defines "professional negligence" as "a negligent act or omission to act by a health care provider in the rendering of professional services, which act or omission is the proximate cause of a personal injury or wrongful death, provided that such services are within the scope of services for which the provider is licensed and which are not within any restriction imposed by the licensing agency or licensed hospital." The California Supreme Court has held that section 1295 permits patients who consent to arbitration to bind their heirs in actions for wrongful death. *Ruiz v. Podolsky*, 50 Cal. 4th 838, 849 (2010). However, this principle extends only to cases for medical malpractice and not elder abuse. If the primary basis for the wrongful death claim sounds in professional negligence as defined by MICRA, then section 1295 applies. If the primary basis is under the Elder Abuse and Dependent Adult Civil Protection Act (Welf. & Inst. Code §§ 15600, et seq.), then section 1295 does not apply. In the latter case, Avila could not be compelled to arbitrate because *he* did not consent to arbitration.

The agreement at issue in the *Avila* case included the statement that disputes "will be determined by submission to arbitration as provided by California law." Of greater importance to the Court of Appeal was the fact that the agreement did "not even mention the FAA, much less expressly adopt its procedural rules." Accordingly, the court held that the FAA's procedural rules did not apply; that "[a]ny state procedural provisions regarding arbitration are valid unless they defeat the rights granted by the FAA to equal enforcement of arbitration clauses."

The Fourth District also rejected defendants' argument that the CAA was preempted by the FAA because Section 1281.2(c) placed arbitration agreement on an unequal footing than other contracts, noting that (a) defendants cited no case law to that effect, and (b) that there was ample case law to the contrary, including the California Supreme Court's decision in *Cronus* which "held that section 1281.2, subdivision (c), does not defeat the rights granted by the FAA, and is therefore not preempted." Id. at ____.

7. The Award and Challenges to the Arbitration Award

(a) *Background Statement*

An arbitration proceeding is concluded by the issuance of an award. The only statutory requirements concerning the form of the award is that it must be in writing, signed by the arbitrator, and include a determination of all questions submitted to the arbitrator that must be decided in order to determine the controversy. Cal. Civ. Proc. Code § 1283.4. There are, however, rules governing the award process that have been adopted by various provider organizations.

As a matter of statutory law, the arbitrator is not required to issue formal findings of fact or conclusions of law. *Cothron v. Interinsurance Exchange*, 103 Cal. App. 3d 853, 861 (1980). Likewise, the arbitrator is not required to disclose his or her rationale or reasons for the award. *Arco Alaska v. Superior Court*, 168 Cal. App. 3d 139, 148 (1985); *Baldwin Co. v. Rainey Const. Co.*, 229 Cal. App. 3d 1053, 1058 n. 3 (1990).[18] However, some provider organizations require that the arbitrator issue an award that includes a statement of the reasons for the award, unless the parties agree otherwise. See, e.g., JAMS Rules, Rule 24. Other provider organizations give the parties the option of requesting a "reasoned award" as part of the process. See, e.g., American Arbitration Association Commercial Rules, Rule R-42. Beyond what is stated in the arbitrator's award, parties may not depose the arbitrator to establish and then challenge his or her reasoning. *Hoeft v. MVL Group, Inc.*, 343 F.3d 57, 66-68 (2d Cir. 2003).

An arbitrator's award is not directly enforceable. Until it is confirmed, an award has no more force or effect than a written contract between the parties to the arbitration. Cal. Civ. Proc. Code § 1287.6; *Jones v. Kvistad*, 19 Cal. App. 3d 836, 840 (1971). However, unless vacated or corrected by the court, an arbitration award is entitled to res judicata and collateral estoppel effect in any subsequent proceedings involving the same parties. *State Farm Mut. Auto. Ins. Co. v. Superior Court*, 211 Cal. App. 3d 5, 14 (1989) (collateral estoppel effect as to issues "actually, necessarily, and finally" resolved in the arbitration proceeding); *Thibodeau v. Crum*, 4 Cal. App. 4th 749, 755 (1992) (res judicata doctrine applies to an arbitration award, even though unconfirmed, and bars subsequent assertion of claims falling within the scope of the arbitration); *Bucur v. Ahmad*, 244 Cal. App. 4th 175 (2016) (same).

The procedure by which a prevailing party obtains a judgment on its award is a petition to confirm. Under both the FAA and CAA, the prevailing party must petition the court to confirm the award. 9 U.S.C. §§ 9, 13; Cal. Code Civ. Proc. §§ 1285, 1286, 1287.4. Under the FAA, the petition to confirm must be filed within one year of the issuance of the award. 9

[18] For cases governed by the FAA, see *Bosack v. Soward*, 586 F.3d 1096, 1102 (9th Cir. 2009) ("Arbitrators are not required to set forth their reasoning supporting an award. An arbitrator's award may be made without explanation of their reasons and without a complete record of their proceedings. [But, if] they choose not to do so, it is all but impossible to determine whether they acted with manifest disregard for the law.").

U.S.C. § 9. Under the CAA, the deadline for filing the petition to confirm is four years from the date of service of the award. Cal. Code Civ. Proc. §§ 1288, 1288.4. Once confirmed, the arbitration award becomes a judgment of the court, has the same force and effect as a judgment in a civil action, and may be enforced like any other judgment of the court in which it is entered. 9 U.S.C. § 13(c); Cal. Code Civ. Proc. § 1287.4; see *Britz, Inc. v. Alfa-Laval Food & Dairy Co.*, 34 Cal. App. 4th 1085, 1106 (1995).

The scope of judicial review of arbitration awards is extremely narrow and is limited to the specific grounds defined by statute, which are directed at the process and not the substance of the award or the merits of the dispute. Generally speaking, an arbitrator's decision is not reviewable for errors of fact or law. *Moncarsh v. Heily & Blase*, 3 Cal. 4th 1, 6 (1992); *City of Palo Alto v. Service Employees Int'l Union*, 77 Cal. App. 4th 327, 333 (1999). Courts may not act *sua sponte*. Cal. Civ. Proc. Code §§ 1286.4, 1286.8; *Valsan Partners Ltd. P'ship v. Calco Space Facility, Inc.*, 25 Cal. App. 4th 809, 818 (1994). Vacatur relief must be sought by petitioning the court to vacate the award and may be filed by any party. *Baldwin Co. v. Rainey Const. Co.*, 229 Cal. App. 3d 1053, 1058 (1991). The time frame for seeking vacatur is quite narrow: three months after the award is "filed or delivered" under the FAA (9 U.S.C. § 12), and 100 days after the date of service of the award under the CAA (Cal. Code Civ. Proc. § 1288)

Vacatur Under the FAA

Grounds for vacatur under the FAA are primarily directed at process errors, as described below:

- The award was procured by corruption, fraud or undue means. 9 U.S.C. § 10(a)(1).
- There was evident partiality or corruption in the arbitrators or either of them. 9 U.S.C. § 10(a)(2).
- The arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy. 9 U.S.C. § 10(a)(3).
- The arbitrators exceeded their powers or so imperfectly executed them that a final and definite award was not made. 9 U.S.C. § 10(a)(4).

For arbitrations governed by the FAA, there are two additional, common law grounds for seeking vacatur of an award, which are quite narrow. The first is the "manifest disregard" of the law exception and allows the award to be vacated where the arbitrator knew applicable law but ignored or refused to apply it,[19] or where an obvious error of law

[19] Under Section 10 of the FAA, vacatur is appropriate where it is evident that "the arbitrators exceeded their powers or so imperfectly executed them that a mutual, final and definite award upon the subject matter

exists.[20] "For an arbitrator's award to be in manifest disregard of the law, it must be clear from the record that the arbitrator recognized the applicable law and then ignored it …." *Matthews v. Nat'l Football League Mgmt. Council*, 688 F.3d 1107, 1115 (9th Cir. 2012).

The second additional common law ground is the "arbitrary and capricious" exception, which allows the award to be vacated where no ground for the decision can be inferred from the facts.[21] This common law ground for vacatur under the FAA is not uniformly accepted. Additionally, as demonstrated by the recent Ninth Circuit decision in *Sanchez v. Elizondo*, 878 F.3d 1216 (9th Cir. 2018), discussed below at page 153, the courts sometimes talk about what does and does not qualify as a statutory ground for vacatur using verbiage that sounds like one of the common law grounds. For example, in the *Sanchez* decision, the Ninth Circuit held that vacatur under Section 10(a)(4) of the FAA is a very high standard that requires a showing that the award issued "is completely irrational." 878 F.3d at 1221.

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submitted was not made. "[A]rbitrators exceed their powers in this regard not when they merely interpret or apply the governing law incorrectly, but when the award is completely irrational, or exhibits a manifest disregard of the law." *Kyocera Corp. v. Prudential Bache Trade Serv. Inc.*, 341 F.3d 987, 997 (9th Cir. 2003) (en banc). "Manifest disregard of the law means something more than just an error in the law or a failure on the part of the arbitrators to understand or apply the law." *Lagstein v. Certain Underwriters at Lloyd's, London*, 607 F.3d 634, 641 (9th Cir. 2010), citing *Mich. Mut. Ins. Co. v. Unigard Sec. Ins. Co.*, 44 F.3d 826, 832 (9th Cir. 1995). See, e.g., *Comedy Club, Inc. v. Improv West Assoc.*, 553 F.3d 1277, 1287 (9th Cir. 2009) (vacatur for manifest disregard of the law where injunction award included collateral relatives not in privity who, under California law, the arbitrator lacked authority to enjoin); see also *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056 (9th Cir. 1991) (vacatur allowed for arbitrator's manifest disregard of the law).

[20] See, e.g., *International Telepassport Corp. v. USFI, Inc.*, 89 F.3d 82 (2d Cir. 1996) (vacatur allowed for error of law which is obvious and capable of being instantly perceived by the average arbitrator); *Roadway Package System, Inc. v. Kayser*, 257 F.3d 287 (3d Cir. 2000), cert. denied, 534 U.S. 1020 (2001) (same); see also *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989); *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995); *Halligan v. Pipe Jaffray, Inc.*, 148 F.3d 197 (2d Cir. 1998); *Tanoma Mining Co. v. Local Union No. 1269*, 896 F.2d 745 (3d Cir. 1990); *Bowen v. Amoco Pipeline Co.*, 254 F.2d 925 (10th Cir. 2001).

[21] See, e.g., *Montes v. Shearson Lehman Bros., Inc.*, 128 F.3d 1456, 1458 (11th Cir. 1997). If no ground for the decision can be inferred from the facts, the award may be vacated as arbitrary and capricious. *Brown v. ITT Consumer Fin. Corp.*, 211 F.3d 1217, 1223 (11th Cir. 2000). Likewise, if an award is "so palpably faulty that no judge . . . could ever conceivably have made such a ruling," the award may be vacated as arbitrary and capricious. *Safeway Stores v. Am. Bakery & Confectionary Workers*, Local 111, 390 F.2d 79, 82 (5th Cir. 1968). The award may also be vacated if it is found to be "completely irrational." *French v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 784 F.2d 902, 906 (9th Cir. 1986); *G.C. & K.B. Investments, Inc. v. Wilson*, 326 F.3d 1096 (9th 2003) (same).

Vacatur Under the CAA

Just like its FAA counterpart, the grounds for vacatur under the CAA are also directed at process errors. Those grounds are similar to Section 10 of the FAA, but have some additional statutory grounds as described below:

- The award was procured by corruption, fraud or undue means. Cal. Code Civ. Proc. § 1286.2(a)(1).[22]

- There was corruption in any of the arbitrators. Cal. Code Civ. Proc. § 1286.2(a)(2).

- The rights of the party were substantially prejudiced by misconduct of a neutral arbitrator. Cal. Code Civ. Proc. § 1286.2(a)(3).

- The arbitrators exceeded their powers and the award cannot be corrected without affecting the merits of the decision upon the controversy submitted. Cal. Code Civ. Proc. § 1286.2(a)(4).[23]

- The rights of the party were substantially prejudiced by the refusal of the arbitrators to postpone the hearing upon sufficient cause being shown therefore or by the refusal of the arbitrators to hear evidence materials to the controversy or by other conduct of the arbitrators contrary to the provisions of this title. Cal. Code Civ. Proc. § 1286.2(a)(5).[24]

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[22] This ground for vacatur applies to extrinsic fraud perpetrated by the arbitrator or a party (i.e., fraud which deprives the party of a fair hearing). *Pacific Crown Dist v. Brotherhood of Teamsters, Etc.*, 183 Cal. App. 3d 1138, 1147 (1986). It also applies to "undue" behavior which deprives a party of a "hearty 'first bite'." *Pour Le Bebe, Inc. v. Guess? Inc.*, 112 Cal. App. 4th 810, 831 (2003).

[23] An arbitrator derives his power solely from parties' arbitration agreement or the stipulation of submission and he has no legal right to decide issues not submitted by the parties. *Moncarsh v. Heily & Blase*, 3 Cal. 4th 1, 8 (1992); *O'Malley v. Petroleum Maintenance Co.*, 48 Cal. 2d 107, 110 (1957); *Luster v. Collins*, 15 Cal. App. 4th 1338, 1346 (1993). A party's failure to request the arbitrator to determine a particular issue within the scope of the arbitration is not a basis for vacating or correcting an award. *Corona v. Amherst Partners*, 107 Cal. App. 4th 701, 706 (2003). Arbitrators do not exceed their powers because they assign erroneous reasons for their decision. *Moncharsh*, supra, 3 Cal. 4th at 28. The focus of this inquiry is on whether arbitrators had the power, based on the parties' submissions, to reach a certain issue, not whether the arbitrator correctly decided the issue. See, e.g., *DiRussa v. Dean Witter Reynolds, Inc.*, 121 F.3d 818, 824 (2d Cir. 1997).

[24] Arbitrators are required to decide all questions submitted that are necessary to determine the controversy. Cal. Civ. Proc. Code § 1283.4. Failure to do so may constitute "other conduct" for vacatur. *Muldrow v. Norris*, 12 Cal. 331 (1859). A party challenging an award on this ground bears the a "heavy burden" because it is presumed that all issues submitted have been decided – and most final awards include language to the effect that all claims, defenses, affirmative defenses, and counterclaims not specifically mentioned in the award were denied. *Rodrigues v. Keller*, 113 Cal. App. 3d 838, 841 (1980). To overcome that presumption, the party challenging the award must show that its claims were expressly raised and not decided by the arbitrator. Id. This is difficult to do because findings are usually not required or part of the

- An arbitrator making the award either (a) failed to make a required disclosure, or (B) was subject to disqualification after making a required disclosure and receiving an objection to his/her appointment, but failed upon receipt of a timely demand to disqualify himself or herself as required by California Code of Civil Procedure § 1281.91. Cal. Code Civ. Proc. § 1286.2(a)(6).[25]

Vacatur Because an Award Violates Well-Defined Public Policy

In 1987, the United States Supreme Court held that courts can decline to enforce an arbitrator's award where enforcement "would violate 'some explicit public policy' that is 'well defined and dominant, and is to be ascertained by reference to the laws and legal precedents and not from general considerations of supposed public interests.'" *United Paperworkers' Int'l Union, AFL-CIO v. Misco, Inc.*, 484 U.S. 29, 43 (1987); see also *Exxon Shipping Co. v. Exxon Seamen's Union*, 11 F.3d 1189, 1191-1192 (3d Cir. 1994) (vacating labor arbitration award that required the reinstatement of a seaman who was found to be highly intoxicated while on duty); *Board of Education, Etc. v. Round Valley Teachers Ass'n*, 13 Cal. 4th 269, 277 (1996) (vacating arbitration award that required school district to comply with collective bargaining agreement procedure for termination a probationary teacher which was preempted by conflicting Education Code provisions). This exception arises out of the contract defense to enforcement where a contract is found to violate public policy. *Vimar Sequros y Reaseguros S.A. v. M/V Sky Reefer*, 515 U.S. 528, 540 (1995). This exception derives legitimacy from the public's interest in having its views represented in matters to which it is not a party but which could harm the public interest. *Seymour v. Blue Cross/Blue Shield*, 988 F.2d 1020, 1023 (10th Cir. 1993); see also *Di Russa v. Dean Witter Reynolds, Inc.*, supra, 121 F.3d at 824-825.

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award. Id. In the case of a monetary award without findings, the decision that one of the parties should pay the other a sum of money "is sufficiently determinative of all items embraced in the submission." *Sapp v. Barenfeld*, 34 Cal .2d 515, 522-523 (1949).

[25] Arbitrators conducting arbitrations in California must comply with the Judicial Council ethics standards which require that an arbitrator make extensive conflict disclosures to the parties before accepting the appointment and hearing the dispute. Cal. Civ. Proc. Code §§ 1281.85, 1281.9 and 1281.91. An arbitrator's failure to comply with the disclosure requirements may be ground for disqualification of the arbitrator and for vacatur of any award issued. *Ovitz v. Schulman*, 133 Cal. 4th 830 (2005). Likewise, an arbitrator's failure to honor a demand for disqualification after making the required conflict disclosures mandates vacatur of any award issued. *Azteca Const., Inc. v. ADR Consulting, Inc.*, 121 Cal. App. 4th 1156, 1168-1169 (2004). An arbitrator's mere failure to disclose a conflict is not a basis for vacatur under the FAA. Proof of evident partiality is required under the FAA. 9 U.S.C. § 10(a)(2); *ANR Coal Co., Inc. v. Cogentrix of North Carolina, Inc.*, 173 F.3d 493, 499-500 (4th Cir. 1999). The significance of California's disclosure requirements is that if an affirmative disclosure is made, that triggers the unqualified right of the parties to object to the arbitrator's appointment *and* the unconditional duty of the arbitrator to recuse himself or herself upon receiving an objection to his or her appointment after making disclosures.

Both state and federal common law recognize this "public policy" exception to confirmation of an award, and thus allow vacatur of such an award. There are not a lot of reported cases involving this ground for vacatur, but there was a 2016 decision by the Second District Court of Appeal – *Sheppard Mullin Richter & Hampton LLP v. J-M Manufacturing Co., Inc.*, 244 Cal. App. 4th 590, cert. granted, 368 P.3d 922 (2016) - discussed at page 154.

Expanded Review by Party Agreement

While arbitration is a creature of contract, the United States Supreme Court ruled in 2008 that Section 10 of the FAA provides the exclusive grounds for vacatur under the FAA; that parties may not contract between themselves for an expanded scope of review. See, *Hall St. Assoc., LLC v. Mattel, Inc.*, 552 U.S. 576, 584 (2008).

The rule is different for arbitrations governed by the CAA. In 2008, the California Supreme Court relied on the United States Supreme Court's statement in *Hall Street* that "[t]he FAA is not the only way into court for parties wanting review of arbitration awards: they may contemplate enforcement under state statutory or common law, for example, where judicial review of different scope is arguable," 552 U.S. at 552, to conclude that *Hall Street* did not foreclose a more searching merits review of arbitral awards when done so under authority other than the FAA. See, *Cable Connection, Inc. v. DirecTV, Inc.*, 44 Cal. 4th 1334, 1354-1355 (2008). The California Supreme Court went on to hold that "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 . . . provid[e] for review of the merits in the arbitration agreement." 44 Cal. 4th at 1364. We have a recent decision out of the Second District Court of Appeal – *Harshad & Nasir Corp. v. Global Sign Systems, Inc.*, 14 Cal. App. 5th 23 (2017), discussed at page 159 - in which the Court held that the language in the parties' arbitration agreement dictates the standard of review when one party seeks vacatur of the award. As discussed below, the language in the parties' arbitration agreement was quite broad and subjected the award to review for both legal and factual errors, which the court found existed, and ordered vacatur.

(b) Award Procured by Fraud or Undue Means

- ***Move, Inc. v. Citigroup Global Markets, Inc.***, 840 F.3d 1152 (9th 2016) – The FAA is subject to the established doctrine of equitable tolling. Vacatur granted four years after confirmation of an arbitration award to redress the Chair's gross misrepresentations about his experience and qualifications.

The old saw is "bad facts make bad law." This case represents a departure where bad facts prompted the Ninth Circuit to make good law, finally establishing case precedent in this circuit allowing for equitable tolling of the short time period for seeking vacatur to promote and enhance the integrity of the process and the fairness of arbitral outcomes.

Online real estate company Move Inc. sued Citigroup Global Markets, Inc. for mismanagement of $131 million of its funds that were invested in speculative auction rate securities. While there was a "Client Agreement" between Move Inc. and Citigroup that contained an arbitration clause covering "all claims or controversies," before initiating the FINRA arbitration proceedings, FINRA required Move Inc. and Citigroup to sign a submission agreement. The matter then proceeded to arbitration, and FINRA provided the parties with a list of 30 proposed arbitrators and their employment histories, including ten proposed arbitrators from FINRA's chairperson roster.

Because the dispute involved a complex securities issue, it was important to Move Inc. that the chairperson be an experienced attorney. Move, Inc. ranked "James H. Frank" first who, according to the FINRA arbitrator disclosure report, was a licensed attorney in California, New York and Florida. Mr. Frank was appointed to serve as the chairperson of the panel. The arbitration proceedings commenced in September 2008 and concluded in December 2009 with a unanimous award denying Move Inc's claims.

Arbitrator Frank sat on nearly 50 panels during the course of his 15 years as a FINRA arbitrator, but was quietly removed from the panel in 2013 when FINRA learned that he had lied about being a lawyer. Move Inc. learned of Frank's deception in March 2014 as the result of a news story and shortly thereafter filed a motion to vacate the 2009 decision. Citigroup countered with a motion to dismiss the case, arguing that the three-month deadline for seeking vacatur under Section 12 of the FAA had long passed and that, even if the limitations period were tolled, vacatur was unjustified on the merits because the decision was unanimous and it only took two arbitrators to rule in favor of Citigroup for it to prevail. While the district court noted that whether equitable tolling was available under the FAA presented an "unsettled question of law" in the Ninth Circuit, it agreed with Move Inc. that equitable tolling was available. The district court denied vacatur, however, finding that Move Inc. had failed to demonstrate that Frank's misbehavior had prejudiced its rights to a fair hearing for purposes of vacatur under Section 10(a)(3). Move, Inc. appealed.

With regard to the equitable tolling issue, the Ninth Circuit agreed with the district court that the case law from other circuits was conflicting and that most circuits had thus far

declined to rule on the issue. 840 F.3d at 1156, citing *Garrett v Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 7 F.3d 882, 883 (9th Cir. 1993), *Fradella v. Petricca*, 183 F.3d 17, 21 (1st Cir. 1999), *Taylor v. Nelson*, 788 F.2d 220, 225-226 (4th Cir. 1986), *Piccolo v. Dain, Kalman & Quail, Inc.*, 641 F.2d 598, 601 (8th Cir. 1981), and *Pfannenstiel v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 477 F.3d 1155, 1158 (10th Cir. 2007). The Ninth Circuit squarely decided the issue, affirming the district court and holding that the FAA is subject to the established doctrine of equitable tolling. In this regard, the Ninth Circuit reasoned that "'[i]t is hornbook law that limitations periods are customarily subject to equitable tolling … unless tolling would be inconsistent with the text of the relevant statute,'" and that "'Congress must be presumed to draft limitations periods in light of this background principle.'" Id., citing *Young v. United States*, 535 U.S. 43, 49-50 (2002). The Court held that that equitable tolling would not undermine the basic purpose of the FAA, which is to make arbitration agreements valid and enforceable. Id. at 1158. It also held that in balancing the needs for both finality and due process, "the arbitral process will not be disrupted if parties are permitted to satisfy the high bar of equitable tolling in limited circumstances," and that permitting equitable tolling would enhance the integrity of the process and the fairness of arbitral outcomes. Id.

With regard to the vacatur issue, the Ninth Circuit held that the question to be answered for vacatur under Section 10(a)(3) was "whether the parties received a fundamentally fair hearing." Id. at 1158. The Court noted that the fact circumstances presented in the case were unique and that neither the Ninth Circuit nor its sister circuits had previously addressed the issue of whether vacatur is proper where an arbitrator's purposeful and material deception resulted in his selection as chairperson of a panel. While there was no evidence that Frank influenced the other members of the panel or that the outcome of the arbitration was affected by his participation, the Ninth Circuit stated that it simply conclude that Move Inc. had received a fundamentally fair hearing under the facts that existed in this case. In this regard, the Court found that Frank's participation in the hearing process was fundamentally prejudicial to Move Inc. because, under FINRA's rules and regulations, Frank's deceit would have permanently disqualified him from serving as a FINRA arbitrator. It was significant to the Court that once Frank's lies were revealed, FINRA immediately (albeit quietly) removed him from its roster. Accordingly, the Ninth Circuit held that Move Inc. was entitled to vacatur under Section 10(a)(4) and reversed the district court's ruling to the contrary.

(c) Evident Partiality or Corruption in the Arbitrator

See, cases discussed in Sections 2 and 3, above.

(d) Arbitrator Misconduct / Refusal to Hear Evidence

- ***Royal Alliance Associates, Inc. v. Liebhaber***, 2 Cal. App. 5th 1092 (2016) – Award vacated for refusal to hear evidence where the arbitration panel only allowed one side to present oral evidence and did not allow the other side to present such evidence or cross-examine the other side.

Liebhaber was an investment customer of Royal Alliance and worked with a broker named Kathleen Tarr. Liebhaber brought a claim against Tarr, alleging that Tarr had improperly placed her retirement funds in risky, illiquid investments. Liebhaber demanded a FINRA arbitration, but settled before the arbitration began. Royal Alliance asked that the arbitration be kept open so that it could move to expunge Liebhaber's allegations against Tarr from FINRA's Central Registration Depository on the ground that the allegations were false. During a telephonic hearing on Royal Alliance's expungement request, Tarr was allowed to speak, but did so without being sworn by the panel. Liebhaber requested that she be allowed to present her own testimony and to cross-examine Tarr. The panel denied Liebhaber's requests, and issued an award recommending expungement. Royal Alliance then moved to confirm the award under the California Arbitration Act, and Liebhaber objected and sought vacatur of the award. The trial court denied confirmation and vacated the award on the ground that Liebhaber's rights were substantially prejudiced by the refusal of the arbitrators to hear evidence material to the controversy. Royal Alliance appealed.

On appeal, Royal Alliance argued that the award should be confirmed because the arbitrators had allowed and considered written submissions from both sides in compliance with the applicable FINRA rules. The Court of Appeal rejected that argument, holding that the pertinent question under Code of Civil Procedure section 1286.2(a)(5) was whether or not the arbitrators had prevented a party from fairly presenting its case and prejudiced the party's rights as a result. While the California Arbitration Act allows parties to be limited to written submission rather than live testimony, if an opportunity to be heard is extended to one side, it must be extended to all parties equally. Because the panel had allowed Tarr to speak during the hearing, but did not allow Liebhaber to speak or to cross-examine Tarr, the Court of Appeal held that Liebhaber had been deprived of a fair opportunity to present her case. The Court of Appeal held that this was prejudicial because the arbitrators could not fully weigh the credibility of the Tarr's statements without Liebhaber being given the opportunity to cross-examine her.

(e) Arbitrator Exceeded His / Her Powers

- ***Emerald Aero LLC v. Kaplan*,** 9 Cal. App. 5th 1125 (4th Dist. Mar. 21, 2017) – State appeals court overturns arbitrator's $30.8 million award finding that the lack of notice of the claimant's increased punitive damages claim and the arbitrator's decision to accept the last minute amendment to the damages claim fell outside the arbitrator's scope of authority.

This matter arose when several investors sued Stephen Kaplan for alleged breach of fiduciary duties pertaining to plaintiffs' investment in a self-storage facility located in Texas. In the court proceedings, plaintiffs sought compensatory damages and declaratory relief, but not punitive damages. The trial court granted defendants' unopposed motion to compel arbitration. About ten months later, in January 2014, plaintiffs submitted a request to the AAA to have a case opened and attached a "claim summary" form in which they stated that they were seeking $1 million in damages and that the basis for their claim was set forth in an attached copy of their state court complaint.

In November 2014, after the arbitrator was appointed, the matter was ordered stayed pending the outcome of Kaplan's criminal prosecution. In terms of what happened next, it's important to first look at Rule R-6 of the AAA Commercial Rules. Rule R-6(a) provides that at any time prior to the close of the evidentiary hearing or by a date established by the arbitrator, a party may increase or decrease the amount of its claim or counterclaim, provided that written notice of the change of claim amount must be provided to the AAA and all parties. Rule R-6(a) also provides that if the change of claim amount results in an increase in the amount of the administrative fee, the balance of the fee is due before the change of claim amount will be accepted (and presumably acted upon) by the arbitrator. Additionally Rule R-6(b) provides that an arbitrator may only award remedies of which the parties had reasonable notice, and that at least 14 days' notice must be given of "[a]ny new or different claim or counterclaim." Where a new or different claim or counterclaim are put forth after the arbitrator has been appointed, Rule R-6(b) provides that the arbitrator must consent to its submission.

In this case, the arbitration proceeding was reactivated after Kaplan pleaded guilty to wire fraud, but before his sentencing hearing. A number of proceedings were held, some it appears without notice to Kaplan or his attorney. In any event, given that plaintiffs' stated claim amount was only $1 million, it appears that whether Kaplan or his attorney received notice or not, Kaplan had opted to devote his attention to other matters and let the chips fall where they might, viewing his maximum exposure as being $1 million.

After numerous continuances, the arbitrator set the matter for a telephonic, default prove-up hearing and did so with only two and one-half week's notice. The day before the hearing, plaintiffs submitted briefing in which they requested over $12 million in compensatory damages, *plus* punitive damages in the amount of three times their actual damages. The evidentiary hearing went forward as noticed, with no appearance or response by Kaplan. Two weeks later, the arbitrator issued an award in favor of plaintiffs in the amount of $30.8 million and did so without specifying the grounds or nature of the award.

Plaintiffs then moved to confirm the award and Kaplan, not surprisingly, moved to vacate the award. Kaplan argued that the award lacked due process and exceeded the arbitrator's powers on various grounds, including that fact that it went beyond the submitted issues and provided for unauthorized remedies. Plaintiffs argued that the arbitrator's award was final and binding, and that the court had no authority to review the merits of the decision. The trial court ruled for plaintiffs, and entered judgment in the amount of the award.

On appeal to the Fourth District Court of Appeal, the judgment was overturned and the award vacated on the grounds that the arbitrator had exceeded his authority by including punitive damages in the award. The ruling, written by Justice Judith L. Haller and concurred with by Presiding Justice Judith McConnell and Justice Richard D. Huffman, said that the award of punitive damages violated the AAA Commercial Rules (discussed above), which were incorporated by reference into the parties' arbitration agreement. The appellate court rejected the argument that Kaplan was not prejudiced because he had already decided not to appear. Justice Haller reasoned that Kaplan might have retained counsel or appeared, at least to oppose the punitive damages request, given that the amount being sought substantially exceeded the $1 million prayed for in the initial arbitration claim. Justice Haller went on to say that there were further procedural irregularities requiring that the award be vacated, including the lack of a showing that Kaplan had notice of prior hearings and orders, ambiguity as to how much the plaintiffs were claiming in compensatory damages, and the case manager's refusal to reassign the case when the arbitrator resigned and refused to hear or rule on Kaplan's motion seeking to set aside the award on the grounds that Kaplan had received no notice that plaintiffs would be seeking punitive damages. Justice Haller wrote that "the extraordinary large amount" of the arbitration award had heightened her concerns about the "numerous procedural shortcomings" in the arbitration. "On the record before us, plaintiffs' counsel took unfair advantage of the situation by making a last-minute demand for more than $30 million in punitive damages…. Given the lack of fair notice, the arbitrator's decision to accept this claimed amount fell outside the arbitrator's authority." Because the arbitrator did not specify how much of the award was punitive damages, the appellate court determined that the entire award must be vacated.

- ***Sanchez v. Elizondo***, 878 F.3d 1216 (9th Cir. Jan. 5, 2018) – Vacatur under Section 10(a)(4) of the FAA for an arbitrator exceeding his / her power is a very high standard that requires more than merely interpreting or applying the governing law incorrectly. The award must be "completely irrational" to meet this standard.

Customer (Elizondo) sued his securities broker (Sanchez) for the alleged mismanagement of his investment portfolio. The dispute was submitted to FINRA arbitration where FINRA Rule 12401 provides that claims for $100,000 or less will be decided by a single arbitrator. In his demand, Elizondo claimed compensatory damages of $100,000, so his case was assigned to a single arbitrator. Shortly before the evidentiary hearing, Elizondo filed a pre-hearing brief in which he claimed to be entitled to damages in the amount of $125,000. Based upon this assertion, Sanchez objected to the matter proceeding with the single arbitrator. The arbitrator asked the parties for briefing on the applicability of FINRA Rule 12401. Interpreting the language in Rule 12401, the arbitrator found that "the amount of the claim" referred to the amount pleaded in the operative demand rather than any amount later sought in the arbitration. Since Elizondo did not amend his demand, and the arbitrator determined that it was appropriate for him to hear the matter as a sole arbitrator. The arbitrator then issued an award in favor of Elizondo in the amount of $75,000. Sanchez petitioned for vacatur on the grounds that the arbitrator had exceeded his powers when he proceeded as a single arbitrator over Sanchez's objection. The district court granted vacatur on two grounds: (1) exceeding the scope of his authority pursuant to Section 10(a)(4) of the FAA, and (2) the common law ground of manifest disregard of the law. The Ninth Circuit disagreed with the district court and reversed the vacatur order.

With regard to the challenge made under Section 10(a)(4) of the FAA, the court found that this is a very high standard to meet and is not met when a petitioner shows that an arbitration panel committed an error or even a serious error. "'It is only when [an] arbitrator strays from interpretation and application of the agreement and effectively "dispense[s] his own brand of industrial justice" that his decision may be unenforceable.'" 878 F.3d at 1221. The court went on to state that it has found arbitrators to exceed their powers only where "the award is completely irrational." Here, the arbitrator's interpretation of FINRA Rule 12401 – finding that Customer's case could be decided by a single arbitrator because he had not amended his demand to enlarge his original damages claim over the $100,000 limit – was plausible, notwithstanding Customer's pre-hearing assertion that he was owed damages totaling $125,000. Thus, the trial court erred in vacating the award. Reversed and remanded for further proceedings.

(f) Award Violates a Well-Defined Public Policy

- ***Sheppard Mullin Richter & Hampton LLP v. J-M Manufacturing Co., Inc.***, 244 Cal. App. 4th 590 (2016), review granted, 368 P.3d 922 (Apr. 27, 2016), fully briefed and awaiting setting for oral argument as of April 2018 - Award vacated where the arbitrator's decision was held to run far afield of the law in the all-important area of an attorney's inviolate duty not to concurrently represent clients who have adverse interests without obtaining their advance consent and waiver of conflicts, and the companion restriction on charging and recovering fees for services rendered where the advance consent and conflict waiver requirements have not been met.

Although Sheppard Mullin (SMRH) obtained an advance conflict waiver from J-M Manufacturing Co. (J-M) in connection with a significant litigation matter, it was disqualified from representation due to the fact that it was concurrently representing (and had represented in the past) South Tahoe Public Utility District (Utility District), who was the plaintiff in the J-M litigation matter and the open-ended advance conflict waiver was invalid.

After being disqualified, SMRH sued J-M for $1.3 million for services rendered before its removal. When J-M cross-complained for breach of fiduciary duty, etc. SMRH successfully moved to compel arbitration pursuant to the arbitration provision contained in the litigation engagement agreement. J-M opposed arbitration partly on the basis that the entire agreement containing the arbitration provision was illegal and void as a matter of public policy because SMRH's undisclosed and unwaived conflict of interest violated Rule 3-310(C)(3) of the Rules of Professional Conduct. The trial court granted SMRH's motion to compel, reasoning that the gravamen of J-M's "illegality" claim was fraudulent inducement – that J-M knew what it was signing, but was allegedly induced to such consent by fraudulent means. The trial court thus determined that this contract defense should be presented to and decided by the arbitrator.[26]

[26] The FAA provides that covered arbitration agreements shall be enforced except "upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. When parties commit to arbitrate contractual disputes, it is a mainstay of the FAA's substantive law that attacks on the validity of the contract, as distinct from attacks on the validity of the arbitration provision itself, are to be resolved "by the arbitrator in the first instance, not by a federal or state court." *Preston v. Ferrer*, 552 U.S. 346, 349 (2008); see also *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967). For these purposes, an arbitration provision is separated from the remainder of the contract – i.e., the separability doctrine unique to arbitration for purposes of determining subject matter jurisdiction as between the courts and the arbitrator. See also *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 445 (2006).

The matter proceeding to arbitration before a panel of three arbitrators, where the panel ruled in favor of SMRH on all claims and counter-claims and awarded SMRH $3.8 million in fees, including pre-judgment interest. When SMRH petition to confirm the award, J-M sought vacatur, arguing that the arbitrators had exceeded their powers by effectively enforcing a contract that was illegal and void. Over J-M's objection, the trial court confirmed the award and specifically held that Professional Rule 3-310 did not render the retainer agreement with the advance waiver provision illegal, void or unenforceable. It reasoned that whether an attorney should be entitled to attorney fees despite the existence of an ethical violation was at the heart of the equitable determination made by the arbitrators, and that the court could not disrupt the legal and factual findings of the arbitrators in this regard.

On appeal by J-M, the Second District reversed and remanded – not with instructions to the trial court to hear and determine J-M's illegality challenge to the enforceability of the retainer agreement and SMRH's entitlement to fees on some other ground (e.g., quantum meruit) - but with instructions to determine that SMRH "is not entitled to its fees for the work it did for J-M while there was an actual conflict with South Tahoe" per the appellate court's reasoning and analysis. The Second District further ordered the trial court to conduct proceedings to determine the amount of fees that SMRH "must reimburse to J-M" consistent with the appellate court's stated reasoning and analysis. In a lengthy and strongly worded opinion, the court basically ruled that SMRH's engagement agreement with J-M was illegal and thus unenforceable as a matter of law and public policy because of the firm's prior / concurrent representation of the South Tahoe Utility District. In this regard, the court found that it "strains credulity" for SMRH's to suggest that the "boilerplate waiver provision" contained in the retainer agreement constituted informed written consent of the firm's actual conflicts to J-M "when, in fact, [SMRH] was silent about any conflict."

With regard to its expanded review of the arbitration award confirmed by the trial court, the Second District held that the limited review standard recognized by the California Supreme Court in *Moncarsh v. Heily & Blasé,* 3 Cal. 4th 1 (1992) was not controlling because it addressed judicial review in the context of when a party has alleged that only a portion of an otherwise enforceable contract is illegal, rather than the contract as a whole. The appellate court then reached back to a 1949 case in which a trial court was reversed for confirming an arbitration award in favor of unlicensed contractors. *Loving & Evans v. Blick*, 33 Cal. 2d 603 (1949). In that case, the Supreme Court held that "the rules which give finality to the arbitrator's determination of ordinary questions of fact or of law are inapplicable where the issue of illegality of the entire transaction is raised in a proceeding for the enforcement of the arbitrator's award." Relying on its earlier decision *Lindenstadt v. Staff Builders, Inc.,* 55 Cal. App. 4th 882, 892, fn. 2 (1997), the Second District held that on appeal from an order confirming an arbitration award, it reviewed the trial court's order (not the arbitration award) under a de novo review standard and that such review is "the standard of review that governs a trial court's review of an arbitrator's decision where one of the parties claims that the entire contract or transaction underlying the award is

illegal."[27] The Second District further ordered the trial court to conduct proceedings to determine the amount of fees that SMRH "must reimburse to J-M" consistent with the appellate court's stated reasoning and analysis.

In April 2017, the California Supreme Court granted review in April 2017. The matter has been fully briefed and, as of April 2018, was awaiting scheduling for oral argument. Among the issues the Court will address is whether a court can rely on non-legislative expressions of public policy to overturn an arbitration award on illegality grounds.

(g) Manifest Disregard of the Law (Federal Only / Court Crafted Grounds)

No 2016 or 2017 cases – but a few recent notable cases:

Lagstein v. Certain Underwriters at Lloyd's, London, 607 F.3d 634 (9th Cir. 2010) – Lloyd's issued a disability policy to Dr. Lagstein. Lagstein developed heart disease and other ailments and filed a claim for disability benefits. After nearly two years without a decision on the claim, Lagstein sued Lloyd's in Nevada district court. At Lloyd's request, the matter was stayed pending binding arbitration pursuant to an arbitration provision in the policy. The arbitration was heard by a three-member panel, and the panel unanimously concluded that Lloyd's had breached the terms of the policy and acted unreasonably in denying Lagstein's claim. The panel awarded Lagstein full policy benefits of $900,000 and an additional $1,500,000 for emotional distress.

Lloyd's filed a motion in district court to vacate the arbitration award on several grounds, including manifest disregard for the law. The district court granted vacatur, finding that the amount of the award "shock[ed] the Court's conscience, suggested bias, was unsupported by the record, manifestly disregarded the law, and contravened public policy." Lagstein appealed, arguing that none of the district court's reasons justified vacatur. The Ninth Circuit agreed, reversed the district court's ruling and remanded the case for confirmation of the award. With regard to manifest disregard of the law, the Court noted that manifest disregard of the law requires "more than just an error in the law or a failure on the part of the arbitrators to understand or apply the law;" that it must be shown that the arbitrator(s) recognized the applicable law and then ignored it. The Court found that neither the district court nor Lloyd's had pointed to a single Nevada statute or decision that the panel had purportedly ignored. Thus, the Court concluded that there was no basis to conclude that the panel had manifestly disregarded the law in making the award in favor of Lagstein.

[27] *Note: This part of the decision is a bit confusing, since the opening part of the decision made it sound like the basis for reversal was that the court – not the arbitrator – should have decided the illegality / enforceability issue and, thus, the arbitrators exceeded their power by deciding the issue. Such a holding presumably would have resulted in remand back to the trial court to hear and decide the matter, but as discussed above, the Second District wanted to decide the illegality / enforceability issue.*

Matthews v. National Football League Management Council, 688 F.3d 1107 (9th Cir. 2012) – Former professional football player brought an action against the professional football league's management council and franchise for which he had played, seeking to vacate the arbitration award that prohibited him from pursuing workers' compensation benefits under California law, based on a forum-selection clause contained in his contract. Matthews argued that the award violated federal labor policy, which provides that an employee may not, through a collective bargaining agreement, bargain away state minimum labor standards. The trial court denied the player's motion and he appealed.

The Ninth Circuit affirmed the trial court's ruling, finding that it did not constitute manifest disregard for California law, nor did it otherwise violate the Full Faith and Credit Clause. For an arbitrator's award to be in manifest disregard of the law, it must be clear from the record that the arbitrator recognized the applicable law and then ignored it." The Court explained that it was not clear that Matthews' workers' compensation claim fell within the scope of California's workers' compensation scheme because had had not shown that an arbitration award preventing him from seeking California benefits deprived him of something to which he was entitled under state law. With regard to the Full Faith and Credit Clause argument, the Court held that California's interest was highly attenuated in this case and that on the facts alleged, it was not clear that the courts of California would consider California's interest sufficient to justify application of California law to Matthews' workers' compensation claim. Accordingly, the Court concluded that because Matthews did not show that the Full Faith and Credit Clause guarantees California's right to apply its law on the facts of his case, he could not establish that the arbitrator recognized yet chose to ignore well defined, explicit and clearly applicable law for purposes of seeking vacatur.

(h) Award is Arbitrary and Capricious (Federal Only / Court Crafted Grounds)

No 2016 or 2017 cases and no recent notable cases.

(i) Other – Standards of Judicial Review

- ***Kaiser Foundation Health Plan, Inc. v. Superior Court***, 13 Cal. App. 5th 1125 (2d Dist. Jul. 31, 2017) – Courts have no jurisdiction to review or confirm "partial" final awards that do not satisfy CCP § 1283.4.

Arbitration cases are fact specific, and this one is no exception!

This was a healthcare payor / provider dispute between Prime Healthcare La Palma LLC and its affiliated hospitals, on the one hand, and Kaiser Foundation Health Plan, Inc., on the other. After a "convoluted multi-year path" through the court system, the parties agreed to submit the matter to arbitration. Once in arbitration, Kaiser moved to dismiss some – but not all – of Prime's claims on the grounds of preemption and failure to exhaust

administrative remedies under the Medicare Act. The arbitration panel denied Kaiser's motion and memorialized its ruling in what it labeled a "Partial Final Award re Medicare Advantage Claims." The award did not otherwise resolve the merits the Medicare Advantage claims, Prime's other claims or Kaiser's cross-claims. The trial court confirmed the award and Kaiser appealed.

The Second District Court of Appeal held that because the partial final award did not determine all of the questions submitted to the arbitration panel, it was not an award under Code of Civil Procedure § 1283.4, and thus deprived the trial court of jurisdiction to confirm it. "If the 'award' does not qualify as an award under Section 1283.4, then the court is deprived of jurisdiction to confirm or vacate it." 13 Cal. App. 5th at 1143. Referring to its earlier decision in *Judge v. Nijjar Realty, Inc.*, 232 Cal. App. 4th 619 (2014), the court reiterated that, to qualify as an arbitration award within the meaning of Section 1283.4, it must include a determination of all of the questions submitted to the arbitrators so as to determine the controversy. That an arbitrator might title his or her ruling as an "award" does not necessarily make it one under Section 1283.4. Likewise, an award's qualification as an award under the rules of an arbitration provider also does not control the Section 1283.4 inquiry.

The appellate court acknowledged that it had previously recognized that Section 1283.4 does not bar judicial review (i.e., confirmation or vacatur) of all interim awards in *Hightower v. Superior Court*, 86 Cal. App. 4th 1415 (2001). In *Hightower*, the Second District held that neither Section 1283.4 nor case law foreclosed "the utilization of a multiple incremental or successive award process as a means, *in an appropriate case*, of finally deciding *all* submitted issues. 86 Cal. App. 4th at 1434. However, in the *Kaiser* case, the court held that the "specific factual context" on which it had based its Section 1283.4 ruling in *Hightower* was "quite different from the factual context here." 13 Cal. App. 5th at 1147.

Hightower arose out of a shareholder dispute between two individuals concerning their respective rights and obligations under the "buy-sell provision" contained in their shareholder agreement. The partial final award issued in *Hightower* was held to satisfy the Section 1283.4 requirements because it did not leave undecided any issues necessary to determine the controversy submitted concerning Hightower's breach of the buy-sell agreement. All that remained to be resolved were potential and conditional issues that might flow from the decision having been made concerning the breach. Under these unique and particular circumstances, the court noted that it had concluded that the arbitrator's use of an "incremental process" and the reservation of jurisdiction to make a final award did not offend Section 1283.4. 13 Cal. App. 5th at 1148-1149.

> "The arbitrator in *Hightower* resolved all the issues necessary as of the date of the award to determine the parties' controversy regarding the breach of the shareholder agreement and the appropriate remedy for the breach. The issues left open for resolution in a subsequent award simply could not have been decided as part of the partial final award because their nature and scope were uncertain as of the award date. Those issues would take shape

> based on contingent events that might, or might not, occur during and after the option period. By contrast here, the issues left open by the partial final award were not potential and conditional ones that would spring into existence based on events that had yet to transpire. Those issues were known and capable of being resolved simultaneously with the Medicare Act preemption and exhaustion issues. The parties simply chose to present the remaining issues to the panel at a later time. This is a far cry from what happened in *Hightower*."

Id. at 1149.

Comment: So where does that leave us with regard to interim and partial awards? It is perfectly fine to "sequence" proceedings during the course of an arbitration and to have orders / awards issue that close the issues related to those proceedings. In fact, most arbitral rules expressly authorize arbitrators to issue interim, interlocutory and partial final awards. See, e.g., AAA Rule R-47(b); JAMS Rule 24(d). Whether such orders or awards are eligible for judicial review by the trial court through a petition for confirmation or vacatur is a separate matter and really goes to the substance of the award. As the Kaiser decision demonstrates, the award at issue was procedural and did not decide any of the substantive claims the parties had asserted in the arbitration. On the other hand, the Hightower decision was one where the merits of the breach of contract claim submitted to arbitration was decided in favor of one and against the other party. While there were possible issues that would flow from that determination and require further hearing, this award was eligible for judicial review via a petition for confirmation (or vacatur) of the award.

- ***Harshad & Nasir Corp. v. Global Sign Systems, Inc.***, 14 Cal. App. 5th 523 (2d Dist. Aug. 15, 2017) – Language in the parties' arbitration agreement dictates the standard of review when one party seeks vacatur of the award.

This matter started as a court proceeding in which Global Sign Systems (Global), a company that repaired commercial signs, sued Friendly Franchisees Corporation (FFC) to recover approximately $100,000 owed on unpaid invoices for services performed. After completing discovery in the state court action and less than one month before trial was to begin, the parties entered into an agreement to submit the dispute to binding arbitration. That agreement stated that the dispute being submitted to arbitration "involves the amount of money FFC owed to Global for services performed." The agreement also provided for expanded judicial review provided as follows:

> "Arbitrator shall apply California law as though he were obligated by applicable statutes and precedents and case law …. The [a]rbitrator shall prepare a written decision that shall be supported by written findings of facts and conclusions which adequately set forth the basis of the decision and which cites the statutes and precedents applied and relied upon in reaching his decision…. Any party may object to the confirmation of the decision and award on the basis that the statement of facts and the conclusions of law do

> not support the decision and award, and/or that the law was incorrectly determined or applied…. The parties agree that the decision of the arbitrator and the findings of facts and conclusions of law shall be reviewed on appeal to the trial court and thereafter to the appellate courts upon the same grounds and standards of review as if said decision and supporting findings of fact and conclusions of law were entered by a court with subject matter and present jurisdiction."

Given the above provision in the parties' arbitration agreement, the arbitrator was "on notice" that he needed to stay within the bounds of the parties' agreement or expose his ruling(s) to vacatur. It is thus somewhat surprising that the arbitrator conducted the arbitration in the way that he did because he expanded the scope of what went to hearing exponentially, flip flopped on various interim rulings, orchestrated a situation where it took five years to get to the final award and required extensive post-hearing discovery and briefing – a botched proceeding that only got worse with time and further brief and most certainly invited a vacatur petition by whichever side lost!

Keeping in mind that the parties had completed discovery in the state court action and were set to start trial when they agreed to submit the dispute to binding arbitration, it is somewhat notable that the matter did not make it to evidentiary hearing for another 2 years. When the matter finally proceeded to arbitration, Global took the position that its claim also encompassed an alleged agreement by FFC and its affiliates for FFC to perform future work – described as "reimaging work" on 66 stores. Global's "amended" claim was that FFC and its affiliates breached that "future work" agreement by hiring a different sign company to perform the work. In connection with this "amended" claim, Global made an oral motion to have the FFC affiliates added as parties to the arbitration, which the arbitrator granted even though the affiliates were not parties to the submission agreement. This ruling was later set aside by the arbitrator pursuant to a stipulation of the parties' counsel.

After the hearing, the arbitrator awarded the plaintiff approximately $25,000 in damages on the outstanding invoices claim. With regard to the amended claim for the "reimaging work," the arbitrator awarded plaintiff approximately $1.1 million in "lost profits" on the reimaging program, approximately $700,000 in pre-award interest and approximately $1.2 million in attorney's fees and costs. The arbitrator also ruled that the FFC affiliates were jointed and joint and several obligors under the award.

FFC and its affiliates moved to vacate the award on the grounds that the arbitrator had exceeded the scope of the arbitration by going outside the submission agreement and awarding lost profits on the "reimaging work" claim and not just amounts due on the past due invoices. FFC also sought vacatur on the grounds that there was no evidence of any agreement for future services related to the alleged "reimaging program." The trial court confirmed the award over FFC's objection on the grounds that it did not have the power to review an arbitration award for errors of law of sufficiency of evidence to support the award. While the trial court recognized that expanded judicial review is available under the CAA pursuant to the California Supreme Court's decision in *Cable Connection, Inc. v.*

DIRECTV, Inc., 44 Cal. 4th 1134, 1360 (2008), it held that the language in the parties' arbitration agreement (quoted above) did not explicitly and unambiguously provide for such expanded judicial review.

On appeal to the Second District Court of Appeal, the court reversed, noting that *Cable Connection* does not require parties to use any particular words but, instead, requires only that the parties "make plain their intention that the award is reviewable for legal error." Here, the Court of Appeal held that the parties clearly expressed an intention to allow for review of errors of law by specifying the standard of review for the arbitration award shall be the same as the standard for review in an ordinary appeal, which would include de novo review of legal conclusions, and substantial evidence review of factual determinations. The court then reviewed the arbitration award based on the proper standard of review and concluded that the award must be vacated because the arbitrator exceeded his authority – as framed by the parties' submission agreement - and the existence of the alleged "reimaging program" contract was not supported by substantial evidence.

Comment: Given the breadth of vacatur review provided by the clause that governed the parties' post-dispute submission of their dispute to binding arbitration, it is really quite remarkable that the arbitrator took the license that he did in his management of the proceedings – both in terms of amount of time he took to decide the matter (5 years), the decisions he made relative to allowing a limited set of claims on past due invoices to be transformed into a multi-million dispute during the course of the evidentiary hearing, thus resulting in what the court called "claim by ambush," and the post-evidentiary hearing made to add the non-signatory Affiliates to the award without having given them an opportunity to appear and present a defense. It really is not too surprising that the Court of Appeal found a way to vacate the award, but it is surprising that the arbitrator conducted the proceedings in this manner and epitomizes the expression – What was he thinking?

8. Miscellaneous

(a) ***CVS Health Corp. v. Vividus, LLC***, 878 F.3d 703 (9th Cir. Dec. 21, 2017) – Ninth Circuit joins the Second and Third Circuits in ruling that Section 7 of the FAA does not authorize arbitrators to summon non-parties for pre-hearing discovery.

Introductory Statement

Civil litigators often take for granted the ease with which they can obtain pre-trial discovery from non-parties in both state and federal courts, and frequently assume that the "presumption in favor of arbitrability" embodied in the Federal Arbitration Act (FAA) includes a statutory grant of subpoena power to arbitrators that matches what is available in federal court. That is not so. In fact, the power to summon non-parties in arbitration – both for discovery and evidentiary hearing – is much more limited, to the extent it exists at all. Additionally, the power to summon non-parties raises other questions, including the following:

- What arbitration statute or statutes apply (FAA and/or state law) for purposes of governing the arbitration proceeding or judicial involvement in the arbitration, and what does that law permit?
- May a non-party be summoned for discovery as well as for an evidentiary hearing?
- Who may summon the witness: party counsel, and administering institution and/or the arbitrator?
- Does the summoning power extend to a non-party residing outside the state or federal district in which the arbitration is held?
- Where and how must the testimony of a distant non-party witness be received: must the non-party witness testify or produce documents in the presence of the arbitrators or can such a witness provide evidence via telephone, video conferencing, computer-assisted conferencing technology or written responses to written questions?
- Does the arbitrator's summoning power include the power to order the testimonial deposition of an unavailable non-party witness?
- What court enforces the summons in the event of non-compliance?
- To whom may the witness raise objections to the subpoena – the arbitrator or the court?

A very good discussion of the above issues is contained in Chapter 9 of THE COLLEGE OF COMMERCIAL ARBITRATORS GUIDE TO BEST PRACTICES IN COMMERCIAL ARBITRATION (4th ed. 2017).

9 U.S.C. § 7

Section 7 of the FAA grants arbitrators authority to "summon in writing any person to attend before them or any of them as a witness and in a proper case to bring with him or them any book, record, document, or paper which may be deemed material as evidence in the case," and such subpoena is then to be served "in the same manner as subpoenas to appear and testify before the court." 9 U.S.C. § 7. Accordingly, the procedural aspects of an arbitral subpoena under the FAA are governed by Rule 45 of the Federal Rules of Civil Procedure, which imposes a geographical limit on an arbitrator's power to compel a non-party witness to appear: namely, 100 miles of where the witness resides, is employed, or regularly transacts business in person.

Whether an arbitrator can compel a non-party witness to testify and/or produce documents other than at an arbitral hearing is dependent on the law of the federal jurisdiction where the arbitral seal is located. On this topic, as it true with many procedural matters concerning arbitration, there is a split in the federal circuits.

Both the Sixth and Eighth Circuits have interpreted Section 7 liberally to allow arbitrators to summon non-parties for pre-hearing discovery. See, *Am. Fed'n of Television & Radio Artists, AFL-CIO v. WJBK-TV*, 164 F.3d 1004, 1009 (6th Cir. 1999) ("… the FAA's provision authorizing an arbitrator to compel the production of documents from third parties for purposes of an arbitration hearing has been held to implicitly include the authority to compel the production of documents for inspection by a party prior to a hearing."); *Sec. Life Ins. Co. of Am. v. Duncanson & Holt*, 228 F.3d 865 (8th Cir. 2000) ("[I]mplicit in an arbitration panel's power to subpoena relevant documents for production at a hearing is the power to order the production of relevant documents for review by a party prior to the hearing."). At least one federal district court outside the Sixth and Eighth Circuits has agreed with this view. See, *Festus & Helen Stacy Found., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 432 F.Supp. 2d 1375, 1379-1380 (N.D.Ga. 2006).

Prior to the Ninth Circuit's decision in *Vividus,* the Second and Third Circuits had adopted a narrow interpretation of Section 7 and held that an arbitration subpoena cannot compel a third-party to produce pre-hearing discovery; that the language of Section 7 plainly and unambiguously restricts an arbitrator's subpoena power to compelling the non-party witness to appear in the physical presence of the arbitrator(s) and to hand over documents at that time. See, *Life Receivables Trust Syndicate 102 at Lloyd's of London*, 549 F.3d 210, 215-216 (2d Cir. 2008) (arbitrators can order production of documents by a non-party witness only in connection with the witness' appearance at a hearing, including preliminary non-merits hearings, the emphasis being on the witness' appearance and production being in the physical presence of the arbitrator(s)); *Hay Group, Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404, 406-407 (3d Cir. 2004) ("… Section 7's language unambiguously restricts an arbitrator's subpoena power to situation in which the non-party has been called to appear in the physical presence of the arbitrator and to hand over the documents at that time."). Several district courts in other federal jurisdictions have

endorsed this relatively restrictive interpretation. See, e.g., *Chi. Bridge & Iron Co. N.V. v TRC Acquisition, LLC*, Civil Action No. 14-1192, 2014 WL 3796395 (E.D.La. 2014); *Alliance Healthcare Servs. v. Argonaut Private Equity, LLC*, 804 F.Supp. 2d 808, 810-811 (ND.Ill. 2011); *Kennedy v. Am. Express Travel Related Servs. Co.*, 646 F.Supp. 2d 1342, 1344 (S.D. Fla. 2009).

Finally, the Fourth Circuit has adopted a hybrid approach, allowing non-party document discovery where the party seeking such discovery establishes a "special need or hardship." See, *COMSAT Corp. v. Nat'l Sci. Found.*, 190 F.3d 269, 276 (4th Cir. 1999).

The Holding in CVS Health Corp. v. Vividus, LLC

This case arose out of a September 2014 antitrust case filed in New York state court by Vividus and other related entities against, among others, Express Scripts and CVS/Caremark Corp. Soon after filing, the case was removed to the U.S. District Court for the Eastern District of New York, which ordered the Vividus entities to arbitrate their dispute with CVS/Caremark in Arizona pursuant to a preexisting arbitration agreement, and to litigate its dispute with Express Scripts before the U.S. District Court for the Eastern District of Missouri, pursuant to a forum selection clause in a preexisting agreement between the parties. The Missouri court, in the course of discovery, ordered Express Scripts to produce certain specified documents. Having been informed of Express Scripts' production in the Missouri litigation, the arbitration panel in the CVS/Caremark dispute issued its own subpoena instructing Express Scripts to produce the documents it had produced in the Missouri litigation, so that they could be used in the Arizona arbitration. Express Scripts, which was not a party to the Arizona arbitration, did not produce documents in accordance with the subpoena. The Vividus parties filed a petition pursuant to § 7 of the FAA asking the U.S. District Court for the District of Arizona to enforce the panel's subpoena and compel production by Express Scripts. The district court denied HMC's petition, holding that the text of the FAA only allows an arbitrator to "summon testimony and documents from a non-party during a hearing." The Vividus parties appealed.

The Ninth Circuit agreed with the district court, holding that "section 7 of the FAA does not grant arbitrators the power to order third parties to produce documents prior to an arbitration hearing." The Ninth Circuit noted that Section 7 grants arbitrators two discrete powers, namely, to "compel the attendance of a person 'to attend before them . . . as a witness,' and second, arbitrators may compel such person 'to bring with him or them' relevant documents." In the event a person instructed to appear before an arbitrator does not heed the arbitrator's order, the FAA empowers district courts in the district where the arbitration is seated to compel the person's attendance before the arbitrator or arbitral panel. The Ninth Circuit affirmed the district court's decision that a plain reading of Section 7 "reveals that an arbitrator's power to compel the production of documents is limited to production at an arbitration hearing." The Ninth Circuit further asserted that "[t]he text of section 7 grants an arbitrator no freestanding power to order third parties to produce documents other than in the context of a hearing."

Notably, the Eighth Circuit has reached the opposite conclusion, finding that "implicit in an arbitration panel's power to subpoena relevant documents for production at a hearing is the power to order the production of relevant documents for review by a party prior to the hearing." To reach this conclusion, the Eighth Circuit relied on the notion that this implicit power furthers the goal of facilitating the efficient resolution of disputes.

Post Script

The Ninth Circuit's decision in the *Vividus* case only scratches the surface of the many undecided issues that exist with regard to an arbitration tribunal's power to summon third-party witnesses, as set forth above. This is a developing area of the law in which there will most likely be future developments. Unfortunately, the Supreme Court and most of the Circuits have yet to rule on this issue. Notwithstanding, the Courts of Appeals that have addressed this question have done so in clear and unambiguous terms, thereby eliminating, or at least greatly reducing, the uncertainty surrounding any future decision on this question of law. Under the majority view, a party to an arbitration will not be able to compel a non-party to produce documents in advance of a hearing, depriving parties of the ability to review those documents before deciding whether to use them. This makes the decision to seek a document subpoena in arbitration one that must be approached with care, and that will reinforce the conventional view that discovery in arbitration should and will be narrower than it is in litigation.

(b) ***Heimlich v. Shivji***, 12 Cal. App. 5th 152 (6th Dist. May 31, 2017), cert granted, 400 P.3d 442 (Aug. 23, 2017) – When a party to an arbitration proceeding makes an offer of compromise pursuant to Code of Civil Procedure section 998 and obtains a result in the arbitration more favorable to it than that offer, how, when, and from whom does that party request costs as provided under section 998?

This is a very interesting case because the court attempted to harmonize – procedurally – the arbitration doctrine of functus oficio with the procedural requirements of CCP § 998(b)(2) and the powers vested in an arbitrator under Rules R-8 and R-47(d)(ii) of the AAA Commercial Rules (the provider rules at issue in the case). However, it has no precedential value because the California Supreme Court has accepted cert to decide the issue of "[w]hen a party to an arbitration proceeding makes an offer of compromise pursuant to CCP § 998 and obtains a result in the arbitration more favorable to it than that offer, how, when and from whom does that party request costs?"

In *Heimlich*, attorney Alan Heimlich (Attorney) sued his client Shiraz Shivji (Client) for unpaid invoices despite a provision in the retainer agreement providing for arbitration. After filing an answer, Client made an offer of settlement under CCP § 998. Later, when the time had passed for Attorney to accept the offer, Client moved to compel arbitration and that request was granted. The arbitration resulted in zero recovery for either side pursuant to an award issued by the arbitrator. Six days after the award was issued, Client asked the arbitrator to award him costs under CCP § 998 because Attorney's non-recovery was less

favorable than the 998 offer Client had made two months before demanding arbitration. Having issued a "final award," the arbitrator determined that he lacked jurisdiction to act on Client's request for a cost award. Client then petitioned the court to confirm the award and grant his request for costs under CCP § 998. The trial court confirmed the arbitration award, but denied costs on the grounds that Client had failed to timely submit a 998 claim to the arbitrator, finding that Client should have presented his 998 request for costs to the arbitrator before the award was rendered. Client appealed.

On appeal, the Sixth District Court of Appeal reversed the trial court and ordered that the trial court partially vacate the award and order the matter back to the arbitrator for a hearing and determination of Client's 998 request. The court held that under the express provisions of CCP § 998(b)(2), the parties in an arbitration can say nothing about the existence of a 998 offer until *after* the award is rendered. CCP § 998(b)(2) provides as follows:

> "If the offer is not accepted prior to trial or arbitration or within 30 days after it is made, whichever occurs first, it shall be deemed withdrawn, and *cannot be given in evidence upon the trial or arbitration.*" (Emphasis added.)

According to the court in *Heimlich*, under the terms of the statute, an arbitrator cannot compare the favorability of an arbitration award to a rejected statutory offer until after the award has been made. The court rejected the argument that it is incumbent on a party to ask the arbitrator to make an interim award (versus a final award) without explaining the reasons why. It also rejected the argument that arbitrators should be burdened with the obligation in every case of making inquiry into whether a 998 offer has been made and rejected because that would require the parties to violate CCP § 998(b)(2) (quoted above) by prematurely disclosing the existence of a rejected statutory offer. The court concluded that "[t]he best practice … would be to present evidence of a rejected section 998 offer after an arbitration award resolves the underlying dispute." 12 Cal. App. 5th at 169. In this regard, the court noted that the AAA rules (which were the provider rules in question) authorize an arbitrator to "assess and apportion the fees, expenses, and compensation" related to an award. While the AAA Rules have no specific provision for awarding costs authorized by CCP § 998, the court stated that "arbitral authority to award costs is presumably subsumed in the authority to award expenses," citing AAA Rule R-47. Id. at 173. Given, the broad discretion vested in arbitrators under the AAA Rule R-8 to "interpret and apply these rules insofar as they relate to the arbitrator's powers and duties," the court reasoned that if and when a party makes a section 998 post-award request, "an AAA arbitrator is empowered to recharacterize the existing award as interim, interlocutory, or partial and proceed to resolve the section 998 request by a subsequent award." Id. at 173-174.

One commentator has noted that being aware of the *Heimlich* decision and its broad interpretation of CCP § 998(b)(2) as applied in an arbitral setting may be a "big deal" going forward because it seems to be at odds with (a) the Second District's decision in *Maaso v. Singer*, 203 Cal. App. 4th 362 (2012), where the court noted without comment that counsel

had raised the 998 issue in general terms *prior* to an award being made (but then failed to obtain a ruling in time thereafter), and (b) two unpublished decisions, one by the First District and one by the Fourth District, that have interpreted CCP § 998(b)(2) narrowly and so as to permit a party to alert the arbitrator to a 998 offer *prior* to an award being made. See, *Barany v. Andron*, 2012 WL 1187934 at *4 (1st Dist. 2012); *Wells Fargo Advisors, LLC v. Fernandez*, 2013 WL 527381 at *4 (4th Dist. 2013).[28]

As noted in the caption above, the California Supreme Court has accepted cert to decide the issue of "[w]hen a party to an arbitration proceeding makes an offer of compromise pursuant to CCP § 998 and obtains a result in the arbitration more favorable to it than that offer, how, when and from whom does that party request costs?" In all likelihood, we will not hear from the Supreme Court on these issues until sometime in 2019.

Comment: Before an award is formally rendered and served on the parties, the final draft is typically provided to the case manager for proofing and "administrative review." My suggestion is a party who has made a 998 offer alert the case manager about the 998 offer and the potential need for further proceedings once the award has been issued. While the record will have been closed on the submitted issues, the issue of 998 costs is something that arises post-hearing and is a product of the award. Once the case manager receives the arbitrator's draft award, he or she can alert the arbitrator of the need for further proceedings and provide the arbitrator with the opportunity to change the title of the award and any "finality" wording. Of course, this all assumes that the California Supreme Court decides that cost awards under 998 are for the arbitrator, and not the court, to decide. Stay tuned!

(c) ***Sanchez v. Elizondo***, 878 F.3d 1216 (9th Cir. Jan. 5, 2018) – The Ninth Circuit decides an issue of first impression with regard to whether an order that vacates an award *and* remands the case for a new arbitration is a "final decision" for purposes of appeal or do the parties have to wait until the second arbitration is completed and an award issued in those proceedings?

Customer (Elizondo) sued his securities broker (Sanchez) for the alleged mismanagement of his investment portfolio. The dispute was submitted to FINRA arbitration where the rules provide that claims for $100,000 or less will be decided by a single arbitrator. In his demand, Elizondo claimed compensatory damages of $100,000, so his case was assigned to a single arbitrator. Shortly before the evidentiary hearing, Elizondo filed a pre-hearing brief in which he claimed to be entitled to damages in the amount of $125,000. Elizondo did not amend his demand, and the arbitrator proceeded to hear the matter as a sole arbitrator over Sanchez's objection. The arbitrator then issued an award in favor of Elizondo in the amount of $75,000. Sanchez petitioned for vacatur on the grounds that the arbitrator had exceeded his powers when he proceeded as a single arbitrator over Sanchez's objection. The district court granted vacatur and remanded the case for further arbitration consistent

[28] Gary A. Watt, "998 Offers & Arbitration," https://www.appellateinsight.com/2017/06/16/998-offers-arbitration.

with its order. Elizondo then appealed. The two issues raised on appeal were whether the district court's order was appealable under Section 16 of the FAA because it was not a "final decision with respect to an arbitration," and whether the arbitrator had exceeded his authority in proceeding as a single arbitrator.

With regard to the appellate jurisdiction issue, the court noted that while other circuits have addressed this jurisdictional question and determined that appellate courts are not deprived of the jurisdiction conferred by Section 16(a) of the FAA when a vacatur order also remands for a new arbitration, it was an issue of first impression for the Ninth Circuit. The Fifth Circuit was the first to decide the issue in *Forsythe Int'l, S.A. v. Gibbs Oil Co. of Texas*, 915 F.2d 1017 (5th Cir. 1990). In that case, the district court vacated an arbitration panel's decision and remanded the case to be heard by a new panel. The Fifth Circuit reasoned that because the district court's decision "nullified the decision of an arbitration panel," it was reviewable on appeal. Id. at 1020. The Ninth Circuit noted that the First, Second, Third and Seventh Circuits have since adopted the reasoning and conclusion of the Fifth Circuit, and stated that it was persuaded by the reasoning of these other circuits in deciding that Section 16 of the FAA permits appellate review of vacatur orders that also remand for a new arbitration. The court found that although the text of Section 16 says nothing with regard to remand orders, but expressly prohibits an appeal of orders granting a stay pending arbitration, directing an arbitration to proceed, compelling arbitration or refusing to enjoin an arbitration, the difference was clear: "§ 16 permit the appeal of orders that *terminate* an existing arbitration, while prohibit the appeal of orders that *continue* an existing arbitration. Because a vacatur that remands for a new arbitration terminates the initial arbitration as conclusively as a vacatur that does not remand, it falls into the former category and is appealable." 878 F.3d at 1219-1220. Applying that reasoning to this case, the court found that because the vacatur was premised on the arbitrator's purported error in allowing the hearing to proceed before a single arbitrator over Sanchez's objection, it was effectively a remand for a new arbitration before a panel of three arbitrators. Accordingly, the court concluded that it had jurisdiction over the appeal.

(d) ***Kum Tat Ltd. v. Linden Ox Pasture LLC***, 845 F.3d 979 (9th Cir. Jan. 13, 2017) – Appeal of district court's order denying motion to compel arbitration was dismissed for lack of appellate jurisdiction. Appeal under Section 16(a) of the FAA is not available where the motion to compel is based on state arbitration law and not Section 4 of the FAA.

Kum Tat sued Linden Ox in California state court claiming breach of an alleged agreement for the sale of a $40 million residential property. Asserting diversity, Linden Ox removed the suit to federal district court. Kum Tat then moved to compel arbitration and stay the court action. It made that motion under CCP §§ 1281.2 and 1281.4 of the California Arbitration, and argued that "California law governs this motion" and that "under California law, this dispute must be arbitrated."[29] The district court denied the motion on its merits,

[29] Since the alleged agreement in which the arbitration clause was contained concerned the purchase and sale of real property located in California, the matter was entirely intrastate and most likely was not one that

finding that the parties had not entered into a binding arbitration agreement or any agreement at all.

Kum Tat took an appeal and in his opening brief cited Section 16(a)(1) of the FAA (9 U.S.C. § 16(a)(1)) as the source of appellate jurisdiction. Section 16(a)(1)(B) provides that an appeal may be taken from an order denying a petition under Section 4 of the FAA seeking an order to compel arbitration. The Ninth Circuit dismissed the appeal for lack of jurisdiction. It held that FAA appellate jurisdiction extends to orders under Sections 3 and 4 of the FAA denying a motion to compel arbitration and stay the litigation. The Court reasoned that Kum Tat's motion to compel arbitration and stay litigation was not brought under the FAA. Thus the order denying the motion was not an order from which Section 16(a)(1) permitted an appeal.

The Ninth Circuit also rejected Kum Tat's effort to fall within the scope of Section 16 of the FAA by arguing that, while it chose to seek arbitration under state law, it's arbitration contract fell within the scope of the FAA and thus it would have been entitled to arbitration under the FAA had it so claimed. The court held that Kum Tat "cannot now morph a motion brought under state law into one brought under the FAA."

Bottom Line: This is a very technical area. Words matter and you really need to think – at the time of contracting *and* at the time of initiating a dispute – what court are you going to look to for relief and support in connection with an arbitration and what law governs the procedural aspects of the arbitration? By virtue of the United States Supreme Court's decision in *Volt Information Sciences v. Board of Trustees of Leland Stanford Jr. University*, 489 U.S. 468 (1989), we know that the FAA has both substantive law and procedural law aspects. As to the latter, the Court has said that "[t]here is 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." Id. at 476. Accordingly, even where an arbitration agreement is not governed by the FAA for substantive law / enforcement purposes, it would appear that they can nevertheless agree that the procedural aspects of the FAA will govern the arbitration.

touched interstate commerce. Based on that fact circumstance, the alleged arbitration agreement most likely was not covered by the FAA, but would look to state arbitration law (in this case California) for enforcement.

(e) ***Sargon Enterprises, Inc. v. Brown George & Ross, LLP***, 15 Cal. App. 5th 749 (2d Dist. Sep. 26, 2017) - It is not a breach of contract for a party to an arbitration agreement to initiate a lawsuit (versus an arbitration). The FAA anticipates that a party to an arbitration agreement may file a lawsuit in court, and it describes the procedural vehicle through which the opposing party may respond – by answer or by a petition to compel.

This case involves the notorious dispute between Sargon and USC concerning a contract the two entered into for a 5-year clinical study of Sargon's patented dental implant. Three years into the contract, Sargon sued USC for breach of contract. Sargon won and was awarded $433,000 in compensatory damages, but no lost profits because the trial court had ordered Sargon's lost profits evidence excluded. Sargon appealed and the Court of Appeal reversed, holding that the trial court erred in excluding Sargon's lost profits evidence.

Sargon retried its case against USC. After an 8-day evidentiary hearing, USC successfully moved to exclude the testimony of one of Sargon's experts as speculative. The parties the stipulated for entry of judgment for Sargon in the amount of $433,00.

After entry of the stipulated judgment, USC filed an interpleader action against Sargon and others to resolve the attorney's fees issues. Sargon prevailed in that matter and was awarded $1.8 million. Sargon appealed from the judgment entered after the second trial, contesting the trial court's ruling excluding his expert's testimony regarding lost profits. The Court of Appeal again reversed and held that Sargon's expert testimony should have been admitted. It remanded for a new trial on lost profits, but affirmed the trial court's $1.8 million attorney fee award to Sargon.

After the second appeal, Sargon sued his attorneys – Brown George & Ross LLP – for malpractice, alleging that the firm had advised it to enter into the stipulated judgment with USC before appealing the order excluding testimony of Sargon's lost profits experts. When that order ultimately was affirmed, Sargon allegedly was not permitted to offer alternative evidence of lost profits because the firm had failed to preserve the issue.

Based on an arbitration clause included in its retainer agreement, the law firm responded by filing a petition for arbitration. It also asserted a claim for damages for the client's alleged breach of the arbitration clause because it had filed a lawsuit instead of asserting its claims in an arbitration proceeding. It also complained that Sargon had breached the agreement by opposing the firm's petition to compel arbitration.

The entire matter was ordered to arbitration and the arbitrator ruled in favor of the law firm and awarded breach of contract damages related to the litigation expenses incurred in the court proceedings. The arbitrator ruled against Sargon with regard to the legal malpractice claim. Sargon sought vacatur of the award on the grounds that the award violated its statutory right to initiate litigation in court. The trial court denied the Sargon's vacatur objection and confirmed the award. Sargon appealed.

On appeal, the Second District Court of appeal reversed, and held that Sargon had not breached the arbitration provision contained in the retainer agreement by first going to court to assert its malpractice claims against the law firm, nor did it breach the agreement by opposing the firm's petition to compel arbitration. The court noted that the CAA anticipates that a party to an arbitration agreement may file a lawsuit in court and then provides a procedural vehicle through which the opposing party may respond – either answer the complaint or file a motion to compel. If the opposing party brings a motion to compel, such a proceeding is a suit in equity where the remedy is specific performance, not a damages award for breach of contract.

On the question of whether the entire award or only the award on the breach of contract should be vacated, the Court of Appeal chose the latter path. Where a part of an arbitration award cannot be confirmed due to the arbitrator's error of law, the award may be corrected by striking the erroneous part if doing so does not affect the merits of the part that remains. The Court held that the firm's breach of contract claim against Sargon and Sargon's legal malpractice claim against the firm were based on separate and distinct facts and legal theories. Therefore, the portion of the arbitration award adjudicating the firm's breach of contract claim and ordering Sargon to pay damages to the firm could be stricken without affecting the merits of the arbitrator's summary disposition (denial) of Sargon's malpractice claim. (*Note: Sargon did not seek vacatur of the arbitrator's ruling on the legal malpractice claim.)*

(f) ***Hopper v. American Arbitration Association***, 708 Fed. Appx. 373 (9th Cir. Dec. 26, 2017) - In an unreported memorandum opinion, the 9th Circuit held that a complaint alleging false advertising on the part of the provider (AAA) withstood a 12(b)(6) motion to dismiss because the conduct complained of was distinct from arbitrator decision making, and thus not entitled to arbitral immunity.

In a brief memorandum opinion, the Court held that a complaint alleging false advertising on the part of the AAA in promising to provide "neutrals" for the cases it administered withstood a 12(b)(6) motion to dismiss because the conduct complained of was distinct from arbitration decision making, and thus not entitled to arbitral immunity.

(g) **Notable Case - *Bucur v. Ahmad***, 244 Cal. App. 4th 175 (4th Dist. 2016) – For purposes of *res judicata*, an unconfirmed arbitration award is equivalent to a final judgment.

In this case, the Court of Appeal affirmed the trial court's orders dismissing an action and imposing sanctions under Code of Civil Procedure section 128.7. The sanctions were awarded after the plaintiffs filed a fifth lawsuit arising from the same hauling contract with FedEx and asserting virtually the same claims as the prior actions. The Court of Appeal held that the dismissal and sanctions were justified because an unconfirmed arbitration award had been granted against the plaintiffs in one of the prior actions – referred to arbitration by the parties' stipulation. The Court of Appeal held that, for purposes of res judicata, even an unconfirmed arbitration award is equivalent to a final judgment. 244 Cal. App. 4th at

189, citing *Thibodeau v. Crum*, 4 Cal. App. 4th 749, 759 (1992), and *Trollope v. Jeffries*, 55 Cal. App. 3d 816, 822 (1976). In this regard, the Court reasoned that the arbitrator's dismissal order in the earlier matter based on the same transactional nucleus of facts asserted in the present case operated as res judicata to bar the current case and provided additional support for the trial court's grant of judgment on the pleadings.

(h) Notable Case - *Condon v. Daland,* 6 Cal. App. 5th 263 (1st Dist. 2016)
- Re-do provision in arbitration agreement was enforced.

The parties' arbitration agreement contained a provision that permitted a *de novo* arbitration before a three-arbitrator panel if a single arbitrator renders an award of $-0- or over $100,000. In the first, single-arbitrator arbitration, the arbitrator awarded claimant $180,000, and respondent asked the arbitral body (ADR Services) to constitute a three-arbitrator / *de novo* panel. The provider refused respondent's request on the grounds that it did not have "appellate rules." Claimant then petitioned the state court to confirm the award. In response, respondent filed a petition for vacatur, as well as a request that the court order a second arbitration pursuant to the contract's terms. The trial court confirmed the award and denied the request for a second arbitration. Respondent appealed.

The Court of Appeal reversed the trial court, finding that the parties had agreed to a *de novo* arbitration (not an arbitration appeal proceeding) if the results of the first arbitration fell outside an agreed upon range. The award from the first arbitration did in fact fall outside the agreed upon range. The fact that ADR Services had no appellate rules for arbitration had no bearing on the issue. The judgment confirming the arbitration award from the first arbitration and denying a new arbitration were reversed, and the trial court was ordered to dismiss the petition to confirm as premature and to order the parties to proceed with a new arbitration before a three-arbitrator panel at ADR Services.

SETTLEMENT AND OFFERS TO COMPROMISE DEVELOPMENTS

1. 998 Offers

(a) *Background Statement*

Under California law, the right to recover costs is derived solely from statutes. In the absence of statutory authority, each party must pay his or her own costs. *Davis v. KGO-TV, Inc.*, 17 Cal. 4th 436, 439 (1998). The general statutory rule allowing recovery of costs is found in Code of Civil Procedure Section 1032. *Scott Co. v. Blount, Inc.*, 20 Cal. 4th 1103, 1108 (1999); *Guerrero v. Rodan Termite Control, Inc.*, 163 Cal. App. 4th 1435, 1439 (2008). Section 1032 requires the trial court to award costs to the prevailing party, except as otherwise provided by statute, and Section 1033.5 identifies the costs that are recoverable under Section 1032.

Code of Civil Procedure Section 998 modifies the general rule set forth in Section 1032, and is designed to encourage the settlement of lawsuits before trial. *Scott Co., v. Blount, Inc.*, supra, 20 Cal. 4th at 1112; *Regency Outdoor Advertising, Inc. v. City of Los Angeles*, 39 Cal. 4th 507, 528 (2006). "Its effect is to punish the plaintiff who fails to accept a reasonable offer from a defendant." *Culbertson v. R.D. Werner Co., Inc.*, 190 Cal. App. 3d 704, 711 (1987). However, a good faith requirement is read into Section 998, requiring that the settlement offer be "realistically reasonable under the circumstances of the particular case" and that there be "some prospect of acceptance." *Bates v. Presbyterian Intercommunity Hospital, Inc.*, 204 Cal. App. 4th 210, 220 (2012); see also *Adams v. Ford Motor Co.*, 199 Cal. App. 4th 1475, 1483 (2011); *Wear v. Calderon*, 121 Cal. App. 3d 818, 821 (1981); *Elrod v. Oregon Cummins Diesel, Inc.*, 195 Cal. App. 3d 692, 698 (1987). A party having no expectation that his offer will be accepted "will not be allowed to benefit from a no-risk offer made for the sole purpose of later recovery large expert witness fees." *Jones v. Dumrichob*, 63 Cal. App. 4th 1258, 1263 (1998). That being said, "[e]ven a modest of 'token' offer may be reasonable if an action is completely lacking in merit." *Nelson v. Anderson*, 72 Cal. App. 4th 111, 134 (1999); see also, *Culbertson v. R. D. Werner Co., Inc.*, supra, 190 Cal. App. 3d 704, 710-711. Whether a Section 998 offer qualifies as reasonable and in good faith is left to the sound discretion of the trial court. *Adams v. Ford Motor Co.*, supra, 199 Cal. App. 4th at 1484. Where the defendant obtains a judgment more favorable than its offer, "'the judgment constitutes prima facie evidence showing the offer was reasonable. . . ." *Santantonio v. Westinghouse Broadcasting Co.*, 25 Cal. App. 4th 102, 117 (1994). The reasonableness of a defendant's Section 998 offer is evaluated in light of what the offeree knows or does not know at the time the offer is made. *Bates v Presbyterian Intercommunity Hospital, Inc.*, supra, 204 Cal. App. 4th at 221.

Subdivision (a) of Section 998 states that "costs allowed under Sections 1031 and 1032 shall be withheld or augmented as provided in this section." Costs are augmented pursuant to Section 998 when an offer to compromise is rejected and the rejecting party fails to

achieve a better outcome at trial. In this situation, Section 998 establishes a procedure for shifting the costs upon a party's refusal to settle and by expanding the type of recoverable costs and fees over and above those permitted by Section 1032. See, *Murillo v. Fleetwood Enterprises, Inc.*, 17 Cal. 4th 985, 1000 (1998); *Westamerica Bank v. MBG Industries, Inc.*, 158 Cal. App. 4th 109, 128 (2007). To be effective, the technical requirements must be satisfied. See., e.g., *Boeken v. Philip Morris USA, Inc.*, 217 Cal. App. 4th 992, 1004 (2013) (failure to include an acceptance provision invalidated plaintiff's offer).

Section 998 authorizes any party to make a statutory offer to settle an action by allowing a judgment or dismissal to be entered based on the offer's terms and conditions. Cal. Code Civ. Proc. § 998(b). The statute seeks to encourage settlement by providing parties a financial incentive to make and accept reasonable settlement offers before trial. *Martinez v. Brownco Const'n Co.*, 56 Cal. 4th 1014, 1019 (2013); *Chaaban v. Wet Seal, Inc.*, 203 Cal. App. 4th 49, 54 (2012). If a plaintiff rejects a defendant's section 998 offer and thereafter fails to obtain a more favorable judgment, (1) "the plaintiff shall not recover his or her post offer costs and shall pay the defendant's costs from the time of the offer," and (2) the trial court may, in its discretion, require the plaintiff to pay the reasonable expert witness fees the defendant incurred. Cal. Code Civ. Proc. § 998(c)(1). If a defendant does not accept a plaintiff's section 998 offer and thereafter fails to obtain a more favorable judgment, (1) the trial court may, in its discretion, require the defendant to pay the reasonable post offer expert witness fees incurred by the plaintiff in preparing for trial and at trial, Cal. Code Civ. Proc. §998(c), and (2) the judgment against the defendant in any personal injury action shall accrue prejudgment interest at the rate of 10 percent per annum from the date of the offer. Cal. Civ. Code §3291.

The policy behind section 998 is "to encourage the settlement of lawsuits prior to trial." *T.M. Cobb Co. v. Superior Court*, 36 Cal. 3d 273, 280 (1984). To effectuate this policy, section 998 provides "a strong financial disincentive to a party – whether it be a plaintiff or a defendant – who fails to achieve a better result than that party could have achieved by accepting his or her opponent's settlement offer." *Bank of San Pedro v. Superior Court*, 3 Cal. 4th 797, 804 (1993). At the same time, the potential for statutory recovery of expert witness fees and other costs provides parties with "a financial incentive to make reasonable settlement offers." Id. Section 998 aims to avoid the time delays and economic waste associated with trials and to reduce the number of meritless lawsuits. *Culbertson v. R.D. Werner Co., Inc.*, 190 Cal. App. 3d 704, 711 (1987); *Wilson v. Wal-Mart Stores, Inc.*, 72 Cal. App. 4th 382, 390 (1999).

(b) Notable Historic *Cases*

- ***Toste v. CalPortland Construction***, 245 Cal. App. 4th 362 (2016) – Defendants may only recover post-offer expert fees under CCP § 998.

In 2015 the legislature amended Code of Civil Procedure section 998. The amendment became effective January 1, 2016. Prior to the amendment there was a legislative oversight with respect to awarding expert witness fees. If a plaintiff rejected a valid defense 998 offer and failed to beat it at trial, the trial court had discretion to award both pre-offer and post-offer expert witness fees to the defendant. If a defendant rejected a plaintiff's valid 998 offer and failed to beat it at trial, the plaintiff could only be awarded post-offer expert witness fees. The 2015 amendment provided that only post-offer expert fees could be awarded to both plaintiffs and defendants.

Toste was a wrongful death action brought by the son of a construction contractor. The father was killed when a truck backed up over him on the construction site. The son rejected 998 offers made by each of the three defendants. The jury entered verdicts establishing that none of the defendants were liable for the death. Pre- and post-offer expert witness fees were awarded to two of the defendants. The case was on appeal when the amendment of Section 998 went into effect.

The appellate court held that the amended version of Section 998 would apply because the case was on appeal at the time the new version went into effect. The court held that the first 998 offer made by one of the defendants was not valid because it was conditioned on the court approving a good faith settlement motion. However, the second offer made by that defendant was unconditional. Therefore, that defendant could only recover expert witness fees incurred after the second offer. The court also held that an offer need not specify that judgment may be entered against the defendant to be valid. An offer that specifies a certain sum will be paid in exchange for dismissal of claims against the defendant is also valid.

[Case Digest Contributed by Chris Blank]

- ***Sanford v. Rasnick***, 246 Cal. App. 4th 1121 (2016) – CCP § 998 offer that required plaintiff to sign a settlement agreement that was not attached to the offer was invalid. Mediation fees are recoverable as costs.

This is an auto v. motorcycle personal injury case. The defendants were a father who owned the car involved in the accident and his daughter who was driving the car. They were both insured under the same policy and represented by the same attorney. They made a CCP 998 offer of $130,000.00 in return for a request for dismissal with prejudice of the entire action, or a good faith settlement finding, plus delivery of an executed and notarized settlement agreement and general release. However, they did not include the proposed settlement agreement with the offer. The case went to trial and plaintiff was awarded $115,036 in damages. Defendants moved for an award of costs based on plaintiff's rejection of the 998 offer. Plaintiff also sought costs as the prevailing party. Defendants moved to tax plaintiff's costs for mediation expenses and costs incurred for delivering documents to the court.

The trial court ruled in favor of the defendants on both motions. The appellate court reversed and remanded. It held that making an offer on behalf of two defendants without apportionment did not invalidate the offer, but requiring execution of a settlement agreement and general release without attaching a draft document to the offer was enough to invalidate it. Defendants argued that in auto crash cases the terms of settlements agreements are standard across the industry. The appellate court was unconvinced, particularly because the supposed standard included a general release that might apply to claims that were not at issue in the lawsuit, as well as a Civil Code Section 1542 waiver. These provisions went beyond what a 998 offeree can legitimately demand.

The appellate court also remanded for the trial court to exercise its discretion regarding awarding mediation fees and delivery expenses to plaintiff. Such expenses are not included in the items automatically covered by CCP Section 1033.5(a), nor are they excluded by section 1033.5(b). Therefore, the court has discretion to award them if it finds that they were "reasonably necessary to the conduct of the litigation rather than merely convenient or beneficial to its preparation." The opinion makes a strong statement about the benefits of mediation and the good reasons for allowing mediation fees and costs to be recovered.

[Case Digest Contributed by Chris Blank]

- ***Ignacio v. Caracciolo***, 2 Cal. App. 5th 81 (2016) – CCP § 998 offer is invalid if it contains a general release and 1542 waiver.

This case involves an auto v. pedestrian accident. Defendant made a $75,000.00 CCP Section 998 offer that included the requirement that plaintiff sign a settlement agreement that included a general release with a waiver of unknown claims under Civil Code section 1542. The plaintiff declined the offer and obtained a $70,000 judgment at trial. The trial court denied the defendant's motion to tax costs and to obtain her own costs under CCP § 998. The Court of Appeal affirmed, holding that the release term invalidated the offer. The defendant argued that *Goodstein v. Bank of San Pedro*, 27 Cal. App. 4th 899 (1994) established that a general release does not necessarily invalidate a 998 offer, but the Court of Appeal held that *Goodstein's* holding was based on a narrow "historical" definition of the term "general release" that included only known and unknown claims arising from the claim in the underlying action. Accordingly, the court held that *Goodstein* did not apply to a general release of *all* known or unknown claims that includes claims unrelated to the underlying litigation. The Court of Appeal held that such a broadly worded general release made it impossible to value the 998 offer and determine whether or not the plaintiff's recovery exceeded the offer.

Defendants lamely asserted that the release was not actually a general release because it had a provision that said the release applied to the claims described above, "including but without, in any respect, limiting the generality of the foregoing, any and all claims that were, or might, or could have been alleged in connection with an accident that occurred on . . . and are the subject of the lawsuit entitled . . ." The court didn't buy it. Language that states the release included the claims related to the lawsuit, but is not limited to those claims, is not a limit at all. The court noted that the trial court asked plaintiff's counsel if she had any other potential claims that were not part of the lawsuit. He replied that she had a potential claim for invasion of privacy against the defendant, her counsel and an investigator they hired. This was enough for the court to conclude that the release was overbroad, thereby making the 998 offer invalid.

- ***Markow v. Rosner***, 3 Cal. App. 5th 1027 (2016) – CCP § 998 offer is not invalid because made by plaintiffs jointly, nor is it invalid because it was conditioned on the accuracy of defendant's discovery responses concerning the limits of his insurance policy.

Mr. Markow was rendered quadriplegic due to Rosner's negligent medical treatment. Mr. Markow sued Rosner for negligence and Mrs. Rosner sued for loss of consortium. Six months prior to trial the Markows made a joint settlement offer for $999,999.99 contingent on the accuracy of Rosner's discovery responses stating that the limit of his insurance coverage was $1.0 million. Rosner did not accept the offer and the jury awarded the Markows $5.2 million. The Markows moved for costs which were awarded. On appeal, Rosner argued that the 998 offer was invalid because it was joint and conditional. The

appellate court rejected both arguments. The Markows' offer was not confusing. They clearly recovered more than they offered to accept in settlement. Apportionment was not a problem because the statutory limit for a loss of consortium claim was $250,000.00, so the balance of the settlement demand must have been allocable to Mr. Markow's claims. The court also concluded, based on prior precedents that it is not improper or unreasonable to condition a settlement offer on the veracity of the opposing party's discovery responses, particularly when those responses involve the policy limit of the insurance covering the potential claims.

[Case Digest Contributed by Chris Blank]

(c) *2017 Cases*

- ***Bigler-Engler v. Breg, Inc.***, 7 Cal. App. 5th 276 (4th Dist. Jan. 6, 2017) – CCP § 998 offer must have an acceptance provision to be valid.

Plaintiff made a CCP Section 998 offer to accept $1,000,000.00 as compensation for her injuries. The offer did not include an acceptance provision; however, the defendant affirmatively rejected it in writing. Plaintiff was awarded farm more than $1,000,000.00 in damages and sought an award of costs under section 998. The trial court denied the request, holding that the offer was invalid because it did not include an acceptance provision. Long standing case law supported this conclusion. However, Plaintiff argued that the defendant's affirmative rejection of her offer should lead to a different result. he appellate court disagreed. Whether a section 998 offer is valid or invalid is determined by reference only to the four corners of the offer. Subsequent events, such as the affirmative rejection of the offer cannot serve to validate an invalid offer. Plaintiff argued for application of the doctrine of Equitable Estoppel, but that was rejected as well. The defendant's conduct did not mislead the plaintiff or induce reliance on a false set of facts.

[Case Digest Contributed by Chris Blank]

- ***Heimlich v. Shivji***, 12 Cal. App. 5th 152 (6th Dist. May 31, 2017), cert. granted, 400 P.3d 442 (Aug. 23, 2017) – Court partially vacates final award and remands the matter back to the arbitrator to reach the merits of the prevailing party's request for costs under CCP § 998.

See digest at page 168, above.

- ***Sviridov v. City of San Diego***, 14 Cal. App. 5th 514 (4th Dist. Jul. 28, 2017) – An award of costs to prevailing employer is mandatory when the plaintiff employee rejects an offer under CCP § 998 and fails to obtain a more favorable judgment.

After his termination, former police officer filed a lawsuit against his employers – the City of San Diego and the San Diego Police Department – alleging causes of action under FEHA and the Public Safety Officers Procedural Bill of Rights Act (POBRA), among others. During the litigation, defendants served the plaintiff with three settlement offers pursuant to CCP § 998, each of which was rejected. Thereafter, the trial court granted summary judgment in favor of the defendants as to all causes of action except for breach of contract and POBRA. After a bench trial on those remaining claims, the trial court entered judgment in favor of the plaintiff and ordered his reinstatement. On appeal, the Fourth District Court of Appeal reversed the judgment on the grounds that plaintiff had not timely appealed his termination and remanded with instructions that judgment be entered in favor of defendants.

After the remittitur, defendants filed a memorandum of costs seeking over $90,000. Plaintiff moved to strike the City's cost bill in its entirety based on his contention that due to the nature of the type of claims being asserted (e.g., claims under POBRA and FEHA), the defending parties were precluded from seeking prevailing party costs. The Court of Appeal rejected that argument and found that prevailing employers that make an offer to a plaintiff employee under CCP § 998 are entitled to costs incurred after the plaintiff's rejection of the offer; that the award of such costs is "mandatory."

Comment: This case has potential significance in the employment arena because it opens the door to risk of a potentially significant cost award should the plaintiff employee reject an offer and fail to obtain a more favorable judgment at trial.

2. Enforcement of Settlement Agreements

- ***Hayward v. Superior Court***, 2 Cal. App. 5th 10 (2016), petition for review granted, 382 P.3d 1135 (Nov. 9, 2016), review dismissed, 389 P.3d 862 (Mar. 1, 2017) – Disqualification of judge invalidates a settlement agreement influenced by rulings that were voided as a result of the disqualification.

In a contentious marital dissolution case, the parties – Hayward and Osuch – stipulated to the appointment of a private judge pro tempore, who failed to make required disclosures of prior relationships with the parties' attorneys. After the private judge issued several adverse rulings against Hayward, the parties entered into a Memorandum of Agreement (MOA) to settle the case. Hayward later argued that she had entered into the MOA under economic duress. While a motion to enforce the MOA under CCP § 664.6 was pending, Hayward learned of the private judge's failure to disclose, and filed a request to disqualify

the private judge. After disqualification was granted, the Court of Appeal held that the private judge's ruling were void as a result of the disqualification, and that the MOA was invalid since Hayward's willingness to enter into the settlement was influenced by the void rulings against her. In so holding, the Court of Appeal explained that the legal correctness of the void rulings was irrelevant, and that the property inquiry was "whether a person aware of the facts might reasonably entertain a doubt that, in the absence of the void rulings, the parties would have agreed to the terms in the MOA."

- ***Iqbal v. Ziadeh***, 10 Cal. App. 5th 1 (3d Dist. Mar. 24, 2017) – Your release may not be as broad as you think!

Plaintiff was hired by a used car lot - Yosemite Auto - to determine why a car recently towed to the lot wouldn't start. Unbeknownst to plaintiff, the tow truck operator had disconnected the transmission shift linkage and then failed to reconnect it after towing the car. Plaintiff confirmed the car was in "park" and crawled underneath it to determine why it would not start. When he tested the electrical connection to the starter, the vehicle immediately ran over him and dragged him through the used car lot, crushing his spine. Plaintiff sued Yosemite Auto and the tow truck operator. All defendants were dismissed with prejudice after the insurer for Yosemite Auto agreed to pay its $1 million policy limits. The settlement agreement released all defendants from liability, including a "1542 release" that covered "any and all known or unknown claims." Significantly, the release included within its scope the defendants' "affiliates" and "all other persons, firms, or corporations, with whom any of the former have been, are now or may hereafter be affiliated." It also included a confidentiality provision.

Within a matter of months, plaintiff filed a second action against the owner of the property where the accident occurred. Plaintiff based this action on the same facts as his first action, and sued the property owner for negligence and premises liability. At the time of the accident, Yosemite Auto leased the property from the owner who had previously operated the used car lot. The property owner had left several vehicles on the lot for Yosemite Auto to sell on consignment. The car that injured plaintiff was one of those vehicles.
In this case, plaintiff was hired by a used car lot, Yosemite Auto, to determine why a car recently towed to the lot wouldn't start. Unbeknownst to plaintiff, the tow truck operator had disconnected the transmission shift linkage and then failed to reconnect it after towing the car. Plaintiff confirmed the car was in "park" and crawled underneath it to determine why it would not start. When he tested the electrical connection to the starter, the vehicle immediately ran over him and dragged him through the used car lot, crushing his spine.

Plaintiff sued Yosemite Auto and the tow truck operator. All defendants were dismissed with prejudice after the insurer for Yosemite Auto agreed to pay its $1 million policy limits. The settlement agreement released all defendants from liability "including, without limitation, any and all known or unknown claims . . . ." Significantly, the release included within its scope the defendants' "affiliates" and "all other persons, firms, or corporations, with whom any of the former have been, are now or may hereafter be affiliated."

The property owner filed a motion for summary judgment contending he was an "affiliate" and third-party beneficiary of the settlement agreement and release resolving the first action. His evidence consisted of a declaration by defense counsel for Yosemite Auto who said he always intended the property owner to be included in the release. Plaintiff's counsel submitted a declaration stating, among other things, the property owner was never part of the settlement discussions or settlement. The trial court granted summary judgment. The Court of Appeal reversed.

Significant to the Court's holding was the confidentiality provision by which the parties agreed that neither they nor their attorneys or representatives would reveal "to anyone" any terms of the settlement agreement, including the release, unless otherwise mutually agreed in writing. The court queried how a prohibited a party who was not supposed to know anything about an agreement (i.e., the property owner) could reasonably expect to benefit from it.

The Court first found an "affiliate" generally is one who is dependent upon, subordinate to, an agent of, or part of a larger or more established organization or group. This is a closer association than that of the property owner who had only a contractual relationship with Yosemite Auto. There was no evidence those contracts—a lease and a consignment agreement—made the property owner dependent upon, under the control of, an agent of, or a part of Yosemite Auto.

Second, the Court found that the release benefited the former defendants' "present and future officers, directors, stockholders, attorneys, agents, servants, representatives, employees, subsidiaries, affiliates, partners, predecessors and successors in interest, and assigns and all other persons, firms, or corporations, with whom any of the former have been, are now or may hereafter be affiliated." To interpret "affiliate" as meaning one who has only a contractual relationship with the former defendants would have been inconsistent with the intent demonstrated by the remainder of the release.

Third, and perhaps the most compelling reason, plaintiff and the former defendants agreed to keep the settlement terms confidential. They agreed neither they nor their attorneys or representatives would reveal "to anyone" any terms of the settlement agreement, including the release, unless otherwise mutually agreed in writing. The court questioned how a prohibited a party who was not supposed to know anything about an agreement (i.e., the property owner) could reasonably expect to benefit from it.

Based on this extrinsic, objective evidence, the Court found the parties had no intention to include the property owner as part of the release and "immunize" him.

Take Aways from this Decision:

First, drafting is the culmination of the settlement negotiation and requires attention to detail.

Second, the use of the term "affiliated" in the release was unfortunate. After paying $1 million to resolve the claim, defense counsel undoubtedly intended to cut off any and all future claims or lawsuits arising out of the incident and "immunize" anyone who could possibly be named. Counsel may have been better off using a release similar to the one used in *General Motors Corp. v. Superior Court* (1993) 12 Cal.App.4th 435. In *General Motors*, plaintiff's wife died as a result of an accident with another driver. Plaintiff, represented by counsel who had earlier notified GM of a possible products liability claim, settled with the other driver involved for $25,000. The release signed by the plaintiff released the driver and "**any and all persons, firms, and corporations**" from liability for the accident. Plaintiff then sued GM. GM filed a motion for summary judgment contending the release signed by plaintiff released GM as well. Plaintiff's counsel submitted a declaration stating the intention of the parties was to release only the other driver, never GM. The trial court denied GM's motion. GM filed a writ. The Court of Appeal directed the trial court to set aside its denial of summary judgment for GM and to grant the motion for summary judgment. The Court held plaintiff presented no evidence raising a triable issue of fact the language of the release did not encompass all persons or entities, including GM.

- ***Krechuniak v. Noorzoy***, 11 Cal. App. 5th 713 (6th Dist. May 12, 2017) – Defendant's challenge to a settlement agreement clause providing for liquidated damages if defendant defaulted on its payment obligations under the settlement required a fact-dependent determination from the trial judge, so it could not be raised for the first time on appeal.

In this case, plaintiff (sister) sued her brother for allegedly defrauding her out of $1.7 million in a real estate development / investment deal. The parties agreed to a settlement in which brother agreed to pay sister $600,000 - $100,000 due immediately and $500,000 to be paid in installments over the next 5 years, with the proviso that if brother defaulted in any of his installment payments, sister could have a stipulated judgment against him for $850,000 ($250,000 more than the $600,000 settlement amount). The parties executed "Memorandum of Settlement" in which they agreed that the memorandum was "fully binding and enforceable" under Code of Civil Procedure § 664.6, notwithstanding that a more formal agreement was to be prepared. While the parties exchanged drafts of a formal settlement agreement, they failed to reach agreement on such a document. Six months later, sister filed a motion to compel enforcement of the settlement as set forth in the Memorandum of Settlement. Since brother had not made a single payment toward the settlement, sister brought a motion to compel enforcement of the settlement and entry of the stipulated judgment in the amount of $850,000.

The trial court granted sister's motion and entered judgment against brother for $850,000. Brother raised various objections to sister's motion, but (a) did not context that the Memorandum of Settlement was valid and binding, and (b) did not raise an objection that the $850,000 judgment for breach of a $600,000 settlement obligation was an unenforceable penalty under Civil Code § 1671. The "penalty" issue was only raised by brother for the first time on appeal. Sister objected on the grounds that brother had forfeited that argument by not raising the issue with the trial court. The appellate court

agreed, and held that it was brother's burden to allege and prove in the trial court that the stipulated judgment provision in the settlement memorandum was unreasonable under the circumstances existing at the time the contract was made. The court noted that far from challenging the reasonableness of the stipulated judgment provision, brother's opposition to sister's enforcement motion "admitted that the settlement memo was 'valid and binding.'" 11 Cal. App. 5th at 726. In support of this holding, the appellate court held that the liquidated damages / penalty issue is a fact-dependent determination which must be made, in the first instance, by the trial judge and is subject to substantial evidence review on appeal – not de novo review, unless the facts are undisputed. Here, since brother did not raise the issue in the trial court, he could not raise it for the first time on appeal. Furthermore, under Civil Code § 1670(b), the party asserting the invalidity of a liquidated damages clause bears the burden of proof on that issue, and by not raising the issue below, brother could not be said to have satisfied that burden.

Comment: This case is unique – both factually and procedurally - so it probably does not provide much in the way of general guidance for litigants attempting to settle disputes with defendant(s) that allow them (a) a discount off of the amount in issue, and (b) terms to pay the agreed upon settlement amount in installments.

[Case Digest contributed by Rebecca Callahan and Chris Blank]

- ***Vitatech International, Inc. v. Sporn***, 16 Cal. App. 5th 796 (4th Dist. Oct. 30, 2017) – When assessing whether the stipulated judgment amount is "reasonable," the relevant inquiry is the damage flowing from the failure to pay the agreed settlement sum, not the damage from the wrong for which the plaintiff originally sued, unless the stipulation includes an admission of liability or a concession as to the amount of damages caused by their alleged breach of the underlying contract.

Vitatech sued defendants for breach of contract and sought to recover $166,000 in damages, plus prejudgment interest, attorney's fees and costs. On the eve of trial, the parties settled based upon defendants' agreement to make a one-time payment of $75,000 by a designated date in the future. To "secure" defendants' payment promise, defendants stipulated to entry of judgment against them "in the full prayer of the Complaint." When defendants failed to pay, Vitatech filed the stipulation and the trial court entered judgment against defendants for more than $300,000, which included compensatory damages, prejudgment interest, attorney's fees and costs.

Defendants moved to vacate, arguing that the stipulated judgment was an unenforceable penalty under Civil Code § 1671(b). The trial court denied defendants' motion, finding that the higher amount was not a penalty or liquidated damages in relation to Vitatech's original claim; that Vitatech had agreed to accept the reduced amount if defendants paid as agreed.

On appeal to the Fourth District Court of Appeal, the court reversed. Under well-established precedent, including the its earlier decision in *Greentree Financial Group, Inc. v. Execute*

Sports, Inc., 163 Cal. App. 4th 495 (2008), the court held that the stipulated judgment for more than four times the amount Vitatech agreed to accept in settlement and bore no reasonable relationship to the range of damages the parties could have anticipated would result from defendants' failure to timely pay the settlement amount. Accordingly, the court of appeal held that the stipulated judgment was an unenforceable penalty under Civil Code § 1671, and remanded to the trial court with instructions to grant defendants' motion to vacate and to enter a new judgment for the $75,000 settlement amount, plus trial court costs.

The court reasoned that the stipulation for entry of judgment was not merely a permissible discount provision because the stipulation represented a compromise of disputed claims in which liability was contested. 16 Cal. App. 5th at 801. Contrary to Vitatech's argument, the stipulation for entry of judgment was not merely a permissible discount provision because, while the defendants stipulated to entry of judgment if they did not timely pay, they did not admit liability on the underlying claim, nor did they concede the amount of damages caused by their alleged breach of the underlying contract.

Comment: What might have saved the stipulated judgment at issue in this case? The Court of Appeal analyzed other cases in which a stipulated judgment had been found to be valid, and suggested that the stipulated judgment here could have survived if the appellants had admitted their liability under the underlying contract or for the damages Vitatech was seeking in its complaint. Apparently, at least in the eyes of the Court of Appeal, there was a difference between the defendants' agreement to stipulate to the "full prayer of the Complaint" and an "admission" of liability for those damages.

This decision illustrates the dangers and difficulties of trying to put "teeth" into a settlement by including provisions that increase the amount the settling defendant must pay if it fails to perform as promised. It also illustrates the need for careful drafting. For example, the settlement amount could have been stated as the full contract amount ($166,000), with an agreed upon discount at $75,000 if paid in full by the agreed upon deadline. It also could have been written to condition the release and dismissal upon payment of the settlement amount, especially since it was a single payment that was to be paid not that far in the near future. Finally, the stipulation for entry of judgment could have expressly included provision for the settling plaintiff to have the right to seek recovery of attorney's fees and pre-judgment interest dating back to the filing of the lawsuit if defendants defaulted in the payment due under the settlement agreement.

Note: An interesting aspect of this case is whether defendants properly sought to vacate the judgment under Code of Civil Procedure § 473(d), which allows for the vacation of void judgments. A judgment can be void when the court lacks fundamental authority over the subject matter, question presented or party, which does not seem to be the case here. However, the Court of Appeal found another example of a void judgment in this case: "void as against public policy." Having found that the judgment was predicated upon a settlement stipulated that contained an unreasonable liquidated damages provision, the court held that the resulting judgment was void as against public policy.

- ***Sayta v. Chu***, 17 Cal. App. 5th 960 (1st Dist. Nov. 29, 2017) – If you want the court to retain jurisdiction to enforce a settlement, make that request to the court before dismissal!

As stated by the First District Court of Appeal in the opening paragraph of its opinion, "[t]his case offers an object lesson on the requirements to invoke section 664.6 and the consequences of failure to comply with those requirements." 17 Cal. App. 5th at 962.

Chu owned apartments in San Francisco and rented one to his niece, Taia. In turn, Taia sublet a bedroom in the apartment to Sayta. Between 2013 and 2015, a series of disputes arose between Sayta and the owner / tenant regarding his tenancy, and those disputes led to actions before the superior court and the San Francisco Rent Board. The parties settled their disputes and the terms of the settlement was confirmed in a written settlement agreement that provided for a mutual general releases, dismissal of the complaint and cross-complaint, withdrawal of any pending rend board petitions, termination of Sayta's tenancy, waiver by the owner / tenant for claims of unpaid rent, and return of Sayta's security deposit. The settlement agreement included a provision that its terms "shall remain confidential" and provided for liquidated damages of $15,000 for breach of the confidentiality provision. The settlement agreement also provided for summary enforcement of the settlement pursuant to Code of Civil Procedure § 664.6.

In accordance with the settlement agreement, the parties requested dismissal of their respective complaint and cross-complaint. Six months later, Sayta filed a motion under 664.6 to enforce the liquidated damages provision of the settlement agreement, complaining that defendants had breached the confidentiality provisions by placing a copy of the agreement in the public record by filing it with the rent board. Sayta also complained that he had received only a partial refund of his security deposit. The trial court denied Sayta's motion on its merits, finding that there was no violation of the settlement agreement. Sayta appealed. On appeal, the First District Court of Appeal held that the trial court's order denying Sayta's motion seeking enforcement of the settlement agreement was void for lack of subject matter jurisdiction. Accordingly, the trial court's order was reversed and remanded with directions to vacate the order.

Although section 664.6 provides a valuable tool to aid in the enforcement of settlements, the clear wording of that section requires that parties to a stipulated settlement request that the court "retain jurisdiction over the parties to enforce the settlement until performance in full of the terms of the settlement." The Court of Appeal noted that this portion of section 664.6 has previously been construed to mean that the request to retain jurisdiction must be made (1) during the pendency of the case, not after the case is dismissed in its entirety, (2) by the parties themselves, and (3) either in a writing signed by the parties or orally before the court. 16 Cal. App. 5th at 966, citing *Wackeen v. Malis*, 97 Cal. App. 4th 429, 440 (2002). The court went to explain that parties to a settlement cannot confer jurisdiction on the trial court simply by including language to that effect in their settlement agreement. "[S]ettlement language purporting to vest the trial court with

retained jurisdiction after the dismissal [is] a nullity: Subject matter jurisdiction cannot be conferred by consent, waiver or estoppel." Id., citing *Hagen Engineering, Inc. v. Mills*, 115 Cal. App. 4th 1004, 1008 (2003).

Bottom Line:

The trial court loses subject matter jurisdiction when an action is voluntarily dismissed and thereafter has no power to enforce a settlement unless, prior to dismissal, the parties ask the court to retain jurisdiction. This makes sense for, as the Court of Appeal pointed out, 664.6 "does not float in the ether to be drawn upon whenever a party seeks enforcement." 17 Cal. App. 5th at 967. In this case, the court noted that Sayta failed "to explain how the court could have fathomed a 'request' for retained jurisdiction, must less granted it sub silentio from a secret handshake of the parties." Id.

Comment: The procedure for retaining federal court jurisdiction to enforce a settlement is similar. When dismissal occurs pursuant to FRCP 41, the district court is empowered – with the consent of the parties – to incorporate the settlement agreement in the order or retain jurisdiction over the settlement contract itself. Absent such action, however, enforcement of the settlement agreement must be had by initiating an action in the state court to enforce the contract, unless there is an independent basis for federal court jurisdiction. See, Kokkonen v. Guardian Life Ins. Co. of America, 511 U.S. 375 (1994).

3. Cost Awards

- ***DeSaulles v. Community Hospital of the Monterey Peninsula***, 62 Cal. 4th 1140 (2016) – Where a settlement does not discuss costs, plaintiff who dismisses the case in exchange for payment is the prevailing party and is entitled to recover costs.

In this case, the parties entered into a settlement agreement calling for the defendant to pay $23,500 to the plaintiff, in exchange for a dismissal with prejudice of the plaintiff's two remaining contract claims. After the claims were dismissed, the trial court awarded the defendant costs as the prevailing party. The Court of Appeal and California Supreme Court both disagreed with the trial court, holding that a plaintiff who dismisses a claim in exchange for a settlement payment has obtained a "net monetary recovery," and thus is the prevailing party under Code of Civil Procedure section 1034(a)(4). Accordingly, the plaintiff, and not the defendant, was entitled to recover costs.

Section 1032(a)(4) provides:

> "'Prevailing party' includes the party with a net monetary recovery, a defendant in whose favor a dismissal is entered, a defendant where neither plaintiff nor defendant obtains any relief, and a defendant as against those plaintiffs who do not recover any relief against that defendant. When any party recovers other than monetary relief and in situations other than as specified, the "prevailing party" shall be as determined by the court, and

under those circumstances, the court, in its discretion, may allow costs or not and, if allowed may apportion costs between the parties on the same or adverse sides pursuant to rules adopted under Section 1034."

The California Supreme Court interpreted this statute to mean that where the defendant pays the plaintiff in exchange for the plaintiff's dismissal of its action, the plaintiff is the prevailing party, and id entitled to an award of costs. In reaching this decision, the Supreme Court disapproved *Chinn v. KMR Property Management*, 166 Cal. App. 4th 175 (2008), which held that a voluntary dismissal is considered a judgment in the defendant's favor. The Supreme Court explained that the cases that *Chinn* relied on all involved voluntary dismissals that were *not* accompanied by a settlement payment, and thus were not applicable where the plaintiff obtained a monetary recovery in the form of a settlement payment. The Court also noted that it was only declaring the default rule, and that the parties to a settlement are free to expressly allocate costs as they see fit.

The majority opinion in *deSaulles* came to the opposite conclusion, holding that a dismissal obtained by paying money to a plaintiff is not a "dismissal in favor of the defendant." Rather, net monetary recovery for the plaintiff can include settlement payments made in exchange for dismissal. The dissent argued that when a plaintiff obtains a settlement payment in exchange for dismissal, both the plaintiff and the defendant are prevailing parties, and therefore, the remaining clause of subsection (4) applies, meaning that whether costs are awarded to either plaintiff or defendant is a matter of discretion left to the court to decide on a case-by-case basis.

[Case Digest Contributed by Chris Blank]

- ***Leetzow v. Metropolitan Life Ins.***, Case No. CV-15-2468-VAP (KKx), 2017 WL 1231719 9C.D.Cal. Mar. 3, 2017) – Mediation fees and costs are recoverable as attorney's fees in an ERISA action.

Plaintiff sued to obtain disability benefits from her employer's group insurance carrier. Plaintiff won at trial and the court awarded prevailing party attorney fees against Metropolitan. Metropolitan objected to the amount requested by Plaintiff's attorney. Among the objections, Metropolitan argued that the fees paid to a mediator prior to trial are not among taxable expenses and should not be considered "attorneys' fees" for the purpose of the award. The court disagreed, holding that "[t]hese costs, however, may be recoverable as attorneys' fees if 'it is "the prevailing practice in a given community" for lawyers to bill those costs separately from their hourly rates.' [citation omitted] Courts within the Ninth Circuit have held '**mediation** costs, printing costs . . .' are billed separately from lawyers' hourly rates and thus recoverable in an ERISA action. [citation omitted]"

[Case Digest Contributed by Chris Blank]

- ***California-American Water Co. v. Marina Coast Water***, 18 Cal. App. 5th 571 (1st Dist. Dec. 12, 2017) – For purposes of the right to recover fees under CCP § 1717, the illegality exception to the rule of mutuality of remedies applies when the contract's subject matter is illegal, but it does not apply when the litigation involves a challenge to the validity or enforceability of an otherwise legal contract.

California-American, a water utility, and Marina and Monterey, public water agencies, entered into contracts to collaborate on a water desalination project. As part of their arrangement, the parties agreed that the prevailing party in any action or proceeding in any way arising from their agreement would be entitled to an award of attorney's fees and costs. After learning that a member of Monterey's board of directors had a conflict of interest - having been paid for consulting work to advocate on behalf of Marina - California-American sued to have the contracts declared void under Government Code § 1090. Monterey agreed that the contracts were void, but Marina did not and filed cross-claims seeking a declaration that the contracts were "valid and enforceable." Years of contentious litigation ensued and culminated in an affirmance by the First District Court of Appeal of the trial court's judgment declaring the agreements void. Marina challenged post-judgment orders that California-American and Monterey were entitled to attorney's fees and costs as prevailing parties under Code of Civil Procedure §§ 1032 and 1717.

The Court of Appeal affirmed, rejecting Marina's argument that they were not entitled to awards because the underlying contracts were declared void. Relying on the California Supreme Court's decision in *Santisas v. Goodin*, 17 Cal. 4th 599 (1998), the appellate court found that the trial court had properly ruled that the case was an "action on a contract" for purposes of awarding attorney's fees under Code of Civil Procedure § 1717. This was so due to the "rule of mutuality." Otherwise, the right to recover attorney's fees would be effectively unilateral whenever a party challenged the validity or enforceability of a contract because only the party seeking to affirm and enforce the agreement could invoke its attorney's fees provision. On this point, the Court of Appeal noted that *Santisas* was unequivocal in holding that a party can be entitled to attorney's fees under section 1717 even when the contract at issue is adjudged to be inapplicable, invalid, unenforceable, or even nonexistent. This entitlement arises because of the section's purpose in protecting the parties' mutuality of remedy.

The Court of Appeal agreed with Marina that a different rule applies when a contract is held to be unenforceable because of illegality; that courts generally will not enforce an illegal contract and so there is no need for a mutual right to attorney's fees since neither party can enforce the agreement. 18 Cal. App. 5th at 579, citing *Yuba Cypress Housing Partners, Ltd. v. Area Developers*, 98 Cal. App. 4th 1077 (2002). The appellate court distinguished illegality from other challenges to a contract's validity or enforceability. The court held that while the contracts at issue in this case were ultimately declared void under Government Code § 1090, there was nothing illegal about their subject matter, which simply governed the parties' relationships and rights in connection with a desalination project.