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'Arbitration' Definition Under the FAA: The Unsettled Law

Circuits are split on two issues.

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Last year the U.S. Supreme Court denied certiorari to the Second Circuit's decision in *Bakoss v. Certain Underwriters at Lloyds of London Issuing Certificate No. 0510135*, 707 F.3d 140 (2d Cir.), cert. denied, 134 S. Ct. 155 (2013), leaving unresolved two important legal issues concerning alternative dispute resolution (ADR) on which the circuits are deeply split. The first is whether state law or federal common law provides the definition of "arbitration" under the Federal Arbitration Act (FAA).[1] Secondly, if the latter, what types of ADR proceedings meet the definition of "arbitration" under federal common law? The current unsettled state of the law has significant implications for both lawyers who draft ADR clauses and those who litigate about them.

BIGSTOCK

'Bakoss' and the Splits in the Circuits

Bakoss arose out of a dispute between the plaintiff, Bakoss, and Lloyds regarding Bakoss' entitlement to disability insurance benefits pursuant to a policy that provided benefits in the event the insured became permanently totally disabled. The insurance certificate contained a third physician provision, which gave each party the right to appoint a physician to examine the insured to determine whether he was totally disabled. The provision further stated that, should the two physicians disagree, they would jointly "name a third Physician to make a decision on the matter which shall be final and binding."[2]

After Lloyds denied coverage, Bakoss refused to submit to examination by the third physician and commenced an insurance coverage action in New York state court. Lloyds removed the action to federal district court contending that the third physician clause was an arbitration agreement, thus providing federal question jurisdiction under the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention), which is implemented by the FAA.[3] Lloyds sought to compel arbitration, in other words, compliance with the third

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physician provision. Accordingly, the federal court's jurisdiction hinged on whether the third physician procedure qualified as "arbitration" under the FAA, which does not define arbitration. The district court held that it did and the Second Circuit affirmed.[4]

Does Federal Judge-Made Law or State Law Define Arbitration Under the FAA? In reaching its conclusion, the Second Circuit addressed for the first time the issue of "whether federal courts should look to state law or federal common law for the definition of 'arbitration' under the FAA."[5] In holding that the meaning of "arbitration" under the FAA is governed by federal common law—not state law—the Second Circuit joined the majority of the Courts of Appeals that have considered the issue. The First, Sixth, and Tenth Circuits have all expressly concluded that federal law ought to govern.[6] As the Second Circuit noted, those courts have relied on "congressional intent to create a uniform national arbitration policy."[7] It found "compelling" the analysis of these circuits, stating that "[a]pplying state law would create 'a patchwork in which the FAA would mean one thing in one state and something else in another.'"[8]

The outliers are the Fifth and Ninth Circuits, which look to state law to determine whether a particular ADR procedure qualifies as "arbitration" under the FAA.[9] Thus, the Ninth Circuit has held that the FAA applied to an appraisal procedure where the governing law of the contract was California law—because California's arbitration statute defines arbitration to include appraisal—but in a subsequent case found that the FAA did not apply to an appraisal procedure governed by Oregon law, which treats appraisals as common law contracts rather than arbitrations.[10] Though in a concurring opinion, the later Ninth Circuit panel questioned whether it was reaching the right result, it remains good law in the Ninth Circuit.[11] Interestingly, many amici curiae in the Supreme Court supported the minority approach, raising states' rights and consumer advocacy concerns.[12]

What Is the Essence of Arbitration? Among those circuits that apply federal common law, there is surprisingly little uniformity. Although *Bakoss* does not discuss at length what types of ADR mechanisms constitute arbitrations under federal common law, it affirmed the district court's holding that the third physician provision was an arbitration clause. In doing so, it quoted approvingly the following language from Judge Jack B. Weinstein's decision in *AMF v. Brunswick*, upon which the district court had relied: "An adversary proceeding, submission of evidence, witnesses and cross-examination are not essential elements of arbitration."[13] Thus, in the Second Circuit, there is no requirement that the clause use the word "arbitration" or that the process be an adversarial one. A committee of the Association of the Bar of the City of New York has criticized *Bakoss*, stating that the Second Circuit's holding that the third physician procedure, which "did not allow for the presentation by the parties of written or testimonial evidence at a hearing before the decision makers, provided no opportunity to cross-examine or submit rebuttal evidence, and no opportunity for the submission of legal memoranda or attorney argument," has "stretched the definition of arbitration virtually beyond recognition."[14]

In other circuits, in contrast, the clause at issue in *Bakoss*—which vested the decision-making in a doctor doing an independent physical examination—clearly would not qualify as an arbitration agreement, given the total lack of an adversarial process. Those circuits do a case-by-case evaluation of how closely the proceeding resembles "classic arbitration." They look for indicia such as "(i) an independent adjudicator, (ii) who applies substantive legal standards … (iii) considers evidence and argument (however formally or informally) from each party, and (iv) renders a decision that purports to resolve the rights and duties of the parties."[15] Yet other circuits focus on whether there is a reasonable expectation that the ADR mechanism will settle the dispute.[16]

Also unsettled is the issue of whether a non-binding ADR procedure, such as non-binding arbitration or even mediation, can qualify as "arbitration" under federal common law. In the Second Circuit, a number of district court decisions prior to *Bakoss* found that the FAA encompassed non-binding ADR procedures, including mediation.[17] While the Second Circuit's decision in *Bakoss* does not explicitly deal with this issue, it emphasized the "final and binding" nature of the third physician clause.[18] Accordingly, a subsequent Southern District decision has concluded that non-binding mediation is not within the scope of the FAA "as it does not purport to adjudicate or resolve a case in any way."[19] Other district court decisions since *Bakoss* have emphasized that in the Second Circuit the "crucial inquiry is whether the parties have agreed to submit a dispute that has arisen between them for *final and binding* determination by a third-party."[20] Even this does not fully resolve the issue of whether "mediation" can be considered FAA "arbitration," as it has been held in the Southern District that while a typical mediation is not "arbitration," a clause that provides for binding mediation is.[21]

The law outside of the Second Circuit is similarly unresolved. Some courts have found non-binding proceedings within the FAA's scope, relying on the strong federal policy in favor of arbitration.[22] Other courts have soundly rejected that notion, emphasizing that "mediation does not resolve a dispute, it merely helps the parties do so … [while] the arbitration process itself will produce a resolution independent of the parties' acquiescence—an award which declares the parties' rights and which may be confirmed with the force of a judgment."[23]

Why Does It Matter?

The above issues are not merely an interesting academic debate about the statutory construction of the FAA. They have broad implications for myriad types of ADR. There are a host of ADR mechanisms, like the clause in *Bakoss*, that do not easily fall into the pre-conceived notion of "arbitration."

These include purchase price adjustment mechanisms, which are commonplace in acquisition agreements and provide for dispute resolution by independent accountants. Insurance policies, real estate contracts and other types of agreements often provide for appraisal or valuation proceedings. Construction contracts typically delegate the resolution of technical disputes to industry experts, such as architects or engineers. There are also voluntary processes, such as mediation. The above list is by no means exhaustive.

Whether the FAA is applicable to these types of ADR proceedings has important ramifications should litigation ensue. The FAA embodies a strong federal policy in favor of arbitration and provides a number of powerful tools.[24] It mandates that courts compel arbitration and stay litigation and provides for interlocutory appeal in the event of a denial of a petition to compel arbitration.[25] It further mandates that courts "must grant [a confirmation] order unless the award is vacated, modified, or corrected as prescribed in [FAA] sections 10 and 11."[26] Confirmation is a summary proceeding that converts the arbitration award to an enforceable judgment.[27] The standard of review is extremely deferential and limited to the grounds set forth under §10, which address "extreme arbitral conduct" such as fraud or evident partiality.[28] Awards are only vacated in exceptional circumstances and will not be vacated for a mistake of fact or law.[29] The U.S. Supreme Court has held that parties are not permitted to expand the scope of review by contract.[30] While the New York Code of Civil Practice Law and Rules provides some analogous protections to appraisal and similar proceedings, the standard of review is somewhat broader and most other states do not have similar statutes.[31]

Whether a proceeding is "arbitration" within the FAA's scope also has implications for international arbitration agreements. As was the case in *Bakoss*, the New York Convention vests the federal district court with jurisdiction. It also provides for enforcement of arbitration awards abroad.[32]

Recommendations

Given the state of the law, there is no foolproof way to ensure that an ADR mechanism that is not classic arbitration will be within the purview of the FAA. However, drafters of agreements would be wise to explore with their clients the ramifications of having an ADR proceeding subject to the FAA and make the contractual intent abundantly clear. If the intent is to have the clause within the FAA's purview, it should recite that the decision is final and binding and it would be helpful to build into the mechanism some indicia of an adversarial process.[33] The provision should recite that the award can be confirmed in any court of competent jurisdiction as some courts, albeit a minority, have held that this language is a prerequisite to FAA confirmation.[34]

The outliers are the **Fifth and Ninth Circuits**, which **look to state law** to determine whether a particular ADR procedure qualifies as "arbitration" under the FAA.

Litigation counsel, seeking to compel arbitration or confirm the result of an ADR proceeding often will have a choice of venue.[35] Careful attention should be paid to that choice as it may drive the result of the litigation. The same holds true for counsel seeking to challenge the result of an ADR proceeding. Finally, counsel should be mindful of the relatively short deadlines in the FAA to move to confirm (one year) or vacate (three months), which will be applicable should the FAA be found to apply.[36]

1. 9 U.S.C. §§1-16, 201-208, 301-307.
2. *Bakoss*, 707 F.3d at 142.
3. Id. The FAA does not provide federal subject matter jurisdiction other than in cases relating to an arbitration agreement falling under the New York Convention. 9 U.S.C. §§201-208.
4. *Bakoss*, 707 F.3d at 144. On the merits, the Second Circuit affirmed the dismissal of the case on late notice grounds. Id.
5. Id. at 143.
6. See *Evanston Ins. v. Cogswell Props.*, 683 F.3d 684, 693 (6th Cir. 2012); *Fit Tech v. Bally Total Fitness Holding*, 374 F.3d 1, 6 (1st Cir. 2004); *Salt Lake Tribune Publ'g v. Mgmt. Planning,* 390 F.3d 684, 689 (10th Cir. 2004). Other circuits have applied federal law without expressly addressing the issue. See *Advanced Bodycare Solutions v. Thione Int'l*, 524 F.3d 1235, 1239 (11th Cir. 2008); *Dow Corning v. Safety Nat'l Cas.*, 335 F.3d 742, 747-48 (8th Cir. 2003); *Dluhos v. Strasberg*, 321 F.3d 365, 370 (3d Cir. 2003); *United States v. Bankers Ins.*, 245 F.3d 315, 322-23 (4th Cir. 2001).
7. *Bakoss*, 707 F.3d at 143.
8. Id. at 144 (quoting *Portland Gen. Elec. v. U.S. Bank Trust Nat. Ass'n as Trustee for Trust No. 1*, 218 F.3d 1085, 1091 (9th Cir. 2000) (Tashima, J., concurring)).
9. *Hartford Lloyd's Ins. v. Teachworth*, 898 F.2d 1058, 1061-63 (5th Cir. 1990) (applying state law); *Wasyl v. First Boston*, 813 F.2d 1579, 1582 (9th Cir. 1987) (applying state law).
10. See *Wasyl*, 813 F.2d at 1582; *Portland Gen. Elec.,* 218 F.3d at 1089-90.
11. *Portland Gen. Elec.*, 218 F.3d at 1091 (Tashima, J., concurring).
12. See, e.g., Briefs of Preemption and Federalism Law Professors, Independence Institute, Florida Consumer Action Network, Southeastern Legal Foundation and Texas Trial Lawyers Association as Amici Curiae Supporting Petitioner, *Bakoss v. Certain Underwriters at Lloyds of London Issuing Certificate No. 0510135*, 134 S. Ct. 155 (2013) (No. 12-1429).
13. *Bakoss*, 707 F.3d at 143 (quoting *AMF v. Brunswick*, 621 F. Supp. 456, 460 (E.D.N.Y. 1985)).
14. Committee on International Commercial Disputes, New York City Bar, Purchase Price Adjustment Clauses and Expert Determinations: Legal Issues, Practical Problems and Suggested Improvements 28-9 (2013) (hereinafter City Bar Report).
15. *Advanced Bodycare Solutions*, 524 F.3d at 1239 (citing *Fit Tech*, 374 F.3d at 7).
16. See, e.g., *Harrison v. Nissan Motor Corp. in U.S.A.*, 111 F.3d 343, 349 (3d Cir. 1997); *Salt Lake Tribune Publ'g*, 390 F.3d at 689-90.
17. *Am. Ctr. for Law & Justice v. Am. Ctr. for Law & Justice*, 2012 U.S. Dist. LEXIS 86940, 2012 WL 2374728 (D. Conn. June 22, 2012); *AMF*, 621 F. Supp. at 460; *CB Richard Ellis v. Am. Envtl. Waste Mgmt.*, 1998 WL 903495, at *3-4 (E.D.N.Y. Dec. 4, 1998).
18. *Bakoss*, 707 F.3d at 142.
19. *Superior Site Work v. Triton Structural Concrete*, 2013 U.S. Dist. LEXIS 104300 (E.D.N.Y. July 24, 2013) (quoting *Advanced Bodycare Solutions*, 524 F.3d at 1240).
20. *Seed Holdings v. Jiffy Int'l AS*, 2014 U.S. Dist. LEXIS 38565 (S.D.N.Y. March 21, 2014) (emphasis added). See also *HBC Solutions v. Harris*, 2014 U.S. Dist. LEXIS 98027 (S.D.N.Y. July 18, 2014).
21. *Cummings v. Consumer Budget Counseling*, 2012 WL 4328637, at *3-4 (E.D.N.Y. Sept. 19, 2012).
22. See *Sekisui Ta Industries v. Quality Tape Supply*, 2009 U.S. Dist. LEXIS 61983, 2009 WL 2170500, *4-5 (D. Md. July 17, 2009); *Fisher v. GE Med. Sys.*, 276 F. Supp. 2d 891, 893-94 (M.D. Tenn. 2003); *Wolsey v. Foodmaker*, 144 F.3d 1205, 1208-09 (9th Cir. 1998).
23. *Advanced Bodycare Solutions*, 524 F.3d at 1240 (11th Cir. 2008); See also *James T. Scatuorchio Racing Stable v. Walmac Stud Mgmt.*, 2013 U.S. Dist. LEXIS 276 (E.D. Ky. Jan. 2, 2013).
24. See *Hall St. Assocs. v. Mattel*, 552 U.S. 576, 588 (2008).
25. 9 U.S.C. §§3, 16(a)(1)(A).
26. 9 U.S.C. §9.
27. See *Hall St. Assocs.*, 552 U.S. at 577.
28. See id.
29. See id. at 586.
30. See id. at 588-92.
31. See City Bar Report, supra note 14, for a detailed discussion of this issue.
32. 9 U.S.C. §§201-208.
33. Addressing purchase price adjustment provisions, the City Bar Report also recommends that, if the mechanism is intended to be arbitration, the provision state that it is intended to be governed by the FAA and use the terms arbitrator and arbitration. See City Bar Report, supra note 14, at 53-4. If not, it suggests that the clause state the agreement is not an arbitration agreement and is to be governed by the law of expert determination and appraisal. See City Bar Report, supra note 14, at 53-4. The City Bar Report includes suggested sample clauses. See City Bar Report, supra note 14, at 53-4.
34. See *PVI v. Ratiopharm GmbH*, 135 F.3d 1252, 1253-54 (8th Cir. 1998).
35. The FAA's venue provisions are permissive, allowing a motion to confirm, vacate, or modify to be brought either in the district where the award was made or in any district proper under the general venue statute. *Cortez Byrd Chips v. Bill Harbert Construction*, 529 U.S. 193, 193 (2000).
36. 9 U.S.C. §§9-12.