U.S. Supreme Court Limits Judicial Review of Arbitration Awards for Errors of Law—Strategies for Drafting Arbitration Agreements in the Aftermath of *Hall Street*

By GARY L. RUBIN

Whether the challenge is adjudicating a pending construction dispute or drafting construction contracts for projects yet to begin, no subject is more critical to experienced construction lawyers than the choice of a dispute resolution forum. Courts and juries are sometimes not a welcoming environment for construction disputes, given their factual complexity and the extensive written records generated by most construction projects. Arbitration offers a potential for decision-making by arbitrators who are more familiar with construction issues. But arbitration also involves important tradeoffs, particularly limited judicial review of arbitration awards by a court system that is all too happy to wash its hands of construction disputes covered by binding arbitration agreements.

The 2008 decision of the U.S. Supreme Court in *Hall Street Associates, L.L.C.* v. *Mattel, Inc.*[1], sharpens the issues for construction lawyers trying to weigh the relative merits of litigation and arbitration (together with arbitration's non-binding cousin, mediation). In conjunction with the 2005 decision of the New York Court of Appeals in *Matter of Diamond Waterproofing Systems, Inc.* v. *55 Liberty Owners*

[1] 552 U.S., 128 S.Ct. 1396, 170 L.Ed.2d 254 (March 25, 2008).

Corp.[2]**, *Hall Street* establishes that judicial review of arbitration awards will be perhaps even more limited than previously thought—and that contract language should be drafted accordingly.**

Underlying Dispute

Hall Street **holds that where arbitrations are governed by the Federal Arbitration Act[3], judicial review of arbitration awards is limited to the narrow statutory grounds established in 9 U.S.C. § 10[4] or 9 U.S.C. § 11[5], even where the parties have tried to contractually establish a broader scope of judicial review. The case involved a dispute between a landlord (Hall Street) and a tenant (Mattel) concerning a lease provision under which the tenant agreed to indemnify the landlord for any costs**

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[2] 4 N.Y.3d 247, 793 NYS2d 831(2005).

[3] 9 U.S.C. §§ 1 *et seq*.

[4] Section 10(a) of the FAA (9 U.S.C. § 10(a)) provides:

"In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—(1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where 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; or of any misbehavior by which the rights of any party have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made."

[5] Section 11 of the FAA (9 U.S.C. § 11) provides:

"In either of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—(a) Where there was an evident material miscalculation of figures or an evident material mistake in the description of any person, thing, or property referred to in the award. (b) Where the arbitrators have awarded upon a matter not submitted to them, unless it is a matter not affecting the merits of the decision upon the matter submitted. (c) Where the award is imperfect in matter of form not affecting the merits of the controversy. The order may modify and correct the award, so as to effect the intent thereof and promote justice between the parties."

resulting from a failure of the tenant or any of its predecessor lessees to follow federal, state, and local environmental laws while using the premises. After environmental pollutants were discovered on the property, Mattel notified Hall Street that it intended to terminate the lease, and Hall Street filed suit against Mattel in federal court seeking, among other things, to enforce the indemnification provision.

Following a bench trial and an unsuccessful mediation, the parties entered into an arbitration agreement which was "so ordered" by the federal district court. The arbitration agreement provided that the federal district court "may enter judgment upon any award, either by confirming the award or by vacating, modifying or correcting the award. The Court shall vacate, modify or correct any award: (i) where the arbitrator's findings of fact are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous."

The arbitrator held in favor of Mattel, finding it had no duty to indemnify Hall Street on the ground that the lease obligation concerning federal, state, and local environmental laws did not include compliance with the testing requirements of the Oregon Drinking Water Quality Act ("Oregon act"), which the arbitrator characterized as dealing with human health as distinct from environmental contamination.

Hall Street moved to vacate the arbitration award, claiming that the arbitrator had committed legal error in failing to treat the Oregon act as an applicable environmental law under the terms of the lease, and that the arbitration agreement authorized vacatur or modification of the arbitration award based on legal error. After a lengthy series of procedural steps, the U.S. Supreme Court granted certiorari "to decide whether the grounds for vacatur and modification provided by §§ 10 and 11 of the [Federal Arbitration Act] are exclusive."[6]

The Supreme Court held that in cases governed by the Federal Arbitration Act, arbitration awards cannot be reviewed by the courts for erroneous conclusions of law even where the parties provide for such judicial review in their arbitration agreements:

> **"Hall Street is certainly right that the FAA lets parties tailor some, even many features of arbitration by contract, including the way arbitrators are chosen, what their qualifications should be, which issues are arbitrable, along with procedure and choice of substantive law. But to rest this case on the general policy of treating arbitration agreements as enforceable as such would be to beg the question, which is whether the FAA has textual features at odds with enforcing a contract to expand judicial review following the arbitration.**
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> **"To that particular question we think the answer is yes, that the text compels a reading of the §§ 10 and 11 categories as exclusive….Sections 10 and 11, after all, address egregious departures from the parties' agreed-upon arbitration: "corruption", 'fraud', 'evident partiality', 'misconduct', 'misbehavior', 'exceed[ing] powers', 'evident material miscalculation', 'evident material mistake', 'award[s] upon a matter not submitted'; the only ground with any softer focus is 'imperfect[ions]', and a court may correct those only if they go to '[a] matter of form not affecting the merits.'…'Fraud' and a mistake of law are not cut from the same cloth.**

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[6] 128 S.Ct. at 1401.

> **"That aside, expanding the detailed categories would rub too much against the grain of the § 9 language, where provision for judicial confirmation carries no hint of flexibility. On application for an order confirming the arbitration award, the court 'must grant' the order 'unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title.' There is nothing malleable about 'must grant', which unequivocally tells courts to grant confirmation in all cases, except when one of the 'prescribed' exceptions applies….**
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> **"Instead of fighting the text, it makes more sense to see the three provisions, §§ 9-11, as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. Any other reading opens the door to the full-bore legal and evidentiary appeals that can 'rende[r] informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process', and bring arbitration theory to grief in post-arbitration process.'"[7]**

The Supreme Court acknowledged that the underlying dispute in *Hall Street* was arguably governed by the District Court's authority to manage its cases under the Federal Rules of Civil Procedure (rather than being governed by the Federal Arbitration Act), since the arbitration agreement was signed in the context of a District Court litigation and was adopted as an order of the District Court after being submitted as a proposed deviation from standard trial procedure. However, after "noting the claim of relevant case management authority independent of the [Federal Arbitration Act]", the Supreme Court held that in cases unambiguously governed by the FAA the courts cannot enforce parties' contractual agreements providing for judicial review of arbitrators' conclusions of law.[8]

New York Construction Projects

[7] 128 S.Ct. at 1404-1405 (citations omitted).

[8] 128 S.Ct. at 1407.

Whether arbitration agreements contained in New York construction contracts are governed by the FAA or Article 75 of the CPLR was addressed by the New York State Court of Appeals in *Diamond Waterproofing*.[9] Diamond, a contractor, entered into a contract with a cooperative owner to repair and reconstruct the entire façade and roof of a residential building in Manhattan. The contract provided for arbitration of "[a]ny controversy or Claim arising out of or related to the Contract", and stated that the contract "shall be governed by the law of the place where the Project is located." Even though the FAA was not mentioned in the contract, the Court of Appeals concluded that the project "affected interstate commerce, triggering application of the FAA"[10]:

> **"Numerous out-of-state entities were involved in the transaction. The project manual and the engineer's drawings were created in a joint effort with a structural engineering firm headquartered in Illinois. Diamond Systems' largest supplier of materials for the project, MJM Studios, Inc., was a New Jersey company, and project meetings and visits were often scheduled at MJM's offices. The largest supplier of equipment for the project, Dunlop Equipment, Inc., was a Massachusetts company. Further, various additional materials, equipment and services for the project were obtained from Oklahoma, Maryland and Kansas."[11]**

Since the involvement of out-of-state entities described in *Diamond Waterproofing* is fairly typical of New York construction projects, *Diamond Waterproofing* suggests that arbitration agreements contained in most New York construction contracts are governed by the FAA, which means that, absent contract language along the lines

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[9] *Supra* at n. 2.

[10] Section 2 of the FAA (9 U.S.C. § 2) states that a written arbitration provision in "a contract evidencing a transaction involving commerce…shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

[11] 4 NY3d at 252, 793 NYS2d at 834.

discussed below, *Hall Street* will generally preclude parties to New York construction contracts from contractually providing for judicial review of arbitrators' errors of law.

Drafting Arbitration Agreements

Within the narrow constraints imposed by *Hall Street*, there are opportunities for creative draftsmanship on the part of construction counsel (and their clients) who are seeking the advantages of alternative dispute resolution while trying to establish greater predictability concerning the legal principles which will govern project disputes.

One way of enhancing legal predictability is to include contractual limitations on the arbitrators' authority. Sections 10 and 11 of the FAA authorize vacatur of an arbitration award where, among other things, "the arbitrators exceeded their powers" (§ 10) or "the arbitrators have awarded upon a matter not submitted to them" (§ 11). This suggests a strategy of including provisions in arbitration agreements expressly limiting what the arbitrators will be authorized to do. For example, if the parties wish to impose limitations on the arbitrators' authority to award damages due to delay (or similar factors), the arbitration agreement might include a provision stating: "Nothing in this arbitration agreement shall authorize the arbitrator(s) to make an award of damages resulting from _____, and the arbitrator(s) are expressly prohibited from doing so. No matter calling for such

award shall be deemed submitted to the arbitrator(s) under the terms of this arbitration agreement."

On the other hand, parties who oppose such limitations on the arbitrators' authority should try to negotiate arbitration provisions reflecting the legal principles that they believe should govern (e.g., "Nothing in this arbitration agreement shall preclude the arbitrator(s) from making an award of damages reasonably resulting from _____, and the arbitrator(s) are expressly authorized to do so.").

These provisions would presumably establish a basis to seek judicial review of the arbitration award (under the language of §§ 10 and 11) if the arbitrators violate the restrictions on their authority set forth in the arbitration agreement. Needless to say, such provisions might also enhance predictability by giving arbitrators express guidance concerning the limits of their authority and the agreed principles they should apply.

It is increasingly common for arbitration clauses in construction contracts to include provision for non-binding mediation as a condition precedent to arbitration. For contracts requiring mediation as a condition precedent to arbitration, counsel should consider whether mediation provisions should limit the mediator's authority so as to be parallel with any *Hall Street*-inspired limitations upon the arbitrators' authority which would be applicable if the mediation is unsuccessful. Arguably such limitations upon the mediator's authority would be counterproductive because a mediator should have a free hand to explore settlement options without preconceived limitations. So long as mediation provisions are properly coordinated

with arbitration provisions to clearly establish whether any mediation-related condition precedents to arbitration have been satisfied, it should be unnecessary to limit the mediator's authority even where arbitrators' authority is limited by the arbitration clause.

In short, construction counsel should consider replacing the traditional "all disputes" arbitration clause with legal provisions expressly tailored as limitations upon the arbitrators' authority—thereby triggering potential protections under §§ 10 and 11 of the FAA.[12] While it is, of course, difficult to anticipate at the drafting stage all potential disputes which may arise in connection with a construction project, it appears that limiting the arbitrators' authority in the language of an arbitration agreement might be an effective means of imposing legal standards in the aftermath of *Hall Street*.

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[12] *See* 7B McKinney's CPLR Practice Commentaries, C7501:13: "*Mastrobuono [v. Shearson Lehman Hutton, Inc.,* 514 U.S. 52, 115 S.Ct. 1212, 131 L.Ed.2d 76 (1995)] suggests that any circumscription of the authority of an arbitrator in an FAA-governed contract must be clearly expressed, whether the matter concerns the arbitrator's power to award particular remedies or to decide the timeliness of a party's claim….The evolving case law suggests that any party to an FAA-governed contract who wishes to preclude an arbitrator from deciding certain issues must explicitly delineate any such restrictions in the arbitration clause itself."