New Jersey Refuses to Enforce Arbitration Agreement
By P. Jean Baker
There was no “meeting of the minds” because the parties did not understand the rights under the arbitration agreement that ostensibly foreclosed the plaintiff’s right to a jury trial.

New Jersey Court Puts Brakes on Arbitration after Car Deals Are Called Off
By Shira Forman
Appellate court finds that, because the parties rescinded their purchase agreement, their agreement to arbitrate all disputes is rescinded too.

Circuit Split Widens over Waiver of FINRA Arbitration Rights
By Beth Graham
Four circuit courts of appeals are split over whether a forum selection clause related to “all actions and proceedings” encompasses FINRA arbitration.

Understanding Prima Paint’s Severability Rule
By Charles E. Harris II
This article provides a detailed explanation of a basic, but often misunderstood, rule under substantive federal arbitration law, Prima Paint’s “severability rule.”

U.S. Supreme Court Justices Unanimous on Threshold Arbitrability Issue
By Melinda G. Gordon
A unanimous Court finds the “wholly groundless” exception to arbitration agreement inconsistent with Federal Arbitration Act and Supreme Court precedent.
Practice Points »

What Will They Think of Next?
By Mitchell L. Marinello
The FAA says state law may not discriminate against arbitration agreements, but state legislatures and courts, most recently in Kentucky, keep coming up with new ways to avoid this ruling.

Parties Share Responsibility for Getting Complete Arbitrator Disclosures
By Jeanne Kohler
A party’s failure to ask questions can doom its later effort to avoid confirmation of the award.
New Jersey Refuses to Enforce Arbitration Agreement

By P. Jean Baker – March 12, 2019

Enforcement of arbitration agreements just got more difficult in New Jersey. Continuing a trend that began in 2014, the New Jersey Appellate Division refused to enforce an arbitration agreement in an employment contract because the drafter did not identify an arbitral forum, such as the American Arbitration Association (AAA), or a process for conducting the proceeding. The parties therefore lacked a “meeting of the minds” because they “did not understand the rights under the arbitration agreement that ostensibly foreclosed plaintiff’s right to a jury trial.” Flanzman v. Jenny Craig, Inc., No. A-2580-17T1 (N.J. Super. Ct. App. Div. Oct. 17, 2018).

Compelling Arbitration

In Flanzman, the plaintiff was terminated at the age of 82 following 26 years of employment. She sued her former employer pursuant to a New Jersey discrimination statute. The employer moved to compel arbitration, relying on an agreement executed by the plaintiff as a requirement of continued employment following 20 years of service. The plaintiff did not recall signing the document at age 76 or agreeing to waive her right to a jury trial. The court granted the defendant’s motion to compel arbitration.

No “Meeting of the Minds”

The Appellate Division reversed the order compelling arbitration for lack of mutual assent. In their initial decision issued on October 17, 2018, the panel reasoned that where an arbitration agreement does not select an arbitral institution, such as the AAA or JAMS, parties lack basic information concerning the rights and procedures that would replace a jury trial; thus, parties will not have the requisite “meeting of the minds” necessary to compel arbitration. The court further explained that institutions like the AAA or JAMS have well-established arbitration rules and procedures and that by selecting one of these arbitral institutions, the parties are well informed about the rights and procedures that will replace the rights that they have waived by agreeing to arbitration.

The court noted that the motion judge recognized that the arbitration agreement failed to specify a forum when he ordered that “the choice of which arbitral body would conduct the arbitration would be turned over to the plaintiff”—thus unilaterally deciding who got to pick the forum. This action violated the New Jersey Supreme Court’s holding in Atalese v. Legal Services Group L.P., 219 N.J. 430 (2014), requiring courts to enforce arbitration agreements
according to the terms mutually agreed upon by the parties. *Atalese* requires courts to “take particular care in assuring the knowing assent of both parties to arbitrate, and a clear understanding of the ramifications of that assent.”

Although not binding precedent, the court noted that when a similar issue arose in another jurisdiction, the Mississippi Supreme Court was unwilling to permit a judge to select—“or, like here, unilaterally allow one party to do so after the fact”—an arbitration forum when the one selected by the parties in their arbitration agreement was unavailable. *Covenant Health & Rehab. of Picayune v. Estate of Moulds Braddock*, 14 So. 3d 695 (Miss. 2009). The *Flanzman* court concluded that by failing to invalidate the arbitration clause in this case, the motion judge had impermissibly attempted to unilaterally rewrite the arbitration agreement.

**The Importance of Selecting an Arbitral Forum**
The court stressed that selecting an arbitral forum informs the parties, at a minimum, about the institution’s arbitration rules and procedures. The AAA’s employment arbitration rules “adhere[] to due process safeguards,” such as notification requirements; initiation of proceedings; discovery; location of hearings; arbitrator selection; and the relevant fees, expenses, and costs. The selection of AAA, JAMS, or any other arbitral forum “informs the parties about the rights that replace those that they waived in the arbitration agreement.”

**No “Magic Words” Guaranteeing Enforcement**
The court went on to clarify that the decision was not meant to imply there must be “magic words” in the agreement as to the rights that replace the right to judicial adjudication. But the arbitration agreement must reflect a “clear and mutual understanding of the ramifications of the parties’ mutual assent to waive adjudication by a court of law.” To do that, the provision must at a minimum “express in some fashion what that process [the arbitration] is.” Thus, “if the parties do not identify an arbitral institution (such as AAA or JAMS), then they should identify the process for selecting an alternate forum.” Failing to do that results in the parties having no realistic idea about the rights that replaced judicial adjudication, “because not all arbitration forums, mechanisms, or settings are alike.”

**Revised Opinion**
On November 13, 2018, the court issued a more expansive opinion that reached the same conclusion but elaborated on the merits of the case and the panel’s reasoning. *Flanzman v. Jenny Craig, Inc.*, No. A-2580-17T1, slip op. at 9–14 (N.J. Super. Ct. App. Div. Nov. 13, 2018). The revised opinion details the actions taken by the trial judge that clearly indicated there had been no “meeting of the minds.” In particular, the trial judge, relying on a confusing reference in the agreement to the plaintiff only having to pay the then current Superior Court of California filing
fee toward the costs of arbitration, concluded “it can be deduced from the arbitration agreement that California law will control the arbitration” so California would be the arbitral forum. At this point in the proceeding, defense counsel “without any support whatsoever in the language of the agreement” began to engage in “improvised negotiation,” stating that the defendant was flexible about permitting the arbitration proceeding to take place closer to New Jersey as long as California law governed. In response, the motion judge “unilaterally” decided “in the interest of fairness” that the plaintiff would have the choice of which “arbitral body” would conduct the arbitration. “In reaching this decision, the motion judge “re-wrote the agreement but failed to clarify its inherent ambiguity.”

In a footnote, the court highlighted that even if the agreement required application of California law—which in the opinion of the court it did not—the motion judge did not analyze whether the agreement was enforceable under California law before compelling arbitration.

**Courts Not Empowered to Select a Forum**

The revised opinion further explains that, unlike the facts in *Kleine* (described below), this was not a situation in which the arbitral forum (AAA) designated in the agreement was unavailable. (*Kleine v. Emeritus at Emerson*, 445 N.J. Super. 545 (App. Div. 2016) (refusing to compel arbitration because there was no meeting of the minds as to an arbitral forum if AAA was not available).) Nor was this a situation in which the parties “simply failed to identify a specific method for selecting an arbitrator.” Had that been the situation, either party could have rectified the procedural problem by having the court appoint an arbitrator in accordance with either the New Jersey statute or the Federal Arbitration Act. Neither statute, however, provides a method for a court to appoint a “forum.” The court concluded the parties were aware of this statutory limitation on court authority because neither side argued on appeal that the motion judge should have appointed an arbitrator.

Having failed to reach any agreement as to the arbitral forum or the general process selected, the parties failed to appreciate fully the ramifications of the supposed arbitration agreement, as required by *Atalese*. Thus, there was no “meeting of the minds” and the arbitration agreement was invalid.

**Practice Tip**

Attorneys representing clients who include arbitration agreements in their contracts need to immediately review the wording of those clauses to ensure enforcement in New Jersey. The baseline standard for enforcement was set by the New Jersey Supreme Court in 2014 in *Atalese*. Namely, there must be “clear and unambiguous language” that explains what rights a plaintiff is waiving by agreeing to arbitrate instead of litigating future claims. In 2016 in *Kleine*,

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the New Jersey Appellate Division added a second potential impediment to enforcement. Should the forum chosen by the parties be unavailable, the arbitration agreement will be invalid unless the parties identified an alternative forum. Flanzman now requires that drafters of arbitration agreements identify an alternative dispute resolution forum or a process for conducting arbitration.

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New Jersey Court Puts Brakes on Arbitration after Car Deals Are Called Off

By Shira Forman – March 12, 2019

Your new car may be returnable, but are you stuck with the arbitration agreement you signed when you bought it?

This was the question confronted by the Appellate Division of the Superior Court of New Jersey in a recent set of appeals involving car purchases that were rescinded, leaving confusion about the enforceability of the arbitration agreements signed by the buyers and sellers: Goffe v. Foulke Management Corp., and Robinson v. Mall Chevrolet, Inc., Nos. A-2658-16T4, A-2659-16T4 (N.J. Super. Ct. App. Div. Apr. 24, 2018).

New Cars . . . and Second Thoughts
The appeal encompassed two separate cases with similar facts. In the first, Sasha Robinson purchased a 2016 Chevrolet Malibu from her local Chevrolet dealer. As part of the purchase, she traded in a vehicle she owned jointly with her mother and was told that her mother would have to co-sign the paperwork to complete the purchase. Robinson signed a sales agreement that included an arbitration provision stating that both parties have an absolute right to demand that any dispute be submitted to arbitration. Robinson paid her security deposit, took home the car, and was told to return with her mother to complete the paperwork.

Robinson returned with her mother—not to sign the papers but to return the car, which she decided was too expensive. The dealership at first told Robinson it would not take back the car and then tried to discourage the return, first by threatening to retain the security deposit and the traded-in car, and next by offering to reduce the monthly charges on the car. Ultimately, the dealership returned the trade-in but refunded the deposit only after Robinson filed a lawsuit.

The second case involved Janell Goffe, who bought a 2013 Buick Verano from her local Mitsubishi dealership, also on a trade-in. She was told at the dealership that financing for her car was approved, and she made an initial payment before leaving with the Buick. Goffe signed the same sales agreement as Robinson, with the same arbitration provision. When she returned two weeks later to pay the rest of her down payment, she was told that financing had not been approved and she could keep the car only if she agreed to an increased down payment and higher monthly payments. Goffe decided to instead return the car. The dealership initially refused to return her down payment and did so only after she filed a lawsuit.
The Arbitration Question
Both Robinson and Goffe sued their respective dealerships for fraud and violations of various New Jersey consumer protection statutes, and the dealerships moved to compel arbitration based on the arbitration provisions in the sales agreements. Both cases were dismissed on the grounds that the plaintiffs’ claims were arbitrable.

On appeal, the plaintiffs argued that the sales contracts—and the arbitration provisions within them—are no longer applicable. That is to say, when the parties reached an agreement to rescind the car sales, the arbitration provisions they had previously signed were also rescinded.

“Return to Square One”
The court agreed with the plaintiffs’ argument and concluded that, as a general rule, when parties to a contract that contains an agreement to arbitrate later agree to rescind that contract, they cannot be compelled to arbitrate disputes that grow out of the agreement to rescind. The legal effect of the rescission, according to the court, is a “return to square one—in legal terms, the status quo ante—defendants implicitly agreed to rescind all plaintiffs’ obligations just as plaintiffs agreed to a rescission of all defendants’ promises.” Just as the rescission nullified the parties’ obligations concerning the car purchase, “there can be no doubt that the arbitration provisions were discarded in the process.”

The court also held that, in each case, there were disputes as to whether the parties ever reached an enforceable sales contract (for reasons including the allegation that neither dealership provided the plaintiffs with a copy of the sale agreement, which is required under state law). If there was no contract, the parties cannot be said to have agreed to arbitrate disputes coming out of said contract. The court concluded that the question of whether a contract was formed is not arbitrable.

Next Steps
Both cases were remanded to the trial court for limited discovery and, possibly, evidentiary hearings, to determine whether the plaintiffs pleaded claims based on the sales agreement and related negotiations or based on the defendants’ performance of the agreements to rescind. The court noted that it “sense[d] the possibility that plaintiffs may have pleaded causes of action that would include arbitrable claims if the preliminary factual questions we have recognized are resolved in defendants’ favor.” Only once these determinations were made could arbitrability of the plaintiffs’ claims be decided.

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Circuit Split Widens over Waiver of FINRA Arbitration Rights
By Beth Graham – March 12, 2019

A circuit split has recently widened regarding whether a securities broker-dealer may use a forum selection clause to deny clients access to the Financial Industry Regulatory Authority (FINRA) arbitral forum. Under FINRA Rule 12200, a dispute between a “member or associated person of a member” and a “customer” must be arbitrated at the customer’s request so long as the dispute “arises in connection with the business activities of the member or the associated person.” Broker-dealer attempts to avoid FINRA arbitration are being met with mixed results in the circuit courts of appeals.

Reading Health System
In Reading Health System v. Bear Stearns & Co., No. 16-4234 (3d Cir. Aug. 7, 2018), Reading Health, a Pennsylvania-based not-for-profit health care system, issued millions of dollars in capital campaign debt using auction rate securities (ARS) that were distributed by securities brokerage Bear Stearns between 2001 and 2007. As part of issuing the ARS, Reading executed a number of contracts with the securities brokerage. Two of those agreements contained a forum selection clause that required the parties to resolve any disputes arising out of the contracts through litigation in the Southern District of New York.

After the ARS market collapsed, Reading Health filed a request for arbitration with FINRA over the brokerage’s purported mishandling of Reading Health’s ARS offerings. The securities brokerage responded by claiming Reading Health waived its right to arbitration when it executed the ARS contracts that contained a forum selection clause. Reading Health then filed an action in the Eastern District of Pennsylvania seeking to compel the securities brokerage to submit to arbitral proceedings before FINRA. The securities brokerage filed a motion to transfer the case to the Southern District of New York and a motion to enjoin FINRA arbitration. The Pennsylvania district court denied the brokerage’s request to transfer the case and ordered the parties to engage in FINRA arbitration. The broker-dealer then filed an interlocutory appeal with the Third Circuit Court of Appeals.

On appeal, the Third Circuit ruled that the “district court properly resolved the transfer dispute before the arbitrability dispute.” Because the forum selection clause included in the parties’ contracts did not waive Reading Health’s rights under FINRA Rule 12200, the Third Circuit held that the district court properly concluded the securities broker was required to arbitrate Reading Health’s claims. The Third Circuit ultimately affirmed the district court’s order.
“declining to transfer Reading’s declaratory judgment action” and compelling the broker-dealer “to submit to FINRA arbitration.”

**Carilion Clinic**

In *UBS Financial Services, Inc. v. Carilion Clinic*, No. 12-2066 (4th Cir. Jan. 23, 2013), the Court of Appeals for the Fourth Circuit held that broker-dealers must engage in arbitral proceedings under FINRA Rule 12200. In that case, Carilion, a Virginia-based not-for-profit health care system, issued a series of auction-rate bonds. As part of the bond issuance, Carilion entered into both broker-dealer and underwriting agreements with UBS and Citi. In response to significant financial losses related to the bonds, Carilion initiated FINRA arbitration proceedings against the two broker-dealers.

UBS and Citi sought a declaratory judgment against Carilion. According to the broker-dealers, “Carilion was not a ‘customer’ entitled to arbitration under the FINRA Rules,” and Carilion previously agreed “in the forum selection clause of the broker-dealer agreements, to litigate, rather than arbitrate, all disputes in a federal court in New York County.” The district court held that Carilion was a customer under the FINRA arbitration rules and stated the forum selection clause at issue had no effect on the broker-dealers’ arbitration obligations due to the “federal policy favoring arbitration.”

On appeal, the Fourth Circuit also rejected the broker-dealers’ claim that Carilion was not a customer under the FINRA rules. In addition, the court stated that it would expect a forum selection clause that was intended to supersede a party’s right to arbitration to mention arbitration. The court added that it was a “more natural reading of the forum selection clause to require that any litigation arising out of the agreement would have to be brought in the U.S. district court in New York County and that as to any such action or proceeding, a jury trial would be waived.” Finally, the court rejected the notion that the forum selection clause waived Carilion’s right to arbitration provided by FINRA Rule 12200 and affirmed the district court.

**Golden Empire School Financing Authority and North Carolina Eastern Municipal Power Agency**

In the consolidated cases of *Goldman, Sachs & Co. v. Golden Empire School Financing Authority* and *Citigroup Global Markets Inc. v. North Carolina Eastern Municipal Power Agency*, Nos. 13-797-CV, 13-2247-CV (2d Cir. Aug. 21, 2014), the Court of Appeals for the Second Circuit held that a later-executed contract that includes a forum selection clause requiring “all actions and proceedings” to be litigated superseded FINRA Rule 12200.
In *Golden Empire School Financing Authority*, a school district issued capital campaign debt using ARS that were distributed by Goldman Sachs. As part of the transaction, the school district and Goldman Sachs executed a series of broker-dealer agreements in 2004, 2006, and 2007. The agreements, however, were silent on the issue of alternative dispute resolution. In addition, the 2007 agreement included a forum selection clause requiring “all actions and proceedings” to be litigated in New York. Each contract included a merger clause stating all agreements executed in connection with the issuance of ARS constituted the parties’ entire agreement.

Later, the school district commenced FINRA arbitration proceedings, and Goldman Sachs filed a motion for declaratory and injunctive relief. A district court ruled that the forum selection clause included in the 2007 broker-dealer agreement superseded the FINRA rule providing for arbitration, and the school district filed an interlocutory appeal. The procedural history in *North Carolina Eastern Municipal Power Agency* was sufficiently similar to be consolidated with the *Goldman Sachs* case.

The Second Circuit distinguished the Fourth Circuit’s recent precedent in *Carilion Clinic* and concluded that the forum selection clause contained in the broker-dealer contracts must be interpreted broadly to include arbitration proceedings. The court also cited its own decision in *Applied Energetics v. NewOak Capital Markets* holding that a FINRA arbitration must be enjoined because the mandatory adjudication provision of the parties’ later agreement superseded an earlier contract requiring arbitration of their disputes. Ultimately, the court held that “the forum selection clause at issue in these cases is plainly sufficient to supersede FINRA Rule 12200.”

**City of Reno**

In *Goldman, Sachs & Co. v. City of Reno*, No. 13-15445 (9th Cir. Mar. 31, 2014), the City of Reno, Nevada, issued more than $200 million in securities with Goldman Sachs acting as both broker-dealer and underwriter in 2005 and 2006. Later, the city brought a FINRA arbitration against Goldman Sachs. Goldman Sachs sought to enjoin the arbitration proceedings. According to the broker-dealer, the City of Reno was not a customer under the FINRA arbitration rules and the city relinquished its right to arbitrate when it signed a contract that contained a forum selection clause. The City of Reno replied by asserting that questions of arbitrability are for an arbitrator to decide.

A district court agreed with the City of Reno and ordered the parties to arbitration. On appeal, the Ninth Circuit Court of Appeals held that the city was clearly a customer under FINRA Rule 12200. Despite this, however, a divided appellate court panel “held that although Reno
qualified as Goldman’s customer under FINRA Rule 12200, Reno disclaimed its right to FINRA arbitration by agreeing to the forum selection clauses in the parties’ agreements.” After that, the case was remanded to the district court.

**Conclusion**
Because the circuit courts of appeals are currently divided on whether the language “all actions and proceedings” encompasses arbitration as well as litigation, it will be interesting to see if the question of whether a party may waive the right to arbitration under FINRA Rule 12200 via a forum selection clause will be addressed by the U.S. Supreme Court.

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Understanding Prima Paint’s Severability Rule

By Charles E. Harris II – March 12, 2019

A fundamental rule of the federal substantive law of arbitrability is that an arbitration provision is severable from the remainder of the contract and thus separately enforceable. Under this rule, commonly referred to as Prima Paint’s severability rule, an arbitrator must decide a challenge to the enforceability of the contract as a whole; conversely, a challenge explicitly directed to the enforceability of an arbitration provision within that contract is a substantive question of arbitrability for judicial determination. While the severability rule seems straightforward enough, courts have misapplied it at times, and it often confuses attorneys. In this article, we discuss the origin of the rule and its correct application. We then examine two recent decisions that illustrate how to properly apply the principle, Rogers v. SWEPI LP, 2018 WL 6444014 (6th Cir. Dec. 10, 2018), and Peeler v. Rocky Mountain Log Homes Canada, Inc., 431 P.3d 911 (Mont. 2018).

Prima Paint and Its Progeny

The severability rule originated in Prima Paint Corp. v. Flood & Conklin Manufacturing Co., 388 U.S. 395 (1967). The precise question the Supreme Court faced was whether a court or an arbitrator should resolve Prima Paint’s fraudulent inducement claim—i.e., that the contract at issue was fraudulently induced and thus unenforceable. As an initial matter, the Court held that the Federal Arbitration Act (FAA) governed the contract because the contract evinced a transaction involving interstate commerce. Id. at 399; see also 9 U.S.C. § 1 (“commerce” means “commerce among the several States”). The court then focused on the FAA’s text to resolve the central issue. Specifically, section 4 of the act states that, “upon being satisfied that the making of the agreement for arbitration . . . is not in issue,” the court must direct the parties to arbitration. 9 U.S.C. § 4 (emphasis added); see also Rent-A-Center, W., Inc. v. Jackson, 561 U.S. 63, 70 (2010) (quoting 9 U.S.C. § 2) (section 2 of the FAA provides that a “written provision” to “settle by arbitration a controversy” is enforceable “without mention of the validity of the contract in which it is contained”). Relying on section 4’s language, the Court held that, when a party claims that the other party fraudulently induced it to consent to an arbitration provision—“an issue which goes to the ‘making’ of the agreement to arbitrate”—the court may decide the dispute. Prima Paint, 388 U.S. at 404. In contrast, section 4 doesn’t permit a court to “consider claims of fraud in the inducement of the contract generally.” Id.
Two subsequent decisions, *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006), and *Rent-A-Center*, helped refine the contours of the severability rule. In *Buckeye*, the Court made clear that the rule applies outside the fraudulent inducement context. It held that, because “an arbitration provision is severable” under federal substantive law, an arbitrator should resolve the issue of the contract’s enforceability “unless the challenge is to the arbitration clause itself.” 546 U.S. at 446. Courts consider whether the “crux” of a complaint is a challenge to the enforceability of the contract as a whole or to the arbitration clause itself to decide if it or an arbitrator should hear a dispute. *Id.* at 444. The Court readily acknowledged that, as a practical matter, the severability rule “permits a court to enforce an arbitration agreement in a contract that the arbitrator later finds to be void.” *Id.* at 448. But this operation of the rule is consistent with the long-standing principle that “any doubts concerning the scope of arbitral issues should 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 also held that the severability rule applies whether a party brings a challenge to the enforceability of an arbitration provision in federal or state court. *Buckeye*, 546 U.S. at 446; see also *Southland Corp. v. Keating*, 465 U.S. 1, 15–16 (1984) (the FAA creates substantive law applicable in state as well as federal courts).

In *Rent-A-Center*, the Court considered whether it should enforce a “delegation provision” embedded in an arbitration agreement. Under delegation provisions, parties depart from the default rule and expressly authorize an arbitrator, not the court, to decide substantive issues of arbitrability, such as the enforceability of the arbitration agreement. 561 U.S. at 71. Invoking the severability rule, the plaintiff, Jackson, argued that the court should decide whether the arbitration agreement was enforceable because he specifically attacked that agreement. *Id.* The Supreme Court disagreed. It noted that the delegation provision in this context is the separate written provision to arbitrate that Rent-A-Center asked the courts to enforce, and the rest of the contract is the agreement to arbitrate Jackson’s underlying claims. Applying the severability rule, the Court held that it must enforce the delegation provision and, under the terms of that provision, leave any challenge to the enforceability of the arbitration agreement as a whole for the arbitrator. *Id.* at 73 (citing 9 U.S.C. § 2). In other words, the delegation provision is simply an additional, antecedent agreement to arbitrate that a party “asks the federal court to enforce, and the FAA operates on this additional arbitration agreement just as it does on any other.” *Id.*

This line of cases establishes seven principles for the severability rule’s application:

1. The FAA creates a body of federal substantive law governing contracts for transactions involving interstate commerce.
2. An arbitration provision is severable from the remainder of the contract as a matter of federal substantive law.

3. An arbitrator must decide a challenge to the enforceability of a contract as a whole.

4. A court must decide a challenge explicitly to the enforceability of an arbitration clause.

5. A court should consider the crux of a complaint to decide whether a party attacks the enforceability of the contract as a whole or the arbitration provision itself.

6. The federal substantive law of arbitrability applies in both state and federal court.

7. An antecedent agreement to arbitrate included in an arbitration agreement is severable from the remainder of the arbitration agreement.

We now discuss how Rogers and Peeler applied some of these principles.

Rogers v. SWEPI LP

The contract in Rogers was a phased oil and gas lease involving Shell. The parties agreed that the FAA applied to their dispute because the lease affected commerce. A portion of the lease became effective on execution, allowing Shell to encumber the property and verify title (the first phase). But the remaining obligations under the lease didn’t become effective until Shell paid Rogers a signing bonus (the second phase). Accepting Rogers’s argument, the district court held that the second phase of the contract—which contained the arbitration provision—never became effective because Shell never paid the signing bonus. Thus, the court denied Shell’s motion to compel arbitration. 2018 WL 6444014 at *2.

A divided Sixth Circuit panel reversed. The court didn’t buy Rogers’s contention that he had attacked the arbitration clause’s formation. Rogers, in fact, admitted that he executed the lease and his “attack on the arbitration provision assumes the contract was formed; that it conferred obligations on the parties; and that Shell failed to perform one of its obligations, meaning the arbitration clause was never triggered.” Id. at *3. The court explained that, while courts resolve challenges to the enforceability of “the specific arbitration clause” as a matter of federal substantive law, Rogers didn’t attack “the enforceability of the ‘specific arbitration clause.’” Id. at *4 (quoting Granite Rock Co. v. Int’l Bhd. of Teamsters, 561 U.S. 287, 296 (2010)). Instead, he argued that “much of the contract, which happens to include the arbitration clause, is unenforceable.” Id. Because Rogers didn’t specifically attack the arbitration clause, the Sixth Circuit held that an arbitrator must consider his enforceability challenge. In reaching a contrary conclusion, the dissenting judge seemingly ignored the dispositive point that Rogers had broadly attacked the validity of the entire contract, not the arbitration agreement specifically. See id. at *8 (Moore, J., dissenting).
Peeler v. Rocky Mountain Log Homes Canada, Inc.

Peeler, a Florida resident, entered into a contract with White River, a Montana company, to build a home in Montana; the contract contained a broad arbitration provision. Peeler filed suit in a Montana trial court for breach of contract and related claims after White River allegedly failed to deliver the home as provided under the contract. But the trial court granted White River’s motion to compel arbitration and dismissed the action. Peeler, 431 P.3d at 917–18.

The Montana Supreme Court unanimously affirmed the trial court’s decision. The court didn’t distinguish between the FAA and the Montana Uniform Arbitration Act because the parties had not contended that the choice of arbitration law made any difference. Id. at 918. Applying the severability rule, the court noted that Peeler didn’t contest that he and White River formed a valid contract or that he freely consented to the contract’s arbitration provision. Quite the contrary, he brought claims, such as breach of contract, that posit the existence of an enforceable agreement. Id. at 920. Noting that Peeler “did not raise any challenge” in the trial court “regarding the validity or enforceability of the arbitration agreement apart from the balance of the larger contract,” the court held that an arbitrator should hear Peeler’s enforceability challenges. Id. It also emphasized that the severability rule prevents a party who “validly agreed to arbitrate from subsequently avoiding arbitration by pleading claims asserting that the large contract, or other aspects thereof, are void.” Id. at 919.

Conclusion

Prima Paint’s severability rule addresses the question of whether a court or an arbitrator decides a challenge to the enforceability of an arbitration provision: An arbitrator hears attacks on the enforceability of an entire contract, while attacks expressly aimed at the arbitration provision are for a court to decide. Indeed, as a matter of federal substantive law, courts decide substantive (or gateway) questions of arbitrability, such as whether the parties have an enforceable arbitration clause, unless the parties clearly and unmistakably provide otherwise. Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79, 83 (2002).

The author has observed that many courts (or attorneys) appear confused by the severability rule in the many cases in which he moved to compel arbitration over the years. E.g., Henderson v. U.S. Patent Comm’n, Ltd., 15 C 3897, 2015 WL 6791396, at *5 (N.D. Ill. Nov. 2, 2015) (citing Buckeye, 546 U.S. at 449) (“Henderson alleges that Defendants’ scheme contained fraudulent elements, but those elements do not relate to the arbitration provisions themselves; they instead affect the validity of the agreements as a whole and thus, again, are matters for the arbitrator”) (internal citations omitted). However, the well-reasoned opinions
in *Rogers* and *Peeler* show that courts do indeed understand how to apply this rule. It is hoped that this article will serve as a helpful tool for any judge, arbitrator, or counsel seeking a better grasp of the severability rule.

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U.S. Supreme Court Justices Unanimous on Threshold Arbitrability Issue

By Melinda G. Gordon – March 12, 2019

Deciding an important gateway issue that has divided the courts, the Supreme Court held in Henry Schein Inc., v. Archer and White Sales Inc. (Schein v. Archer & White), No. 17-1272, slip op. (Jan. 8, 2019), that the Federal Arbitration Act (FAA) requires courts to enforce arbitration agreements that delegate issues of arbitrability to the arbitrator even if they believe that the claim of arbitrability is “wholly groundless.” In a unanimous decision, the Supreme Court determined that the “wholly groundless,” exception to arbitrability, which would permit a court, instead of an arbitrator, to resolve the arbitrability issue, is inconsistent with the FAA. Relying on both the FAA and Supreme Court precedent, the Court found that the threshold question of arbitrability is a question for the arbitrator, not the courts, to decide.

Recognizing that the parties to an arbitration agreement may agree to arbitrate the merits of the dispute, in addition to “gateway” questions of arbitrability, the Court, citing AT&T Technologies Inc., v. Communications Workers, 475 U.S. 643, 649–50 (1986), concluded that a court may not decide an arbitrability question that the parties have agreed to submit to an arbitrator. The Court noted that it has consistently held that parties may delegate threshold arbitrability questions to the arbitrator as long as the parties’ agreement does so by “clear and unmistakable” evidence. First Options of Chi., Inc. v. Kaplan, 514 U.S. 938, 943–44 (1995); Rent-A-Center, W., Inc., v. Jackson, 561 U.S. 63, 69 n.1 (2009).

Background

In this case, the contract between the parties, Henry Schein, Inc., and Archer and White Sales, Inc., contained an arbitration agreement that specifically excluded the arbitration of certain disputes, including actions seeking injunctive relief. Archer and White sued Schein alleging antitrust violations. Archer and White asserted that the dispute was not arbitrable because the complaint sought, in part, injunctive relief. Schein moved to compel arbitration, asserting that an arbitrator, not the court, should decide the threshold arbitrability issue. Schein argued that the arbitration agreement’s express reference to the American Arbitration Association (AAA) rules providing that arbitrators are empowered to decide questions of arbitrability indicated that the arbitrator, not the court, must initially determine whether the dispute was subject to arbitration. Archer and White countered that Schein’s argument for arbitration was “wholly groundless.”
Lower Courts
The district court denied Schein’s motion to compel arbitration finding that the dispute could not proceed to arbitration because the plain language of the arbitration clause expressly excluded arbitration of matters involving requests for injunctive relief. *Archer and White Sales, Inc. v. Henry Schein, Inc.*, 2016 WL 7157421, at *8–9 (E.D. Tex. Dec. 2016). Reviewing the district court’s decision de novo, the Fifth Circuit affirmed. *Archer and White Sales, Inc. v. Henry Schein*, 878 F.3d 488, 495–98 (5th Cir. 2017). Both the district court and the Fifth Circuit determined that regardless of how clear the agreement of the parties might be, it would be a waste of time to send the case to an arbitrator because the claim of arbitrability was “wholly groundless.” *Schein v. Archer & White*, slip op. at 3.

Analysis
Based on the division between the U.S. Courts of Appeals for the Fourth, Fifth, Sixth, and Federal Circuits and the U.S. Courts of Appeals for the Tenth and Eleventh Circuits as to whether or not the “wholly groundless” exception is consistent with the FAA, the Supreme Court granted certiorari to review this important threshold arbitration issue. The Supreme Court determined that the “wholly groundless” exception is inconsistent with the FAA and Supreme Court precedent.

When the parties’ contract delegates the arbitrability question to an arbitrator, a court may not override the contract. In those circumstances, a court possesses no power to decide the arbitrability issue. That is true even if the court thinks that the argument that the arbitration agreement applies to a particular dispute is wholly groundless.

*Schein v. Archer & White*, slip op. at 5.

The Court determined that under the FAA, arbitration is a matter of contract and courts must enforce arbitration contracts, according to their terms. *Id.* at 4 (citing *Rent-A-Center*). The Court noted that because the FAA does not contain a “wholly groundless” exception, the Court was not “at liberty to rewrite the statute passed by Congress and signed by the President.” *Id.* at 2. In rejecting the “wholly groundless” exception, the Supreme Court expressed no view about whether the contract at issue, in this case, delegated the arbitrability question to the arbitrator. The Court vacated the judgment of the Fifth Circuit and remanded the case to the Fifth Circuit to decide whether the parties’ incorporation of the AAA’s arbitration rules, which included a provision empowering an arbitrator to rule on his or her own jurisdiction, constituted “clear and unmistakable” evidence that the parties agreed to delegate the question of arbitrability to...
the arbitrator. *Id.* at 8. Parties preferring courts, rather than arbitrators, to decide gateway arbitrability issues may wish to consider specifically incorporating such language into their arbitration agreements.

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PRACTICE POINTS

What Will They Think of Next?

By Mitchell L. Marinello – February 27, 2019

The United States Supreme Court has issued several recent decisions stating that the Federal Arbitration Act (FAA) preempts state laws that discriminate against arbitration agreements by placing special conditions or limitations on their enforceability. E.g., Kindred Nursing Home Centers v. Clark, 137 S. Ct. 1421, 1426 (May 15, 2017). But, in some quarters, those decisions are not so popular and state legislatures and courts keep coming up with new ways to avoid them. The latest effort comes from Kentucky. Northern Kentucky Area Development District v. Snyder, 2018 WL 4628143 (September 27, 2018) (Northern District).

In Northern District, the Northern Kentucky Area Development District (Northern) required plaintiff Snyder to enter into an arbitration agreement before hiring her. Snyder signed Northern’s arbitration agreement but, when her employment was terminated, she refused to arbitrate and instead filed suit. The Kentucky trial court denied Northern’s motion to compel arbitration and both the Kentucky appellate court and the Kentucky Supreme Court affirmed. All three courts relied on a Kentucky statute that prohibits an employer from requiring an employee to sign an arbitration agreement as a condition of employment.

The Kentucky statute provides that:

. . . no employer shall require as a condition or precondition of employment that any employee or person seeking employment waive, arbitrate, or otherwise diminish any existing or future claim, right, or benefit to which the employee or person seeking employment would otherwise be entitled under any provision of the Kentucky Revised Statutes or any federal law.

KRS 336.700(2) (KRS 336)

The Kentucky Supreme Court said that it found the “broad preemptive effect of the FAA . . . undeniable” but nonetheless said that “we fail “to see how a law . . . that does not actually attack, single out, or specifically discriminate against arbitration agreements must yield to the FAA.” Id. at 4.

The court held that KRS 336 did not prevent Northern from agreeing to arbitration, “it simply prevents [Northern] from conditioning employment on the employee’s agreement to
arbitration.” According to the court, this was the “key distinction.” *Id.* Explaining its position another way, the court said:

This is not an attack on the arbitration agreement—it is an attack on the employer for basing employment decisions on whether the employee is willing to sign an arbitration agreement.

*Id.* at 5.

Those sympathetic to anti-arbitration protests may find the *Northern District* holding legitimate and even somewhat ingenious. The Kentucky Supreme Court pointed out that KRS 336 does not discriminate against arbitration alone but rather outlaws any attempt by an employer to condition the hiring or continued employment of an employee on the employee’s agreement to relinquish any rights the employee may have against his or her employer; presumably, this would include the employee’s right to sue the employer in a court of law. Whether that reasoning stands up to analysis, however, is questionable. Is the right to bring a lawsuit, which would seem to be a procedural mechanism for vindicating rights, in the same category as a substantive right, such as the protection afforded by state wage and hour laws? And isn’t arbitration a substitute for a civil lawsuit and, in fact, the very substitute that the FAA says state law may not discriminate against?

Of course, whether Northern will seek review and whether SCOTUS will grant any such review are unknown at this time. Ultimately, the question may well be one of priorities if not stamina. Given all of the other important legal issues it faces in a given year, does SCOTUS have the time and energy to supervise every state court that comes up with a new way to distinguish (if not get around) its arbitration rulings?

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Parties Share Responsibility for Getting Complete Arbitrator Disclosures

By Jeanne Kohler – February 13, 2019

The Ninth Circuit recently decided a significant case concerning arbitrator disclosures. It basically held that parties have an obligation to ask questions about the disclosures an arbitrator makes, and if they fail to do so, parties may later not be successful in opposing confirmation of the award on the ground that the arbitrator’s disclosures were incomplete. American Brokerage Network and Cung Thai v. American General Life Insurance Co., No. 3:16-cv-06952 (9th Cir. Nov. 30, 2018).

In 2009, American Brokerage Network and its owner Cung Thai (collectively, ABN) and American General Life and Accident Insurance Company (American), a subsidiary of American International Group, Inc. (AIG), entered into a master general agent agreement, which was terminated in 2013. In 2015, ABN brought an arbitration against American, AIG, and others for various claims under and/or relating to the agreement, and respondents counterclaimed. The sole arbitrator disclosed certain relationships her law firm had with the respondents and their subsidiaries. ABN asked no questions about her disclosures, and she was accepted as the arbitrator.

In June 2016, the arbitrator dismissed AIG from the case. In September 2016, after the evidentiary hearing, the arbitrator issued a final award, denying both sides’ claims for relief. Thereafter, ABN learned, through public records, of alleged undisclosed relationships between the arbitrator’s law firm and the respondents’ subsidiaries. ABN moved in a California federal district court to vacate the final award due to the arbitrator’s alleged incomplete disclosures. The district court granted the motion to vacate, holding that the arbitrator breached her duties of disclosure and investigation, and that the nondisclosures created a reasonable impression of bias. It also held ABN did not waive its right to challenge the arbitrator. Respondents appealed to the Ninth Circuit which reversed.

The Ninth Circuit stated that “given the arbitrator’s disclosure that AIG was a former client of her firm, ABN had some duty to inquire about the nature of that relationship,” but instead “asked no questions and proceeded with the hearing.” According to the court, “the laborious efforts required to discover the undisclosed relationships give credence to the reasonableness of the arbitrator’s investigation.” Finally, the court held that “the undisclosed relationships,
considered in the light of those the arbitrator did disclose, are insufficient to create a ‘[r]easonable impression of partiality.’” Thus, the Ninth Circuit reversed the California district court’s decision and remanded the case with instructions to enter judgment confirming the award.

Arbitrators have a duty to be complete in their disclosures, and their failure to do so can lead, as it did here, to expensive and time-consuming litigation. At the same time, however, this case demonstrates that the parties have an obligation of reasonable inquiry into the disclosures the arbitrator does make. A party’s failure to ask questions can doom its later effort to avoid confirmation of the award.

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