

Recent Case Law Under The Federal Arbitration Act

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There have been a number of recent cases interpreting various aspects of the Federal Arbitration Act (FAA). While none of the cases are specific to reinsurance, all have implications for the reinsurance industry and the reinsurance arbitration process. This article will address three such recent cases, two from the Supreme Court of the United States and one from the United States Court of Appeals for the Third Circuit.

PREEMPTION AND THE FAA

The FAA makes clear that arbitration provisions *shall* be enforced by the courts of the United States. See 9 U.S.C. §2 (a written provision . . . in a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable and enforceable). What if, however, a state declares a certain category of dispute to be unarbitrable as against public policy? This is precisely the situation the United States Supreme Court was tasked with deciding in *Marmet Health Care Center, Inc. v. Brown*, 565 U.S. ___, 2012 WL 538286 (2012).

In *Brown*, the state of West Virginia held that “as a matter of public policy . . . an arbitration clause in a nursing home admission agreement adopted prior to an occurrence of negligence that results in a personal injury or wrongful death, shall not be enforced to compel arbitration of a dispute concerning the negligence.” *Id.* at *1 (quoting *Brown v. Genesis Healthcare Corp.*, No. 35494 (W.VA. June 29, 2011)). In other words, West Virginia held that a specific category of disputes (*i.e.*, personal injury and negligence suits arising from nursing home negligence) were exempt from arbitration and that the FAA did not preempt such a decision. The Supreme Court vacated the West Virginia court’s decision holding that “when state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: the conflicting rule is displaced by the FAA.” *Id.* at *2.

Simply put, *Brown* makes clear that parties are free to contract for arbitration for any type of claim or dispute and that states cannot create any specific exemption from arbitration regardless of the particular states’ public policy concerns. In the reinsurance industry, the *Brown* decision demonstrates that arbitration provisions in reinsurance contracts will be enforced as written and that any efforts to limit their applicability, even if arguably against public policy, will be met with resistance by the federal courts.

BIFURCATION OF ARBITRABLE AND NON-ARBITRABLE CAUSES OF ACTION

In a typical situation, a contract containing an arbitration provision will require that “all disputes” arising under the agreement will be submitted to arbitration. Sometimes, however, an arbitration provision may not cover “all disputes” and where a dispute involves multiple causes of action, some may fall under the arbitration provision and some may not.

In this situation, the question is whether each cause of action should be adjudicated in the same forum (*i.e.*, litigation or arbitration) or whether the causes of action should be broken up into arbitrable and non-arbitrable claims and each set adjudicated separately. This issue was resolved in *KPMG, LLP v. Cocchi*, 132 S.Ct. 23 (U.S. 2011).

In *KPMG*, a lawsuit raising four separate causes of action was brought against KPMG by investors of a limited partnership known as the Rye Funds. *Id.* at 24. The Rye Funds were managed by Tremont Group Holdings, Inc. and Tremont Partners, Inc., both of which were audited by KPMG. *Id.* The Rye Funds were invested with financier Bernard Madoff and allegedly lost millions of dollars as a result of a scheme to defraud. *Id.* at 25.

Based on an audit services agreement that KPMG entered into with the Tremont defendants, KPMG moved to compel arbitration against the plaintiffs. The audit services agreement provided that “[a]ny dispute or claim arising out of or relating to . . . the services provided [by KPMG] . . . shall be resolved” either by mediation or arbitration. *Id.* at 25. The Florida Circuit Court of the Fifteenth Judicial Circuit Palm Beach County denied the motion and the Fourth District Court of Appeal of the State of Florida affirmed noting that “[n]one of the plaintiffs . . . expressly assented in any fashion to [the audit services agreement] or the arbitration provision.” *Id.* Critical to the court’s decision was its finding that the arbitration clause could only be enforced if plaintiffs’ claims were derivative (*i.e.*, they arose from the services KPMG performed for the Tremont defendants pursuant to the audit services agreement). Because the Florida court found that two of the four claims were direct, not derivative, KPMG’s motion to compel arbitration was denied in its entirety.

KPMG appealed the Florida court’s decision to the United States Supreme Court. In vacating the Florida court’s decision, the Supreme Court noted that “when a complaint contains both arbitrable and non-arbitrable claims, the [FAA] requires courts to compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums.” *Id.* at 26. Put another way, the lower court’s decision to deny KPMG’s motion to compel simply because two of the four claims were direct (*i.e.*, non-arbitrable) was in error. The United States Supreme Court remanded the case back to the Florida court of appeal to determine if the other two claims were direct or derivative and, if derivative, those claims were to be decided by arbitration. *Id.*

The *KPMG* case dictates that where a dispute involves both arbitrable and non-arbitrable claims, the arbitrable claims must be decided by arbitration. For the reinsurance industry, this decision makes clear that a ceding company or reinsurer is well within its rights to demand that any arbitrable cause of action be decided by arbitration regardless of whether other causes of action are non-arbitrable and regardless of the inefficiency that may be caused by the bifurcation of the claims.

COMPELLING ARBITRATION WHERE PROCEDURE OUTLINED IN ARBITRATION PROVISION IS UNAVAILABLE

It is not entirely uncommon for arbitration clauses in reinsurance contracts to specify that an arbitration is to be decided by a certain organization or that one or all of the arbitrators is to be selected by a certain organization. What if, however, the specified organization is no longer around? Can parties to agreements in this situation still be compelled to arbitrate and, if so, who selects the replacement arbitrators/umpire? Based on the Third Circuit Court of Appeals’ decision in *Khan v. Dell Inc.*, 2012 WL 163899 (3d Cir. Jan. 20, 2012), parties can be compelled to arbitrate even if the specified organization is unable to adjudicate the dispute and any missing arbitrators/umpire will be selected by the courts.

In *Dell*, Khan purchased a Dell computer online through Dell's website. To complete the purchase, Khan was required to agree to "Dell's Terms and Conditions of Sale." One of the terms was that any dispute "SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION ADMINISTERED BY THE NATIONAL ARBITRATION FORUM (NAF) under its Code of Procedure then in effect." *Id.* at *1 (emphasis in original). Following a number of problems with the computer, Khan filed a putative consumer class action lawsuit against Dell. At the time the lawsuit was filed, the NAF had been barred from conducting consumer arbitrations by Consent Judgment, which resolved litigation brought by the Attorney General of Minnesota. *Id.* at *2.

In response to Khan's lawsuit, Dell moved to compel arbitration arguing that the arbitration provision was binding and covered all of Khan's claims. *Id.* at *3. Khan responded that the arbitration provision was unenforceable because the NAF, which the arbitration provision designated as the arbitrable forum, was no longer permitted to conduct consumer arbitrations. *Id.* Kahn also argued that the NAF's designation was integral to the arbitration provision such that, because the NAF could not perform its function, the arbitration provision in the Terms and Conditions should not be enforced. *Id.*

The district court denied Dell's motion to compel arbitration holding that the language of the arbitration provision demonstrated the parties' intent to arbitrate exclusively before a particular arbitrator, not simply an intent to arbitrate generally. *Id.* While the district court acknowledged that some courts had held that § 5 of the FAA provides a mechanism for the appointment of an arbitrator when a chosen arbitrator is unavailable,^[1] the court found that the designation of the NAF as the arbitrator was integral to the agreement and that substituting another arbitrator would improperly force the parties to "submit to an arbitration proceeding to which they have not agreed." *Id.*

On appeal, the Third Circuit noted that in determining the applicability of § 5 of the FAA when an arbitrator is unavailable, courts have focused on whether the designation of the arbitrator was "integral" to the arbitration provision or was "merely an ancillary consideration." *Id.* at *4. To be deemed "integral," the court must find that the parties unambiguously expressed their intent not to arbitrate their disputes in the event the designated arbitral forum is unavailable. *Id.* As the Third Circuit found no such unambiguous expression by the parties in *Dell*, the court vacated the decision of the district court and instructed the court to appoint a substitute arbitrator. *Id.* at *7.

The *Dell* decision suggests that parties to an arbitration agreement may be required to arbitrate regardless of whether the arbitration can proceed as specifically outlined in the pertinent contract. The only exception to this rule, at least in the Third Circuit, is where the parties unambiguously provide that the agreement to arbitrate is contingent on arbitrating in the precise manner set out in the arbitration agreement. For the reinsurance industry, *Dell* teaches that parties seeking to avoid arbitration based on a technical reading of the arbitration provision will face an uphill battle and that courts are ready and willing to appoint replacement arbitrators/umpire when appropriate to do so.

[1] Section 5 of the FAA provides: If in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators or umpire, such method shall be followed; but . . . if for any other reason there shall be a lapse in the naming of an arbitrator, or arbitrators or umpire, or in filling a vacancy, then upon the application of either party to the controversy the court shall designate and appoint an arbitrator or arbitrators or umpire, as the case may require . . .

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