



A Potential “Chink” in the so-called “Armor” of an Arbitration Clause – and the Recommended Solution

From David A. Robinson, Esq.

The California Supreme Court recently changed the rules, again, relative to the enforcement of arbitration clauses. Ever since the California Court of Appeals’ much publicized decision in *Energy Group, Inc. v. Liddington*, 192 Cal. App. 3d 1520 (1987), it has been generally understood and accepted that the Federal Arbitration Act (9 U.S.C.A. § 1 *et seq.*, or “FAA”) broadly preempts California law with respect to contracts involving interstate commerce. More particularly, it has been understood the FAA preempts those provisions of the California Arbitration Act that allow a judge, under certain circumstances, to “. . . refuse to enforce the arbitration agreement . . . or stay arbitration pending the outcome of the court action or special proceeding.” Code Civ. Proc. § 1281.2. Indeed, if one looks up § 1281.2 on Westlaw even today, a “red flag” will appear citing the following cases holding that statute is FAA preempted: *Nyko, Inc. v. First Union Securities, Inc.*, 2002 WL 192904, 5 (2002); *Warren-Guthrie v. Health Net* (2000) 84 Cal. App. 4th 804, 810-812 (2000); *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205 (9th Cir. 1998).

Not any more. Largely relying on the United States Supreme Court’s much earlier decision in *Volt Info. Sciences v. Leland Stanford Jr. University*, 489 U.S. 468, (1989), this Spring the California high court in *Cronus Investments, Inc. v. Concierge Services*, 35 Cal. 4th 376, 383 (2005) (hereinafter “*Cronus*”) held the FAA does not preempt the *procedural* aspects of California law regulating arbitration. Finding section 1281.2(c) to be purely procedural in nature, and further declaring that “[l]ike other federal procedural rules. . . ‘the procedural provisions of the [FAA] are not binding on state courts ...’ (35 Cal. 4th at 390), *Cronus* once again allows California judges to decide, in certain instances, whether to enforce or ignore arbitration clauses.

When might a California judge decide not to enforce an otherwise perfectly good arbitration clause? When:

1. “A party to the arbitration agreement is also a party to a pending court action . . . with a third party . . .”;
2. The claims involving the third party “aris[e] out of the same transaction or series of related transactions . . .”; and
3. “. . . there is a possibility of conflicting rulings on a common issue of law or fact.”

Section 1281.2(c)

How often could this possibly happen? More than one might think. Indeed, as the law now stands, section 1281.2(c) is an open invitation to clever litigation counsel to join new parties and claims to existing, otherwise arbitrable disputes. Provided they can show the “new” claims are transactionally related to the “original” or arbitrable claims, they have a ticket to argue that the interests of judicial economy (*i.e.*, the public policy favoring the avoidance of a multiplicity of lawsuits) warrant disregarding the contracting parties’ bargained for alternative dispute resolution mechanism. Why? Because they can argue, correctly, that non-contracting parties cannot be forced to participate in arbitrations.

Is there any way, in light of the California Supreme Court’s holding in *Cronus*, to safeguard ROI Network’s interests against such creative litigation tactics? Yes. The last paragraph of *Cronus* holds the key. If the arbitration clause in question explicitly incorporates both the substantive and procedural

aspects of the FAA, then section 1281.2(c) cannot be used as a tool to defeat arbitration. This is because, under the FAA, none of the foregoing arguments hold water. 9 U.S.C.A. § 3 *mandates* that any lawsuit involving “. . . an issue referable to arbitration under an agreement in writing for such arbitration . . . [be] stay[ed] . . . until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.” Put another way, under federal law a trial judge has no discretion to ignore or stay enforcement of an arbitration clause.

Our recommendation: If you want to make sure ROI Network's disputes are definitely sent to arbitration, and the question of ROI Network's right to arbitrate is not clouded by the possible joinder of third parties and non-arbitrable disputes in future litigation, then add words to the following effect in your agreements:

For purposes of enforcement of this arbitration clause, the parties hereby incorporate by reference the

substantive and procedural provisions of the Federal Arbitration Act, 9 U.S.C.A. § 1 *et seq.*

Further Information

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Readers are urged to consult their regular contacts at ECG or the principal author of this publication, David A. Robinson, Esq. (telephone: 949-833-8550; email: drobenson@enterprisecounsel.com) concerning their own situations or any specific legal questions they may have.



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