When in California, Choose Your Arbitration Terms Carefully and Avoid a Two-Front War

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Your project is in California, subject to California law, and now disputes have arisen. You initiate the arbitration procedure of your contract. At the same time, however, a third party not subject to your arbitration agreement files a lawsuit against you involving related claims and issues. You are now in a two-front war; dueling in arbitration and courthouse litigation, and confronted with the spectre of duplicative fees and costs and potentially contradictory outcomes.

In response to this problem, California enacted California Code of Civil Procedure § 1281.2, which authorizes the court to refuse to enforce a contractual arbitration provision if arbitration threatens to produce a result that may conflict with the outcome of related litigation not subject to arbitration. Contrast, however, the Federal Arbitration Act (“FAA”), which “leaves no place for the exercise of discretion by a district court, but instead mandates that district courts shall direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed.” Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 218 (1985). Hence, the issue is joined: for contracts subject to California law, will the state’s civil procedure § 1281.2 prevail over the FAA to allow you to avoid the two-front war? The answer depends on the terms of your arbitration agreement and the discordant opinions from California courts and federal courts.

The California and Federal Arbitration Acts

The California Arbitration Act (“CAA”) is a comprehensive statutory scheme regulating private arbitration in California. See Cal. Civ. Proc. Code § 1280 et seq. Under the CAA, if the court determines that a party to an arbitration agreement is also a party to a pending court action arising out of the same transaction and there exists a possibility of conflicting rulings on a common issue of law or fact, the court may, among other actions, refuse to enforce the arbitration agreement and order intervention or joinder of all parties in a single action, or stay the arbitration pending the outcome of the court action. Cal. Civ. Proc. Code § 1281.2(c).

The CAA is said to coexist with the FAA, the latter applicable to all arbitration agreements involving interstate commerce. 9 U.S.C. § 3. Unlike the CAA, however, the FAA does not give courts the option to refuse enforcement of arbitration agreements “save upon such grounds as exist at law or in equity for the revocation of any contract.” 9 U.S.C. § 2. Section 2, the FAA’s primary substantive provision, embodies “a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary.” Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983). The FAA therefore preempts and invalidates all state laws that limit those agreements against the parties' will or withdraws the parties’ power to enforce their arbitration agreement. How does § 1281.2 coexist with the FAA?

The Courts’ Discordant Opinions


Before Volt Info. Sciences v. Bd. Of Trustees of Leland Stanford Jr. University, 489 U.S. 468 (1989), the frequent assertion was that the FAA preempted California procedure § 1281.2(c).
The U.S. Supreme Court addressed this assertion in *Volt*, a case arising out of a construction project in California.

The contract provided for binding arbitration, and included a choice-of-law provision, stating that “[t]he Contract shall be governed by the law of the place where the Project is located.” Id. at p. 470. A dispute arose and Volt commenced arbitration. Stanford, in turn, filed suit against Volt and two nonparties to their arbitration agreement. Pursuant to § 1281.2 (c), the trial court stayed the arbitration and the appellate court affirmed.

The Supreme Court affirmed the lower courts’ decisions, holding that § 1281.2(c) is not preempted by the FAA where the parties’ choice-of-law provision designates California law. *Id.*

The Court’s opinion was based on freedom of contract principles wherein parties may contract for whichever procedural rules they want, even if it means their arbitration will be joined with a court action or delayed indefinitely: “There is no federal policy favoring arbitration under a certain set of procedural rules; the federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.” *Id.* at p. 476.

- **Conflict in the California Courts After Volt**

Although the *Volt* court made clear that a general California choice-of-law provision was enough to incorporate § 1281.2 into an arbitration agreement, the federal Ninth Circuit Court of Appeals reached a contrary conclusion. In *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205, 1209 (9th Cir. 1998), the contract’s choice-of-law provision stated that the contract would be "interpreted and construed under the laws of the State of California, U.S.A." The federal appellate court followed *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995), in which the United States Supreme Court held that a generic choice-of-law clause incorporated only the chosen state’s substantive law and not its procedural rules governing arbitration. After deciding that it was bound by *Mastrobuono* instead of *Volt*, the Ninth Circuit Court held that the contract at issue did not incorporate California procedure § 1281.2 (c) because its choice-of-law provision contained no specific reference to that statute. *Wolsey, supra*, at pp. 1212-1213. The ruling was the start of the California courts’ conflict in their holdings.

In 2000, the California Court of Appeal also found that the FAA preempted the application of § 1281.2, despite an arbitration provision that incorporated the entire CAA. In *Warren-Guthrie v. Health Net*, 84 Cal.App.4th 804, 815 (2000), the contract at issue provided that any dispute would be submitted to binding arbitration and that “[a]ll Arbitration shall be conducted in accordance with the California Code of Civil Procedure, commencing with § 1280." The Court held that the provision did not evidence intent to apply § 1281.2(c) because “[u]nlike in *Volt*, the parties did not agree that California law shall apply for all purposes. Rather, the agreement limits . . . the scope of California law to that law pertaining to the manner in which the arbitration is to be conducted.” *Id.* at p. 815.

Two years later, in *Mount Diablo Medical Center v. Health Net of California, Inc.*, 101 Cal.App.4th 711, 716 (2002), the same state court reached a different conclusion based on a choice-of-law provision that provided “[t]he validity, construction, interpretation and enforcement of this Agreement shall be governed by the laws of the State of California.” Although the provision did not expressly refer to § 1281.2(c), the court held that it applied, reasoning that such specificity was unnecessary because a choice-of-law provision “almost invariably is meant to encompass the entire agreement." *Id.* at p. 722. The *Mount Diablo* Court distinguished its holding from *Warren-Guthrie*, noting that the arbitration agreement in that case provided that arbitration would be “conducted” under California law, whereas the agreement before it provided for its “enforcement”, thereby demonstrating an intent to have California law
govern whether proceedings to enforce the agreement should be before the court or an arbitrator. *Id.*

Last year, the California Supreme Court added a new twist to the case law, holding that §1281.2(c) was not preempted by federal law, despite an arbitration provision stating that the parties’ choice of California law would not prevent the application of the FAA. *Cronus Investments, Inc. v. Concierge Services*, 35 Cal.4th 376 (2005), involved arbitration proceedings and a court action arising from six related contracts, some with and some without arbitration clauses. The contracts providing for arbitration contained choice-of-law provisions specifying that "[t]his agreement shall be construed and enforced in accordance with and governed by the laws of the State of California ...." *Id.* at p. 381. The relevant arbitration clause stated that "[t]he designation of a situs or specifically a governing law for this agreement or the arbitration shall not be deemed an election to preclude application of the [FAA], if it would be applicable." *Id.* The trial court judge stayed arbitration pending resolution of the litigation pursuant to §1281.2(c), and the Court of Appeal affirmed.

The California Supreme Court affirmed the lower courts’ decisions based on the language of the contract. In so doing, it stressed that it was not precluding parties from agreeing to arbitrate their disputes under the FAA’s procedural provisions instead of state procedural law: “We simply hold that the language of the arbitration clause in this case, calling for the application of the FAA ‘if it would be applicable,’ should not be read to preclude the application of § 1281.2(c), because it does not conflict with the applicable provisions of the FAA and does not undermine or frustrate the FAA's substantive policy favoring arbitration.” *Id.* at p. 394. The court also footnoted its disapproval of *Wolsey* and *Warren-Guthrie* to the extent that their holdings were “predicated on the conclusion that § 1281.2(c) limits the authority of arbitrators and conflicts with the FAA.” *Id.* at p. 393 fn.8.

**Recommendations**

When negotiating an arbitration agreement, construction professionals and practitioners should consider what law they would want to govern its enforcement. Although it is beyond the scope of this article to evaluate what strategic and tactical considerations may play into this decision based on the facts of a given matter, parties may opt for § 1281.2(c) because it provides an avenue of relief should they find themselves embroiled in multiple proceedings and threatened by contradictory judgments.

Those drafting choice-of-law provisions intended to ensure the application of §1281.2 should incorporate language that tracks the provision at issue in *Mt. Diablo*, particularly the word “enforcement”, as that was the word that distinguished its holding from *Warren-Guthrie*.

In addition to the *Mt. Diablo* language, it is suggested that the arbitration clause state that §1281.2 shall apply to the enforcement of the agreement in both the choice-of-law and the arbitration provision. In *Warren-Guthrie*, the arbitration provision specifically referenced the CAA, which, of course, includes § 1281.2. Nonetheless, § 1281.2 was still held to be preempted by the FAA. Specific mention of the statute will make it very difficult to argue that the parties did not intend for it to be included in their agreement.

If, on the other hand, the goal is to ensure that an arbitration proceeding will go forward as quickly as possible, it is probably advisable to select the FAA’s procedural rules. To do this, state in certain terms that the arbitration agreement shall be governed by the FAA; do not use the equivocal language like that used in *Cronus*. Moreover, if California law governs the rest of the contract, the arbitration or choice-of-law provision should expressly state that §1281.2(c) shall
not apply to the enforcement of the agreement to further evidence that the parties did not intend for the courts to have authority to stop or delay arbitration proceedings.

Additionally, be aware that California and the Ninth Circuit Court of Appeals have split on how choice-of-law provisions should be interpreted when they concern state and federal arbitration rules. In Cronus, the California Supreme Court signaled its disapproval of Wolsey to the lower California courts. The federal district courts in California, however, are bound by the Ninth Circuit. In light of Wolsey, the federal courts are much more likely to find that § 1281.2 does not apply if the contractual language permits such an interpretation. See, e.g., Stone & Webster, Inc. v. Baker Process, Inc., 210 F.Supp.2d 1177 (S.D. Cal. 2002). Consequently, the choice of state or federal court to enforce an arbitration agreement can influence, if not dictate, the governing procedural rules.

Despite the discord in the courts, construction professionals and practitioners should not lose sight of the essential teaching of Volt, which, in its simplest terms, instructs that parties can contract for any procedural rules they want to apply to their arbitration agreement. The best way to assure that your preferred arbitration rules will control is to state in clear and unmistakable terms the particular procedural rules that will govern. Consideration of the key differences between state and federal arbitration rules and careful drafting of choice-of-law and arbitration provisions will allow parties to contract so as to avoid the two-front war.

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