Kluwer Arbitration Blog

Arbitration Agreements Versus Agency Deference

Gary B. Born (Wilmer Cutler Pickering Hale and Dorr LLP) · Thursday, January 5th, 2012 · WilmerHale

When the strong federal policy in favor of honoring arbitration agreements in the U.S. comes into conflict with another strong legal principle, which one should come out on top? The United States Court of Appeals for the Ninth Circuit recently illustrated this tension in *Kolev v. Euromotors West/The Auto Gallery*, 658 F.3d 1024, holding that a mandatory arbitration agreement in an auto sales contract was invalid because a federal agency's regulation supposedly barred it. This decision demonstrates the danger of excessive deference to agency rules, which can limit the enforcement of arbitration agreements on dubious legal grounds.

The plaintiff, Diana Kolev, bought a used Porsche from an auto dealership in California. The car developed serious mechanical problems. When the dealership refused to honor Ms. Kolev's warranty claims, she sued the dealership and manufacturer in federal court. The dealership petitioned to compel arbitration, pursuant to a mandatory arbitration provision in the sales contract for the car. The trial court granted the motion, sending the case to binding arbitration.

Ms. Kolev appealed the district court's order granting the petition to compel arbitration. On 20 September 2011, a divided panel of the Ninth Circuit – over a pointed dissent by Judge N. Randy Smith – reversed the district court's decision.

The panel majority held that Ms. Kolev's claims were not subject to arbitration, notwithstanding the mandatory arbitration clause in the sales contract for the Porsche. The court's ruling was based on the Magnuson-Moss Warranty Act ("MMWA"), the 1975 federal law that governs consumer product warranties. The panel acknowledged that "the text of the MMWA does not specifically address the validity of pre-dispute mandatory binding arbitration." Opinion at 1025. However, the panel then observed that under the MMWA, Congress had delegated rulemaking authority to the Federal Trade Commission ("FTC") to implement the statute. According to the panel, the FTC "issued a rule prohibiting judicial enforcement of such provisions with respect to consumer claims brought under the MMWA." *Id.*

The panel then examined whether the FTC's rule (as the panel understood it) was valid. The panel performed the two-step *"Chevron"* inquiry that the United States Supreme Court has applied to judicial review of federal agency action, named after the very influential 1984 Supreme Court decision that established the standard. Under step one of the *Chevron* inquiry, the court examines whether Congress, in passing the statute, expressed a clear intent on the issue in question. Then, if Congress's intent is not clear, the court examines whether the agency's interpretation of the law is based on a permissible construction of the statute. If the construction is permissible, then the court

will defer to the agency's interpretation.

The *Kolev* court first found, under *Chevron* step one, that Congress had not expressed a clear intent on the issue, because the MMWA did not specifically address binding arbitration. Next, under Chevron step two, the court found that the FTC's supposed interpretation of the MMWA as prohibiting mandatory arbitration provisions in warranty contracts was a permissible one. Therefore, the panel deferred to the FTC's rule that barred the enforcement of mandatory arbitration clauses in warranty agreements. Accordingly, the panel reversed the district court's ruling compelling arbitration and remanded the case to the district court to adjudicate Ms. Kolev's warranty claims in the first instance.

The Ninth Circuit's decision flew in the face of the Federal Arbitration Act ("FAA"), the 1925 law that requires the enforcement of arbitration agreements and resolves any doubts about the validity of such agreements in favor of arbitration. To reach this remarkable result, the panel in *Kolev* made multiple errors of law and logic – many of which were pointed out in Judge Smith's dissent.

Error One: The court's *Chevron* inquiry should have ended before it began, because the FTC's rule regarding dispute settlement mechanisms did not even apply to the mandatory arbitration agreement in the auto sale contract in this case. Thus, the Ninth Circuit's entire opinion was based on an incorrect premise.

The MMWA "encourage[s] warrantors to establish procedures whereby consumer disputes are fairly and expeditiously settled through informal dispute settlement mechanisms." 15 U.S.C. § 2310(a)(1). The MMWA authorizes the FTC to issue rules establishing minimum requirements for such "Mechanisms."

However, contrary to the *Kolev* majority's assumption, the MMWA does not say that *all* means of alternative dispute resolution are "Mechanisms" subject to the FTC rule. In fact, in its rulemaking, the FTC made clear that "nothing in the rule precludes the parties from agreeing to use some avenue of redress other than the Mechanism if they feel it is more appropriate." 40 Fed. Reg. at 60,211. Such other avenues, according to the FTC, specifically included "binding arbitration." *Id*. The *Kolev* majority simply ignored this discussion. Although the FTC's Mechanism rule prohibits the use of binding arbitration in warranty agreements that contain Mechanisms, that does not mean that all arbitrations *are* Mechanisms.

This conclusion is further bolstered by the text of the MMWA. The MMWA provides that when a warranty agreement includes a valid Mechanism, "the consumer may not commence a civil action … unless he initially resorts to such procedure." 15 U.S.C. § 2310(a)(3). However, the whole point of binding arbitration is that a party *cannot* "commence a civil action" after the arbitrator has rendered a final award. Arbitration is an *alternative* to proceeding in court, not a precursor to it. The notion that the MMWA's section on Mechanisms was supposed to cover all binding arbitration betrays an apparent misconception of what arbitration is.

Error Two: Having misread the FTC regulation as barring the arbitration clause before it, the Ninth Circuit then failed to consider whether the FTC had the statutory authority to impose such a rule. As Judge Smith pointed out in dissent, the MMWA did not permit the FTC to restrict all binding arbitration provisions in warranty contracts. Rather, the law only empowered the FTC to impose requirements on pre-litigation Mechanisms as defined in the MMWA. But as discussed above, a mandatory binding arbitration clause is not necessarily a Mechanism. Thus, even if the FTC had

intended to prohibit all binding arbitration – and as discussed above, it did not – it would have had no statutory authority to do so. Because the FTC lacked that authority, the court need not and should not have proceeded to the *Chevron* inquiry to determine whether the agency rule was permissible.

Error Three: Step one of the *Chevron* test is to determine whether Congress has directly spoken to the question at issue. The Ninth Circuit found that Congress had not directly spoken to the question of arbitration in the MMWA, and therefore moved onto *Chevron* step two.

However, the court ignored the fact that another Congressional enactment – the FAA – *has* spoken directly to the question of the validity of arbitration agreements. That should have been the end of the inquiry: the *Kolev* majority acknowledged that the text of the MMWA does not, on its face, evidence a Congressional intention to prohibit mandatory binding arbitration clauses. Thus, the clear pro-arbitration intent of the FAA should have controlled, requiring the invalidation of a rule barring all arbitration agreements.

Error Four: Finally, the Ninth Circuit upheld its reading of the FTC regulation under *Chevron* step two, finding that such a regulation was based on a permissible construction of the MMWA. The court put forth various rationales for its defense of a prohibition on binding arbitration provisions in warranty agreements. None of these rationales is persuasive, however, because none address the facts that (1) the MMWA does not evidence an intent to limit the FAA's clear policy favoring arbitration, and (2) the U.S. Supreme Court has repeatedly repudiated agency hostility to the advantages of arbitration.

Implications of the Kolev Decision

The *Kolev* decision, however questionable its result, does raise the difficult question of how to resolve any conflict between the proverbial irresistible force of *Chevron* agency deference and the immovable object of the FAA's pro-arbitration presumption. When these two strong legal principles come into tension, what wins? If a federal agency reads an ambiguous statute as allowing it to prohibit arbitration, should that interpretation be granted the normal deference afforded agencies under *Chevron*?

A reading of the Supreme Court's arbitration jurisprudence suggests that when arbitrability is at issue, the strong federal policy favoring arbitration short-circuits the normal *Chevron* analysis. Rather, the FAA and the New York Convention limit the deference courts normally give to federal agencies in interpreting statutes. In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 227 (1987), the Supreme Court held that if a party wants to show that another federal law limits the pro-arbitration scope of the FAA, "[t]he burden is on the party opposing arbitration . . . to show that Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue." With respect to international agreements in particular, the Supreme Court has held that courts should recognize "subject-matter exceptions" to arbitrability only where Congress has "expressly directed the courts to do so." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc*., 473 U.S. 614, 639 n.21 (1985).

Thus, under *McMahon* and *Mitsubishi Motors*, a party claiming that the federal policy favoring arbitration is trumped by another law must demonstrate a clear Congressional intent in that law to limit arbitration. Under this standard, whether the agency's construction of the law is "permissible" under *Chevron* step two should make no difference. Rather, the only question is whether the

statute's text, history, or purpose shows that Congress clearly intended to curtail the arbitrability of certain disputes. If it did not, then the agency cannot take action that limits arbitration, no matter how reasonable or permissible its implementation of the law otherwise is.

This is also the preferable policy. The United States, like other signatory countries to international arbitration conventions, has committed to recognize and enforce consensual arbitration agreements. National legislation in the United States supports this goal as well. A government agency should not be able to negate the objectives of these laws and treaties based on the flimsiest statutory grounds. The *Kolev* decision illustrates this problem.

In any event, the Ninth Circuit panel's decision may not be the last word on this issue. On 4 October 2011, the parties moved the Ninth Circuit for *en banc* rehearing of the decision. Moreover, unless the Ninth Circuit corrects its own error, it will have created a split with the U.S. Courts of Appeals for the Fifth and Eleventh Circuits, both of which have come to the opposite conclusion regarding the enforcement of arbitration agreements under the MMWA. This split among federal circuits may eventually persuade the United States Supreme Court to weigh in on the issue and resolve this important question.

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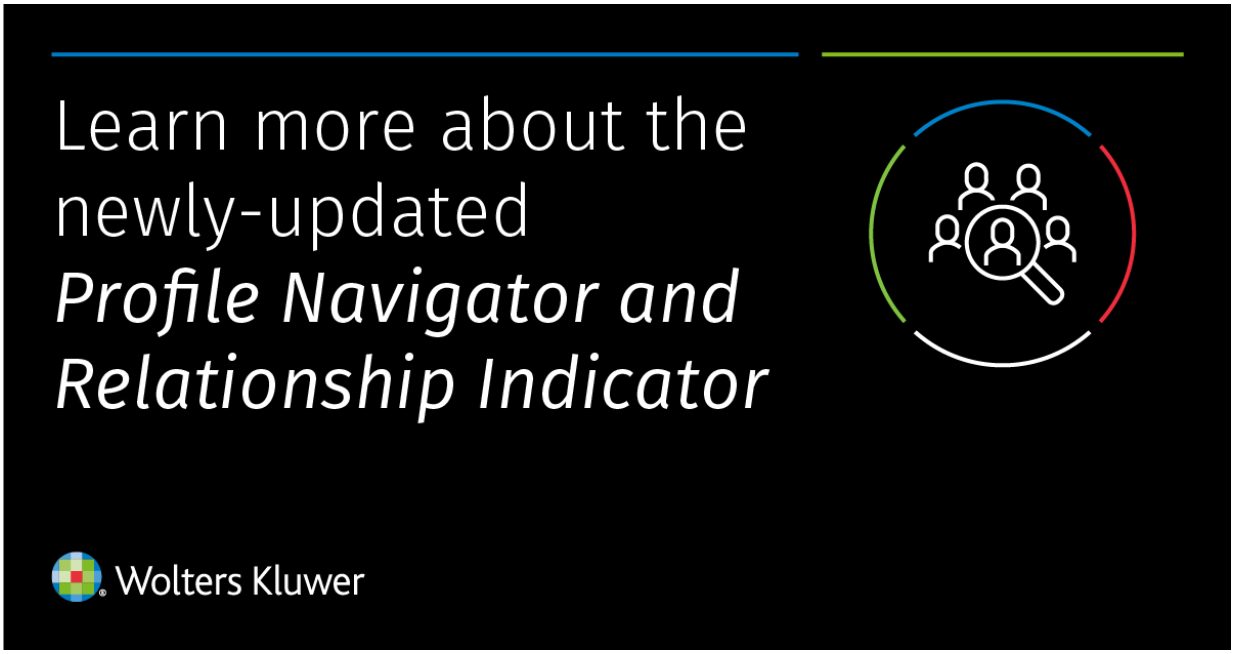

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