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MZM Construction Company – Third Circuit Affirms "Clear and Unmistakable" Standard, But Did Its Dicta Go Too Far?

Giorgio Sassine (Musick, Peeler & Garrett LLP) · Sunday, October 25th, 2020

Recently, the U.S. Court of Appeals for the Third Circuit (the "Third Circuit" or the "Court") addressed what it referred to as a "mind-bending" and "seemingly circular" question "dubbed 'the queen of all threshold issues' in arbitration law:" whether a court or arbitrator(s) decides if an agreement exists when the alleged agreement itself "includes an arbitration provision empowering an arbitrator to decide whether an agreement exists." (*MZM Construction Company, Inc. dba MZM Construction & Transportation v. New Jersey Building Laborers Statewide Benefit Fund*, Case Nos. 18-3791 & 19-3102 (3d. Cir. Sept. 14, 2020).)

The Third Circuit affirmed the U.S. District Court for the District of New Jersey's (the "District Court") determination that under the Federal Arbitration Act (the "FAA"), 9 U.S.C. § 4, "questions about the making of the agreement to arbitrate are for the courts to decide unless the parties have *clearly and unmistakably* referred those issues to arbitration in a written contract *whose formation is not in issue*." (Emphasis added.) This post discusses the background of the dispute, its procedural history, and where the decision falls within broader discourse on the FAA and U.S. public policy on arbitrability.

Background of the Dispute

In 2001, MZM Construction Company ("MZM") hired local labor union workers for the construction of the Newark Liberty International Airport in New Jersey. The following year, in 2002, MZM signed a short form agreement ("SFA") with the union. Importantly, the SFA fully incorporated prior collective bargaining agreements ("CBAs"). The 2002 CBA included an arbitration clause, which read in relevant part that the parties agree to arbitrate: "questions or grievances involving the interpretation and application of this Agreement" and "[t]he Arbitrator shall have the authority to decide whether an Agreement exists, where that is in dispute."

A dispute arose when the New Jersey Building Laborers' Statewide Benefit Fund (the "Fund"), into which employers were to make contributions under the 2002 CBA, determined that MZM owed unpaid contributions. The Fund then filed for arbitration pursuant to the 2002 CBA's arbitration provision.

MZM's Action in District Court

MZM sought a declaratory judgment in the District Court that it was not a signatory to the CBA, that it had no obligation to arbitrate under the CBA, and that it was not liable to the Fund under any CBA. MZM importantly argued that "*fraud in the execution* voided the SFA and the incorporation of the CBAs, and therefore, no agreement exists between MZM and the Funds." (Emphasis added.) In response, the Fund argued that MZM had not alleged a claim for *fraud in the execution*, but instead alleged a claim for *fraud in the inducement*. The Fund argued that this "distinction is material to whether the court or the arbitrator decides if an enforceable contract exists." After oral arguments, the District Court doubted whether a valid arbitration agreement existed due to fraud in the execution and granted a preliminary injunction to preserve the *status quo*.

Discussion

On appeal, the Third Circuit considered whether MZM intended to execute the SFA incorporating the CBA's arbitration provisions, or simply execute the SFA without the CBA's arbitration provision. The Third Circuit began with the "threshold issue" of whether the District Court had the "power to resolve questions about the formation or existence of a contract when the putative contract includes a provision delegating 'the authority to decide whether an Agreement exists' to the arbitrator."

A. Strong U.S. Federal Policy Favoring Arbitration and Severability Doctrine

The Third Circuit first discussed the U.S. federal policy of compelling arbitration and "guarding against unwarranted judicial interference with arbitration." (*see Sandvik AB v. Advent Int'l Corp.*, 220 F.3d 99, 104 (3d Cir. 2000); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 338 U.S. 395, 406 (1967) (holding that arbitrators have the primary power to decide legal issues relating to the parties' contract absent evidence indicating the parties intended to exclude those issues from arbitration).

The Third Circuit considered *Prima Paint* relevant, stating the severability doctrine prevents a party from avoiding arbitration by attacking the container contract, but rather the party must challenge the arbitration agreement itself. The Court explained that under the severability doctrine, "a claim of fraud in the inducement *of the arbitration clause* is for the court to decide, but a claim of fraud in the inducement *of the container contract* is for the arbitrator." The Court acknowledged that *Prima Paint* did not specifically address the question at hand: whether the severability doctrine applies when the formation of the container contract is at issue.

B. Federal Courts Should Not Assume Parties Agreed to Arbitrate Arbitrability Unless There Is Clear and Unmistakable Evidence

After noting that *Prima Paint* did not address the issue presented, the Court questioned: "So, who decides whether an arbitration agreement exists when the formation or the existence of the container contract is disputed – the court or the arbitrator?"

Relying upon *Sandvik* (220 F.3d at 108-09) and section 4 of the FAA, the Court determined that it must compel arbitration if it has been satisfied that the "making of the agreement for arbitration … is not an issue" and, to do so, must decide whether there was mutual assent to the arbitration

agreement. The Court explained that this is a "necessary prerequisite" of the federal court's "gate keeping function." The Court additionally noted the federal jurisprudence *against* arbitrators deciding their own jurisdiction, something which is provided for in other jurisdictions, such as in France. (*See* Article 1448 of the French Code of Civil Procedure.)

However, the Court acknowledged U.S. Supreme Court precedent that parties may contractually empower arbitrators to decide their own jurisdiction. The Court reiterated that federal courts should not "should not assume that the parties agreed to arbitrate arbitrability unless there is clear and unmistakable evidence that they did so." The Court explained that when parties agree to arbitrate arbitrability, such provisions are called "delegation provisions." Therefore, pursuant to the severability doctrine, if a party does not challenge the *delegation provision* specifically, the court must treat the delegation provision as valid and send "any challenge the validity of the underlying *arbitration agreement* to the arbitrator."

C. Whether a Delegation Provision or Not, Courts Retain Primary Power to Decide Mutual Assent to Agreement to Arbitrate

Satisfied with the foregoing, the Court moved to addressing the following question: "So, what happens when, as here, the container contract, whose formation or existence is being challenged, has a delegation provision empowering the arbitrator to decide whether an agreement exists? Who decides the threshold issue then?"

Noting that MZM did not specifically challenge the delegation provision, the Court reduced the parties' dispute between "an unchallenged delegation provision in a disputed contract be enforced as presumptively valid, and section 4 of the FAA, which, as construed in *Sandvik*, 220 F.3d at 109, 'affirmatively requires' a court to rule on the formation of the container contract." Further noting that the Third Circuit has not addressed this issue, the Court believed that its decision in *Sandvik* dictated a similar outcome. In so doing, whether a delegation provision or not, the Court stated that it is "inevitable that a court will need to decide questions about the parties' mutual assent to the container contract to satisfy itself that an arbitration agreement exists and *vice versa*."

The Court, however, acknowledged that neither the Third Circuit nor the U.S. Supreme Court have specifically addressed "a contract-formation dispute involving a delegation provision assigning that task to the arbitrator." Nevertheless, recognizing the Supreme court's "repeated admonition that, at its core, 'arbitration is a matter of contract,'" the Court stated that "we believe that the text of section 4 of the FAA – mandating that the court be 'satisfied' that an arbitration agreement exists – tilts the scale in favor of a judicial forum when a party rightfully resists arbitration on grounds that it never agreed to arbitrate at all." The Court therefore held that "under section 4 of the FFA, courts retain the primary power to decide questions of whether the parties mutually assented to a contract containing or incorporating a delegation provision."

The Court's *Dicta* May Have Gone Too Far

While the Court reached a holding consistent with U.S. precedent, the Court's *dicta* may have opened the gates to arguments of mutual assent and may have also set the bar too high to draft an arbitration agreement delegating arbitrability to the arbitrator.

Notably, the Court stated "it can hardly be said that contracting parties clearly and unmistakably

agreed to have an arbitrator decide the existence of an arbitration agreement *when one of the parties has put the existence of that very agreement in dispute*." (Emphasis added.) At first glance, if taken to its limits, parties could troublingly put the existence of the agreement to arbitrate in issue merely by arguing an alleged lack of mutual assent to escape an otherwise objective, clear and unmistakable agreement to arbitrate.

The Court also provided guidance on drafting delegation provisions to empower arbitrators with competence-competence. For example, the Court stated "parties can enter into *pre-negotiation contracts* in which they agree to arbitrate all arbitrability issues pertaining to future contracts between them." (Emphasis added.) Such a high bar seems counter to reality. As arbitration clauses are knowingly called "champagne clauses," which in many respects are not considered of paramount importance in the midst of negotiations, it seems unlikely that parties are going to seriously enter into pre-negotiation contracts on this precise issue. Such a request from one party, especially when not in a strong bargaining position, seems unlikely.

Nevertheless, despite its recommended example, the Court cautioned: "Even then, the arbitrators' determination as to whether the parties agreed to arbitrate in the first place will be reviewable *de novo* by a court of competent jurisdiction on the backend if the arbitrators render an *award in the absence of a validly existing arbitration agreement over a party's objection*." (Emphasis added.) In the end, even if the parties enter a pre-negotiation contract to empower arbitrators with competence-competence, as recommended, *if* one party objects, parties may still find themselves in court.

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