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“Wholly Groundless” Exception Not Grounded in Federal Arbitration Act

Article By:

Lisa M. Richman

Daniel Campbell

Arbitration as a method of dispute resolution is only as effective as the contractual provisions made to trigger it. Recent US case law has shed light on who gets to determine “threshold arbitrability”, and whether or not the arbitration is “wholly groundless”.

The newest Supreme Court Justice, Brett Kavanaugh, asked the following question on 8 January 2019, in *Henry Schein, Inc., et al. v Archer and White Sales, Inc,.*

> *Under the Federal Arbitration Act [FAA], parties to a contract may agree that an arbitrator rather than a court will resolve disputes arising out of the contract. When a dispute arises, the parties sometimes may disagree not only about the merits of the dispute but also about the threshold arbitrability question—that is, whether their arbitration agreement applies to the particular dispute. Who decides that threshold arbitrability question?*

Writing for a unanimous Court, Justice Kavanaugh explained that when parties to a contract delegate the “threshold arbitrability question to the arbitrator” in a clear and unmistakable manner, the arbitrator decides whether the dispute is arbitrable, even if the arguments in support of arbitration are “wholly groundless.”

He did not, however, explain what constitutes a “clear and unmistakable manner” and what parties can do to protect themselves. Schein provides only limited guidance on the former issue, but it is possible to identify some of the steps that parties contemplating arbitration with a US seat can, and should, take to protect themselves.

LESSONS FROM SCHEIN

The case involved a dispute between Henry Schein, Inc., and Archer and White Sales, Inc. Archer and White entered into a contract with Schein’s predecessor, and the contract contained the

following dispute resolution clause:

> *This Agreement shall be governed by the laws of the State of North Carolina. Any dispute arising under or related to this Agreement (**except for actions seeking injunctive relief** and disputes related to trademarks, trade secrets, or other intellectual property of [Schein]), shall be resolved by binding arbitration in accordance with the arbitration rules of the American Arbitration Association [(AAA)]. The place of arbitration shall be in Charlotte, North Carolina. Authors' emphasis added.*

When the relationship between the parties soured, Archer and White sued Schein in Federal District Court in Texas, alleging antitrust violations, and seeking money damages and injunctive relief. Schein moved to compel arbitration, invoking the FAA and the dispute resolution clause in the contract, asking the court to refer the claims to arbitration.

Archer and White argued that the dispute was not subject to arbitration, and that the district court should decide the threshold arbitrability of the claims, stating that Schein's arguments in favor of compelling arbitration were "wholly groundless" because "actions seeking injunctive relief" were exempted from the arbitration agreement.

Relying on Fifth Circuit precedent, the court held that Schein's arguments in favour of compelling arbitration were "wholly groundless" and denied Schein's motion to compel arbitration. The Fifth Circuit affirmed the lower court's decision and Schein appealed. The Supreme Court accepted the case on the narrow question of whether or not a "wholly groundless" exception exists under the FAA.

GENESIS OF THE "WHOLLY GROUNDLESS" EXCEPTION

While the Fifth Circuit adopted the "wholly groundless" exception, this judicially created exception to the FAA gained prominence in *Qualcomm, Inc. v Nokia Corp.,* 466 F.3d 1366 (Fed. Cir. 2006).

Qualcomm concerned a denial of a motion to stay litigation pending arbitration. The Federal Circuit vacated the order and remanded for further proceedings, holding the district court failed to conduct an inquiry into whether or not the arguments in favour of arbitration were "wholly groundless." In *Qualcomm,* the parties' agreement clearly and unmistakably delegated the arbitrability question to the arbitrator, but the Federal Circuit, borrowing from a line of California state cases, decided that the court needed to determine, on remand, if the assertion of arbitrability was wholly groundless.

In addition to the Fifth and Federal Circuits, the Fourth and Sixth Circuits adopted some form of the "wholly groundless" test. The Tenth and Eleventh Circuits rejected it. The Supreme Court reviewed Schein to resolve the circuit split.

Finally, the Supreme Court rejected policy arguments that the "wholly groundless" exception was necessary to deter frivolous motions to compel arbitration. The Court explained that arbitrators are perfectly capable of disposing of frivolous claims, and that deterrents exist in arbitrations in the form of fee shifting.

> "Notably, a court may also determine whether or not an agreement is subject to the FAA."

LESSONS LEARNED FROM SCHEIN

Based on the text of the FAA, the Supreme Court resolved the narrow issue that courts must enforce contractual provisions delegating to the arbitrator(s) the threshold question of arbitrability. The Court did not reach the issue of whether or not the parties "clearly and unmistakably" delegated the question of arbitrability to the arbitrator(s). As a result, it is still open to question whether or not incorporating arbitration rules, such as the AAA rules, is sufficient to "clearly and unmistakably" delegate the question of arbitrability. The answer to this still varies from circuit to circuit.

The *Schein* decision states that a court must determine whether or not a valid and enforceable agreement to arbitrate exists, and whether or not the parties "clearly and unmistakably" delegated the question of arbitrability to the arbitrator. That is all a court is permitted to do, and it cannot consider whether or not the claims are "wholly groundless"; that analysis is squarely within the province of the arbitrator(s).

Notably, a court may also determine whether or not an agreement is subject to the FAA. The Supreme Court explained this in its most recent arbitration decision on 15 January 2019, New Prime, Inc. v Oliveira, No. 17-340. The Court held that courts, not arbitrators, decide whether or not an agreement is excluded from the FAA, and that contracts of employment, including those with independent contractors, are excluded.

Some may read *Schein* and *New Prime* as inconsistent, but they are easily reconciled. *New Prime* holds that whether or not an agreement is excluded from the FAA is decided by a court, even when the arbitrability question is decided by an arbitrator. Schein holds that threshold issues of arbitrability are decided by the arbitrator(s) when an agreement is covered by the FAA (that is, it does not fall under any exclusion); when the arbitration agreement is valid; and when the parties "clearly and unmistakably" delegated arbitrability to the arbitrator, regardless of whether the arguments in favour of arbitration are "wholly groundless."

Schein serves as a reminder that parties should be aware of what they are agreeing to in their arbitration clauses. The question of whether or not the incorporation of a particular set of rules "clearly and unmistakably" delegates the arbitrability question to the arbitrator remains an open question. Parties should therefore carefully make their preferences clear in their arbitration agreements, especially where the arbitral rules identified by the parties delegate the arbitrability question to the arbitrator(s).

If there is any legitimate question as to whether or not the parties have "clearly and unmistakably" delegated the question of arbitrability to the arbitrator, a court will determine if such delegation was clear and unmistakable. These sorts of ambiguities regularly create inefficiencies and additional costs. The *Schein* decision should, nevertheless, reassure parties around the world that US courts will not disregard or overrule the contracting parties' delegation of an issue to arbitration.

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