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The Third Circuit Holds That Lack of a Contractually-Designated Arbitration Forum Does Not Nullify an Arbitration Agreement

A. Introduction

A very recent decision by the United States Court of Appeals for the Third Circuit has once again demonstrated the liberal policy of the Federal Arbitration Act ("FAA"), 9 U.S.C. §§ 1 *et seq.* (2012) in favor of arbitration. In a matter of first impression for the Third Circuit, a divided panel has held that Section 5 of the FAA requires the appointment of a substitute arbitrator where the forum that the parties designated in their arbitration agreement is no longer available to conduct arbitrations. *Khan v. Dell, Inc.*, 2012 U.S. App. LEXIS 1167 (3d Cir. Jan. 20, 2012).

In an opinion authored by Judge Roth, the panel found the arbitration agreement to be ambiguous as to whether the designated National Arbitration Forum ("NAF") was intended to be the exclusive forum for resolving disputes and thus an integral part of that agreement. The majority resolved this ambiguity in favor of arbitration, holding that the designation of the NAF was **not** exclusive and, therefore, not integral to the agreement, and the unavailability of the NAF did not render the arbitration agreement unenforceable. *Id.* The panel further held that such unavailability constituted a "lapse" within the meaning of Section 5, thereby requiring the appointment of a substitute arbitrator. *Id.* at *19. The *Khan* decision is a good example of how the FAA's policy in favor of arbitration mandates resolution of an ambiguity in an arbitration agreement in a manner consistent with enforcement of the obligation to arbitrate.

B. The Parties' Agreement to Arbitrate Before the NAF

The plaintiff in *Khan* purchased a Dell 600m computer in September 2004 from defendant Dell Inc. ("Dell") through Dell's website where the plaintiff clicked a box stating "I agree to Dell's Terms and Conditions of Sale" (hereinafter the "Terms and Conditions"). Below the box was a notice stating, *inter alia*, that the Terms and Conditions contain "an agreement to resolve disputes through arbitration, rather than through litigation." *Id.* at *2. The arbitration provision, set forth in Paragraph 13 of the Terms and Conditions, provided in relevant part:

> ANY CLAIM, DISPUTE, OR CONTROVERSY (WHETHER IN CONTRACT, TORT OR OTHERWISE, WHETHER PRE-EXISTING, PRESENT OR FUTURE, AND INCLUDING STATUTORY, COMMON LAW, INTENTIONAL TORT AND EQUITABLE CLAIMS) BETWEEN CUSTOMER AND DELL, its agents, employees, principals, successor, assigns, affiliates, (collectively for purposes of this paragraph, "Dell") arising from or relating to this Agreement, its interpretation, or the breach, termination or validity thereof, the relationships which result from this Agreement ..., Dell's advertising, or any related purchase *SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION*

> ***ADMINISTERED BY THE NATIONAL ARBITRATION FORUM ("NAF")*** under its Code of Procedure then in effect (available via the Internet at http://www.arb-forum.com or via telephone at 1-800-474-2371) ... This transaction involves interstate commerce ***and this provision shall be governed by the Federal Arbitration Act 9 U.S. sec. 1-16 (FAA)....***

Khan, 2012 App. U.S. Lexis 1167 at *3-4 (capital letters in original, emphasis added). Rule 1 of the NAF's Code of Procedure provided that "[t]his Code shall be administered only by the National Arbitration Forum or by any entity or individual providing administrative services by agreement with the National Arbitration Forum." *Id*.

...the district court found that here the designation of the NAF as the arbitrator was "integral to the arbitration clause."

The plaintiff filed a putative class action on behalf of himself and other similarly situated purchasers and lessees of defectively-designed 600m computers, asserting violation of the New Jersey Consumer Fraud Act and various common law claims. Dell thereafter moved to compel arbitration. At the time Plaintiff had filed suit, the NAF had been barred from conducting consumer arbitrations by a consent judgment with the Minnesota Attorney General. *Khan*, 2012 U.S. App. LEXIS 1167 at *5-6. That consent judgment barred NAF "from the business of arbitrating credit card and other consumer disputes and [ordered the NAF to] stop accepting any new consumer arbitrations or in any manner participate in the processing or administering of consumer arbitrations." *Id*. at *6.

The district court denied the motion to compel arbitration. *See Khan v. Dell Inc*., 2010 U.S. Dist. LEXIS 85042 (D.N.J. Aug. 18, 2010). Judge Pisano found that the clause "SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION AND ADMINISTERED BY THE NATIONAL ARBITRATION FORUM (NAF) under its Code of Procedure then in effect . . ." demonstrated "the parties' intent to arbitrate exclusively before a particular arbitrator, not simply an attempt to arbitrate generally." *Id*. at *12-13. Observing that while some courts have held that Section 5 of the FAA "provides a mechanism for the appointment of an arbitrator when a chosen arbitrator is unavailable," the district court found that here the designation of the NAF as the arbitrator was "integral to the arbitration clause." *Id*. at *6, 12. Judge Pisano concluded that the "unavailability of the NAF precludes arbitration" and "the Court cannot appoint a substitute arbitrator and compel the parties to submit to an arbitration proceeding to which they have not agreed." *Id*. at *4.

C. The Third Circuit's Decision

On appeal, the Third Circuit panel framed the issue as whether designation of NAF as the arbitrator "is exclusive to the NAF and is an integral part of the agreement between Dell and Khan, thus preventing the appointment of a substitute arbitrator" under Section 5 of the FAA. *Khan*, 2012 U.S. App. LEXIS 1167 at *10. In providing "a mechanism for substituting an arbitrator when the designated arbitrator is unavailable, *Id*. at *12-13, Section 5 provides in relevant part:

> If in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators, or an umpire, such method shall be followed; but if no method be provided therein, or if a method be provided and any party thereto shall fail to avail himself of such method, or if for any other reason ***there shall be a lapse in the naming of an arbitrator or arbitrators*** or umpire, when filling a vacancy, then

> upon the application of either party to the controversy ***the court shall designate and appoint an arbitrator or arbitrators or umpire***, as the case may require, who shall act under the said agreement with the same force and effect as if he or they had been specifically named therein . . . .

U.S.C. § 5 (2012) (emphasis added).

The *Khan* panel observed that in determining the applicability of Section 5 when an arbitrator is unavailable, courts have "focused on whether the designation of the arbitrator was 'integral' to the arbitration provision or was merely an ancillary consideration." *Khan,* 2012 U.S. App. LEXIS 1167 at *11 (citing *Reddam v. KPMG LLP*, 457 F.3d 1054, 1061 (9th Cir. 2006), *abrogated on other grounds by Atlantic Nat'l Trust LLC v. Mt. Hawley Ins. Co.*, 621 F.3d 931 (9th Cir. 2010); *Brown v. ITT Consumer Fin. Corp.*, 211 F.3d 1217, 1222 (11th Cir. 2000)). "Only if the choice of forum is an integral part of the agreement to arbitrate, rather than an 'ancillary logistical concern,' will the failure of the chosen forum preclude arbitration." *Khan*, 2012 U.S. App. LEXIS 1167 at *11-12 (quoting *Brown*, 211 F.3d at 1222). Thus, "a court will decline to appoint a substitute arbitrator, as provided in the FAA, only if the parties' choice of forum is "so central to the arbitration agreement that the unavailability of that arbitrator [brings] the agreement to an end." *Id.* at *12 (quoting *Reddam*, 457 F.3d at 1061). Accordingly, for the arbitration provision to be rendered unenforceable, "the parties must have unambiguously expressed their intent not to arbitrate their disputes in the event that the designated arbitral forum is unavailable." *Id.* at *12.

Plaintiff argued that the clause "SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION ADMINISTERED BY THE NATIONAL ARBITRATION FORUM" designates the NAF as the exclusive arbitral forum, asserting that disputes should not be arbitrated if the NAF is unavailable. *Id.* at *13. This language the *Khan* majority found to be ambiguous, ruling that the word "EXCLUSIVELY" could be read to modify "BINDING ARBITRATION," "THE NATIONAL ARBITRATION FORUM," or both. *Id.* The panel held that the provision incorporating the NAF rules "is also ambiguous as to what should happen in the event that the NAF is unavailable," observing that these rules provide that "they shall be interpreted in a manner consistent with the FAA and that, if any portion of the NAF rules are found to be unenforceable, that portion shall be severed and the remainder of the rules shall continue to apply." *Id.*

The *Khan* majority found support for its finding of ambiguity in the Eleventh Circuit's decision in *Brown*, where the defendant moved to compel arbitration pursuant to an arbitration provision that was "virtually identical to the clause" at issue in *Khan*. The Eleventh Circuit found that the unavailability of the NAF did not nullify the arbitration clause because Section 5 of the FAA "provided a mechanism for appointing a replacement arbitrator." *Brown*, 211 F.3d at 1222. While noting that arbitration will be precluded where the designated arbitration forum is "integral" to the arbitration agreement rather than an "ancillary logistical concern," the court concluded that there was "no evidence supporting the [plaintiff's] claim that the forum provision was integral to the arbitration clause." *Id.*, 211 F.3d at 1222; *see also Adler v. Dell, Inc.*, 2009 U.S. Dist. LEXIS 112204 (E.D. Mich. Dec. 3, 2009) (concluding that the clause, "SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION ADMINISTERED BY THE NATIONAL ARBITRATION FORUM," was

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ambiguous as to whether the NAF's exclusive designation was integral to the provision or the intent to arbitrate superseded that designation, that district court found that because the designation of the arbitrator was not shown to be "as important a consideration as the agreement itself," the arbitration provision did not fail).

The court concluded that it "must resolve the ambiguity *in favor* of arbitration."

The *Khan* majority found "the *Brown* line of cases" to be persuasive authority in light of "the liberal federal policy in favor of arbitration." *Khan*, 2012 U.S. App. LEXIS 1167 at *16-17. The court held that the language relied on by plaintiff "is at best ambiguous as to whether the parties intended to have their disputes arbitrated in the event that NAF was unavailable for any reason" and that therefore "it is not clear whether the designation of NAF is ancillary or is as important a consideration as the agreement to arbitrate itself." The court concluded that it "must resolve the ambiguity *in favor* of arbitration." *Id.* at *17 (emphasis in original).

The court held further that the NAF's unavailability to hear the parties' dispute constitutes a "lapse" for purposes of Section 5. Plaintiff argued that the term "lapse" means "a lapse in the naming of the arbitrator or in the filling of a vacancy on a panel of arbitrators or some other mechanical breakdown in the arbitrator selection process," not the NAF's unavailability to arbitrate the dispute. *Id.* at *18 (citing *In re Salomon Inc. Shareholders Derivative Litigation*, 68 F.3d 554, 560 (2d Cir. 1995)). The *Khan* majority disagreed with plaintiff's definitional argument, finding that the unavailability of the NAF by a consent judgment with the State of Minnesota preventing it from acting as an arbitrator, "appears to us to be a breakdown in the mechanics in the appointment process." *Khan's*, U.S. App. LEXIS 1167 at *18. A "narrower construction of Section 5," the panel concluded, "would be inconsistent with the FAA's 'liberal federal policy in favor of arbitration.' " *Id.*

In her dissenting opinion, Judge Sloviter rejected the majority's conclusion that the clause "EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION ADMINISTERED BY THE NATIONAL ARBITRATION FORUM" was ambiguous. She observed that the phrase is "written in all capital letters yet surrounded by clauses written in lower case letters." *Id.* at *22. She found that "this aesthetic prominence indicates the parties' intent for the entire phrase to be read together and emphasized as an essential part of the agreement." *Id.* Agreeing with the district court that "[t]he NAF is expressly named, the NAF's rules are to apply, ... no provision is made for an alternate arbitrator [, and the] language is mandatory, not permissive, Judge Sloviter concluded that "[f]ull analysis of the plain text of the agreement as a whole shows that the selection of the NAF as arbitrator was an integral part of the agreement to arbitrate" and that Section 5 is therefore "inapplicable and the unavailability of the NAF precludes arbitration." *Id.* at *23.

D. Conclusion

While significant for its holding that the unavailability of the NAF to hear the parties' dispute constituted a lapse under Section 5 of the FAA, thereby requiring the appointment of a substitute arbitrator, *Khan* is equally notable in that the interpretation of the arbitration provision in question leading to this outcome

is the direct result of the FAA's "liberal policy in favor of arbitration." Specifically, a very high standard must be met for the court to decline to appoint a substitute arbitrator under Section 5. As the *Khan* majority ruled, "the parties must have unambiguously expressed their intent not to arbitrate their disputes in the event that the designated arbitral forum is unavailable." Id. at *12. The language of the panel's concluding clause "SHALL BE RESOLVED EXCLUSIVELY AND FINALLY BY BINDING ARBITRATION ADMINISTERED BY THE NATIONAL ARBITRATION FORUM" was subject to more than one plausible interpretation of the effect of the word "EXCLUSIVELY," *i.e.*, whether it modifies "BINDING ARBITRATION" or "THE NATIONAL ARBITRATION FORUM," or both phrases. In light of these conflicting interpretations, the plaintiff could not show that the parties "unambiguously expressed their intent not to arbitrate" in the event the NAF became unavailable to hear the claims. The FAA's pro-arbitration policy therefore mandated that the ambiguity be resolved by finding that the designation of the NAF was not integral to the arbitration agreement and the agreement to arbitrate was not nullified by NAF's unavailability. The *Khan* decision demonstrates how a court will interpret *any* ambiguity in an arbitration provision governed by the FAA to uphold the obligation to arbitrate.

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

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