

# Still Searching for That Safe Harbor

## Revising Your ADR Provisions:

### Look Before You Leap

*Terry Sternberg, Esq.  
Gary Barr, Esq.*

In a decision handed down in mid-February of this year, the California Supreme Court has thrown a significant element of uncertainty into the viability of choosing a judicial reference as your alternative dispute resolution (“ADR”) vehicle.

By way of brief background, there are three basic forms of ADR: arbitration, mediation and judicial reference. Parties can include in their agreement provisions requiring that disputes be kept out of court and instead resolved by any one or more forms of ADR.

Judicial reference is something of a hybrid between arbitration and a court case, with some elements of both and some unique features. A judicial reference takes place under the auspices of the court and, thus, begins with the filing of a lawsuit. Once suit is filed, the parties ask the court to issue an order taking the case out of the court system and placing in the hands of a judicial referee. Like an arbitrator, the referee may be a retired judge, a lawyer or a non-lawyer, and is paid by the parties, as they may agree. As in an arbitration, there is no jury. Unlike an arbitration, the documents filed in a judicial reference are filed with the court, the full range of discovery is automatically available and the referee must abide by the rules of evidence and follow the law. Although the

parties to an arbitration are free [under the California Arbitration Act (the “CAA”), but not the Federal Arbitration Act (the “FAA”)] to agree that the arbitrator’s decision may be reviewed by a court for errors of law, absent such agreement, there is no such right. In contrast, a referee’s decision is always subject to review by the court.

Judicial references took on added interest under Dodd-Frank because although Dodd-Frank clearly prohibits pre-dispute agreements<sup>1</sup> to arbitrate or mediate in certain consumer transactions, it is less than clear that it prohibits pre-dispute agreements calling for a judicial reference. Up until the Supreme Court’s recent decision, it was widely assumed that a court would all but automatically enforce an agreement for a judicial reference,<sup>2</sup> at least in agreements not covered by Dodd-Frank.

As with many an assumption, that one was wrong.

In a decision filed February 22, 2011<sup>3</sup>, the Supreme Court held that a trial court has the discretion to deny enforcement of an agreement requiring that the parties resolve their disputes by judicial reference. That means that parties who had agreed to stay out of court might find that they cannot.

*Tarrant Bell* involved a lawsuit brought by 120 current and former residents of a mobile home park against the park’s current and former owners. The plaintiffs sought damages for the owners’ alleged failure to properly maintain the park.<sup>4</sup> Most, *but not all*, of the plaintiffs had signed leases containing ADR provisions that required that any dispute brought by a tenant would be determined by arbitration. The leases also had a fall back provision: if the arbitration provision was found to be unenforceable, then the parties’ dispute would be resolved through judicial reference. Why didn’t all of the leases have the ADR provision? Simply and innocently enough, what had happened is that, over the course of time, the different park owners had revised their lease forms so that, by the time plaintiffs sued, most tenants had the newer lease form that contained the ADR provision. However, some of the older tenants whose leases did not have the ADR provision were still around and had joined in the lawsuit.

Disputes arose, plaintiffs sued, and the defendants asked the court to order those plaintiffs whose leases contained the ADR provision to submit their disputes to an arbitrator. However, the trial court declined to do so. Undaunted, the defendants then

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moved to enforce the provision that said that the parties would go to a judicial reference if the arbitration provision was held to be unenforceable. Once again, the trial court said, “No.” Defendants appealed all the way to the Supreme Court ... and lost again.

Defendants argued that a trial court had no discretion to deny a valid agreement to submit disputes to judicial reference. The Supreme Court rejected that argument on the basis of statutory construction and the legislative history of the statute that governs the enforcement of agreements calling for judicial reference. (Code of Civil Procedure section 638.) When a court interprets a statute, the term “may” is generally viewed as permissive, in contrast to the term “shall,” which is generally deemed mandatory. Section 638 provides that a trial court *may* order a reference based on the parties’ agreement. Section 638’s legislative history supported the interpretation of the word “may” as permissive because it showed that the legislature had considered but rejected a proposal to require a court to enforce the parties’ agreement for a judicial reference. Once the court held that, as used in Section 638, “may” meant permissive, it necessarily followed that a trial court has the discretion to deny enforcement.

The Supreme Court also upheld the basis upon which the trial court exercised its discretion to deny enforcement. About twenty of the plaintiffs could not be ordered into a reference because their leases did not contain the ADR provision. If the trial court ordered the one hundred plaintiffs with ADR provisions into a reference, that would burden the judicial system with two nearly identical lawsuits – one involving the cases that remained in court and one involving those ordered to reference – moving along two separate tracks at the same time. Each lawsuit would involve the same discovery, motions and hearings, resulting in a complete duplication of effort. This wasteful burden on the parties and the court was compounded by the prospect that the two lawsuits might result in two different rulings, one favoring the plaintiffs

and one favoring the defendants. Even in healthier economic times, the courts are careful to protect their always limited judicial resources. It is safe to assume that in today’s economic climate, the Supreme Court was that much more concerned about so wasteful a prospect.

What does this mean to you as you consider whether to include, or *revise*, an ADR provision in your deal documents? Let’s first put this in perspective and then make a few suggestions.

Perspective: the ruling in *Tarrant Bell* places agreements calling for a judicial reference on the same footing as ADR agreements requiring arbitration under the CAA. The CAA already provides that a trial court may refuse to enforce an agreement to arbitrate when doing so would create a risk of conflicting rulings. Indeed, the trial court had refused to enforce the arbitration provision in the plaintiffs’ leases because doing so would create just that kind of risk.<sup>5</sup> Notably, under the FAA, the court does not have the discretion to deny arbitration under such circumstances. That does not necessarily mean that you automatically elect to have an agreement to arbitrate covered by the FAA, rather than the CAA. The distinction noted here is but one of a number of differences between the two statutory schemes, so that a full analysis of whether to use one over the other must be undertaken.<sup>6</sup>

The holdings also emphasize the need to make sure that if you select ADR under the CAA, that you have given full consideration to whether all possible parties are bound by agreement to submit their claims to ADR. Most often, you will want to make sure that all potential parties are so bound, but there are circumstances in which you might not want to do that.<sup>7</sup>

Of equal importance, this decision highlights the need to exercise caution when considering whether – and how – to update your ADR provision. To be sure, revision is sometimes indicated – and may even be required – as the rules or your circumstances change (witness Dodd-

Frank’s impact.) However, and whatever the motivation, recognize that for some period of time you may be faced with the risk that a court will not enforce your ADR agreement for the same reasons the courts refused to enforce the ADR provisions under discussion in this article. There is, of course, no “one-size-fits-all” solution. Rather, as you must in many situations, you have to weigh the risks and rewards of which ADR solution to employ and how best to construct it based on the best information at hand. ▲

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Terry Sternberg is a real estate litigation attorney with offices in Woodland Hills, CA.

Gary Barr is a real estate transactional and litigation attorney with offices in Encino, CA.

#### Endnotes:

- 1 Unless stated otherwise, the discussion that follows concerns only pre-dispute agreements calling for ADR. Parties are generally free to agree to ADR once a dispute has arisen.
- 2 There were no prior decisions on the question.
- 3 *Tarrant Bell Property, LLC v. Superior Court* (2011), Case Number S179378
- 4 Some of the facts summarized here are taken from a companion case, discussed below, *Abaya v. Spanish Ranch I, L.P.* (2010) 189 Cal. App.4th 1490.
- 5 *Spanish Ranch*, cited in footnote 3, above, deals with the trial court’s refusal to order arbitration. Faced with the trial court’s refusal to order arbitration, the defendants then sought to enforce the fall back ADR provision calling for a judicial reference. That failed effort led to the decision in *Tarrant Bell*.
- 6 To cite but one example: Under the CAA, the parties have the right to agree that the arbitrator’s decision will be subject to judicial review for errors of law; there is no such right under the FAA.
- 7 An extended discussion on this point is beyond the scope of this update. Briefly, however, the California Association of Realtors’ standard form purchase agreement does not bind the brokers to arbitrate even when the parties have agreed to do so. This allows the brokers, but not the parties, the significant advantage of being able to decide whether to arbitrate *after* the dispute has arisen.

