SIMPSON THACHER

REPORT FROM WASHINGTON

Supreme Court Hears Arguments on Standard of Judicial Review of Arbitration Awards and the Constitutionality of Tax-exempt Bonds

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TO VIEW A TRANSCRIPT OF THE ORAL ARGUMENTS BEFORE THE SUPREME COURT OF THE UNITED STATES IN THE *HALL STREET* CASE, PLEASE CLICK HERE.

TO VIEW A TRANSCRIPT OF THE ORAL ARGUMENTS BEFORE THE SUPREME COURT OF THE UNITED STATES IN THE *DEPARTMENT OF REVENUE* CASE, PLEASE CLICK HERE.

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Last week, the Supreme Court heard oral arguments in two cases relevant to the business community. In *Hall Street Assocs. v. Mattel, Inc.*, the Court is considering whether a federal court can enforce the parties' agreement for a more expansive judicial review of an arbitration award than provided under the Federal Arbitration Act ("FAA"). The FAA provides that all written agreements to arbitrate are enforceable and specifies limited circumstances in which a court can modify an arbitrator's award. The Court's decision may affect the ability of parties contractually to grant courts additional grounds on which to reverse or modify an arbitrator's award upon review.

In *Dep't of Revenue of Kentucky v. Davis*, the Supreme Court is considering whether a state can constitutionally provide a tax exemption for interest income realized from bonds issued by state governmental entities while taxing interest income realized from bonds issued by out-of-state governmental entities. A Supreme Court decision that tax exemptions are unconstitutional would affect both holders and issuers of such bonds, and the thirty-eight states that currently provide the bond taxation structure at issue may be left to decide individually whether to provide all bonds with tax exemptions or eliminate such exemptions completely.

HALL STREET ASSOCS. v. MATTEL, INC., Docket No. 06-989 (U.S.)

BACKGROUND

The *Hall Street* case arose from a dispute over an indemnification clause in a lease agreement between Hall Street Associates and Mattel. The contract lacked an arbitration clause, but the parties agreed to arbitration of their dispute with the understanding that the district court could "vacate, modify, or correct any award where the arbitrator's conclusions of law

HALL STREET ASSOCIATES:

"It seems to be that if the purpose of the [FAA] is to promote confidence in the arbitration process, then if parties agree to have the double assurance that the arbitrator hasn't made some strange ruling of law, that that's quite consistent with the whole purposes of arbitration."

JUSTICE KENNEDY

"That's a strange argument in this respect. You are arguing that . . . if the judge controlled this arbitrator, somehow that would violate Article III. But if the judge has no control and is essentially little more than a rubber stamp . . . then that's all right."

JUSTICE GINSBURG

are erroneous." Notwithstanding the parties' agreement, § 9 of the FAA specifies only limited circumstances in which a court may modify an arbitration award and, for instance, does not provide for modification even if the arbitrator makes an erroneous finding of fact or law.

The United States District Court for the District of Oregon twice refused to enforce the arbitration award. First, the district court found that the award was based on an erroneous legal conclusion. Mattel appealed, arguing that the decision was outside the permitted scope of the court's judicial review under the FAA. Agreeing with Mattel, the Ninth Circuit remanded the case with instructions to "confirm the award, unless the district court determines that the award should be vacated . . . or modified or corrected under the grounds allowable under [the FAA]." On remand, the district court found the award "implausible" and again refused to enforce it. The Ninth Circuit reversed the district court for a second time, explaining that "[i]mplausibility is not a valid ground for avoiding an arbitration award under" the FAA. The Ninth Circuit emphasized that "errors of law . . . are not a sufficient basis for a federal court to overrule an arbitration award."

SUMMARY OF THE ARGUMENT

Petitioner Hall Street Associates argued in front of the Supreme Court that parties to an arbitration agreement should be free to decide standards for a court to modify an arbitrator's decision. Petitioner argued that the parties were not prescribing a standard of review for the court, but merely agreeing on what aspects of the arbitrator's decision were binding and what aspects were subject to review by a court. In response to a question by Justice Ginsburg, Petitioner admitted that there are limits to party autonomy, but those limits were not even remotely implicated in this case, and future parties were unlikely to agree to review standards "alien to the judicial process."

Chief Justice Roberts asked Petitioner why the result mattered: the arbitration agreement was simply a contract, and if it did not fall within the FAA, it still could be enforced under state law that existed before the FAA was enacted. Petitioner responded that the district court was prepared to enforce the arbitration agreement as a contract, but that the Ninth Circuit had refused to allow it because of the FAA. Under § 2 of the FAA, Petitioner argued, the court should enforce the intent of the parties.

Respondent Mattel, Inc. argued that §§ 9 to 11 of the FAA provide the exclusive grounds on which a court can vacate, modify, or correct an arbitration award and that those grounds do not include legal error. Respondent argued that Congress made the choice to provide a streamlined procedure under § 9. When Chief Justice Roberts again brought up the possibility that the case should fall outside of the FAA and be decided under state law, Respondent argued that the case falls within § 9 because there was an agreement to confirm the arbitrator's award, which the court below had held was not severable: the only issue was whether the court could review for errors of law, contrary to § 9.

Justices Ginsburg and Breyer expressed concern that a decision in Respondent's favor would limit the ability of judges and litigants to peel off parts of a

"I don't see what the big deal is . . . . Use normal contract law and say to the district court: Well, you don't have the Federal Arbitration Act . . . but we have a contract, it's perfectly valid, it sets a different standard of review, you should enforce it."

CHIEF JUSTICE ROBERTS

DEP'T OF REVENUE:

"[W]e have an enormous market, the effect of interrupting which we really, as a Court, cannot tell very much. And that seems to me a very good reason to give the nod to the [status quo]."

JUSTICE SOUTER

case for decision by arbitrators. Respondent responded by pointing out that an agreement to arbitrate is an agreement to transfer part of a case to the streamlined processes of § 9. Justice Kennedy suggested that, if the purpose of the FAA is to promote confidence in the arbitration process, then allowing parties to ensure that an arbitrator has not made "some strange ruling of law" is consistent with that purpose. When Respondent argued that parties could contract around the limitations of § 9 and rely on state contract law, Justice Kennedy noted that the policy rationale for the FAA was to avoid the state law bias against arbitration.

Justice Stevens asked Respondent whether there were public policy reasons for Congress to prohibit the type of agreement at issue. Respondent argued that Congress wanted to give parties an *option* for a quick, simple, cost-effective, and final way for dispute resolution; other, less efficient methods were left to state contract law. Chief Justice Roberts and Justice Souter appeared to consider the possibility that Congress may have made a policy choice to make the § 9 limits mandatory because of a desire not to completely override state law: if parties wanted to arbitrate under the FAA, they could only do so subject to § 9; otherwise, they would fall into a state contract law regime.

IMPLICATIONS

In light of the growing share of disputes that parties resolve through arbitration, it is of significant practical importance to see whether the Supreme Court decides that the FAA provides the exclusive standard of review for arbitration awards or that the FAA merely proscribes the minimum standard of review. If the Court were to confirm the Ninth's Circuit ruling, parties would be unable to agree upon a more liberal standard of review without relying on possibly inconsistent and ambiguous state law. On the other hand, by reversing the Ninth Circuit, the Court would provide greater contractual freedom to parties negotiating the scope of their arbitration clauses—including the ability to agree upon a more arduous review by the courts.

DEP'T OF REVENUE OF KENTUCKY v. DAVIS, Docket No. 06-666 (U.S.)

BACKGROUND

The *Davis* appeal arises from a class action complaint filed on behalf of Kentucky citizens who paid tax on interest income realized from bonds issued by out-of-state municipalities. A Kentucky statute provides a tax exemption for interest income derived from bonds issued by Kentucky, but makes no such exemption for bonds issued by other states. The complaint alleges that Kentucky's taxation structure violates both the Commerce and Equal Protection Clauses of the U.S. Constitution. The Commerce Clause not only gives Congress the power to regulate commerce among the states, but also prevents the states from favoring in-state businesses by discriminating against out-of-state businesses.

The Jefferson Circuit Court granted the Department of Revenue's motion for summary judgment, finding the Kentucky statute constitutional in part because they "encourage states and cities to improve the lives of their citizens by keeping the benefits they generate within

"The victims under [Respondent's] approach, as I understand it, are the 49 other States, and all of them seem to support [Petitioner] in the briefs that were filed in this case."

JUSTICE STEVENS

"All politics is local. All States want to protect their residents and make it look like they're doing something for their residents. And that's exactly the purpose of [the] Commerce Clause prohibition against explicit discrimination, which is what this is."

JUSTICE KENNEDY

their borders." The court explained that those who buy in-state bonds "ultimately become the beneficiaries of the issuance of the bonds for state issues such as capital improvements [such] as quality schools, hospitals and roads."

However, the Kentucky Court of Appeals vacated the grant of summary judgment and remanded the case. The court stated that "[c]learly, Kentucky's bond taxation system is facially unconstitutional" because it "affords more favorable tax treatment to in-state bonds than it does to extraterritorially issued bonds." The Kentucky Court of Appeals started its analysis by examining *Shaper v. Tracy,* 97 Ohio App. 3d 760, N.E.2d 550 (Ohio Ct. App. 1994), a decision of the Ohio Court of Appeals that held a similar taxation system constitutional. Yet the court criticized the *Shaper* decision, stating that "the court failed to fully analyze the issue" and that a "potentially problematic and constitutionally infirm statute does not become permissible simply because it has not been previously found to be unconstitutional."

The Supreme Court's decision in Davis likely will be heavily influenced by the Court's opinion in *United Haulers Ass'n, Inc. v. Oneida-Herkimer Solid Waste Management Auth.*, 127 S. Ct. 1786 (2007), which the Court decided earlier this year. In that case, the Court acknowledged that "when a law favors in-state business over out-of-state competition, rigorous scrutiny is appropriate," but that "it does not make sense to regard laws favoring local government and laws favoring private industry with equal skepticism." The Court explained that "[l]aws favoring local government . . . may be directed toward any number of legitimate goals unrelated to protectionism." In light of *United Haulers*, the *Davis* case may turn on whether the Court decides the municipal bond market is an issue of favoring a private business over its competitors or instead is a government function with the legitimate goal of raising funds for state projects.

SUMMARY OF THE ARGUMENT

Petitioner Department of Revenue argued in front of the Supreme Court that Kentucky's tax exemption for municipal bond interest treats all private entities the same and favors only state governmental entities. According to Petitioner, under *United Haulers*, laws that favor only state governmental entities do not discriminate against interstate commerce and do not violate the dormant Commerce Clause.

Justice Breyer asked Petitioner to draw a distinction between hypothetical milk producers in Kentucky asking the legislature to impose a tax on imported milk (a clearly unconstitutional tax) and hypothetical cities in Kentucky looking to finance their schools asking the legislature to impose a tax on school bonds issued by cities outside Kentucky. Petitioner argued that the former hypothetical involves favoritism of a private industry, while the latter hypothetical involves favoritism of "the most public of industries, education."

Chief Justice Roberts pointed out that, unlike the situation in *United Haulers*, Kentucky was competing with other public entities in the municipal bond market, much like competition among private entities. Petitioner responded that the key distinction laid out in *United Haulers* was between entities that had responsibility for the welfare of citizens within a jurisdiction

and all other entities. In this case, other state bond issuers had no responsibility for the welfare of Kentucky citizens and were no different from private issuers in Kentucky.

Respondent argued that Kentucky's facially discriminatory tax was no different from those in the established line of cases striking down such taxes. According to Respondent, Kentucky governmental entities issued bonds in the highly competitive bond market but are given a discriminatory advantage. Justice Breyer took issue with treating these bonds as commodities, noting that the bonds financed the most basic governmental functions such as libraries, schools, and streets. According to Respondent, the purpose of a law has no bearing if it is facially discriminatory: as long as there is competition between the locally produced tax-exempt product and non-exempt products from out of states, there is a discriminatory effect.

Respondent argued that the case was a "classic race to the bottom" in which each state would attempt to hoard investment capital by discriminating against bonds issued by other states. Justice Breyer suggested that states could go to Congress for a legislative solution, and Chief Justice Roberts implied that that was indeed the preferred solution.

On rebuttal, Petitioner noted that Kentucky and other states required tax exemptions for their own bonds decades before they even had income taxes. Therefore, the idea of a race to the bottom was post hoc reasoning. When Justice Kennedy pointed out that the purpose of the Commerce Clause is to protect against explicit discrimination, Petitioner reported that Congress had studied the issue and decided not to act, and that the Court should not interfere with this determination.

IMPLICATIONS

If the Supreme Court were to find the *Davis* taxation structure unconstitutional, its decision would have a profound impact on the nearly $2.1 trillion municipal bond market. The thirty-eight states that currently provide the bond taxation structure at issue would have to change their tax structures by treating in-state and out-of-state bonds the same—by either eliminating all tax-exemptions or applying the same tax to all such bonds.

For further information about this decision, please feel free to contact members of the Firm's Litigation Department, including:

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