The Arbitration Newsletter

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The Arbitration Newsletter is published periodically by Whitaker Chalk Swindle & Schwartz PLLC, Fort Worth, Texas, to explore the rapidly developing law and practice of commercial arbitration both in the U.S. and other countries.[1]

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THE RITZ-CARLTON CASES[2]

Narayan v. Ritz-Carlton Dev. Co., 135 Haw. 327 (2015).

On January 11, 2016, the U.S. Supreme Court granted certiorari for the Ritz-Carlton cases and, in the same stroke, vacated the Supreme Court of Hawaii's judgment and remanded the cases "to the Supreme Court of Hawaii for further consideration in light of *DirecTV, Inc. v. Imburgia*, 577 U.S. ___, 136 S. Ct. 463 (2015)."[3]

i. The Players & the Project

The underlying project was a condominium development[4] formerly known as "the Ritz-Carlton Club & Residences at Kapalua Bay."[5] The project comprised eighty four (84) private-ownership condo units developed by Kapalua Bay, LLC. The project was "a joint venture owned by Defendants Marriott International, Inc. (["]Marriott["]), Exclusive Resorts, Inc., and Maui Land & Pineapple Co., Inc."[6] Of the total 84 units, Kapalua Bay, LLC owns fifty six (56) of the units, and Krishna Narayan, et al. (collectively, "Homeowners") purchased ten of the condominiums units from Kapalua Bay, LLC.[7] The Homeowners, Kapalua Bay, LLC, and other

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[1] Nothing in *The Arbitration Newsletter* is presented as or should be relied on as legal advice to clients or prospective clients. The sole purpose of *The Arbitration Newsletter* is to inform generally. The application of the comments in *The Arbitration Newsletter* to specific questions and cases should be discussed with the reader's independent legal counsel. My thanks to Macdonald A. Norman, a third-year law student at Texas A&M University School of Law, for his research and drafting assistance.

[2] *The Ritz-Carlton Development Company, Inc. v. Narayan* and *The Ritz-Carlton Development Company v. Nath* (Docket Nos. 14-378, -379, -406). *Ritz-Carlton Dev. Co. v. Narayan*, 2016 U.S. LEXIS 365; *Ritz-Carlton Dev. Co. v. Narayan*, 2016 U.S. LEXIS 288; *Ritz-Carlton Dev. Co. v. Nath*, 2016 U.S. LEXIS 45. *Certiorari—Summary Dispositions*, SUPREME COURT OF THE UNITED STATES, http://www.supremecourt.gov/orders/courtorders/011116zor_n7io.pdf [perma.cc/3MRT-8UGX].

[3] *Id.*

[4] The Condominium Declaration filed of record contained the arbitration agreement in question.

[5] *Narayan v. Ritz-Carlton Dev. Co.*, 135 Haw. 327, 330 (2015).

[6] *Id.*

[7] *Id.*

third-party owners comprise the Association of Apartment Owners of Kapalua Bay Condominium ("AOAO").[8]

"Ritz-Carlton Development Company, Inc. . . . and the Ritz-Carlton Management Company, LLC . . . were the original development and management companies for the project, and were then wholly-owned subsidiaries of Marriott."[9] John Albert and Edgar Gum served on the AOAO board of directors while, allegedly, in either Marriott or Ritz-Carlton's employment.[10]

ii. The Problem—Money

In April 2012, Kapalua Bay, LLC and affiliated entities defaulted on project loans. Consequently, Kapalua could not pay maintenance and operator fees to Marriott management subsidiaries.[11] In turn, Marriott defaulted on its AOAO assessments and ultimately decided to abandon the project.[12] One million three hundred thousand dollars ($1,300,000) was withdrawn from the AOAO operating fund by Marriott or a Marriott subsidiary.[13] AOAO board members, many employees of interested entities (Marriott, Ritz-Carlton, etc.), "did not attempt to block Marriott from taking these actions."[14]

iii. The Arbitration Agreement

Hawaii Revised Statutes ch. 514A ("HRS") requires the recording of certain project governance documents in State of Hawaii Bureau of Conveyances.[15] Before the sale of individual condo units to the Homeowners, "the Declaration of Condominium Property Regime of Kapalua Bay Condominium . . . [("Declaration")] and the Association of Apartment Owners of Kapalua Bay Condominium Bylaws . . .[("Bylaws")]" were recorded with the Bureau of Conveyances.[16] Additionally, Kapalua recorded a "Condominium Public Report . . . [("Public Report")] with the Hawaii Real Estate Commission."[17]

All of these documents were incorporated by reference through a purchase agreement executed by Homeowners at the time the condos were purchased.[18] Furthermore, the homeowners *received copies of each* of the recorded documents "*along with their purchase agreements.*"[19]

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[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.* at 331.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.* (emphasis supplied) ("The Homeowners do not dispute that they received the condominium declaration, the public report, and the AOAO bylaws along with their purchase agreements.").

The arbitration clause at issue was in the condominium declaration.[20] The Declaration was referenced over twenty (20) times in the purchase agreement.[21] Yet, the references do not explicitly mention a binding agreement to arbitrate.[22] Further, only two clauses in the purchase agreement relate to dispute resolution:

> 47. Waiver of Jury Trial. Seller and Purchaser hereby expressly waive their respective rights to a jury trial on any claim or cause of action that is based upon or arising out of this Purchase Agreement. . . . Venue for any cause of action brought by Purchaser hereunder shall be in the Second Circuit Court, State of Hawai'i.
>
> 48. Attorneys['] Fees. If any legal or other proceeding, including arbitration, is brought . . . because of an alleged dispute, breach, default or misrepresentation in connection with any provisions of this Agreement, the successful or prevailing party or parties shall be entitled to recover reasonable attorneys' fees, court costs and all expenses even if not taxable as court costs, . . . in addition to any other relief to which such party or parties may be entitled.[23]

Yet, the Declaration, not the Purchase Agreement, contained an arbitration agreement. In pertinent part, the arbitration agreement in the declaration:

1) required arbitration "of any controversy or claim arising out of, or related to, this Declaration or to any alleged construction or design defects pertaining [to the project]";
2) required arbitration before a single arbitrator in Honolulu, Hawaii;
3) prohibited the arbitrator from awarding punitive, exemplary, or consequential damages;
4) limited discovery to the exchange of nonrebuttable exhibits and witness lists, unless parties agree otherwise;
5) required confidentiality related to the dispute and arbitration; and
6) stated a one year statute of limitations for claims of fraud, misrepresentation, or fraudulent inducement.[24]

In contrast to these terms, the Purchase Agreement incorporated both the Public Report and AOAO Bylaws. The Public Report contained a clause that stated:

> "The Condominium Property Act (Chapter 514A, HRS), the Declaration, Bylaws, and House Rules control the rights and obligations of the apartment owners with respect to the project and the common elements, to each other, and to their respective apartments. The provisions of these documents are intended to be, and in most cases are, enforceable in a court of law."[25]

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[20] *Id.*
[21] *Id.*
[22] *Id.*
[23] *Id.* at 332 (alterations in original).
[24] *Id.*
[25] *Id.* (alterations in original).

iv. Procedural Posture

On June 7, 2012, the Homeowners sued in "the Circuit Court of the Second Circuit (circuit court) asserting claims for breach of fiduciary duty, 'access to books and records,' and injunctive/declaratory relief."[26] The Respondents filed a motion to compel arbitration, which was denied after a hearing.[27] Respondents then appealed to the Intermediate Court of Appeals ("ICA").[28] The Homeowners argued a lack of assent because the arbitration agreement was "buried" in the Condominium Declaration.[29]

Additionally, Homeowners argued that the Purchase Agreement was ambiguous. In the alternative, if Homeowners did agree to arbitrate, the dispute at issue was outside the scope of the agreement.[30] Finally, the Homeowners argued the arbitration agreement was unconscionable because the agreement: 1) "severely limited discovery"; 2) "imposed a one-year limitations period"; and 3) "unilaterally shielded Ritz-Carlton, and partners, from potential liability."[31]

The ICA rejected all Homeowners' arguments and held there was a valid arbitration agreement and the dispute fell within the scope of the agreement. Without reaching substantive unconscionability, the ICA held the agreement was not procedurally unconscionable because Homeowners received reasonable notice of the provision, acknowledged through signature, and had a cancellation right for thirty (30) days from receipt of the public report.[32] The Homeowners then appealed to the Supreme Court of Hawaii.

v. Supreme Court of Hawaii

Under Hawaiian law, an arbitration agreement "'must be unambiguous as to the intent to submit dispute or controversies to arbitration . . .'"[33] Further, there are at least two circumstances where "unambiguous intent to arbitrate may be lacking."[34] First, intent may be lacking in a contract that contains one or more dispute resolution clauses that conflict.[35] Second, intent may be lacking if a party received insufficient notice of an arbitration clause in an external document.[36]

The Hawaiian Supreme Court held the arbitration agreement was unenforceable because the various condominium documents were ambiguous regarding Homeowners' intent. The court

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[26] *Id.* at 333.
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.* at 334.
[34] *Id.*
[35] *Id.*
[36] *Id.* at 334–35.

based its decision on apparent conflicts between the Purchase Agreement's venue clause, the Declaration's arbitration provision, and the Public Report.[37]

The Supreme Court of Hawaii then held the arbitration agreement was both procedurally and substantively unconscionable.[38] On the issue of procedural unconscionability, the court reasoned the declaration was an adhesion contract that "often satisf[ies] the procedural element of unconscionability."[39] According to the court, the declaration was drafted by a party with superior bargaining position and recorded in the State of Hawaii Bureau of Conveyances.[40] As such, the Homeowners had no choice but to conform in order to purchase a Ritz-Carlton condo.[41] Further, the court noted the arbitration clause was "buried in an auxiliary document and was ambiguous" when read in conjunction with other documents that concerned dispute resolution.[42] In its critique of the ICA opinion, the Supreme Court of Hawaii stated that the ICA opinion suggested a condo developer may impose substantively unconscionable terms if the developer complied with HRS ch. 514A and provided reasonable notice of the unconscionability.[43]

The Hawaiian Supreme Court also held the arbitration agreement was substantively unconscionable. Quoting Davis v. O'Melveny & Myers,[44] the court reasoned an arbitration clause that both severely limits discovery and contains a confidentiality provision may deprive a plaintiff of "the ability to adequately discover material information about his or her claim."[45] In the current case, the court concluded the clause, as written, would deprive the Homeowners of an adequate alternative forum because of a virtual inability to investigate their claims.[46]

While noting Hawaiian law "already disfavors limited damages for intentional and reckless conduct," the court reasoned parties in superior bargaining positions could use adhesion contracts to insulate "outrageous conduct" that typically results in punitive damages.[47] "Extending these principles," the Hawaiian Supreme Court endorsed the view that adhesion contracts that prohibit punitive damages are substantively unconscionable.[48]

The Hawaiian Supreme Court vacated the ICA's judgment, affirmed the trial court order that denied the motion to compel arbitration, and remanded the case.

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[37] The venue clause stated the "Venue for any cause of action brought by Purchaser hereunder shall be in the Second Circuit Court, State of Hawai'i." The Declaration stated that arbitration "shall be held in Honolulu, Hawaii." The Public Report stated "[T]he Declaration, Bylaws, and House Rules control the rights and obligations of the apartment owners.... The provisions of these documents are intended to be, and in most cases are, enforceable in a court of law." *Id.* (alterations in original).

[38] *Id.* at 336.

[39] *Id.*

[40] *Id.* at 336–37.

[41] *Id.* at 337.

[42] *Id.*

[43] *Id.*

[44] Davis v. O'Melveny & Myers, 485 F.3d 1066, 1078–79 (9th Cir. 2007), *overruled on other grounds by* Ferguson v. Corinthian Colleges, Inc., 733 F.3d 928, 933–34 (9th Cir. 2013).

[45] *Id.* at 338.

[46] *Id.*

[47] *Id.* at 339.

[48] *Id.*

OBSERVATIONS

1. This is an FAA-governed case where the state courts both at the trial court and the highest appellate court levels failed to follow the clear principles in FAA jurisprudence.

2. Except in highly specific situations, the arbitration clause drafter should provide that the FAA governs the arbitration.

3. This case also illustrates the state courts' refusal to treat the arbitration contract like any other contract.

4. The "baby" being "thrown out with the bath water" in these cases is the sanctity of contract. The arbitration clause is a **contract** and cannot be treated differently than any other contract under state contract principles.

5. Adhesion contracts "are not *per se* unconscionable or void."[49]

6. In the employment and consumer contexts, the arbitration clause drafter should resist the urge to ignore the employee/consumer's contract rights.

7. In all contexts, the arbitration clause drafter should not ignore applicable state contract law unconscionability doctrine.

[49] *In re Palm Harbor Homes, Inc.*, 195 S.W.3d 672, 678 (Tex. 2006); *In re H.E. Butt Grocery Co.*, 175 S.W.3d 360, 376-71 (Tex. App. – Houston [14th Dist.], orig. proceding) ("Adhesion contracts are not automatically unconscionable or void.").