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Commonwealth of Kentucky

Court of Appeals

NO. 2017-CA-000149-MR

AMBAC ASSURANCE CORPORATION APPELLANT

v.

APPEAL FROM HARDIN CIRCUIT COURT
HONORABLE KELLY EASTON, JUDGE
ACTION NO. 14-CI-01820

KNOX HILLS LLC APPELLEE

OPINION
REVERSING AND REMANDING

** ** ** ** **

BEFORE: KRAMER, J. LAMBERT AND TAYLOR, JUDGES.

KRAMER, JUDGE: This appeal involves a February 1, 2007 design/build agreement governing the rights of the several parties involved with a military housing construction and renovation project at Fort Knox, Kentucky. Specifically, on October 31, 2014, appellee Knox Hills, LLC (the owner of the project) filed a breach of contract action in Hardin Circuit Court against Ambac Assurance

Corporation (the senior lender of the project) relating to what it characterized as Ambac's wrongful withholding of consent to a change order that would have substantially reduced the scope of the project. Additionally, Knox Hills sought an order staying the proceedings and compelling Ambac to arbitrate. For reasons discussed more thoroughly below, Ambac opposed Knox Hills' motion to compel arbitration.[1] The circuit court granted the motion. Following arbitration, the circuit court entered an order confirming the arbitrator's award in favor of Knox Hills. Ambac now appeals. Upon review, we reverse the circuit court in both respects and remand for further proceedings.

There are two dispositive questions presented in this appeal. First, which tribunal should have determined whether arbitration was required between Knox Hills and Ambac? Second, was arbitration required? With respect to the first of these questions, the answer depends upon whether Ambac's refusal was based upon procedural arbitrability or substantive arbitrability -- a point that was recently and succinctly explained by the United States Court of Appeals for the Eighth Circuit:

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[1] Ambac also moved to dismiss Knox Hills' suit on the basis of standing. The circuit court denied Ambac's motion, and Ambac has not raised it as an issue on appeal.

Under the FAA,[2] arbitration agreements are deemed "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. But the FAA also imposes a basic principle: arbitration is a process of consent and not coercion. *See Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662, 681, 130 S.Ct. 1758, 176 L.Ed.2d 605 (2010). "[A]rbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit." *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83, 123 S.Ct. 588, 154 L.Ed.2d 491 (2002) (internal quotation marks omitted). Courts must therefore play a threshold role to determine "whether the parties have submitted a particular dispute to arbitration." *Id.*

These threshold or gateway issues are called substantive questions of arbitrability. Substantive questions include "whether the parties have a valid arbitration agreement at all or whether a concededly binding arbitration clause applies to a certain type of controversy." *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444, 452, 123 S.Ct. 2402, 156 L.Ed.2d 414 (2003). Courts presume that substantive questions are "for judicial determination [u]nless the parties clearly and unmistakably provide otherwise." *Howsam*, 537 U.S. at 83, 123 S.Ct. 588 (alteration in original) (internal quotation marks omitted). Because arbitration is about consent of the parties, we "hesitate to interpret silence or ambiguity" in an agreement as grounds for committing such important questions to an arbitrator. *See First Options of Chi., Inc.*

[2] Any arbitration pursuant to the design/build agreement was governed by the Federal Arbitration Act. In relevant part, it provided:

> **12.5.4 Arbitration Act**. This agreement to arbitrate and all procedural aspects thereof, including the construction and interpretation of such agreement to arbitrate, the scope of arbitrable issues, allegations of waiver, delay or defenses as to arbitrability, and the rules (except as otherwise expressly provided herein) governing the conduct of the arbitration, shall be governed by and construed pursuant to the United States Arbitration Act, 9 U.S.C. §§1-11, as amended.

> *v. Kaplan*, 514 U.S. 938, 945, 115 S.Ct. 1920, 131 L.Ed.2d 985 (1995).
>
> Many questions that arise in the arbitration context are procedural or subsidiary questions that courts presume an arbitrator may decide. *Howsam*, 537 U.S. at 84, 123 S.Ct. 588. "Procedural questions arise once the obligation to arbitrate a matter is established, and may include such issues as the application of statutes of limitations, notice requirements, laches, and estoppel." *Dell Webb Cmtys., Inc. v. Carlson*, 817 F.3d 867, 873 (4th Cir.), cert. denied sub nom. *Carlson v. Del Webb Cmtys., Inc.*, ___U.S. ___, 137 S.Ct. 567, 196 L.Ed.2d 444 (2016). These are questions for an arbitrator both because the parties would most likely expect an arbitrator to decide them, *see Howsam*, 537 U.S. at 84, 123 S.Ct. 588, and because they do not challenge the arbitrator's underlying authority, *see AT&T Techs., Inc. v. Commc'ns Workers of Am.*, 475 U.S. 643, 648-49, 106 S.Ct. 1415, 89 L.Ed.2d 648 (1986).

Catamaran Corp. v. Towncrest Pharmacy, 864 F.3d 966, 970 (8th Cir. 2017) (footnote added).

Here, Ambac refused to arbitrate Knox Hills' breach of contract action for two interrelated reasons. First, Knox Hills failed, prior to commencing arbitration, to submit its dispute to an "Advisor" described in the agreement. Second, Knox Hills and other relevant parties to the contract concededly failed to designate the "Advisor" within forty-five days after the agreement was executed on

February 1, 2007.[3] To understand what this means, and whether it dealt with matters of substantive arbitrability (as Ambac argues) or procedural arbitrability (as the circuit court cited as its basis for allowing the arbitrator to address it) requires a close examination of the Article of their agreement relating to arbitration. In relevant part, it provides:

ARTICLE 12.

DISPUTE RESOLUTION PROCEDURES

> **12.1 Dispute Prior to Claim Notice**. If either the Owner or the D/B Contractor disputes a directive given, objects to a failure to act, or disputes an approval or consent (or failure to give approval or consent) by the Construction Consultant, or objects to a failure to act or disputes the approval or consent (or failure to give approval or consent) required to be given by the Owner, the Army or the Senior Lender then such directive, approval, consent, act or failure to act shall not be disputed unless a Claim Notice is given pursuant to Section 12.2 by the disputing party to all other parties to such dispute within thirty (30) days of the disputing party's becoming aware of such directive, approval, consent, act, or failure to act.
>
> **12.2 Claim notice**. If a dispute or claim arises in connection with this Agreement or the subject matter hereof, including, without limitation, a claim (i) in tort, (ii) under statute, (iii) for restitution based on unjust

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[3] As noted below, Section 12.4 of the agreement required the "Advisor" to be designated by agreement of the "Owner" (Knox Hills), the "D/B Contractor" (an entity by the name of Actus Lend Lease, LLC), and the "Construction Consultant" (an entity by the name of Marx/Okubo Associates, Inc.). Seven years after the design/build agreement was consummated, these parties conceded that they had never designated an Advisor.

enrichment or (iv) for rectification, then the disputing party or parties shall deliver notice to all other parties to such dispute which adequately identifies the pertinent details of the dispute (a "**Claim Notice**"). Notwithstanding the existence of any dispute, the Owner, the D/B Contractor and the Construction Consultant shall continue to perform their respective obligations under this Agreement, except as otherwise provided for herein.

12.3 Dispute Resolution Process. If a Claim Notice is delivered, the parties to the dispute shall endeavor in good faith to resolve the dispute within ten (10) days of the delivery of the Claim Notice. If they cannot agree within such ten (10) day period, any party to the dispute may elect, by written notice to all other parties (a "**Dispute Notice**"), to submit the matter to the Advisor referred to in Section 12.4 for resolution. In such event, the parties to the dispute shall send representatives to meet with the Advisor as soon as practicable, and shall promptly submit such information and materials as they deem relevant to the matter in dispute. Within ten (10) days after receipt of the Dispute Notice and any relevant information and materials submitted by the parties to the dispute, the Advisor shall notify the parties to the dispute of his or her determination concerning the matter in dispute (a "Determination Notice"). The decision of the Advisor in the Determination Notice shall be binding upon the Owner, the D/B Contractor and the Construction Consultant only for the limited purposes of the continued performance of the Work. HOWEVER, THE PARTIES TO ANY DISPUTE ARISING HEREUNDER EXPRESSLY RESERVE THE RIGHT TO CONTEST THE DECISION OF THE ADVISOR BY COMMENCING BINDING ARBITRATION PURSUANT TO THIS ARTICLE 12, SUCH COMMENCEMENT TO BE ACHIEVED BY THE SENDING OF AN ARBITRATION COMMENCEMENT NOTICE TO ALL OTHER PARTIES TO THE DISPUTE WITHIN TEN (10) DAYS OF THE DETERMINATION NOTICE. THE

ARBITRATOR IN SUCH PROCEEDINGS SHALL CONSIDER THE ISSUES IN SUCH DISPUTE ON A DE NOVO BASIS WITHOUT REGARD FOR THE ADVISOR'S DECISION IN THE DETERMINATION NOTICE.

12.4 Advisor. The D/B Contractor, the Owner and the Construction Consultant shall designate a Person as the advisor (and such other Persons as they may agree to serve as alternate advisors) (any such Person, the "**Advisor**") by mutual agreement prior to the Financial Closing Effective Date or within forty-five (45) Days thereafter. The Advisor shall render determinations pursuant to this Article 12. The Advisor shall be retained by the Owner to perform the services described herein and the party serving the Dispute Notice, if not the Owner, shall reimburse the Owner promptly upon demand for one-half of all sums due the Advisor in connection therewith; the terms of such retention shall specify that the Advisor is an impartial party acting on behalf of the Owner, the D/B Contractor and the Construction Consultant, and that all costs relating to the retention of the Advisor shall be borne equally by the Owner and the party serving a Dispute Notice, if not the Owner.

. . . .

12.5.2 Procedures for Binding Arbitration. Unless otherwise agreed by the parties to the dispute, any binding arbitration involving a claim or dispute shall be conducted, except as otherwise specifically provided herein, in accordance with the Rules of the AAA, as such Rules may be modified by agreement of the parties to the dispute, provided, however, that the Arbitrator shall determine the resolution of the dispute within thirty (30) days after his or her appointment. In no event shall the demand for arbitration be made after the date when the applicable statute of limitations would bar institution of a legal or equitable proceeding based on such claim, dispute or other matter in question. The award rendered

by any Arbitrator shall be final, and judgment may be entered upon it in accordance with applicable Law in any court having jurisdiction. The parties to any dispute brought before the Arbitrator hereby agree to be bound by the decision of the Arbitrator. The expenses of arbitration shall be borne equally by the disputing parties, except that each party shall separately pay for its own witness and counsel fees. Time shall be of the essence with respect to any period of time specified in this Article 12.

. . . .

12.6 Resolution of Non-Arbitrable Disputes. Claims or disputes determined by a court of competent jurisdiction to be non-arbitrable and claims or disputes in which a disputing party seeks specific performance shall be subject to litigation in a court of competent jurisdiction as specified in Section 14.12. No complaint for monetary damages shall be filed in a court until after the date which is ninety (90) days after the date of receipt of the Dispute Notice.

12.7 Dispute Resolution Procedures binding upon Third Party Beneficiaries. The dispute resolution procedures set forth in this Article 12 shall be binding upon the parties to this Agreement and to any and all third party beneficiaries which are indicated in Section 14.13, including, without limitation, the Army, the Senior Lender and the Construction Consultant. Such agreement by the third party beneficiaries to be bound by the provisions of this Article 12 shall be conclusively evidenced by their respective agreement to execute and deliver the Operative Documents to which they are a party.

To summarize the plain terms of the agreement, the parties provided themselves two avenues of dispute resolution -- either the courts[4] or arbitration. Down either avenue, the dispute resolution process would have been initiated by serving the "Claim Notice" described in Section 12.2 to all other interested parties. *See* Section 12.1. Thereafter, if the parties were unable to resolve the dispute themselves, they could resort to judicial process or, alternatively, "any party to the dispute may elect, by written notice to all other parties (a 'Dispute Notice'), to submit the matter to the Advisor referred to in Section 12.4 for resolution." *See* Section 12.3. In the event of the latter, the Advisor, in turn, would become the sole conduit for proceeding to binding arbitration; the agreement limits the scope of any dispute potentially subject to binding arbitration to *de novo review* of a *decision* from the Advisor and conditions the commencement of binding arbitration upon the receipt of a "determination notice" reflecting the Advisor's decision. *See* Section 12.3. There is no other type of "binding arbitration" specified in Section 12.3, nor does the agreement provide any process for commencing binding arbitration outside of the process specified in Section 12.3.[5] In other words, the

[4] In Section 14.11 of their agreement, the parties likewise qualified dispute resolution through the courts by waiving the right to a jury trial.

[5] The only other provision throughout the agreement that discusses the commencement of arbitration underscores in three separate instances that the arbitration in question is "pursuant to Section 12.3." *See* Section 12.5.1.1. Likewise, Section 12.5.3 underscores the agreement contemplated "any dispute" that proceeded through the dispute resolution process outlined in Article 12 would entail "respective decisions of the Advisor and the Arbitrator[.]"

parties' agreement prohibited arbitrators from functioning as a tribunal of first review and only allowed for compulsory arbitration where the arbitrator served in an appellate capacity.

Knox Hills, for its part, maintains the circuit court correctly determined the basis of Ambac's refusal was a matter of *procedural arbitrability* for the arbitrator to decide because, in its view, having an Advisor was merely a condition precedent to any party to the agreement *invoking the right to arbitrate*. *See, e.g., John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543, 557, 84 S. Ct. 909, 11 L. Ed. 2d 898 (1964) (explaining an arbitrator should decide whether the first two steps of a grievance procedure were completed, where these steps are prerequisites to invoking a right of arbitration pursuant to an otherwise valid and binding agreement).

Ambac, on the other hand, argues that timely appointment of the Advisor was a precondition to the validity of the arbitration clause itself, which is a matter of *substantive arbitrability*. *See Howsam*, 537 U.S. at 84, 123 S. Ct. 588 ("[A] gateway dispute about whether the parties are bound by a given arbitration clause raises a question of arbitrability for a court to decide. . . . Similarly, a disagreement about whether an arbitration clause in a concededly binding contract applies to a particular type of controversy is for the court." (Quotations and citations omitted)).

Upon review, we agree with Ambac. The issue is not whether Knox Hills properly *invoked* its right to compel arbitration by failing to submit its dispute to the Advisor described in Section 12.4 of the agreement. It is whether Knox Hills -- or any other party to the agreement -- ever *had* a right to compel arbitration under any circumstances. The requirement set forth in Section 12.4 of the agreement, mandating the designation of an "Advisor" within forty-five days after the agreement was executed on February 1, 2007, affected whether the parties had such a right: Without an Advisor, the right in question never could have vested for any party because, without a tribunal of *first* review, there could be no *second* review from an arbitrator.

Notwithstanding that this is an issue of substantive arbitrability, Knox Hills contends it was nevertheless appropriate for the arbitrator to decide the effect that the failure to timely designate an Advisor had upon the validity of the arbitration agreement. This, Knox Hills argues, is because Sections 12.5.1.1 and 12.5.2 of the agreement indicate that any binding arbitration pursuant to the agreement would proceed according to the dispute resolution procedures of the American Arbitration Association; and, Knox Hills notes, in the absence of anything to the contrary in an arbitration agreement, it has been held that this language is evidence capable of supporting an inference that the parties intended for arbitrators, rather than courts, to decide issues of substantive arbitrability. *See,*

e.g., Fallo v. High-Tech Institute, 559 F.3d 874, 878 (8th Cir. 2009) (concluding the act of incorporating the AAA Rules provides clear evidence of the parties' intent to leave the question of arbitrability to the arbitrator because the AAA Rules expressly allow the arbitrator the power to rule on his or her own jurisdiction).

However, any such inference would run contrary to the plain language of the agreement in this matter. As Section 12.6 makes explicitly clear, "[c]laims or disputes *determined by a court of competent jurisdiction to be non-arbitrable* . . . shall be subject to litigation in a court of competent jurisdiction[.]" (Emphasis added.) Accordingly, the answer to the first dispositive question presented in this appeal is that *the circuit court*, not the arbitrator, should have determined whether arbitration was required between Knox Hills and Ambac.

Regarding the second dispositive question, arbitration was *not* required. Under the explicit language of the agreement itself, the timely designation of the Advisor (*i.e.*, within forty-five days after the agreement was consummated) was more than a material term; exact compliance in this respect was essential and, absent a valid modification of the contract, inexcusable. This is so because, pursuant to Section 12.5.2, the agreement explicitly made time "of the essence" with respect to the period allowed for the designation of the Advisor. *See* 15 WILLISTON ON CONTRACTS § 46:2 (4th ed. 2017) (explaining when a period of time to perform a contractual function is made "of the essence," "the performance

by one party at or within the time specified in the contract is . . . so material that exact compliance with the terms of the contract in this respect is essential to the right to require counterperformance." (footnotes omitted)). *See also Farmers Bank and Trust Co. of Georgetown, Kentucky v. Willmott Hardwoods, Inc.*, 171 S.W.3d 4, 8-9 (Ky. 2005) (explaining where time is expressly made of the essence in a contract for performing a given act, the time allowed by contract for performance is an essential element and any alteration of it is a material change).

In short, an essential precondition to the formation of the agreement to arbitrate was never met; the right to compel binding arbitration accordingly never vested for any party to the agreement; and thus, in deciding to compel arbitration for *any* reason, the circuit court effectively wrote a new agreement -- something it was never at liberty to do. Consequently, the circuit court erred by submitting the question of arbitrability to the arbitrator, and further erred in subsequently refusing to vacate the arbitrator's award. We REVERSE the circuit court in both respects, and REMAND for further proceedings not inconsistent with this opinion.

J. LAMBERT, JUDGE, CONCURS.

TAYLOR, JUDGE, CONCURS AND WRITES SEPARATE OPINION.

TAYLOR, JUDGE, CONCURRING: I concur with the majority opinion but would additionally submit that in my opinion the claim asserted by

Knox Hills was not subject to the arbitration clause under Section 12.6 of the Design/Build Agreement. The relief sought by Knox Hills was clearly specific performance of the contract which Section 12.6 plainly and succinctly requires to be litigated in a court of competent jurisdiction. Thus, the claim was not even subject to the arbitration analysis and the motion to compel arbitration should have been denied on its face by the circuit court.

This case again looks to the perceived panacea of arbitration, which often causes excess delay and expense to the parties under the misperception that a court proceeding would be more burdensome and expensive than binding arbitration. Had the appellee simply asked the court to enforce the agreement through specific performance in 2014, this case would have long been resolved by the parties with only a filing fee and attorney's fees, rather than the additional $52,000 in expense incurred by the parties in laboring through the arbitration.

As I noted, in *Ison v. Robinson*, 411 S.W.3d 766, 773 (Ky. App. 2013):

> While arbitration is favored in the law, this case clearly highlights the perils and pitfalls facing parties and their counsel who enter into binding arbitration under applicable federal and state law. By agreement, the parties submit their claims to an individual who is not a judge, where the proceedings become exclusively subject to the rules and procedures of the arbitration venue. The arbitrator effectively becomes both the judge and jury whose decision is binding on the parties. Parties who enter into arbitration customarily agree not to avail

> themselves of evidentiary rules and procedural safeguards that are mandatory in court proceedings. And perhaps most importantly, there exists very limited judicial review of an arbitrator's decision as set forth in the statutory authority that has been highlighted in this opinion.

While our case is premised on a completely different set of facts from *Ison*, it nonetheless again highlights the perils and pitfalls of attempting to unnecessarily utilize arbitration in a circumstance which I believe was expressly prohibited by the agreement of the parties in this case.

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