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December 07, 2021

Remedial Construction Services v AECOM: Incorporating arbitration provisions by reference under California law

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On 15 June 2021, the California Court of Appeal denied a construction subcontractor's motion to compel arbitration in a published decision, holding that an arbitration clause in the prime contract, which was incorporated by reference into the subcontract, did not provide for a 'clear agreement' to submit the dispute to arbitration.[1] This decision by a state appellate court initially raised concerns over the enforceability of arbitration provisions in California that are incorporated into a commercial relationship by reference. Nevertheless, the authors here submit that this decision should be narrowly construed, and that it may not apply at all to cases involving international construction projects.

Incorporation by reference and conflicting terms

The dispute in this matter arose out of a subcontract executed in connection with a project for the decommissioning of an oil terminal on the central coast of California. AECOM Inc,[2] the party moving to compel arbitration and the general contractor for the decommissioning project, signed a prime contract with the owners of the facility (the Prime Agreement), Shell Oil Products US, LLC and Shell Pipeline Company LP (Shell). AECOM in turn subcontracted (the Subcontract) with Remedial Construction Services, LP (RECON) to perform portions of the work.

The agreement between RECON and AECOM made reference to the Prime Agreement, specifically incorporating its provisions, and excerpts from it were appended to the Subcontract. Importantly, the Prime Agreement included an agreement to arbitrate, which stated that '[a]ny dispute or claim, arising out of or in connection with' the Prime Agreement 'will be finally and exclusively resolved in arbitration' under the International Centre for Dispute Resolution's (ICDR) International Dispute Resolution Procedures. Despite the clear reference to arbitration, however, within the Subcontract itself, a standard clause referring to litigation was also included, reading:

'[a]ny litigation initiated by and between the Parties arising out of or relating to this Subcontract shall be conducted in the federal or state court of jurisdiction in the State whose law govern this Subcontract and Contractor and Subcontractor each consents to the jurisdiction of such court'.

The trial court denies the motion to compel arbitration

Once a dispute under the Subcontract arose, RECON initiated a state court action, in response to which AECOM moved to compel arbitration based on the arbitral provision of the Prime Agreement. The Superior Court of California (ie, the court of first instance) denied the motion to compel, which was then appealed to the California Court of Appeal. Upon review, the Court of Appeal concluded that AECOM failed to establish the existence of an arbitration agreement to arbitrate RECON's claims. The Court expressed the view that the incorporation of the Prime Agreement's arbitration clause into the Subcontract

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was not 'sufficiently clear' per California law for there to be an effective agreement to arbitrate. While the Court acknowledged that the terms of the Prime Agreement, including arbitration under the Prime Agreement in certain circumstances, had been clearly referred to in the Subcontract, the Court reserved particular scepticism for the arbitration provision's general application and effect on the lower tier contract:

'[i]t is not reasonable to conclude that an arbitration clause in a 151-page document would override the litigation forum selection provision in the text of the Subcontract itself'.[3]

The Court also engaged in an extensive analysis of the Subcontract and Prime Agreement's provisions, finding that the arbitration agreement was not effective against RECON. In particular, the Court noted that a waiver of a right of access to a judicial forum should not be found lightly, a sentiment that appeared to prompt the Court to view the applicability of the arbitration clause with heightened scrutiny.[4] In further support of its decision, the Court of Appeal also considered that the provision referring to court litigation within the Subcontract would have been rendered 'superfluous' if arbitration were compelled, an outcome that would violate rules governing the interpretation of contracts under California law.[5]

Remedial v AECOM and arbitration in California

It may be tempting to see *Remedial* as potentially adding hurdles to the practice of incorporating arbitration provisions into a commercial relationship by reference under California law. If that is true, this development could prove problematic for the construction industry where contracts are often voluminous and contain flow down provisions incorporating other terms into an agreement. While, from an arbitration perspective, the Court's reasoning may be at some points questionable in *Remedial*, there are reasons to think this decision will not enjoy broad application.

First, for most internationally operating contractors and subcontractors involved in California projects, the applicable law governing their right to arbitrate will often be the US Federal Arbitration Act (FAA), not state law. Under the FAA, it has long been settled that arbitration clauses should not be subject to heightened scrutiny, even if the net effect of their application is to deprive one of access to a judicial forum. The US Supreme Court has reiterated that the FAA requires courts to place arbitration agreements 'on equal footing with all other contracts'.[6] The FAA also makes plain in section 2 that if an agreement to arbitrate is found to exist, even if buried in a large commercial contract, it is irrevocable. Thus, the Court's apparent reticence to enforce an arbitration provision because it was incorporated by reference to a voluminous contract, and general concern over waiving access to a judicial forum, may not be shared by other courts who review such issues under the FAA.

Second, the *Remedial* Court engaged in extensive contractual analysis to determine that the arbitration provision did not apply to the dispute between AECOM and RECON, but this may not be appropriate. The analysis concerned the issue of scope, insofar as the Court reviewed the agreement to arbitrate to see if it fitted the dispute. Although it appears that the issue was not raised here, when contractual parties have incorporated rules such as those of the ICDR into their agreement, it is generally the arbitrators and not the courts who decide jurisdictional issues like scope, because the rules explicitly delegate such matters to the arbitral tribunal.[7] In the 2017 case *Portland Gen Elec Comp v Liberty Mutual Ins Comp, et al, (PGE)* the US Court of Appeals for the Ninth Circuit found that an arbitral tribunal, not the court, should decide whether an arbitration agreement found in contractual exhibit, or a reference to the local courts in the main EPC contract, should govern where the dispute was heard. Like in *Remedial*, the parties in PGE had incorporated rules (the ICC Rules)

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delegating the authority to decide questions of scope to the arbitrators. The Ninth Circuit upheld such a delegation under long-settled FAA precedent.

Third, while the *Remedial* Court found a reference to court litigation and arbitration to be irreconcilable, many other federal and state courts have not. Other courts have interpreted forum selection clauses that exist alongside an agreement to arbitrate, to require that the parties must litigate only those disputes that are not subject to arbitration – for example, a suit to challenge the validity or application of the arbitration clause or an action to enforce an arbitration award.[8] Again, many of these decisions reflect the pro-arbitration bias of the FAA and, to the extent another court or arbitrator is confronted with the presence of these two clauses, it may consider that provisions may be read congruently, and not follow the *Remedial* Court's position.

Conclusion

While the *Remedial v AECOM* decision was not necessarily a positive one for arbitration in California, as noted above, its ramifications may be limited. Nevertheless, one cannot help but be reminded in this instance of the importance of paying careful attention to the alignment of various contractual dispute resolution provisions when preparing multiple agreements for a project.

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[1] *Remedial Construction Services, LP v AECOM, Inc, et al* (2d Civ No B303797), at 2.

[2] AECOM, Inc and AECOM Technical Services, Inc were the formal parties to the contract (collectively, 'AECOM').

[3] See n 1 above, at 6.

[4] *Ibid*.

[5] *Ibid*, at 7.

[6] *Kindred Nursing Ctrs Ltd P'ship v Clark*, 137 S Ct 1421, 1424 (2017). California state courts have also decided similarly. *Armendariz v Foundation Health Psychcare Servs, Inc*, 24 Cal 4th 83, 127 (Cal 2000).

[7] Pursuant to Art 19(1) of the ICDR Rules, 'The arbitral tribunal shall have the power to rule on its own jurisdiction'. That is, the ICDR Rules incorporate the well-established international commercial arbitration principle of competence-competence.

[8] See, eg, *Pers Sec & Safety Sys Inc v Motorola Inc*, 297 F.3d 388, 395–96 (5th Cir 2002); *Bank Julius Baer & Co v Waxfield Ltd*, 424 F.3d 278, 285 (2d Cir 2005); and *UBS Fin Servs v Carilion Clinic*, 706 F.3d 319 (4th Cir 2013).

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