

CHAPTER 23

ARBITRATORS MUST INVESTIGATE OR DISCLOSE, SECOND CIRCUIT SAYS: COURT OPENS DOOR TO EVIDENT PARTIALITY ATTACKS

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I. Introduction

One of the selling points of arbitration under the Federal Arbitration Act (FAA) is the relative finality of an award. Arbitration awards may be vacated only under limited circumstances. The Second Circuit's July 9, 2007, ruling in *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S.*,¹ which imposes a duty on arbitrators to either investigate conflicts of interest of which they become aware, or inform the parties that no investigation was undertaken, opened the door a little wider for disgruntled parties to undo an award they do not like based on "evident partiality."²

II. Background and Procedural History

Applied Industrial Materials Corp. (AIMCOR) commenced an arbitration proceeding against Ovalar Makine Ticaret Ve Sanayi, A.S. under the FAA alleging breach of a contract to deliver petroleum coke, a chemical created during oil refinery.³ The dispute involved the distribution of profits under the contract.

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¹ 492 F.3d 132 (2d Cir. 2007).

² 9 U.S.C. § 10(a)(2).

³ The FAA applies to written provisions "in any maritime transaction or a contract evidencing a transaction involving [interstate] commerce to settle by arbitration a

The parties' arbitration agreement imposed relatively detailed disclosure and conflict-avoidance obligations on the arbitrators. For example, it said that "[p]rior to the first hearing or initial submissions," the arbitrators had to "disclose any circumstance which could impair their ability to render an unbiased award based solely upon an objective and impartial consideration of the evidence presented." They also had to decline to serve "where the arbitrator or the arbitrator's current employer has a direct or indirect interest in the outcome of the arbitration."

The parties each selected an arbitrator. Then the two party-appointed arbitrators selected Charles Fabrikant to serve as the chair of the arbitral tribunal. Fabrikant was the chairman, president and CEO of Seacor Holdings, a multi-billion dollar company with 50 offices in 30 countries.

Before the hearings started, in September 2003, AIMCOR disclosed that it would be sold to Oxbow Industries and noted that the transaction might be "relevant to the disclosure issue." After receiving notice of this transaction, Fabrikant submitted a statement to the parties that he "ha[d] no personal or business relationship with any of the parties . . . or their affiliates" and "reserve[d] the right to amend or add to this disclosure should future circumstances warrant it."

On April 16, 2005, after the parties agreed to bifurcate the liability and damages phases of the arbitration, Fabrikant sent an email to the parties, stating: "Gentlemen: it came to my attention yesterday, or day before yesterday, that my St. Louis office, which runs our barge operation under the name SCF, has recently been engaged [in conversation] with Ox-bow of Palm Beach. The subject of the conversation is a contract for the carriage of petroleum coke. I had no knowledge of such conversations taking place prior to the past week. I do not participate in contract negotiations or get involved in day-to-day operations of SCF."

The email continued as follows: "I would like to amend my prior disclosures. At that time I did ask if there had been contacts between my group and these parties and there were none. I do not plan to become involved in discussions between SCF and Ox-Bow, should there be further conversations between them." He also wrote: "I do not feel my ability to decide this case on the merits is impaired." No party responded to this disclosure. On Sept. 22, 2005, the arbitral tribunal ruled against Ovalar on liability, with the third arbitrator casting the deciding vote.

controversy thereafter arising out of such contract or transaction." 9 U.S.C. § 2. *See also* 9 U.S.C. § 1 (defining "commerce").

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Two months later, after retaining new counsel, and learning that SCF had been transporting petroleum coke for Oxbow since 2004 (well before the liability award), Ovalar asked Fabrikant to withdraw from the tribunal. Soon thereafter, Fabrikant refused to withdraw, explaining to Ovalar that when he first learned that SCF was negotiating with Oxbow, he told SCF's president that he "wished to know nothing about SCF's conversations, or be a party to information about our activities with Oxbow or be consulted concerning any business with them."

The Southern District of New York granted Ovalar's motion to vacate the award and denied AIMCOR's motion to confirm, after concluding that Fabrikant, whose vote as chair of the tribunal was dispositive, acted with evident partiality by failing to investigate the potential conflict of interest that he became aware of during the arbitration. The court also found that Fabrikant should have earlier disclosed the Oxbow-SCF relationship and his failure to investigate SCF's negotiations with Oxbow and his subsequent lack of knowledge did not excuse his lack of disclosure.

III. The Second Circuit's Analysis

The Second Circuit affirmed, concluding that even though there was no evidence of actual bias, there was evident partiality under the FAA.⁴ The court focused on FAA standards, rather than on the parties' agreement, making its decision broadly applicable to all FAA arbitrations, regardless of contract language.

The court began its analysis with the seminal 1968 U.S. Supreme Court decision on "evident partiality" in *Commonwealth Coatings Corp. v. Continental Casualty Co.*⁵ At least partly because of a "fractured court," different circuits have applied this decision differently. The Second Circuit interpreted *Commonwealth Coatings* in *Morelite Construction Corp. v. New York City District Council Carpenter Benefit Funds*.⁶ Finding the "appearance of bias" standard to be "too low" and the "proof of actual bias" standard "too high," it held in *Morelite* that evident partiality will be found "where a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration." The court went on to hold that a father-son relationship between an

⁴ 9 U.S.C. § 10(a)(2).

⁵ 393 U.S. 145 (1968).

⁶ 748 F.2d 79 (2d Cir. 1984).

arbitrator and an officer of one party to the arbitration rose to the level of evident partiality.

However, *Morelite* was not a disclosure case, leaving the Second Circuit free to address that situation in *Applied Industrial Materials*. The court had made it quite clear that the failure to disclose actual knowledge of a material relationship with a party constitutes “evident partiality.” But *Applied Industrial Materials* did not involve evidence of actual knowledge, as Fabrikant took steps to be shielded from that knowledge by asking the president of the company to establish what is often called a “Chinese wall.”

Citing Justice Byron White’s statement in *Commonwealth Coatings* that “arbitrators are not automatically disqualified by a business relationship with the parties before them if both parties are informed of the relationship in advance, or if they are unaware of the facts but the relationship is trivial,”⁷ the Second Circuit articulated a new “investigate or disclose” standard in *Applied Industrial Materials*:

[A]rbitrators must take steps to ensure that the parties are not misled into believing that no nontrivial conflict exists. It therefore follows that where an arbitrator has reason to believe that a nontrivial conflict of interest might exist, he must (1) investigate the conflict (which may reveal information that must be disclosed under *Commonwealth Coatings*) or (2) disclose his reasons for believing that there might be a conflict and his intention not to investigate.⁸

A. No Freestanding Duty to Investigate

The court emphasized that it was not creating a “freestanding duty to investigate.” But it said that there is a duty to investigate “when an arbitrator knows of a potential conflict.” In that situation, the court said,

⁷ 393 U.S. at 150 (White, J., concurring).

⁸ The Ninth Circuit has articulated a similar “investigate or disclose” requirement, but its analysis relies in part on particular rules governing the subject arbitration. See *Schmitz v. Zilveti*, 20 F.3d 1043 (9th Cir. 1994) (adopting investigate or disclose standard based in part on requirement in NASD rules); see also *New Regency Productions, Inc. v. Nippon Herald Film, Inc.*, 501 F.3d 1101 (9th Cir. 2007) (holding investigate or disclose standard warranted in part by AFMA arbitral rule which incorporate California law) (citing *Schmitz* and *Applied Industrial Materials* with approval). In *Applied Industrial Materials*, the Second Circuit took a broader view.

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“a failure to either investigate or disclose an intention not to investigate is indicative of evident partiality.”

Applying this principle, the court concluded that Fabrikant knew, at a minimum, that there was a potential conflict and, whatever he believed about its likelihood of influencing his decision, he was obligated to investigate the potential conflict and disclose its details. The court also found that even though Fabrikant only reserved the right to update his disclosure, this, in effect “assured the parties” that he would update his disclosure when the need arose.

B. Implications for Arbitrators

It is the author’s opinion that the facts in this case did not warrant the court’s decision to vacate the award. The arbitrator was the head of a huge company, which had a division involved in a relationship with the parent company of a party. The transaction generated an arguably trivial amount of revenue in relation to the company’s size, and there was no evidence that the arbitrator personally benefited from the relationship. The arbitrator disclosed the facts as he understood them almost immediately after discovering them, but Ovalar did not appear to care about the relationship until after it lost on liability. Furthermore, Ovalar was on notice, from the statements in Fabrikant’s email, that he did not have all the facts and likely would not know if and when those facts changed.

In *Vigorito v. UBS PaineWebber, Inc.*,⁹ the United States District Court for the District of Connecticut considered the *Applied Industrial Materials* “investigate or disclose” standard. On the facts of that case, despite a basis for finding “evident partiality,” the court found that the plaintiffs waived any objection and refused to vacate the arbitration award even though the arbitrator had failed to disclose his son’s part-time employment by an office of the defendant until the tribunal was empaneled.¹⁰ The Court found that the arbitrator’s “conduct echoe[d] that of Fabrikant’s: despite knowing of at least an appearance of conflict prior to the hearing, [the arbitrator] said nothing until after the panel was sworn in and had conducted no investigation into the details of his son’s employment with the defendant, nor advised that he intended not to do so. From such omissions, evident partiality could be found.”¹¹ However,

⁹ 557 F. Supp. 2d 303 (D. Conn. 2008).

¹⁰ *Id.* at 304.

¹¹ *Id.* at 306.

the Court concluded that plaintiffs had waived any objection to the conflict or to the late disclosure of the conflict on the record by asking the arbitrator whether he could render an award against the defendant and then stating satisfaction with the affirmative response.¹² The Court was not persuaded by the plaintiffs' contention that their counsel assented only reluctantly to an "awkward, uncomfortable situation not of their making," holding that plaintiffs could not "waive an objection, staying silent hoping for a favorable outcome, and then lodge an objection in a motion to vacate when the arbitration ends adversely to it."¹³

The new investigate-or-disclose standard provides a fresh opportunity for post-arbitration gamesmanship and will likely increase the number of attempts to vacate arbitration awards in the Second Circuit unless arbitrators become particularly diligent about their disclosures. Given the clarity of the plaintiffs' waiver of any objection, *Vigorito* did not explore the limits of the investigate-or-disclose standard. In addition, while the *Applied Industrial Materials* Court claimed that its new standard "is not an onerous one," and that it does not establish a free-standing duty to investigate, it is not clear how much actual or constructive knowledge an arbitrator must have or how material a potential conflict must be to give rise to an obligation to investigate. This could force arbitrators to impose on themselves a potentially onerous free-standing duty to investigate to avoid having their decisions challenged in court after arbitration.

IV. Conclusion

In order to safeguard the finality of awards, parties may want to do some early investigation of their own, even if it is just a Google search linking the arbitrator's company with the parties and their affiliates, and make sure that any potentially troublesome issues are disclosed before the parties find themselves in court arguing about application of the new *Applied Industrial Materials* standards.

¹² *Id.* at 306-07.

¹³ *Id.* at 307-08.