

ARBITRATOR BIAS IN THE U.S.: A PATCHWORK OF DECISIONS

by

Mitchell L. Lathrop

May 2012

Internet: <http://www.LathropADR.com>

ARBITRATOR BIAS IN THE U.S.: A PATCHWORK OF DECISIONS

By Mitchell L. Lathrop¹

The statutes governing arbitration in the United States universally require that arbitrators be impartial and independent. But no clear picture of what constitutes bias of a degree sufficient to disqualify an arbitrator or vacate an arbitral award has emerged from the plethora of judicial decisions which have considered the issue. A leading commentator pointed out:

The amount of interest which will create a disqualification does not admit of any precise definition; but any circumstances indicating an evident bias in favor of either party will be open to suspicion. It is for the parties to decide whether the circumstance, thus disclosed, is such as to invite withdrawal by the Arbitrator.

Arbitration laws consider impartiality so important that they quite universally provide that, upon proof of bias, the award shall be set aside. Rules attach so much importance to it that they establish qualifications and contain provisions for vacating the office when bias is proved. But, finally, and ultimately, the responsibility rests squarely upon the parties: If they wish to appoint impartial arbitrators they may do so, for the parties make their own choice.²

The seminal case dealing with arbitrator bias is *Commonwealth Coatings Corp. v. Continental Casualty Co* (“*Commonwealth Coatings*”).³ *Commonwealth Coatings* was a subcontractor. When the prime contractor failed to pay *Commonwealth Coatings* for a painting job completed by *Commonwealth Coatings*, *Commonwealth Coatings* sued the sureties on the prime contractor’s bond to recover the sums due. The painting contract contained an arbitration provision for the resolution of disputes.

Both parties appointed an arbitrator, and the two party-appointed arbitrators selected the third arbitrator, an engineering consultant for building construction projects. One of the consultant’s regular customers was the prime contractor whose sureties were defendants in the case. The evidence showed that the consultant’s relationship with the prime contractor was sporadic, and there had been no dealings between them for about a year immediately preceding

¹ Mr. Lathrop is a Chartered Arbitrator and a Fellow of the Chartered Institute of Arbitrators. He serves as an arbitrator for a number of domestic and international arbitral providers. Mr. Lathrop is licensed to practice law in California, New York and the District of Columbia. Mr. Lathrop may be reached on e-mail at mllathrop@earthlink.net.

² Kellor, *American Arbitration* (1st ed. 1948) 236-237.

³ 393 U.S. 145, 89 S.Ct. 337, 21 L.Ed.2d 301 (1968).

the arbitration. At the same time, the prime contractor's utilization of the consultant's services was repeated and significant. The consultant had even rendered services on the very projects which were involved in the lawsuit.

The parties proceeded to arbitrate the dispute. The facts concerning the close business relationship between the consultant and the prime contractor were unknown to Commonwealth Coatings and were never revealed to it by the consultant or the prime contractor until after an award had been made. Commonwealth Coatings challenged the award on the ground of arbitrator bias, among others. Nevertheless, the District Court refused to set aside the award and the Court of Appeals affirmed.⁴ The United States Supreme Court granted certiorari.⁵

In a 6-to-3 decision, the Supreme Court reversed, holding "that where the arbitrator has a substantial interest in a firm which has done more than trivial business with a party, that fact must be disclosed. If arbitrators err on the side of disclosure, as they should, it will not be difficult for courts to identify those undisclosed relationships which are too insubstantial to warrant vacating an award."⁶ The Court observed:

It is true that arbitrators cannot sever all their ties with the business world, since they are not expected to get all their income from their work deciding cases, but we should, if anything, be even more scrupulous to safeguard the impartiality of arbitrators than judges, since the former have completely free rein to decide the law as well as the facts and are not subject to appellate review. We can perceive no way in which the effectiveness of the arbitration process will be hampered by the simple requirement that arbitrators disclose to the parties any dealings that might create an impression of possible bias.⁷

In the years which have followed the *Commonwealth Coatings* decision, courts have been divided on precisely what is a sufficient showing of bias to justify disqualification of an arbitrator or vacation of an award. The situation is made even more confusing because under most circumstances, an arbitrator cannot be disqualified for bias until after the award has been made.⁸

⁴ 382 F.2d 1010 (1st Cir. 1967).

⁵ 390 U.S. 979 (1968).

⁶ 393 U.S. at 152, 21 L.Ed.2d at 341.

⁷ 393 U.S. at 149, 21 L.Ed.2d at 305.

⁸ *See Aviall, Inc. v. Ryder Sys., Inc.*, 110 F.3d 892, 895 (2d Cir. 1997) ("Although the FAA provides that a court can vacate an award 'where there was evident partiality or corruption in the arbitrators,' ... it does not provide for pre-award removal of an arbitrator.") (quoting 9 U.S.C. § 10); *Petition of Dover Steamship Company, Inc., etc., for an order directing N. V. Rotterdamsche Kolen Centrale to proceed to arbitration*, 143 F.Supp. 738 (S.D.N.Y. 1956).

In *Excelsior 57th Corporation v. Kern*,⁹ the New York trial court dismissed a petition to stay an arbitration and to disqualify the arbitrator appointed by Ralph W. Kern. In 1965 the parties had entered into a long term lease of property owned by Kern. The lease provided for periodic recalculation of the rent. For the period of August 1990 to August 1998 the rent was agreed to be either \$ 310,000 or 6% of the appraised value of the land, whichever was greater. The lease contained an arbitration provision which provided that if the parties were unable to agree on rent for the period, they would resolve the dispute by arbitration.

Excelsior 57th Corporation commenced an arbitration in July 1990 and named Jerome Block as its arbitrator. Kern brought a special proceeding seeking Block's disqualification on the grounds that he had previously worked on an unrelated matter with Excelsior's counsel and was, therefore, not "fit and impartial." After the trial court refused to stay the arbitration or disqualify Block, the arbitration proceeded. The umpire and Excelsior's party-appointed arbitrator, Bryant, agreed and an award was issued, to which Block dissented. The trial court confirmed the award and entered judgment in favor of Excelsior.

Kern appealed. Block had revealed that during the pendency of the arbitration proceeding, the umpire selected by the two party-appointed arbitrators received a communication from a nonparty representing Morgan Guaranty Trust Company of New York. Morgan Guaranty had obtained the umpire's name from the law firm representing Excelsior in the ongoing arbitration. Morgan Guaranty was considering hiring an arbitrator and appraiser for an upcoming matter. The umpire did not disclose the communication to the parties at any time prior to the issuance of the award.¹⁰ The Appellate Division reversed the trial court's confirmation of the award, noting:

The failure of the neutral umpire to disclose the existence and nature of the communication by the Morgan Guaranty Trust Company representative raises, under the particular circumstances herein, a question of possible bias or partiality, since the umpire's name was referred to Morgan Guaranty by the petitioner's attorney well before the panel's deliberations had begun and this was made known to the umpire. Consequently, the integrity of the process appears to have been compromised. The record demonstrates that communication between the umpire and Morgan Guaranty Trust Company did not become known to the respondents until after issuance of the panel's determination, and in these circumstances at a minimum, it created an appearance of impropriety.

The arbitration was commenced once again and once again Excelsior appointed Bryant as its party-appointed arbitrator. Kern brought a proceeding to stay the arbitration and to disqualify Bryant. Bryant submitted three affidavits in connection with the disqualification proceedings in

⁹ 218 A.D.2d 528, 630 N.Y.S.2d 492 (1995).

¹⁰ See *Matter of Kern*, 204 A.D.2d 152, 153, 611 N.Y.S.2d 547 (1994).

which he attacked Block's partiality to Kern and was "particularly agitated" that Block revealed the communication made to the umpire by Morgan Guaranty, thereby causing a vacatur of the award. The Appellate Division ruled, "Based on Bryant's comments concerning the prior arbitration including, but not limited to, his statements about the petitioner's conduct, and his precarious position of having already heard the evidence, we find that he cannot fairly hear the evidence in this case. His actions and his contact with the party seeking his appointment demonstrate 'evident partiality'." The court ruled that neither Bryant nor Block could be reappointed as arbitrators in the new arbitration.

Some situations seem more obvious than others. In *Morelite Construction Corp. v. New York City District Council Carpenters Benefit Funds* ("Morelite"),¹¹ the Second Circuit vacated an arbitral award where one of the arbitrators was the son of the vice-president of the United Brotherhood of Carpenters and Joiners of America, the international union of which the District Union was a local. The father also served as the international union's supervisor and trustee of the District Union.

A similar situation existed in *Middlesex Mutual Insurance Co. v. Levine*.¹² There one of the arbitrators was aware that his family-owned insurance company had been in a dispute with Middlesex and another insurer, and that he was under investigation by the Florida Bar concerning a trust account violation involving those insurers. He failed to disclose his adversary relationship with the insurers and with another arbitrator rendered a \$ 1,200,000 award in favor of Levine, the claimant. The district court vacated the arbitration award on the ground of evident arbitrator partiality and the Eleventh Circuit affirmed.

Equally obvious was the outcome in *Porter v. City of Flint*.¹³ A group of plaintiffs filed racial discrimination cases in which the Mayor of Flint was named a defendant. The cases were consolidated and the parties agreed to binding arbitration. One of the arbitrators was a lawyer who had previously filed a discrimination case which named the Mayor as a defendant and who had commented to the press about the Mayor's involvement. The district court recognized the general rule that "[a] district court does not have jurisdiction over disputes involving allegations of bias until after the arbitration proceedings have come to a close and the party claiming bias has received an award,"¹⁴ but applied general contract principles "as exist at law or in equity."¹⁵ Particularly, the court noted, there is an exception "where, prior to the commencement of any arbitration proceedings, the plaintiff alleged specific instances of actual misconduct on the part of

¹¹ 748 F.2d 79 (2d Cir. 1984).

¹² 675 F.2d 1197 (11th Cir. 1982).

¹³ 736 F.Supp.2d 1095 (E. D. Mich. 2010).

¹⁴ Citing *Vestax Secs. Corp. v. Desmond*, 919 F. Supp. 1061, 1075 (E.D. Mich. 1995).

¹⁵ *Id.* (quoting 9 U.S.C. § 2).

an arbitrator.”¹⁶ The lawyer was disqualified.

Where the parties to an arbitration know in advance of facts which could form the basis for the disqualification of an arbitrator, but fail to raise the issue during the arbitration, they will be held to have waived the right to seek vacatur on that ground. For example, in *Health Services Management Corp. v. Hughes*,¹⁷ the parties agreed to arbitrate a dispute over payment for the construction costs of a long-term care facility. The names of three neutral arbitrators were provided to the parties by the American Arbitration Association (“AAA”). The three arbitrators knew each other and had engaged in prior business dealings. The disclosures had been made to the AAA but had not been communicated to counsel.

At the initial hearing, counsel for Health Services Management Corporation (“HSM”) indicated that he had not been advised of the disclosures. The chairman stated that if either party wanted to place any objections on the record, they should do it that time. Counsel for HSM stated that he relied on the statements of the arbitrators that their prior relationships would not have a prejudicial effect.

Counsel for HSM proceeded with the arbitration. No objections were voiced. Following the issuance of the award by the arbitral tribunal, HSM moved for a new arbitration, arguing that HSM had been prejudiced in the proceedings by AAA’s failure to advise HSM of the prior relationships that existed, that one of the arbitrators had coached a witness to a particular answer, and that the chairman had denied a motion before the other two arbitrators had the opportunity to hear the motion.

HSM moved to vacate the arbitral award, which the district court denied. On appeal, the Seventh Circuit carefully analyzed each of the points raised by HSM and affirmed the district court’s confirmation of the award.

A similar result was reached in *Delta Mine Holding Co. v. AFC Coal Properties, Inc.*¹⁸ There the parties in a mine lease dispute appointed arbitrators, who in turn appointed the chairman. The party-appointed arbitrator for Delta Mine went so far as to participate in Delta Mine’s witness preparation and strategy sessions and was to act as Delta Mine’s expert in preparing witnesses for depositions and the hearings. No objection was made during the hearings to Delta Mine’s arbitrator. When Delta Mine petitioned the court to confirm the award,¹⁹ AFC

¹⁶ *Vestax, supra*, 919 F.Supp. at 1075 (citing *Metro. Prop. & Cas. v. J.C. Penney Cas.*, 780 F.Supp. 885, 893-94 (D. Conn. 1991) (court found exception where allegations of bias concerned *ex parte* discussions on the merits of the claim prior to being selected on the arbitration panel).

¹⁷ 975 F.2d 1253 (7th Cir. 1992).

¹⁸ 280 F.3d 815 (8th Cir. 2001).

¹⁹ There were actually two arbitrations and two awards, but that is immaterial for the purposes of this paper.

asked the court to vacate the award on the ground that Delta Mine’s arbitrator exhibited evident partiality to Delta Mine.

The district court vacated the award and Delta Mine appealed. The Eighth Circuit agreed with the district court’s assessment that, “[Delta Mine’s party arbitrator] was obviously partial, and his conduct during the course of the arbitrations was clearly inconsistent with the impartiality required of a neutral arbitrator in numerous cases such as the Supreme Court’s *Commonwealth Coatings* decision.”²⁰ Nevertheless, the Eighth Circuit reversed the district court and held that AFC waived evident partiality by failing to raise it to the arbitrators. Even if AFC had sought to disqualify Delta Mine’s arbitrator in advance of the proceedings, it would have been denied because the arbitration agreements expressly contemplated the selection of partial arbitrators. Finally, AFC failed to show that Delta Mine’s arbitrator’s “evident partiality” had a prejudicial impact on the arbitration award. The court explained:

When a neutral arbitrator fails to disclose a relationship with one party that casts significant doubt on the arbitrator’s impartiality, as in *Commonwealth Coatings*, it is appropriate to assume that the concealed partiality prejudicially tainted the award. But where the parties have expressly agreed to select partial party arbitrators, the award should be confirmed unless the objecting party proves that the party arbitrator’s partiality prejudicially affected the award.²¹

Exactly how one is supposed to determine whether a partial party-appointed arbitrator’s conduct and reasoning prejudicially affected the award was not stated. It is arguable that the appointment of a non-neutral, partial arbitrator is itself a violation of section 10(a)(2) of the FAA. In regrettable circumstances such as those in the *Delta Mine* case, it might have been preferable to have a single, truly neutral arbitrator handle the case. Where an arbitral panel consists of three arbitrators, two of whom are evidently partial to the party which appointed them, the practical effect is that the decision of the chairman or umpire will be the decision of the panel. It would undoubtedly be cheaper and more efficient to have a sole neutral in the first place. The concept of non-neutral, party-appointed arbitrators who act as much as advocates as arbitrators seems to be far more prevalent in the United States than elsewhere in the world.

In *Sphere Drake Insurance Ltd. v. All American Life Insurance Co.*,²² the court was again faced with the issue of what constitutes “evident partiality.” One of the party-appointed arbitrators had previously represented a Bermuda subsidiary of Sphere Drake in an unrelated

²⁰ 280 F.3d at 821.

²¹ 280 F.3d at 821-822.

²² 307 F.3d 617 (7th Cir. 2002), rehrg. denied, rehrg. en banc denied by *Sphere Drake Ins., Ltd. v. All Am. Life Ins. Co.*, 2002 U.S. App. LEXIS 23017 (7th Cir. 2002), cert. denied *sub nom.*, *Am. Gen. Life Ins. Co. v. Sphere Drake Ins. Ltd.*, 155 L.Ed.2d 512, 123 S.Ct. 1754 (2003), motion to vacate denied, motion to strike denied, 2004 U.S. Dist. LEXIS 3494 (N.D. Ill. 2004).

matter. The district court vacated the arbitration award on the ground that the party-appointed arbitrator was evidently partial. The Seventh Circuit reversed, noting:

A federal judge would be disqualified on account of prior legal work “where in private practice he served as lawyer in the matter in controversy, or a lawyer with whom he previously practiced law served during such association as a lawyer concerning the matter, or the judge or such lawyer has been a material witness concerning it”. 28 U.S.C. § 455(b)(2). [The party-appointed arbitrator] fits none of these categories. The work he did for Sphere Drake was unrelated to the controversy with All American; . . . and neither [the party-appointed arbitrator] nor any lawyer at [his law firm] is a “material witness” in this case. Arbitration differs from adjudication, among many other ways, because the “appearance of partiality” ground of disqualification for judges does not apply to arbitrators; only *evident* partiality, not appearances or risks, spoils an award.²³

Still, it is a close question as to when “evident partiality” exists such that an arbitration award may be vacated. The better practice is to appoint arbitrators sufficiently removed from the parties and the controversy to avoid challenges which should have been considered at the outset. It is much cheaper for qualified counsel to educate arbitrators about the particulars of a specific industry or dispute rather than appointing an industry insider and risking having to repeat the entire arbitration because the award has been vacated. After all, juries sit on complicated intellectual property cases and seem to reach reasonable verdicts.

Business relationships, even though not direct, can result in denial of confirmation of arbitral awards. One such case was *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S.* (“AIMCOR”).²⁴ Applied Industrial entered into a joint venture with Ovalar Makine Ticaret Ve Sanayi, A.S. (“Ovalar”), a Turkish corporation, to provide petroleum coke. When a dispute arose over the distribution of profits, the parties agreed to arbitrate the dispute pursuant to an arbitration provision in their contract. The party-appointed arbitrators selected a chairman of the arbitral tribunal who was a prominent businessman and the head of a “multi-billion dollar company with 50 offices in 30 countries.”

The arbitration provision mandated certain disclosures by all of the arbitrators:

Prior to the first hearing or initial submissions, all the arbitrators are required 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 to the Panel. . . .

²³ *Id.*, slip op. at 8-9. Emphasis original. See also *Nationwide Mutual Insurance Co. v. Home Insurance Co.*, 429 F.3d 640 (6th Cir. 2005).

²⁴ 492 F.3d 132 (2d Cir. 2007).

No arbitrator shall accept an appointment or sit on a Panel, where the arbitrator or the arbitrator's current employer has a direct or indirect interest in the outcome of the arbitration.

All such disclosed relationships, experience and/or interests must be objected to by the parties at or before the first procedural hearing, or they shall be deemed waived as creating a bias, prejudice or conflict of interest which would warrant overturning the final award in this matter.

Before the first hearing, the parties were informed that Applied Industrial was being sold to Oxbow Industries, and that might affect the required disclosures by the arbitrators. That news prompted the chairman to send the following notification to the parties and their party-appointed arbitrators:

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 with Ox-Bow of Palm Beach. The subject of 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.

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.

I do not feel my ability to decide this case on the merits is impaired.²⁵

The arbitration was bifurcated into liability and damages. At the conclusion of the liability phase, the panel issued a 2-to-1 decision in favor of Applied Industrial, following which counsel for Ovalar wrote the chairman asking him to withdraw. Ovalar had uncovered evidence that prior to the arbitration a commercial relationship existed between SCF and Oxbow, the parent of AIMCOR. SCF had been transporting petroleum coke for Oxbow, a relationship which had generated approximately \$ 275,000 in revenue.

The chairman refused to withdraw. The damages phase was concluded and an award was issued in favor of Applied Industrial. The U.S. District Court for the Southern District of New York refused to confirm the award and granted Ovalar's motion to vacate the award. Applied Industrial appealed to the U.S. Court of Appeals for the Second Circuit.

The Second Circuit affirmed the district court. The court observed that *Commonwealth Coatings*²⁶ provided little authority for determining what constitutes "evident partiality" within

²⁵ *Id.*, slip op. at 4.

²⁶ *Supra.*

the meaning of section 10(a)(2) of the Federal Arbitration Act (“FAA”),²⁷ which provides that arbitral awards can be vacated where there is “evident partiality” on the part of the arbitrator(s).²⁸ The court observed that the standard of “appearance of bias” was too low to meet the requirements of section 10, while “proof of actual bias” was too high. The court established a middle ground, holding that the standard for “evident partiality” should be “where a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration.”²⁹

A different standard for evaluating evident partiality was adopted by the court in *Free Country Design & Construction, Inc. v. Proformance Group, Inc.*³⁰ There the court held that “[t]o show evident partiality of an arbitrator, the defendant must demonstrate that the interest or bias of the arbitrator was ‘direct, definite, and capable of demonstration, rather than remote, uncertain, or speculative.’”³¹

Ultimately, it is in the best interests of all participants in arbitral proceedings for the courts to adopt a uniform, well reasoned definition of what constitutes “evident partiality.” The Oxford dictionary defines “evident” as “plain or obvious.” “Partiality” is defined as “favoring one side in a dispute above the other.” So we have come full circle. The safest solution is to require truly neutral arbitrators.

²⁷ 9 U.S.C. § 1 *et seq.*

²⁸ 9 U.S.C. § 10(a)(2). *Commonwealth Coatings* “provided us ‘with little guidance concerning what standard is to be applied in construing the “evident partiality” language of the statute.’” *See Morelite, supra*, 748 F.2d at 83.

²⁹ 42 F.2d at 137, citing *Morelite, supra*, 748 F.2d at 84. But see *Merit Insurance Co. v. Leatherby Insurance Co.*, 714 F.2d 673 (7th Cir. 1983) (no vacatur where neutral arbitrator failed to disclose prior work under one party’s president).

³⁰ Case No. 09-06129-CV-SJ-DGK, W.D. Missouri, December 5, 2011, 2011 U.S. Dist. LEXIS 139275.

³¹ *Id.*, citing *National Ave. Bldg. Co. v. Stewart*, 910 S.W.2d 334, 343 (Mo. App. S.D. 1995).