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Federal Court Raises Bar on Arbitrators Disclosing Possible Conflicts

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(7.20.2007) The U.S. Circuit Court of Appeals for the Second Circuit recently reformulated the disclosure obligation for arbitrators by determining that an arbitrator who is aware of a possible conflict of interest and either fails to investigate the matter or inform the parties that no investigation was undertaken acted with evident partiality.

In a July 9 opinion in Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi, A.S. (No. 06-3297), the court stressed that it was not "creating a free-standing duty to investigate," but rather holding that an arbitrator who is aware of a possible conflict must investigate the matter or inform the parties that no investigation was undertaken.

Lawrence W. Newman, an attorney and arbitrator with Baker & McKenzie LLP in New York, said the ruling clarifies an aspect of disclosure that had not been discussed prior to the case. It stands for the proposition that an arbitrator who is given information about a possible conflict of interest "can't touch on it lightly, but instead must look into the matter further or inform the parties about the possible conflict," Newman said.

David M. White, an attorney with White & Associates in New York and an adjunct professor at Fordham Law School, predicted that the ruling would alarm arbitrators but suggested it should be applauded "as the reasoned evolution of case law precedent." He opined that the "investigate or disclose" requirement created by the decision for nontrivial conflicts "does no more than promote transparency of process, a fundamental safeguard of arbitration." He went on to say, "The court has sent an unmistakably clear message that an arbitrator's subjective good faith action, no matter how well-intended, is insufficient to allay the concerns of an anxious party."

Facts and Trial Court Decision

The case arose out of a joint venture agreement whereby Applied Industrial Materials Corp. (AIMCOR) would buy and transport petroleum coke to Ovalar, which would then distribute the coke in Turkey. A dispute arose in 1997 over the distribution of profits and the parties resorted to arbitration pursuant to the contract.

As required by the arbitration clause, the two sides each appointed one arbitrator and the two selected arbitrators chose Charles Fabrikant, president and CEO of the multibillion-dollar international company, Seacor Holdings, as the third arbitrator and chairman of the panel. The arbitration clause stated that "[n]o person shall serve as an arbitrator who has or has had a financial or personal interest in the outcome of the arbitration or who has acquired from an interested source detailed prior knowledge of the matter in dispute."

Prior to the hearing in September 2003, the arbitrators were informed that AIMCOR was in the process of being sold to Oxbow Industries, and that this transaction could be "relevant to the disclosure issue." Three weeks later, Fabrikant provided a disclosure statement indicating that he had "no personal involvement with any of the parties to this proceeding, or their affiliates" and he reserved the right to amend or add to this statement should future circumstances warrant it.

In March 2005, the parties agreed to bifurcate the liability and damages phases of the arbitration. After the liability phase commenced, Fabrikant informed the parties that he became aware that his company's St. Louis office, which runs a barge operation under the name SCF, had a contract with Oxbow to transport petroleum coke. Fabrikant's statement said, "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 do not plan to become involved in discussions between SCF and Oxbow, should there be further conversations between them . . . I do not feel my ability to decide this case on the merits is impaired." The parties made no response to this additional disclosure before the panel decided the liability issue, 2-1 against Ovalar, in September 2005, with Fabrikant casting the deciding vote.

Two months later, Ovalar requested that Fabrikant withdraw from the panel based on his failure to disclose the relationship between Oxbow and SCF earlier. Its investigation had concluded that there had been a commercial relationship between SCR and Oxbow since 2004, well before the liability phase of the arbitration, one that generated more than a trivial amount of income. Fabrikant wrote a letter to Ovalar stating his refusal to withdraw. The letter revealed that after he learned of SCF's discussions with Ovalar, he had asked SCF's president to create a so-called "Chinese wall" to prevent himself from learning of any possible conflicts with regard to the SCF-Oxbow deal.

AIMCOR moved to confirm the partial award on liability in February 2006 and Ovalar moved to vacate it based on Fabrikant's allegedly deficient disclosure. The district court agreed, finding that Fabrikant's actions created an appearance of partiality under Section 10(a)(2) of the Federal Arbitration Act. AIMCOR appealed.

Decision on Appeal: With Knowledge Comes Responsibility

The 2nd Circuit affirmed the order of the district court vacating the award for evident partiality. In so holding, the court created an obligation on the part of arbitrators to investigate potential conflicts of interest of which they become aware.

The court discussed the U.S. Supreme Court decision in *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145 (1968), which stated that evident partiality exists where an arbitrator failed to disclose that one of the parties was a sometime customer. Writing for a plurality in *Commonwealth Coatings* , Justice Hugo Black reasoned that requiring arbitrator disclosure of possible conflicts of interest would not harm the process and give parties information to allow them to decide whether to object to an arbitrator's service.

In *Morelite Construction Corp. v. New York City District Council Carpenter Benefit 11 Funds*, 748 F.2d 79 (1984), the 2nd Circuit said 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." It went on to say: "An arbitrator who knows of a material relationship with a party and fails to disclose it meets *Morelite's* 'evident partiality' standard: A reasonable person would have to conclude that an arbitrator who failed to disclose under such circumstances was partial to one side."

Although the district court never made such a finding, that did not end the 2nd Circuit's analysis, because, "[w]hile the presence of actual knowledge of a conflict can be dispositive of the evident partiality test, the absence of actual knowledge is not."

With this conclusion, the court developed the duty to "investigate or disclose," saying that if Justice White's statement in *Commonwealth Coatings* that "arbitrators are not automatically disqualified by a business relationship with the parties if both parties are informed of the relationship in advance, or they are unaware of the facts but the relationship is trivial," then "arbitrators must take steps to ensure that the parties are not misled into believing that no nontrivial conflict exists."

Therefore, once an arbitrator has reason to believe that a conflict of interest may exist he or she must investigate the conflict or disclose to the parties the reasons why he or she believes no conflict exists and an intention not to look into the matter, the court said.

The 2nd Circuit emphasized that a failure to investigate is not sufficient in and of itself to vacate an arbitration award. It is only when "an arbitrator knows of a potential conflict" that a failure to either investigate or disclose an intention not to investigate is indicative of evident partiality, the court concluded.

In the present case, Fabrikant had a continuing obligation to disclose. Though he may have believed in good faith that nothing had occurred to affect his impartiality because the contract with Oxbow was relatively small and involved a Seacor subsidiary, subjective good faith is not the test. Once Fabrikant knew that one of the Seacor companies was in talks with Oxbow, he failed to investigate or inform the parties that he was not going to investigate. The court ruled that given these circumstances, "a reasonable person would have to conclude that evident partiality existed."

The court defended its "investigate or disclose" requirement, saying it was not "onerous" and it served the twin goals of "encourag[ing] conflicts over arbitrators to be dealt with

early in the arbitration process and help[ing] limit the availability of collateral attacks on arbitration awards by a disgruntled party."

In a footnote, the court added it was not prepared to find that a Chinese wall is an "inadequate substitute for an investigation" of a potential conflict. However, it expressed the view that it is "preferable for the arbitrator to consult the parties before putting a 'Chinese wall' into place, rather than informing the parties after he has chosen that course of action unilaterally."