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SOUTHERN DISTRICT CIVIL PRACTICE ROUNDUP

Expert Analysis

Gatekeepers and Critics: Judicial Scrutiny of Arbitration

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As a consequence of the strong public policy favoring arbitration, courts generally give a wide berth to arbitrators and routinely defer to their authority and decisions. Despite that deference, courts continue to play an important role at the perimeters, policing to a limited, but important, extent what cases are subject to arbitration, and when, and ensuring that neither the process nor the ultimate decision is tainted by gross injustice. The recent cases we discuss below from the U.S. District Court for the Southern District of New York illustrate that in the right circumstances courts will protect against abuses of the arbitration process, but that litigants try far more often than they succeed to lure courts into the arbitration fray.

Whose Decision Is It?

Southern District Judge Jed S. Rakoff issued a series of decisions over the past year in *Jock v. Sterling Jewelers Inc.* that focus on the delicate line between an arbitrator's power to define the scope of his or her authority and the court's responsibility to intercede when an issue is beyond the arbitrator's reach. The plaintiffs in *Jock*, female employees of the defendant jewelry store chain, commenced a class action discrimination lawsuit in federal court and then moved to refer that dispute to arbitration on a class-wide basis, based on agreements requiring arbitration of their employment disputes. Over the defendant's objection, Judge Rakoff determined that the arbitrator should, in the first instance, determine whether the arbitration agreements permitted class-wide arbitration.[1]

Applying then controlling Second Circuit authority permitting class arbitration where not expressly prohibited by an arbitration agreement, the arbitrator ruled that the class arbitration could proceed. Judge Rakoff refused to vacate that determination[2]—a decision that the defendant appealed to the U.S. Court of Appeals for the Second Circuit. Shortly thereafter, the U.S. Supreme Court handed down its decision in *Stolt-Nielsen, S.A. v. AnimalFeeds International Corp.*, holding that parties must affirmatively consent to class arbitration, and reversing the Second Circuit decision on which the arbitrator had based her determination that class arbitration could proceed where the agreement was silent on this point.[3]

In the aftermath of the Supreme Court's decision in *Stolt-Nielsen*, Judge Rakoff vacated the arbitration order permitting the class-wide arbitration to proceed, in the absence of evidence in the record manifesting the parties' intent to arbitrate class claims.[4] Although Judge Rakoff stayed that order to permit the plaintiffs an opportunity to appeal, he declined to stay the arbitration proceedings—noting that the court's authority to enter such a stay was unclear, and finding that the arbitrator should decide whether a stay was appropriate pending the Second Circuit's decision as to whether the class arbitration could proceed.[5]

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In his next decision, Judge Rakoff addressed head-on the question of whether a court has the authority to stay an arbitration. In the procedural wrangling that followed the Supreme Court's decision in *Stolt-Nielsen*, the defendant (i) tried to oppose plaintiffs' motion to expedite the Second Circuit appeal on the question of whether they could arbitrate their claims as a class, (ii) filed 46 individual arbitrations against the individual claimants in the putative class, (iii) consented to a stay of the class arbitration, and (iv) refused to consent to a stay of the individual arbitrations.

Judge Rakoff called defendant's commencement of the individual arbitrations a "blatant exercise of gamesmanship," designed as an end-run around plaintiffs' appeal of the class arbitration issue. Against that backdrop, he took up consideration of plaintiffs' motion for a stay of the individual proceedings, resolving in the affirmative the question of whether the court had the authority to enter such a stay.[6]

Citing *Westmoreland Capital Corp. v. Findlay*, Judge Rakoff noted that the question of whether a court has authority under the Federal Arbitration Act (FAA) to stay an arbitration was not completely clear in the Second Circuit. In *Westmoreland*, the Second Circuit raised, but did not decide whether the FAA gives federal courts the power to stay arbitrations.[7] Judge Rakoff observed that both before and after *Westmoreland*, however, the Second Circuit had upheld decisions enjoining arbitrations, albeit not pursuant to the FAA. He noted that only one district court has found it lacked authority under the FAA to stay an arbitration,[8] while others have held, or assumed without deciding, that the FAA does permit court injunctions of arbitrations.[9] He concluded that the thrust of these cases, and those from other circuits, "is that the Court's power to compel arbitration under the FAA necessarily implies the power to enjoin arbitration."[10]

Having found that he had the authority to enter a stay, Judge Rakoff determined that a stay of the individual arbitrations was appropriate, finding that the burden and expense of pursuing potentially unnecessary duplicative arbitrations posed a risk of irreparable harm to the plaintiffs. He noted that one of the factors militating in favor of a stay was that plaintiffs' appeal might otherwise be mooted. For that reason, he held that the stay would remain in effect only until oral argument on that appeal, at which time the Second Circuit "which putatively has its own power to stay the arbitrations" could do so if it so chooses.[11]

Use It or Lose It—Waiver

Courts also take an active gatekeeping role in deciding whether a party has waived arbitration. In *In re Merrill Lynch Auction Rate Securities Litig.*,[12] Southern District Chief Judge Loretta A. Preska addressed the question of how much litigation a party may engage in before waiving its right to arbitrate. She found that the plaintiffs in one of several cases centralized in a multidistrict litigation against Merrill Lynch relating to the collapse of the auction rate securities market, had waited too long and engaged in too much litigation before moving to compel arbitration of their claims.

Judge Preska noted that "[w]hether a party has waived arbitration is a fact-specific question for which no bright-line test exists." Setting forth the prevailing rule that "'[a] party is deemed to

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have waived its right to arbitration if it engages in protracted litigation that results in prejudice to the opposing party,'"[13] she listed three factors that "may assist" in the waiver determination: (1) the time elapsed between commencement of the litigation and the request for arbitration; (2) the amount of litigation that has taken place (including motion practice and discovery); and (3) proof of prejudice.[14] Applying these factors, Judge Preska found that plaintiffs had evidenced an intent to litigate rather than arbitrate.

First, she noted that plaintiffs had waited 11 months after initiating litigation before seeking to arbitrate. Second, she found that significant litigation had already taken place. Recognizing that a plaintiff does not waive arbitration merely by filing a complaint,[15] she found that here, by filing a state court complaint and three iterations of its federal complaint, plaintiffs had reiterated their choice of a litigation forum. She also took into consideration the fact that plaintiffs had stipulated to a scheduling order under which they had obtained a detailed letter from Merrill Lynch outlining the deficiencies in their second amended complaint and that Merrill Lynch had answered their third amended complaint and had already expressed its intent to file a motion for judgment on the pleadings.[16]

On the question of prejudice, Judge Preska observed that Merrill Lynch had expended significant resources in defending the action. She recognized that incurring legal fees is not, in and of itself, sufficient evidence of prejudice to lead to a waiver of arbitration, but found that compelling arbitration would disrupt the multidistrict litigation and "'at this point would be unfair as well as a waste of both judicial and arbitral resources.'"[17]

The Second Circuit affirmed Judge Preska's decision on an interlocutory appeal. In an opinion authored by Judge José A. Cabranes, the Second Circuit stressed that the "key" to the waiver analysis is prejudice to the other party.[18] Elaborating on Judge Preska's discussion of prejudice, the circuit found that arbitration would result in both substantive prejudice and procedural prejudice to Merrill Lynch. Based on the amount of litigation that had already transpired, the court found that Merrill Lynch "would be procedurally prejudiced if it were compelled to arbitrate nearly a year into the litigation…, and after winning several key procedural victories…."

The court also found that at this point in the litigation, compelling arbitration to a forum that discouraged motions to dismiss would give the plaintiffs a litigation advantage that posed the risk of substantive prejudice to Merrill Lynch, particularly where plaintiffs had already obtained the benefit of Merrill Lynch's detailed letter outlining the deficiencies in their case.[19]

Vacatur of Arbitration Awards

At the other end of the process, courts may, but rarely do, inject themselves into arbitrations following an award. Under the FAA, a party may seek to vacate an arbitration award that was procured by corruption or fraud, where there is "evident partiality or corruption" of the arbitrators, or where the arbitrators engaged in misconduct or exceeded their authority.[20] Although not expressly set forth in the FAA, some courts, including the Second Circuit, have recognized "manifest disregard of the law" as another basis for vacating an arbitration award; however, the bar for vacating an award on this ground is exceedingly high.[21]

Arbitrator Bias

Under Second Circuit authority, evident partiality exists "where a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration."[22] As demonstrated by the recent decision in *CRC Inc. v. Computer Sciences Corp.*,[23] establishing arbitrator bias is an uphill battle. In that case, CRC, the disappointed claimant in an arbitration, sought to vacate an arbitration award claiming arbitrator bias in large part because the chairman of the panel headed the litigation department of a law firm that worked closely with the firm representing the respondent.

The arbitrator's initial disclosure statement revealed only one instance of joint work between his firm and the respondent's lawyers, when, in fact, his firm had worked or served as co-counsel with the other law firm on at least five cases generating substantial fees for the arbitrator's firm. After petitioner sought to vacate the award, the arbitrator supplemented his disclosure statement, explaining that he had not been aware of the extent of the relationship with the respondent's lawyers.

> In 'In re Merrill Lynch Auction Rate Securities Litig.,' Southern District Chief Judge Loretta A. Preska noted that '[w]hether a party has waived arbitration is a fact-specific question for which no bright-line test exists.'

Southern District Judge Harold Baer Jr. declined to vacate the award. He held that although the arbitrator's initial position that "no current or recent relationship existed between [his firm] and any of the parties or their counsel" was misleading and deficient, the facts, "while unfortunate, do not permit a finding that 'a reasonable person would have to conclude' that the arbitrator was partial to [r]espondent." He concluded that aside from the fact that an arbitrator could not be biased based on relationships he did not know about, the relationships here were "too attenuated" to rise beyond speculation to "evident partiality."[24]

By contrast, the claimant in *Scandinavian Reinsurance Co. Ltd. v. St. Paul Fire & Marine Ins. Co.*[25] was able to show sufficient bias to warrant vacatur, where two panel members failed to disclose important facts concerning their role in an arbitration on a similar issue, involving a common witness and a related party. Specifically, after the panel was selected for the *Scandinavian Re* arbitration, two of the panel members were chosen for another arbitration, which like the *Scandinavian Re* arbitration involved determination of whether a particular type of reinsurance contract should be interpreted according to its terms or in light of the parties' intent at formation.

Both arbitrations involved a common key witness, and the second arbitration involved a party who had some relationship with the respondent in the *Scandinavian Re* arbitration—although the parties disagreed as to the nature and extent of that relationship. Neither of the overlapping arbitrators updated their disclosures to reflect their involvement, together, in the second arbitration.

In finding that their undisclosed simultaneous service in the two arbitrations rose to the level of "evident partiality," Southern District Judge Shira A. Scheindlin noted that the two arbitrators had access to ex parte information, were apt to carry over credibility determinations about the common witness, and could influence each other's thinking. She found irrelevant the arbitrators' good faith belief that they could be impartial, vacating the award and remanding for arbitration in front of a new panel.[26]

Conclusion

As these cases demonstrate, when parties agree to arbitrate a dispute, they generally cede their fates to the arbitrators—for better or worse. Courts nevertheless play an important, albeit limited, role in monitoring the process, to guard against gamesmanship by the parties and abject unfairness in the arbitration.

1. 564 F.Supp.2d 307 (S.D.N.Y. 2008) (explaining reasons for earlier order referring procedural matters to arbitrator).
2. 677 F.Supp.2d 661 (S.D.N.Y. 2009).
3. —U.S.—, 130 S. Ct. 1758, 1776 (2010).
4. No. 02 Civ. 2875 (Aug. 6, 2010) (unpublished order vacating the arbitrator's determination permitting class-wide arbitration for the reasons set forth in an earlier "indicative ruling" pursuant to Fed.R.Civ.P. 62.1 indicating that the court would vacate the arbitrator's award if the Second Circuit returned jurisdiction to the district court. See 725 F.Supp.2d 444 (S.D.N.Y. 2010)). By order dated Aug. 3, 2010, the Second Circuit did remand the matter to Judge Rakoff.
5. —F.Supp.2d—, 2010 WL 3621514 (S.D.N.Y. Sept. 18, 2010).
6. 2010 WL 5158617 (S.D.N.Y. Dec. 10, 2010).
7. 100 F.3d 263, 266 n.3, 268 (2d Cir. 1996) (noting that §3 of the FAA gives courts authority to stay trials pending arbitrations, and that a number of courts had found authority under §4 to enjoin arbitrations, but declining to decide the question of whether a court had such authority because it lacked federal subject matter jurisdiction in that case).
8. 2010 WL 5158617, at *2 (citing *Ghassabian v. Hematian*, 2008 WL 3982885, at *2 (S.D.N.Y. Aug. 27, 2008) (Scheindlin, J.)).
9. Id. (citing *L.F. Rothschild & Co. v. Katz*, 702 F.Supp. 464, 467 (S.D.N.Y. 1988) (Sweet, J.); *Oppenheimer & Co. v. Deutsche Bank AG*, 2009 WL 4884158, at *6 (S.D.N.Y. Dec. 16, 2009) (Preska, Ch.J.)).
10. Id.
11. Id. at *4. Oral argument on the appeal took place on Feb. 9, 2011.
12. 2010 WL 532855 (S.D.N.Y. Feb. 8, 2010), aff'd, 626 F.3d 156 (2d Cir. 2010).
13. Id. at *2 (quoting *S&R Co. of Kingston v. Latona Trucking Inc.*, 159 F.3d 80, 83 (2d Cir. 1998)(internal quotation omitted)).
14. Id. (citing *Louis Dreyfus Negoce S.A. v. Blystad Shipping and Trading Inc.*, 252 F.3d 218, 229 (2d Cir. 2001)).
15. Id. at *3 (citing *Louis Dreyfus*, 252 F.3d at 229).
16. Notably, although many of the litigation steps listed by Judge Preska were undertaken by Merrill Lynch rather than the plaintiffs, Judge Preska found that the litigation activities, in toto, illustrated the plaintiffs' unmistakable intent to litigate.
17. Id. at *4 (citing *PPG Industries Inc. v. Webster Auto Parts Inc.*, 128 F.3d 103, 110 (2d Cir. 1997)).
18. *Louisiana Stadium & Exposition District v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 626 F.3d 156, 159 (2d Cir. 2010) (citing cases).
19. Id. at 160.
20. 9 U.S.C. §10.
21. *Goldman Sachs Execution & Clearing, L.P. v. Official Unsecured Creditors' Committee of Bayou Group, LLC*, 2010 WL 4877847, at *1-2 (S.D.N.Y. Nov. 30, 2010)(Rakoff, J).
22. *Morelite Construction Corp. v. New York City District Council Carpenters Benefit Funds*, 748 F.2d 79, 84 (2d Cir. 1984).
23. 2010 WL 4058152 (S.D.N.Y. Oct. 14, 2010).
24. Id. at *4 (citing *Lucent Technologies Inc. v. Tatung Co.*, 379 F.3d 24, 31 (2d Cir. 2004)).
25. —F.Supp.2d—, 2010 WL 653481 (S.D.N.Y. Feb. 23, 2010).
26. Id. at *8.