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IN FOCUS

FEDERAL COURT REVIEW

Settling the standards for neutrals' impartiality

Two circuits suggest a standard for judging violations of neutrality.

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SECTION 10(a)(2) OF THE FEDERAL Arbitration Act authorizes courts to vacate awards "where there was evident partiality...in the arbitrators." 9 U.S.C. 1, et seq. Since the U.S. Supreme Court's 1969 decision in *Commonwealth Coatings Corp. v. Continental Cas. Co.*, 393 U.S. 145 (1968), courts have struggled to formulate a workable definition of "evident partiality" to use in cases where a party challenging an award alleges that an arbitrator failed to disclose conflicts of interest bearing on his ability to serve.

The 5th and 6th U.S. circuit courts of appeals recently addressed what constitutes "evident partiality" in analytically different "nondisclosure" scenarios—one involving a party-appointed arbitrator, one a neutral. Although the courts applied different standards, a closer examination reveals that the choice of standards was influenced by what the courts believed to be the parties' legitimate expectations arising from the different methods of dispute resolution each freely chose.

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For context, a brief discussion of *Commonwealth Coatings* is helpful. There, the court vacated an arbitration award based on a neutral arbitrator's failure to disclose a significant business relationship with one of the parties, which included providing consulting services on the construction project at issue in the arbitration. Six justices of the court agreed the award should be vacated, but it was unclear whether a consensus was reached on the applicable standard. 9 U.S.C. 10(a)(2); 393 U.S. at 148-51 (Black, J.); 393 U.S. at 150-52 (White, J., concurring).

Justice Hugo L. Black's "Opinion of the Court," joined by three other justices, suggested that commercial arbitrators were subject to the same standards of impartiality as federal judges, declaring that the court should "be 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." 393 U.S. at 148-149. According to Black, arbitrators must "avoid even the appearance of bias" and are required to disclose "any dealings that might create a reasonable impression of possible bias." 393 U.S. at 148-49 & 150.

Justice Byron R. White's concurring opinion, joined by Justice Thurgood Marshall, appears at first to embrace Black's opinion, stating: "While I am glad to join my Brother BLACK's opinion in this case, I desire to make...additional remarks." Yet the opinion next appears to reject much of Black's rationale, declaring that "the Court does not decide today that arbitrators are to be held to the standards of judicial decorum of Article III judges, or indeed of any judges." 393 U.S. at 150. The apparent conflict between these opinions was the starting point from which the 5th and 6th circuits embarked.

Party-appointed arbitrators

Nationwide Mut. Ins. Co. v. Home Ins. Co., 429 F.3d 640 (6th Cir. 2005), reh'g and reh'g en banc denied (Feb. 16, 2006) (*Nationwide IV*), arose out of a multiphase reinsurance arbitration featuring numerous arbitration awards and three prior 6th Circuit appeals. See *Nationwide Mut. Ins. Co. v. Home Ins. Co.*, 150 F.3d 545 (6th Cir. 1998) (*Nationwide I*); *Nationwide Mut. Ins. Co. v. Home Ins. Co.*, 278 F.3d 621 (6th Cir. 2002) (*Nationwide II*); *Nationwide Mut. Ins. Co. v. Home Ins. Co.*, 330 F.3d 843 (6th Cir. 2003) (*Nationwide III*). The parties' arbitration agreement provided for tripartite arbitration, allowing each party to select a party-appointed arbitrator and requiring the party-appointed arbitrators to appoint a neutral umpire. The agreement did not require the party-appointed arbitrators to be neutral or disinterested, nor did it

The parties' expectations are the deciding factor.

incorporate the rules of any alternative dispute resolution organization.

In 1999, the parties selected their party-appointed arbitrators for Phase III of the arbitration, who, in turn, selected a neutral umpire. The arbitrators disclosed their relationships with the parties' counsel. As explained in *Nationwide I*, *III* and *IV*, in the 1980s Cigna Corp. entered into a corporate transaction with Home that included the reinsurance contract at issue, and administered the contract in the name of, and on behalf of, Home. ACE Ltd. was Cigna's successor in respect of that corporate transaction. See 429 F.3d at 642; 330 F.3d at 844; 150 F.3d at 547. Neither Cigna nor ACE were parties to the arbitration because they assumed no liability to Nationwide. See 150 F.3d at 547-49. Home's arbitrator disclosed that he had served as a party-appointed arbitrator for or against Home or its successor—Cigna and ACE—or clients represented by Home's counsel on numerous occasions; as an umpire in certain cases involving certain of those entities; as a partner in a law firm that acted as ACE's general counsel; and as an expert witness in an ongoing, unrelated matter for one of Home's counsel's clients. In 2002 he updated those disclosures at Nationwide's request.

In May 2002, the U.S. District Court for the Northern District of Illinois vacated an award in an unrelated arbitration in which Home's party-appointed arbitrator was a party-appointed arbitrator for another, unrelated party. The court found that he did not adequately disclose his law firm's prior representation of a subsidiary of the party that appointed him and that this nondisclosure established evident partiality. *Sphere Drake Ins. Ltd. v. All American Life Ins. Co.*, No. 01-C-5226, 2002 WL 1008464 (N.D. Ill.), rev'd, 307 F.3d 617 (7th Cir. 2002).

Relying on this decision, Nationwide sent Home's arbitrator a series of detailed, written questions concerning his relationships with Home, ACE and Cigna, including questions about the amount of compensation received from those engagements. He responded that since 1979 he had participated in more than 100 reinsurance arbitrations; served as an arbitrator appointed by ACE or Cigna in 20 arbitrations, three of them still pending; and served as a party-appointed arbitrator for and against Home in six cases. 429 F.3d at 648. He did not respond to the inquiries concerning compensation because he believed them inappropriate and unwarranted. Nationwide objected to Home's arbitrator's continued service on the panel, claiming his disclosures concerning these entities were deficient.

The 7th U.S. Circuit Court of Appeal subsequently reversed the district court's decision in *Sphere Drake*, finding that Home's arbitrator's relationships in that unrelated case would not have disqualified him even if he were subject to the neutrality standards applicable to federal judges, which, according to the court, were more demanding than those applicable to neutral—let alone party-appointed—arbitrators. 307 F.3d at 622.

Arbitrators are not held to the same standard as judges.

In 2003, when the panel issued its award, Nationwide moved to vacate, arguing that Home's arbitrator did not adequately disclose his relationships with Home, Cigna, ACE and Home's counsel. The district court denied Nationwide's motion to vacate, and the 6th Circuit affirmed.

'Morelite/Apperson' standard

The principal issue on appeal was the standard for an evident-partiality challenge based on a party-appointed arbitrator's alleged nondisclosure. The 6th Circuit had previously ruled, in *Apperson v. Fleet Carrier Corp.*, 879 F.2d 1344 (6th Cir. 1989), cert. denied, 495 U.S. 947 (1990), that to establish evident partiality one must show that "a reasonable person would have to conclude" that the arbitrator was biased in favor of one party or against the other. The 6th Circuit derived that standard from the 2d Circuit's decision in *Morelite Constr. Corp. v. New York City Dist. Council*, 748 F.2d 79 (2d Cir. 1984), in which the 2d Circuit concluded that the opinions of Black and White in *Commonwealth Coatings* were impossible to reconcile. Concluding that much of Black's opinion was dicta, the 2d Circuit formulated the "reasonable person would have to conclude" standard (the "*Morelite/Apperson* standard"), which the 6th Circuit embraced in *Apperson* and subsequent decisions. *Nationwide II*, 278 F.3d at 626; *Dawahare v. Spencer*, 210 F.3d 666, 669 (6th Cir.), cert. denied, 531 U.S. 878 (2000); *Andersons Inc. v. Horton Farms Inc.*, 166 F.3d 308, 328-29 (6th Cir. 1998).

Nationwide argued that the court should limit the *Apperson/Morelite* standard to "actual bias" cases, in which the evident-partiality claim is based on facts known to the parties prior to the arbitration or disclosed by the arbitrator and objected to by one of the parties prior to or during the arbitration. Nationwide contended that *Commonwealth Coatings* required the court to apply either a "reasonable impression of bias" or "appearance of bias" standard, and that the alleged nondisclosures justified vacatur under either standard.

The court found that "the present circumstances do not warrant deviation from *Apperson*'s case-by-case objective inquiry into evident partiality, particularly where, as here, the complaint of evident partiality concerns a party-appointed, as opposed to a neutral, arbitrator." 429 F.3d at 645. The court discussed *Sphere Drake*—the 7th Circuit decision that had exonerated Home's arbitrator from the other, unrelated evident-partiality attack launched against him—concluding that "the Seventh Circuit's well-reasoned decision...reinforces our conclusion that we should continue to adhere to the *Apperson* standard in this case, where evident partiality based on the alleged nondisclosure of material relationships by a party-appointed arbitrator is claimed." 429 F.3d at 647.

The expectations of the parties drove the decision. The court found compelling *Sphere Drake*'s explanation of how expertise and impartiality are weighted differently in arbitration versus adjudication. *Nationwide IV*, 429 F.3d at 646 (quoting *Sphere Drake*, 307 F.3d at 620) (citations omitted). See also *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 714 (7th Cir. 1983) (Posner, J.).

"Industry arbitration, the modern law merchant, often uses panels composed of industry insiders, the better to understand the trade's norms of doing business and the consequences of proposed lines of decision,"

the court ruled. "The more experience the panel has, and the smaller the number of repeat players, the more likely it is that the panel will contain some actual or potential friends, counselors, or business rivals of the parties. Yet all participants may think the expertise-impartiality tradeoff worthwhile; the Arbitration Act does not fasten on every industry the model of the disinterested generalist judge." *Nationwide IV*, 429 F.3d at 646 (quoting *Sphere Drake*, 307 F.3d at 620) (citations omitted).

The court characterized as "apt" Judge Richard A. Posner's explanation of how the use of party-appointed arbitrators to act as "representative[s] rather than...genuine umpire[s]" "dramatically illustrates" this principle: "No one would dream of having a judicial panel composed of one part-time judge and two representatives of the parties, but that is the standard arbitration panel, the panel Leatherby chose—presumably because it preferred a more expert to a more impartial tribunal—when it wrote an arbitration clause into its reinsurance contract with Merit." *Nationwide IV*, 429 F.3d at 645, n.8 (quoting *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 714 (7th Cir. 1983)).

The 6th Circuit also found relevant *Sphere Drake*'s conclusion that *Commonwealth Coatings* had not imposed a per se rule requiring disclosure by party-appointed arbitrators and "did [not] so much as hint that party-appointed arbitrators are governed by the norms under which neutrals operate." 429 F.3d at 647.

After concluding that there was no basis for abandoning the *Morelite/Apperson* standard, the 6th Circuit found that Nationwide failed to demonstrate that "a reasonable person would have to conclude" that Home's arbitrator was biased.

AAA rules

The case before the 5th Circuit, *Positive Software Solutions Inc. v. New Century Mortgage Corp.*, 436 F.3d 495 (5th Cir. 2006), concerned an evident-partiality challenge against a neutral arbitrator appointed under the American Arbitration Association (AAA) rules. The arbitrator was selected by a process under which the parties ranked candidates provided by the AAA. Although the arbitrator had indicated on the AAA notice of appointment form that he had nothing to disclose, after he issued his award the losing party discovered that he and his former law firm had, several years earlier, represented the prevailing party in a significant, unrelated litigation.

The U.S. District Court for the Northern District of Texas granted Positive Software's motion to vacate the award, holding that the neutral arbitrator's prior relationship "might create a reasonable impression of possible bias" and therefore should have been disclosed. *Positive Software Solutions Inc. v. New Century Mortgage Corp.*, 337 F. Supp. 2d 862, 878 (N.D. Texas 2004). The 5th Circuit affirmed.

Are they umpires or advocates, the courts want to know.

The court analyzed whether *Commonwealth Coatings* set forth the applicable standard to determine whether the nondisclosure constituted evident partiality. The court noted that some courts construed Black's opinion as a plurality opinion and "felt free to reject Justice Black's statement that 'evident partiality' is met by an 'appearance of bias,' " applying, instead, the "much narrower" *Morelite/Apperson* standard. 436 F.3d at 500 (citing *Morelite*, *Apperson* and *Nationwide IV*). Others adopted a more lenient standard under which evident partiality is established if the " 'undisclosed facts show a reasonable impression of partiality.' " 436 F.3d at 501 (quoting *Schmitz v. Zilveti*, 20 F.3d 1043, 1049 (9th Cir. 1994)). The 5th Circuit rejected the *Morelite/Apperson* interpretation of *Commonwealth Coatings*, finding that White did not "reject" but "embraced" the "appearance of bias" standard and "attempt[ed] to more precisely define its parameters." 436 F.3d at 500 n.29.

Quoting from the 9th Circuit decision in *Schmitz v. Zilveti*, the court explained that "in a nondisclosure case, the integrity of the process by which arbitrators are chosen is in issue" and requiring the challenging party to show only a "reasonable impression of partiality" will protect the parties' right to "choose their arbitrators intelligently." 436 F.3d at 501 (quoting *Schmitz*, 20 F.3d at 1047). The court held that "in a case in which the parties chose the arbitrator," the "arbitrator selected by the parties displays evident partiality by the very failure to disclose facts that might create a reasonable impression of partiality." 436 F.3d at 502.

The divergent expectations of the parties in *Nationwide IV* and *Positive Software* shed considerable light on why the courts adopted different standards to address distinct factual scenarios.

First, the parties had different expectations in terms of impartiality. Positive Software agreed to have a single, neutral arbitrator decide disputes. Nationwide, however, agreed disputes should be resolved by a neutral umpire and two party-appointed arbitrators, each of whom was expected to advocate, at least to some degree, the positions of the party that appointed him.

Second, the parties had different expectations concerning their right to choose the challenged arbitrator. In *Positive Software*, the court believed that the nondisclosure had deprived the challenging party of an opportunity to make an informed choice of arbitrator. In *Nationwide IV*, however, each party had no right to choose the other party's arbitrator, let alone a right to make an "informed choice."

Nationwide IV and *Positive Software* are excellent examples of how important the parties' expectations may be in evident-partiality cases. A court's perception of those expectations may drive the outcome and influence the choice of standard. Practitioners and parties may benefit from careful consideration of the extent to which, if at all, an alleged nondisclosure frustrated a party's expectations—and, if so, whether the nature and extent of that frustration was serious enough to warrant vacatur. NLJ

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