U.S. Federal Court Establishes New Standard for Arbitrator Disclosure

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In a decision issued in New York this summer in *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi*, A.S., 492 F.3d 132 (2d Cir. 2007), the U.S. Court of Appeals for the Second Circuit established new disclosure rules applicable to arbitrators faced with a potential conflict of interest. The ruling may impact any arbitration—including those held entirely outside the United States—which may at some point be subject to review in the federal courts located within the Second Circuit (most notably, those in New York).

Background

The underlying dispute at issue arose from a joint venture formed in 1992 between Applied Industrial Materials Corp. (Aimcor) and Ovalar Makine Ticaret Ve Sanayi, A.S. (Ovalar). The joint venture sold and transported petroleum coke. The joint venture agreement provided that Aimcor and Ovalar would settle disputes through arbitration in New York. In 1997, a dispute arose between the parties concerning the distribution of profits.

According to the joint venture agreement, the parties submitted the dispute to arbitration, with Aimcor and Ovalar each selecting one arbitrator. The two appointed arbitrators, in turn, selected Charles Fabrikant, the chairman, CEO, and president of Seacor Holdings, to serve as the third arbitrator and chairman of the panel. The joint venture agreement had several provisions concerning arbitrator bias and conflicts of interest and provided for certain disclosures prior to the start of the arbitration proceeding. The agreement did not address whether an arbitrator was required to make disclosures concerning potential bias after the commencement of the arbitration. However, provisions of the agreement did provide that a person could not accept appointment as, or serve as, an arbitrator if he or she had an interest in the outcome of the proceedings.

In March 2005, after the arbitration proceedings were underway, Fabrikant informed the parties that it had come to his attention that the St. Louis, Missouri office of Seacor Holdings, which operated a barge operation under the name SCF, had "recently" started doing business with Ox-Bow, the owner of Aimcor. SCF and Ox-Bow's relationship centered around a contract for the carriage of petroleum coke. Fabrikant told the parties that he had not been personally involved in any negotiations with Ox-Bow and that he did not have any involvement in the day-to-day operations of SCF.

Subsequently, the panel ruled in a 2-1 decision that Ovalar was liable to Aimcor for breach of the joint venture agreement (a decision on damages was to be issued later). Fabrikant was the deciding vote in Aimcor's favor. After the arbitrators issued the decision on liability, Ovalar conducted an investigation concerning the relationship between SCF and Ox-Bow. Ovalar claimed that its

investigation disclosed that the relationship between SCF and Ox-Bow started in 2004 and had generated approximately US$275,000 in revenue for SCF.

Based on the information disclosed by its investigation, Ovalar requested that Fabrikant recuse himself from the proceedings, arguing that Fabrikant's prior disclosures had inadequately disclosed the SCF/Ox-Bow relationship. Fabrikant refused, justifying his refusal on a previously undisclosed ethical screen he had directed Seacor Holdings to implement, which shielded him from information concerning his company's relationship with Ox-Bow. Fabrikant took the position that the screen had effectively walled him off from any knowledge of SCF's relationship with Ox-Bow, the details of which he only learned from Ovalar's recusal request and could not have previously disclosed.

In February 2006, Aimcor sought confirmation of the award on liability in the federal district court in New York City. Ovalar opposed confirmation, and cross-moved to vacate the partial award, on the ground that Fabrikant's failure to withdraw violated the provisions of the Federal Arbitration Act (FAA) that provide for vacating an award where "there was evident partiality or corruption in the arbitrators." The court denied Aimcor's motion to confirm and granted Ovalar's motion to vacate the partial award.

Second Circuit's Decision

The Second Circuit, focusing on the FAA's "evident partiality" standard, affirmed the lower court's decision because Fabrikant did not investigate the potential conflict and also did not disclose to the parties that he did not plan to investigate.

Then existing Second Circuit case law was silent as to the scope of an arbitrator's duty to disclose or investigate suspected conflicts. However, a concurring opinion in the U.S. Supreme Court's decision in *Commonwealth Coatings Corp. v. Continental Casualty Corp.* noted 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" (emphasis added).

The Second Circuit concluded that this language compelled arbitrators to "take steps to insure that the parties are not misled into believing that no nontrivial conflict exists." The court held that the "steps" an arbitrator must take are that where an arbitrator has reason to believe that a nontrivial conflict of interest exists between the arbitrator and one of the parties, the arbitrator must investigate the conflict; or disclose to the parties the reasons for believing that a conflict may exist and explain the arbitrator's intention not to investigate. Although the court clarified that it was not creating a free-standing duty to investigate, where an arbitrator knows of a potential nontrivial conflict and fails to either investigate or disclose that no investigation will be made, that failure renders any resulting award subject to being vacated under the FAA.<

Relevance of the Aimcor Decision

The Aimcor decision, unless overturned on appeal to the U.S. Supreme Court, will directly apply to challenges to arbitration awards on the basis of alleged conflicts of interest brought in the federal courts within the Second Circuit. A prevailing party's efforts to confirm an arbitration award, as in Aimcor, could trigger such challenges. Thus, the new Second Circuit rule could come into play in a number of arbitration matters—including arbitrations conducted outside the United States between non-U.S. parties—if the arbitration award is eventually the subject of review by a court sitting in the Second Circuit due to enforcement efforts or other actions which bring the arbitration award up for

review by a court.

A chain of events which leads to a completely international arbitration award being subject to review under the Aimcor standard is quite foreseeable, particularly because New York is in the Second Circuit. The Aimcor standard, unless or until overruled, should remain a consideration for non-U.S. parties when drafting arbitration agreements, and for non-U.S. parties who engage in arbitration outside the United States that may implicate the U.S. assets of the losing party. Parties should keep in mind that they can specifically incorporate the Aimcor disclosure standard in their arbitration agreements to foster the type of disclosure the Aimcor court found the FAA requires.