New Developments on the Standard for Finding “Evident Partiality”

Article contributed by: Howard S. Suskin and Suzanne J. Prysak, Jenner & Block LLP

In September, the Fifth Circuit, sitting en banc, will hear oral arguments in the case of Positive Software Solutions, Inc. v. New Century Mortgage Corporation, No. 04-11432 (5th Cir. filed Nov. 29, 2004) for the second time as it revisits the issue of whether an arbitrator’s failure to disclose prior dealings with counsel for one of the parties to an arbitration justifies vacating the arbitration award, even where there is no evidence of actual bias. The Fifth Circuit granted rehearing in Positive Software Solutions on May 5, 2006 following its January 11, 2006 opinion, wherein the court upheld the district court’s decision vacating the arbitration award because the court found that the arbitrator’s failure to disclose that he previously had served as co-counsel with the attorney for one of the parties demonstrated “evident partiality” under the Federal Arbitration Act (FAA).

“Evident Partiality” Standards & The Emerging Circuit Split:

Section 10(a) of the FAA sets forth the grounds that justify vacating arbitration awards. One of those enumerated grounds -- “where there was evident partiality” -- continues to be the subject of somewhat conflicting and inconsistent judicial interpretation when an arbitrator’s failure to disclose prior dealings is at issue. That is true despite the fact that in 1968, the United States Supreme Court arguably settled any debate over the standard for showing “evident partiality” in the failure to disclose context in the case of Commonwealth Coatings Corp. v. Continental Casualty Co., 393 U.S. 145 (1968).

In Commonwealth Coatings, one of the arbitrators, an engineering contractor, failed to disclose that he had performed services for one of the parties to the arbitration on repeated, but sporadic, occasions. Following the arbitration panel’s unanimous decision in favor of the party with whom one of the arbitrators previously had done business, the losing party sought to vacate the award based on the arbitrator’s “evident partiality” resulting from his failure to disclose his prior business relationship with the winning party in the arbitration.

Justice Black, writing for the majority, upheld the finding of “evident bias” and opined that arbitrators must disclose any dealings that might “create the impression of possible bias,” regardless of whether there is actual bias. Id. at 149. Comparing arbitrators to judges, Justice Black noted that there is no basis for refusing to apply the same standards of impartiality and disclosure to arbitrators as are mandated for judges. Id. at 148. To the contrary, Justice Black instructed courts to be even more “scrupulous” of arbitrators than judges because arbitrators, unlike judges, are given “free reign” and are not subject to appellate review. Id. at 148-149.

Despite what appeared to be a clear message regarding the “evident partiality” standard from the Supreme Court, the opinion in Commonwealth Coatings has been narrowly interpreted by many courts that have considered the decision to be a plurality opinion, and have imposed a stricter burden of proof to vacate an arbitration award. As a result, there has been a split among the circuits, where some courts require something more than an “appearance of bias” to vacate an arbitration award, while other courts consider the “appearance of bias” enough for vacatur.

For example, in Morelite Construction Corp. v. New York City District Council Carpenters Benefit Funds, 748 F.2d 79, 82-83 (2d Cir. 1984), the Second Circuit referred to Justice Black’s opinion as a plurality opinion and considered much of it to be dicta. The Second Circuit held that a

showing of something more than a mere "appearance of bias" is necessary to vacate an arbitration award. *Id.* at 83-84. That case, however, did not involve a situation where the arbitrator failed to disclose a potentially biasing contact, and in that case the Second Circuit ultimately reversed the district court's refusal to vacate an arbitration award where the arbitrator's son was an officer of a union of which a party to the arbitration was a local.

The Fourth Circuit in *Peoples Security Life Insurance Co. v. Monumental Life Insurance Co.*, 991 F.2d 141, 146 (4th Cir. 1993), similarly held that "a mere appearance of bias is insufficient to demonstrate evident partiality," and despite Justice Black's majority opinion in *Commonwealth Coatings*, the Fourth Circuit opined that arbitrators are not held to the same ethical standards required of judges. The court stressed the high hurdle faced by a party seeking to vacate an arbitration award for "evident partiality," noting that "the burden on a claimant for vacation of an arbitration award due to 'evident partiality' is heavy, and the claimant must establish specific facts that indicate improper motives on the part of an arbitrator." *Id.*

The Sixth, Seventh, and Tenth Circuits also require something more than an "appearance of bias" to vacate an arbitration award. *See Health Services Management Corp. v. Hughes*, 975 F.2d 1253, 1264 (7th Cir.1992) (evidence of "evident partiality" must be "direct and definite" and mere appearance of bias is not enough); *Apperson v. Fleet Carrier Corp.*, 879 F.2d 1344, 1358 (6th Cir. 1989) (specifically rejecting the "appearance of bias" standard and holding that "to invalidate an arbitration award on the grounds of bias, the challenging party must show that 'a reasonable person would have to conclude that an arbitrator was partial' to the other party to the arbitration"); *Ormsbee Development Co. v. Grace*, 668 F.2d 1140, 1147 (10th Cir. 1982) (holding that "[f]or an award to be set aside, the evidence of bias or interest of an arbitrator must be direct, definite and capable of demonstration, rather than remote, uncertain or speculative").

In contrast, some courts, including the Ninth and Eleventh Circuits, have adopted the "appearance of bias" standard for "evident partiality" that was articulated by Justice Black in *Commonwealth Coatings*. In particular, in *Schmitz v. Zilveti*, 20 F.3d 1043, 1046 (9th Cir. 1994), the Ninth Circuit disagreed with the other circuits' limiting characterization of Justice Black's majority opinion in *Commonwealth Coatings* as a plurality opinion, and held that evident partiality exists when "undisclosed facts show a reasonable impression of partiality." In *Schmitz*, the arbitrator failed to disclose that his law firm previously had represented the parent company of one of the parties to the arbitration. *See also Middlesex Mutual Insurance Co. v. Levine*, 675 F.2d 1197, 1201 (11th Cir. 1982) (adopting the "reasonable impression of partiality" standard); *Crow Construction v. Jeffrey M. Brown Associates, Inc.*, 264 F. Supp. 2d 217, 220 (E.D. Pa. 2003) ("evident partiality" is established when an arbitrator fails to disclose "any dealings that might create an impression of possible bias").

*Positive Software Solutions, Inc. v. New Century Mortgage Corporation & the Fifth Circuit's January 11, 2006 Decision Upholding Finding of Evident Partiality:*

In its January 11, 2006 decision in *Positive Software Solutions*, the Fifth Circuit adopted Justice Black's lessened standard of proof for showing "evident partiality" when it held that "an arbitrator selected by the parties displays evident partiality by the very failure to disclose facts that might create a reasonable impression of the arbitrator's partiality. The evident partiality is demonstrated from the non-disclosure, regardless of whether actual bias is established." *Positive Software Solutions, Inc. v. New Century Mortgage Corp.*, 436 F.3d 495, 502 (5th Cir. 2006).

In *Positive Software Solutions*, the sole arbitrator in a breach of contract and copyright infringement case previously served as co-counsel in different, protracted patent litigation in the 1990s with one of the attorneys who represented the respondent in the arbitration. Neither the arbitrator nor respondent's counsel disclosed that prior relationship, despite the fact that the
arbitrator was reminded repeatedly of his “obligation to disclose any circumstances likely to affect impartiality or create an appearance of partiality.” Indeed, the Notice of Appointment form supplied by the American Arbitration Association provided a list of twelve questions to assist the arbitrator in determining whether any past relationship required disclosure, including “Have you had any professional or social relationship with counsel for any party in this proceeding or with the firms for which they work?” Nevertheless, the arbitrator indicated that he had nothing to disclose.

After losing the arbitration on all counts, counsel for claimant Positive Software Solutions conducted its own investigation, and discovered the arbitrator’s undisclosed, prior relationship with counsel for respondent New Century Mortgage. Positive Software then moved the district court to vacate the arbitration award on the basis of “evident partiality,” and the district court granted the motion, holding that the undisclosed, prior relationship between the arbitrator and counsel for one of the parties “might create a reasonable impression of possible bias.” Positive Software Solutions, Inc. v. New Century Mortgage Corp., 337 F. Supp. 2d 862, 878 (N.D. Tex. 2004).

In affirming the district court’s decision to vacate the arbitration award in Positive Software Solutions, the Fifth Circuit held that “an arbitrator selected by the parties displays evident partiality by the very failure to disclose facts that might create a reasonable impression of the arbitrator’s partiality.” Id. at 502. The court then noted that such a “demanding disclosure rule” ensures that the parties will have knowledge of any potential biases at the outset, so that they may accept or reject the arbitrator and be the “architects of their own arbitration process.” Id. (quoting Commonwealth Coatings, at 151.). Further, the Fifth Circuit made clear that while it was not adopting an “inflexible per se” rule in nondisclosure cases in that an arbitrator need not disclose “trivial” relationships, the court instructed that an arbitrator should “always err in favor of disclosure.” Id. at 503. The court emphasized that the relevant inquiry in determining whether disclosure should have been made by an arbitrator is “only whether [the arbitrator’s] prior professional relationship might reasonably give someone who is considering his services as an arbitrator the impression that he might favor one litigant over the other.” Id. at 504. The Fifth Circuit noted that “such relationships must be disclosed to the parties if the integrity and effectiveness of the arbitration process is to be preserved.” Id.

Fifth Circuit Grants Rehearing In Positive Software Solutions:

Following the Fifth Circuit’s January 2006 decision upholding the district court’s vacation of the arbitration award in Positive Software Solutions, New Century Mortgage petitioned the Fifth Circuit for rehearing. The Fifth Circuit agreed to re-hear the case en banc and scheduled oral arguments for the last week in September 2006.

Conclusion:

Given the growing popularity of arbitration in all areas of the law, including securities disputes, it is critical that arbitrators are governed by a uniform set of standards and rules for disclosure of potentially biasing information. Likewise, courts across the country should adopt and apply the same rules and standards for the consequences of a failure to disclose and for making a finding of “evident partiality.” We should know shortly whether the Fifth Circuit’s en banc hearing in Positive Software Solutions will bring the courts of appeals closer to uniformity of standards or sharpen the current conflict among the circuits.

Howard S. Suskin is a partner in Jenner & Block's Chicago office, and is Co-Chair of the Firm’s Class Action Litigation and Securities Litigation Law Practices. He has substantial experience counseling and representing clients in arbitrations, and is an arbitrator with the AAA, NYSE,
NASD, CBOE, and NFA.

Suzanne J. Prysak is a partner in Jenner & Block’s Chicago office, and is a member of the Firm’s Litigation & Dispute Resolution, Class Action, and Securities Litigation practices. Ms. Prysak focuses her practice in the commercial litigation area, representing clients in a broad range of areas in state and federal courts.

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1 Positive Software Solutions Inc. v. New Century Mortgage Corp., 436 F.3d 495 (5th Cir. 2006).