Expanded Review of Arbitration Awards in New York

A recent decision by the New York Appellate Division Court in *Wien & Malkin LLP v. Helmsley-Spear, Inc.* suggests that New York courts will increasingly apply a federal standard when determining whether to confirm or vacate an arbitration award. Under the federal standard, a court can vacate an arbitration award if it finds that the arbitrator committed a “manifest disregard of the law.” Although this standard is difficult to overcome, it at least allows a court to consider the legal reasoning of an arbitrator’s award. The New York standard, on the other hand, is much more stringent and does not afford the court the opportunity to delve into the legal soundness of the award. Prior to this decision, New York courts applied the federal standard for reviewing arbitration awards only when the underlying transaction had a substantial effect on interstate commerce. Now, it seems clear that New York courts will apply the broader federal standard of review if the transaction at issue has any effect on interstate commerce.

What does this recent decision mean? First, more arbitration awards will be reviewed for legal soundness. As a result, clients contemplating whether to include an arbitration clause in a contract will need to consider the effects of each standard’s application. In deals where a client’s priority is making sure an arbitrator’s decision is final, language mandating use of New York law may be appropriate.

Second, parties to an arbitration should consider requesting a reasoned explanation of the award. While costly, an explanation can legitimize the decision in the eyes of the court and provide the “colorable justification” that the Second Circuit requires to avoid vacatur under the FAA.

**THE FEDERAL STANDARD**

Under Section 10 of the Federal Arbitration Act (“FAA”), an award can be vacated where:

- The award was procured by corruption, fraud, or undue means;
- There was evident partiality or corruption by the arbitrators;
- The arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or
- Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

Aside from this narrow list of statutory vacatur grounds, the federal courts have come up with their own “manifest disregard of the law” or “manifest disregard of the facts” escape clause allowing federal courts to vacate awards where the arbitrators simply got it wrong. Where did the courts find authority for this standard? In *Wilko v. Swan*, where the United States Supreme Court stated that “interpretations of the law by the arbitrators, in contrast to manifest disregard, are not subject, in the federal courts, to judicial review for error.” Federal courts have used the words “in contrast to manifest disregard” to support the implication that the Supreme Court has held that
the courts have the power to review arbitration awards for such disregard.\textsuperscript{10}

In the days since \textit{Wilko}, federal courts have tried to explain “manifest disregard.” Generally, an award will be vacated if it is clear that the arbitrator knew the relevant law and chose not to follow it. The Second Circuit, for example, requires that “the error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator. Moreover, the term ‘disregard’ implies that the arbitrator appreciates the existence of a clearly governing legal principle but decides to ignore or pay no attention to it.”\textsuperscript{11} In other words, a party must make a two-part showing in order to have an arbitration award vacated under the federal law’s “manifest disregard” standard: (1) the arbitrators knew of a governing legal principle, yet refused to apply it or ignored it altogether; and (2) the law at issue was well-defined, explicit and clearly applicable to the case.\textsuperscript{12} Of course, the “manifest disregard” standard is not an easy one to meet, since it is the rare arbitrator who will make clear that he understands the law and at the same time chooses to disregard or ignore it.\textsuperscript{13} Still, allowing courts to ask these questions at all will inevitably open the door for more arbitration awards to be vacated.

\textbf{THE NEW YORK STANDARD}

When a New York court is called upon to review an arbitration award, it will vacate only for one of the following statutory reasons:

- Corruption, fraud, or misconduct in procuring the award;
- Partiality of an arbitrator appointed as a neutral, except where the award was by confession; or
- Failure to follow the procedure of the statute, unless the party applying to vacate the award continued with the arbitration with notice of the defect and without objection.\textsuperscript{14}

There is no judicially-created “manifest disregard of the law” test under New York law. As recently as April 29, 2004, the First Department refused to apply the manifest disregard analysis, stating that “arbitrators are not strictly tethered to substantive

\textbf{THE HISTORY OF WIEN}

The FAA applies when the arbitration evidences a “transaction involving interstate commerce.”\textsuperscript{18} In the original \textit{Wien} case, the First Department interpreted this to mean that the transaction must have a “substantial effect” on interstate commerce.\textsuperscript{19} \textit{Wien} was a dispute between Wien & Malkin, a partnership that supervised real estate in New York City and Helmsley-Spear, the long-time managing agent of Wien & Malkin’s properties. Wien & Malkin supervised the owner partnerships of the buildings while Helmsley-Spear managed and operated them. Wien & Malkin terminated Helmsley-Spear “for cause” and upon a vote concerning certain of the properties, but the arbitrators found that the vote to remove Helmsley-Spear was not valid and ordered that any future meeting to remove Helmsley-Spear be put off for at least six months and make use of proxies that are both complete and accurate. Since \textit{Wien} involved only New York entities and addressed the termination of Helmsley-Spear as managing agent of buildings within New York City, the court concluded that no substantial effect on interstate commerce existed.\textsuperscript{20} Therefore, the New York statute was applied, and the court found that the arbitrators’ findings “while perhaps questionable, were not so arbitrary as to warrant vacatur.”\textsuperscript{21}

Wien & Malkin moved to appeal this decision to the New York State Court of Appeals, but that motion was denied.\textsuperscript{22} Then, on October 6, 2003, the Supreme Court of the United States granted certiorari and remanded the case back to the First Department to be considered in light of the Supreme Court’s holding in \textit{The Citizen’s Bank v. Alafabco}.\textsuperscript{23} \textit{Alafabco} clarified the test by which courts should determine whether the link between the subject matter of an arbitration and interstate commerce is
sufficient to require that the arbitration award be
analyzed under the FAA. The underlying
transaction in Alafabco was a debt-restructuring
agreement between an Alabama lending institution
and an Alabama fabrication and construction
company. The agreement contained an arbitration
clause mandating application of the FAA. Unable
to restructure its debt from a series of transactions
with Citizens, Alafabco sued, and Citizens moved to
compel arbitration. The Circuit Court of Lawrence
County, Alabama granted Citizens’ motion, but the
Supreme Court of Alabama reversed, stating that the
transaction lacked sufficient ties to interstate
commerce to make it eligible for FAA analysis. The
United States Supreme Court reversed that decision,
holding that “involving interstate commerce” meant
“affecting commerce.” The Supreme Court
emphasized the breadth of this category of
transactions by noting that the Commerce Clause
powers extended even to individual cases that do
not have a specific effect upon interstate commerce
so long as the aggregate economic activity
represents a general practice subject to federal
control.

In Alafabco, the debts were secured by goods which
contained parts and materials from beyond
Alabama’s borders. Moreover, Alafabco’s business
had ties throughout the Southeastern United States.
Finally, the Court noted that commercial lending, as
a general practice, greatly impacts interstate
commerce. For these reasons, the Court found that
the agreement “affected” interstate commerce and
compelled the application of the FAA to the
arbitration.

Applying this standard, the Wien court found (with
the agreement of both parties) that the underlying
transaction did affect interstate commerce. Therefore,
the court reviewed the arbitration award
under the federal standard, looking to see if it
represented a manifest disregard of the law on the
part of the arbitrators. The court found that the
arbitrators had manifestly disregarded the law by:
(1) overlooking a covert assignment of personal
services contracts by Helmsley-Spear, and (2)
disregarding Helmsley-Spear’s termination because
of an alleged defect in the proxy procedure. So,
the award, which had previously been upheld under
the New York standard, was vacated under the
federal standard.

POLICY ANALYSIS

Deference to an arbitrator’s determination of the
merits serves to promote finality and avoid excess
post-arbitration litigation. The New York Court of
Appeals has stated that the rule that arbitrators are
not bound by substantive law is “in furtherance of
the laudable purposes served by permitting
consenting parties to submit controversies to
arbitration.” Therefore, it makes sense to have a
strict standard for vacating arbitration awards.
Making arbitration more expensive by adding on
the costs of a probable appeal might make it a less
attractive option. Moreover, parties who choose to
insert arbitration clauses into their contracts may
have their purposes frustrated if they can expect
likely litigation over the finality of any arbitration
award.

Still, it is possible that broader judicial review will
increase, not decrease, parties’ willingness to choose
arbitration. Knowledge that an award that is clearly
contrary to the law will not stand might provide
security to parties and integrity to the process. In
more complex cases, with more at stake, parties
might desire more fundamental safeguards in the
arbitration process.

CONCLUSION

Wien’s application of the Supreme Court’s Alafabco
decision makes it clear that more arbitration awards
will be reviewed for legal soundness. Such review
increases the possibility of having the award
vacated. Parties should take control of this situation
by understanding the different standards of review
that exist under federal and New York law and
contract to use the law that is most favorable to their
position. A party desiring finality to an arbitration
award without resort to a review of the legal merits
should make sure to mandate New York law, while a
party concerned with legal consistency should allow
the federal law to apply. Moreover, parties that find
themselves in the midst of an arbitration should
consider asking for reasoned explanations of any
award issued.
ENDNOTES


5. See Wallace v. Butler, 378 F.3d 182, 198-193 (2d Cir. 2004). The Second Circuit has noted that, while a justification is not required, a court that is leaning towards a finding of “manifest disregard” can use the absence of an explanation to reinforce its opinion. Halligan, 148 F.3d at 204.


7. Wallace, 378 F.3d at 198-193; Spear, Leeds & Kellogg, 291 A.D.2d at 256, 738 N.Y.S.2d at 28; Halligan, 148 F.3d at 204.


9. Id. 346 U.S. at 436-37, 74 S. Ct. at 187-188.


14. N.Y. CPLR §7511(b).


16. Wien 1, 300 A.D.2d at 33, 751 N.Y.S.2d at 22.

17. Id.


19. Wien 1, 300 A.D.2d at 33, 751 N.Y.S.2d at 22.

20. Id., 300 A.D.2d at 32, 751 N.Y.S.2d at 22.

21. Id., 300 A.D.2d at 33, 751 N.Y.S.2d at 22.


25. Id.

26. Id., 539 U.S. at 56-58, 123 S.Ct. at 2040-41.

27. Wien at 4.

28. Id.

29. Sprinzen, 46 N.Y.2d at 262, 389 N.E.2d at 458.

30. John F.X. Peloso, A Discussion of Whether Arbitrators Have a Duty to Apply the Law, 949 PLI/Corp. 61, 63 (1996).


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