IN THIS month’s column, we discuss two significant decisions issued recently by the U.S. Court of Appeals for the Second Circuit addressing the finality of arbitration awards — in the context of both motions to vacate/confirm an award and efforts by litigants to seek the collateral estoppel effect of arbitral findings. In the first decision, the Second Circuit reaffirmed, in pointed language, precisely how narrow judicial review of arbitration awards should be and how seldom an arbitral award should be upset. In the second, the Second Circuit narrowly construed the circumstances under which collateral estoppel may apply to issues decided in arbitration.

Judicial Review

In Duferco International Steel Trading v. T. Klaveness Shipping A/S,1 the Second Circuit, in an opinion written by Judge Richard J. Cardamone, and joined by Judges Wilfred Feinberg and Robert D. Sack, affirmed the district court’s confirmation of an arbitration award. In its decision, the court provided an exegesis on the extreme deference district courts must accord arbitration awards.

The appeal in Duferco concerned an arbitration award that required plaintiff Duferco International Steel Trading Co. (Duferco) to indemnify defendant T. Klaveness Shipping A/S (Klaveness) against damages that resulted from a third-party arbitration, but not the attorney’s and arbitrators’ fees associated with that arbitration. Duferco and Klaveness had entered into a contract to charter a boat to carry a shipment of steel from Taranto, Italy, to New Orleans, La. The charter provided that the steel would be loaded onto Klaveness’ boat at “one (1) safe port/safe berth Taranto.”

To fulfill its contract with Duferco, Klaveness chartered a boat from Lifedream Shipping Co. Ltd. (Lifedream). The charter permitted Klaveness to use the boat for a defined period of time. The charter also contained a safe-berth warranty, requiring that the boat trade at “safe port(s), safe berth(s), [and] safe anchorage(s).” When the crew loaded Duferco’s steel at Taranto, seasonal wind swells and back waves damaged the mooring equipment and required Lifedream to incur extra costs to keep the boat stable.

Lifedream commenced an arbitration against Klaveness in London to recover for these damages. Klaveness sought to join Duferco in the London arbitration through a process called vouching-in — a procedure that allows a party to join a non-party in an action where the non-party allegedly is required to indemnify the party. Vouching-in therefore was not appropriate. Klaveness argued that the warranties in its London and New York arbitrations were substantially identical, making the vouching-in of Duferco appropriate and binding Duferco under the London arbitration award. Duferco countered that it could not be bound by the result of the arbitration because the warranty in its charter with Klaveness provided for a specific port — Taranto — and the warranty between Klaveness and Lifedream did not contain such a limitation. Because settled principles of maritime law provide that a charter that names a specific port relieves the charterer of liability for damages arising from the conditions of that port so long as they are reasonably foreseeable, Duferco argued its charter was not substantially identical to the charter between Klaveness and Lifedream and that vouching-in therefore was not appropriate.

A divided panel of arbitrators found that Duferco was liable to Klaveness with respect to the damages portion of the award. The majority found that the safe-berth warranties were sufficiently identical for vouching-in and that Duferco was bound by the outcome of the London arbitration. Seemingly contradictorily, the panel also found that Duferco was not liable for the attorney’s or arbitrators’ fees, reasoning that “inasmuch as the London arbitrators did
not consider the safe-berth warranties of the voyage charter as properly not before them, no 'previous determination' had been made, and therefore, Klaveness must not be permitted to now use the London award against Duferco offensively for vouching-in or collateral estoppel purposes."

Second Circuit Opinion

In its opinion affirming the district court's decision to confirm the arbitral award, the Second Circuit went out of its way to pronounce the extremely limited nature of a district court's review of an arbitration award. The court first noted that "[i]t is well-established that courts must grant an arbitration panel’s decision great deference." The court then stated that federal statutory law (under the Federal Arbitration Act) only permits vacatur of an arbitration award in four very limited circumstances, all of which involve corruption, fraud or other impropriety on the part of the arbitrators.1

Although Duferco did not make any statutory arguments for vacatur of the award, it argued that the award could be vacated because it was in manifest disregard of the law. Emphasizing how narrow this circumstance is, the Second Circuit stated that an award is in manifest disregard of the law "only [in] those exceedingly rare instances where some egregious impropriety on the part of the arbitrators is apparent, but where none of the provisions of the FAA apply."2 The Second Circuit explained the rationale for such limited review of arbitration awards: "arbitrators are hired by the parties to reach a result that conforms with industry norms and the arbitrators notions of fairness. To interfere with this process would frustrate the intent of the parties, and thwart the usefulness of arbitration, making it ‘the commencement, not the end, of litigation.' "3

The Second Circuit then applied a three-part test to determine whether the award was in manifest disregard of the law. First, the law must be clear and explicitly applicable to the matter before the arbitrators. Second, the law must have been improperly applied by the arbitrators and the improper application of the law must have resulted in an improper result. Third, the arbitrators must be found to have intentionally disregarded the law.

The Second Circuit concluded that the first prong was satisfied. The court reasoned that the principles of vouching-in were clear and that, if properly vouched-in, a party can be bound by the result of an action even if it chooses not to participate in the action. In the context of this case, the court concluded that the law was clear that Duferco could not be bound by the London arbitration unless the safe-berth warranty issue was identical in the New York and London proceedings.

The court then turned to the second prong of the test — whether the law was improperly applied by the arbitrators — and concluded that the second prong was not satisfied because it found a plausible reading of the arbitrators’ decision that did not constitute an improper application of law. The court reasoned that the arbitrators’ decision could be read to include a finding that the two warranty provisions were substantially identical with respect to their damage liability provisions. The court stated: "Once this determination was made, the New York arbitrators could then properly have used [the principles of] collateral estoppel to import the London arbitrators’ findings of fact regarding liability against Klaveness, which were fully and fairly litigated in London."4 Next, the court reasoned that the New York arbitrators could have found that the charters were not sufficiently identical for purposes of finding an obligation to pay attorney’s and arbitrators’ fees and, therefore, that the London arbitrators’ findings on this issue could not be applied to Duferco. Such a result would be possible because the principles of collateral estoppel apply to specific issues rather than entire proceedings.

The court stressed that it "look[s] only to plausible readings of the award, and not to probable readings of it. Even absent a plausible reading free of error, [the court] would confirm the award if it independently found legal grounds to do so."5 A the court found that there was an interpretation of the arbitrators’ decision that plausibly constituted a proper application of the law, the court did not need to consider the third prong of the test — the subjective knowledge of the arbitrators.

The Duferco decision represents perhaps the Second Circuit’s strongest pronouncement that arbitral awards are not to be upset, absent truly extraordinary circumstances — a statement that comports fully with the Second Circuit’s decisional law in this area since 1960, when the "manifest disregard" statement was first articulated.

Collateral Estoppel

In Postlewaite v. McGraw-Hill Inc.,6 the Second Circuit, in an opinion written by Judge Almy L. Kearse, and joined by Judges James L. Oakes and Barrington D. Parker Jr., vacated a district court’s judgment dismissing plaintiffs’ claim based on principles of collateral estoppel. In so ruling, the court narrowly interpreted the rule that collateral estoppel may be applied to an issue resolved in arbitration where the issue in question was actually decided in the prior arbitration and the issue was essential to the arbitrators’ final judgment.

Plaintiffs in Postlewaite were authors of a treatise, Partnership Taxation, Fifth Edition. Plaintiffs entered into a publishing contract (contract) with a division of McGraw-Hill, Shepard’s Publishing Division (Shephard’s), which provided for payment to plaintiffs of royalties of 20 percent of the full, undiscounted list price of each copy of the treatise sold, as well as “20 percent of the Publisher’s gross receipts from the sale, assignment, or licensing to others by the Publisher of any rights to the [treatise] ...” The contract also provided that it may not be assigned by either party "without the prior written consent of the other party or parties, which shall not be unreasonably withheld."7

Two years after entering into the contract, McGraw-Hill sold the assets of Shepard’s to Thomson Legal Publishing. In anticipation of the sale, McGraw-Hill sent letters to plaintiffs seeking their consent to the assignment of the contract to Thomson.

Applying collateral estoppel to arbitration issues under N.Y. law may be a problem because arbitrators need not provide explanations.
Plaintiffs signed the consent letters and returned them to McGraw-Hill. Subsequently, plaintiffs commenced an arbitration proceeding against McGraw-Hill, claiming that, under the royalty provision of the contract, the assignment of the contract to Thomson required McGraw-Hill to pay plaintiffs 20 percent of the portion of the gross receipts of the sale attributable to the assignment of the rights to their treatise. The arbitrators disagreed and found that “no royalties [were due] plaintiffs as a result of the assignment.” The arbitrators gave no explanation for their decision, which was affirmed by the district court.

Plaintiffs then commenced the action at issue in Postlewaite, alleging that McGraw-Hill breached the contract by failing to pay them royalties based on McGraw-Hill’s assignment to Thomson of a software agreement providing for the creation of a CD-ROM version of the treatise. Plaintiffs asserted that they had not learned of the software agreement or its assignment until three months after the arbitrators’ award.

In response, McGraw-Hill asserted, among other things, the defense of collateral estoppel, arguing that plaintiffs’ claim had been decided in the earlier arbitration. Plaintiffs responded that collateral estoppel did not apply because the arbitrators did not state the basis for their decision and the arbitration award could have been based on other grounds, specifically waiver or unjust enrichment.

The district court ruled on summary judgment that plaintiffs’ claims were barred by collateral estoppel. The district court found that, while the arbitrators did not provide a rationale for their award, the only colorable reason for the award was that “the assignment of the entire [Contract] to Thomson merely replaced McGraw-Hill with Thomson.... On this rationale, McGraw-Hill would not be liable for any royalty resulting from any assignment, including the assignment of the Software Agreement.”

And in the Second Circuit

The Second Circuit explained that, under federal and New York law, collateral estoppel, or issue preclusion, bars the relitigation of an issue that was raised, litigated and actually decided in a prior proceeding. The issue in question must have been essential to the judgment, although it need not have been explicitly decided. The Second Circuit then noted that, while collateral estoppel may be applied to issues resolved in arbitration under New York law, such application may be problematic because arbitrators are not required to provide explanations for their decisions. Moreover, as the court explained, the party asserting issue preclusion bears the burden of showing “with clarity and certainty what was determined by the prior judgment.... In order to obtain summary judgment on collateral estoppel grounds based on an arbitration award, the defendants must make a showing so strong that no fair-minded jury could fail to find that the arbitrator necessarily denied the claim for the reason they assert.”

The Second Circuit found that McGraw-Hill failed to meet this stringent standard. The court noted that the district court’s decision confirming the arbitration award stated that the arbitrators “could have found that the assignment of the entire [contract] to Thomson merely replaced McGraw-Hill with Thomson.” This left room for the possibility that the arbitrators could have based their award on some other finding.

Specifically, the Second Circuit found that the arbitrators could have based their decision on waiver or unjust enrichment, rather than on an interpretation of the royalty provision of the contract. McGraw-Hill had raised a waiver defense in its answer to plaintiffs’ complaint and had referred several times to plaintiffs’ letters of consent. The court explained that the letters of consent signed by plaintiffs required Shepard’s to pay plaintiffs royalties until the time of the sale, after which time the royalties would be paid by Thomson. The court found that this division of responsibility for the payment of royalties could have been interpreted to constitute a waiver of any claim against McGraw-Hill for royalties on the basis of the assignment.

In contrast, the court noted that waiver could not apply to the assignment of the software agreement at issue before the court, if one accepted plaintiffs’ assertion that they had no knowledge of the software agreement when they gave their consent.

If the arbitrators had made their decision based on waiver or unjust enrichment, an interpretation of the royalty provision of the contract would not have been “essential to the award.” A corollingly, the Second Circuit concluded that plaintiffs’ claim was not barred by collateral estoppel, vacated the district court’s judgment and remanded the case.

Beyond a Shadow of a Doubt

The court in Postlewaite underscored that a party seeking to secure the collateral estoppel effect of an arbitral finding bears a stringent burden and is required, essentially, to demonstrate, beyond a shadow of a doubt, that the arbitrators necessarily decided a particular issue for a particular reason — and that no other justification for that ruling was possible.

(1) No. 02-7238, 2003 WL 21448305 (2d Cir. June 24, 2003).
(2) Id. at *3 (quoting New York arbitrators’ decision).
(3) Under the FAA, a court may vacate an arbitration award “(1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; (3) where 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 of any other misbehavior by which the rights of any party have been prejudiced; or (4) 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.” Id. at n.1 (quoting 9 U.S.C. §10(a)).
(4) Id. at *4.
(5) Id. (quoting Burchell v. Marsh, 58 US 344, 349 (1854)).
(6)Id. at *7 (emphasis in original).
(7) Id. at 8.
(9) Id. (quoting contract).
(10) Id. (quoting arbitrators’ award).
(12) Id. at 5.
(13) Id. at 7 (quoting BBS Norwalk One, Inc. v. Raccolta, Inc., 117 F. 3d 674, 677 (2d Cir. 1997)) (emphasis omitted).
(15) Id. at 8.

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