



## SECOND CIRCUIT REVIEW

## Expert Analysis

# Sanctions Awards In Arbitration Proceedings

This month, we discuss *ReliaStar Life Insurance Company of New York v. EMC National Life Company*,<sup>1</sup> a decision issued by the U.S. Court of Appeals for the Second Circuit that expands the scope of an arbitrator's authority to impose sanctions. In a 2-1 decision, over Circuit Judge Rosemary S. Pooler's dissent, Circuit Judge Reena Raggi, joined by David G. Trager (District Judge for the Eastern District of New York, sitting by designation), reversed and remanded a district court order vacating an arbitration award of attorney's and arbitrator's fees as a sanction for a party's failure to arbitrate in good faith.

The panel held that the inclusion of a general provision that each party will bear the fees of its own arbitrator and attorneys in an arbitration agreement does not deprive an arbitral panel of its inherent authority to award such fees as a sanction against a party that acted in bad faith during the arbitration.

### Procedural History

In December 1997, EMC National Life Company, also known as National Travelers Life Company ("National Travelers"), and ReliaStar Life Insurance Company of New York ("ReliaStar") entered into two identical coinsurance agreements, which provided that any disputes arising under the agreements would be resolved by arbitration and that "[e]ach party shall bear the expense of its own arbitrator...and related outside attorney's fees, and shall jointly and equally bear with the other party the expenses of the third arbitrator."<sup>2</sup> This language is a modified application of the "American Rule," which provides generally that all litigants must bear their



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own attorney's fees. By their terms, the agreements were to be governed by the laws of New York and, to the extent applicable, the Federal Arbitration Act.

When disputes arose between the parties, National Travelers initiated arbitration proceedings seeking (1) a declaration that the coinsurance agreements had been terminated and (2) approval for a proposed terminal accounting. ReliaStar opposed

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both National Travelers' termination claim and its proposed method for conducting a terminal accounting. Following discovery, an arbitration panel conducted a two-week hearing. On Aug. 4, 2006, the panel entered an interim award, finding that the coinsurance agreements remained in force and directing National Travelers to pay ReliaStar more than \$21 million past due under the agreements. Without explanation, a majority of the panel also awarded ReliaStar attorney's and arbitrator fees and costs.

The parties complied with the decision,

except for that part granting ReliaStar fees and costs. The parties agreed that National Travelers could submit that issue for reconsideration to the panel and, if necessary, commence a court proceeding. After further briefing on the issue of fees and costs, the arbitration panel entered a final award on Oct. 20, 2006. Again, a majority of the panel awarded ReliaStar attorney's and arbitrator fees, plus interest, explaining that it viewed the conduct of National Travelers in the arbitration as "lacking good faith."

ReliaStar then petitioned the district court to confirm the final arbitration award. National Travelers filed a counter-petition to vacate the award to the extent it granted ReliaStar fees and costs. In the district court proceedings, National Travelers argued that the arbitration panel had exceeded its authority in awarding attorney's and arbitrator fees and costs in light of the language of the coinsurance agreements. The district court agreed and vacated that part of the final award, before confirming it in all other respects.

### The Second Circuit Decision

On appeal, the Second Circuit, in a 2-1 ruling, reversed the district court's ruling with respect to the arbitral panel's award of attorney's and arbitrator fees. The majority began by noting that because the scope of an arbitrator's authority stems from the intention of the parties to an arbitration, as expressed in their agreement, the court will uphold a challenged award as long as the arbitrator offers "a barely colorable justification for the outcome reached."<sup>3</sup> Thus, the panel majority limited its examination to the question whether, in light of the parties' agreement, the arbitrators were authorized to sanction bad-faith conduct by awarding attorney's and arbitrator fees, and did not reach the question whether the arbitrators correctly identified bad-faith conduct or whether the amount awarded was an appropriate sanction.

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It concluded that the parties' agreements were sufficiently broad to confer equitable authority on the arbitrators to sanction bad-faith conduct in the arbitration, and that the statement of the American Rule in the agreements operated only to limit an arbitrator's authority to award attorney's and arbitrator fees where the parties participate in an arbitration in good faith.<sup>4</sup>

#### Equitable Authority

The court found that "a broad arbitration clause...confers inherent authority on arbitrators to sanction a party that participates in the arbitration in bad faith and that such a sanction may include an award of attorney's or arbitrator's fees."<sup>5</sup> In reaching this holding, the panel majority reviewed several cases that addressed the equitable powers of an arbitrator to award fees and costs.

In *Synergy Gas Co. v. Sasso*, an arbitrator ordered the reinstatement of a discharged employee with back pay and awarded the employee his union attorney's fees. The *Synergy* court upheld that award, reasoning that had the employer not acted in bad faith, the attorney's fees would not have been incurred. Since the award was compensatory in nature, rather than penal, it did not contravene New York's public policy against punitive arbitration awards.<sup>6</sup> The *ReliaStar* court noted that it did not reach the question whether an arbitrator has the authority to award attorney's fees in excess of the amount necessary to compensate a party for losses attributable to bad faith, as National Travelers did not argue that the fee award was a penalty.

The panel then addressed the Ninth Circuit's decision in *Todd Shipyards Corp. v. Cunard Line, Ltd.* *Todd Shipyards* concerned the arbitration of a commercial contract for the repair and refitting of passenger cruise ships, which contained an arbitration clause incorporating American Arbitration Association Commercial Rule 43 ("[t]he arbitrator may grant any remedy or relief which the Arbitrator deems just and equitable within the scope of the agreement of the parties").<sup>7</sup><sup>8</sup>

The *Todd Shipyards* court rejected a challenge to the arbitrator's award of attorney's fees and recognized a bad-faith exception to the American Rule.<sup>9</sup> The *Todd Shipyards* court reasoned that because there was an accepted bad-faith conduct exception to the American Rule, and given the broad power of arbitrators to fashion appropriate remedies, it was within the

power of an arbitration panel to award attorney's fees.<sup>10</sup>

The Second Circuit rejected National Travelers' attempt to distinguish *Todd Shipyards* on the basis that the agreement at issue there integrated Rule 43. The court did not find a reference to Rule 43 expressly granting the arbitrator the right to fashion alternative remedies or relief to be essential since, by its terms, the parties' arbitration clause applied broadly to every dispute arising under the coinsurance agreement and since the arbitrators found that National Travelers did not arbitrate in good faith.<sup>11</sup>

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Parties to arbitration agreements, if found to have acted in bad faith, may be liable for their adversary's attorney's or arbitrator's awards, despite seemingly contradictory terms in the agreement. Should parties to an arbitration agreement wish to limit the scope of an arbitrator's authority to impose sanctions, they must make that intent crystal clear in their agreement.

#### Construction of the Provision

The Second Circuit also rejected National Travelers' argument that the language in the arbitration agreements limited the arbitration panel's sanction authority to exclude the award of attorney's or arbitrator fees. Applying a plain-meaning interpretation, the court concluded that the provision was a restatement of the American Rule, simply extending the principle to apply to the fee of each party's arbitrator.

Noting that New York law implies a covenant of good faith and fair dealing in every contract, the court understood the provision "to reflect the parties' agreement as to how fees are to be borne, regardless of the arbitration's outcome, in the expected context of good faith dealings." Nor did the language signal the parties' intent to limit the arbitrators' authority to sanction bad-faith participation in the arbitration; in the absence of specific language referencing bad faith or sanction remedies, there was no basis to conclude that the parties actually considered the question of whether to limit the arbitrators' authority to sanction bad-faith conduct.<sup>12</sup>

National Travelers argued that such a reading is contrary to principles of contract interpretation: because the American Rule would apply by default even in the absence of such language, reading it as a restatement of the American Rule would

render it superfluous. The Second Circuit disagreed, noting that parties may incorporate the American Rule into their arbitration agreements for any number of reasons, including, for instance, if their arbitrators come from jurisdictions that employ the "English Rule" where the prevailing party's fees are routinely paid by an unsuccessful opponent.<sup>13</sup>

#### Dissent and Conclusion

Judge Pooler dissented, arguing that the case should be governed by the principle that "[v]acatur [of an arbitral award] is appropriate only if the arbitral award contradicts an express and unambiguous term of the contract...or if the award so far departs from the terms of the agreement that it is not even arguably derived from the contract." Judge Pooler argued that the arbitral award plainly contradicted the "express and unambiguous term" of the agreements, which divested the arbitral panel of any authority to make an award of attorney's fees.<sup>14</sup>

The Second Circuit's decision in *ReliaStar* reflects a desire on the part of the court to sanction parties that engage in bad-faith litigation, even in circumstances where there may exist some doubt as to the basis for imposing such a sanction. As a result, parties to arbitration agreements, if found to have acted in bad faith, may be liable for their adversary's attorney's or arbitrator's awards, despite seemingly contradictory terms in the agreement. Should parties to an arbitration agreement wish to limit the scope of an arbitrator's authority to impose sanctions, they must make that intent crystal clear in their agreement.

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1. Docket No. 07-0828-cv, 2009 WL 941173 (2d Cir. April 9, 2009).
2. *ReliaStar* at \*1.
3. *ReliaStar*, 2009 WL 941173 at \*3 (citing *Banco de Seguros del Estado v. Mut. Marine Office, Inc.*, 344 F.2d 255, 260 (2d Cir. 2003)).
4. *Id.* at \*6.
5. *Id.* at \*3.
6. *Synergy Gas Co. v. Sasso*, 85 F.2d 59 (2d Cir. 1988).
7. *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1064 (9th Cir. 1991) (quoting Rule 43).
8. *Id.*
9. *Id.*
10. *Id.*
11. *ReliaStar* at \*4.
12. *ReliaStar* at \*5.
13. *Id.*
14. *Id.* at \*6 (citing *Westerbeke Corp. v. Daihatsu Motor Co.*, 304F.3d200,222(2dCir. 2002).