Second Circuit Decision Clarifies and Bolsters Arbitrators’ Authority

BY JAMES E. BERGER

On January 14, 2010, the U.S. Court of Appeals issued a key ruling clarifying arbitrators’ authority in two key areas. Specifically, in T. Co. Metals v. Dempsey Pipe & Supply, Inc., the Court of Appeals (a) clarified the narrow scope of the manifest disregard doctrine, and (b) refined its rules concerning arbitrators’ authority to amend final awards once they have been issued. Taken together, the Court’s ruling in T. Co. makes clear that Second Circuit (and the district courts under its jurisdiction) will apply an exceedingly narrow scope of review to arbitral awards, and that they will, wherever possible, defer to arbitrators’ decisions both on both their arbitral jurisdiction and the merits of the controversies that are referred to them.

The Dispute and the Arbitration

The parties in T. Co. had entered into an agreement for the sale of steel pipe. The agreement, which was governed by New York law, provided that the seller could not be liable for consequential damages. When the purchaser received the pipe, it discovered that a substantial amount of the pipe was bowed or bent beyond the agreed specifications. The buyer rejected only a small portion of the pipe, choosing instead to fix the pipe itself and resell it. The buyer refused to pay the full invoice price, however, withholding approximately $338,000.

The seller commenced arbitration under the ICDR Rules promulgated by the American Arbitration Association to recover the unpaid portion of the invoice; the buyer interposed a counterclaim for the diminished value of the defective pipe that it accepted. The seller objected to the counterclaim on the ground that it sought to recover lost profits, which it claimed constituted consequential damages under New York law; as noted above, the agreement barred the recovery of consequential damages. In addition to claiming that the contractual limitation barring recovery of consequential damages had been superseded by a later agreement, the buyer claimed that even if the contractual limitation remained in place, it could still recover for the diminished value of the pipe because those damages constituted “benefit of the bargain” damages within the meaning of Section 2-714(2) of the Uniform Commercial Code.

The arbitrator found that the limitation against consequential damages remained in effect, but nonetheless held that the buyer’s counterclaim was permissible under Section 2-714(2) of the UCC. The arbitrator’s initial award awarded $333,039.72 to the seller as compensation for the non-payment, and $420,357 to the buyer as damages for the diminished value of the steel. The arbitrator calculated the damages he awarded to the buyer by examining invoices from similar transactions.
Both parties petitioned the arbitrator to amend the original award pursuant to Article 30(1) of the ICDR Rules, which permits an arbitrator to “correct any clerical, typographical or computation errors or make an additional award as to claims presented but omitted from the award.” The arbitrator rejected the seller’s contention that the award in the buyer’s favor had resulted from “manifest errors,” both on the ground that such an objection was not warranted under Article 30(1) and that his award was not, in his view, affected by any such errors. The arbitrator did, however, agree with the seller that his calculation of damages was affected by an erroneous consideration of four invoices; he consequently reduced the damage award to the buyer by approximately $80,000. Despite the limited scope of Article 30(1), the arbitrator left little question that his reduction of the damage award to the buyer did not result solely from a recalculation or ministerial correction, but rather that a re-examination and interpretation of the evidence had been necessary. The arbitrator explained his correction as follows:

While the consequences of these four corrections is not a mere computational issue, and necessarily involves the same appreciation of the evidence ... the Arbitrator believes that he has the power under Article 30 of the ICDR International Rules to reach conclusions derived from correction of clerical errors. Article 30 of the ICDR International Rules does not say that errors subject to correction must be set out in an award’s conclusions. It is therefore to be understood that an Arbitrator is empowered to change conclusions based upon clerical errors in the body of an award, even where such correction process entails an exercise beyond rote computation.

Post Arbitration Judicial Review

Each party filed a petition in the U.S. District Court for the Southern District of New York seeking to modify or vacate the award. The seller sought to vacate the award on the ground that it was made in manifest disregard of the law, while the buyer sought to modify the award based on a claim that the arbitrator’s amendment of the award was improper. The district court rejected the seller’s manifest disregard claim in its entirety. Specifically, the district court found that manifest disregard as an independent ground for vacatur was no longer available as a result of the Supreme Court’s decision in *Hall Street Assoc. L.L.C. v. Mattel, Inc.*, that the seller had not adequately argued that the arbitrator’s award of lost profits violated any specific provision of the FAA, and that even if manifest disregard review were available to it, the arbitrator’s award would not be subject to vacatur under that doctrine.

The district court accepted the buyer’s contention that the arbitrator exceeded his powers and violated the doctrine of *functus officio* by amending the award to correct errors that were not evident on the face of the original award. Accordingly, the district court vacated the amended award, and confirmed the original award.

The Second Circuit’s Decision

The Second Circuit first addressed the seller’s claim that the award of lost profits was made in manifest disregard of the law. Recognizing that the Supreme Court’s ruling in *Hall Street* and its 2008 decision in *Stolt-Nielsen S.A. v. AnimalFeeds Int’l Corp.* resulted in a “reconceptualization” of manifest disregard from an independent ground for vacatur to one grounded in Section 10(a)(4) of the FAA, the Court of Appeals accepted the district court’s analysis, concluding that whatever the legal foundation of the manifest disregard doctrine, it was inapplicable in the case, since the arbitrator’s lost profits award was based upon his reasonable interpretation of the Uniform Commercial Code and the parties’ contractual bar on consequential damages. After a brief discussion of authorities and treatises
discussing the nature of consequential damages and lost profit damages, the Court of Appeals concluded that “[t]he legal distinction between diminution-in-value damages and consequential damages ... resembles the kind of ‘ambiguous law’ that eludes analysis under the manifest disregard doctrine.”

The second question, regarding the arbitrator’s authority to amend the award to correct errors not apparent on the face of the original award, required more careful consideration. The Court of Appeals began its analysis by noting that it has “accorded the narrowest of readings” to the authorization to vacate awards pursuant to Section 10(a)(4) of the FAA on the ground that the arbitrator exceeded his powers, and its conclusion that the arbitrator had not exceeded his powers by amending the award was based on a careful analysis of the doctrine of *functus officio*, which provides that once an arbitrator has fully exercised his authority over the questions referred to him, his authority is ended and he has no further ability to modify the award, and an important clarification of that doctrine.

The Court of Appeals began its analysis by considering its 1999 decision in *Hyle v. Doctor’s Associates, Inc.*, in which it recognized an exception to the *functus officio* doctrine permitting an arbitrator to “correct a mistake which is apparent on the face of the award.” The seller had relied heavily on *Hyle*, claiming that because the arbitrator’s amended decision did not address errors appearing on the face of the original award, the amendment was impermissible. The Court of Appeals found that the seller’s argument overlooked another caveat to the *functus officio* doctrine, which holds that the doctrine applies only “absent an agreement by the parties to the contrary.” While there was no evidence of an express agreement by the parties to permit the arbitrator to amend his award for non-facial defects, the Court of Appeals found the required agreement in the ICDR Rules that the parties had agreed to arbitrate under:

The arbitrator in this case was empowered by both parties to consider requests for revisions to be made in the arbitration award by virtue of the fact that the parties had agreed the arbitration would be conducted pursuant to the ICDR Rules. Here, the arbitrator interpreted ICDR Article 30(1) to permit him to make some corrections to the Original Award and to bar him from making others. The arbitrator thus relied not upon his inherent power to correct facial errors, but upon his interpretation of the corrective authority bestowed upon him by the ICDR Articles, which the parties expressly designated as the rules governing their arbitration. To decide whether the arbitrator exceeded his authority by correcting the Original Award, then, we must ascertain whether the arbitrator acted within his authority in determining that his revisions fell within his power under ICDR Article 30(1) to correct ‘clerical, typographical or computational errors.

The buyer had argued that Article 30(1) should be interpreted as conferring only the same corrective authority as the exception to the *functus officio* doctrine that was recognized by the Second Circuit in *Hyle*. The Court of Appeals did not agree, finding that the propriety of the arbitrator’s action under Article 30(1) could only be examined after determining, as a threshold matter, the degree of deference required to be given the arbitrator’s interpretation of that rule. In the court’s view, that question itself begat another: whether the proper scope of Article 30(1) is properly a question for the arbitrator, or for the court. If the former, the Court of Appeals held, a reviewing court must give “considerable leeway” to the arbitrator’s interpretation of the rule, and reject that interpretation only in “certain narrow circumstances.” If the latter, the court’s review of the arbitrator’s determination would essentially be de novo. Taking note of the well-established federal authorities holding that questions concerning arbitral jurisdiction are to be resolved by a reviewing court “unless the parties
clearly and unmistakably provide otherwise,” and further taking note of its decision in Contec Corp. v. Remote Solution Co., in which the Second Circuit held that parties’ agreement to arbitrate under rules which vest the arbitrator with authority to determine his own jurisdiction provides a “clear and unmistakable agreement” sufficient to place the arbitrator’s determination of arbitrability largely beyond the reach of reviewing courts, the Second Circuit held that because the ICDR Rules provide that an arbitration tribunal “shall interpret and apply these Rules insofar as they relate its powers and duties,” the parties had given sufficient authority to the arbitrator to interpret Article 30(1) and had removed questions concerning the scope of that provision from searching judicial scrutiny.

The Second Circuit, in rejecting the buyer’s contrary arguments, underscored the strength of the public policy favoring arbitration. In response to the buyer’s argument that according deference to the arbitrator’s interpretation of Article 30(1) (and/or any similar rules) could result in arbitrators expanding their powers on a “case-by-case” basis, the Second Circuit observed that “it is hardly controversial to acknowledge that the FAA allows arbitrators to operate with considerable autonomy” and that the Circuit’s “kid-gloved approach” to judicial review “enables the parties to obtain the efficient dispute resolution they bargained for, while affording them the freedom to design the kind of adjudicative proceedings that will best suit their needs.” The Court of Appeals summed up its rejection of the buyer’s inconsistency objection by noting that “[t]he remedy for unduly broad arbitral powers is not judicial intervention: it is for the parties to draft their agreement to reflect the scope of power they would like their arbitrator to exercise.”

The Court of Appeals likewise rejected the buyer’s argument that permitting an arbitrator to exercise broad reconsideration powers could result in inconsistent awards; the buyer had noted that because nothing in the FAA or the ICDR Rules provides that an amended award automatically supersedes a prior award, there exists the possibility that either award might be confirmed. While noting that the argument was “undoubtedly clever,” the Court of Appeals harbored little concern for this possibility, essentially finding that while the possibility of multiple confirmable awards was conceivable, it would not likely result in practical difficulties.

The Court of Appeals ultimately concluded that the buyer had provided “no ground on which we could justify shirking our obligation to grant deference to the arbitrator’s interpretation of the scope of ACDR 30(1).” Applying the limited inquiry that is appropriate when the parties have conferred authority to answer a question to the arbitrator – i.e., whether the arbitrator had the authority to reach an issue, and not whether he decided it correctly – the Court of Appeals held that the arbitrator’s interpretation of Article 30(1) to permit reconsideration of errors not appearing on the face of the original award did not exceed his grant of authority. The Court of Appeals thus reversed and vacated the district court’s order finding that the amendment was not proper, and it remanded the case to the district court with instructions to confirm the amended award.

Conclusion

The Second Circuit’s decision in T. Co. constitutes a natural extension of its recent arbitration jurisprudence insofar as it closely curtails judicial scrutiny of arbitration awards and holds the parties to the terms of their arbitration agreements, even where those terms are incorporated by reference through their inclusion in rules that the parties have agreed to arbitrate by. The court’s decision makes clear, consistent with prior cases, that Second Circuit courts may not ordinarily use “manifest disregard” review (whether identified as such or, consistent with the Court’s recent holding in Stolt-Nielsen, as a species of arbitrator error warranting vacatur under Section 10 of the FAA) as a ground for addressing an arbitrator’s legal conclusions. Second, and more importantly, the Court of Appeals’
decision makes clear that the Contec rule applies not only to threshold questions of arbitrability and jurisdiction, but also to specific questions addressed by arbitrators in the course of a proceeding.

In sum, the decision in T. Co. underscores the importance of choosing a first-rate arbitrator who is knowledgeable about both the law applicable to a dispute and the business out of which the dispute arises. It further underscores the importance of carefully reviewing – at the time the arbitration agreement is being made, rather than when an arbitration under that agreement arises – the body of arbitral rules that is sought to be used in an arbitration agreement, since those rules will likely become a part of that arbitration agreement.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

**New York**

James E. Berger
212-318-6450
jamesberger@paulhastings.com

---

1 F.3d ___, (No. 08-3897-CV(CON), 08-4379-CV(XAP), 08-3894-CV(L)), 2010 WL 114832 (2d Cir. Jan. 14, 2010).

2 128 S. Ct. 1396 (2008). The district court decision predated the Second Circuit’s ruling in Stolt-Nielsen SA v. AnimalFeeds Int’l Corp., 548 F.3d 85 (2008), cert. granted, 129 S. Ct. 2793 (2009), in which the Court of Appeals held as a matter of circuit law that the manifest disregard doctrine no longer constitutes an independent ground for vacatur of an arbitration award, but recognized the doctrine’s continued viability as a “judicial gloss on the specific grounds for vacatur” provided for in Section 10 of the Federal Arbitration Act (“FAA”). Stolt-Nielsen, 548 F.3d at 94-5. While the U.S. Supreme Court has granted certiorari to review Stolt-Nielsen, it has done so explicitly on another issue, and the Second Circuit’s conclusion that manifest disregard review continues to be available within the rubric of Section 10(a)(4) of the FAA is consistent with the rulings of the Courts of Appeals for several other circuits that have ruled on the issue. See, e.g., Citigroup Global Mkts., Inc. v. Bacon, 562 F.3d 349 (5th Cir. 2009); Comedy Club, Inc. v. Improv. West Assoc., 553 F.3d 1277 (9th Cir. 2009).

3 See note 2, supra.


5 198 F.3d 368 (2d Cir. 1999).

6 398 F.3d 205, 208 (2d Cir. 2005).