"Manifest Disregard" Standard of Judicial Review of Arbitral Awards: No Longer Good Law?

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Introduction

On July 7, 2008, Judge Richard J. Holwell of the U.S. District Court for the Southern District of New York issued a ruling in Robert T. Rosen Associates, Ltd. v. Webb, that must be viewed as the first step in the federal courts' reconsideration of the acceptable scope of judicial review of arbitral awards, in the wake of the Supreme Court's recent ruling in Hall Street Assoc., L.L.C. v. Mattel, Inc. In the March 2008 Hall Street decision, the Supreme Court held that the grounds set forth in the Federal Arbitration Act ("FAA") are the exclusive grounds upon which an arbitral award may be vacated or modified. Extrapolating from that decision, Judge Holwell ruled in Rosen Associates that Hall Street abrogated the "manifest disregard" standard, the only non-statutory means of vacating or modifying an arbitral award recognized by the federal courts to date. Prior to this decision, the manifest disregard standard has been recognized by the U.S. Court of Appeals for the Second Circuit as a legitimate ground for nonrecognition of an arbitral award since at least 1967. If appealed and affirmed, Judge Holwell’s decision in Rosen Associates will represent Hall Street’s first significant ripple, and will eliminate a ground for nonrecognition that has been a well-established element of arbitration jurisprudence in virtually every circuit for decades.

Background: The Federal Arbitration Act

The FAA establishes the basic parameters of judicial review of arbitral awards. Chapter 1 of the FAA governs all arbitral awards, while Chapters 2 and 3 specifically govern foreign arbitral awards that fall within the scope of the United Nations Convention on the Enforcement of Foreign Arbitral Awards ("New York Convention") and The Inter-American Convention on International Commercial Arbitration ("Panama Convention"). Section 9 of the FAA implements the United States’ strong policy in favor of arbitration, providing, in pertinent part, that:

If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant such an order unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title.

As is clear from the foregoing language of Section 9, U.S. courts are required to confirm an
arbitral award (and to enter judgment thereon) where the parties have so agreed and where none of the grounds for vacatur, modification, or correction set forth in Sections 10 and 11 is present.

Sections 10 and 11 set forth the (relatively few) grounds for nonrecognition of an award. Section 10 sets forth four “prescribed exceptions” that, when present, authorize a court not to recognize and award:

• the award was procured by corruption, fraud or undue means;
• there was evident partiality or corruption on the part of 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 of any other misbehavior by which the rights of any party have been prejudiced; or
• the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final and definite award upon the subject matter was not made.5

Likewise, Section 11 permits a reviewing court to modify or correct an award where:

• there was an evident miscalculation or figures or an evident material mistake in the description of any person or property referred to in the award;
• the arbitrators have awarded upon a matter not submitted to them; or
• the award is imperfect as to form, but in a manner not affecting the merits of the dispute.

From the time the FAA was adopted in 1925, courts had generally held that the grounds for nonrecognition, modification, or correction set forth in Sections 10 and 11 were exclusive and that no other grounds could be relied upon to refuse to recognize or annul an arbitral award. Notwithstanding these rulings, however, at least one additional ground for judicial nonrecognition was developed by the federal courts.

In 1953, the Supreme Court decided Wilko v. Swan,6 a case involving the validity of an arbitration agreement, the enforcement of which might have had the effect of depriving the plaintiff/investor of various remedies which would otherwise be available in court under the Securities Act. Discussing the potential difficulties with permitting a case brought pursuant to the Securities Act to be arbitrated, the Court noted in dictum that “the interpretations of the law by the arbitrators in contrast to manifest disregard, are not subject, in federal courts, to judicial review for error in interpretation.”7

Since the Wilko decision, courts of appeals in every circuit have recognized the Supreme Court’s dicta to imply that an arbitral award could be annulled pursuant to Section 10 of the FAA where the reviewing court found that the award in question reflected a “manifest disregard of the law” by the arbitrator(s).8 While neither consistently applied nor expressly adopted in each circuit, “manifest disregard” is nevertheless uniformly regarded as a narrow doctrine.9

Under the Second Circuit’s adaptation of the doctrine, a court could only refuse to recognize an award where (1) the arbitrator knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the legal principle ignored by the arbitrator was well-defined, explicit, and clearly applicable to the case.10 The practical effect of this standard was that if an arbitral award presented a “barely colorable justification for the outcome reached,” it was required to be upheld. Despite these limitations, however, various awards have been set aside by reviewing courts, in the Second Circuit and elsewhere, on the ground that the award evinced a manifest disregard of the law.11 As a result, the doctrine represented a
significant, if only seldom applied, weapon in the arsenal of a party seeking to avoid an arbitration award.

**Hall Street**

In *Hall Street*, the Supreme Court was asked to consider whether parties to an arbitration agreement could, through their agreement, permit more expansive judicial review of an award than would be permitted under Sections 9 through 11 of the FAA. The arbitration agreement at issue in *Hall Street* provided, in pertinent part, that the court "shall vacate, modify or correct any award: (i) where the arbitrator's findings of fact are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous." By including these provisions in the arbitration agreement, the parties essentially established a *de novo* standard of review for any resulting award, a much more searching standard than would ordinarily apply under the FAA.

Arbitration ensued. *Hall Street*, the unsuccessful party, sought to vacate the award on the ground that the arbitrator had committed an error of law by failing to properly apply an Oregon state statute. In accordance with the express terms of the parties’ arbitration agreement, the district court found that the arbitrator had indeed committed an error of law, vacated the award, and remanded the matter to the arbitrator. On appeal, the Ninth Circuit reversed the district court’s order vacating the initial arbitration award, and remanded the matter to the district court with instructions to confirm the award unless one of the grounds for vacatur or modification set forth in Sections 10 and 11 of the FAA were present. Following further proceedings before the district court and a second appeal to the Ninth Circuit, the Supreme Court granted *certiorari* to "decide whether the grounds for vacatur and/or modification provided by Sections 10 and 11 of the FAA are exclusive and may not be modified by contract. The Court specifically rejected the petitioner’s argument that the Court’s prior decision in *Wilko* supported the notion that parties could modify the degree of judicial review to suit their needs."14

**Rosen Associates**

While the Supreme Court’s decision in *Hall Street* did not expressly revisit its prior ruling in *Wilko*, the Court’s holding that the grounds for vacatur and modification set forth in Sections 10 and 11 are exclusive necessarily casts doubt upon the continuing vitality of the manifest disregard standard. In *Rosen Associates*, a case with a procedural history described by the district court as "tortuous," the parties had filed cross-motions to confirm and deny an arbitral decision in which the arbitrator had, without holding a hearing, dismissed *Rosen Associates’* claim for the legal fees it had incurred in attempting to confirm its initial arbitral award. *Rosen Associates’* principal contention was that the arbitrator’s decision was rendered in manifest disregard of the law.

At the outset of its analysis, the district court observed that the Second Circuit, relying upon dicta from *Wilko*, "has held that ‘manifest disregard of the law’ provides an additional judicial basis for vacatur.”16 The district court then analyzed the continued applicability of that doctrine following *Hall Street*, and concluded as follows:

*Necessary to Hall Street’s* holding are two related propositions: first, that the FAA’s statutory grounds [for vacatur and/or modification] are exclusive, and second, that the Supreme Court has never endorsed manifest disregard as an independent basis for vacatur. Together, these propositions undercut the rationale for the Second Circuit’s prior adherence to the manifest disregard standard. [Citation omitted.] As the Second Circuit’s traditional understanding of *Wilko* and § 10 – that *Wilko* endorsed manifest disregard and that
§ 10’s grounds are not exclusive – is inconsistent with the basis for the holding in Hall Street, the Court finds that the manifest disregard of the law standard is no longer good law.¹⁷

Implications

Judge Holwell’s decision in Rosen Associates is not binding on any other court, and a conclusive determination of whether manifest disregard remains a ground for vacatur or modification under the FAA will lie with the federal courts of appeals and, ultimately, the Supreme Court. What the decision makes clear, however, is that the lower federal courts are likely to take a more circumscribed view of their authority to review arbitral awards, and are even less likely to annul an arbitral award based on the manifest disregard standard than they were before. Parties that are contemplating entering into arbitration clauses that may raise novel, complex, or technical legal issues should therefore be forewarned that an arbitral decision is likely to be the last word on a dispute, and that they will almost certainly be required to accept arbitral decisions even if they contain material errors of law. Furthermore, given the large number of arbitration agreements that designate the Southern District of New York as the venue for post-arbitral confirmation proceedings, rulings from that district court warrant particularly close attention.

The decision in Rosen Associates also implicates the ability of parties to “contract around” the FAA. Courts have long recognized that parties wishing to have their arbitration agreements and awards governed by more flexible state statutes or common law are generally free to agree to do so, provided they clearly demonstrate their intent to have the arbitration governed by a parallel authority. This ability to avoid the FAA can be somewhat illusory, however, as the FAA extends to any arbitration agreement that “involv[es] commerce”¹⁸ – an exceedingly broad standard that the Supreme Court has held is coextensive with Congress’s powers under the Commerce Clause¹⁹ – and has been held to preempt any state law that singles out arbitration agreements or awards for unfavorable treatment.²⁰ By cabining courts’ authority to annul or modify arbitral awards to the specific grounds set forth in Sections 10 and 11, the Supreme Court’s decision in Hall Street (and the district court’s decision in Rosen Associates) may lead to decisions expanding the FAA’s preemptive sweep by holding that any state law permitting an arbitral award to be annulled on grounds other than those in Sections 10 and 11 necessarily disfavors arbitration, and is thus preempted.

In sum, the district court’s decision in Rosen Associates constitutes a further strengthening of the federal policy favoring arbitration and the finality of arbitral decisions. While further litigation over the scope of judicial review is all but assured, parties must be increasingly mindful of the likelihood that attempts to annul or avoid arbitral awards will be met with greater judicial scrutiny and resistance.

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3 Saxis S.S. Co. v. Multifacs Intern Traders, Inc., 375 F.2d 577, 582 (2d Cir. 1967).
4 9 U.S.C. § 9. See, e.g., also Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) (“In enacting [the FAA], Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.”).
5 9 U.S.C. § 10(a) (1)-(4).
7 346 U.S. at 436-37 (emphasis added).
10 See, e.g., Hoeft v. MVL Grp., Inc., 343 F.3d 57, 64 (2d Cir. 2003).
11 See, e.g., Porzig v. Dresdner, Kleinwort, Benson, North America LLC, 497 F.3d 133 (2d Cir. 2007); Halligan v. Piper Jaffray, Inc., 148 F.3d 197 (2d Cir. 1998).
12 Hall Street, 128 S. Ct. at 1400.
13 Id. at 1401. This question had divided the federal courts of appeals; prior to the Supreme Court’s ruling, the Ninth and Tenth Circuits had held that parties could not contract for expanded judicial review, while the First, Third, Fifth and Sixth Circuits had reached the opposite conclusion.
14 Id. at 1403-04
17 Id. at *4.

See, e.g., Perry v. Thomas, 482 U.S. 483, 490 (1987) (the Act "embodies Congress' intent to provide for the enforcement of arbitration agreements within the full reach of the Commerce Clause"); Southland Corp. v. Keating, 465 U.S., at 14-15 (the "involving commerce" requirement is a constitutionally "necessary qualification" on the Act's reach, marking its permissible outer limit).