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## The Fifth Circuit's Positive Software Solutions v. New Century Mortgage - Underscoring the Need for a Positive Solution to Arbitrator Disclosure for a New Century

by L.E. Foster and S.R. Cappell

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# **The Fifth Circuit’s *Positive Software Solutions v. New Century Mortgage*— Underscoring the Need for a Positive Solution to Arbitrator Disclosure for a New Century**

**By: Laurie E. Foster & Shana R. Cappell**

## **Introduction**

With the increase in cross-border transactions, international arbitration has enjoyed significant growth in recent years, driven in large part by the ease of enforceability of awards as well as the perception that the arbitral venue provides a neutral and impartial alternative to local court litigation. By the same token, the increase in international trade, multinational conglomerates, and large global law firms, have created increasingly difficult conflict of interest issues. This, in turn, has provided more opportunities for disgruntled losing parties to commence post-award litigation to challenge arbitral awards in court. Arbitrator partiality continues to be a favorite basis for parties seeking vacatur of both domestic and international arbitration awards made in the United States. As discussed more fully below, despite a Supreme Court decision issued forty years ago on this very topic, the United States federal courts have been unable to adhere to any uniform standards regarding arbitrator disclosure, only serving to further encourage post-award litigation.

In an effort to provide some order to the issue of arbitrator conflicts of interest within a growing international arbitration community, in May 2004, the International Bar Association (“IBA”) approved *Guidelines on Conflicts of Interest in International Arbitration* (the “IBA Guidelines”). In that same year, the American Arbitration Association and the American Bar Association revised and jointly promulgated *The Code of Ethics for Arbitrators in Commercial Disputes* (the “Ethics Code”). Although less detailed than the IBA Guidelines, Canon II of the Ethics Code takes the same general approach to disclosure as the IBA Guidelines. Despite these thoughtful efforts, the uncertainties regarding the standards for arbitrator disclosure under the Federal Arbitration Act (“FAA”)<sup>1</sup> continue to plague the federal courts.

Indeed, in yet another display of the unsettled state of the law in the U.S. federal courts, in January of this year, the Fifth Circuit sitting *en banc* issued its decision in *Positive Software Solutions, Inc. v. New Century Mortgage Corp.*, 476 F.3d 278 (5th Cir. 2007). The decision, which reconsidered the earlier decision of a panel of the Fifth Circuit,<sup>2</sup> includes a majority opinion, a dissenting opinion, and an opinion specially concurring in the dissent, exemplifying the federal bench’s conflicting viewpoints concerning arbitrator disclosure requirements.

When considered together, each of the views expressed in the Fifth Circuit opinion embodies all of the varying approaches to the arbitrator disclosure obligation dilemma. Unsurprisingly, therefore, the opinion itself does little to clarify the muddled area of arbitrator disclosure. On

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<sup>1</sup> 9 U.S.C. §1, *et seq.*

<sup>2</sup> 436 F.3d 495 (5th Cir. 2006).

June 11, 2007, the United States Supreme Court denied *certiorari* in this case,<sup>3</sup> refusing to revisit arbitrator disclosure obligations despite the apparent inconsistencies among U.S. circuit court opinions addressing arbitrator impartiality. Consequently, absent the passage of legislation to amend the FAA, we submit that the most effective method of ensuring that the international community has the highest level of confidence in arbitration which has its seat in the United States would be for the federal courts to routinely consult the IBA Guidelines and the Ethics Code for guidance in reaching their determinations.

### ***Commonwealth Coatings and its Progeny***

The FAA, which has been held to apply to motions to vacate both domestic awards and international awards rendered in the United States,<sup>4</sup> provides that an arbitration award may be vacated by a federal district court “where there was evident partiality or corruption in the arbitrators, or either of them.”<sup>5</sup> Given the vagueness of this statute, the U.S. Supreme Court attempted to clarify the meaning of “evident partiality” in the seminal case *Commonwealth Coatings Corp. v. Continental Casualty Co.*<sup>6</sup> In *Commonwealth Coatings*, the Supreme Court found that an arbitrator’s failure to disclose the close financial relations between himself and a party to the arbitration amounted to evident partiality. In framing the disclosure requirements of an arbitrator, Justice Black, delivering the opinion of the Supreme Court, explained that “[w]e can perceive no way in which the effectiveness of the arbitration process will be hampered by the simple requirement that arbitrators disclose to the parties *any dealings* that might create *an impression of bias*.”<sup>7</sup> Furthermore, the Court stated that “any tribunal...not only must be unbiased but also must avoid even the *appearance of bias*.”<sup>8</sup> Accordingly, the Supreme Court’s opinion commands a clear “when in doubt, disclose” policy.

The clarity of the *Commonwealth Coatings* opinion becomes somewhat murky, however, when read in conjunction with Justice White’s concurring opinion in that same case. While Justice White, together with Justice Marshall, does join in Justice Black’s opinion, he adds that “arbitrators are not automatically disqualified by a business relationship with the parties before them if...[the parties] are unaware of the facts but the relationship is trivial.”<sup>9</sup> This slight addendum creates uncertainty over whether Justice White, as the fifth vote in the case, intended to join the majority opinion’s broad finding that any business dealing that may create an

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<sup>3</sup> See *Positive Software Solutions v. New Century Mortgage Corp.* No. 06-1352, 2007 WL 1090443 (June 11, 2007).

<sup>4</sup> See e.g. *Yusuf Ahmed Alghanim & Sons, W.L.L. v. Toys “R” US, Inc.*, 126 F.3d 15, 16 (2d Cir. 1997) (“We read Article V(1)(e) of the Convention [on the Recognition of Foreign Arbitral Awards] to allow a court in the country under whose law the arbitration was conducted to apply domestic arbitral law, in this case the FAA, to a motion to set aside or vacate that arbitral award.”). But see *Industrial Risk v. M.A.N. Gutehoffnungshutte*, 141 F.3d 1434, 1447 (11th Cir. 1998).

<sup>5</sup> 9 U.S.C. § 10(a)(2).

<sup>6</sup> 393 U.S. 145 (1968).

<sup>7</sup> *Id.* at 149 (emphasis added).

<sup>8</sup> *Id.* at 150 (emphasis added).

<sup>9</sup> *Id.*

“impression of bias” must be disclosed, or whether his concurrence actually limits the disclosure obligation to business dealings that are more than “trivial,” thereby relegating the majority opinion to a plurality decision.

The Circuit Courts have grappled with this very same question. On the one hand, the Second, Fourth, Sixth, and Seventh Circuits have chosen to view Justice White’s concurring opinion as limiting the majority opinion to a mere plurality.<sup>10</sup> The Tenth and Eleventh Circuits have arrived at similar conclusions.<sup>11</sup> The Ninth Circuit, however, has rejected the view that Justice White’s concurrence limits the *Commonwealth Coatings* holding and has instead endorsed the “reasonable impression of bias” standard as a majority opinion.<sup>12</sup> In short, although a majority of circuits ascribe to the view that in order to warrant vacatur of an arbitration award, the arbitrator’s undisclosed connection must implicate a direct and substantial interest or relationship between a party and the arbitrator, there is still no consensus on the matter.

### **The Fifth Circuit Joins the Fray**

In 2006, the Fifth Circuit, consisting of a panel of three judges, heard the case *Positive Software Solutions, Inc. v. New Century Mortgage Corp.* on appeal from the District Court of the Northern District of Texas.<sup>13</sup> In the arbitration out of which the case arose, which was a domestic arbitration, the arbitrator failed to disclose that he and counsel for one of the parties to the arbitration had jointly represented a client in a lawsuit that ended seven years prior to the arbitration at issue. Although the arbitrator and party counsel never attended any meetings or hearings together during the course of that litigation, their names appeared together on various pleadings. The District Court found that the arbitrator’s nondisclosure of the prior relationship raised a reasonable impression of partiality and therefore warranted vacatur of the arbitration award.<sup>14</sup> The Fifth Circuit panel affirmed the district court’s decision, finding that the arbitrator at issue in the case displayed “evident partiality” by failing to make the disclosure at issue.

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<sup>10</sup> See *Morelite Constr. Corp. v. N.Y. City Dist. Council Carpenters Benefit Funds*, 748 F.2d 79, 83 n.3 (2d Cir. 1984) (“Because the two opinions are impossible to reconcile, however, we must narrow the holding to that subscribed to by both Justice White and Black.”); *ANR Coal Co., Inc. v. Cogentrix of N.C., Inc.*, 173 F.3d 493, 499-500 (4th Cir. 1999) (noting that courts have given Justice White’s “concurrence particular weight” and that “mere nondisclosure does not in itself justify vacatur.”); *Nationwide Mut. Ins. Co. v. Home Ins. Co.*, 429 F.3d 640, 644 n.5 (6th Cir. 2005) (“a majority of the Court did not endorse the ‘appearance of bias’ standard set forth in the plurality opinion.”); *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 681 (7th Cir. 1983) (stating *Commonwealth Coatings* “provides little guidance because of the inability of a majority of Justices to agree on anything but the result.”).

<sup>11</sup> See *Ormsbee Dev. Co. v. Grace*, 668 F.2d 1140, 1147 (10th Cir. 1982) (citing Justice White’s opinion and requiring “clear evidence of impropriety” for vacatur); *Univ. Commons-Urbana, Ltd. v. Univ. Constructors Inc.*, 304 F.3d 1331, 1339-40 (11th Cir. 2002) (citing Justice White’s opinion and allowing for vacatur only if facts creating “a reasonable impression of partiality” are not disclosed.”).

<sup>12</sup> See *Schmitz v. Zilveti*, 20 F.3d 1043 (9th Cir. 1994) (treating *Commonwealth Coatings* as a majority opinion that mandates a “reasonable impression of bias” standard).

<sup>13</sup> 436 F.3d 495 (5th Cir. 2006).

<sup>14</sup> *Positive Software Solutions, Inc. v. New Century Mortgage Corp.*, 337 F.Supp.2d 862, 886-7 (N.D. Tex. 2004), *aff’d*, 436 F.3d 495 (5th Cir. 2006), *rev’d*, 476 F.3d 278 (5th Cir. 2007).

On May 5, 2006, the Fifth Circuit granted a petition for rehearing of the case *en banc*.<sup>15</sup> In January of this year, the Fifth Circuit issued its *en banc* decision, disagreeing with the findings of the Fifth Circuit panel regarding the alleged evident partiality of the arbitrator and reversing the opinion of the District Court.<sup>16</sup> The Court found that the FAA “does not mandate the extreme remedy of vacatur for nondisclosure of a trivial past association” and declined to vacate the arbitration award.<sup>17</sup> Joining the majority of circuit courts, the Fifth Circuit ultimately concluded that vacatur is not required unless “it creates a concrete, not speculative impression of bias” and that such a harsh remedy as vacatur is “only warranted upon nondisclosure that involves a significant compromising relationship.”<sup>18</sup>

Although the Fifth Circuit opinion articulates an apparent standard of the extent of arbitrator disclosure obligations – namely, that an insubstantial prior relationship between an arbitrator and a party to the proceeding need not be disclosed – the Fifth Circuit judges are clearly not of a unified mind. The dissent disagrees with the majority’s holding, arguing that *Commonwealth Coatings* must be treated as a majority opinion, thereby requiring the lower courts to accept the principle that failure to disclose any dealings that might create an impression of bias warrants vacatur of an arbitration award.<sup>19</sup> And in yet another demonstrated difference of opinion, one judge issued a concurring opinion agreeing with the dissent’s findings, but wrote separately to urge that “full, unredacted disclosure of every prior relationship – must be rigorously adhered to and strenuously enforced.”<sup>20</sup>

### **The Bar Associations’ Efforts to Create Order in a Chaotic Field**

On May 22, 2004, the IBA promulgated the IBA Guidelines. Recognizing that national laws and arbitration rules governing arbitration offer standards without providing “detail in their guidance” and “uniformity in their application,” the IBA set out to supply clarity and consistency to the decision making process.<sup>21</sup> The IBA Guidelines actually consist of two parts: Part I includes seven general standards concerning arbitrator conflicts of interest and Part II includes four tables that offer examples to help clarify the standards espoused in Part I.

The IBA Guidelines set forth a subjective test and provide that, when determining if a potential conflict of interest should be disclosed to the parties, the potential arbitrator must disclose “[i]f facts or circumstances exist that may, in the eyes of the parties, give rise to doubts as to the arbitrator’s impartiality or independence.”<sup>22</sup> In an effort to provide further clarity on the subject, the IBA also advocates erring on the side of disclosure, including an instruction that “[a]ny

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<sup>15</sup> *Positive Software Solutions, Inc. v. New Century Mortgage Corp.*, 449 F.3d 616 (5th Cir. 2006).

<sup>16</sup> *Positive Software Solutions, Inc. v. New Century Mortgage Corp.*, 476 F.3d 278 (5th Cir. 2007).

<sup>17</sup> *Id.* at 279.

<sup>18</sup> *Id.* at 286.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> IBA Guidelines, at p.3, ¶2.

<sup>22</sup> IBA Guidelines, General Standard 3(a), at p.9.

doubts as to whether an arbitrator should disclose certain facts or circumstances should be resolved in favour of disclosure.”<sup>23</sup>

Taking a practical approach, Part II of the IBA Guidelines offers examples of specific situations likely to arise in arbitration practice, summarized in four tables. The IBA explains that the decision to list the hypotheticals in these specific tables “reflect[s] international principles to the best extent possible.”<sup>24</sup> These tables cover instances spanning: (1) circumstances where a non-waivable, objective conflict of interest exists (the “Non-Waivable Red List”); (2) circumstances where a waivable, objective conflict of interest exists (the “Waivable Red List”); (3) situations which subjectively in the eyes of the parties may give rise to justifiable doubts as to arbitrator impartiality, so that the arbitrator has a duty to disclose such situations (the “Orange List”); and (4) a non-exhaustive enumeration of specific situations where no appearance of, and no actual, conflict of interest exists from the relevant objective point of view, so there is no duty to disclose (the “Green List”).<sup>25</sup> The Green List is an acknowledgement by the IBA that there are some situations that objectively will virtually never amount to partiality, and therefore need not be disclosed, regardless of the parties’ perspective.

Domestic bar associations have also made recent attempts to codify arbitrator disclosure requirements. Indeed, on February 9, 2004, the American Bar Association House of Delegates and the Executive Committee of the Board of Directors of the American Arbitration Association approved revisions to its Code of Ethics for Arbitrators in Commercial Disputes (the “Ethics Code”). Canon II of the Code deals exclusively with arbitrator disclosure requirements, and contains a number of significant revisions, including a new standard for disclosure by arbitrators of interests and relationships. The Code requires disclosure of any known financial, business, professional or personal relationships that “might reasonably affect impartiality or lack of independence in the eyes of any of the parties.”<sup>26</sup> Although this test is considered a subjective test, by inserting the word “reasonably” into the Canon, the drafters infused the rule with an objective element, much like the IBA had with the Green list.<sup>27</sup> Similar to the IBA rules, the Code makes clear that any doubt as to whether disclosure is to be made should be resolved in favor of disclosure.<sup>28</sup> These statements demonstrate a clear stance in favor of full disclosure of relevant information by all arbitrators.

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<sup>23</sup> IBA Guidelines, General Standard 3(c), at p.9.

<sup>24</sup> IBA Guidelines, at p. 19, ¶8.

<sup>25</sup> See IBA Guidelines, Non-Waivable Red List, Waivable Red List, Orange List and Green List, at p. 20-25.

<sup>26</sup> Ethics Code, Canon II.A(2).

<sup>27</sup> Unlike the ABA and IBA approaches, the Circuits are in agreement that the test to determine “evident partiality” under the FAA is always objective. See e.g., *Nationwide Mutual Ins. Co. v. Home Ins. Co.*, 429 F.3d 640, 645 (6th Cir. 2005), citing *Morelite Construc. Corp. v. N.Y. City Dist. Council Carpenters Benefit Funds*, 748 F.2d 79, 84 (2d Cir. 1984) (stating “evident partiality ‘will be found where a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration.”); see also *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 682 (7th Cir. 1983) (stating “the standard [for determining evident partiality] is an objective one, but less exacting than the one governing judges.”); *Apusento Garden, Inc. v. Superior Court of Guam*, 94 F.3d 1346, 1352 (9th Cir. 1996) (stating “the test is an objective one—whether such an impression of possible bias is created in the eyes of the hypothetical reasonable person.”) (internal citations omitted).

<sup>28</sup> Ethics Code, Canon II.D.

## **Application of the IBA Guidelines and the Ethics Code to *Positive Software Solutions***

It is true that neither the IBA Guidelines nor the Ethics Code is binding on the federal courts. Indeed, the Ethics Code itself states in its Preamble that “[t]his Code does not take the place of or supersede such laws....All provisions of this Code should therefore be read as subject to contrary provisions of applicable law and arbitration rules.”<sup>29</sup> Similarly, the IBA Guidelines acknowledge that they “are not legal provisions and do not override any applicable national law. . . .”<sup>30</sup> Accordingly, federal courts are not obliged to follow the bar associations’ arbitrator policies. However, as the Working Group that developed the IBA Guidelines recognized, in “many, especially common law, jurisdictions where the judge-made law is unclear on a particular point, the Guidelines might be of use to arbitrators as well as to judges in exercising their discretion” and could “serve to influence courts and assist with filling the gaps in national law.”<sup>31</sup> Given the uncertainty in the current state of the law in the United States, the usefulness of applying the policies to federal cases is unmistakable.

The Fifth Circuit’s multiple opinions generated in *Positive Software Solutions* exemplifies what happens when a court is left to reach a decision regarding arbitrator disclosure obligations based only upon an interpretation of the Supreme Court’s contradictory statements in *Commonwealth Coatings*. The Fifth Circuit majority ended up issuing an opinion that prompted a dissenting opinion and a separate opinion specially concurring in the dissent. In all, eleven judges held that the failure to disclose did not mandate vacatur of the award and five judges voted to affirm the judgment vacating the award. Had the Fifth Circuit chosen instead to consult the IBA Guidelines or the Ethics Code, it would have reached the same conclusion as the majority did in the *Positive Software Solutions* case, but it likely would have avoided the multiple opinions and could have presented a unified position.

The IBA Guidelines actually include as a hypothetical in one of its tables the example where “[t]he arbitrator and counsel for one of the parties...have previously served together...as co-counsel,”<sup>32</sup> the exact relationship presented in *Positive Software Solutions*. The IBA lists this hypothetical on its “Green List,” indicating that such a relationship does *not* give rise to a duty to disclose. Accordingly, the IBA Guidelines are consistent with the Fifth Circuit’s majority decision that the relationship at issue was of a trivial nature and did not warrant disclosure. Similarly, the dissenting opinion, which advocates that an “impression of bias” is the proper standard under which the case should have been decided, would be pointless, given that the IBA Guidelines specifically delineate the relationship at issue in *Positive Software Solutions* on its Green List, indicating that it is a relationship that generates “no appearance of, and no actual” bias.<sup>33</sup> Furthermore, because the IBA Guidelines state that any doubts regarding disclosure

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<sup>29</sup> Ethics Code, Preamble at p.2-3.

<sup>30</sup> IBA Guidelines, Introduction, para 6.

<sup>31</sup> For the Working Group, Otto L.O. de Witt Wijnen, Nathalie Voser & Neomi Rao, *New IBA Guidelines on Conflicts of Interest in International Arbitration*, 5 Bus. Law Int’l. 433. 439 (2004).

<sup>32</sup> IBA Guidelines, Green List at p. 24, ¶4.4.2.

<sup>33</sup> IBA Guidelines, at p. 18, ¶6.

should be resolved in favor of disclosure, the concurring opinion issued in *Positive Software Solutions* becomes unnecessary.

The Fifth Circuit would have also reached the same conclusion in *Positive Software* if it had chosen to consult the Ethics Code. Although the Ethics Code does not incorporate in its Canons the helpful illustrations that the IBA Guidelines feature, the Ethics Code's requirement to disclose all interests that "reasonably affect" the parties would have led the Fifth Circuit to decide the *Positive Software Solutions* case in the same manner – namely, that the disclosure interest at issue presented an insubstantial connection that did not warrant disclosure.

While the Fifth Circuit chose to disregard the available guidelines,<sup>34</sup> other federal courts have not made that same mistake. Indeed, the U.S. Supreme Court itself chose to consult the American Arbitration Association ("AAA") rules to aid its decision in *Commonwealth Coatings*.<sup>35</sup> The Supreme Court reasoned that although the AAA rules were "not controlling in this case," they were "highly significant" to the Court's analysis.<sup>36</sup>

More recently, in the 2006 case *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi*, the Southern District of New York chose to consult both the Ethics Code and the IBA Guidelines in considering the situation where the Chair of an arbitration panel failed to disclose an ongoing commercial relationship between his company and one of the parties to the proceeding.<sup>37</sup> By consulting the standards for arbitrators set forth by the Ethics Code and the IBA Guidelines, the Court determined that the commercial relationship at issue warranted disclosure and vacated the arbitration award.<sup>38</sup> The district court stated that under the IBA Guidelines, the arbitrator had a duty to investigate the potential conflict of interest and the arbitrator's purported lack of knowledge did not excuse his lack of disclosure.<sup>39</sup> The Court also cited to the Ethics Code to support the propositions that an arbitrator's duty to disclose is an ongoing duty and that any doubts regarding disclosure should be resolved in favor of disclosure.<sup>40</sup>

In consulting the various arbitration codes, the Southern District reasoned that "[i]t is important that courts enforce rules of ethics for arbitrators in order to encourage businesses to have confidence in the integrity of the arbitration process, secure in the knowledge that arbitrators will

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<sup>34</sup> In a footnote in the *Positive Software Solutions* case, the Fifth Circuit pointed out that the American Arbitration Association's rules "requires broad prophylactic disclosure" but then stated that the AAA rules "play[] no role in applying the federal standard embodied in the FAA." *Positive Software Solutions*, 476 F.3d at 284, n.5.

<sup>35</sup> *Commonwealth Coatings*, 393 U.S. at 399.

<sup>36</sup> *Id.*

<sup>37</sup> See *Applied Industrial Materials Corp. v. Ovalar Makine Ticaret Ve Sanayi*, 05 CV 10540, 2006 U.S. Dist. LEXIS 44789 (S.D.N.Y. Jun. 28, 2006).

<sup>38</sup> *Id.* at \*26-7.

<sup>39</sup> See e.g., IBA Guidelines, General Standard 7 at 15-16.

<sup>40</sup> *Applied Industrial Materials*, 05 CV 10540, 2006 U.S. Dist. LEXIS 44789, at \*22-4.

adhere to these standards.”<sup>41</sup> Particularly in the context of international arbitration, which necessarily involves parties from many different cultures and legal systems, it is crucial that a body of rules exists so that there is some uniformity regarding arbitrator disclosure obligations. As the Southern District itself pointed out in the *Applied Industrial Materials* opinion, “[b]ecause of the increase in international transactions and the corresponding increase in disputes it is crucial that there exist a requirement of an appearance of impartiality in arbitrations conducted in this jurisdiction, and that courts take actions designed to assure foreign entities that arbitrations in the United States are free from the suggestion of partiality.”<sup>42</sup>

## Conclusion

The standards set forth for arbitrators in the IBA Guidelines and in the Ethics Code, if routinely consulted by federal judges, will provide parties with confidence in the arbitral panel’s ability to render fair and impartial decisions and enhance the reputation of the United States as a venue for international arbitration. The IBA Guidelines and the Ethics Code provide uniformity in an area of federal law that is riddled with inconsistency and contradiction. The Fifth Circuit’s recent *en banc* opinion underscores the need for the federal bench to standardize its approach to arbitrator disclosure obligations, and the various bar association policies are an obvious and sensible place to start.

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<sup>41</sup> *Id.*, at \*27.

<sup>42</sup> *Id.* at \*27-8.