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When Does an Arbitrator's Award Disregard the Law?

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For decades, the conventional wisdom was that courts would rarely, if ever, overturn arbitration awards in commercial matters.

The conventional wisdom was especially prevalent in circumstances where the subject matter of the arbitration touched upon interstate commerce, and thus the awards were subject to the Federal Arbitration Act (the FAA).

However, a series of cases from state and federal courts in New York have cast doubt on this conventional wisdom. In these cases, courts have overturned commercial arbitration awards on the ground that the award was made in manifest disregard of the law.¹ To be sure, in most cases, the

courts continued to routinely affirm awards², but the trend of courts to examine the factual and legal basis for the arbitration awards is striking. In defiance of this trend, the pendulum may be shifting back if a recent Court of Appeals case is any indication.³

Manifest Disregard of Law

This article examines the developing law of arbitration awards arising from commercial disputes in the New York courts. We conclude that the courts are far more likely to confirm arbitrators' rulings where the decision involves one or more mixed questions of law and fact. However, where the validity of the award raises pure questions of law, the courts will overturn awards where they believe that outcome-determinative legal issues have been ignored and incorrectly decided. The cases are not clear as to the difference between a "mere error" of law as opposed to a "manifest disregard of the law." However, from the cases it appears that manifest disregard arises when the error is crucial to the result and the arbitrators were confronted the principle but still misapplied it.

The standard for confirmation of arbitration awards is different under New York law than under the FAA.⁴ The FAA, by its terms, is applicable where the "arbitration agreement relat[es] to transactions affecting interstate commerce."⁵ As virtually every commercial transaction arguably affects interstate commerce, the FAA is deemed to apply to most commercial contract arbitrations.⁶

In the past, courts regularly upheld commercial arbitration awards.⁷ The reviewing standard was that arbitration awards would be upheld if there was any rational basis for doing so anywhere in the record, whether or not articulated by the arbitrators as the basis for the decision.⁸ These courts also uniformly held that an arbitrator could not be deemed to have manifestly disregarded the law unless the party making the challenge had specifically argued the legal issue to the arbitrators.⁹

The shift away from this well-established law was triggered, in part, by the U.S. Court of Appeals for the Second Circuit opinion in *Halligan v. Piper Jaffray*.¹⁰ In *Halligan*, the court held that a reviewing court should examine the record and may refuse to confirm an award that is in manifest disregard of the evidence presented to the arbitrators, especially where the arbitrators did not articulate the reasons for their decision. Every litigator understands that there is a fine line between a case where the arbitrator acted in manifest disregard of the evidence and a case where the court simply comes to a different conclusion than did the arbitrator on the same evidence. The cases that follow illustrate the difficulty of finding that line.

*Sands Brothers & Co., Ltd v. Generex Pharmaceuticals*¹¹ represents a case where it appears that the courts were simply substituting their judgment for that of the arbitrators'. In *Sands*, the First Department remanded back to the arbitrators in a securities case an award granting the issuance of certain warrants because the court found that certain terms of the award were too vague to be enforced. The court held that the arbitrators could cure the defect and supply the missing terms upon a finding of competent evidence that the missing language was simply boilerplate that could be determined by reference to common standards in the industry. The court also ruled that if the arbitrators could not supply those missing terms by reference to industry standards, it could award money damages in lieu of the warrants. Upon remand, the arbitrators made a specific finding that industry standard boilerplate terms would complete the agreement, but the Appellate Division essentially took a de novo view of the record and affirmed the trial judge, finding that the award was irrational. Although neither the trial court nor the Appellate Division employs the phrase "manifest disregard of the facts," it is clear that both courts were simply substituting their judgment for that of the arbitrators.¹²

In *Wallace v. Buttar*¹³, the Second Circuit retreated a bit from *Halligan*. In *Wallace*, the court held that, although a reviewing court may overturn an award on the ground that the arbitrator exhibited a manifest disregard of the law¹⁴, it could not do so if there is merely a manifest disregard of the facts.

The New York Court of Appeals seems to have followed that lead. In *Wien v. Malkin*, the U.S. Supreme Court reversed a judgment upholding an arbitration award under New York State law because the lower courts had applied the Civil Practice Law and Rules (CPLR) standard and not the FAA standard. The Supreme Court remanded the case back to the New York Supreme Court to determine if the award should be confirmed under federal standards. The trial court affirmed the award, but the Appellate Division reversed finding that the arbitrators had manifestly disregarded the terms of the contracts that were the subject matter of the dispute.

The Court of Appeals determined that the Appellate Division erred when it found that was a manifest disregard of the law. In the Court of Appeals' view, the arbitrators simply had construed the facts differently than the Appellate Division would have liked. As a factual dispute represented an insufficient basis to overturn the arbitrators' findings, the Court of Appeals reinstated the trial court's determination upholding the award.

These cases leave ambiguity in the interpretation of "manifest disregard" of the law. The Second Circuit has long held that a "mere error in law" is not sufficient to vacate an arbitration award.¹⁵ And in its most recent pronouncement, the court interpreted manifest disregard of the law to mean "more than error or misunderstanding with respect to the law."¹⁶

New York Practitioner

What is the New York practitioner to make of all of this? Is there a difference between an "error of law" and a "manifest disregard of the law"? It seems to depend on context. Where the issues involve mixed questions of fact and law, courts generally will ignore errors of law and confirm the award. That finding tends to occur in questions like the arbitrators' interpretation of a contract.¹⁷ Where the court finds that the arbitrators have improperly interpreted or applied a purely legal issue that is independent of factual findings, the court is likely to characterize it as a "manifest disregard of the law" and vacate the award. A good example of that is a question concerning vicarious liability or corporate form.

The *Wallace* case itself provides a useful illustration. In *Wallace*, the respondents sought to vacate the award arguing that the arbitrators applied the wrong standard for control person liability under federal law. While the Second Circuit agreed that the arbitrators had misinterpreted federal law, it nevertheless confirmed the award because the facts supported the imposition of control person liability under state law. Thus, reasoned the court, the arbitrators' award had an independent ground for confirmation and was not in manifest disregard of the law.

These types of issues often arise in customer disputes with securities firms where the claimant seeks to impose liability on employers or employees under the respondeat superior doctrine.¹⁸ If the arbitrators impose liability on the brokerage house on the basis of respondeat superior, but not on the broker individually, some courts have held that the award is in manifest disregard of the law.¹⁹ These courts have reasoned that the brokerage firm cannot be liable as a matter of law unless the broker himself was liable. Thus, an award that penalizes the firm but not the

broker is in manifest disregard of the law. In contrast, if the award itself does not recite the reasoning of the arbitrator, but the result is the same, i.e., liability imposed against the firm but not the individual broker, this award can be sustained if there is any legal reason in the record to support it. For example, the firm could be liable for failing to properly supervise the broker and thus the award can be sustained on that basis.²⁰ If the panel gives an independent basis for the brokerage house to be liable that makes legal sense, then that award can be confirmed as well.²¹ At bottom, as long as it is conceivable for a legitimate rule of law to be applied on the facts in the record, the award is confirmed.

Courts have also differed as to whether arbitrators can ignore the corporate form when they believe it is appropriate to do so. For example, can arbitrators fashion their award to the individuals who are the 100 percent shareholders of a corporation, which has no debt, when the claim legally belongs to the corporation?

This is what the arbitrators did in *Spear, Leeds & Kellogg v. Bullseye Securities, Inc.*,²² but the First Department vacated the award and remanded the matter to the arbitrators. *Bullseye* involved a claim by a trading company and its 100 percent shareholders against a brokerage firm and the trader at the firm who handled the claimants' account. The arbitrators made an award to the individual shareholders of the trading company, but not to the trading company itself. Upon remand, the arbitrators justified their award by pointing to an agreement directly between the brokerage firm and the shareholders coupled with the brokerage firm's negligent supervision of the trader.

Once again, the New York Supreme Court vacated the award on the grounds that public policy precluded an award to individuals for damages sustained by a corporation, even though the arbitrators had specifically articulated the reasons why it did so. The First Department reversed, accepting the arbitrators' explanation and confirming the award.²³

Conclusion

There are obvious, cogent reasons for requiring arbitrators to adhere to well-developed rules of law, while affording them greater latitude in finding facts. Yet, there is no guideline to distinguish between rules of law that are significant and those that are trivial. Only by strictly requiring compliance with clear rules of law can courts rationally review awards.

Since the courts (a) are supposed to treat as waived any rule of law not clearly presented to the arbitrators, (b) not supposed to question any finding of fact made by the arbitrators, and (c) are obliged to search the record for any possible fact and rule of law on which to support an award, they have ample grounds to sustain awards without having to abrogate pure rules of law clearly presented to the arbitrators and not properly applied by them.

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Endnotes:

1. Sands Brothers & Co, Ltd. v. Generex Pharmaceuticals, Inc., 298 A.D. 2d 307, 749 N.Y.S.2d 17 (1st Dept. 2002); Spear, Leeds & Kellogg v. Bullseye Securities, Inc, 291 A.D.2d 255, 738 N.Y.S.2d 27 (1st Dept. 2002); [Wien & Malkin LLP v. Helmsley-Spear, Inc.](#) 12 A.D.3d 783, 783 N.Y.S.2d 339 (1st Dept. 2004);.
2. [Morgan Stanley DW Inc. v. Afridi](#), 13 A.D.3d 248, 788 N.Y.S.2d 11 (1st Dept. 2004); [Roffler et. al. v. Spear, Leeds, & Kellogg](#), 13 A.D.3d 308, 788 N.Y.S. 326 (1st Dept. 2004); Banc of America Securities v. Knight, 4 Misc.3d 756, 781 N.Y.S.2d 829 (Sup. Ct. N.Y.Cty. 2004).
3. [Wien & Malkin, LLP v. Helmsley-Spear, Inc.](#) 12 NY3d 21, 2006) ("Wien v. Helmsley")
4. Compare CPLR §7511 with FAA §10, 9 U.S.C. §10; See, Elsberg, Federal Arbitration Act. vs. New York State Arbitration Law, N.Y.L.J., May 6, 2005.
5. Morgan Stanley DW Inc. v. Afridi, 13 A.D.3d 248, 249, 788 N.Y.S.2d 11, 12 (1st Dept. 2004) and cases cited therein.
6. See, Wien v. Helmsley, fn. 8; [The Citizens Bank v. Alafabco, Inc.](#) 539 U.S. 52, 123 S.Ct. 2037 (2003) and [Wien & Malkin LLP v. Helmsley-Spear, Inc.](#) 540 U.S. 801, 124 S.Ct. 222 (2003). New York courts have been struggling with whether or not to use the manifest disregard standard. See discussion in [America Securities v. Knight](#), 4 Misc.3d 756, 781 N.Y.S.2d 829 (Sup. Ct. N.Y.Cty. 2004).
7. [Willemijn Houdstermaatschappij v. Standard Microsystems Corp.](#) 103 F.3d 9, 12 (2d Cir. 1997); [The Wackenhut Corp. v. Amalgamated Local 515, et. al.](#) 126 F.3d 29, 32 (2d Cir. 1997).
8. [Willemijn Houdstermaatschappij, BV. v. Standard Microsystems Corp.](#) 103 F.3d 9, 13 (2d Cir. 1997); [Lew Lieberbaum & Co., Inc. v. E. Tate Randle, et. al.](#) 85 F. Supp. 2d 123 (E.D.N.Y. 2000).
9. [DiRussa v. Dean Witter Reynolds Inc.](#), 121 F3d 818, 821 (2d Cir.1997)
10. 148 F.3d 197 (2d Cir. 1998)
11. 298 A.D.2d 307, 749 N.Y.S.2d 17 (1st Dept. 2002) and earlier opinion in the same case at 279 A.D. 2d 377, 720 N.Y.S.2d 450 (2001).
12. Commentators have recognized the "nitpicking" nature of this decision. See Young, "Courts Are Intervening In Arbitration Cases More," NYLJ, 2/24/2003.
13. 378 F.3d 182, 192-193 (2d Cir. 2004)

14. There are other statutory, and even nonstatutory grounds for upsetting arbitration award under the FAA. They are, however, beyond the scope of this article.

15. *I/S Stavborg v. National Metal Converters, Inc.* 500 F.2d 424, 431 (2d Cir. 1974).

16. *Wallace v. Buttar*, 378 F.3d 182, 189 (2d Cir. 2004)

17. New York cases that find arbitrators not bound by substantive law also refer to contract interpretation. E.g. *Gleason v. Michael Vee Ltd.*, 284 A.D.2d 666, 726 N.Y.S.2d 493 (3rd Dept. 2001).

18. [Hardy v. Walsh Manning Securities, L.L.C.](#) 341 F.3d 126 (2d Cir. 2003).

19. *Hardy v. Walsh Manning Securities, L.L.C.* 341 F.3d 126 (2d Cir. 2003)

20. *Perpetual Securities, Inc. v. Tang*, 290 F3d 132, 139-140 (2d Cir 2002); *Morgan Stanley DW Inc. v. Afridi*, 13 A.D.3d 248, 788 N.Y.S.2d 11 (1st Dept. 2004).

21. *Roffler et. al. v. Spear Leeds & Kellogg*, 13 A.D.3d 308, 788 N.Y.S.2d 326 (1st Dept. 2004)

22. 291 A.D.2d 255, 256, 738 N.Y.S.2d 27,28 (1st Dept. 2002).

23. *Roffler et. al. v. Spear Leeds & Kellogg*, 13 A.D.3d 308, 788 N.Y.S.2d 326 (1st Dept. 2004)

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