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Arbitration Panels Can Award Attorney Fees and Arbitrator Fees Due to “Bad Faith” by a Participant in an Arbitration

On April 9, 2009, in *ReliaStar Life Insurance Company of New York v. EMC National Life Company*, No. 07-0828-CV (2d. Cir. April 9, 2009) the United States Court of Appeals for the Second Circuit issued a noteworthy decision that may allow arbitrators to ignore the parties contractual agreement requiring each side to pay its own arbitrator and attorneys. A majority of the appellate panel ruled that arbitrators can in some circumstances validly require a “losing” party in an arbitration to pay the attorney fees and arbitrator fees incurred by the “winning” party — even though the arbitration clause in their contract specified that each party should bear the expense of its own arbitrator and outside counsel.

Background

This case involved two coinsurance agreements between EMC National Life Company (“National Travelers”) and ReliaStar Life Insurance Company of New York (“ReliaStar”). Both agreements had identical arbitration clauses which most practitioners would find to be rather typical. The first section of the arbitration clause broadly provided for arbitration of any disputes “relating in any way” to the contract; the second section provided that the arbitrators should consider the customary and standard practices in the life and health reinsurance business, and there would be no appeal from the decision of the majority of arbitrators; the third section said that each party would bear the expense of its own arbitrator and outside counsel, and the two parties would jointly bear the expense of the third arbitrator; and the fourth section provided that the arbitration hearing would be held in New York and that the law of New York, and the Federal Arbitration Act if applicable, would govern the arbitration.

There is no reported evidence that the arbitration clause mentioned “good faith” or “bad faith,” or contained any explicit assumptions relevant to that topic. Likewise, there does not seem to be any evidence as to whether the parties who negotiated and drafted the contracts gave the subject any particular consideration.

Under these circumstances it might seem reasonable to believe that — although the arbitration clause was silent as to many potential issues — one thing was certain: each side would pay its own arbitrator and its own outside counsel. Yet, the arbitration panel and the appellate court concluded otherwise.

The Arbitration

National Travelers initiated arbitration against ReliaStar and sought a finding that the two coinsurance agreements had been terminated and there should accordingly be a “terminal accounting.” ReliaStar resisted and ultimately, at the conclusion of a two-week hearing, the arbitration panel entered an award in favor of ReliaStar. The panel found that the coinsurance agreements remained in force, National Travelers owed ReliaStar more than \$21 million, and National Travelers was required to pay the attorney fees and arbitrator expenses (totaling in excess of \$3 million) of ReliaStar because the conduct of National Travelers in the arbitration had been “lacking in good faith.”¹

District Court Proceedings

National Travelers asked the U.S. District Court for the Southern District of New York to vacate the award to the extent that it granted ReliaStar’s attorney fees and arbitrator fees. The court did so, citing to the relevant arbitration clauses which specified that each party would bear the expense of its own arbitrator and outside counsel.

ReliaStar appealed the vacatur.

Court of Appeals

The appellate court reversed the lower court, and remanded the case with directions that the district court must enter judgment confirming the arbitration award in all respects.

The appellate court noted that its task in this case was to determine whether “...the arbitrators were

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authorized to sanction bad faith conduct by awarding attorney’s fees and arbitrator’s fees.” The court did not, and was not requested to, analyze whether the arbitral finding of “bad faith conduct” was correct or whether the specific amount of the fee award was appropriate for the particular conduct in this case.

Essentially, the appellate court decided that the arbitration clause in this instance was “broad” and presumed that the parties would arbitrate in “good faith.” While acknowledging that the arbitration clause provided that each party would pay its own arbitrator and attorneys, the court concluded that this provision is only applicable in the context of an arbitration conducted in good faith. Therefore, once the arbitration panel made a finding that the conduct of National Travelers was “lacking in good faith,” the arbitration panel was no longer constrained by the portion of the arbitration clause that specified that each party would pay its own arbitrator and its own attorneys.

In sum, a majority of the appellate panel concluded that a broad arbitration clause results in an “inherent” authority by which an arbitration panel can sanction bad faith conduct. Contracting parties can opt to limit this “inherent” authority but in this instance — according to the majority — they did not do so. Instead, the contract only specified how arbitrators and attorneys would be paid in a typical (i.e., “good faith”) arbitration proceeding.

One of the judges on the appellate panel submitted a dissenting opinion arguing that: 1) the arbitral award “plainly contradicts an express and unambiguous term” in the contracts agreed by the parties; and 2) those contracts “divested the arbitration panel of any authority to make an award of attorneys fees.” Yet, of course, the majority opinion prevails unless there are some further appellate proceedings in this matter.

Commentary

This is a remarkable decision that should be watched for any further appellate developments and should be carefully considered by companies

that have arbitration clauses in their contracts. It significantly increases the potential exposure to the losing party in an arbitration, and it does not set forth the limitations — if there are any — on the ability of an arbitration panel to make a preliminary finding of “bad faith” which can then be used to impose substantial punishment that may never have been contemplated by either of the parties when they originally entered into their contract.

Contract drafters, contract negotiators, and arbitration attorneys all need to pay heed. As deals are being formed, and as parties are considering their arbitration strategy and are selecting individuals to serve on arbitration panels, the potential impact of this decision must be kept in mind.

Endnotes

- 1 The arbitration panel did not specify whether the National Travelers conduct in the arbitration that was “lacking in good faith” was: a) the initial strategic decision to initiate an arbitration and contend that the coinsurance agreements were terminated; or b) tactical and procedural misconduct during the course of the arbitration.

About the Author

Robert E. Sweeney is a partner in the Chicago office of LLB&L. His practice focuses on commercial disputes involving insurance and reinsurance contracts. He has counseled clients in the contract formation stage and the pre-dispute stage, but he has also served many times as trial attorney and arbitration attorney in various jurisdictions. His experience includes Life and Health matters as well as Property and Casualty.