MEALEY'S™
International Arbitration Report

Recent U.S. Court Decisions Confirm Arbitrator Discretion To Limit Discovery

by
Gregory A. Litt
and
Colm P. McInerney

Skadden, Arps, Slate, Meagher & Flom LLP
New York

A commentary article reprinted from the August 2013 issue of Mealey's International Arbitration Report

LexisNexis®

Commentary

Recent U.S. Court Decisions Confirm Arbitrator Discretion To Limit Discovery

By Gregory A. Litt
and
Colm P. McInerney

[Editor's Note: Gregory A. Litt is counsel, and Colm P. McInerney is an associate, in the International Litigation and Arbitration Group of Skadden, Arps, Slate, Meagher & Flom LLP in New York. The views expressed in this article are the authors' and do not necessarily reflect the views of their firm. *Responses are welcome.]*

I. U.S. Courts Permit Limits On Discovery In Arbitration

Parties interested in international arbitration often wonder whether selecting an arbitration venue in the United States will subject them to full U.S.-style discovery. Three recent decisions by the U.S. Courts of Appeals in New Orleans, Boston and New York reaffirm the longstanding position that arbitrators in U.S.-based arbitrations have discretion to determine the proper scope of discovery and are not bound to follow U.S. litigation discovery practices.

Courts in the U.S. generally are not involved in routine decisions regarding discovery during the course of an arbitration, but from time to time, they are asked to focus on an arbitrator's discovery rulings at the arbitral award enforcement stage. The losing party may seek to vacate the award on the basis of Section 10(a)(3) of the Federal Arbitration Act (the "FAA"), which provides that the federal district court within which an award was made may vacate the award "where the arbitrators were guilty of misconduct . . . in refusing to hear evidence pertinent and material to the controversy." (9 U.S.C. § 10(a)(3).)[1]

In three recent appellate decisions, the courts rejected vacatur motions aimed at arbitrators' rulings limiting discovery and excluding evidence:

- In *Bain Cotton Co. v. Chesnutt Cotton Co.*, 2013 WL 3155953 (5th Cir. June 24, 2013), the United States Court of Appeals for the Fifth Circuit affirmed the district court's denial of a vacatur motion even though an arbitral tribunal had apparently first ignored a party's requests for discovery and thereafter faulted that party for failing to provide proof to support its claims.

- In *Doral Financial Corporation v. García-Vélez*, 2013 WL 3927685 (1st Cir. July 31, 2013), the United States Court of Appeals for the First Circuit affirmed the district court's denial of a vacatur motion that had been premised on the basis that the arbitral tribunal had improperly refused to allow the respondent to serve third party subpoenas.

- Finally, in *LJL 33rd Street Assoc. v. Pitcairn Properties Inc.*, 2013 WL 3927615 (2d Cir. July 31, 2013), the United States Court of Appeals for the Second Circuit overturned a district court's vacatur of an award which had been premised upon the arbitrator's exclusion of certain documents on the basis of hearsay.

In all three cases, discussed below, the courts emphasized the wide latitude given to an arbitrator's rulings on discovery and evidence. In *Bain*, the district court stated

that it was "disinclined to disturb an arbitration award even if the parties did not receive the full measure of discovery and procedure as would have been obtained in a court setting." *Bain Cotton Co. v. Chesnutt Cotton Co.*, Civil Action No. 5:11-cv-189 (N.D.Tex.) at 6. The Fifth Circuit added that while it "might disagree with the arbitrators' handling of Bain's discovery requests, that handling" did not rise to the level for vacatur under the "extremely narrow" judicial grounds for review. *Bain Cotton Co. v. Chesnutt Cotton Co.*, 2013 WL 3155953, at *1 (5th Cir.). The *Doral* court also professed "[t]he limited scope of our review [of an arbitrator's discovery rulings]." *Doral Financial Corporation v. García-Vélez*, 2013 WL 3927685, at *3 (1st Cir.). In turn, the *LJL Court* remarked that "[a]rbitrators have substantial discretion to admit or exclude evidence." *LJL 33rd Street Assoc. v. Pitcairn Properties Inc.*, 2013 WL 3927615, at *8 (2d Cir.).

II. Cotton Acreage Contracts: *Bain Cotton Co. v. Chesnutt Cotton Co.*

The dispute in *Bain Cotton Co.* arose from certain acreage contracts between Bain Cotton Company ("Bain") and Chesnutt Cotton Company ("Chesnutt"), pursuant to which Chesnutt was to deliver to Bain the cotton produced upon a number of acres specified in the contracts. Bain commenced an action against Chesnutt after its delivery of cotton fell below the amount estimated for delivery. *See Bain Cotton Co. v. Chesnutt Cotton Co.*, Civil Action No. 5:11-cv-189 (N.D.Tex.), Order dated October 17, 2012, at 2-3. Bain requested that Chesnutt produce certain forms which stated the number of acres planted on a specific date and what type of crop was planted, which it argued would support its breach of contract claim. *See id.* at 3-4. Although the arbitral record was not entirely clear, it appears that the tribunal accepted Chesnutt's claims that it did not have these forms in its possession and could not easily obtain them. *See id.* at 4, 4 n. 4.

After the tribunal rendered an award in Chesnutt's favor, rejecting Bain's claims, Bain moved to vacate the award in federal court in Dallas, arguing, *inter alia*, that the award should be vacated because of the tribunal's failure to order discovery of the acreage forms requested by Bain. The district court denied the motion, stating that it was "disinclined to disturb an arbitration award even if the parties did not receive the full measure of discovery and procedure as would have been obtained in a court setting." *Id.* at 6. Indeed, "shorten[ing]" such procedures was "[t]he entire purpose of arbitration." *Id.*

The Fifth Circuit summarily affirmed in a brief two-page decision. It noted that Bain had moved to vacate the award on the purported basis that the tribunal had committed misconduct by ignoring and then denying Bain's repeated requests for discovery, "and then summarily condemn[ing] Bain for failing to provide proof supporting its claims – proof that was out of Bain's control and that the [arbitrators] refused to discover." *Bain Cotton Co. v. Chesnutt Cotton Co.*, 2013 WL 3155953 (5th Cir.) at *1. However, the Fifth Circuit wasted no time rejecting Bain's arguments.

The appellate court stated that "[t]his appeal presents a quintessential example of a principal distinction between arbitration and litigation, especially in the scope of review." *Id.* Had the discovery dispute been before a district court, the Fifth Circuit allowed that it may well have reversed the court's decision. However, judicial review of an arbitral award was far narrower. The court ruled that "[r]egardless of whether the district court or this court—or both—might disagree with the arbitrators' handling of Bain's discovery requests, that handling does not rise to the level required for vacating under any of the FAA's narrow and exclusive grounds." *Id.*

III. Limpets in Heavy Seas: *Doral Financial Corporation v. García-Vélez*

In *Doral Financial Corporation*, the court rejected a party's claim that the arbitral award should be vacated because the tribunal had refused to hear pertinent evidence, finding that the tribunal had presided over a fair hearing by giving the party an opportunity to argue why the evidence should be admitted. The arbitration involved a claim by the former president of Doral's consumer banking division, Calixto Garcia-Velez, for contractually-due severance compensation following the termination of his employment. In the arbitration, Doral countered that Garcia-Velez was not entitled to compensation as his termination was "for cause" and, further, because he had breached the non-competition clause of his employment contract by accepting a position with one of Doral's competitors.

The arbitral tribunal set May 15, 2009 as the deadline for final requests for information, and August 7, 2009

as the deadline for the submission of final witness lists. The scheduling order further stated that "if a party wishes to issue a subpoena to a third party . . . the parties shall first confer and determine if there is any disagreement to the date and propriety of the subpoena . . . Any dispute, as to a subpoena, shall be resolved by the Tribunal." *Doral Financial Corporation v. García-Vélez*, 2013 WL 3927685 (1st Cir.) at *1.

The hearings commenced in September 2009 and Garcia-Velez testified at that time, but the hearings were then postponed until December 2009 due to Doral's attorney falling ill. In the interim, Doral filed a formal application with the tribunal to issue pre-hearing subpoenas to Garcia-Velez's new employer. Garcia-Velez opposed the application as untimely and the tribunal agreed, denying Doral's application. Doral thereafter filed an application for hearing subpoenas directed at Garcia-Velez's employer, and a motion for reconsideration of the tribunal's denial of its application to serve pre-hearing subpoenas. The tribunal again denied Doral's requests, stating that Doral " 'should have requested the information it believed relevant to its claim during the Exchange of Information process.' " *Id.* at *2.

After the hearings concluded, the tribunal issued an award, finding that Garcia-Velez was entitled to compensation under the employment agreement and that Doral had failed to establish that Garcia-Velez breached the non-competition provision of his employment agreement.

Doral moved to vacate the award in the District of Puerto Rico, arguing, inter alia, that the tribunal improperly denied the issuance of the subpoenas and thus engaged in "misconduct in refusing to hear evidence pertinent and material to the issue of Mr. García–Vélez'[s] violation of the non-compete clause of the Employment Agreement." *Id.* at *3. The district court denied Doral's motion for vacatur and resulting motion for reconsideration, and the First Circuit affirmed.

The First Circuit stated that Section 10(a)(3) of the FAA "requires vacatur of an award when 'the arbitrators were guilty of misconduct in refusing to . . . hear evidence pertinent and material to the controversy . . .' " *Id.* at *4. It further noted, though, that Section 10(a)(3) "does not require arbitrators to consider every piece of relevant evidence presented to them." *Id.* (internal citation omitted). Vacatur would only be appropriate where "the exclusion of relevant evidence so affects the rights of a party that it may be said that he was deprived of a fair hearing." *Id.*

Having set out the legal test, the First Circuit remarked that Doral was "cling[ing] like a limpet in the heaviest sea to the 'fair hearing' requirement subsumed in § 10(a)(3), urging us to find that the tribunal abridged it in refusing to issue the subpoenas." *Id.* The court found that "Doral's contentions ring hollow," *id.* at *6, for two main reasons.

First, the court stated that "the record is devoid of evidence showing that Doral was not afforded a 'fair hearing.' " *Id.* at *4. The court explained that the concept of a "fair hearing" was "rooted in due process concerns and thus calls for (1) notice, and (2) an opportunity to present relevant evidence and arguments." *Id.* (internal citation omitted). Here, the tribunal had provided adequate notice of the arbitration schedule and the process governing the issuance of subpoenas, and gave Doral the opportunity to argue on three occasions for its right to serve the subpoenas. *See id.*

Second, despite Doral's speculation to the contrary, the First Circuit observed that "there is nothing concrete in the record that would indicate that Garcia-Velez in fact violated the non-competition clause." The tribunal had rejected Doral's allegations that Garcia-Velez had made misrepresentations in the arbitration regarding his employment, and the First Circuit stated it had "no authority to second guess the tribunal's decision on this issue." *Id.* at *5 (internal citation omitted). The court explained that its review "honors the parties' decision to have disputes settled by an arbitrator." *Id.* at *8 (internal quotation marks omitted).

IV. Valuing Manhattan Skyscrapers: *LJL 33rd Street Associates v. Pitcairn Properties Inc.*

Finally, in the case of *LJL 33rd Street Assoc.*, the Second Circuit affirmed the principle that it is within an arbitrator's discretion to determine whether to apply the rules of evidence followed by the local courts. The case involved a dispute between LJL 33rd Street Associates, LLC ("LJL") and Pitcairn Properties, Inc. ("Pitcairn"), which were the sole equity owners of a limited liability

company whose single asset was a luxury high-rise apartment building in Manhattan. LJL sought to exercise its contractual option under the parties' Operating Agreement to purchase Pitcairn's ownership stake in the building. The Operating Agreement provided that if the parties could not agree on the value of the building, which they could not, then the dispute could be resolved by expedited arbitration.

At the arbitration hearing, each party introduced testimony and appraisal reports and cross-examined the other party's witnesses. LJL's appraiser testified that the building was worth approximately $50-52 million while Pitcairn's appraiser testified that it was worth approximately $65 million. The arbitrator sustained LJL's objections, on hearsay and other grounds, to four documents proffered by Pitcairn with respect to the building's value. *See LJL 33rd Street Assoc. v. Pitcairn Properties Inc.*, 2013 WL 3927615 (2d Cir.) at *3-4. He then entered an award determining, *inter alia*, that the building's value was $56.5 million.

The district court granted Pitcairn's motion to vacate the arbitrator's valuation by reason of the exclusion of the four Pitcairn exhibits. *See LJL 33rd Street Associates, LLC v. Pitcairn Properties, Inc.*, 2012 WL 613498 (S.D.N.Y.). Judge Rakoff noted that the arbitrator had excluded "essentially all of the factual evidence about genuine market activity and valuation even though this evidence was critical to a determination of fair market value." *Id.* at *6. He concluded that the exclusion of this "material and pertinent" evidence prejudiced Pitcairn's rights in the arbitration because it prevented Pitcairn showing that its expert valuation of $66 million was reasonable and that LJL's "expert was an outlier" and LJL's $51 million valuation was too low. *Id.* Judge Rakoff rejected the argument that the arbitrator had properly excluded Pitcairn's exhibits on the basis of hearsay. He noted that the arbitration was conducted pursuant to the AAA's Expedited Arbitration procedures, which state that "conformity to legal rules of evidence shall not be necessary" and instead provide that "the arbitrator shall determine the admissibility, relevance, and materiality of the evidence offered and may exclude evidence deemed by the arbitrator to be cumulative or irrelevant." *Id.* In Judge Rakoff's view, the arbitrator's evidentiary rulings "should have gone to the weight afforded to the Excluded Evidence rather than its admissibility." *Id.*

Judge Rakoff concluded that "[t]he 'touchstone' for a finding of arbitral misconduct under the FAA is the concept of "fundamental fairness" and "[t]he arbitrator's refusal to hear this evidence constituted affirmative misconduct and rendered the proceedings fundamentally unfair." *Id.* Thus, he held that the award should be vacated. *Id.*

On appeal by LJL, the Second Circuit vacated Judge Rakoff's decision on this point. *See LJL 33rd Street Assoc. v. Pitcairn Properties Inc.*, 2013 WL 3927615 (2d Cir.). It agreed with the "general proposition that an arbitrator's unreasonable exclusion of pertinent evidence, which effectively deprives a party of the opportunity to support its contentions, can justify vacating an award." *Id.* However, it did not view the arbitrator's exclusion of evidence here as "an instance of such fundamental unfairness." *Id.* The Second Circuit agreed with Judge Rakoff's statement that "arbitrators are not bound by the rules of evidence and may consider hearsay," but it further stated that "it does not follow that arbitrators are prohibited from excluding hearsay evidence." *Id.* Here, Pitcairn could have presented the evidence "unencumbered by the hearsay objections, merely by calling the makers of the exhibits." *Id.* at *8. Pitcairn chose not to do so. Indeed, had the arbitrator admitted the exhibits, then "LJL would have been severely prejudiced" because it would have had no opportunity to cross-examination the authors of the documents. *Id.*

The Second Circuit observed that "[a]rbitrators have substantial discretion to admit or exclude evidence," citing to Rule 31(b) of the American Arbitration Association's Commercial Rules, which state that "[t]he arbitrator shall determine the admissibility, relevance, and materiality of the evidence offered and may exclude evidence deemed by the arbitrator to be cumulative or irrelevant." *Id.*

V. Conclusion

These recent decisions reinforce the view that arbitration in the United States is not bound by the same discovery rules as domestic litigation, and arbitrators generally have discretion to determine how much (or how little) discovery to allow. An arbitrator's discretion is of course subject to the particular arbitration clause applicable in a given case, and parties can provide for specific rules on discovery. However, arbitration clauses frequently say little or nothing regarding discovery, and

most arbitration rules provide arbitrators with the discretion to determine the scope of discovery.

Endnotes

1. Where a party seeks to confirm an arbitral award rendered abroad that is subject to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, 330 U.N.T.S. 3 (the "New York Convention"), the U.S. domestic grounds for vacatur (including Section 10(a)(3)) will not apply. However, if the award is subject to the New York Convention but was rendered in the U.S., then the court may apply both the domestic grounds for vacatur and the Convention grounds for non-recognition. *See Yusuf Ahmed Alghanim & Sons, W.L.L. v. Toys "R" Us, Inc.*, 126 F.3d 15 (2d Cir. 1997). ■

MEALEY'S: INTERNATIONAL ARBITRATION REPORT
edited by Lisa Schaeffer
The Report is produced monthly by

1600 John F. Kennedy Blvd., Suite 1655, Philadelphia, PA 19103, USA
Telephone: (215)564-1788 1-800-MEALEYS (1-800-632-5397)
Email: mealeyinfo@lexisnexis.com
Web site: http://www.lexisnexis.com/mealeys
ISSN 1089-2397