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USA

The Daesang Decision: New York's Manifestly Misunderstood Law on Vacating Awards

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On 27 September 2018, an appellate court of the State of New York overturned the ruling of a first instance New York judge that had vacated in significant part an ICC award on the basis of 'manifest disregard of the law'. This commentary reflects on what impact the appellate decision, confirming and vindicating the Arbitral Tribunal's award, might or should have on the perceptions outside of the US of New York and the US as hosts of international arbitration.

The *Daesang* case

The parties' commercial dispute arose from an unconsummated asset transfer between a US purchaser (NutraSweet) and Korean producers of the artificial sweetener aspartame (Daesang). The US purchaser had opted not to complete the deal, and defended against Daesang's breach of contract money damages claims on the ground that Daesang had materially breached various contractual warranties about its manufacturing operations. In a New York-seated international commercial arbitration, the Tribunal rendered an award in favor of the Korean claimant, and the US purchaser's counterclaims seeking rescission of the asset purchase contract based on a theory of fraud were rejected.

NutraSweet invited the first instance New York judge to second-guess the Tribunal's rejection of NutraSweet's counterclaims. Under the applicable New York law, NutraSweet had claimed, Daesang's allegedly false contractual warranties about its operations were actionable on a theory of fraud even though they were contained in the contract, and, said NutraSweet, the proper remedy for such fraud is to declare the contract null and void *ab initio*. The Tribunal had rejected that position based on New York case law that sets stringent limiting conditions for permitting a theory of fraud to be pursued rather than breach of contract when an allegedly false representation has been made within the contract. And while the Tribunal considered that these limiting conditions had not been met by NutraSweet, the first instance judge thought the Tribunal's refusal to find those conditions satisfied amounted to an egregious error of judgment.

But in *Daesang Corp. v. NutraSweet Co.*¹ the unanimous four-Justice appellate panel saw no such error: indeed whereas the Tribunal had chosen legal guidance from case law cited by Daesang in preference to other case law cited by NutraSweet — cases that evidently offered different guidance on the criteria for allowing a contractual mis-statement to be actionable as fraud — the Tribunal's choice between two legitimate sources of legal guidance, in the appellate court's view, could scarcely qualify as a willful refusal by the Tribunal to apply a clear and well-defined governing rule of law.

The good news here goes beyond the mere result. In this opinion, we find an encouraging reminder that New York law has, for nearly a century, espoused the position that arbitration's outcomes are subject to judicial review only for exceptional irregularity in the process and not for errors of fact or judgment. Quoting from a 1931 case in the same Appellate Division, the Court remarks that '[e]rrors, mistakes, departures from strict legal rules, are all included in the arbitration risk'. Moreover this was a paraphrase of an even earlier New York decision, from the Court of Appeals in 1902, also cited, where the State's highest court had observed:

Where the merits of a controversy are referred to an arbitrator selected by the parties, his determination, either as to the law or the facts, is final and conclusive; and a court will not open an Award unless perverse misconstruction or positive misconduct upon the part of the arbitrator is plainly established.

1 167 A.D. 3d 1, 2018 WL 4623562, New York Appellate Division, First Judicial Department, 27 Sept. 2018, also found at <https://law.justia.com/cases/new-york/appellate-division-first-department/2018/655019-16-5973.html> (last visited 18 Nov. 2018).

And the reminders of New York's own pro-arbitration jurisprudence are juxtaposed at the head of the opinion with a declaration — so often stated in the arbitration case law of our federal courts — that the 'emphatic federal policy in favor of arbitral dispute resolution embodied in the [Federal Arbitration Act] ... applies with special force in the field of international commerce'.

'Manifest disregard of the law'

To begin, a refresher on the US legal framework may provide context for the non-US reader. First, this American phenomenon of 'manifest disregard' concerns only US-made 'Convention awards' (New York or Panama),² as it is only with regard to such awards that, in ruling on a motion to set aside the award (or as in *Daesang*, a part of it), our courts may apply the grounds for vacatur in (or associated with) the domestic arbitration chapter of the US Federal Arbitration Act ('FAA', Chapter 1). Second, it is rare that confirmation or vacatur actions in regard to US-made Convention awards are heard in state courts rather than US federal courts. Litigants concerned with award enforcement or annulment mainly find themselves in the federal courts, either by the initial filing choice of the movant or the non-movant's option of removal under the US statutes implementing the New York and Panama Conventions (FAA, Chapters 2 and 3). The body of precedent, binding or persuasive, in the federal system is deeper, providing a brake on maverick adjudication (which the first instance ruling in *Daesang* seems to have been). Third, for a decade since the US Supreme Court decided *Hall Street Assocs. v. Mattel Inc.* (552 U.S. 576 [2008]), where the Court in *obiter dicta* wondered whether 'manifest disregard of the law' is or ever properly was an independent ground for vacatur of an arbitration award as opposed to perhaps a pithy phrase to capture the spirit of an express FAA statutory ground for vacatur like excess of power.

Lower federal courts in the past decade have been divided into three post-*Hall Street* camps in regard to manifest disregard: those that reject the doctrine entirely by turning *Hall Street's dicta* into a rule, those that continue to apply manifest disregard (nearly always by finding its strict requirements unsatisfied)

2 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the 'New York Convention')(1958), text and status of ratifications available at http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html; Inter-American Convention on International Commercial Arbitration (the 'Panama Convention') (1975), text and status of ratifications available at http://www.oas.org/en/sla/dil/inter_american_treaties_B-35_international_commercial_arbitration.asp.

because *Hall Street* did not formally abolish it, and those that re-conceive manifest disregard not as an 'independent' ground (that is, one rooted in common law not the FAA statute) but as a formula for applying certain FAA statutory grounds for vacatur, notably excess of power. This last approach, treating manifest disregard as a 'gloss' on the exclusive express statutory grounds for vacatur, is in force in federal courts for the US Second Judicial Circuit embracing New York. But fourth, and important to the legal tapestry into which we now weave *Daesang*, the courts of the several states, including New York, are not bound (in sense of common law *stare decisis*) by the FAA jurisprudence applied in the neighboring US Courthouses, unless it is a definitive ruling from the US Supreme Court. This final factor explains to a considerable extent the margin of judicial discretion that invites an outlier first instance state court vacatur decision like the one in *Daesang*. Fortunately for the claimant in *Daesang*, and for the ambassadors of New York as an arbitral seat, New York's highest state court had opted several years ago to embrace the most widely-accepted common law formulation of manifest disregard:

1. the disregarded rule of law should be clear, definitive, and clearly applicable;
2. the disregarded rule of law should have been brought to the attention of the Tribunal by a party or the parties, unless it was a rule whose existence and application was so obvious as to have been presumptively known to the arbitrators;
3. the applicability of the disregarded rule should have been recognized by the Tribunal, which nevertheless refused to apply it; and
4. as a corollary principle, that 'manifest disregard' applies only to principles of governing law, not to facts, evidence, or other aspects of the arbitral procedural record.

Concluding remarks

Daesang's vindication of settled principles has inspired considerable rejoicing in New York's international arbitration community. Its denizens had spent a long, anxious, year-in-waiting, worried over the potential damage to New York's brand. However unfair it would have been for arbitral seat promoters in Miami, Atlanta, California, Texas, and other upstart North American venues to claim that their own courts could be trusted, more than those in erratic New York, to uphold the decisions of thoughtful international arbitrators, it is far

better from a New York 'brand' perspective for us to be able to deliver this clear vote of confidence. And indeed this is good news reputationally for all US arbitral seats.

But non-US readers should be disabused of the impression that there has been a slaying of the manifest disregard dragon in the *Daesang* case. As with so many other legendary dragons, from Long Lung to Lindworm, the supposed menace of manifest disregard was largely imaginary. New York's international arbitration community sought to prove this in a systematic study published in 2012 by the prestigious International Commercial Disputes Committee of the New York City Bar Association (then chaired by the Chair of the Arbitral Tribunal in *Daesang*). That report demonstrated how very rarely any award — domestic or international — had actually been vacated based on the 'manifest disregard' doctrine, and also took pains to point out how other major host nations for international arbitration provide in their arbitration laws checks on the power of arbitrators when those powers are abused.³ But six years later, one would be hard-pressed to find a New York arbitrator who believes that the reputational harm to the US as a seat, presumed to be inflicted by the manifest disregard doctrine, has subsided to a meaningful degree. More recent data would seem to dispel our fears. My own inquiry into recent case law (a data base search) shows that in the last twelve months, there were 38 published federal court decisions adjudicating a claim of manifest disregard as a basis to vacate or refuse confirmation of an award, and this ground was rejected in every case. Further, only two of those 38 cases involved Convention awards. And to take the measure of state court involvement, I made a database search of the state courts in leading US arbitral venues (California, Florida, Texas, New York) for published decisions considering a manifest disregard challenge to a Convention award, not limited by date, and found only two: *Daesang*, and a 2012 California case where the court held that manifest disregard is not an available ground for vacatur under California arbitration law.

So, if manifest disregard is manifestly not used opportunistically by activist American judges to review US-made international arbitral awards on their merits, and if the chances of vacatur on this basis are negligible at best, then what are the *legitimate* concerns that are thought to motivate non-US litigants to avoid US seats

if they reasonably can do so? Primarily, it seems, the concerns are the cost and time involved in a US vacatur action, and the potential impediment to recognition and enforcement. But if recognition and enforcement might be had elsewhere, foreign courts ought to be mostly reluctant to stay proceedings pending a US vacatur action when the chances of a US vacatur are so predictably remote. As to cost and time, parties that fear a manifest disregard challenge to an award have a number of options:

- > One is to urge the Tribunal to award post-award interest at a rate that punishes delayed compliance, and to draft contracts that authorize or require a tribunal to do so.
- > Another is to provide in arbitration clauses that enforcement costs (offensive and defensive) shall be borne by the party prevailing in the enforcement case.
- > A third option is to obtain in the contract a prospective waiver of the right provided in Article VI of the New York Convention to secure a stay in an enforcement court pending a vacatur action at the seat, save upon deposit of security for the award in a form and sum satisfactory to the prevailing party.

If non-US arbitration specialists maintain the view that 'manifest disregard' is a flaw or weakness in the US legal environment for international arbitration, this is a regrettable and I submit mistaken position. No legal system supporting international arbitration could attract users if it could not assure them that there is a fail-safe method to correct an outcome that openly refuses to apply the law and instead provides an arbitrary and enigmatic disposition. ICC has long recognized this in current Rule 21(3) and its predecessors: 'The arbitral tribunal shall assume the powers of an *amiable compositeur* or decide *ex aequo et bono* only if the parties have agreed to give it such powers'. In the US, our Supreme Court has stated in another context that an arbitrator exceeds her powers when she dispenses 'her own brand of industrial justice', untethered from the contract or the applicable law. Manifest disregard insofar as it persists as an independent doctrine, serves in exceedingly rare instances to permit enforcement of these values. And for that, the arbitration community worldwide should take comfort.

³ New York City Bar Association, Report by the Committee on International Commercial Disputes, 'The "Manifest Disregard of Law" Doctrine and International Arbitration in New York', August 2012, <https://www2.nycbar.org/pdf/report/uploads/20072344-ManifestDisregardofLaw--DoctrineandInternationalArbitrationinNewYork.pdf>, also published in Vol. 24(2), *American Review of International Arbitration* at p. 209 (2013).