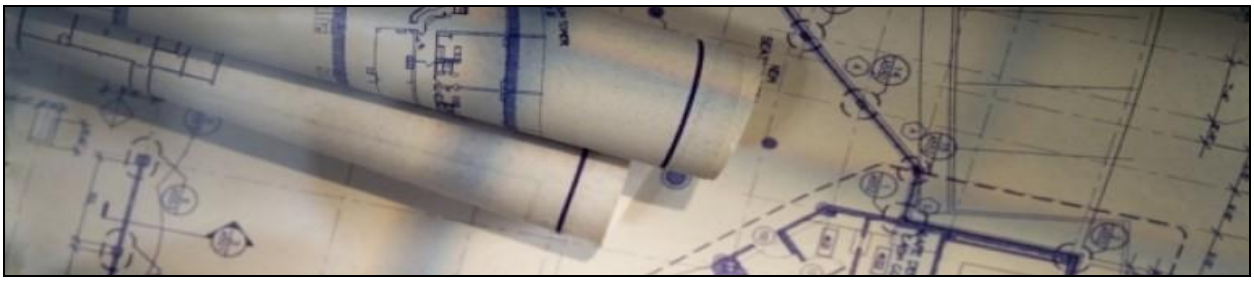
N.C. Construction Law, Policy & News

Matthew C. Bouchard, Esq.
919.719.8565
mcb@lewis-roberts.com
www.nc-construction-law.com



Arbitration News: Fourth Circuit Weighs In On "Manifest Disregard" Confusion

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Consider the following hypothetical:

You are claims counsel for a large surety company who has spent the better part of last December preparing for and participating in eight days of arbitration hearings arising from the termination of your bonded principal in late 2010. Back then, you had made the decision to contest liability under the performance bond on several grounds, not the least of which was the owner's retention of a replacement general contractor without surety consent and otherwise in violation of the conditions precedent set forth in the AIA-A312 form of performance bond utilized on the project. Your bonded principal is now in bankruptcy, and you were required to take a leading role in the arbitration proceeding as a result.

Your outside counsel is now on the phone, announcing that the Award of the Arbitrator has been issued. Unfortunately, it's not pretty. The arbitrator has awarded the owner virtually the entire completion premium it had been seeking in the arbitration proceeding, minus a few adjustments here and there. Adding insult to injury, the award is completely devoid of any reference to your A312 conditions precedent defense, which from day one you believed to be a winner, based on your interpretation of the prevailing legal authorities.

"That can't be right," you complain to your outside counsel. "That's clear error by the arbitrator. Doesn't the Federal Arbitration Act give me a right to challenge his obvious failure to apply the law?"

"Well," outside counsel begins, "likely not. Generally speaking, the FAA only permits a judge to vacate an arbitration award upon proof of gross misconduct by the arbitrator. I'm talking about partiality or corruption, or misconduct in refusing to hear evidence pertinent to the dispute, that kind of stuff. And frankly, proving any of those statutory grounds would be a steep uphill battle for us."

"Okay, let's put the FAA to the side for a moment," you respond. "If I'm right, and the arbitrator completely blew it on our A312 defenses, aren't there cases out there that allow us to challenge this award if we can prove that it demonstrates a manifest disregard of the law by the arbitrator?"

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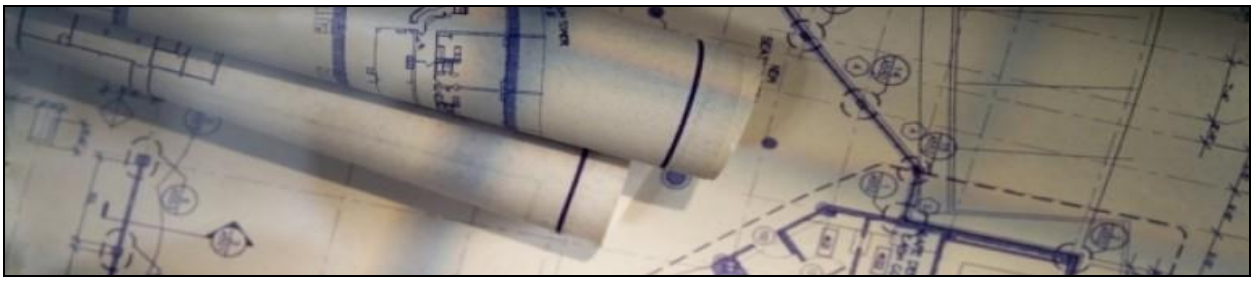

Ah, manifest disregard of the law. For over fifty years, this common law doctrine has represented the last best hope for parties seeking to challenge the enforceability of an arbitration award. But ever since the U.S. Supreme Court's decision in *Hall Street Associates v. Mattel, Inc*. in 2008, there's been a decided split in the federal courts -- and therefore a tremendous amount of confusion -- as to whether manifest disregard still exists. Last week, the U.S. Court of Appeals for the Fourth Circuit, which handles appeals from the North Carolina's federal trial courts (as well as from the federal trial courts in MD, VA, WV and SC), finally took its stance in the ongoing mess. And at least in this jurisdiction, manifest disregard lives on.

While not a construction case, *Wachovia Securities, LLC v. Brand, II et al.* will likely be applied to project disputes resolved via arbitration. In its discussion about the manifest disregard doctrine, the decision notes that in the *Hall Street* case, the U.S. Supreme Court ruled that parties could not contractually negotiate for judicial review of legal errors in an arbitration agreement, because the grounds for vacating arbitration awards set forth in the Federal Arbitration Act were "exclusive."

While *Hall Street* itself says nothing about the manifest disregard doctrine, the use of the term "exclusive" has created uncertainty in the lower courts as to whether manifest disregard -- a doctrine first established in a 1953 U.S. Supreme Court case -- still exists. Prior to the 4th Circuit's decision in *Wachovia Securities*, the federal circuit courts had split on the question, as noted in footnote 7 of the *Wachovia Securities* decision.

By way of summary, the 5th and 11th Circuits have ruled that manifest disregard is dead because, as *Hall Street* ruled, the FAA's stated grounds for vacatur are "exclusive." The 1st Circuit appears to have taken the same approach, although in dicta. The 6th Circuit, on the other hand, has read Hall Street narrowly, holding that it only prevents parties from negotiating additional grounds for vacating arbitration awards; manifest disregard still exists there. So too in the 2nd and 9th Circuits, where those courts have held that manifest disregard remains -- not as its own independent ground for challenging arbitration awards, but as a shorthand or "judicial gloss" on two of the grounds for vacatur set forth in the FAA at 9 U.S.C. § 10(a):

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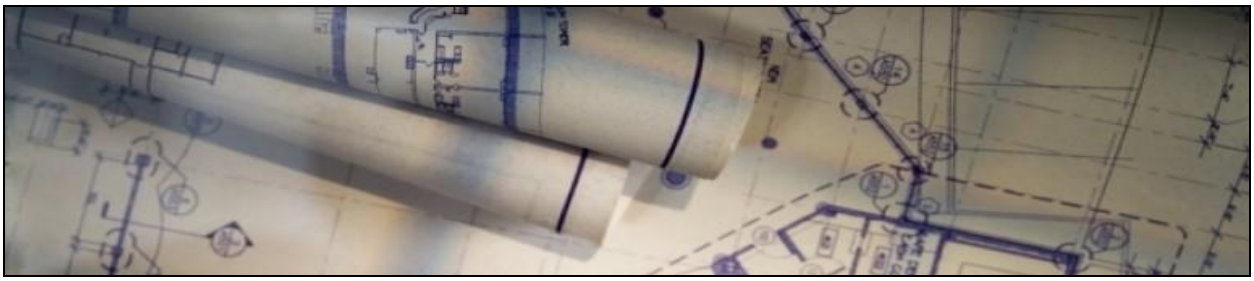

> "(3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced; or
>
> "(4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made."

On February 16, 2012, the 4th Circuit sided with the 6th, 2nd and 9th Circuits in holding that manifest disregard lives on, either as its own independent ground for challenging arbitration awards or as a "judicial gloss" to the two FAA grounds set forth above. But make no mistake, challenging arbitration awards under the manifest disregard standard is no picnic. We're not talking garden-variety legal error here. *Wachovia Securities* reaffirms the strict two-part standard for proving manifest disregard of the law: (1) the applicable legal principle must be clearly defined and not subject to reasonable debate; and (2) the arbitrator refused to heed that principle. Indeed, the 4th Circuit in *Wachovia Securities* held that even though manifest disregard has survived Hall Street in this jurisdiction, the party challenging the arbitration award in that case failed to satisfy this strict two-part test.

The take-away? In this jurisdiction, arbitration awards can still be vacated under the manifest disregard standard. But that standard is incredibly difficult to surmount -- particularly in construction cases, where many of the legal principles applicable to our industry may not be clearly defined under North Carolina law. One of the clear benefits of construction arbitration is claim resolution by an industry professional intimately familiar with construction legal standards and contracting risk. But a potential drawback, particularly in disputes where legal issues dominate, is that in the vast majority of cases, the arbitrator's decision is the final word on the matter; the courts, generally speaking, won't interfere, even under the still-breathing manifest disregard doctrine.