

Conflicts in Arbitration Proceedings: Two Recent Federal Cases

BY ROY SIMON

Arbitration proceedings are generally conducted out of public view, in private. Consequently, conflicts of interest and other ethics issues that arise during arbitration proceedings remain largely hidden. But suits to confirm arbitration awards or to compel arbitration provide a glimpse behind the veil. In this article, I discuss two recent New York federal district court cases that address conflicts of interest in the context of arbitration proceedings.

Simply Fit of North America, Inc. v. Poyner

In *Simply Fit of North America, Inc. v. Poyner*, 2008 WL 4416662 (E.D.N.Y., Sept. 26, 2008) (Arthur Spatt, J.), plaintiff Simply Fit of the northeast (“northeast”) negotiated a Distribution Agreement with Simply Fit Holdings, L.L.C. (“Holdings”) that gave Holdings exclusive distributorship of the defendants’ wellness drink product, “Simply-Fit.” The relationship soured and northeast sued Holdings and various individuals associated with Holdings (Cort L. Poyner, Robert L. Cox, Ishmael Gonzalez, and Daniel Minahan) for fraud and for breach of contract. All of the defendants were represented by the law firm Altman & Company P.C. (the “Altman firm”), Defendants moved to dismiss the action in favor of arbitration, citing a clause in the Distribution Agreement that said: “All controversies, claims and matters of difference arising between the parties under this Agreement shall be submitted to binding arbitration”

Defendants argued that this broad arbitration provision of the Distribution Agreement required plaintiffs to arbitrate any claims arising from or “touching on” the Agreement. In opposition, plaintiff contended:

Central to the fraud and defendants’ efforts to conceal the fraud was the negotiation of an arbitration clause in the contract with Plaintiff. The sole purpose of such clause was to evade public scrutiny of its efforts to defraud Plaintiff and move illicit gains from other frauds into [Holdings], until the defendants decided it was time to “squeeze out” Plaintiff without the consequence from any evidence that could be developed in a public forum, such as a Court, and handed over to the SEC, IRS or The Justice Department.

Plaintiff also contended that the arbitration clause was unenforceable because it was “part and parcel of a larger stock fraud scam committed by defendants” Judge Spatt rejected all of plaintiff’s challenges to arbitration and ordered that all claims be submitted to arbitration. But Judge Spatt still had to address conflict of interest issues, to which I now turn.

Who Decides a Motion to Disqualify Counsel in an Arbitration Proceeding?

The conflict of interest issue arose when defendant Cox discharged the Altman firm six months after the action was filed. The Altman firm then moved to withdraw from representing both Holdings and Cox. Judge Spatt granted that motion. Plaintiff then moved to disqualify the Altman firm from representing

the remaining individual defendants (Poyner and Minahan) because of an alleged conflict of interest. Specifically:

[P]laintiff asserts that while allegedly working on behalf of Holdings, the Altman firm was also advising its purported licensor, Silverman & Minahan Beverage Company LLC, ("SMBC"), and its principals, Poyner and Minahan. The plaintiff asserts that throughout the Altman firm's representation of the defendants, its "mutli-hatted" activities were inappropriate and the interests of SMBC, Poyner and Minahan were routinely favored to the detriment of Holdings and Cox. The plaintiff further charges that the Altman firm aided, abetted, and facilitated the looting of Holdings by engaging in sham transactions.

[Plaintiff] northeast contends that the Altman firm, and especially Steven Altman, Esq., have violated several Canons of Ethics of the New York Code of Professional Responsibility by representing various parties with adverse interests. The plaintiff contends that Altman has failed to exercise independent professional judgment on behalf of his client, Cox. Further, the plaintiff charges that Altman knowingly let a client commit perjury during an unrelated SEC investigation. In addition, the plaintiff asserts that Cox and Holdings "must" have a reasonable apprehension that Altman and his firm will make use of negative information obtained as a result of his joint representation of the defendants.

The Altman firm and Poyner and Minahan retorted that the continued representation of Poyner and Minahan did not conflict with the firm's prior representation of all of the defendants. Altman said that although the positions of the defendants did not conflict when the Altman firm first appeared in the action, he had explained to his clients at that time the potential for future conflicts. In addition, Altman said that Cox had executed a retainer agreement on behalf of himself and Holdings acknowledging that the Altman firm could continue to represent Poyner if a conflict developed. In late June of 2008, Cox and other Holdings officers resigned from the company and fired the Altman firm as their counsel. Shortly thereafter, SMBC revoked Holdings' license to make and sell the Simply Fit product and commenced an action against Cox and other former Holdings personnel for trademark infringement and unfair competition.

The Altman firm apparently conceded for the sake of argument that confidences imparted to the Altman firm by Cox might now prove useful against Cox. Although that and adverse use of a former client's confidential information would ordinarily violate DR 5-108(A) (governing conflicts with former clients), Altman contended that disqualification would be inappropriate here because "Cox and Holdings did not have a reasonable expectation to believe that their confidences would be kept from co-defendants." This raised interesting issues under the "accommodation client" line of cases in the Second Circuit starting with *Allegaert v. Perot*, 565 F.2d 246, 251 (2d Cir.1977). The question was whether the court should decide these issues or should instead leave them for the arbitrator.

Judge Spatt had no trouble concluding that the court, not the arbitrator, should address the conflict issues and decide the motion to disqualify. Citing two recent Southern District cases, *Munich Reinsurance America, Inc. v. ACE Prop. & Cas. Ins. Co.*, 500 F.Supp.2d 272, 275 (S.D.N.Y. 2007) (Baer, J.), and *In Matter of Arbitration Between R3 Aerospace Inc. and Marshall of Cambridge Aerospace Ltd.*, 927 F.Supp. 121, 123 (S.D.N.Y. 1996), Judge Spatt said that courts in the Second Circuit had held that "disqualification of an attorney for an alleged conflict of interest, is a substantive matter for the courts and not the arbitrator."

Accordingly, Judge Spatt was required to decide the disqualification issue before submitting the matter for arbitration.

The details of his decision on the motion to disqualify are not unusual, and therefore not worth recounting in detail here. Judge Spatt summed up his ruling in the following paragraph:

The defendants to this action have yet to take inconsistent, no less adverse, positions with respect to their liability to northeast. Further, there is no indication here that the Altman firm has attained information through the course of its representation of Cox and Holdings that would be used to the detriment of Poyner and Minahan. Finally, according to the Altman firm, Cox signed a knowing waiver of potential conflicts when the firm undertook joint representation of Cox and his codefendants. There is no allegation here that the Altman firm has violated New York's Code of Professional responsibility DR. 5-105 by failing to obtain Cox's informed consent to joint representation. Accordingly, the Court finds no reason to disqualify the Altman firm on the basis of a conflict of interest at this time.

The interesting point about the *Simply Fit* case is Judge Spatt's conclusion that a motion to disqualify counsel in an arbitration proceeding should be decided by a court, not by the arbitrator. His conclusion seems correct under New York law. In *Munich Reinsurance*, the most recent case cited by Judge Spatt, Munich Reinsurance America asked the court to appoint an umpire for arbitration. All parties agreed that the dispute belonged in arbitration, but ACE Property & Casualty Insurance Company, the defendant, opposed the motion because its motion to disqualify Munich reinsurance's counsel was pending in the Pennsylvania courts.

The court began its discussion by saying: "Preliminarily and perhaps dispositive, is whether the issue of disqualification is a matter for the arbitration panel or the court, a matter not free from doubt amongst the Circuits." Without surveying other circuits, however, Judge Baer had no trouble concluding that New York law requires motions to disqualify to be decided by courts, not arbitrators. Judge Baer called disqualification of an attorney on conflict of interest grounds "a substantive matter for the courts and not arbitrators." He noted that the Federal Arbitration Act, which was the statutory basis for Munich Re's motion, was "designed to provide merely a procedural remedy which would not interfere with state substantive law." He added: "Attorney discipline has historically been a matter for judges and not arbitrators because it requires an application of substantive state law regarding the legal profession and results in an enforceable judicial order."

Summing up, and citing *In Matter of Arbitration Between R3 Aerospace Inc.* (the second case that Judge Spatt cited to support his ruling in *Simply Fit*), Judge Baer said that New York (and Pennsylvania) courts "have determined with some degree of certainty that 'possible attorney disqualification-is not capable of settlement by arbitration.'"

Judge Baer also cited a New York State case, *Bidermann Indus. Licensing, Inc. v. Avmar N.V.*, 173 A.D.2d 401, 402, 570 n.y.S.2d 33 (1st Dep't 1991), in which the First Department unequivocally reserved attorney disqualification issues to the courts. The *Bidermann* court said:

... we have held matters of attorney discipline are beyond the jurisdiction of arbitrators. issues of attorney disqualification similarly involve interpretation and application of the Code of

Professional responsibility and Disciplinary rules, as well as the potential deprivation of counsel of the client's, and cannot be left to the determination of arbitrators selected by the parties themselves for their expertise in the particular industries engaged in.

Thus, the law in both state and federal courts in New York is clear. Motions to disqualify counsel that arise in connection with arbitration proceedings are to be decided by courts, not by arbitrators.

1199 SEIU United Healthcare Workers East v. Lily Pond Nursing Home

The second recent case that I want to address is *1199 SEIU United Healthcare Workers East v. Lily Pond Nursing Home*, 2008 U.S. Dist. LEXIS 74481(S.D.N.Y. Sept. 29, 2008) (Jay Francis IV, Magistrate Judge). There, 1199 SEIU (the "Union"), brought an action to confirm an arbitration award rendered against Lily Pond nursing Home ("Lily Pond"). In the underlying dispute, the arbitrator ruled that Lily Pond had violated the terms of its collective bargaining agreement by failing to make proper contributions to the 1199 SEIU greater New York Benefit, Pension, Education, Child Care, Job Security, and Worker Participation Funds. When Lily Pond failed to comply with the arbitrator's award, the Union filed this lawsuit.

About two months after the Union filed the lawsuit, Lily Pond discovered that its counsel during the arbitration proceedings (Robin Rosen and John Chobor) had "substantial conflicts of interest" because "both attorneys were employer Trustees of the 1199 SEIU greater New York Funds." After discovering this, Lily Pond retained new counsel and raised the conflict as an affirmative defense to the Union's action seeking to confirm the award. Lily Pond never filed a separate motion to vacate the arbitration award, but argued before magistrate Judge Francis that the conflict warranted a denial of the plaintiff's motion for summary judgment to confirm the arbitration award and warranted a separate ruling vacating the award.

After reviewing the federal policy regarding labor arbitration awards, magistrate Judge Francis noted that "the showing required to avoid summary confirmation of an arbitration award is high, and the party arguing in favor of vacating an award shoulders a heavy burden of proof." In that context, magistrate Judge Francis turned his attention to Lily Pond's conflict of interest argument.

As an initial matter, Magistrate Judge Francis held that although Lily Pond had missed the ninety-day deadline for moving to vacate the arbitration award, its challenge to the arbitration award here based on its counsel's conflict of interest was not time-barred. Lily Pond alleged that it first learned of its former attorneys' conflicts of interest on March 2, 2007. Lily Pond then promptly raised the issue as an affirmative defense. "Lily Pond was unknowingly represented by conflicted counsel for the whole of the ninety-day limitations period following the award," the magistrate said. "Under these facts, it would be unfair to penalize Lily Pond for inaction on the part of its attorneys." Therefore, the court considered it appropriate to consider the merits of Lily Pond's request to vacate.

On the merits, the magistrate observed that defendant's former attorneys "had conflicts of interest that offended New York's Code of Professional responsibility," because, in their role as trustees, "Ms. Rosen and Mr. Chobor had fiduciary duties to the Funds that were directly opposed to their duties as advocates. As advocates, Ms. Rosen and Mr. Chobor had a responsibility to zealously promote Lily Pond's best interests – which were, of course, to avoid contributing to the Funds."

Nevertheless, although Lily Pond had established that its attorneys were “genuinely conflicted,” it “failed to demonstrate that the conflicts affected the arbitration proceedings in any way.” Lily Pond alleged that the arbitration process was “irreparably tainted” by the conflict of interest. The alleged taint either (1) “caused the arbitrator to render decisions that were in conflict with the essence of the collective bargaining agreement,” or (2) caused the arbitration awards to be procured by “undue means,” in violation of Federal Arbitration Act.

Magistrate Francis described the first argument as “nonsensical.” On its face, the arbitrator’s award was “a straightforward application” of the collective bargaining agreement, which requires Lily Pond to make monthly contributions to the 1199 Funds. The magistrate found “not one iota of evidence” showing that the arbitrator had overstepped the bounds of his authority.

Magistrate Judge Francis said that Lily Pond’s “undue means” argument was “at least tenable,” but it also ultimately failed. An arbitration award will be vacated only if “clear and convincing evidence” shows that the award was procured by undue means. Lily Pond could not meet that test because it “failed to offer any proof showing that its former attorneys acted improperly during arbitration or that any particular part of the arbitration process was unfair.” Unless they are substantiated, “general complaints as to the integrity of the process and allegations that the award is tainted” are insufficient grounds for vacatur of an arbitration award. More significantly, Magistrate Judge Francis said:

I can not find a single case, nor does the defendant cite to any, to support the proposition that the mere presence of an attorney conflict of interest could render an arbitration proceeding invalid per se. On the contrary, in the analogous situation where a party seeks to vacate a final judgment in a civil case on the grounds of attorney misconduct, the Second Circuit has established that “an attorney’s mistake or omission based on ignorance of the law, failure to follow rules and deadlines, inability to handle caseload and complete and total disregard for client rights or professional ethics are not bases for relieving a party from a final judgment.” For better or for worse, parties are generally bound by the acts of their freely chosen lawyer-agents. Lily Pond has offered no reason to disregard this general principle here, and is thus stuck with the results of the arbitration proceedings.

Conclusion: Two Simple Principles

The two cases described in this article set forth two simple principles. First, *Simply Fit* makes clear that courts, not arbitrators, should decide attorney disqualification motions based on conflicts of interest that arise in the context of arbitration proceedings. Second, *1199 SEIU* makes clear that “the mere presence of an attorney conflict of interest” does not render an arbitration proceeding invalid per se. Rather, a party seeking to vacate an arbitration award on grounds that its counsel had an improper conflict of interest must put forth clear and convincing evidence showing that its attorneys “acted improperly during arbitration” or showing that some particular part of the arbitration process was “unfair.”

Taken together, the two principles suggest that raising conflicts of interest during an arbitration proceeding is time consuming and expensive (requiring resort to a court, which will typically require a separate, independent proceeding, rather than the convenience of seeking a ruling by the arbitrator), and that raising conflicts of interest as a ground for vacating an arbitration award requires strong and specific

proof that the conflict adversely affected the conflicted attorney's independent professional judgment during the arbitration proceedings. In short, a party seeking to disqualify opposing counsel in an arbitration proceeding must seek the assistance of a court, and a party seeking to challenge an arbitration award based on a conflict of interest is unlikely to prevail absent powerful proof of the conflicted attorney's improper conduct. These complementary principles are likely to discourage parties from raising conflicts of interest during or after arbitration proceedings.

Roy Simon is the Howard Lichtenstein Distinguished Professor of Legal Ethics at Hofstra University School of Law. He annually publishes Simon's New York Code of Professional Responsibility annotated. The 2008 edition is now available from Thomson West.