ARE "UNREASONED" ARBITRATION AWARDS "IRRATIONAL"?

By

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I. Introduction

The title of this article is tongue-in-cheek for two reasons. The term "unreasoned award" is a misnomer since all arbitration awards are supported by reasons but they are not expressed or explained in this type of award. Second, such awards are very seldom irrational in the general sense of the term but may be in the sense of that term used and applied by the courts under the Federal Arbitration Act.

The purpose of this article is to examine a recent unreasoned award found to be irrational by a federal district court along with selected case law in order to support the argument that failure to provide the reasoning to an arbitration award increases rather than decreases the chance of an award being vacated by a court.

II. *PMA Capital Ins. Co. v. Platinum Underwriters Bermuda, Ltd.,* 2009 U.S.Dist. Lexis 85046 (E.D. Pa.)

A. The Facts[1]

St. Paul Re reinsured PMA from 1999 through 2001 under a finite aggregate excess treaty that contained: (a) an experience fund to which premiums were paid; and (b) a deficit carry-forward provision with respect to losses in excess of the experience fund which were paid by St. Paul Re. Any excess in the experience fund after losses ran off would revert to PMA.

In 2003, St. Paul Re was spun off and became Platinum Re. At that point, Platinum Re and PMA entered into another treaty (an aggregate stop loss) that allowed any deficit from the 1999 – 2001 treaty to be rolled into the 2003 treaty. Any unused portion of the experience fund for the 2003 treaty would be returned to PMA upon the "finalization" of losses *i.e.* the earlier of a commutation of losses, losses reaching Platinum Re's limits or December 31, 2021. The decision does not specify the class of business involved but such transactions usually involve long tail business.

PMA challenged the validity of the carry forward of losses from the 1999 – 2001 treaty into the 2003 treaty. The parties also disputed the method of calculation of the deficit. At one point, PMA made a regulatory filing that placed the deficit at just over $6 million but at the time of the arbitration, PMA

argued that there was no deficit. Platinum Re calculated the deficit as $10.7 million. Given the structure of the transaction, as described in the prior paragraph, PMA and Platinum Re faced the potential for a very long running dispute *i.e.* until December 31, 2021. This was particularly troublesome for the panel as Platinum asked the panel to retain jurisdiction over the dispute to insure PMA's compliance with the deficit carry forward calculation.

The 2003 treaty contained the following arbitration clause:

> The arbitrators will interpret this Agreement as an honorable engagement and not merely as a legal obligation. They are relieved of all judicial formalities and may abstain from following the strict rules of law. They will make their award with a view to effecting the general purpose of this Agreement in a reasonable manner rather than in accordance with a literal interpretation of the language.

Platinum Re demanded arbitration seeking "a declaration that, in the calculation of the balance of the Experience Account under Article 15 of the [2003 treaty], Platinum is entitled to the benefit of the [d]eficit carry forward from [the 1999 – 2001 treaty]."[2] In an unreasoned opinion, the arbitration panel ordered PMA to pay Platinum Re $6 million and ordered that reference to the deficit carry forward from the 1999 – 2001 treaty be stricken from the 2003 treaty. In essence, the panel commuted the deficit carry forward from the earlier contract and eliminated it as an issue for the 2003 treaty.

Obviously, the panel's order went somewhat beyond the declaration originally sought as to whether the deficit carry forward from the 1999 – 2001 treaty should be rolled into the 2003 treaty and how it should be calculated. (For those readers who think the panel did <u>exactly</u> the right thing, *see* § IV B, *infra*.) PMA filed a motion to vacate the panel's award arguing that the panel contradicted the 2003 treaty by: (a) not allowing the losses to develop and be finalized in the manner required by the treaty; and (b) ordering a current payment of $6 million. In so doing, PMA argued, the panel exceeded its proper authority.

B. <u>The Ruling of the Court</u>

Initially, the court acknowledged the broad discretion of an arbitration panel generally and particularly with respect to a contract with the "honorable engagement" clause. However, it found that such discretion did not allow the panel to rewrite the 2003 treaty:

> Even broad discretion has limits, however. The Honorary Engagement Clause allowed the Arbitrators to stray from "judicial formalities" and the 2003 Contract's "literal language" to effect in a "reasonable manner" the Contract's "general purposes." No court has held that such a clause gives arbitrators authority to re-write the contract they are charged with interpreting. Rather, courts have held just the opposite . . . .
>
> The 2003 "contract itself" requires the enforcement of the Deficit Carry Forward Provision, not its elimination. . . .

> In these circumstances, the Panel's award cannot be rationally derived from the 2003 Agreement.[3]

The court found that the panel's ruling could not be derived rationally from the issues submitted by the parties for resolution by the panel:

> The Parties never asked the Panel to eliminate the Deficit Carry Forward Provision. Rather, they disputed the size of the 1999 – 2001 deficit, how it should be calculated, and whether Platinum was entitled to carry forward the deficit St. Paul Re had incurred. . . .
>
> Moreover, the Parties did not ask the Panel to order PMA immediately to pay any such deficit (whether $6 million or some other amount) to Platinum. PMA argued, *inter alia*, that even if Platinum could "carry forward" St. Paul's 1999 – 2001 losses, Platinum was not entitled to any offset because contractual pre-conditions had not been met.[4]

Finally, the court found that the panel's award was completely irrational:

> Even when an arbitration award cannot be rationally derived from the underlying agreement or from the parties' submissions, that award is not subject to judicial revision unless it is "completely irrational." An arbitration award based on the interpretation of a contract is irrational if the award "does not draw its essence" therefrom . . . .
>
> The Panel apparently believed it could "reasonably" resolve these disagreements [over the deficit carry forward provision] by eliminating the Provision itself. . . . This, in my view, is "completely irrational," the Panel's broad discretion notwithstanding.[5]

The court noted that its finding of "complete irrationality" was based in part on the unreasoned nature of the award: "Any evaluation of the Arbitrators' decision is made more difficult by their failure to offer any supporting explanation or reasoning."[6]

III. Selected Case Law on Point

A good deal of the relevant case law on point seems to follow a case involving arbitration under a collective bargaining agreement in *United Steelworkers of America v. Enterprise Wheel & Car Corp.*, 363 U.S. 593 (1960) wherein the court stated:

> When an arbitrator is commissioned to interpret and apply the collective bargaining agreement, he is to bring his informed judgment to bear in order to reach a fair solution of a problem. This is especially true when it comes to formulated remedies. There the need is for flexibility in meeting a wide variety of situations. The draftsmen may never have thought of what specific remedy should be awarded to meet a particular contingency. Nevertheless, an arbitrator is confined to interpretation and application of the collective bargaining agreement; he does not sit to dispense his own brand of industrial justice. He may of course look for guidance from many sources, *yet his award*

> *is legitimate only so long as it draws its essence from the collective bargaining agreement.* When the arbitrator's words manifest an infidelity to this obligation, courts have no choice but to refuse enforcement of the award. (Emphasis added)[7]

A. Cases in which Awards were Vacated

A case cited often by the *PMA Capital* court is *Swift Industries Inc. v. Botany Industries, Inc.*, 466 F.2d 1125 (3rd Cir. 1972). This involved a warranty of no tax liability when a corporation was sold. A claim for taxes was assert by the IRS and while that claim was being litigated, an arbitration was initiated between the buyer and seller of the corporation in order to determine whether the seller would be liable for any taxes that were ultimately due. The arbitrator ruled that the Seller was liable for taxes and ordered seller to pay to the buyer $6 million, or provide a surety bond in equal amount, to secure the buyer with respect to any tax ultimately found to be due. The court vacated the award on the basis that it did not draw its essence from the contract:

> We have sought to distill from the Agreement the essence of the arbitrator's authority. Whatever that authority may be, it is clear to us that it does *not* include the authority to award a six million dollar cash bond to cover a liability which contrary to the requirements of the applicable breach of warranty clause, has not yet been (and may not be) "incurred or suffered," in a situation where the parties did not provide for such security in their agreement, although they might have done so. (Emphasis in the original)[8]

Inter-City Gas Corp. v. Boise Cascade Corp., 845 F.2d 184 (8th Cir. 1988) involved an arbitration over rates for natural gas. The court found that the relevant contract clearly called for a certain rate. The arbitrator did not provide written findings but clearly used a different rate in his award of damages. The court found that the arbitrator had exceeded his authority commenting: "The arbitrator's authority, however, is not unlimited. Although the arbitrator may interpret ambiguous language, the arbitrator may not disregard or modify unambiguous contract provisions." [9]

A similar case is *Missouri River Services, Inc. v. Omaha Tribe of Nebraska*, 267 F.3d 848 (8th Cir. 2001). This involved damages concerning construction of a casino on tribal land in Nebraska. The relevant contract called for damages to be paid from revenues from the Nebraska casino but the arbitrator's order called for damages to be paid from revenues in other states as well. The court found that the award did not draw its essence from the contract because the award was contrary to the contract and an effort to re-write it.

B. Cases in Which Arbitration Awards were not Vacated

An arbitration award reinstating an employee without back pay was the basis for *St. Mary Home, Inc. c. Service Employees Int'l Union,* 116 F.3d 41 (2nd Cir. 1997). The plaintiff argued that the decision was beyond the authority of the arbitrator under the collective bargaining agreement. The court found that the arbitrator resolved the issues put to him and commented: "Since the arbitrator explained his

conclusions in terms that offer a "colorable justification for the outcome reached," our inquiry is at an end." (Internal citations omitted)[10]

Whether "any loss" paid by the cedent was reinsured by the reinsurer was the issue for the arbitrators in *Industrial Risk Insurers v. Hartford Steam Boiler Co.,* 779 A2d 737 (Conn. 2001). The arbitration panel affirmed coverage and went on to value the cedent's claim as $22 million. The court characterized the submission to the panel as requiring "the panel to determine what amount Hartford Steam Boiler was required to pay Industrial Risk under the terms of the reinsurance contract."[11] Apparently, the court did not recognize the difference between liability and damages. Based on this generous reading of the submission to the arbitrators, the court found that the panel did not exceed its authority under the relevant arbitration agreement.

In the Matter of the Arbitration between Andros Compania Maritima and Marc Rich & Co., 579 F.2d 691 (2nd Cir. 1977) is a case in which the court declined to vacate an award on the basis that it did not draw its essence from the contract noting: "When arbitrators explain their conclusions . . . in terms that offer even a barely colorable justification for the outcome reached, confirmation of the award cannot be prevented by litigants who merely argue, however persuasively, for a different result."[12]

IV. Analysis and Commentary

A. Reasoned Award Reduces Chance it will be Vacated

In terms of motivation, an overworked and underpaid judge has no incentive to vacate arbitration awards. Reinsurance disputes can be highly technical meaning that a judge must spend considerable time and effort to understand business context and relevant custom and practice. Realistically, courts are reluctant to vacate arbitration awards unless there seems to be a serious miscarriage of justice. An example is *Industrial Risk Insurers, supra*, in which the court went considerably out of its way to reinterpret the issue posed to the arbitrators to match the award. In that case, it made a great deal of sense to quantify coverage as well as determine whether or not there was coverage.

Because reinsurance disputes can be quite technical, it can be difficult for a judge to understand how a terse, unreasoned award relates to the questions which the judge understands to be at issue in the arbitration. Several of the cases described above indicate that a reasoned award which helps the judge understand the connection between the issues and the award will avoid a vacation of the award.

Cases in which the court vacated the award after commenting specifically on the arbitrators' lack of explanation are *Inter-City Gas Corp. and PMA Capital.* Cases in which the court declined to vacate and noted the benefit of the reasoned award are *St. Mary Home, Inc.* and *In the Matter of the Arbitration between Andros Compania Maritima.* In words of the court in the latter decision, "even a barely colorable justification for the outcome reached"[13] counters an allegation of irrationality.

B. A Second Look at PMA Capital Ins. Co. v. Platinum Underwriters Bermuda, Ltd.

It is difficult to deduce the rationale of a panel for a particular award when the award is unreasoned and the record of the arbitration is not available. However, it is possible for one experienced in the business to speculate that the panel found that: (a) determining that the deficit from the 1999 – 2001 treaty should be rolled into the 2003 treaty and how it should be calculated would not resolve the dispute; (b) this dispute might not be finalized until 2021 and then only by another arbitration; (c) there was sufficient evidence to quantify the net present value of the deficit carry forward at $6 million; (d) using such a net present value did no violence to the "finalization" conditions in the 2003 treaty; and (e) removing the 1999 – 2001 deficit carry forward issue allowed the 2003 treaty to roll forward without the drag of prior year losses. With such an explanation, court might not have found the panel's award to be irrational.

ENDNOTES

1 The facts are derived from the decision itself as well as the briefs involved in the motions to confirm and vacate which were published in Mealey's Litigation Report, Reinsurance, Vol. 20 Issue #11, October 2, 2009.
2 2009 U.S.Dist. Lexis 85046*7.
3 *Id.* *15.
4 *Id.**15-17.
5 *Id.**20-21.
6 *Id.**20.
7 363 U.S. 593, 596-97.
8 466 F.2d 1125, 1133.
9 845 F.2d 184, 187.
10 116 F.3d 41, 44.
11 779 A.2d 737, 745.
12 579 F.2d 691, 704.
13 *Id.*