

Rejecting Attempts to Frustrate the Arbitration Process: Indemnification of Arbitrators

By Karl S. Vasiloff and Christine Phan

The success of arbitration as an effective and cost-effective alternative to litigation depends in part on the willingness of the parties to be reasonable. A recent opinion from the Seventh Circuit illustrates how difficult and drawn out a process arbitration can become when one of the parties is determined to sabotage the process by refusing to enter into a basic agreement to indemnify the arbitrators.

The arbitration claims in *Moglia v. Pacific Employers Ins. Co.*, 547 F.3d 835 (7th Cir. 2008) arose out of several "program agreements" that Outboard Marine Corporation entered into with insurers. As a condition of coverage, OMC agreed to post collateral security for its obligations to pay premiums and to reimburse the insurers for certain anticipated future costs. The program agreements provided that any controversy, dispute, claim or question concerning the arrangements be resolved by arbitration.

After Outboard Marine entered into bankruptcy, its insurers used the collateral security to pay expenses stemming from the program agreements. OMC's Bankruptcy Trustee contended that the collateral exceeded Outboard Marine's obligations to the insurers and brought claims in the bankruptcy proceedings to collect the excess funds. In light of the arbitration clause contained in the program agreements, the Bankruptcy Court ordered the parties to arbitrate those claims.

It has become routine in commercial arbitrations for arbitration panelists to seek and obtain hold harmless agreements from the parties. These agreements typically provide that the parties will not assert any claims, bring any actions, or institute any lawsuits against the arbitrators and that the parties will indemnify arbitrators if the arbitrators are subject to any third-party claims arising from the arbitration.

In this case, however, the Bankruptcy Trustee refused to sign the standard hold harmless agreement sent to him by the arbitrators, and the arbitration panel refused to proceed with the arbitration. After months of fruitless negotiations, the Trustee petitioned the Bankruptcy Court to vacate its arbitration order on the grounds that refusing to sign the hold harmless agreement was "an exercise of [the Trustee's] business judgment" and was thus "a matter within his discretion." The Bankruptcy Court agreed, and an appeal to the federal District Court followed.

Could The Trustee Refuse To Sign The Indemnity Agreement?

The Trustee argued before the District Court that the Federal Arbitration Act undermined the policies of the Bankruptcy Code by, for example, precluding the Trustee from choosing the best forum in which to expeditiously and efficiently liquidate claims. The Trustee further argued that if he executed a hold harmless agreement, he would create an impermissible contingent claim against the Estate based upon the possibility that

Outboard Marine might be liable to the arbitrators in the event that the arbitrators were sued for their actions in connection with the arbitration.

The District Court termed those arguments an "end run" around the key issue at hand: whether an arbitration panel may require a hold harmless agreement before proceeding with an arbitration under the AAA rules. *Pacific Employers Ins. Co. v. Moglia*, 365 B.R. 863 (N.D. Ill. 2007). The District Court answered the question in the affirmative, holding that the hold harmless agreement simply codified the immunity already afforded to an arbitration panel under common law due to the panel's status as a quasi-judicial body. Noting that the arbitral immunity provided to arbitrators at common law is already broad, the District Court rejected the Trustee's arguments that a hold harmless agreement would provide even more protection to arbitrators. The District Court further observed that hold harmless agreements and, more generally, broad arbitral immunity, create the necessary incentives for arbitrators to serve and thus further the public policy favoring arbitration. The District Court ordered the Trustee and the insurers to sign the hold harmless agreement and proceed with the arbitration.

The Seventh Circuit Rejects Trustee's "End Run."

The Trustee appealed to the Seventh Circuit. The Seventh Circuit agreed with the insurers that it did not have jurisdiction to hear the appeal because the District Court's decision was a non-appealable stay of the suit pending arbitration under 9 U.S.C. § 16(b). Despite ruling that it lacked jurisdiction, the Seventh Circuit took pains to discuss the merits of the dispute. The Court dismissed the Trustee's contingent claim argument, effectively calling it an attempt to circumvent the parties' arbitration obligations. Moreover, the Court pointed to the "irrationality" of the Trustee's argument, noting that the costs created by the Trustee's prolonged litigation proceedings far exceeded the size of any contingent claim that could be created by the hold harmless agreement.

The Court of Appeals also addressed the Trustee's argument that the insurance contracts were executory contracts that had been rejected when they were not assumed for a certain period after the bankruptcy proceedings began. Because the contracts were rejected, the Trustee argued, Outboard Marine should be able to avoid all promises under the contract, including the promise to arbitrate. The Trustee, however, simultaneously sought to require the insurers to perform their obligations under the contracts. The Seventh Circuit not surprisingly observed that "[a] Trustee can't have things both ways," but again noted that it did not have jurisdiction to decide whether the contracts had been rejected.

Lessons of Moglia?

Although the District Court opined that it was simply recognizing protections for arbitration panels that already existed at common law, the Moglia decisions could be viewed as an expansion of the existing protections afforded to arbitrators as well as a strong endorsement of the process itself.

Despite their common use, hold harmless agreements are not specifically required under the AAA rules and, even though the Seventh Circuit did not have jurisdiction to hear the appeal, the Court went out of its way to criticize the Trustee's arguments against arbitration. Indeed, the Seventh Circuit concluded its opinion by noting that the Bankruptcy Court should consider whether the Trustee should personally bear the

attorneys' fees associated with the protracted litigation regarding the agreement to arbitrate.

Indeed, under similar circumstances, a party facing such an impasse should give consideration to petitioning the court to enter an order indemnifying the panel, as no panel is likely to proceed far without such protection.

Regardless of whether the *Moglia* decisions are viewed as an expansion of the rights of an arbitration panel and the reach of arbitration generally, these latest opinions provide powerful ammunition to those seeking to enforce arbitration agreements in the face of a recalcitrant opponent.

© 2009 Zelle Hofmann Voelbel & Mason LLP. All Rights Reserved.