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COMMENTARY

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Beware the Dangers of Arbitrators Morphing Into Mediators

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Flexibility and adaptability are hallmarks of alternative dispute resolution, and the ability to fit procedures to the needs of the particular quarrel is often central to realizing the benefits of arbitration and mediation. What is often needed, to render timely, affordable and efficient justice, is a system in which a decision-maker can exercise particularized judgments not only on the ultimate issues, but also on how the dispute process itself unfolds.

A recent California case illustrates, however, the risks of "flexibility": if not managed with due care, an overly fluid process can leave the parties sorely disappointed and the arbitrator exposed to claims he or she would otherwise be immunized against.

In *Morgan Phillips, Inc. v. JAMS/Endispute, LLC,* 140 Cal. App. 4th 795 (2006), the court of appeal overturned the grant of a demurrer, ruling that arbitral immunity did not bar breach of contract and other claims against a mediator/arbitrator and the ADR organization with which he was associated. Although the court-sanctioned exception to arbitral immunity was framed as a narrow one, ambiguities in the ruling raise disturbing issues.

Our account of the case rests wholly on plaintiff's complaint, a pleading which JAMS disputes as "filled with bizarre allegations that were all false." Nevertheless, the trial and appellate courts were bound on a demurrer to accept the allegations of the complaint as true.

The case begins with a dispute over bedding. Morgan Phillips, a retailer of specialty bedding products, contracted with two suppliers who were to manufacture mattresses and box springs to Morgan Phillips' exacting specifications. When they failed to do so, the company sued. The parties retained JAMS mediator John Bates to help them resolve the case, and in September 2000 they reached a settlement. They also agreed any future disputes would be submitted to Bates for binding resolution.

Two years later, Morgan Phillips was again unhappy with its mattresses. The company invoked the dispute resolution provision, and JAMS and Bates agreed to conduct binding arbitration to resolve the clash. In September 2002, Bates held a four-hour hearing at which Morgan Phillips presented its evidence. He then continued the hearing for six weeks, advising the parties that if they were "unable to settle the dispute before the next scheduled arbitration session," Bates would decide as arbitrator. Morgan Phillips warned Bates that the breach was causing severe financial distress, and that "there was a substantial risk that Morgan Phillips would be unable to continue in business if the dispute was not decided promptly."

In late October, the arbitration reconvened; however, the hearing was concluded and the case was ripe for decision. According to the First Amended Complaint, Bates then resumed acting as mediator and tried to force the parties to settle. Bates "separated the parties into different rooms and [met] with each side separately in an apparent effort to settle the case without rendering an arbitration award." Over the next few hours, "Bates shuttled back and forth between the parties to discuss various alternative resolutions. However, as the lunchtime break was ending, Bates suddenly announced, with no lawful justification, that he decided to withdraw as the arbitrator. Bates thereafter failed and refused to issue a binding arbitration award . . . ."

Bates tried to "coerce Morgan Phillips into an unfavorable settlement by unlawfully withdrawing as the designated arbitrator," Morgan Phillips alleges, as part of a "plan and scheme to coerce Morgan Phillips to settle the dispute in order to relieve Bates from his duty and responsibility to enter a binding arbitration award."

Morgan Phillips sued Bates and JAMS for breach of contract and negligent breach of the duty to provide binding arbitration services. Defendants demurred, asserting

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that their arbitral roles immunized them from suit. The Superior Court granted the demurrer, but a unanimous panel of the Second District reversed.

Arbitrators have long enjoyed immunity—in California, based on common law—similar to that of judges. So, for example, a party to an arbitration could not sue an arbitrator for defamation based on statements in the arbitrator's award.

Should Arbitrators Err on the Side of Ethical Concerns Once an Arbitration Begins or Ignore Potential Ethical Restrictions?

"Generally speaking," the *Morgan Phillips* panel observed, "arbitral immunity 'shields all functions which are integrally related to the arbitral process.' " "The purpose of arbitral immunity is to encourage fair and independent decision-making by immunizing arbitrators from lawsuits arising from conduct in their decision-making role." As the court confirmed, however, "California common law has recognized a narrow exception to arbitral immunity: the immunity does not apply to the arbitrator's breach of contract by failing to make any decision at all."

"The failure to render an arbitration award is not integral to the arbitration process; it is, rather, a breakdown of that process . . . [B]y failing to make a timely decision the arbitrator . . . has simply defaulted on a contractual duty to both parties."

Although "mindful of the need to protect arbitrators from vexatious litigation arising from conduct in their quasi-judicial function," the appellate court noted that "Morgan Philips' allegations portray conduct foreign to that function . . . . [A]rbitral immunity . . . cannot be used to immunize the unprincipled abandonment of the arbitration and refusal to make a decision."

Nonetheless, arbitrators are not vulnerable to claims in every instance in which they withdraw before rendering an award: An arbitrator's "decision to withdraw because of substantial doubt of the ability to [be] fair and impartial, or because of a conflict of interest, is entitled to immunity." "An arbitrator's decision to withdraw based on ethical standards . . . is covered by arbitral immunity."

The *Morgan Phillips* decision, on its face, appears unobjectionable: Why should an arbitrator who shirks his duties to the parties and breaches his contractual obligation to decide be entitled to immunity—particularly if the withdrawal was not compelled by ethical considerations? Unfortunately, however, back in the real world, allegations are easy to assert. But it is not clear whether withdrawal for ethical reasons would effectively be immune to legal challenge under *Morgan Phillips*, and the possible forfeiture of arbitral immunity may create undesirable incentives in ethically close cases.

"[W]e do not mean to suggest," said the court of appeal, "that parties to an arbitration proceeding are entitled to litigate the validity of an arbitrator's stated ethical grounds for recusal in . . . a later civil suit . . . for breach of the duty to conduct a binding arbitration." This assurance is less than entirely comforting to arbitrators, however, for it was immediately undermined:

> But in the instant case, we must accept as true the allegations of Morgan Philips' first amended complaint. The allegations of the complaint do not reveal whether Bates gave any reason for his withdrawal. Morgan Philips alleges that Bates withdrew without justification in order to coerce a settlement . . . . If these facts are true, and in the absence of any other showing, Bates' withdrawal (and the resultant refusal to render an award) is not immunized as a decision necessitated by ethical strictures.

Morgan Phillips carries two practical implications for arbitral immunity. First, notwithstanding the court's supposed deference to arbitrators' ethical concerns, cases alleging wrongful withdrawal before decision will not easily be dismissed on the pleadings. To defeat a demurrer under *Morgan Phillips*, a complaint need only *omit the arbitrator's asserted reason* for withdrawal and *allege the legal conclusion* that the withdrawal was "without justification." Second, in such a case, "immunity" does not mean that the arbitrator can escape the cost and bother of litigation. It means only that the arbitrator can assert the arbitral immunity defense in a summary judgment motion or at trial.

Morgan Phillips purports to teach that, if the arbitrator's reason for withdrawing was an ethical concern, arbitral immunity will preclude challenges to the "validity" of that concern. Nonetheless, whether a stated ethical concern was *authentic* or a *pretext* might well be a litigable issue under the decision, and it could be difficult for the arbitrator to prevail on that issue on summary judgment.

The ambiguity of *Morgan Phillips* has disturbing implications. Once arbitrators sign an oath, they accept a contractual duty to hear and decide the case. Suppose, after the hearing begins, a "borderline" ethical issue emerges. Suppose further that withdrawal was not compelled by clearly established ethical principles, but the arbitrator, feeling uncomfortable with the situation nonetheless elects to withdraw. Would arbitrators be vulnerable to a claim that they abandoned the arbitration "without justification" because (a disgruntled party may argue) the decision to withdraw was based on an "unreasonable" ethical concern? The arbitrator's dilemma: proceed notwithstanding colorable ethical concerns and risk a subsequent challenge to the arbitration or withdraw due to those concerns and face a lawsuit for breach of the duty to decide?

Put another way, the issue generated by *Morgan Phillips'* "narrow exception" to arbitral immunity is this: Should arbitrators err on the side of ethical concerns once an arbitration begins or (prompted by their own material interest in avoiding suit) ignore potential ethical problems? Under the practical logic of *Morgan Phillips,* arbitrators will inevitably consider the risk of a breach-of-contract lawsuit against when they weigh close questions of ethics. Because the courts have traditionally demanded that decision-makers avoid even the appearance of impropriety, it would seem inconsistent to provide the opposite incentive.

What actually occurred in *Morgan Phillips* is not clear, hence no criticism of Bates or JAMS is intended. Nonetheless, a few lessons are evident.

First, in any case in which the neutral's role shifts between mediation and arbitration, the risks of misunderstanding, coercion, and challenge may be reduced if the neutral and the parties explicitly define the neutral's intended role and put in writing any agreement to change that role.

Second, once a neutral has begun to act as an arbitrator, it is of utmost importance that any subsequent agreement that s/he mediate be voluntary in fact as well as in theory. Faced with an arbitrator who proposes to morph into a mediator, a party might well feel constrained to go along out of fear of antagonizing the neutral if s/he resumes her/his arbitrator role.

Third, any shift from one role to the other will almost certainly generate not only power dynamics that are suspect, but also nontrivial ethical concerns. For example, no party should be bludgeoned into a settlement, yet a party might feel obliged to defer to the mediator's perceived preference if the mediator might still wield the power of an arbitrator. (This also raises the risk a party might later challenge an agreed-to settlement on grounds of coercion.) Further, in his role as a mediator, a neutral may obtain information inappropriate for his consideration in the role of arbitrator. Finally, the role shift might prompt an apprehension that the arbitrator will impose, as the arbitration award, the compromise he could not get the parties to agree to during the mediation, rather than decide the case on the merits as he would be bound to do as arbitrator.

Such considerations do not necessarily preclude an informed decision to allow the neutral to play more than one role. But these concerns—and the possible forfeiture of arbitral immunity—underline the risks of fluidity and ambiguity in role definition. It is certainly not clear, in *Morgan Phillips,* who was most responsible for making the uncomfortable bed in which the neutral and the parties all found themselves. But focusing on these concerns might have avoided having the alternative dispute resolution process itself degenerate into litigation. ❑