

The Arbitration from Hell

6/6/2013

By: Stephen M. Proctor

Practices: Commercial, Competition & Trade, Litigation

Supporters of arbitration as a form of dispute resolution point to its many advantages. These include quicker resolution, finality and use of an impartial arbitrator. There are many arbitration proceedings in which these advantages are well-illustrated. But one of them was not the arbitration in *Thomas Kinkade Company v. White and Lighthouse Galleries* (6th Circuit Court of Appeals, No. 10-1634, April 2, 2013)

Thomas Kinkade Company (Kinkade) is the well-known purveyor of popular art sold at many art galleries. One of these galleries was Lighthouse Galleries, owned and operated by Nancy and David White. In the late 1990's, the Whites and Kinkade entered into several agreements in which the Whites agreed to be "Signature Dealers" of Kinkade's artwork. The agreements included a provision in which disputes would be resolved by arbitration.

In 2002, Kinkade and the Whites filed claims and counterclaims in arbitration. Kinkade claimed the Whites had not paid for artwork in the hundreds of thousands of dollars. The Whites claimed they had been fraudulently induced to enter into the dealer agreements. But the key figure in the court's decision was not Kinkade, or either of the Whites. It was the "neutral" arbitrator, an attorney named Mark Kowalsky.

Under the arbitration provision, each side would appoint one arbitrator which would *de facto* advocate that party's position on the arbitration panel. Those two arbitrators would appoint a third, neutral arbitrator. Kinkade appointed Burton Ansell and the Whites chose Mayer Morganroth. Together Ansell and Morganroth appointed Kowalsky.

Said the court, "The arbitration itself was a model of how not to conduct one." It clearly did not reflect many of the commonly viewed advantages of arbitration.

- Arbitration is Quick.

The arbitration stretched over five years and fifty hearing days, indicating the arbitration was not being conducted efficiently and expeditiously. On top of that was the conduct of legal counsel for the Whites. In January 2006, Kinkade's counsel discovered that the Whites' counsel had been secretly sending a live feed of the hearing transcripts to a hotel room miles from the arbitration location where a disgruntled former Kinkade employee would review the transcripts in real time and send proposed cross-examination questions to the Whites' counsel. This continued for more than a year. When discovered, Whites' counsel at first denied and then tearfully admitted the scheme. The Whites obtained new counsel from the same law firm, but he was convicted of federal tax fraud. So the Whites retained a third attorney from the same law firm.

- The Arbitrator is Neutral

This is where the court is most critical of the arbitration and the supposedly "neutral" arbitrator, Kowalsky. To fast forward, Kinkade lost virtually all of the arbitration. It appealed to the American Arbitration Association, motioning to disqualify Kowalsky. The AAA denied the motion. So Kinkade appealed in court, leading to the 6th Circuit decision. So why was Kinkade such a sore loser?

Kowalsky did not seem to be acting as a "neutral" arbitrator. For example, early in the arbitration, Kinkade had sent discovery requests to the Whites asking for all documents supporting the Whites' claim for damages. The Whites produced virtually no documents and the expert they hired used *pro formas* that the Whites had prepared before entering into the agreements with Kinkade, not upon actual financial records. The expert offered no opinion on causation.

The day after submission of closing briefs and closing arguments in December 2006, when the parties probably thought they were finally finished, Kowalsky asked for further briefing on causation and asked the Whites to present a "detailed accounting" of their damages. The Whites took advantage of this "do over" and, in July 2007, submitted an 8,800 page production of financial records to support its damage claim. Of course, Kinkade had requested these records four years earlier and the Whites not only failed to produce them, but said they did not exist.

Kinkade had reason to be concerned about Kowalsky's "neutrality." In February, 2007, between the time of the closing arguments and briefs and the Whites submission of financial information, the Whites and persons associated with the Whites began sending business to Kowalsky's law firm. First, Whites' arbitrator, Morganroth, hired one of Kowalsky's partners as a defense expert in a malpractice case pending against Morganroth in which the expert expected "substantial" fees. Less than eight weeks later, Kowalsky disclosed that David White (an actual party to the arbitration) had hired another of Kowalsky's partners to represent White in an unrelated arbitration. Incredibly, Kowalsky seemed to believe that it was sufficient to disclose these conflicts to Kinkade and continue to serve as the "neutral" arbitrator.

Kinkade filed objections with the AAA to the engagements by Kowalsky's partners by White and persons associated with the Whites. The AAA responded, without explanation, that Kowalsky's partner in the unrelated arbitration had withdrawn, but otherwise gave Kinkade no satisfaction. As instructed by the AAA, presumably to preserve Kowalsky's "neutrality", Kowalsky was not copied on Kinkade's objections. But Whites' counsel "blew that cover" when he told Kowalsky in an e-mail that he had been "re-confirmed" as an arbitrator. Kinkade believed that Kowalsky would suspect Kinkade of trying to remove Kowalsky and would perhaps hold a grudge. Kinkade then tried to disqualify Kowalsky outright, but the AAA denied the motion. Kinkade then submitted the same demand to Kowalsky directly, but he did not see the need to disqualify himself.

In May, 2008, the arbitration panel issued an "Interim Award." It confirmed all of Kinkade's fears. The award was conclusory, simply stating that the proofs did, or did not, support recovery. The Whites were awarded \$567,300 in damages. The panel denied Kinkade's claim for payment for paintings never paid for, a claim that was virtually uncontested. Ansell, the arbitrator appointed by Kinkade, dissented on numerous grounds.

That was not all. The Whites had claimed attorneys' fees and its claim was not mentioned in the Interim Award. According to the Award, "[a]ll claims that are not expressly granted are hereby denied." So Kinkade thought that, at least, it would not have to pay the Whites' attorneys' fees. But on June 3, 2008, Kowalsky asked the

parties to submit applications for "fees and costs." On February 26, 2009, the panel (over Ansell's objections) awarded the Whites \$487,000 in attorneys' fees, \$215,846.20 in costs, and \$258,121 in prejudgment interest. There was a small penalty against the Whites for withholding financial records and for the internet feed scheme (totaling \$100,000). But the Whites were the clear victors. They netted over \$1.4 million.

The next day, Kinkade filed a petition in federal district court in Detroit to vacate the award. In a 21 page opinion, the district court vacated the arbitration award in its entirety. Clearly, the district court did not agree with the AAA or with Kowalsky himself that he was a "neutral" arbitrator.

- Arbitrations are final.

Fortunately for Kinkade, the arbitration award was not the final word. The appeals court acknowledged the limited grounds under which federal courts can vacate an arbitration award, including "evident partiality or corruption in the arbitrators." The challenging party "must establish specific facts that indicate improper motives on the part of the arbitrator."

The court noted the incredible coincidence that, of all the law firms in Michigan, the arbitrator for the Whites hired Kowalsky's law firm. Compounding the coincidence was Mr. White's hiring of Kowalsky's law firm. So the motive for bias was established.

Kowalsky then seemed to confirm Kinkade's concerns by giving the Whites two and three chances to bolster their claims and denied Kinkade's virtually uncontested claims based on non-payment. Kowalsky then awarded the Whites attorneys' fees after the Interim Award indicated that attorneys' fees were denied.

Disclosure by Kowalsky of these obvious conflicts was not enough. Disclosure at the outset of the arbitration would at least have permitted the parties to consider these facts in selecting or rejecting an arbitrator. But disclosure five years into the arbitration gave no such opportunity. Kinkade was in the obvious dilemma of either keeping its concerns to itself and letting the conflicts slide, or objecting to them and risking alienating Kowalsky. As the court concluded, "A party who pays a neutral arbitrator to prepare for, and then sit through, nearly 50 days of hearings over a five year period, deserves better treatment than this." So the 6th Circuit Court of Appeals affirmed the district court in vacating the arbitration award favoring the Whites.

As the court noted, the arbitration serves as a negative example that, it is hoped, other arbitrators will choose not to follow.