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Seventh Circuit Rejects Challenge To Appointment of Replacement Arbitrator Because Party Waited Until Conclusion of Arbitration

The United States Court of Appeals for the Seventh Circuit recently ruled that a party contesting the appointment of a replacement arbitrator — because an arbitrator resigned — must ask the district court to appoint the replacement under Section 5 of the Federal Arbitration Act (“FAA”) before proceeding with the arbitration instead of waiting until after the arbitration award. *WellPoint, Inc. v. John Hancock Life Ins. Co.*, No. 08-2283, 2009 WL ____ (6th Cir. August 7, 2009).

Background

The dispute in the arbitration arose out of WellPoint Health Networks’ purchase of certain business operations of John Hancock Life Insurance Company. The issue was whether WellPoint was obligated to make certain payments to Hancock.

The various purchase agreements required that any dispute be resolved through binding arbitration. As a result, WellPoint filed a demand for arbitration, asking the arbitrators to compel Hancock to disclose certain information about the contested books of business as well as to declare WellPoint’s rights and obligations under the purchase agreements. Hancock filed a counterdemand for arbitration and sought \$42.4 million in damages. The parties then appointed the arbitrators,

and an umpire was designated by the American Arbitration Association, as provided in the purchase agreements.

While discovery was ongoing, Hancock advised WellPoint that it would seek \$464.6 million in damages — more than a tenfold increase from the initial amount. Shortly thereafter, WellPoint retained new counsel and, for unknown reasons, requested that the arbitrator it had appointed resign. Hancock objected. However, after WellPoint confirmed that the hearing would not be delayed, the arbitrator formally asked the panel to authorize the withdrawal, and the panel did so.

WellPoint proposed two replacement arbitrators. Hancock objected to both. Shortly thereafter, the arbitrator appointed by Hancock suggested that WellPoint choose a candidate from three individuals proposed by the remaining panel members. Hancock appeared to accept this approach, and its counsel stated that the proposal was supported by the case law. WellPoint, on the other hand, rejected the idea at first but eventually accepted the arrangement. A replacement candidate was ultimately selected by WellPoint from the three proposed candidates.

Hancock subsequently renewed its objections to the resignation of WellPoint’s

initial arbitrator but acknowledged that the replacement candidate satisfied the requirements to serve as the arbitrator. Afterwards, the umpire advised the parties that the panel was “duly constituted” and the arbitration proceeded. The panel eventually ruled in favor of Hancock with respect to two out of the three books of business at issue and awarded \$26.4 million in damages plus additional amounts for offsetting balances and interest.

WellPoint sought confirmation of the award in federal district court. Hancock, however, argued that the award should be vacated based on its earlier objection that the replacement arbitrator was not selected in accordance with the arbitration provisions in the purchase agreements. The district court rejected Hancock’s challenge and confirmed the award, which resulted in Hancock’s appeal.

Court’s Decision

Hancock claimed that the award should be vacated under Section 10 of the Federal Arbitration Act because the panel exceeded its authority in accepting the arbitrator’s resignation, allowing WellPoint to choose a replacement, and eventually appointing WellPoint’s new candidate. In evaluating this argument, the court reviewed the arbitration provisions, which were silent on the process for replacing a panel member. As a result, Hancock asserted that the arbitration process should have begun anew after the resignation.

The Seventh Circuit rejected Hancock’s argument because it was “inflexible and wasteful....” Turning to the FAA, the court found that Section 5 applies to “the mid-stream loss of an arbitrator.” That section provided that, “in filling a vacancy,” as well as in other circumstances, the court should appoint an arbitrator upon the application of either party to do so. The court held that “[n]o ‘reservation of right’ to challenge the issue on appeal absolves Hancock from this requirement.”

In addition, the approach advocated by Hancock would run afoul of Section 5 because it would require starting over instead of asking the court to appoint the replacement arbitrator. The court concluded that it would be inconsistent with the purpose of the FAA “to permit a party like Hancock to sit silently by while a substitute arbitrator is selected according to the procedure proposed by its own representative on the panel, and then raise an objection” after losing before the panel. To allow a party to challenge an award after the fact — instead of utilizing Section 5 — would result in a “heads I win, tails you lose” system.

The court also rejected Hancock’s claim that a court proceeding under Section 5 for replacement arbitrators would result in “the specter of endless interlocutory appeals, which would delay the arbitration....” Though this mechanism may “temporarily affect the arbitration, it is far less efficient” to wait until after the award.

In addition, the court noted that there may be a case where Section 5 “cannot address the problem” or where a party “can show good cause to overcome a forfeiture” of the Section 5 process in favor of a challenge after the arbitration award pursuant to Section 10 of the FAA. However, this case did not merit any such exception, given “Hancock’s equivocal behavior” — that the substitution method was suggested by its arbitrator, the admission by Hancock’s counsel that case law supported the replacement proposal, Hancock’s acknowledgment that the new candidate met the necessary qualifications, and the decision by Hancock to wait until after the award to challenge the procedure.

Implications

This case is significant because — contrary to the case law precluding court involvement in the arbitration process until after an award is issued — the *WellPoint* court required a party contesting the appointment of a replacement candidate to utilize Section 5 under the FAA. *WellPoint* illustrates that there may be times when it is appropriate, and even necessary, to seek court intervention during the arbitration proceedings. Waiting until after an award to object to the replacement procedure would be considered too late under the court’s decision. The ruling also makes clear that, in general, an attempt to reserve a party’s rights based on its objections would be insufficient.

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