The Use of Arbitration to Recover Ill-Gotten Gains

By Mark H. Alcott*

New York State Bar Association, Global Conference
Tokyo, Japan November 2019

The hallmark of arbitration is its consensual nature. Arbitration proceedings are, after all, in derogation of the parties' right to adjudicate their dispute in a court of law. Parties cannot be compelled to forgo that right; they must agree to do so.

Accordingly, a party who has been defrauded or otherwise wrongfully deprived of assets can use arbitration as a vehicle for recovering ill-gotten gains from the alleged wrongdoer only if there is a valid, applicable contract between the parties, and it contains an arbitration clause covering the matter in dispute.

Usually arbitration occurs when the claim arises in the context of a commercial transaction between the parties, when the central allegation is that one or the other party to that transaction failed to perform its obligations, and when the underlying contract contains a dispute resolution clause calling for arbitration.

But suppose the claim goes beyond a mere failure to perform contractual obligations. Suppose there is a claim of fraud, embezzlement or some other wrongdoing that led to ill-gotten gains by one of the contracting parties. There are three issues that might call

* The author acknowledges with thanks the assistance of Patrick J. McCusker and William Taylor in the preparation of this article.

into question the use of the contract's arbitration clause to resolve such a dispute.

First: If the fraud or misconduct is severe, doesn't that vitiate the contract; and once the contract falls, doesn't the arbitration clause fall with it?

The short answer to that question is "no" – because of the doctrine of severability. Under that doctrine, the invalidity of the contract in chief does not, *ipso facto*, invalidate the arbitration clause contained within it, and vice versa. A challenge to the arbitration clause must stand or fall on its own merits.[1]

Under the Federal Arbitration Act, which embraces the doctrine of severability, the validity of a contract so challenged would be for the arbitrators to decide; whereas, under FAA Section 4 (9 U.S.C. 54), the court would resolve any such challenge to the arbitration clause.[2]

Second: The standard arbitration clause in a commercial contract provides for the arbitration of "any dispute arising under this agreement" or "any claim for the alleged failure to perform this agreement", or words to that effect.[3] In other words, the parties agree to arbitrate a garden variety breach of contract claim.

---

[1] *See Separability of Arbitration in US Arbitration*, WEST LAW PRACTICE NOTES; *Buckeye Check Cashing Inc.* v. *Cardegua*, 546 U.S. 449, 445-46 (2006) (contract claimed to be usurious and therefore invalid); *Prima Paint Corp*. v. *Flood & Conblin Mfg. Co.*, 388 U.S. 395, 403-04 (1967) (alleged fraud). *But see Opals on Ice Lingerie* v. *Body Lines, Inc*., 320 F3d. 362 (2d Cir. 2003) (allegedly forged signatures).

[2] *Opals*, 320 F.3d 362.

[3] *See, e.g.*, the standard arbitration clause recommended by the ICDR: "Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be determined by arbitration administered by

But a claim for ill-gotten gains is likely to sound in tort, not contract. Is it covered by such an arbitration clause?

Although this issue is not as clear cut as the severability issue, the answer is probably "yes" – especially because the courts tend to favor arbitration and interpret arbitration clauses generously.

An analogous issue was decided by the Tenth Circuit in *Zink* v. *Merrill Lynch Pierce Fenner & Smith*.[4] There the parties engaged in certain securities transactions in 1980; no arbitration clause existed at that time. Later, in 1982, they entered into a securities account agreement providing that "any controversy between us arising out of your business or this agreement shall be submitted to arbitration . . . ."[5] In 1983, a dispute erupted about the 1980 transaction. The Tenth Circuit, relying on "the principal that arbitration agreements are favored and are to be broadly construed with doubts being resolved in favor of coverage," held that "the arbitration agreement is clearly broad enough to cover the dispute at issue."[6] Not much reasoning there; the Court simply resorted to "clearly" to resolve the issue.

Third: The kind of misconduct that results in ill-gotten gains can lead to remedies going beyond those awarded in standard breach of contract cases – including, in particular, punitive damages. It that a permissible result in arbitration? The availability of punitive damages in arbitration is a much discussed issue. Today, sophisticated

---

the International Centre for Dispute Resolution in accordance with the its International Arbitration Rules." ICDR, INTERNATIONAL DISPUTE RESOLUTION PROCEDURES, p 8.

[4] 13 F.3d 330 (10th Cir. 1993).

[5] *Id*. at 331.

[6] *Id*. at 332.

practitioners generally cover the point in their arbitration clause. In the absence of a specific provision in that clause, or in the rules of the arbitral institution,[7] punitive damages in the "ill-gotten gains" case we are discussing would be treated no differently than in any other arbitration.

The above discussion addresses the case of allegedly ill-gotten gains obtained where there is an existing arbitration agreement. But suppose the purported misconduct occurs, and the controversy erupts, in the absence of such agreement. Suppose the parties agree *post facto* to arbitrate their dispute. Is that possible, feasible, desirable – and does it ever happen?

The answer is yes, yes, yes – and absolutely yes.

Why would an alleged wrongdoer agree to such a thing? Because of that key word – "alleged". An outright bandit or international pirate would presumably never agree to anything, could never be found for the purpose of negotiating an agreement, and would not comply with such an agreement even if made. But, otherwise, an entity or person accused of obtaining ill-gotten gains might elect or agree, after the controversy arises, to go to arbitration for the same reason one would opt for it before the fact: to obtain a relatively swift, low-cost, confidential alternative dispute resolution mechanism.[8] Indeed, a post facto arbitration agreement – if one can be reached – has

[7] *See* AMERICAN ARBITRATION ASSOCIATION, COMMERCIAL ARBITRATION RULES, RULE 47, which appears to leave this issue to the arbitrator.

[8] Whether these perceived advantages still exist is worth an article of its own, or, for that matter, a conference of its own. Many such conferences have in fact been held.

certain obvious benefits not available in the pre-dispute phase. Such an agreement avoids the inevitable dilatory controversy about whether the claim is arbitrable – including the very issues discussed above. And, it allows the parties to customize the ADR procedures to fit the needs of the specific case that has arisen.

Is a post-dispute agreement to arbitrate enforceable? Will an award resulting from such a proceeding be enforced by the courts – in particular, in a cross-border context, under the New York Convention?

The answer to both of these questions is clearly yes.

Neither the New York Convention nor the FAA draw any distinction between pre- and post-dispute arbitration agreements. The plain text of both the FAA and the Convention confirm this point:

- Section 2 of the FAA specifically provides that, in addition to standard arbitration clauses embedded in contracts, "an agreement in writing to submit to arbitration an *existing controversy* arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable . . ."[9]

- 9 U.S.C. § 202, part of the legislation that implemented the New York Convention, notes that any arbitration agreement as defined by Section 2 falls under the Convention, again

[9] 9 U.S.C.A. § 2 (emphasis added).

supporting the proposition that post-dispute agreements are enforceable under each regime.

- From Article II, Section 1 of the New York Convention: "Each Contracting State shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences *which have arisen or may arise* between them in respect of a defined legal relationship…" (emphasis added).

Whether an agreement to arbitrate is reached before or after the dispute arises does not change how either an arbitrator or court determines the question of arbitrability.

- A reporters' note to Section 1-1 of the Restatement (3d) of the US Law of International Commercial Arbitration observes that "[t]he rules governing international commercial arbitration do not normally differ according to whether the agreement has a pre-dispute or post-dispute character."[10]

- If anything, the inquiry may be simpler post-dispute, because the question of separability does not need to be considered when the arbitration agreement is not embedded in the original contract. Thus, the parties do not need to worry that some issue relating to the validity of the initial commercial contract might threaten the arbitrator's jurisdiction.

[10] *See* RESTATEMENT (THIRD) OF US LAW OF INTERNATIONAL COMMERCIAL ARBITRATION § 1-1, n. d (AM. LAW INST. 2011).

- The Western District of Texas, for example, noted in dicta that "[t]he arguments in favor of arbitration only get stronger in a case such as this where the agreement to arbitrate is reached after the dispute arises and both parties are represented by counsel."[11].

All of which brings us full circle to the opening point: Arbitration is a creature of contract, and, by carefully drafting their arbitration agreement – either pre *or* post dispute – the parties can get the kind of dispute resolution process they need.

Suppose the parties do opt for arbitration. Suppose further that their proceeding is seated outside the United States, but that material evidence – documentary or testimonial – is located within the United States. Can the parties access that evidence by availing themselves of American discovery tools?

The answer is maybe.

The most likely such device – not as well-known as it should be – is 28 U.S.C.§ 1782. As summarized by the United States Supreme Court in *Intel* v. *Advanced Micro Devices, Inc.*:

> "Section 1782(a) provides that a [U.S.] federal district court 'may order' a person 'resid[ing]' or 'found' in the district to give testimony or produce documents 'for use in a

[11] *Schofield* v. *Int'l Dev. Grp. Co. Ltd.*, No. SA-05-CA-1110-RF, 2006 WL 504058, at *3 (W.D. Tex. Feb. 2, 2006).

> foreign or international tribunal . . . upon the application of any interested person.'").[12]

Although it is often challenging to meet the requirements of Section 1782(a) – as elaborated in *Intel* – this provision can be a very effective tool when those requirements *are* met *and* when the foreign proceeding is a litigation pending in a traditional court.[13]

When it comes to arbitration, however, the issue is more complex.

Courts have been uncertain about whether the term "tribunal," as it is used in the statute, applies to arbitration proceedings. Prior to the Supreme Court's decision in *Intel*, there was a substantial body of lower court decisions finding that private commercial arbitrations were not within the ambit of the statute; in particular, holdings in the Second and Fifth Circuits articulated this view.[14] Dicta in *Intel*, however, suggested more flexibility in construing the term "tribunal." In the course of finding that a European regulatory body qualified as a "tribunal," the *Intel* Court emphasized that Congress had revised Section 1782 by, among other things, replacing the phrase "in any judicial proceeding pending in any court in a foreign country" with the words "in a proceeding in a foreign or international tribunal."[15] The

---

[12] 524 U.S. 241 (2004).
[13] *See, e.g., Texas Keystone, Inc.* v. *Prime Nat. Res., Inc.*, 694 F.3d 548, 554 (5th Cir. 2012) ("[O]nce an interested party makes the requisite showing that it has met the statutory factors, the district court judge has the discretion to grant the application seeking the authority to issue subpoenas."); *Lancaster Factoring Co. Ltd* v. *Mangave*, 90 F 3d (2d Cir. 1996) (holding that an Italian bankruptcy case is a "proceeding" and the bankruptcy trustee's agent is an "interested person" within the ambit of Section 1782, and affirming the district court's order directing compliance with discovery subpoena).
[14] *See Nat'l Broad Co.* v. *Bear Stearns & Co.*, 165 F.3d 184 (2d Cir. 1998); *Rep. of Kazakhstan* v. *Biedermann Int'l*, 168 F. 3d 880 (5th Cir. 1999).
[15] *See Intel*, 542 U.S. at 248-49.

Court further noted legislative history "[which] explains that Congress introduced the word 'tribunal' to ensure that 'assistance' is not confined to proceedings before conventional courts, but extends also to 'administrative and quasi-judicial proceedings.'"[16]

But *Intel* did not involve an arbitration. Lower courts are split as to whether the *Intel* dicta is a sufficient mandate to read "tribunal" in Section 1782 to include private commercial arbitration. Some district courts have held that it is,[17] explicitly rejecting the contrary prior holdings in the Second and Fifth Circuits.[18] Other courts have held that *Intel* did not overturn the rulings in the Second and Fifth Circuits excluding private commercial arbitration from the ambit of Section 1782, since it did not directly address the issue.[19]

The Second and Fifth Circuits had considered the same legislative history before *Intel* but did not reach the expansive reading suggested by *Intel*.[20] Even after the *Intel* decision, the Fifth Circuit reiterated its holding, notwithstanding the *Intel* dicta, on the ground that it could not

---

[16] *Id.* at 249.

[17] *See, e.g.*, *In re Babcock*, 583 F. Supp. 2d 233, 238 (D. Mass. 2008) (declining on other grounds to enforce a Section 1782 request, but holding that under *Intel*, private arbitral bodies qualify as a "tribunal"); *In re Hallmark Capital Corp.*, 534 F. Supp. 2d 951, 955 (D. Minn. 2007) ("[The approach in *Intel*] suggests that the Court would not restrict the scope of 'tribunal' to necessarily preclude assistance for use in private arbitrations."); *In re Roz Trading Ltd*., 469 F. Supp. 2d 1221, 1224 (N.D. Ga. 2006) ("[*Intel*] provided sufficient guidance for this Court to determine that arbitral panels . . . are 'tribunals' within the statute's scope.").

[18] *See In re Roz Trading Ltd.*, 469 F. Supp. 2d at 1228 ("[T]his Court declines to follow the Second and Fifth Circuits because, in light of *Intel*, they are not persuasive authority.").

[19] *See, e.g.*, *In re Servotronics*, No. 2:18-mc-00364-DCN, 2018 WL 5810109, at *4 (D. S.C. Nov. 6, 2018) ("[S]tretching the language of *Intel* to apply to private arbitration is simply too far of a reach absent more explicit language from Congress or the Supreme Court."); *Ex re Application of Winning (HK) Shipping Co*., No. 09–22659–MC, 2010 WL 1796579, at *7 (S.D. Fla. Apr. 30, 2010); *In re Operadora DB Mexico, S.A. de C.V.*, No. 6:09–cv–383–Orl–22GJK, 2009 WL 2423138, at *6 (M.D. Fla. Aug. 4, 2009); *In re Arbitration in London, England*, 626 F. Supp. 2d. 882, 884 (N.D. Ill. 2009); *La Comision Ejecutiva Hidroelectrica Del Rio Lempa* v. *El Paso*, 617 F. Supp. 2d. 481, 486 (S.D. Tex. 2008).

[20] *See Nat'l, Broad Co. v. Bear Stearns & Co.*, 165 F.3d 184, 190 (2d Cir. 1999); *Republic of Kazakhstan* v. *Biedermann*, 168 F. 3d 880, 882 (5th Cir. 1999).

overrule the decision of a prior panel "unless such overruling is unequivocally directed by a controlling Supreme Court precedent."[21] No other circuit court of appeals has taken up this issue since *Intel* was decided; however, the issue is pending on appeal in the Fourth Circuit.[22]

So, keep an eye out.

One last point: It is settled that Section 1782 *does* apply to arbitral proceedings in a forum reviewable by a court of the host jurisdiction. In making this distinction, courts have analyzed the relevant procedural and strategic scheme to determine the availability of judicial review, and, on that basis determined the application of Section 1782. As demonstrated by the decisions collected below, this issue is not always free from doubt. The review of the case law in *Winning* is particularly enlightening. [23]

---

[21] *El Paso Corp.* v. *La Comision Ejecutiva Hidroelectrica Del Rio Lempa*, No. 08–20771, 2009 WL 2407189, at *3 (5th Cir. Aug 6, 2009) (quotation omitted).

[22] *See In re Servotronics*, No. WL 5810109, at *4.

[23] *See In re Operadora DB Mexico*, 2009 WL 2423138, at *9 (finding that an arbitral panel constituted under the International Chamber of Commerce International Court of Arbitration is not a "tribunal" for Section 1782 purposes in part because judicial review is narrowly limited to modifying the form of the award); *La Comision Ejecutiva Hidroelectrica Del Rio Lempa*, 617 F. Supp. 2d. at 485-86 (distinguishing private arbitral proceedings from a "quasi-adjudicative proceeding before review by true judiciary powers"); *In re an Arbitration in London, England*, 626 F. Supp. 2d. at 885 (distinguishing the case before it form *Intel* partly on the grounds that "private arbitrations are generally considered alternatives to, rather than precursors to, formal litigation"); *Ex re Application of Winning (HK) Shipping Co*., 2010 WL 1796579, at *8 ("[I]n *Intel*, the Supreme Court primarily focused on the judicial reviewability of the decision of the European Commission in determining that the body was a foreign or international tribunal under Section 1782.").