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UNITED STATES DISTRICT COURT
For the Northern District of California

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

THE THOMAS KINKADE COMPANY, f/k/a
MEDIA ARTS GROUP, INC., a California
corporation and RICHARD F. BARNETT,

No. C 06 7034 MHP

Plaintiffs,

v.

KAREN HAZLEWOOD, JEFF SPINELLO, and
THOMAS KINKADE AT THE DOWNTOWN
MALL, LLC, a Virginia corporation,

Defendants.

MEMORANDUM & ORDER
Re: Plaintiffs' Motion to Vacate
Arbitration Award

Plaintiffs The Thomas Kinkade Company (“TKC”) and Richard F. Barnett (collectively “plaintiffs”) bring this motion vacate an arbitration award issued in favor of Karen Hazlewood, Jeff Spinello and Thomas Kinkade at the Downtown Mall, LLC (collectively “defendants”) in October 2006. Plaintiffs claim that the award exceeds the arbitrators’ powers, that the award was procured by undue means and fraud, that the neutral arbitrator was biased, that the defendants’ non-neutral arbitrator was corrupt, that the award was untimely issued and therefore null, that the award manifests complete disregard for the law, and that the damage award is wholly speculative and irrational. Having considered the arguments of the parties and for the reasons set forth below, the court enters the following memorandum and order.

1 BACKGROUND¹

2 I. Business Dealings Between the Parties

3 Plaintiff The Thomas Kinkade Company, formerly known as Media Arts Group, Inc.,² is a
4 California corporation with its principal place of business in Morgan Hill, California. Plaintiff
5 manufactures, markets, distributes and licenses reproductions of artwork based on the paintings of
6 Thomas Kinkade.³ Levitt Dec. ¶¶ 13–14. Richard Barnett, a California resident, is the Senior Vice
7 President of TKC and held the same position with Media Arts Group, Inc. Barnett helped create and
8 manage the “Signature Gallery Program,” which serves as the main channel of distribution for
9 TKC’s merchandise. Id. ¶ 16.

10 Defendants Karen Hazlewood and Jeff Spinello (collectively “the Hazlewoods”) are
11 individuals residing in Virginia. Defendant Thomas Kinkade at the Downtown Mall, LLC is or was
12 a Virginia limited liability company owned and operated by the Hazlewoods.

13 Pursuant to the Signature Gallery Program, TKC entered into two “Signature Gallery Dealer
14 Agreements” (“Dealer Agreements”) with the Hazlewoods in January 1999 and March 2000. Id. ¶¶
15 22–23. The Hazlewoods opened a gallery in Charlottesville, Virginia in March 1999 pursuant to the
16 first agreement and a second gallery in Fredericksburg, Virginia in December 2000 pursuant to the
17 second agreement. Id. Both galleries failed and were closed in March and November 2003,
18 respectively.

19 The Dealer Agreements both contained identical arbitration clauses. Id. ¶¶ 31–35. The
20 Agreements provided:

21 **THE PARTIES AGREE THAT ALL DISPUTES BETWEEN**
22 **THEM SHALL FIRST BE SUBMITTED FOR INFORMAL**
23 **RESOLUTION TO THEIR CHIEF EXECUTIVE OFFICERS,**
24 **OR IF NO CHIEF EXECUTIVE OFFICER, TO THE OWNERS.**
25 **ANY REMAINING DISPUTE SHALL BE SUBMITTED TO A**
26 **PANEL OF THREE (3) ARBITRATORS WITH EACH PARTY**
27 **CHOOSING ONE (1) PANEL MEMBER, AND THE THIRD**
28 **PANEL MEMBER BEING CHOSEN BY THE FIRST TWO (2)**
PANEL MEMBERS. THE PROCEEDINGS SHALL BE
CONDUCTED IN ACCORDANCE WITH THE COMMERCIAL
ARBITRATION RULES OF THE AMERICAN ARBITRATION
ASSOCIATION. THE AWARD OF THE ARBITRATORS
SHALL INCLUDE A WRITTEN EXPLANATION OF THEIR

1 **DECISION. THIS ARBITRATION PROCEEDING WILL BE**
 2 **BINDING UPON THE PARTIES.**

3 Id., Exhs. 42 at 3920 & 43 at 3934 (all emphasis in original). The Agreements further provided for a
 4 period within which to submit disputes:

5 Notice of all disputes shall be submitted to the other party within one
 6 (1) year from the date facts occur which create the basis for such
 7 dispute. Failure to provide notice of any dispute within such time
 8 shall result in waiver of right to submit any dispute relying upon such
 9 facts.

10 Id., Exhs. 42 at 3920 & 43 at 3933–34. The Agreements further placed limitations on damages
 11 available under the Agreements. In the section titled “Remedies and Liabilities,” the Agreements
 12 provided, in part:

13 **IN NO EVENT SHALL EITHER PARTY BE LIABLE**
 14 **HEREUNDER FOR ANY INDIRECT, INCIDENTAL OR**
 15 **CONSEQUENTIAL DAMAGES (INCLUDING LOST**
 16 **BUSINESS PROFITS) SUSTAINED BY THE OTHER PARTY**
 17 **OR ANY OTHER INDIVIDUAL OR ENTITY FOR ANY**
 18 **MATTER ARISING OUT OF, ABOUT, OR PERTAINING TO**
 19 **THE SUBJECT MATTER OF THIS AGREEMENT.**

20 Id., Exhs. 42 at 3919 & 43 at 3933 (all emphasis in original). The Dealer Agreements contain choice
 21 of law provisions for California law. Id., Exhs. 42 at 3920 & 43 at 3934.

22 II. The Arbitration Proceeding

23 The Hazlewoods initiated an arbitration with the American Arbitration Association (“AAA”)
 24 on September 26, 2003 against TKC, Barnett, and nineteen other individual respondents. Id. ¶ 37.
 25 The claim set forth twelve causes of action, including fraudulent concealment. Id. Specifically, the
 26 claim alleged that the respondents had fraudulently concealed three facts: (1) that the Dealer
 27 Agreements were franchise agreements; (2) that The Hazlewoods would be subject to TKC’s Retail
 28 Sales Policy; and (3) that Barnett and other TKC employers were paid commissions on sales of art to
 Signature Dealers. Id. ¶ 38. TKC filed a counterclaim on November 22, 2003, alleging that the
 Hazlewoods owed \$25,000 for merchandise that had been delivered to them. The Hazlewoods filed

1 a First Amended Claim (“FAC”) on January 2, 2004, adding their limited liability company as a
2 claimant. Id. ¶ 44, Exh. 40 (hereinafter “FAC”).

3 As provided for in the Dealer Agreements, each side appointed a non-neutral arbitrator to the
4 Arbitration Panel (“the Panel”). Defendants appointed Mayer Morganroth, a Detroit, Michigan
5 attorney who has also been selected as the non-neutral arbitrator in a separate arbitration against
6 TKC involving another Signature Dealer (“the White arbitration”). Id. ¶ 41. TKC appoint Los
7 Angeles attorney Richard Chernick as its non-neutral arbitrator. Id. ¶ 40. Morganroth and Chernick
8 then named James Grossman as the non-neutral arbitrator. Id. ¶ 43. According to plaintiffs,
9 Morganroth and Grossman became “fast friends.” Id. ¶ 43. Grossman allegedly picked up
10 Morganroth at his hotel each morning and drove him to the arbitration, and the two men “almost
11 always ate lunch together.” Id. Defendants allege that Morganroth used this time with Grossman to
12 improperly influence him, including by misrepresenting events in the White arbitration. Id.

13 On May 6, 2004, the Panel granted portions of TKC’s motion to dismiss, dismissing eighteen
14 of the individual plaintiffs (including Thomas Kinkade). Id. ¶¶ 53–55. As the arbitration proceeded,
15 the parties engaged in additional motion practice and extensive discovery. Id. ¶ 45. The arbitration
16 hearings began in December 2004. Id. ¶ 76. On April 6, 2005, defendants filed a motion for leave
17 to file a Second Amended Claim (“SAC”), seeking to reinstate Kinkade as a respondent and
18 presenting new allegedly concealed facts. Id. ¶¶ 113, 122, Exh. 83 (hereinafter “SAC”). The Panel
19 denied the motion orally on April 18, 2005. Id. ¶ 112, Exh. 14, Transcript, Day 12 at 2731:12–17.
20 The First Amended Complaint therefore remained the operative pleading. Defendants proceeded
21 with their claim on a theory of lost profits rather than rescission. Id. ¶ 121. Defendants hired a
22 damages expert to testify as to the proper measure of damages. Id.

23 The parties filed closing briefs with the Panel on November 12, 2005. Id., Exhs. 50 & 85.
24 Plaintiffs assert that defendants’ closing brief concentrated almost exclusively on the alleged
25 instances of fraudulent concealment that had been set forth only in the rejected Second Amended
26 Claim. Id. ¶ 122, Exh. 85. Accordingly, in its reply closing brief, TKC argued that the proposed
27 Second Amended Claim was not the operative pleading, that TKC’s discovery and its entire case
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1 were directed to allegations of the First Amended Claim, and argued that the Panel could not rule on
2 the rejected claims in the Second Amended Complaint. Id. ¶ 124, Exh. 86. After closing arguments
3 on December 5, 2005, TKC made four separate offers of proof, and requested additional hearing
4 days to present evidence relevant to the allegations from the Second Amended claim. Id. ¶ 125,
5 Exh. 88. The Panel denied the additional hearing dates, and the majority rejected each of the four
6 offers of proof. Id. ¶ 126.

7
8 III. Alleged Misconduct During the Arbitration Proceeding

9 Plaintiffs have identified numerous incidents during the arbitration proceeding that they
10 claim support vacating the award. These include purported misconduct by Morganroth, Grossman,
11 and defense counsel.

12
13 A. Morganroth

14 Plaintiffs allege that defendants hired Morganroth as an arbitrator on a *de facto* contingency
15 fee basis, and that this was not disclosed during the proceeding. Plaintiffs admit that they do not
16 know the exact nature of Morganroth's fee arrangement due to an inability to take discovery related
17 to the agreement during the arbitration proceeding. However, plaintiffs allege that Morganroth was
18 never paid in full by Hazlewood and Spinello, and is currently owed at least \$199,000. Id. ¶ 42.
19 According to plaintiffs, "Mr. Morganroth understood from the very beginning that he would not be
20 paid unless the Hazlewoods won the arbitration and won big." Mot. at 9. Plaintiffs claim that this
21 created a financial interest in the outcome of the arbitration that Morganroth was required to disclose
22 pursuant to Canon X of the AAA Code of Ethics for Arbitrators in Commercial Disputes (hereinafter
23 "Canon X").

24 In addition, plaintiffs claim that Morganroth violated Canon X by failing to "act in good faith
25 and with integrity and fairness." Specifically, plaintiffs assert that Morganroth (1) falsely accused
26 TKC's counsel of criminal conduct,⁴ (2) repeatedly interrupted counsel in a rude and aggressive
27 way, (3) "beat up on TKC's witnesses," including interrupting and badgering TKC's Chief Financial
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1 Officer, and (4) interjected false claims about events in the White arbitration, including falsely
2 implying that the White Arbitration Panel had found TKC and its counsel liable for discovery
3 abuses. Id. ¶¶ 96–107.

4
5 B. Grossman

6 Plaintiffs also allege improper conduct on the part of Grossman, the neutral arbitrator. One
7 of plaintiff’s principal contentions regarding Grossman is that Grossman, as chair of the Panel,
8 improperly changed the rules regarding time limits in the midst of the proceedings such that
9 defendants were afforded the unfair advantage of additional time. Id. ¶¶ 78–80. According to
10 plaintiffs, when TKC’s counsel objected to the change in the rules and reminded Grossman that the
11 Panel had placed time limits on each parties case months earlier, Grossman replied, “In your mind.”
12 Id. ¶ 80, Exh. 21, Transcript, Day 19 at 4594:22–4595:3. Plaintiff further claims that Grossman
13 forced TKC’s counsel to agree to the rule change by threatening to rule against TKC on a pending
14 discovery motion. Id. ¶ 82, Exh. 21, Transcript, Day 19 at 4597:21–4598:11.⁵

15 In addition to the incident regarding the timing rule change, plaintiffs allege that Grossman’s
16 conduct demonstrated bias in favor of Hazlewood. Specifically, plaintiffs allege that on August 1,
17 2006, after a “bitterly contested, two-day hearing” on defendants’ request for more than five million
18 dollars in fees and costs, “Mr. Grossman gave a loving embrace and kiss to Ms. Hazlewood.” Mot.
19 at 3; André Dec. ¶ 3; Levitt Dec. ¶ 12; Zorina Dec. ¶ 2. Plaintiffs further claim that the alleged bias
20 exposed by this act of physical affection “infected the entire hearing.” Mot. at 3.

21
22 C. Defense Counsel

23 Plaintiffs assert that defense counsel (“the Yatooma Firm”) engaged in substantial
24 misconduct during the arbitration proceeding. The Yatooma Firm was sanctioned on multiple
25 separate occasions by the Panel. See Levitt Dec., Exh. 1 (hereinafter “Final Award”) at 13. The
26 Yatooma Firm’s alleged transgressions include: (1) repeated ex parte contact with an adverse party
27 represented by TKC’s counsel, (2) theft of a privileged email from TKC’s headquarters during an
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1 inspection, (3) threats of criminal prosecution against Kinkade during his deposition, and (4) abusive
2 tactics and language toward opposing counsel. Id., ¶¶ 60, 62–63 & 65, Exhs. 70 & 71. Additionally,
3 plaintiffs allege that the Yatooma Firm devised an elaborate scheme involving former TKC
4 employee Terry Sheppard, whereby Sheppard secretly monitored the White arbitration proceeding
5 and transmitted cross-examination questions to the Yatooma Firm lawyers in real time. Id., Exhs.
6 66–74. Plaintiffs allege that Sheppard was paid for his involvement in this scheme, but that when
7 Sheppard testified in the Hazlewood proceeding nine months earlier had explicitly denied receiving
8 compensation from Mr. White, and was presented as a neutral, third-party witness despite being a
9 paid consultant. Id., ¶ 68.⁶

10
11 IV. The Arbitration Award

12 The Panel issued a Majority Interim Award on February 23, 2006, finding that plaintiffs were
13 liable for fraud in the amount of \$860,000 and denying their counterclaim. Id., Exh. 2 (hereinafter
14 “Interim Award”) at 12. Defendants were afforded an opportunity to make an application for
15 attorneys’ fees, costs, expenses and interest. Id. at 13. Additional discovery, briefing, and hearings
16 took place regarding the fee application, and a final award was transmitted to the parties on October
17 10, 2006.⁷ Id., Exh. 1.

18 The Final Award confirmed that TKC and Barnett were liable for fraud, and dismissed the
19 remaining claims and counterclaims. Id. The factual bases for fraud liability were: (1) plaintiffs
20 “painted an unrealistic and misleading picture of the prospects of success for a dealer”; (2) Barnett
21 failed to disclose his own “special relationship with Thomas Kinkade” and the resulting “lucrative
22 advantages”; (3) failure on the part of plaintiffs to disclose the “inherent risk involved in becoming
23 an art gallery owner”; and (4) plaintiffs’ failure to advise defendants of relevant changes in financial
24 conditions regarding corporate stores and other Signature Gallery dealers which impacted the
25 information that plaintiffs initially provided to defendants. Id. at 9. The majority further found that
26 Barnett was responsible for the misconduct of a purportedly independent financial consultant. Id. at
27 10.

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1 Additionally, the majority determined that “any limitations on damages contained in” the
2 Dealer Agreements “would be of no force or effect” in light of the majority’s finding of fraud in the
3 inducement of the contract. Id. at 5. The majority further found that the disputes underlying
4 defendants’ claims were brought to the attention of plaintiffs as they arose, and that the fraud claims
5 were not barred by the statute of limitations. Id. at 6–7, 10. With regard to Terry Sheppard, who
6 was allegedly involved in a deceptive scheme with the Yatooma Firm, the majority stated that it
7 “gave little if any weight to Sheppard or his testimony.” Id. at 11.

8 In determining damages, the majority stated that while it “f[ound] some merit in the
9 Claimants’ experts [sic] arguments,” it “determined that there must be a significant discount from
10 the numbers provided by the Claimants’ expert in determining damages for a number of reasons.”
11 Id. The majority then discussed four concerns tending to discredit the expert’s estimations, and
12 stated that it would “reduce the award by these factors described above which Claimants’ expert left
13 to the Panel to determine.” Id. at 11–12. The final damage figure was \$860,100, comprised of
14 \$122,500 in “out of pocket expenses” and \$737,600 in “loss of income” and “the value of the
15 possible sale of the business.” Id. at 12.

16 In addition to these fraud damages, the Final Award added \$900,000 in attorneys’ fees, and
17 allocated \$200,000 of Morganroth’s compensation to be paid by plaintiffs. Id. at 16. The final
18 award also included awards of administrative fees, witness fees, and an allocation of the neutral
19 arbitrator’s compensation. Id.

20

21 LEGAL STANDARD

22 The Federal Arbitration Act (“FAA”), 9 U.S.C. sections 1 et seq., allows a district court to
23 vacate the decision of an arbitration panel in four situations:

- 24 (1) where the award was procured by corruption, fraud, or undue
25 means;
26 (2) where there was evident partiality or corruption in the arbitrators,
27 or either of them;
28 (3) where the arbitrators were guilty of misconduct in refusing to
 postpone the hearing, upon sufficient cause shown, or in refusing to
 hear evidence pertinent and material to the controversy; or of any

1 other misbehavior by which the rights of any party have been
 2 prejudiced; or
 3 (4) where the arbitrators exceeded their powers, or so imperfectly
 4 executed them that a mutual, final, and definite award upon the subject
 5 matter submitted was not made.

6 9 U.S.C. § 10(a)(1)–(4). In addition to these statutory bases for vacatur, a federal court may vacate
 7 an arbitration award if “the award itself is ‘completely irrational’ or ‘constitutes manifest disregard
 8 of the law.’” Coutee v. Barington Capital Group, L.P., 336 F.3d 1128, 1132–33 (9th Cir. 2003)
 9 (quoting G.C. & K.B. Invs., Inc. v. Wilson, 326 F.3d 1096, 1105 (9th Cir. 2003)). In any case,
 10 “judicial review of an arbitration award is both limited and highly deferential.” Sheet Metal
 11 Workers’ Int’l Ass’n Local Union No. 359 v. Madison Indus., Inc., of Az., 84 F.3d 1186, 1190 (9th
 12 Cir. 1996). “Neither erroneous legal conclusions nor unsubstantiated factual findings justify federal
 13 court review of an arbitral award” Kyocera Corp. v. Prudential-Bache Trade Servs., Inc., 341
 14 F.3d 987, 994 (9th Cir. 2003). This court reviews an arbitrator’s award cognizant of the repeated
 15 admonitions by the Supreme Court and the Ninth Circuit that section 10 is to be interpreted
 16 narrowly. See, e.g., First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 943 (1995) (when the
 17 parties agree that an issue should be resolved by arbitration “the court should give considerable
 18 leeway to the arbitrator, setting aside his or her decision only in certain narrow circumstances”); see
 19 also Todd Shipyards Corp. v. Cunard Line, Ltd., 943 F.2d 1056, 1060 (9th Cir. 1991) (discussing
 20 “Supreme Court authority strictly limiting federal court review of arbitration decisions”).

21 DISCUSSION

22 I. Whether the Majority Exceeded Its Powers

23 The Federal Arbitration Act allows vacatur “[w]here the arbitrators exceeded their powers, or
 24 so imperfectly executed them that a mutual, final, and definite award upon the subject matter
 25 submitted was not made.” 9 U.S.C. § 10(a)(4). This subsection has been interpreted to allow a court
 26 to vacate an arbitration award where the arbitrators exceeded their authority by ruling on a matter
 27 not submitted to them or acting outside the scope of the contractual agreement. See Michigan Mut.
 28 Ins. Co. v. Unigard Sec. Ins. Co., 44 F.3d 826, 830 (9th Cir. 1995). In order to determine that

1 arbitrators did not exceed their authority, courts must ensure that an award is based on the words of
2 the contract and the conduct of the parties. Id. at 831 (quoting Edward Hines Lumber Co. of Or. v.
3 Lumber & Sawmill Workers Local No. 2588, 764 F.2d 631, 635 (9th Cir. 1985)).

4 Plaintiffs assert that the majority exceeded its powers in four respects. First, plaintiffs claim
5 that the Panel improperly heard disputes for which no notice was given. Second, plaintiffs assert
6 that the Panel improperly awarded lost profits and consequential damages, which are prohibited by
7 the Dealer Agreements. Third, plaintiffs argue that the Panel's award of non-neutral arbitrator fees
8 was unauthorized. Finally, plaintiffs assert that the Final Award was untimely and therefore null.

9
10 A. Notice

11 The Dealer Agreements provided that notice of any dispute must be given within one year of
12 the occurrence of the facts underlying the dispute, and that failure to give such notice will result in
13 waiver of the right to submit that dispute to arbitration.⁸ Levitt Dec., Exhs. 42 at 3920 & 43 at
14 3933–34. The Dealer Agreements did not specify the manner of providing notice, only that disputes
15 were to be submitted first to CEOs or owners of each party for informal resolution. Plaintiffs assert
16 that defendants made no effort in the arbitration to prove that they gave any notice of the disputes
17 underlying any of their claims.

18 Both members of the Panel majority explicitly found that defendants had given some form of
19 notice to plaintiffs regarding their various problems. The Final Award states that “[m]any issues
20 arose between the parties subsequent to the entering into of the Deal Agreement and in many
21 instances the nature of the dispute was made known by Claimants to Media Arts. These issues have
22 been well documented in the extensive briefing in this matter.” Final Award at 7. Morganroth's
23 concurrence to the Interim Award likewise states that “[t]he issues regarding disputes being
24 submitted for informal resolution was heard in motions, and it was well supported that complaints
25 were made regarding these matters, which Claimants were aware of before filing proceedings.”
26 Interim Award, Morganroth Concurrence at 2. The Panel therefore found that the notice
27 requirements had been satisfied.

28

1 Because the Dealer Agreement is vague as to what constitutes sufficient notice, and because
2 the question of whether notice was provided is one of fact, plaintiff's challenge in this regard is an
3 attempt to overturn the Panel's interpretation of the Dealer Agreement and factual findings. The
4 court finds that plaintiff has not made a sufficient showing that the Panel exceeded its authority by
5 determining that notice had properly been given under the terms of the Dealer Agreement.⁹

6
7 B. Lost Profits

8 The Final Award included \$737,600 in "loss of income which could have been earned" and
9 "the value of the possible sale of the business." Final Award at 12. Plaintiffs claim that this portion
10 of the award goes beyond the Panel's authority because the Dealer Agreement expressly disclaims
11 liability for "indirect, incidental or consequential damages (including lost business profits)"
12 Levitt Dec., Exhs. 42 at 3919 & 43 at 3933. Resolution of this issue requires the court to determine
13 first whether the damages limitation is applicable, and if so, whether the damages limitation is
14 legally valid.

15
16 1. Applicability

17 In response to plaintiffs' argument regarding the operation of the damages limitation,
18 defendants claim that this provision is inapplicable to the arbitration proceeding, because it is a term
19 of the overall contract rather than the arbitration clause. Defendants assert that the Panel was
20 empowered to resolve "'all disputes' under the Agreement," Opp. at 32, and that this authority
21 encompassed the awarding of lost profits and other consequential damages. Furthermore, the
22 majority itself stated that the contractual limitations on damages were inoperative because the Dealer
23 Agreement was set aside based on fraud in the inducement. Final Award at 5.

24 In a commercial arbitration, "an arbitrator ' . . . does not sit to dispense his own brand of
25 industrial justice . . . (h)is award is legitimate only so long as it draws its essence from the . . .
26 agreement.'" Coast Trading Co. v. Pac. Molasses Co., 681 F.2d 1195, 1197-98 (9th Cir. 1982)
27 (quoting United Steelworkers of Am. v. Enter. Wheel & Car Corp., 363 U.S. 593, 597 (1960)).
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1 Here, the Panel’s authority extended over “all disputes” arising from the agreement. The agreement
2 itself explicitly and unequivocally states that plaintiff shall not “be liable *hereunder* for any indirect,
3 incidental or consequential damages (including lost profits) . . . *for any matter arising out of, about,*
4 *or pertaining to the subject matter of this agreement.*” Levitt Dec., Exhs. 42 at 3920 & 43 at 3933
5 (emphasis added). The damages limitation is therefore inextricably linked to the arbitration
6 provision, and the two clauses must be read together. The Panel, taking jurisdiction over a dispute
7 arising from the Dealer Agreement and acting pursuant to the terms of the same agreement, could
8 not go beyond these parameters.¹⁰ The Panel’s award of lost profits and business value therefore
9 plainly exceeded its authority.

10 Defendants argue that this is a matter of contract interpretation, and that this court must defer
11 to the Panel’s interpretation of the agreement. See San Francisco-Oakland Newspaper Guild v.
12 Tribune Publ’g Co., 407 F.2d 1327, 1327 (9th Cir. 1969) (per curiam) (holding that “so far as the
13 arbitrator’s decision concerns construction of the contract, the courts have no business overruling
14 him, because their interpretation of the contract is different than his.”). However, “where the
15 arbitrator exceeds the express limitations of his contractual mandate, judicial deference is at an end,”
16 and jurisdictional challenges focusing on whether an award is grounded in a contract are considered
17 *de novo*. See Delta Queen Steamboat Co. v. Dist. 2 Marine Eng’rs Beneficial Ass’n, 889 F.2d 599,
18 602 (9th Cir. 1989). Arbitrators are not free to interpret commercial agreements to give themselves
19 more power than the parties bargained for.

20 The inquiry in this action, however, is complicated by the fact that the majority purported to
21 set aside the Dealer Agreement. As a general matter, “an arbitration provision is severable from the
22 remainder of the contract,” and therefore a finding of contract invalidity does not affect the
23 applicability of an arbitration clause. Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440, 126
24 S.Ct. 1204, 1209 (2006) (holding that an arbitration clause in an otherwise usurious contract was
25 enforceable where the validity of the arbitration clause was not specifically challenged). Even if the
26 arbitration clause is severable from the Dealer Agreement, however, a question exists as to whether
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1 the damages limitation set forth in a separate section of the Dealer Agreement remains operative
2 along with the arbitration clause.

3 In light of the severability between arbitration provisions and the remaining contractual
4 provisions, the court must consider the arbitration clause to be a contract for arbitration in and of
5 itself, and give effect to the nature and scope of arbitration to which the parties agreed. “[P]arties
6 are generally free to structure their arbitration agreements as they see fit. Just as they may limit by
7 contract the issues which they will arbitrate, so too may they specify by contract the rules under
8 which the arbitration will be conducted.” Volt Info. Scis., Inc. v. Bd. of Trustees of the Leland
9 Stanford Junior Univ., 489 U.S. 468, 478 (1989) (citations omitted). “The Federal Arbitration Act
10 ‘requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in
11 accordance with their terms.’” Western Employers Ins. Co. v. Jefferies & Co., 958 F.2d 258, 261
12 (9th Cir. 1992) (quoting Volt Info. Scis., 489 U.S. at 478).

13 Given the requirement that courts give effect to the specific terms of arbitration agreements,
14 courts have given effect to various contractual terms that limit the scope of an arbitrator’s power.
15 For example, in Farkar Co. v. R. A. Hanson DISC, Ltd., 583 F.2d 68, 71 (2d Cir. 1978), the court
16 held that a limitation of liability provision set forth as a separate clause from the arbitration
17 provision prevented the arbitrators from awarding damages excluded by the liability limitation.
18 Likewise, in National Iranian Oil Co. v. Ashland Oil, Inc., 817 F.2d 326, 334 (5th Cir. 1987), the
19 court held that a separate forum selection clause was not divisible from an arbitration agreement.

20 Here, the fact that the Dealer Agreement provides for arbitration of “all disputes” indicates
21 that the damages limitation must be read as a term of the arbitration agreement, rather than a
22 separate, divisible provision that was set aside along with the rest of the contract. The surviving
23 arbitration provision must be interpreted in light of all contractual provisions pertaining to the
24 arbitrators’ power. Accordingly, the fact that the Panel purported to set aside the contract had no
25 effect on the unavailability of lost profit damages.

26 Defendants dispute this conclusion, arguing that the damages limitation applies only to
27 actions in contract rather than tort. Because an action for fraud sounds in tort rather than contract,
28

1 defendants claim, the damages provision is inapplicable. This assertion is incorrect. The damages
2 limitation applies to “any matter arising out of, about, or pertaining to the subject matter of this
3 agreement.” Levitt Dec., Exhs. 42 at 3920 & 43 at 3933 (emphasis added). Courts have held that
4 this type of language in the context of arbitration provisions extends to tort claims as well as contract
5 claims. See, e.g. Tate v. Saratoga Sav. & Loan Ass’n, 216 Cal. App. 3d 843, 855 (1989)
6 (interpreting the phrase “arising out of or relating to [this Agreement]” as encompassing “tort, as
7 well as contractual, liabilities so long as the tort claims have their roots in the relationship between
8 the parties which was created by the contract”) (internal quotations omitted); Chiron Corp. v. Ortho
9 Diagnostic Sys., Inc., 207 F.3d 1126, 1131 (9th Cir. 2000) (interpreting the phrase “Any dispute,
10 controversy or claim arising out of or relating to the validity, construction, enforceability or
11 performance of this Agreement” as “broad and far reaching”); Britton v. Co-op Banking Group, 4
12 F.3d 742, 745 (9th Cir. 1993) (holding that such language is “routinely used in many securities and
13 labor agreements to secure the broadest possible arbitration coverage”). Because the damages
14 limitation is to be interpreted in conjunction with the arbitration provision, the use of this broad
15 language extends to fraud claims. Accordingly, if the damages limitation is valid, it remained
16 operative during the arbitration, and the award of lost profits would have exceeded the Panel’s
17 authority. The court now turns to the question of whether the damages limitation is valid.

18

19 2. Validity

20 Defendants claim that the damages limitation is invalid under California law to the extent
21 that it purports to exempt plaintiffs from liability for fraud. California Civil Code section 1668
22 provides: “All contracts which have for their object, directly or indirectly, to exempt anyone from
23 responsibility for his own fraud, or willful injury to the person or property of another, or violation of
24 law, whether willful or negligent, are against the policy of the law.” In light of this provision,
25 “contractual releases of future liability for fraud and other intentional wrongs are invariably
26 invalidated.” Farnham v. Super. Ct., 60 Cal. App. 4th 69, 71 (1997). However, “contractual
27 releases of future liability for ordinary negligence, as well as contractual indemnity provisions,
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1 insurance contracts, and other *limitations* on liability are generally enforceable.” *Id.*; see also
2 McQuirk v. Donnelley, 189 F.3d 793, 796–97 (“Farnham thus stands for the proposition that § 1668
3 invalidates the total release of future liability for intentional wrongs.”).

4 It appears, therefore, that a limitation on fraud liability, rather than a full exemption, would
5 be valid under California law. The available caselaw, however, is manifestly unclear on this point.
6 The Court of Appeal in Farnham, 60 Cal. App. 4th at 71, addressed the validity of a contractual
7 provision which included a waiver of any rights to bring a suit for damages against any shareholder,
8 director, officer, or employee of a company, but allowed for suits against the company itself. The
9 court hinted at a dichotomy between full exemptions and qualified limitations when it framed the
10 question of the validity of the contractual waiver as “whether Farnham’s retention of his rights
11 against [the company] permits us to view his waiver of his claims against [shareholders, officers and
12 directors] as a *limitation* on liability rather than as a complete exemption from *all* liability.” *Id.* at 75
13 (emphasis in original). The court upheld the provision, stating that although the plaintiff may have
14 been able to show that he had not been fully compensated for his injuries by the company, the fact
15 that he “retain[ed] his right to seek redress from the corporation” rendered the “contractual
16 *limitation* on the liability of directors for defamation” valid under Section 1668. *Id.* at 76–77
17 (emphasis in original).

18 However, the court explicitly stated that its analysis was limited to the particular cause of
19 action at hand—defamation—and that the court “express[ed] no view about the validity of the ‘sole
20 remedy’ provision if Farnham’s claim alleged fraud or some other intentional tort.” *Id.* at 77 n.7.
21 The court then noted “the existence of a line of cases based on various kinds of alarm company
22 limitations on liability,” and that “such provisions are sometimes upheld as to intentional torts as
23 well as negligence and gross negligence, but not as to fraud.” *Id.* This suggests that fraud is set
24 aside as warranting special consideration when assessing the validity of contractual limitations of
25 liability.

26 Nonetheless, the parties point to no California authority, and the court has found none,
27 squarely applying this framework to the type of damages limitation at issue here.¹¹ The court is
28

1 mindful of the fact that, under California law, “Section 1668 is not strictly applied,” *id.* at 74, and is
2 therefore hesitant to hold that a contractual provision which merely excludes certain *types* of
3 damages from fraud liability falls within the class of *exemptions* prohibited by Section 1668.

4 In sum, the damages limitation provision was a valid circumscription of the Panel’s
5 authority, which remained operative as part of the valid arbitration agreement. Because the Panel’s
6 award of lost profits was barred by the damages limitation, the Panel exceeded its authority. The
7 Final Award must therefore be vacated at least as to the award of lost profits.¹²

8
9 C. Non-Neutral Arbitrator Fees

10 The Final Award included \$200,000 for Morganroth’s non-neutral arbitrator fees assessed
11 against plaintiffs. Final Award at 16. Plaintiffs assert that this award exceeded the Panel’s authority
12 and violated the Commercial Arbitration Rules. The majority cited only AAA Rule R-43 in support
13 of this award. Rule R-43(c) provides: “In the final award, the arbitrator shall assess the fees,
14 expenses, and compensation provided in Sections R-49, R-50, and R-51. The arbitrator may
15 apportion such fees, expenses, and compensation among the parties in such amounts as the arbitrator
16 determines is appropriate.” The arbitrator’s ability to apportion fees, expenses, and compensation is
17 therefore limited to “*such* fees, expenses, and compensation” provided in Sections R-49, R-50 and
18 R-51 (emphasis added). Of these three rules, only Rule R-51 deals with arbitrator compensation,
19 and it deals only with the compensation of the neutral arbitrator. Under the doctrine of *expressio*
20 *unius est exclusio alterius*, “[w]hen a statute limits a thing to be done in a particular mode, it includes
21 a negative of any other mode.” Longview Fibre Co. v. Rasmussen, 980 F.2d 1307, 1312–1313 (9th
22 Cir. 1992) (quoting Raleigh & Gaston Ry. Co. v. Reid, 80 U.S. (13 Wall.) 269, 270 (1871)). In light
23 of this doctrine, it would be improper to interpret the AAA Rules to implicitly allow for allocation of
24 non-neutral arbitrator compensation when the text of the rules provides for allocation only of neutral
25 arbitrator compensation. Accordingly, the court finds that the Panel lacked authority to shift
26 Morganroth’s fees to plaintiffs, and that portion of the final award must be set aside.

1 D. Timeliness of Award

2 Plaintiffs claim that the award was not issued within the time prescribed by the AAA rules,
3 and is therefore null. AAA Rule R-41 provides that “[t]he award shall be made promptly by the
4 arbitrator and, unless otherwise agreed by the parties or specified by law, no later than 30 days from
5 the date of closing the hearing” Based on a “draft order” submitted by AAA on August 22,
6 2006, the matter was deemed submitted “on or about September 5, 2006,” and the final award would
7 issue “on or before October 6, 2006.” Levitt Dec., Exh. 1C at 150. By letter dated October 7, 2006,
8 plaintiffs’ counsel informed the three arbitrators that they had not received an award on or before
9 October 6, 2007, that the Panel no longer possessed jurisdiction to issue an award, and that “any
10 award which the Panel purports to issue on or after this date is a legal nullity.” Id., Exh. 1D. Three
11 days later, plaintiffs’ counsel sent another letter to the three arbitrators informing them that a final
12 award had still not issued, and reiterating their position that the Panel had lost all jurisdiction. Id.,
13 Exh. 1E. Plaintiffs’ counsel sent a similar letter to the Vice President of AAA’s Western Case
14 Management Center. Id. The Final Award itself was transmitted by fax to counsel for both parties
15 on October 10, 2006. Id., Exh. 1. Grossman and Morganroth’s signatures are both dated October 4,
16 2006, while Chernick’s signature is dated October 6.

17 California law provides that an arbitration award “shall be made within the time fixed
18 therefor by the agreement” Cal. Civ. Proc. Code § 1283.8. Here, the parties’ agreement
19 incorporates the AAA rules, which require that an award be “made” within 30 days of the close of
20 hearing. AAA Commercial Arbitration Rules § R-41. The California Court of Appeal has held that,
21 where a contract provides for the time within which an arbitration award is to be issued, “an
22 arbitrator loses jurisdiction if a timely award is not forthcoming.” Baar v. Tigerman, 140 Cal. App.
23 3d 979, 985 (1983) (superseded by statute on other grounds).

24 While plaintiffs acknowledge that all three arbitrators apparently signed their respective
25 opinions by October 6, they assert that the signature date is irrelevant because the California Code
26 provides for waiver of objections based on untimeliness “unless he gives the arbitrators written
27 notice of his objection prior to the service of a signed copy of the award on him.” Cal. Civ. Proc.

28

1 Code § 1283.8. See also Rusnak v. Gen. Controls Co., 183 Cal. App. 2d 583, 584–85 (1960)
2 (holding that where the award was signed by the arbitrator within the time provided by the
3 agreement but was not delivered until such time had expired, the award was null).

4 Other federal courts addressing the timeliness of arbitration awards have applied the
5 applicable state law provisions. See, e.g., Hasbro, Inc. v. Catalyst USA, Inc., 367 F.3d 689, 692–93
6 (7th Cir. 2004) (applying Wisconsin law and finding that failure to abide by the 30-day provision in
7 AAA rules did not nullify the award because time was not of the essence); Success Vill. Apartments,
8 Inc. v. Amalgamated Local 376, Int’l Union United Auto. Aerospace & Agric. Implement Workers
9 of Am., UAW, 380 F. Supp. 2d 95, 98 (D. Conn. 2005) (finding that failure to issue a timely award
10 as required by a Connecticut regulation did not render the award invalid where there was no prior
11 objection to the delay and no showing of actual harm resulting from the delay). Although other
12 courts have applied varying standards to determine whether an untimely award is necessarily void,
13 California courts have interpreted the rule strictly, recognizing that “the provisions of an agreement
14 requiring the arbiter to render an award within a specified period are mandatory and jurisdictional
15 and that an award rendered after the time has expired is a nullity and must be vacated by the court
16 upon proper application.” Bosworth v. Whitmore, 135 Cal. App. 4th 536, 550 n.12 (2006) (quoting
17 Rusnak, 183 Cal. App. 2d at 584)). Furthermore, it is the delivery of the award, not the signing
18 thereof by the arbitrators, that constitutes an award having been “made.” See Oats v. Oats, 148 Cal.
19 App. 3d 416, 420–21 (1983).

20 Defendants raise four arguments in defense of the timeliness of the award. First, defendants
21 assert that the majority final award is dated October 4, 2006, and is therefore timely. As discussed
22 above, however, the date of the award itself is irrelevant where the award is not transmitted to the
23 parties within the specified time period.

24 Second, defendants claim that the California Code is inapplicable because the time of the
25 award was not fixed by agreement of the parties, but by the Arbitration Panel members themselves.
26 This assertion, even if true, is irrelevant. Under the Code, “[t]he award shall be made within the
27 time fixed therefor by the agreement or, if not so fixed, within such time as the court orders on
28

1 petition of a party to the arbitration.” Cal. Civ. Proc. Code § 1283.8. The Panel therefore was not
2 empowered to set a deadline other than one agreed upon by the parties or ordered by a court. The
3 Dealer Agreements state that “the proceedings shall be conducted in accordance with the
4 Commercial Arbitration Rules of the American Arbitration Association,” Levitt Dec., Exhs. 42 at
5 3920 & 43 at 3934, indicating that the Dealer Agreements incorporated Rule R-41. The Panel’s
6 authority therefore expired on October 5, 2006 (not October 6 as the draft order stated). All
7 plaintiffs were required to do in order to invoke this deadline was to “give[] the arbitrators written
8 notice of [their] objection prior to the service of a signed copy of the award on [them].” Id.

9 Third, defendants assert that plaintiffs’ objection is barred by the fact that it was raised and
10 considered by AAA and the Panel. Because this is a jurisdictional challenge, this court’s analysis is
11 without deference to the Panel’s decision. Accordingly, this is not a valid defense to plaintiffs’
12 timeliness argument.

13 Finally, defendants argue that plaintiffs’ non-neutral arbitrator is the only arbitrator to sign
14 his opinion after October 4, and that defendants should therefore not suffer the results of tardiness
15 brought about by Chernick’s delay. The additional delay brought about by Chernick is significant in
16 light of the fact that the deadline was October 5, and the majority opinion was signed on October 4.
17 Presumably, the Panel would have issued the Final Award on October 4 or October 5 if Chernick
18 had not waited until October 6 to sign his opinion. In light of the hypertechnical nature of plaintiffs’
19 argument regarding the jurisdictional deadline, the court must be rigid in all respects. Vacating the
20 award on this basis would effectively allow the dissenting Panel member to void the Final Award by
21 delaying his own signature. Such a result is unacceptable.

22 Accordingly, the court rejects plaintiff’s claim that the award should be vacated based on
23 Section 1283.8.

24
25 II. Denial of a Hearing

26 Plaintiffs assert that, with respect to its determination that TKC was liable for fraudulent
27 concealment, the majority improperly relied on evidence and claims from the Second Amended
28

1 Claim despite having ruled that the First Amended Claim was the operative pleading. Chernick's
2 discussion of the issue, which plaintiffs incorporate into their motion, is as follows:

3 The parties and the Panel also consistently treated the pleadings as
4 determinative of the Tribunal's power. For example, the motions to
5 dismiss resolved some claims and were intended to define what was
6 and what was not in dispute in this proceeding; also, the claims for
7 attorneys' fees by both sides contained in their pleadings provides the
8 only basis for the Tribunal to award such fees (*see* Interim Award at
9 12). Finally, Claimants sought sanctions against Respondents for
10 abuses of the discovery process. The Tribunal sought to enforce the
11 parties' discovery rights and the Majority granted Claimants' motion
12 (Interim Award at ¶. 3-4).

13 The Majority should have treated the issue of the proposed Second
14 Amended Claim in the same fashion. Instead, it relied on evidence
15 that was not the subject of the Claims Notification Process; not
16 disclosed by a pleading that was permitted to be filed in this case; and
17 that was never tested by discovery. Respondents were unable to offer
18 opposing evidence during the hearing and were not permitted to
19 reopen to offer such evidence when it was later discovered after the
20 close of the hearing.

21 Final Award, Chernick Dissent at 7.

22 Defendants make no response to this argument other than stating that it falls "under the
23 province of the arbitrator's discretion," and is therefore not subject to review. *Opp.* at 34. This is
24 plainly incorrect, as arbitrators do not have discretion to "refus[e] to hear evidence pertinent and
25 material to the controversy." 9 U.S.C. § 10(a)(4). When relevant evidence is excluded, a federal
26 court may vacate an arbitration award where the exclusion of such evidence "so affects the rights of
27 a party that it may be said that he was deprived of a fair hearing." Hoteles Condado Beach, La
28 Concha & Convention Ctr. v. Union de Tronquistas Local 901, 763 F.2d 34, 40 (1st Cir. 1985)
(internal quotation omitted).

29 Reviewing the Final Award, much of the factual basis for plaintiffs' fraud liability (the sole
30 claim on which defendants were awarded damages), stems from conduct alleged only in the SAC.
31 The majority discussed plaintiffs' failure to advise defendants of the "inherent risk involved in
32 becoming an art gallery owner" beyond the specific risks associated with competing with other
33 Thomas Kinkade galleries. Final Award at 9; SAC ¶¶ 31-32. Additionally, the majority devotes
34 substantial discussion to plaintiffs' presentation of financial information related to the Signature

1 Gallery program, and plaintiffs' failure to inform defendants of the changed financial conditions of
2 TKC and other Signature Gallery dealers during the time between the initial presentation of financial
3 information and the execution of the first Dealer Agreement. Final Award at 9. These allegations
4 appear in the SAC, but nowhere in the FAC. SAC ¶¶ 33–34, 42. While there were other bases for
5 fraud liability that were pled both in the FAC and SAC, the majority improperly relied on allegations
6 and evidence related to a pleading that the Panel had explicitly rejected, without affording plaintiffs
7 an opportunity to conduct discovery or present evidence in rebuttal. This is plainly at odds with the
8 requirements of the FAA, and warrants vacatur of the award.

9
10 III. Undue Means or Fraud

11 As used in the FAA, “undue means” “clearly connotes behavior that is immoral if not
12 illegal.” A.G. Edwards & Sons, Inc. v. McCollough, 967 F.2d 1401, 1403 (9th Cir. 1992) (per
13 curiam). Furthermore, “the statute requires a showing that the undue means caused the award to be
14 given.” Id. In other words, the party seeking vacatur must show that the arbitrators relied on the
15 fraud or undue means in reaching the award. Id.

16 Plaintiffs allege numerous instances of misconduct on the part of the Yatooma firm related to
17 the final award. With the exception of the attorneys' fee application, which the court will consider
18 in a separate order, each alleged instance appears to have been presented to and considered by the
19 Panel during the proceeding. The Panel sanctioned the Yatooma firm four times, and the Final
20 Award indicates that the damage award has been adjusted based on counsel's misconduct. Final
21 Award at 13. The Final Award also states that the majority all but disregarded the testimony of
22 Sheppard. Id. at 11. Allegations of fraud and undue means which are presented to and considered
23 by the Arbitration Panel cannot support vacatur of the arbitration award. A.G. Edwards & Sons, 967
24 F.2d at 1404 (holding that “where the fraud or undue means is not only discoverable, but discovered
25 and brought to the attention of the arbitrators, a disappointed party will not be given a second bite at
26 the apple”); see also Kotakis v. Gruntal & Co., No. C 97-0202 CRB, 2000 WL 1006541, at *4 (N.D.
27 Cal. July 11, 2000) (Breyer, J.) (holding that the examples of fraud and undue means that had been
28

1 presented to the arbitrators could not support an order vacating the arbitration award). Accordingly,
2 apart from allegations related to defendants' application for fees and costs, the court does not find
3 that the award was procured by fraud or undue means.

4
5 IV. Arbitrator Bias and Corruption

6 "Evident partiality" has been shown in cases of nondisclosure and in cases of actual bias.
7 Woods v. Saturn Distribution Corp., 78 F.3d 424, 427 (9th Cir. 1996). In the former case, vacatur is
8 appropriate where the arbitrator's failure to disclose information gives rise to a "reasonable
9 impression" of bias in favor of one party. Id. If such a reasonable impression is made, the faultiness
10 of the arbitrator's decision itself is not necessarily relevant because the failure to disclose facts
11 infects the proceeding itself. Id. On the other hand, a party alleging actual bias must "establish
12 specific facts which indicate improper motives." Id. "The appearance of impropriety, standing
13 alone, is insufficient' to establish evident partiality in actual bias cases." Id. (quoting Sheet Metal
14 Workers Int'l Ass'n Local Union No. 420 v. Kinney Air Conditioning Co., 756 F.2d 742, 746 (9th
15 Cir. 1985) (hereinafter Kinney)). Although there is little guidance as to what "specific facts" suffice
16 to show evident partiality, "[e]ven repeated rulings against one party will not establish bias absent
17 some evidence of improper motive." Kinney, 756 F.2d at 746; see also Nordahl Dev. Corp. v.
18 Salomon Smith Barney, 309 F. Supp. 2d 1257, 1267 (D. Or. 2004).

19
20 A. Grossman

21 The centerpiece of plaintiffs' attack on Grossman's neutrality is the alleged hug and kiss that
22 Grossman gave to Hazlewood following the fee application hearing. Defendants can neither deny
23 nor confirm that the affectionate actions took place, but merely dispute their significance assuming
24 they did occur. Defendants claim that the alleged conduct was so brief that it went unnoticed by
25 everyone in the room except plaintiffs' counsel and his two assistants.

26 Plaintiffs claim that Grossman's bias, as evidenced by the hug and kiss, played itself out in
27 numerous adverse rulings and other actions throughout the proceeding. Specifically, plaintiffs fault
28

1 Grossman with the following conduct: abruptly changing the time rules in the middle of the
2 arbitration to plaintiffs' prejudice, and responding flippantly to plaintiffs' counsel's objection (Levitt
3 Dec. ¶¶ 76–86); asking easy questions to Hazlewood during her rebuttal testimony, allegedly
4 “designed to rehabilitate her struggling testimony” (*Id.* ¶ 110); repeated failure to effectively
5 sanction defense counsel for its “persistent misconduct”; and denying plaintiffs discovery and a
6 hearing regarding Morganroth's fee request (Final Award, Chernick Dissent at 11). Furthermore,
7 plaintiffs claim that Grossman was poisoned against plaintiffs by Morganroth as a result of the two
8 men's hastily formed friendship and repeated lunch outings.

9 Before assessing Grossman's alleged bias, it is necessary to determine whether plaintiffs'
10 bias claim regarding Grossman is timely. Defendants note that the hug and kiss purportedly
11 occurred on August 1, 2006, over two months before the final award was issued, Levitt Dec. ¶ 12,
12 but that plaintiffs never objected or mentioned this conduct before bringing the instant motion. In
13 addition, the declarations of two the percipient witnesses are each dated in August 2006. André
14 Dec.; Zorina Dec. “By failing to object to the arbitrator proceeding as arbitrator, and continuing to
15 participate in the hearing after the arbitrator's full disclosure,” a party waives any claim that the
16 resulting award should be set aside as a result of alleged arbitrator bias or corruption. Theis
17 Research, Inc. v. Brown & Bain, 400 F.3d 659, 666 (9th Cir. 2005); see also Delta Mine Holding
18 Co. v. AFC Coal Props., Inc., 280 F.3d 815, 821 (8th Cir. 2001) (“Even when a neutral arbitrator is
19 challenged for evident partiality, the issue is deemed waived unless the objecting party raised it to
20 the arbitration panel.”).

21 Plaintiffs raise two responses to defendants' waiver argument. First, plaintiffs make the
22 unsupported suggestion that waiver of objection to a non-neutral arbitrator is only applicable in
23 nondisclosure, rather than actual bias, cases. Second, plaintiffs claim that the alleged hug and kiss
24 took place months after the majority had made a finding of liability, and that objecting to Grossman
25 at that point would have been pointless. Assuming that attempting to disqualify Grossman in August
26 2006 would not have resulted in re-litigating the entire proceeding, plaintiffs are correct that little
27 would have been gained by objecting to Grossman at that point. The damage, if any, had been done.

28

1 Accordingly, plaintiffs did not waive their right to challenge Grossman’s neutrality by failing to
2 object during the proceedings.

3 The court nonetheless finds that plaintiffs have failed to make a sufficient showing of actual
4 bias on the part of Grossman. Plaintiffs point to several instances where Grossman’s conduct was
5 adverse to plaintiffs during the extensive arbitration proceeding. These alone are insufficient to
6 show bias. Plaintiffs’ one piece of extrinsic evidence is the hug and kiss which, while questionable,
7 does not rise to the level of bias supporting vacatur. Instances of evident partiality typically involve
8 concrete financial interests or established, ongoing relationships. The Supreme Court in
9 Commonwealth Coatings Corp. v. Continental Cas. Co., 393 U.S. 145, 149–150 (1968), on which
10 plaintiffs rely, stated that an arbitrator “should, however, in pending or prospective litigation before
11 him be particularly careful to avoid such action as may reasonably tend to awaken the suspicion that
12 his *social or business relations or friendships*, constitute an element in influencing his judicial
13 conduct” (emphasis added). Here, there is no evidence, or allegation, of an actual relationship
14 between Grossman and Hazlewood. Plaintiffs have therefore failed to demonstrate evident partiality
15 on the part of Grossman.

16
17 B. Morganroth

18 Plaintiffs claim that Morganroth failed to disclose the fact that defendants had not paid him
19 in full. From this premise, plaintiffs leap to the conclusion that Morganroth was operating on a *de*
20 *facto* contingency basis, that he knew he would not be paid unless defendants “won and won big,”
21 and that the failure to disclose this arrangement created the impression of bias. This argument
22 would create a *per se* requirement that non-neutral arbitrators be paid up-front. Plaintiffs point to no
23 authority for this rule and the court declines to adopt one now. Even if Morganroth might not have
24 been paid absent a substantial cash award in favor of defendants, he would still be *owed* the balance
25 of his fees regardless of the outcome of the arbitration. Plaintiffs’ attempt to shoehorn this situation
26 into an undisclosed contingency fee arrangement is unavailing.¹³ See Barcume v. City of Flint, 132
27 F. Supp. 2d 549, 557 (E.D. Mich. 2001) (holding that the defendant’s argument that “because
28

1 Plaintiffs owed [the] Arbitrator . . . her fees for some time, that unduly influenced her to render a
2 decision in their favor” was “not enough for a reasonable person to conclude that an Arbitrator was
3 partial to one party to the arbitration”).

4 Plaintiffs further allege that Morganroth violated Canon X by failing to “act in good faith and
5 with integrity and fairness.” Specifically, plaintiffs assert that Morganroth (1) falsely accused
6 TKC’s counsel of criminal conduct, (2) repeatedly interrupted counsel in a rude and aggressive way,
7 (3) “beat up on TKC’s witnesses,” including interrupting and badgering TKC’s Chief Financial
8 Officer, and (4) interjected false claims about events in the White arbitration, including falsely
9 implying that the White Arbitration Panel had found TKC and its counsel liable for discovery
10 abuses. Levitt Dec. ¶¶ 96–107. To begin with, courts have held that violations of Ethical Canons do
11 not constitute grounds for vacating an arbitration award. See Delta Mine Holding Co., 280 F.3d at
12 820 (“It is well-settled that only the statutory grounds in § 10(a) of the Act justify vacating an
13 award; arbitration rules and ethical codes do not have the force of law.”) (internal quotations
14 omitted). Furthermore, in terms of partiality, the standards applicable to non-neutral arbitrators do
15 not necessarily apply to party-appointed arbitrators because “the main party-appointed arbitrators are
16 *supposed* to be advocates.” Sphere Drake Ins. Ltd. v. All Am. Life Ins. Co., 307 F.3d 617, 620 (7th
17 Cir. 2002) (emphasis in original); see also Delta Mine Holding Co., 280 F.3d at 821 (rejecting the
18 claim that “general statutory language calling for the arbitrators to be impartial should be interpreted
19 as refusing enforcement to the awards of arbitrations in which the parties contract for partisanship”).
20 Morganroth’s conduct during the proceeding therefore does not rise to the level of evident partiality
21 or corruption sufficient to vacate an arbitration award.

22

23 V. Complete Disregard for the Law

24 Federal Courts of Appeals have repeatedly held that “[m]anifest disregard of the law’ means
25 something more than just an error in the law or a failure on the part of the arbitrators to understand
26 or apply the law. It must be clear from the record that the arbitrators recognized the applicable law
27 and then ignored it.” See Carter v. Health Net of Cal., Inc., 374 F.3d 830, 838 (9th Cir. 2004)

28

1 (discussing cases). Plaintiffs assert that the Panel manifestly disregarded clear California law in
2 three respects: first, plaintiffs claim that the evidence is uncontradicted that defendants' fraud claims
3 were barred by the statute of limitations; second, plaintiffs claim that Spinello's allegedly concealed
4 bankruptcy clearly afforded plaintiffs a complete defense to Spinello's fraud claim based on the
5 doctrine of unclean hands; third, plaintiffs claim that the Panel's award of damages was inconsistent
6 with its finding that the Dealer Agreement had been rescinded.

7
8 A. Statute of Limitations and Unclean Hands

9 With respect to the statute of limitations and unclean hands defenses, plaintiffs point to
10 nothing in the record showing that the arbitrators knew the applicable law and ignored it, as opposed
11 to merely making errors of fact or law. With regard to the statute of limitations issue, in particular,
12 the majority stated as follows:

13 There was discussion by Respondents relating to the statute of
14 limitations with regard to the fraud allegations. The Majority finds
15 that the significant failures of disclosure—that is, the omissions—such
16 as the change in fortune of both the corporate stores and many
17 signature dealers—[sic] did not come to light in many instances until
18 the discovery phase of this arbitration. Thus, such omissions allow for
19 delayed discovery by Claimants which is certainly reasonable and tolls
20 any statute of limitations. Accordingly, with regard to the fraud claim,
21 the statute did not expire based on the evidence with regard to the
22 claim for fraud in the inducement.

23 Final Award at 10. This certainly may have been an incorrect application of law (the record is
24 unclear), but it does not show that the majority willfully ignored the law, as required to vacate an
25 award.¹⁴ Accordingly, plaintiffs have failed to show manifest disregard for the law regarding the
26 statute of limitations and unclean hands.

27 B. Damages

28 In their supplemental briefing, plaintiffs and defendants disagree as to whether the Panel
properly awarded consequential damages after setting aside the Dealer Agreement. Plaintiffs assert
that, because rescission is meant to put the rescinding party in the *status quo ante*, consequential

1 damages are unavailable following rescission because such damages presume the existence of a
2 contract.

3 Defendants, meanwhile, argue that California’s statutory provisions regarding rescission
4 provide for complete relief including consequential damages. The California Civil Code provides:

5 A claim for damages is not inconsistent with a claim for relief based
6 upon rescission. The aggrieved party shall be awarded complete
7 relief, including restitution of benefits, if any, conferred by him as a
8 result of the transaction *and any consequential damages to which he is*
9 *entitled*; but such relief shall not include duplicate or inconsistent
10 items of recovery.

11 Cal. Civ. Code § 1692 (emphasis added). In Runyan v. Pac. Air Indus., Inc., 2 Cal. 3d 304, 319
12 (1970), following a lengthy discussion of California rescission law before and after the enactment of
13 Section 1692, determined that “loss of income” damages were properly awarded following the
14 rescission of a contract. The court held that Section 1692 allowed a rescinding party to recover
15 “original consideration and the damages he sustained in reliance on the contract.” Id. The Panel’s
16 award of consequential damages after setting aside the contract therefore appears to be squarely
17 consistent with California law, and at the very least does not amount to a manifest disregard for the
18 law. Accordingly, the award need not be vacated on these grounds.

19 VI. Rationality of Damage Award

20 Plaintiffs claim that the majority’s calculation of damages was “completely irrational” and
21 must be thrown out. The only evidence that the Panel heard on the issue of damages was testimony
22 from defendants’ damages expert. The majority ultimately awarded damages based on the expert’s
23 testimony, finding “some merit” in the testimony but applying “a significant discount” to the
24 expert’s estimate due to various doubts about the estimate’s reliability. Final Award at 11–12.
25 Plaintiffs assert that this amounts to the majority having “picked a number out of thin air,” and that
26 the award was therefore speculative and irrational. While the majority’s methodology is neither
27 clear or perfect, it is not “completely irrational.” Having no evidence other than the expert’s
28 testimony, but finding some problems with the expert’s credibility, the majority adjusted the

1 estimate downward by a substantial amount. This is not a completely irrational approach to
2 determining the appropriate damage award.

3
4 VII. Further Issues to Be Resolved

5 The parties have separately briefed the issue of whether the Panel's award of attorneys' fees
6 to defendants should be vacated based on alleged fraudulent conduct on the part of defense counsel.
7 The motion to vacate the award of attorneys' fees is currently under submission. The parties are
8 hereby ordered to submit supplemental briefs directed to the sole question of what effect, if any,
9 vacatur of the arbitration award has on the Panel's award of attorneys' fees. On or before June 20,
10 2007, each party shall submit its supplemental brief, not to exceed eight pages.

11
12 CONCLUSION

13 The court has determined that the portions of the arbitration award consisting of non-neutral
14 arbitrator fees and lost profits must be vacated. The court has further determined that the award was
15 improperly based on the Second Amended Claim, and that plaintiffs were deprived of a fair hearing
16 on the evidentiary issues giving rise to the award. Although the court has ruled in favor of
17 defendants on certain other grounds for vacatur, the court's holding regarding the denial of a hearing
18 warrants vacatur of the entire award.

19 For the reasons stated above, the court GRANTS plaintiffs' motion to vacate the arbitration
20 award. The parties are ORDERED to submit further briefs directed to the sole question of what
21 effect, if any, vacatur of the arbitration award has on the Panel's award of attorneys' fees, not to
22 exceed eight pages, on or before June 20, 2007.

23 IT IS SO ORDERED.

24
25 Dated: June 5, 2007



MARILYN HALL PATEL
United States District Court Judge
Northern District of California

ENDNOTES

- 1
2 1. Unless otherwise indicated, the background facts are taken from the parties' submissions,
3 declarations, and attachments thereto.
- 4 2. Throughout this order, the abbreviation "TKC" refers to both The Thomas Kinkade Company
5 and Media Arts Group, Inc.
- 6 3. Thomas Kinkade himself is not a party to these proceedings.
- 7 4. During Day 2 of the hearing, Morganroth criticized plaintiffs' counsel for apparently instructing
8 deposition witnesses not to give their home addresses, and stated that "[i]n a criminal case, that
9 would be obstruction of justice and you would be accused of being a criminal." Levitt Dec., Exh. 4,
10 Transcript, Day 2 at 296:14–17.
- 11 5. During Day 19 of the hearing, plaintiffs' counsel interpreted a comment by Grossman as "a little
12 pressure, Mr. Grossman, to accede in the face of the Panel's prior rulings to allow Mr. Ejbeh to have
13 cross examination when his time runs out when he shouldn't." Grossman denied that this was his
14 implication.
- 15 6. Plaintiffs raise a separate set of arguments alleging that the Yatooma Firm's application for fees
16 and costs was fraudulent. The court will consider these arguments in a separate order.
- 17 7. The final award was signed by Grossman and Morganroth on October 4, and by Chernick on
18 October 6. The exact date on which the award was "made" for the purposes of applicable legal
19 standards is in dispute, as discussed *infra*.
- 20 8. Plaintiffs rely heavily on Gueyffier v. Ann Summers, Ltd., 50 Cal. Rptr. 3d 294 (Cal. App. 2d
21 Dist. 2006) in support of their argument regarding notice. After plaintiffs filed the instant motion,
22 the California Supreme Court granted review of Gueyffier. 53 Cal. Rptr. 3d 802 (2007). In light of
23 this, and because the court's analysis of the notice issue does not depend on Gueyffier, the court
24 does not consider the parties' arguments related to that case.
- 25 9. Although plaintiffs characterize the notice issue as jurisdictional, the Panel's interpretation of the
26 facts and contracts are nonetheless entitled to deference. It is undisputed that the Panel had
27 jurisdiction over properly notice disputes. The Panel's determination as to whether the disputes at
28 issue were properly noticed is therefore within its discretion. This is therefore distinguishable from
the lost profits argument, discussed *infra*, in which the Panel determined that it possessed
jurisdiction over a matter that was specifically excluded from the Dealer Agreement.
10. This view is confirmed by the AAA rules themselves, which provide that "[t]he arbitrator may
grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the
agreement of the parties, including, but not limited to, specific performance of a contract." AAA
Commercial Arbitration Rule R-43(a) (emphasis added).

1 11. Defendants chiefly rely on Ting v. AT & T, 182 F. Supp. 2d 902, 924–25 (N.D. Cal. 2002)
2 (Zimmerman, J.), aff'd in part, rev'd in part, 319 F.3d 1126 (9th Cir. 2003), in which Judge
3 Zimmerman held that a similar limitation of liability was invalid under Section 1668. Judge
4 Zimmerman's analysis, however, was directed principally at whether the provision at issue applied
5 under the circumstances, and there is no discussion of the distinction between exemptions and
6 limitations under California law. Furthermore, the Ninth Circuit did not reach the Section 1668
7 holding on appeal. See Ting, 319 F.3d at 1149 n.13. Because Ting is not a California case, and
8 because much of the core analysis is inapplicable, the court declines to adopt the holding in that case
9 regarding Section 1668.

10 12. As an additional attack on defendants' Section 1668 argument, plaintiffs claim that Section
11 1668 is preempted by the FAA. Because the court finds that Section 1668 is inapplicable, the court
12 need not reach this issue. However, Judge Chesney in this district has squarely held that Section
13 1668 is not preempted by the FAA. Winig v. Cingular Wireless LLC, No. C 06 4297 MMC, 2006
14 WL 2766007, at *6–7 (N.D. Cal. Sept. 27, 2006) (Chesney, J.). Although the specific basis for
15 unconscionability in that case was California's prohibition on certain waivers of class action rights,
16 the court reached its holding based on its conclusion that the class action waiver was an "exemption
17 of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of
18 another.'" Id. at *4 (quoting Cal. Civ. Code § 1668)). Because the prohibitions embodied in
19 Section 1668 apply to all contracts, rather than to arbitration agreements only, Section 1668 is not
20 preempted by the FAA.

21 13. Of course, Morganroth clearly had a financial interest in the majority's decision to allocate
22 \$200,000 of Morganroth's compensation to plaintiffs. This portion of the award was invalid under
23 the AAA rules, but did not affect the remaining aspects of the final award.

24 14. Chernick dissented on the statute of limitations issue, but acknowledged that this point "goes to
25 the sufficiency of the evidence and constitutes an assertion of legal or factual error which . . . may or
26 may not be considered by a reviewing court under the Ninth Circuit's interpretation of the Federal
27 Arbitration Act." Final Award, Chernick Dissent at 8.
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