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The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?

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In 1987 the securities industry achieved a major victory. Until then, because of the Supreme Court's 1953 holding in *Wilko v. Swan*[1] that agreements to arbitrate federal securities claims contained in customer agreements were unenforceable, customers could sue brokerage firms and their salespersons in court, frequently before juries amenable to sizable verdicts, including punitive damages. Success came first in *Shearson/American Express, Inc. v. McMahon, Inc.*[2] and then, two years later, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*[3] As a result of these two decisions, brokerage firms could require customers to arbitrate all disputes, even federal securities claims, in industry-sponsored arbitration forums.

The securities industry brought its arbitration campaign at the right time. *McMahon* and *Rodriguez* marked the perfect alignment of two strong Supreme Court policies: support for arbitration[4] and antipathy toward investors' claims for securities damages in federal court.[5] Many commentators initially viewed these decisions as a defeat for investors.[6]

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1. 346 U.S. 427, 438 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Exp., Inc., 490 U.S. 477 (1989).

2. 482 U.S. 220, 238 (1987) (holding that claims under Securities Exchange Act of 1934 (SEA) could be arbitrated).

3. 490 U.S. 477, 486 (1989) (holding that claims under Securities Act of 1933 could be arbitrated).

4. *See, e.g.*, Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) (stating that Federal Arbitration Act (FAA) "declared a national policy favoring arbitration").

5. *See, e.g.*, Santa Fe Indus. v. Green, 430 U.S. 462, 479-80 (1977) (excluding corporate mismanagement and breach of fiduciary duty claims from Rule 10b-5 coverage because of concerns of vexatious litigation); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 n.33 (1976) (requiring scienter to limit class of plaintiffs who can sue under Rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-40 (1975) (restricting standing under Rule 10b-5 because of "widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general").

6. The following statement by Justice Blackmun, in his dissenting opinion in *McMahon*, expresses this view: "[t]he Court thus approves the abandonment of the judiciary's role in the resolution of claims under the Exchange Act and leaves such claims to the arbitral forum of the securities industry at a time when the industry's abuses towards investors are more apparent than ever." 482 U.S. at 243. Investors' advocates urged Congress to enact legislation to overturn the result. *See, e.g.*, *McMahon Decision Should be Overturned to Protect Investors, House Panel Told*, 20 Sec. Reg. & L. Rep. (BNA) 492 (Mar. 31, 1988).

After *McMahon*, the Securities and Exchange Commission (SEC) recognized the need to reform the arbitration process to meet the expectations of unhappy investors whose disputes would now be heard before the industry's arbitration forums. Working with the Securities Industry Conference on Arbitration (SICA)[7] and the Self-Regulatory Organizations (SROs),[8] the SEC instituted reforms to make the securities arbitration forums fairer and more neutral,[9] a process that still continues. Today investors may find arbitration preferable to litigation, particularly since their claims frequently are stronger on the equities than on the law.[10]

Illustrating a classic example of "be careful what you wish for," brokerage firms no longer find arbitration entirely to their liking. Increasingly they turn to the courts to resist arbitration, to interfere with ongoing arbitration, or to undo the results of arbitration. The Supreme Court has twice thwarted these attempts, adhering to its pro-arbitration policy and reaching decisions that favor the investor. Despite these decisions, brokerage firms continue to send their lawyers to the courthouse. Unfortunately, as a result, both federal and state courts are becoming increasingly involved in the securities arbitration process to the detriment of investors.

This Article argues that increased judicial involvement in the securities arbitration process is unwarranted. Although there are legitimate concerns about the use of arbitration to resolve consumer and employment disputes in lieu of litigation, the SRO arbitration process fares well when measured by the components identified as necessary for a fair arbitration. To the extent there are issues about the fairness of the SRO arbitration forums, it is the investor, not the brokerage firm or brokers, who has reason to be concerned.

Part I of this Article reviews the post-*McMahon/Rodriguez* Supreme Court decisions that are pro-arbitration and pro-investor. Part II discusses lower court decisions in which firms or individual brokers have sought to enjoin or interfere with the arbitration of investors' disputes. Part III looks at lower court decisions in which firms or individual brokers have sought to vacate arbitration awards in favor of investors.

7. SICA, consisting of representatives of the SROs, the public, and the Securities Industry Association (SIA), developed and continues to revise a Uniform Code of Arbitration. For background on SICA, see Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 488-90 (1996).

8. SROs are defined in Section 3(a)(26) of the SEA, 15 U.S.C. § 78c(a)(26) (1994), and include the national securities exchanges and the National Association of Securities Dealers, Inc. (NASD), the largest SRO.

9. *See* Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 999-1005 (2002).

10. *Id.* at 1035-1040.

Part IV examines whether the securities arbitration forums provide customers with a fair process, and it argues that increased judicial involvement is not necessary to ensure fairness and, in fact, works to the detriment of investors. The Article concludes that courts, in the face of brokerage firms' propensity to involve them in arbitration, may be exhibiting anti-arbitration, or even anti-investor, tendencies. Courts should heed the Supreme Court's message and resist brokers' attempts to defeat arbitration's goal of "fair and expeditious resolution" of disputes.[11]

PART ONE

Two post-*McMahon/Rodriguez* Supreme Court decisions involving customer-broker disputes establish the Court's pro-arbitration and pro-investor slant. In *Mastrobuono v. Shearson Lehman Hutton, Inc.*,[12] the brokerage firm moved to vacate the punitive damages portion of an arbitration award, asserting that the arbitrators had no authority to award them. The customer agreement contained a New York choice of law clause, and at that time New York law did not allow arbitrators to award punitive damages.[13] Reversing the lower federal courts' decisions in favor of the firm, the Supreme Court held that the New York choice of law clause did not clearly establish the parties' intent to adopt the New York limitation on arbitrators' powers. Significantly, the Court did not base its opinion solely on technical grounds of contract interpretation, but also on its pro-arbitration policy that "due regard must be given to the federal policy favoring arbitration, and ambiguities as to the scope of the arbitration clause itself resolved in favor of arbitration."[14]

Mastrobuono settled the question of arbitrators' authority to award punitive damages, an ironic outcome given that one of the principal attractions of arbitration to the securities industry was to avoid punitive

11. Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79, 85 (2002).

12. 514 U.S. 52 (1995).

13. *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 794 (N.Y. 1976). While the New York Court of Appeals has not yet overruled *Garrity*, most Appellate Division courts have abandoned the *Garrity* rule and allow punitive damages awards. *See, e.g.*, Americorp Sec., Inc. v. Sager, 656 N.Y.S.2d 762, 764 (1st Dept. 1997).

14. *Mastrobuono*, 514 U.S. at 62 (quoting Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 476 (1989)).

damages. Strong industry opposition to punitive damages continues,[15] as I later discuss.[16]

The second decision, *Howsam v. Dean Witter Reynolds, Inc.*,[17] resolved a conflict among the circuits involving the National Association of Securities Dealers (NASD) Dispute Resolution's[18] six-year eligibility rule, which bars arbitration of stale claims.[19] After *McMahon* and *Rodriguez*, firms regularly asked courts to enjoin customers' arbitration on the ground that the claims were time-barred under the applicable SRO's eligibility rule. The circuit courts were evenly divided on the characterization of the eligibility rule: did it raise a question of arbitrability that the court must decide, or was it analogous to a statute of limitations that the arbitrators could decide?[20]

In *Howsam*, the Court rejected the former view and limited the scope of arbitrability to questions

> where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate.[21]

The Court easily concluded that since the firm's customer agreement provided for arbitration before the NASD, the parties would expect that the arbitrators would decide procedural questions like NASD's own time limit rule.

Both *Howsam* and *Mastrobuono* reject the brokerage firms' attempts to limit arbitrators' powers. Moreover, *Howsam* contains a broader mess-

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15. *See* SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BOARD OF GOVERNORS NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. 36-38 (1996) for a summary of the industry's arguments.

16. For post-*Mastrobuono* challenges to punitive damages awards, see *infra* notes 153-59 and accompanying text.

17. 537 U.S. 79 (2002).

18. In July 2000 the NASD spun off its subsidiary, the NASD Regulation Office of Dispute Resolution, as a new company, NASD Dispute Resolution, Inc., to administer NASD dispute resolution services. *See* Press Release, NASD Dispute Resolution, NASD Launches New Dispute Resolution Subsidiary (July 17, 2000), *available at* http://www.nasdadr.com/news/pr2000/ne_section00_160.html (last visited June 25, 2003). For simplicity's sake I refer throughout to the NASD's dispute resolution office as NASD.

19. *See* NAT'L ASS'N OF SEC. DEALERS, CODE OF ARBITRATION PROCEDURE, Rule 10304 (2003), *available at* http://www.nasdadr.com/arb_code/arb_code.asp (last visited June 23, 2003) [hereinafter NASD CODE 2003]. The New York Stock Exchange (NYSE) has a similar rule, *see* NYSE DEPT. OF ARBITRATION, ARTICLE XI AND NYSE CONSTITUTION AND ARBITRATION RULES, Rule 603, at 8 (2003), *available at* http://www.nyse.com/pdfs/Rules.pdf (last visited June 25, 2003) [hereinafter NYSE 2003].

20. For background, see Barbara Black, *Securities Arbitration Is Not Supposed To Be So Complicated: Arbitrability, the Eligibility Rule, and Whose Law Decides*, 30 SEC. REG. L.J. 134, 140-42 (2002).

21. *Howsam*, 537 U.S. 79, 83-84.

age: the importance of minimizing judicial involvement in the arbitration process in order to promote the goal of "a fair and expeditious resolution of the underlying controversy."[22] Both of these decisions are pro-arbitration *and* pro-investor. The law has come a long way since *McMahon* and *Rodriguez*.

PART TWO

As *Howsam* illustrates, brokerage firms frequently go to court to enjoin pending arbitrations on grounds that they have not agreed to arbitrate the dispute or that arbitration is inappropriate for some other reason. In extreme instances they have even sought judicial intervention, not to contest arbitration, but to challenge an arbitration panel's procedural ruling.[23] *National Planning v. Achatz*[24] is a particularly egregious example of judicial intervention. In *Achatz*, a firm initially was successful in persuading a federal district court to dissolve an arbitration panel because it failed to return its list of proposed arbitrators to NASD on time. Only after the case was transferred to another district did the second court order the arbitration to proceed with the panel as it was originally constituted.

In too many instances courts have uncritically accepted brokers' assertions that the disputed issue involves a question of arbitrability that courts should decide, rather than dismissing the lawsuit and allowing the arbitrators to resolve it. This section examines some of these recurring situations.

Arbitrability

Since "arbitration is a matter of contract,"[25] a dispute about whether there is an agreement to arbitrate raises a question of arbitrability that ordinarily courts should decide. In disputes arising out of ordinary customer-broker relationships, however, there is ordinarily no question that the matter is arbitrable, because of brokerage firms' nearly universal use of predispute arbitration clauses in customer agreements.[26]

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22. *Id.* at 85.

23. *See, e.g.*, Gruntal & Co. v. Maharaj, 13 F. Supp. 2d 566 (S.D.N.Y. 1998) (denying firm's application for a TRO staying a scheduled hearing after arbitrators denied firm's adjournment request).

24. No. 02-CV-0196E(SR), 2002 WL 31906336 (W.D.N.Y. Dec. 17, 2002).

25. *Howsam*, 537 U.S. at 83 (citation omitted); *see also* First Options of Chi., Inc. v. Kaplan, 514 U.S. 938, 943 (1995).

26. Courts have enforced PDAAs even in situations where the individual broker engaged in massive fraud over a substantial period of time, including stealing money from customers' accounts. *See* Fazio v. Lehman Bros., 340 F.3d 386 (6th Cir. 2003); Deputy v. Lehman Bros., 2003 WL 22227977 (7th Cir. 2003).

As part of the post-*McMahon/Rodriguez* reforms, the NASD imposes requirements on the content and form of predispute arbitration agreements, including a statement that the parties are waiving their right to seek remedies in court.[27] While this language was principally designed to provide notice to customers of the rights they are giving up, the language contractually commits the brokerage firms as well. The NASD makes this even clearer by its prohibition on any term in the customer agreement that limits or contradicts its rules, limits the ability of a party to file an arbitration claim, or limits the arbitrators' ability to make an award.[28] Firms sometimes overlook the significance of this language.[29]

Even if they have not signed a predispute arbitration agreement, customers can demand arbitration[30] because SRO rules offer them the option to arbitrate.[31] NASD Rule 10301[32] provides that a customer can demand arbitration of any eligible claim between it and "a member and/or associated person[33] arising in connection with the business of such member or in connection with the activities of such associated person." The NYSE[34] rule is broader than the NASD's and provides that anyone, whether a customer or not, can demand arbitration of any dispute between it and "a member . . . and/or associated person arising

27. *See* NAT'L ASS'N OF SEC. DEALERS, CONDUCT RULES, Rule 3110(f)(1), *Books and Records (Requirements When Using Predispute Arbitration Agreements With Customers)* (2003), *available at* http://cchwallstreet.com/NASD/NASD_Rules (last visited June 26, 2003) [hereinafter NASD CONDUCT 2003].

28. *Id.* at (f)(4). *See also* Self-Regulatory Organizations; Order Approving Proposed Rule Changes by the New York Stock Exchange, Inc., National Association of Securities Dealers, Inc., and the American Stock Exchange, Inc. Relating to the Arbitration Process and the Use of Predispute Arbitration Clauses, 54 Fed. Reg. 21144, 21154 (Exchange Act Release No. 34-26805) (May 16, 1989) ("[t]his provision makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes represents solely a choice of arbitration as a means of dispute resolution"); NASD Notice to Members 89-58, *Amendment re: Predispute Arbitration Clauses in Customer Agreements,* 1989 WL 931069 (National/Federal) (Aug. 1989) (calling the attention of its members to the provision).

29. *See* NASD Notice to Members 95-16, *Predispute Arbitration Clauses in Customer Agreements,* 1995 WL 1712330 (National/Federal) (Mar. 1995) (alerting its members that some members' customer agreements contain prohibited restrictions).

30. *See* Kidder, Peabody & Co. v. Zinsmeyer Trusts P'ship, 41 F.3d 861 (2d Cir. 1994) (holding that a customer can require a broker to arbitrate, even though the arbitration clause had been stricken from the customer's agreement).

31. *See, e.g.,* Pa. Merch. Group v. Schultz, No. CIV.A.96-8443, 1997 WL 71428, at *1 (E.D. Pa. Feb. 13, 1997); Hanney v. Taylor, No. 121349/00, 2001 N.Y. Misc. LEXIS 761, at *8 (N.Y. Sup. Ct. Oct. 26, 2001).

32. *See* NASD CODE 2003, *supra* note 19, Rule 10301.

33. An "associated person" is broadly defined in Section 3(a)(18) of the SEA, 15 U.S.C. § 78c(a)(18), and includes partners, officers, directors, branch managers, controlling persons, and employees (except those performing solely clerical or ministerial tasks) of broker-dealers.

34. *See* NYSE 2003, *supra* note 19; NYSE Const., Art. XI, § 1, at 1; Rule 600(a) at 2.

in connection with the business of such member . . . and/or associated person in connection with his activities as an associated person."

Notwithstanding the inclusiveness of these rules, brokerage firms may contest their application to a particular dispute when an investor seeks arbitration. In resisting arbitration before the NASD, the firm typically argues that the investor is not a "customer;"[35] in resisting arbitration before the NYSE, the firm argues that the dispute does not involve "exchange business."[36] These disputes present two questions: (1) who should decide the arbitrability issue, the courts or the arbitrators, and (2) how should the arbitrability issue be decided?

The Supreme Court addressed both issues in *First Options of Chicago, Inc. v. Kaplan*.[37] As to the first issue, the Supreme Court cautioned that "[c]ourts should not assume that the parties agreed to arbitrate arbitrability unless there is 'clea[r] and unmistakabl[e]' evidence that they did so."[38] Because the parties might not have considered the "rather arcane"[39] question of who would decide the arbitrability issue, a more explicit expression of intent on this question is necessary so that unwilling parties are not forced to arbitrate a matter they reasonably would expect a judge to decide.[40] On the second issue, *First Options* affirmed the principle that arbitration agreements are to be interpreted broadly, and "[a]ny doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."[41]

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35. NASD Rule 10301 does not define "customer." There are two definitions of "customer" in other NASD rules: General Provisions Rule 0120(g) defines "customer" as not including a broker or dealer, *see* NAT'L ASS'N OF SEC. DEALERS, GEN. PROVISIONS, Rule 0120(g), *Definitions* (2003), *available at* http://cchwallstreet.com/NASD/NAASD_Rules (last visited June 26, 2003); Conduct Rule 2270(b) defines "customer" as "any person who, in the regular course of such member's business, has cash or securities in the possession of such member," *see* NASD CONDUCT 2003, *supra* note 27, Rule 2270(b), *Disclosure of Financial Condition to Customers*. *See, e.g,* Fleet Boston Robertson Stephens, Inc. v. Innovex, Inc., 264 F.3d 770 (8th Cir. 2001), where the court relied on the latter rule and found that a company could not arbitrate a dispute involving advice provided by the firm about a merger.

36. *See, e.g.,* Spear, Leeds & Kellogg v. Cent. Life Assurance Co., 85 F.3d 21, 29 (2d Cir. 1996) (holding that an alleged victim of a NYSE member's fraud can arbitrate a dispute over "exchange-related business," even though there is no relationship between victim and firm). *Spear, Leeds* leaves open whether, when a NYSE member is accused of wrongdoing, the claim is arbitrable even if it does not arise from "exchange-related" business. *Compare* FSP, Inc. v. Societe Generale, No. 02-C4786, 2003 U.S. Dist. LEXIS 493 (S.D.N.Y. Jan. 13, 2003), *aff'd and remanded*, 2003 U.S. App. LEXIS 23086 (2d Cir. Nov. 12, 2003) (holding that a buyer of a NYSE member's securities business could not arbitrate a contractual dispute, since it was not "exchange-related" business).

37. 514 U.S. 938 (1995).

38. *Id.* at 944 (citation omitted).

39. *Id.* at 945.

40. *Id.*

41. *Id.* at 944-45 (quoting Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp., 460 U.S. 1, 24-25 (1983)).

I now examine three categories of cases where brokerage firms or their principals challenge arbitrability: definition of "customer," fraudulent conveyance, and successor-in-interest liability. While courts generally have appropriately adopted an expansive view of arbitrability (with one notable exception, successor-in-interest liability), it is striking that courts have decided uniformly (frequently without discussion) that they, not arbitrators, decide whether the matter is arbitrable.

Definition of "Customer"

Four recurring fact patterns illustrate difficulties with determining who is a "customer" under SRO rules: (1) the investor did business with an "associated person" of the firm, who, instead of opening an account for the customer with the firm, misappropriated the funds;[42] (2) the investor did business with an "associated person" of the firm, but the dispute did not involve an account or business with the firm;[43] (3) the investor had an account with the firm, but a person who was not associated with the firm made all the investment decisions;[44] (4) the investor did business with a person who was not associated with the firm, who in turn transacted business with the firm.[45] The courts have

42. Arbitrable: *see, e.g.*, Oppenheimer & Co. v. Neidhardt, 56 F.3d 352, 357-58 (2d Cir. 1995).

43. Arbitrable: *see, e.g.*, WMA Sec. v. Wynn, 32 Fed. Appx. 726, 729 (6th Cir. 2002); Vestax Sec. Corp. v. McWood, 280 F.3d 1078, 1081-82 (6th Cir. 2002); John Hancock Life Ins. Co. v. Wilson, 254 F.3d 48, 59-60 (2d Cir. 2001); Wash. Square Sec. v. Hicks, 271 F. Supp. 2d 1058 (S.D. Ohio 2003); Jefferson Pilot Sec. Corp. v. Blankenship, 257 F. Supp. 2d 962, 967 (N.D. Ohio 2003); Wash. Square Sec. v. Aune, 253 F. Supp. 2d 839, 844 (W.D. N.C. 2003); MONY Sec. Corp. v. Bornstein, 250 F. Supp. 2d 1352 (M.D. Fla. 2003); Smith v. Bartolini, 2003 WL 21148940 (N.D. Ill. May 2003); Fin. Network Inv. Corp. v. Thielbar, 2003 U.S. Dist. LEXIS 14889 (N.D. Ill. Aug. 2003); Wash. Square Sec. v. Sowers, 218 F. Supp. 2d 1108, 1117-18 (D. Minn. 2002); Multi-Fin. Sec. Corp. v. Brown, 2002 WL 32130291 (E.D. Pa. Dec. 2002); Fin. Network Inv. Corp. v. Becker, 741 N.Y.S.2d 837 (N.Y. Sup. Ct. 2002), *aff'd*, 762 N.Y.S.2d 25 (N.Y.A.D. 1 Dept. 2003); BMA Fin. Serv. v. Guin, 164 F. Supp. 2d 813, 821 (W.D. La. 2001); First Montauk Sec. Corp. v. Four Mile Ranch Dev. Co., 65 F. Supp. 2d 1371, 1381 (S.D. Fla. 1999); Lehman Bros. v. Certified Reporting Co., 939 F. Supp. 1333, 1340-41 (N.D. Ill. 1996) (decided under NYSE Rule 600); Royal Alliance Assoc. v. Davis, 897 F. Supp. 783, 788 (S.D.N.Y. 1995).

Not arbitrable (not enough to be customers of "associated person"; investors must be "customers" of firm): *see, e.g.*, MONY Sec. Corp. v. Vasquez, 238 F. Supp. 2d 1304, 1308 (M.D. Fla. 2002); Investors Capital Corp. v. Brown, 145 F. Supp. 2d 1302, 1308 (M.D. Fla. 2001).

To some courts, it depends on whether the customer thought the person was associated with the firm: *see, e.g.*, Investors Capital Corp. v. Rimmler, No. 600CV1092ORL22DAB, 2001 WL 114936, at *1 (M.D. Fla. Feb. 5, 2001); WMA Sec. v. Ruppert, 80 F. Supp. 2d 786, 789 (S.D. Ohio 1999).

In some cases, the firm also asserts that the individual was not an "associated person" of the firm: *see, e.g.*, *Wynn*, 32 Fed. Appx. 726; Hornor, Townsend & Kent, Inc. v. Hamilton, 218 F. Supp. 2d 1369 (N.D. Ga. 2002).

44. Arbitrable: *see, e.g.*, K.W. Brown & Co. v. McCutchen, 819 So. 2d 977, 980-81 (Fla. Ct. App. 2002).

45. Not arbitrable: *see, e.g.*, Bensadoun v. Jobe-Riat, 316 F.3d 171 (2d Cir. 2003); Brookstreet Sec. Corp. v. Bristol Air, Inc., No. C02-0863SI, 2002 U.S. Dist. LEXIS 16784, at *26-27 (N.D. Cal. Aug. 5, 2002).

consistently held that situations (1), (2), and (3) are arbitrable because the investor is considered a "customer" of either the "associated person" or the firm and that (4) is not arbitrable because the investor is not a "customer" of either.

John Hancock Life Ins. Co. v. Wilson[46] is one of the few decisions to provide much discussion of the "who decides" issue. It held that courts must decide whether an investor is a "customer" in instances where the investor is invoking arbitration under the arbitration forum's rules and there is no separate agreement between the parties giving the arbitrators authority to decide. The court believed that the need for a separate agreement followed from *First Options* and the need for "clear and unmistakable" evidence of the intent to confer this authority on the arbitrators, lest the unwilling party's "reasonable expectations" that a court would decide this issue be thwarted.[47]

What are the reasonable expectations of a brokerage firm that does not wish to arbitrate a claim brought by someone it asserts is not its customer? In instances where there is a customer agreement between the investor and the firm, the clear intent of the required language[48] is that arbitrators have full power to decide all issues relating to the claim, including arbitrability. This, at the least, covers the category (3) cases above. But beyond this, brokerage firms understand that they are bound by applicable SRO rules that confer broad authority on the arbitrators to interpret and determine the applicability of all provisions of the Code.[49] NASD Rule 10106, in particular, prohibits a party from instituting or prosecuting any litigation against any other party "touching upon any of the matters referred to arbitration."[50]

John Hancock recognizes the SROs' authority to require their members to present arbitrability issues to the arbitrators,[51] but maintains that the language must be found in a separate agreement with the other party to the dispute. This requirement is needlessly formalistic. Given the clarity of the language in NASD Rule 10106, the securities firms' reasonable expectation should be that the arbitration panels at SRO forums will decide all issues, including arbitrability, arising from a dispute with an investor. It is hard to see how, in the case of NASD

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46. 254 F.3d 48, 57 (2d Cir. 2001).

47. *Id.* at 55.

48. *See* discussion *supra* notes 27-29 and accompanying text.

49. *See* NASD CODE 2003, *supra* note 19, Rule 10324; NYSE 2003, *supra* note 19, Rule 621.

50. *See* NASD CODE 2003, *supra* note 19, Rule 10106. *See* UBS PaineWebber, Inc. v. Stone, No. 02-471, 2002 U.S. Dist. LEXIS 5162 at *8 (E.D. La. Mar. 8, 2002) (refusing firm's request for injunctive relief in connection with ongoing arbitration because NASD Rule 10106 prohibits the firm from bringing this action).

51. *John Hancock*, 254 F.3d at 57.

arbitrations, there could be any clearer expression of intent than NASD Rule 10106.

In the main, courts have decided arbitrability issues correctly. Investors are harmed, nonetheless, by the delay and expense caused when firms bring litigation contesting arbitration. In *John Hancock*, for example, while the court ultimately ordered the firm to arbitrate claims commenced by customers of the firm's "associated person" in late 1999 and early 2000, it was not until mid-2001 that the Second Circuit issued its opinion affirming the district court's order compelling arbitration.

Fraudulent Conveyance Claims

It is common in the securities industry for brokerage firms to go out of business and leave arbitration awards against them unpaid.[52] Investors holding unpaid awards have few options, but if they can establish that the firm, prior to closing its doors, transferred assets to its principals to evade creditors, they can bring another arbitration claim against the defunct firm's principals on fraudulent conveyance grounds. The difficulties of this option are illustrated in *Miller v. Flume*,[53] where the investors obtained an $180,000 award against the firm in early 1994. The firm ceased operations while its motion to vacate the award was pending, and it did not pay the award when it was confirmed in 1995. The investors then commenced arbitration against the principals, charging fraudulent transfer of the defunct firm's assets. The principals, however, persuaded the federal district court to enjoin the arbitration, successfully arguing that the investors were no longer customers and that a fraudulent conveyance claim was not a claim arising in connection with the firm's securities business. The Seventh Circuit, relying on NASD Rule 10301, reversed on both grounds.[54] More than two years after the investors had instituted the second arbitration (and four years after obtaining the original award), they were finally able to proceed with their only chance at collection.

Although the Seventh Circuit was correct in finding the matter arbitrable, it made the same mistake as the *John Hancock* court and held that *First Options* required the court, rather than the arbitrators, to decide

52. The United States General Accounting Office (GAO) has issued three reports in four years on the problem of unpaid securities arbitration awards: *Securities Arbitration: Actions Needed to Address the Problem of Unpaid Awards*, GGD-00-115 (Wash. D.C. June 15, 2000); *Evaluation of Steps Taken to Address the Problem of Unpaid Arbitration Awards*, GAO-01-654R (Wash. D.C. Apr. 27, 2001), and *Follow-Up Report on Matters Relating to Securities Arbitration*, GAO-03-162R (Wash. D.C. Apr. 11, 2003), *all available at* http://www.gao.gov (last visited June 26, 2003).

53. 139 F.3d 1130 (7th Cir. 1998).

54. *See* discussion *supra* note 32 and accompanying text.

the question of arbitrability. Even though the court recognized that the language of the NASD Code could be interpreted to confer power on the arbitrators to decide the question, it did not find the language sufficiently "clear and unmistakable" to meet the *First Options* test.[55]

Successor-in-Interest Liability Claims

When a brokerage firm discontinues business, another firm may purchase its business operations with the expectation that the customers of the transferor firm will move their accounts to the transferee firm. These transactions are typically structured as a sale of assets, and the purchase agreements state that the purchaser assumes no liability for any customers' claims against the seller. Notwithstanding this disclaimer, in some instances, liability may be imposed on the purchaser based upon common law principles as a successor-in-interest to the transferor firm.[56] When customers bring arbitrations against successor firms, the firms frequently seek judicial determination that they cannot be held liable on this basis, sometimes even after the arbitrators have already declined to dismiss the claims. Unfortunately, every court save one that has considered this question has summarily treated this as a question of arbitrability to be decided by the court.[57] Moreover, unlike the previous two categories—definition of customer and fraudulent conveyance claims—the courts have been reluctant to find successor claims arbitrable.

Wheat, First Sec., Inc. v. Green[58] is the leading case on successor-in-interest liability. Even though the investors had transferred their accounts to the firm purchasing the assets, the court held that they could

55. *Miller*, 139 F.3d at 1134. The court's analysis is also questionable because of its substantial reliance on pre-*Howsam* Seventh Circuit precedent holding that courts should decide eligibility rule issues.

56. A court will impose liability on a successor-in-interest theory if (1) the purchaser agreed to assume the debt, (2) there was a *de facto* merger of the two corporations, (3) the purchaser was a mere continuation of the seller, or (4) the transaction was fraudulent. *See* Wheat, First Sec., Inc. v. Green, 993 F.2d 814, 821 (11th Cir. 1993); Ryan Beck & Co. v. Campbell, No. 02 C 7016, 2002 WL 31696792, at *3 (N.D. Ill. Dec. 2, 2002).

57. *See Green*, 993 F.2d at 819; Ryan Beck & Co. v. Faust, No. 03-CV-636 (W.D. Pa. May 7, 2003) (unpublished opinion on file with author), *later case* 2003 U.S. Dist. LEXIS 15164 (W.D. Pa. Aug. 2003); *Campbell*, No. 02 C 7016, 2002 WL 31696792, at *2, *later case* 2003 U.S. Dist. LEXIS 17428 (N.D. Ill. Oct. 2003); Prudential Sec. v. Bellomo, No. C-97-0020 SI, 1997 U.S. Dist. LEXIS 8775, at *7 (N.D. Cal. June 6, 1997); Gruntal & Co. v. Steinberg, 843 F. Supp. 1, 9 (D. N.J. 1994), *aff'd*, 46 F.3d 1116 (3d Cir. 1994); Prudential Sec. v. Dusch, No. 93-1470-IEG (RBB), 1994 U.S. Dist. LEXIS 21623, at *10 (S.D. Cal. Mar. 28, 1994). *But see* Ryan, Beck & Co. v. Fakih, 268 F. Supp. 2d 210 (E.D.N.Y. 2003) (holding that arbitrators could decide arbitrability if investors became customers of the successor firm), *later case* 275 F. Supp. 2d 393 (E.D.N.Y. 2003).

58. 993 F.2d 814 (11th Cir. 1993).

not demand arbitration as customers under NASD Rule 10301,[59] interpreting the rule to apply only to customers of the firm at the time of the complained-of activity. According to the court, any obligation on the part of the purchaser firm to arbitrate claims arising under the seller's accounts had to be found either through interpretation of the asset purchase agreement or through application of common law principles, responsibilities that belonged to the courts.[60] Implicit in the court's reasoning is a skepticism that the arbitrators will get it right.

The court's rationale for interpreting NASD Rule 10301 to apply only to customers at the time of the complained-of activity was fair notice to the firm: "[W]e cannot imagine that any NASD member would have contemplated that its NASD membership alone would require it to arbitrate claims which arose while a claimant was a customer of another member merely because the claimant subsequently became its customer."[61] Why is this so unimaginable? In instances where the investor does not transfer his account, then perhaps *Green* is correct that it would be unfair to require the purchaser to arbitrate claims against someone who was never its customer;[62] although a firm that purchases assets from another firm that is ceasing operations, with the expectation of taking over its customers' accounts, perhaps should be on notice that any customer of the defunct firm may pursue a successor-in-interest arbitration claim against it. But the facts in *Green* are stronger than the court concedes because the investors became customers of the successor firm and alleged that the wrongdoing continued after the transfer.

The district court in *Ryan, Beck & Co., LLC v. Fakih*,[63] in contrast, arrived at a better decision. It rejected *Green's* narrow interpretation of Rule 10301 and held that, as to the investors who transferred their accounts to the purchaser, the arbitrators would decide the question of arbitrability. The court, however, refused to extend Rule 10301 to encompass claims of an investor who closed his account with the seller a year before the sale of assets. In the latter instance, the court would decide whether the investor could arbitrate the claim against the transferee firm on a successor-in-interest theory.

Green's refusal to allow the arbitrators to decide whether to impose liability on a successor-in-interest theory caused a delay in the arbitra-

59. *Id.* at 820; *see* discussion *supra* note 32 and accompanying text.

60. *Id.* at 819 (stating that "[t]he district court correctly concluded that it should not turn this responsibility over to the arbitrators".)

61. *Id.* at 820.

62. The court in *Fakih*, 268 F. Supp. 2d 210, makes this distinction. The investors in *Campbell*, No. 02 C 7016, 2002 WL 31696792, and *Steinberg*, 854 F. Supp. 324, did not transfer their accounts.

63. 268 F. Supp. 2d 210 (E.D.N.Y. June 23, 2003).

tion of all claims until conclusion of the firm's lawsuit, which resulted in the issuance of an injunction prohibiting the arbitrator from hearing claims prior to the transfer of the account, but allowing arbitration of the post-transfer claims. Surely any benefit of narrowing the arbitration claims is not worth the expenditure of judicial resources and the delay in arbitration. The courts should refer successor-in-interest claims to the arbitrators and trust them to make the right decision.

Summary

Courts should recognize that SRO rules provide clear expression of the intent that arbitrators will decide arbitrability issues and that brokerage firms have fair notice that arbitrators will decide these questions. Judicial resolution of arbitrability issues results in unwarranted delays (frequently of years) in the submission of the matter to arbitration. While previously an argument might have been made that courts should decide arbitrability issues in order to generate precedent,[64] there is now sufficient case law to provide guidance to arbitrators. Indeed, the types of issues that tend to occur in this area are not legal or policy questions where judicial involvement would provide added value, but are rather technical and intensely factual issues best left to the arbitrators, who are assumedly familiar with the field.[65]

Merits-Based Grounds for Enjoining Securities Arbitrations

Courts have not limited their involvement in ongoing arbitrations to arbitrability questions. They have also impermissibly enjoined securities arbitrations on merits-based grounds that should be decided by arbitrators. In this section, I look at three areas where courts have interfered: dismissal on the merits, res judicata/collateral estoppel defenses, and New York's statute of limitations.

Dismissal on the Merits

If a customer brings an arbitration against a firm and the firm believes it has a complete defense to the customer's complaint, the firm should raise the defense in the arbitration, in a dispositive motion if

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64. The privatization of broker-dealer law and its effect on securities arbitration is discussed in Black & Gross, *supra* note 9, at 1013-1030.

65. *See, e.g.*, Bensadoun v. Jobe-Riat, 316 F.3d 171 (2d Cir. 2003) (remanding to trial court for an evidentiary hearing on whether the investors were customers).

appropriate.[66] On occasion, unfortunately, courts accept the firm's invitation to decide the case on the merits and enjoin arbitration. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Green*,[67] the firm sought to enjoin an arbitration brought by a customer who felt aggrieved because the firm reported suspicious activities in his account to federal authorities without notifying him. Because a federal banking statute expressly immunized the firm from liability, the court refused to allow the arbitration to go forward. Similarly, in *WFC Commodities Corp. v. Alston*,[68] the firm was successful in enjoining the customer's arbitration because the court found that the claim was time-barred under a one-year limitations period contained in the customer agreement.

Brokerage firms have no right to expect judicial protection from arbitration. If it is so clear that the defense must prevail, the broker should win the arbitration expeditiously. Moreover, the risk of losing because the decision-maker "got it wrong" is a possibility all parties face in either arbitration or litigation. Courts that take away legal issues from the arbitrators reflect an inappropriate suspicion that the arbitrators will not arrive at the right result.

Res Judicata/Collateral Estoppel Defenses

Res judicata or collateral estoppel principles may bar arbitration of issues previously contested in either litigation or arbitration. In addressing the question of who decides the preclusive effect of a prior judgment or an arbitration award, courts frequently treat the two questions differently.

A distinctly minority position is that the preclusive effect of a prior judgment is a merits-related defense like any other that arbitrators decide.[69] Most federal courts[70] and some state courts,[71] however, express

66. *See, e.g.*, Sheldon v. Vermonty, 269 F.3d 1202, 1206 (10th Cir. 2001) (holding that arbitrators can dispose of legal matters on dispositive motions).

67. 936 F. Supp. 942, 944-45 (S.D. Fla. 1996) (also finding that customer waived his right to arbitrate by his previous actions).

68. No. OOC0044, 2000 WL 33534178, at *1 (N.D. Ill. Mar. 8, 2000) (treating this as an arbitrability issue, pre-*Howsam*).

69. *See, e.g.*, U.S. Fire Ins. Co. v. Nat'l Gypsum Co., 101 F.3d 813, 816-17 (2d Cir. 1996). *Compare* Hoover v. Prudential Sec., No. C-3-01-331, 2003 U.S. Dist. LEXIS 17307 (Aug. 5, 2003) (deciding that its prior judgment did not bar arbitration, but recognizing that arbitrators may decide this issue under *Howsam*).

70. *See, e.g.*, John Hancock Mutual Life Ins. Co. v. Olick, 151 F.3d 132, 139 (3d Cir. 1998); *In re* Y & A Group Sec. Litig., 38 F.3d 380, 383 (8th Cir. 1994); Kelly v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 985 F.2d 1067, 1069 (11th Cir. 1993).

71. *See, e.g.*, Leon C. Baker, P.C. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 821 So. 2d 158, 163-64 (Ala. 2001), *cert. denied*, 535 U.S. 987 (2002).

a strong policy to protect their own judgments; accordingly, only the court rendering the judgment should determine its preclusive effect.

Some courts similarly believe that the preclusive effect of a prior arbitration award is an issue so important that only courts can decide it.[72] The better view, however, is that since the institutional concerns raised when the prior decision is a judgment are absent in this situation, there is no reason to treat the preclusive effect of prior arbitration awards differently from any other merits-based defense. Because the SRO rules give broad authority to arbitrators to decide all issues, the courts should not involve themselves in a matter that the panel in an ongoing arbitration can resolve.[73]

New York Statute of Limitations

Howsam made clear that ordinarily arbitrators decide procedural issues like statute of limitations.[74] In New York, however, the state arbitration statute provides that a party to an arbitration may ask the court to determine if arbitration is barred by the statute of limitations.[75] While the statute by its terms does not take away the arbitrators' power to decide the issue as well, New York's highest court has stated that under New York law "*statutory* time limitations . . . as opposed to *contractual* time limitations agreed upon by the parties—are for the courts, not the arbitrators" to decide.[76] Two district courts have addressed the issue of whether firms, by including in their customer agreements a New York choice of law clause specifically applicable to arbitration,[77] can require judicial resolution of statute of limitations issues, and reached different results.

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72. *See, e.g.,* Waterfront Marine Constr., Inc. v. N. End 49ers Sandbridge Bulkhead Groups A, B and C, 251 Va. 417, 433 (1996). Many courts do not provide any explanation of why they, instead of the arbitrators, should decide preclusion issues, *see, e.g.,* Tucker Anthony v. Baird, 12 F. Supp. 2d 23, 25 (D.D.C. 1998).

73. *See, e.g.,* Chiron Corp. v. Ortho Diagnostic Systems, 207 F.3d 1126, 1134 (9th Cir. 2000); *Olick*, 151 F.3d at 140; Nat'l Union Fire Ins. Co. of Pittsburgh, PA v. Belco Petroleum Corp., 88 F.3d 129, 135 (2d Cir. 1996); Bd. of Ed. of Patchogue-Medford Union Free Sch. Dist. v. Patchogue-Medford Cong. of Teachers, 399 N.E.2d 1143, 1144 (N.Y. 1979).

74. 537 U.S. 79, 84 (2002).

75. *See* N.Y. C.P.L.R. §§ 7502(b), 7503(a) (McKinney 2003).

76. Smith Barney, Harris Upham & Co. v. Luckie, 647 N.E.2d 1308, 1313 (N.Y. 1995); *but see* Smith Barney Shearson, Inc. v. Sacharow, 689 N.E.2d 884, 889 (N.Y. 1997) (limiting *Luckie* to choice-of-law provisions that are applicable to both the contract's construction and its enforcement).

77. After *Mastrobuono*, a general New York choice-of-law clause in the customer agreement is not sufficient to invoke the New York Rule. *See, e.g.,* Shaw Group v. Triplefine Int'l Corp., 322 F.3d 115, 123-25 (2d Cir. 2003); PaineWebber, Inc. v. Bybyk, 81 F.3d 1193, 1201-02 (2d Cir. 1996).

In *Coleman & Co. Securities v. Giaquinto Family Trust*,[78] the customer agreement provided that "[a]ny arbitration under this agreement shall be conducted pursuant to the Federal Arbitration Act and the laws of the State of New York."[79] The court found no ambiguity in the language and interpreted it to mean that New York's arbitration statute was applicable.[80] It also held, relying on *Volt* and *Mastrobuono*, that the FAA did not preempt the state statute, since the central purpose of the FAA is to ensure that private agreements to arbitrate are enforced according to their terms.[81]

In contrast, another district court, in *Dean Witter Reynolds, Inc. v. Sanchez Espada*,[82] found language in a customer agreement insufficiently clear to warrant application of the New York rule, even though, unlike *Coleman*, the choice of law provision contained in the arbitration clause referred specifically to the statute of limitations issue: "The law of the State of New York will apply in all respects, including but not limited to determining of applicable statutes of limitation and available remedies."[83] The court found this language "murky" and the firm's interpretation of it "strained," particularly since the agreement contained the NASD-required language that "[t]he parties are waiving their right to seek remedies in court."[84]

The *Sanchez Espada* court has the better argument in terms of contract interpretation. There is not just ambiguity, but a direct conflict, between the waiver of a judicial remedies clause and the New York choice of law clause, if the latter is interpreted to authorize the firm to seek judicial determination of the statute of limitations issues. The NASD has made it clear that a firm's contractual assertion of the New York rule conflicts and contravenes the waiver of judicial remedies clause.[85]

In sum, decisions in these three areas—fraudulent conveyance claims, res judicata/collateral estoppel defenses, and New York statute of limitations defenses—demonstrate that courts frequently interfere with

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78. No. 00 CIV. 1632, 2000 WL 1683450, at *1 (S.D.N.Y. Nov. 9, 2000), *later decision*, 236 F. Supp. 2d 288, 293 (S.D.N.Y. 2002) (finding customer's claims time-barred).

79. *Coleman*, No. 00 CIV. 1632 (DC), 2000 WL 1683450, at *1.

80. *Id.* at *4.

81. *Id.* at *3.

82. 959 F. Supp. 73 (D.P.R. 1997).

83. *Id.* at 75.

84. *Id.* at 82; *see also supra* notes 27-29 and accompanying text.

85. "[T]he use of a governing law clause or other clause anywhere within a customer agreement that thwarts any NASD arbitration provision will be deemed violative." NASD Notice to Members 95-16, *supra* note 29, at *2.

ongoing arbitrations and take away from the arbitrators issues that they should properly decide.

PART THREE

Increasingly, brokerage firms and individual brokers seek to vacate arbitration awards in favor of customers,[86] even though federal and state courts articulate an extremely deferential standard of review of arbitrators' awards, stating that courts should vacate arbitrators' awards only in very unusual circumstances.[87] Because the statutory grounds for vacatur do not lend themselves to broad interpretation, firms frequently assert that the arbitrators "manifestly disregarded the law," a non-statutory ground for vacatur. Many courts recognize "manifest disregard" as a basis for vacatur, although to date they seldom vacate awards on this ground.

The industry's persistence in making vacatur motions on dubious grounds presents two problems. First, when firms and brokers consistently make motions to vacate, the potential exists for overly intrusive judicial review, contrary to the Supreme Court's directive for finality.[88] Second, in some instances firms and brokers are making frivolous motions to vacate in order to delay payment to the customer or even to extort a lower payment in settlement. The judiciary should not provide assistance to practices that breach a broker's duty to deal fairly with its customers.

Standard of Judicial Review of Arbitration Awards

Judicial review of arbitration awards in the federal courts is "very limited."[89] Courts "do not sit to hear claims of factual or legal error by an arbitrator as an appellate court does in reviewing decisions of lower

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86. A comprehensive survey of motions to vacate securities arbitration awards from 1988-2000 shows an increase in industry challenges from 33% to 51% and suggests that challenges may increase because of increased application of the manifest disregard standard. Richard P. Ryder, *Securities Arbitration 2000, Today's Trends, Predictions for Tomorrow*, SECURITIES ARBITRATION 2000, at 1141, 1171 (PLI 2000).

87. *See, e.g.*, First Options of Chi., Inc. v. Kaplan, 514 U.S. 938, 942 (1995); Hackett v. Milbank, Tweed, Hadley & McCloy, 654 N.E.2d 95, 102 (N.Y. 1995).

88. *See* Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79, 85 (2002).

89. Alberti v. Dean Witter Reynolds, Inc., 205 F.3d 1321, 2000 WL 19090, at *1 (2d Cir. 2000) (unpublished opinion) (quoting Willemijn Houdstermaatschappij, BV v. Standard Microsystems Corp., 103 F.3d 9, 12 (2d Cir. 1997). For similar language, see, *e.g.*, Dawahare v. Spencer, 210 F.3d 666, 669 (6th Cir. 2000); Spicuzza v. Sec. Serv. Network, 32 Fed. Appx. 327, 328 (9th Cir. 2002); Cohig & Assoc. v. Stamm, 149 F.3d 1190, 1998 WL 339472, at *2 (10th Cir. 1998) (unpublished opinion); Davis v. Prudential Sec., Inc., 59 F.3d 1186, 1190 (11th Cir. 1995).

courts."[90] Furthermore, "[l]imiting judicial review is necessary to encourage the use of arbitration as an alternative to . . . litigation" and to achieve the "'twin goals of arbitration, namely, settling disputes efficiently and avoiding long and expensive litigation.'"[91] The disappointed party should not be able to circumvent the parties' agreement to have an arbitrator decide the dispute "by the back door" of appellate review.[92] State courts have similarly expressed a strong public policy in favor of finality under their state arbitration statutes.[93]

Procedural Grounds

The Federal Arbitration Act (FAA) sets forth four process-based grounds for vacating an award.[94] The first two involve a corrupt process[95] or a corrupt arbitrator.[96] The third addresses serious procedural errors,[97] and the fourth, somewhat cryptically, allows for vacatur "[w]here the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made."[98] The statute also allows for correcting an award for mechanical or transcription errors.[99]

Brokers frequently attempt to vacate awards because the arbitrators refused their requests to postpone a scheduled hearing[100] or refused to

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90. Advest, Inc. v. McCarthy, 914 F.2d 6, 8 (1st Cir. 1990) (quoting United Paperworkers Int'l Union v. Misco, Inc., 484 U.S. 29, 38 (1987)).

91. Remmey v. PaineWebber, Inc., 32 F.3d 143, 146 (4th Cir. 1994) (quoting Folkways Music Publishers, Inc. v. Weiss, 989 F.2d 108, 111 (2d Cir. 1993)).

92. Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 706 (7th Cir. 1994).

93. *See, e.g.,* Hackett v. Milbank, Tweed, Hadley & McCloy, 654 N.E.2d 95, 102 (N.Y. 1995), Moncharsch v. Heily & Blasé, 832 P.2d 899, 919 (Cal. App. Div. 1992).

94. 9 U.S.C. § 10(a)(1-4) (2003).

95. *Id.* at (a)(1) ("[w]here the award was procured by corruption, fraud, or undue means").

96. *Id.* at (a)(2) ("[w]here there was evident partiality or corruption in the arbitrators, or either of them"). *See also* Montez v. Prudential Sec., 260 F.3d 980, 984 (8th Cir. 2001) (holding that arbitrator partiality is not established by an arbitrator's undisclosed past associations with the law firm representing one of the parties, dating back five years); Mariner Fin. Group v. Bossley, 79 S.W.3d 30 (Tex. 2002) (holding that the arbitrator's failure to disclose that the customer's expert witness had previously testified against him presented factual issues as to his partiality).

97. 9 U.S.C. § 10(a)(3) ("[w]here 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 other misbehavior by which the rights of any party have been prejudiced").

98. *Id.* at (a)(4).

99. 9 U.S.C. § 11(c) (2003).

100. *See, e.g.,* Fogleman v. Testerman, 165 F.3d 911, 1998 WL 795194 at **2 (4th Cir. 1998) (unpublished opinion); Bisnoff v. King, 154 F. Supp. 2d 630, 633 (S.D.N.Y. 2001); Morrow v. Jersey Capital Markets Group, Inc., No. 90 CIV.5305 (RPP), 1995 WL 70630, at *2 (S.D.N.Y. Feb. 17, 1995). One notorious firm, Stratton Oakmont, and its principals have unsuccessfully made this argument in numerous district court opinions, including *Shamah v. Schweiger*, 21 F. Supp. 2d 208, 211 (E.D.N.Y. 1998), and *Card v. Stratton Oakmont*, 933 F. Supp. 806, 809 (D. Minn. 1996).

hear some of the proffered evidence,[101] but courts rarely vacate awards on these grounds. Arbitrators have broad discretion in managing the arbitration process, and procedural defects are not grounds for vacating an award so long as the arbitration process was "fundamentally fair."[102]

Courts have also resisted efforts to interpret broadly the statutory ground that the arbitrators "so imperfectly executed [their powers] that a mutual, final, and definite award upon the subject matter submitted was not made."[103] For example, the Seventh Circuit found that the statutory requirements of finality and definiteness were "more of form than . . . substance:"[104] the judge must confirm the award so long as he or she can determine that the arbitrators decided the dispute and what the resolution was.[105]

Similarly, challenges to awards on the ground that the arbitrators exceeded their powers are seldom successful. So long as the process was fundamentally fair, courts will confirm the award.[106] A few courts, however, have improperly used this ground to review the merits of a dispute. In *Spear, Leeds & Kellogg v. Bullseye Securities, Inc.*,[107] an intra-industry dispute, the claimant firm alleged damages resulting from negligence on the part of the respondent firm's employee. Because the

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101. *See, e.g.*, Maiocco v. Greenway Capital Corp., No. CIV.A 97-A-MC-0053, 1998 WL 48557 at *2, 10 (E.D. Pa. Feb. 2, 1998) (finding that arbitrator's comment that he would throw cases in the "trash" did not, in context, warrant vacatur); Steiner v. Glenn, No. 00 C 7645, 2002 WL 31133197, at *3 (N.D. Ill. Feb. 2, 2002).

102. *See, e.g.*, Bowles Fin. Group v. Stifel, Nicolaus & Co., 22 F.3d 1010, 1013 (10th Cir. 1994); Hayne, Miller & Farni, Inc. v. Flume, 888 F. Supp. 949, 952 (E.D. Wis. 1995); Plank v. Vision Ltd. P'ship, No. 02 C 4453, 2003 WL 76864, at *2 (N.D. Ill. Jan. 9, 2003) (holding that a charge that the award was obtained through perjured or prejudicial testimony is not a basis for challenging that award, as it amounts to impermissible review of the arbitrator's assessment of the evidence or witnesses' credibility).

103. 9 U.S.C. § 10(a)(4) (2003).

104. IDS Life Ins. Co. v. Royal Alliance Assoc., Inc., 266 F.3d 645, 650 (7th Cir. 2001).

105. *Id.* at 650-51.

106. *See, e.g.*, Gibbons v. Smith, 67 Fed. Appx. 52, 55, 2003 U.S. App. LEXIS 11548, (2d Cir. 2003) (unpublished opinion) (confirming proceeding against absent broker who received notice of arbitration pursuant to SRO rules); *In re* Beckman v. Greentree Sec., 663 N.E.2d 886, 889-90 (N.Y. 1996) (to same effect); Sheldon v. Vermonty, 269 F.3d 1202, 1207 (10th Cir. 2001) (confirming award that granted dispositive motion after telephonic hearing); Ashraf v. Republic N.Y. Sec. Corp., 14 F. Supp. 2d 461, 469 (S.D.N.Y. 1998) (confirming award where the broker had no opportunity to respond to a new theory of damages introduced in customer's post-hearing brief); Young v. Alagna, No. CIV.A3:99-CV-2309G, 2000 WL 472863, at *6 (N.D. Tex. Apr. 24, 2000) (confirming award where the broker was reinstated as a respondent after he did not appear to testify as customer's witness pursuant to an agreement). A rare instance of a court's vacating a customer's award on procedural grounds is N.E. N.Y. Dist. Council Pipefitters Welfare Fund, Local 773 v. Calapa (N.Y. Sup. Ct. Albany County Nov. 21, 2002) (unpublished opinion on file with author). The broker believed that the firm's attorney was also representing him, but the firm had settled with the customer and apparently had not notified the broker, who received no notice about the hearing. The court found the arbitrators acted improperly in going forward with the arbitration without inquiring about the absence of the broker.

107. 738 N.Y.S.2d 27 (App. Div. 2002).

statement of claim asserted only corporate claims, the court vacated an award in favor of the claimant firm's owners.[108] If the court had simply remanded the matter to the arbitrators for clarification or correction of this matter, the vacatur would be unobjectionable. The court, however, went further and found the award "inherently inconsistent" and "irrational" because it found no basis to impose liability on the respondent firm since the arbitrators specifically denied the claims against the allegedly negligent employee.[109]

"Manifest Disregard of the Law"

The Supreme Court, in *Wilko v. Swan*,[110] referred to a non-statutory basis for vacatur, "manifest disregard of the law," without identifying the source of this standard. Although *Rodriguez* overruled *Wilko*, the Court subsequently referred to the manifest disregard standard as applicable to arbitration awards, again without explanation, in *First Options of Chicago, Inc. v. Kaplan*.[111] The manifest disregard standard, with its dubious origins, conflicts with the policy that the arbitrators' decision is final so long as the parties received a fair hearing.[112] Nevertheless, almost every circuit recognizes some formulation of a manifest disregard standard in the context of securities arbitration awards, and many state courts have also adopted the manifest disregard standard under their state arbitration statutes. Courts consistently state that the manifest disregard standard is extremely narrow and "means more than error or misunderstanding with respect to the law."[113] There is a strong presumption that the arbitrator has not acted in manifest disregard of the law.[114]

There are, however, degrees of narrowness. The Seventh Circuit confines vacatur to awards that direct the parties to violate the law,[115] and the Fifth Circuit to awards that "would result in significant injus-

108. *Id.* at 28.

109. *Id.* at 29.

110. 346 U.S. 427, 436-37 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

111. 514 U.S. 938, 942 (1995).

112. The California Supreme Court provides a clear statement of this policy in *Moncharsch v. Heily & Blasé*, 832 P.2d 899 (Cal. 1992), discussed *infra* note 128 and accompanying text.

113. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 933 (2d Cir. 1986).

114. *See, e.g.*, Westerbeke Corp. v. Daihatsu Motor Co, 304 F.3d 200, 218 (2d Cir. 2002), a non-securities arbitration case that the Second Circuit subsequently referred to, in a securities arbitration context, as providing "an extensive and comprehensive recapitulation of [its] case law" on this point. The GMS Group, LLC v. Benderson, 326 F.3d 75, 77 (2d Cir. 2003).

115. *See, e.g.*, Geo. Watts & Son, Inc. v. Tiffany & Co., 248 F.3d 577, 579-80 (7th Cir. 2000); *see also* IDS Life Ins. Co. v. Royal Alliance Assoc., 266 F.3d 645, 650 (7th Cir. 2001).

tice."[116] Unfortunately, however, most circuits allow a slightly more expansive review, just enough so that a firm could avoid sanctions for a frivolous vacatur motion.[117]

Currently applied, the manifest disregard standard does not allow for vacatur simply because the arbitrators misapplied the law. Rather, the test is designed to correct situations where the arbitrators "willfully flouted" the governing law.[118] The Second Circuit's two-prong test, with "both an objective and subjective component," demonstrates the difficulty in convincing a court to vacate an award under this standard.[119] First, the party seeking vacatur must establish that the law to be applied is "well defined, explicit, and clearly applicable."[120] Its applicability to the dispute must be "obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator."[121] Second, the party seeking vacatur must show that the arbitrator "appreciate[d] the existence of a clearly governing legal principle but decide[d] to ignore or pay no attention to it."[122] Courts may find intentional disregard if the arbitrators' reasoning "strains credulity."[123] Other circuits have adopted similar tests.[124]

116. Williams v. Cigna Fin. Advisors, 197 F.3d 752, 762 (5th Cir. 1999) (quoting Macneil, Speidel, & Stipanowich, 4 FEDERAL ARBITRATION LAW §40.7.2.6 at 40:95 (Supp. 1999)).

117. *See, e.g.*, Al-Azhari v. Merit Capital Assoc., NO. 99 CIV. 9795 (LAK), 2000 WL 151914, at *3 (S.D.N.Y. Feb. 14, 2002) (denying customer's Rule 11 motion for sanctions since firm's manifest disregard argument was weak, but "not wholly frivolous").

118. *Westerbeke*, 304 F.3d at 217; *see also Bobker*, 808 F.2d at 936-37 (finding no "manifest disregard" where the arbitrators did not follow the SEC's interpretation of its rule, since the record showed that the arbitrators carefully considered the rule's rationale).

119. *Westerbeke*, 304 F.3d at 209. In *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197, 202 (2d Cir. 1998), where a former employee charged the firm with age discrimination, the Second Circuit articulated an additional "manifest disregard of the facts" standard; *Benderson*, however, stated that *Halligan* did not create an additional basis for vacatur, 326 F.3d at 80.

120. *Westerbeke*, 304 F.3d at 209 (quoting *Bobker*, 808 F.2d at 934).

121. *Westerbeke*, 304 F.3d at 209 (quoting *Bobker*, 808 F.2d at 933).

122. *Westerbeke*, 304 F.3d at 209 (quoting *Bobker*, 808 F.2d at 933); *see also* DiRussa v. Dean Witter Reynolds Inc., 121 F.3d 818, 823-24 (2d Cir. 1997) (confirming a $200,000 award to a former employee that did not include attorney's fees, although the relevant statute required an award of attorney's fees to a prevailing party, since the record did not establish that the attorney made the arbitrators aware of the law).

123. *Westerbeke*, 304 F.3d at 218 (citation omitted).

124. In the First Circuit, the disappointed party must show that the award is "(1) unfounded in reason and fact; (2) based on reasoning so palpably faulty that no judge, or group of judges, ever could conceivably have made such a ruling; or (3) mistakenly based on a crucial assumption that is concededly a non-fact." Advest, Inc. v. McCarthy, 914 F.2d 6, 8-9 (1st Cir. 1990). More succinctly, it requires "some showing in the record, other than the result obtained, that the arbitrators knew the law and expressly disregarded it." *Id.* at 10 (citation omitted). The Tenth Circuit has adopted similar language; *see* Cohig & Assoc., v. Stamm, 149 F.3d 1190, 1998 WL 339472, at **3 (10th Cir. 1998). According to the Fourth Circuit, the party seeking vacatur must show that "the arbitrators were aware of the law, understood it correctly, found it applicable to the case before them, and yet choose to ignore it in propounding their decision." Remmey v. PaineWebber, Inc., 32 F.3d 143, 149 (4th Cir. 1994) (citation omitted). Similarly, in the Sixth, Ninth and Eleventh Circuits, to find manifest disregard, the relevant law must be "clearly defined and not subject to

In most securities arbitrations, the arbitrators do not state reasons in the award. Because of the strong presumption in favor of confirming awards, courts should uphold these awards so long as any colorable—or even "slightly colorable"—justification supports them.[125] Courts cannot permit the deposition of an arbitrator in order to ascertain his or her thought processes in arriving at a decision.[126] If the court can find any "legally plausible" line of argument to support the award, it must be confirmed.[127] This may not be as easy for judges to do as it sounds; it may require them both to examine the hearing record to determine what facts the arbitrators could have found and to consider the relevant law. As some opinions demonstrate, judges can devote considerable effort to assure themselves that they can confirm the award, even in some instances remanding the award to the arbitration panel for clarification.[128]

State courts also restrict judicial review of arbitration awards under their state arbitration statutes in varying degrees. California illustrates the most restrictive standard. It limits judicial review of arbitration awards to the statutory grounds and does not recognize the manifest disregard standard, reasoning that the risk of arbitrator mistake is acceptable in light of the judicial review available for arbitrator corruption or serious misconduct.[129] New York takes an intermediate position, recognizing limited non-statutory grounds in addition to the

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reasonable debate," and the arbitrators must have consciously chosen not to apply it. Dawahare v. Spencer, 210 F.3d 666, 669 (6th Cir. 2000) (citation omitted); *see also* Spicuzza v. Sec. Serv. Network, 32 Fed. Appx. 327, 2002 WL 460249, at *1 (9th Cir. 2002); Montes v. Shearson Lehman Bros., 128 F.3d 1456, 1461 (11th Cir. 1997) (in the award the arbitrators noted the attorney's plea to disregard the law and did not repudiate it).

Some Circuits have articulated additional or alternative tests: "completely irrational," *see* Hruban v. Steinman, 40 Fed. Appx. 723, 724 (3d Cir. 2002) (citation omitted), and "arbitrary and capricious," *see* Brown v. Rauscher Pierce Refsnes, Inc., 994 F.2d 775, 779 (11th Cir. 1993) (citation omitted). Because the Supreme Court has not recognized these tests, they are of even more suspect validity than "manifest disregard." For discussion of them, see Stephen L. Hayford, *A New Paradigm for Commercial Arbitration: Rethinking the Relationship between Reasoned Awards and the Judicial Standard for Vacatur*, 66 GEO. WASH. L. REV. 443, 489-92 (1998).

125. *Westerbeke*, 304 F.3d at 218.

126. Hoeft v. MVL Group, Inc., 343 F.3d 57 (2d Cir. 2003).

127. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros, 70 F.3d 418, 421 (6th Cir. 1995).

128. *See, e.g.*, Hardy v. Walsh Manning Sec., 341 F.3d 126 (2d Cir. 2003) (remanding to panel for clarification of the grounds for imposing liability on the CEO); Tripi v. Prudential Sec., 2003 WL 22208351 (S.D.N.Y. Sept. 2003) (remanding award for clarification because it awarded customer only three per cent of his losses); Sawtelle v. Waddell & Reed, Inc., 754 N.Y.S.2d 264 (App. Div. 2003) (remanding for explanation of punitive damages award court viewed as excessive). For *Sawtelle's* subsequent history, *see infra* note 159.

129. *See* Moncharsch v. Heily & Blasé, 832 P.2d 899, 904-05 (Cal. 1992); *see also* Nohre v. W.J. Gallagher & Co., No. B151769, 2002 WL 31424914, at *4 (Cal. App. Oct. 30, 2002) (confirming an award in favor of the customer and awarding attorneys fees because of the firm's frivolous motion to vacate).

statutory grounds.[130] The arbitrators' decisions on issues of law and fact are "conclusive"[131] unless the award is "totally irrational or violative of a strong public policy."[132] Finally, Illinois is an example of a state that has adopted manifest disregard in addition to the statutory grounds.[133]

Because there are many unsettled legal questions in federal and state securities law,[134] and because most questions of legal liability turn upon sometimes complicated issues of fact, including witness credibility, there are very few arbitrations involving customer-broker disputes where the broker could demonstrate that the arbitrators willfully flouted governing law.[135] To the contrary, in the typical customer-broker dispute, arbitrators hear conflicting evidence that could support a decision for either party.[136] Consequently, as the Supreme Court stated in *First Options*, only in "very unusual circumstances" should a court vacate an award.[137] Case law bears this out.[138] I have found only a handful[139] of awards vacated in customer-broker arbitrations on manifest disregard grounds, and most of them at the instance of the broker. Recently,

130. *See* N.Y. C.P.L.R. 7511 (McKinney 2003).

131. Motor Vehicle Accident Indemnification Corp. v. Aetna Cas. & Surety Co., 674 N.E.2d 1349, 1354 (N.Y. 1996).

132. Hackett v. Milbank, Tweed, Hadley & McCloy, 654 N.E.2d 95, 100 (N.Y. 1995) (quoting Maross Constr. v. Cent. N.Y. Reg'l Transp. Auth., 488 N.E.2d 67, 70 (N.Y. 1985)). Some lower courts have, however, also adopted "manifest disregard" as a standard. *See, e.g.*, UBS Warburg LLC v. Auerbach, Pollack & Richardson, Inc., 744 N.Y.S.2d 364, 365 (App. Div. 2002) (finding that the arbitrators "overtly disregarded" an SEC rule and "did not merely misinterpret it").

133. *See* Quick & Reilly, Inc. v. Zielinski, 713 N.E.2d 739, 743 (Ill. App. 1999). The Georgia legislature became the first to amend its arbitration statute to include manifest disregard as a statutory ground for vacatur, *see* 2003 Ga. Laws 363, amending GA. CODE ANN. § 9-9-13(b).

134. *E.g.*, controlling person liability, liability of clearing firms to retail customers, definition of recommendation. *See* Black & Gross, *supra* note 9, at 992-93.

135. *See* Westerbeke v. Daihatsu Motor Co., 304 F.3d 200, 217 (2d Cir. 2002).

136. *See, e.g.*, Remmey v. PaineWebber, Inc., 32 F.3d 143, 150 (4th Cir. 1994).

137. 514 U.S. 938, 942 (1995).

138. I focused my research on opinions deciding motions to vacate customer-broker awards in federal and selected state (New York, California, Florida, and Illinois) courts from January 1995 to present. While I do not claim that my survey is exhaustive, it is sufficient to illustrate current trends.

139. Several recent instances where brokers obtained vacatur or remand are discussed subsequently: Wallace v. Buttar, 239 F. Supp. 2d 388 (S.D.N.Y. 2003), discussed *infra* notes 141-147 and accompanying text; Tacher v. Parsons, 98 CV 4482 (JM) (E.D.N.Y. May 5, 2000) (unpublished opinion on file with author), discussed *infra* note 147; and Hardy v. Walsh Manning Sec., 341 F.3d 126 (2d Cir. 2003), discussed *infra* notes 218-19 and accompanying text. *See also* Stifel, Nicolaus & Co. v. May, Civ. Act. No. 3:02-CV-688-S (W.D. Ky. Aug. 19, 2003) (unpublished opinion on file with author) (vacating award in favor of customer as to two common law claims because customer had dismissed all claims except those based on the state securities statute). A recent instance where a customer obtained vacatur on non-statutory grounds is *Brabham v. A.G. Edwards & Sons*, 265 F. Supp. 2d 720, 725-26 (S.D. Miss. 2003), where the court found a damages award of approximately $125,000 "arbitrary and capricious" because there was no "reasonable factual basis in the record" for the award. The firm claimed that there were no damages, and the customer's expert testified that damages were at least $500,000. *See also* Tripi v. Prudential Sec., 2003 WL 22208351 (S.D.N.Y. Sept. 2003), discussed *supra* note 128.

however, some courts have begun to refer awards back to the arbitration panels for clarification or explanation, with a clear implication that the court may vacate the award on manifest disregard grounds if it finds the panel's explanation unconvincing.[140]

The existence of the manifest disregard standard is dangerous because it gives judges an invitation to review the merits of an award and throw it out when they believe that the arbitrators wrongly decided the dispute. *Wallace v. Buttar*[141] illustrates the dangers of judicial review under this standard. In that case, two investors charged that their broker made fraudulent misrepresentations, inducing them to purchase large blocks of stocks in two companies for which the broker's firm acted as the placement agent. The president and two director-shareholders of the now defunct firm[142] were successful in vacating an award that, in addition to imposing liability on the individual broker, found the other three individuals "liable for fraud and also as 'Control Persons'" under both federal and state securities laws.[143] The district court reviewed the evidence and found none that showed that the president and the two director-shareholders knew of the fraudulent activity—a requirement, in the view of the court, for controlling person liability.[144] The court did not believe that the evidence established the requisite intent, largely because the president was president in name only and supervision of the operations was delegated to another employee.[145]

The district court was probably wrong on the merits as to the controlling person liability, but, more importantly, its scope of review of the arbitration award was unduly intrusive. There is nothing in the opinion to suggest that there were any procedural deficiencies in the arbitration hearing, no evidence to suggest that the arbitrators were corrupt or even incompetent or confused. Moreover, the Second Circuit's "manifest disregard" test was not met under either prong:[146] the law on controlling person liability is by no means well-defined, and there was no evidence that the arbitrators intended to flout the law. At most, the arbitrators may have stretched the law on controlling person liability to arrive at the conclusion that a person who holds himself out as president and the two shareholder/directors who brought the

140. *See supra* note 128.

141. 239 F. Supp. 2d 388 (S.D.N.Y. 2003).

142. The award was vacated as to all three individuals, although it appears that only the president actively prosecuted the motion to vacate, and most of the court's analysis focuses on the involvement of the president.

143. *Wallace*, 239 F. Supp. 2d at 397.

144. *Id.* at 396.

145. *Id.* at 394-95.

146. *See* discussion *supra* notes 118-123 and accompanying text.

transactions in question to the firm are responsible for the losses suffered by defrauded investors of the defunct firm. The parties received the arbitration they were entitled to, and those disappointed with the result should not have been given a second chance to argue their case before the district court.[147]

Why are Firms Bringing Motions to Vacate?

Even though motions to vacate arbitration awards in customer-broker disputes are rarely successful, there is a perception among investors' attorneys that firms increasingly are filing them. In this section I look at reasons why firms bring vacatur motions. I also argue that brokers violate the duty of fair dealing that they owe their customers (including former customers) when they bring motions to vacate to delay payment of awards. Finally, I propose reforms to deal with the problem.

Manifest disregard is intended to address a form of arbitrator misconduct, not to provide judicial illumination on unsettled or cutting-edge legal questions. Nevertheless, brokers frequently seek vacatur on manifest disregard grounds where there is scant controlling legal authority. Awards in this category include those allowing customers of the introducing broker to recover damages from the clearing firm,[148] allowing clients of an investment advisor to recover damages from the broker,[149] awarding damages to a "day-trader,"[150] and allowing an institutional investor engaged in "desperate speculation" to recover when the broker provided no investment advice.[151] In all these cases, the arbitration awards were confirmed. Brokers have so frequently challenged awards of punitive damages and attorney's fees that these categories warrant more detailed analysis.

147. *Wallace*, 239 F. Supp. 2d at 397. For another misapplication of the manifest disregard standard, see Tacher v. Parsons, 98 CV 4482 (JM) (E.D.N.Y. May 5, 2000) (unpublished opinion on file with author), where the court vacated an award of approximately $1.4 million. Even though it correctly stated the two-prong test that requires finding the arbitrators flouted the law," the court found only that the panel apparently committed a "gross error" in applying South Carolina law of damages when the customer agreement contained a New York choice of law clause.

148. *See, e.g.,* Koruga v. Fiserv Correspondent Serv., 40 Fed. Appx. 364, 366 (9th Cir. 2002); McDaniel v. Bear Stearns & Co., 196 F. Supp. 2d 343, 366-67 (S.D.N.Y. 2002); RPR Clearing, a Div. of Rauscher Pierce Refsnes, v. Glass, No. 97 CIV.0017JSM, 1997 WL 460717, at *2-3 (S.D.N.Y. July 28, 1997); Cohen v. J.B. Oxford & Co., No. C-1-02-571, 2002 U.S. Dist. LEXIS 21177, at *11 (S.D. Ohio Oct. 9, 2002).

149. *See, e.g.,* Bear Stearns & Co. v. Buehler, 23 Fed. Appx. 773, 776 (9th Cir. 2001).

150. *See, e.g.,* Rosati v. Bekhor, 167 F. Supp. 2d 1340, 1348 (M.D. Fla. 2001).

151. *See, e.g.,* Investors Equity Life Ins. Co. of Hawaii v. ADM Inv. Serv., 1 Fed. Appx. 709, 1997 WL 33100645, at *9, 11 (D. Haw. Dec. 15, 1997), *aff'd*, 1 Fed. Appx. 709, 2001 WL 32048 (9th Cir. Jan. 12, 2001).

One constant over the years has been the efforts of brokerage firms to vacate customers' awards containing punitive damages; only their arguments have changed. Pre-*Mastrobuono*,[152] brokers argued that arbitrators did not have the authority to award punitive damages under applicable state law. Post-*Mastrobuono*, brokers continued their efforts to vacate punitive damages awards on manifest disregard grounds,[153] either because the applicable statute did not authorize them[154] or because the evidence did not support them.[155] Since *Mastrobuono*, these efforts have been consistently unsuccessful.

After *BMW of North America, Inc. v. Gore*,[156] in which the Supreme Court held that there are due process limits on punitive damages verdicts, brokers have sought to vacate "excessive" punitive damages awards on constitutional grounds. Most courts have rejected this argument, finding no "state action" present in SRO arbitrations[157] and noting that the limited scope of judicial review of arbitration awards is incompatible with the *Gore* analysis.[158] A recent New York state court opinion, however, vacated a punitive damages award as excessive in a non-customer securities arbitration context.[159] While finding no constitutional constraint, the court looked to the *Gore* factors to find that the

152. *See* discussion *supra* notes 12-14 and accompanying text.

153. *See, e.g.*, R. Allen Fox, Ltd. v. Stratton Oakmont, Inc., No. 93 C 2228, 1996 WL 288771, at *2 (N.D. Ill. May 29, 1996); Greening v. Stratton Oakmont, Inc., No. C-95-4288 SI, 1996 WL 61095, at *3 (N.D. Cal. Feb. 5, 1996), *aff'd*, No. 96-15370, 113 F.3d 1241, 1997 WL 222341 (unpublished opinion; affirmed as to individual respondent); Commonwealth Assoc. v. Letsos, 40 F. Supp. 2d 170, 173 (S.D.N.Y. 1999)

154. *See, e.g.*, Sav-A-Trip v. Belfort, 164 F.3d 1137, 1139-40 (8th Cir. 1999); Barnes v. Logan, 122 F.3d 820, 823 (9th Cir. 1997); R.C. Layne Constr. v. Stratton Oakmont, Inc., 651 N.Y.S.2d 973, 975 (App. Div. 1996); Shearson Lehman Bros. v. Neurosurgical Assoc. of Ind. 896 F. Supp. 844, 848 (S.D. Ind. 1995); Wilson v. Sterling Foster & Co., No. 98 C 2733, 1998 U.S. Dist. LEXIS 16913, at *19 (N.D. Ill. Oct. 15, 1998); Jeppsen v. Piper, Jaffray & Hopwood, Inc., 879 F. Supp. 1130, 1136 (D. Utah 1995).

155. *See, e.g.*, Cmty. Hosp. of Springfield & Clark County v. Kidder Peabody & Co., 81 F. Supp. 2d 863, 876 (S.D. Ohio 1999).

156. 517 U.S. 559, 580-83 (1996); *see also* State Farm Mut. Auto Ins. Co. v. Campbell, 123 S. Ct. 1513, 1524-26 (2003) (holding that $145 million punitive damages award on $1 million compensatory damages violated due process).

157. *See, e.g.*, Davis v. Prudential Sec., 59 F.3d 1186, 1193 (11th Cir. 1995) (stating that "the federal policy favoring arbitration, as well as the absence of the bias and runaway punitive awards prevalent in the jury context, distinguish the arbitral award . . . from the jury award of punitive damages"); Olde Discount Corp. v. Dartley, No. 604507/97, 1997 N.Y. Misc. LEXIS 726, at *17-18 (N.Y. Sup. Ct. Nov. 20, 1997).

158. *See* Morgan Keegan & Co. v. Lalonde, No. CIV. A. 00-2520, 2001 WL 43600, at *1 (E.D. La. Jan. 16, 2001).

159. *See* Sawtelle v. Waddell & Reed, Inc., 754 N.Y.S.2d 264, 273-74 (App. Div. 2003). The court also remanded the matter to the panel for reconsideration of punitive damages. The panel subsequently issued a "revised" award that awarded the same amount of punitive damages that the court found excessive. *See* Susanne Craig, *Panel Reinstates Punitive Award Against Waddell*, WALL ST. J., Sept. 8, 2003, C-5. The court again vacated the punitive damages award and directed a new panel to consider the issue. Sawtelle v. Waddell & Reed, Inc., Index No. 115056/01 (N.Y. Sup. Ct. Jan. 22, 2004) (unpublished opinion on file with author).

punitive damages were excessive and therefore in manifest disregard of the law. This opinion, unfortunately, will only encourage firms to persist in their challenges to punitive damages awards in customer cases.

Brokers frequently seek to vacate awards of attorney's fees to customers on the ground that the "American rule" does not permit the award of attorney's fees to the prevailing party without statutory authority.[160] Most courts have upheld these awards, reasoning that the arbitrators' broad discretion in determining remedies includes awarding attorney's fees.[161] In an anomalous decision in an intra-industry securities arbitration award, a New York state court found that the arbitrators exceeded their powers in awarding attorney's fees since the parties' agreement only provided that the other party could recover them.[162] Again, it would be unfortunate if this encouraged firms to continue to challenge awards of attorney's fees.

Given the inapplicability of the manifest disregard standard to cutting-edge issues, as demonstrated by the courts' consistent rejection of it, brokers should not continue to challenge awards in similar circumstances. If the firm wishes judicial determination of its liability, it should negotiate with the customer for judicial resolution of the dispute in lieu of arbitration.

Brokers apparently challenge some customers' awards simply because they believe that the arbitrators reached the wrong result. In *The GMS Group, LLC v. Benderson*,[163] the arbitration panel awarded the customer $150,000, a modest recovery considering the customer claimed approximately $1.5 million in losses. The firm nevertheless brought an unsuccessful motion to vacate for the purpose, as the Second Circuit noted, of rearguing the disputed factual and legal issues. In response to the firm's argument that where federal statutory rights were involved the Second Circuit's deferential standard was inappropriate, the court tartly

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160. *See, e.g.*, WMA Sec. v. Wynn, 105 F. Supp. 2d 833, 839 (S.D. Ohio 2000), *aff'd*, 32 Fed. Appx. 726, 730 (6th Cir. 2002); Waddle v. LT Lawrence & Co., No. 98 C 5015, 1998 WL 901687, at *5 (N.D. Ill. Dec. 17, 1998).

161. *See. e.g.*, Coutee v. Barington Capital Group, 336 F.3d 1128 (9th Cir. 2003); Bialecki v. Patterson Travis, Inc., No. 00C5520, 2001 WL 333076, at *2 (N.D. Ill. Mar. 27, 2001); Mutual Serv. Corp. v. Spaulding, 972 F. Supp. 1126, 1127 (N.D. Ill. 1997); RAS Sec. Corp. v. Williams, 674 N.Y.S.2d 303, 303 (App. Div. 1998) (imposing Rule 11 sanctions for frivolous vacatur motion). *But see* Quick & Reilly, Inc. v. Zielinski, 306 Ill. App.3d 93 (1999) (vacating award of attorney's fees because arbitrators exceeded their power). Where the agreement does not provide for attorney's fees, Florida requires the arbitration award to provide the basis for awarding them and judicial determination of entitlement. *See* Moser v. Barron Chase Sec., 783 So. 2d 231, 237 (Fla. 2001).

162. UBS Warburg LLC v. Auerbach, Pollack & Richardson, Inc., 744 N.Y.S.2d 364, 364-65 (App. Div. 2002). The court also vacated the award of damages because it found "manifest disregard" of the SEC's net capital rule.

163. 326 F.3d 75, 76 (2d Cir. 2003).

observed that "any solicitousness the [Supreme] Court has expressed for a party's substantive rights in arbitration was on behalf of *claimants* under federal statutes, not defendants like GMS."[164]

Wallace v. Buttar[165] is another example where a firm sought (and received) a second chance to argue the issue of controlling person liability.[166] Other instances where brokers were re-arguing the merits are listed in the footnote.[167]

The FAA confers power on courts to review arbitration awards for the limited purpose of assuring that the parties received a fair hearing, not to afford the disappointed party another opportunity to argue the merits. A firm is abusing judicial resources and violating the customer agreement's commitment that arbitration is final and binding when it brings a vacatur motion to get a second chance to argue the merits.

Finally, and most disturbingly, some firms appear to use motions to vacate simply to delay paying awards or to exert "economic coercion" on the customer.[168] Customers' attorneys have reported that brokers are

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164. *Id.* at 80.

165. *See* discussion *supra* notes 139-145 and accompanying text.

166. *See also* Hardy v. Walsh Manning Sec. LLC, 341 F.3d 126 (2d Cir. 2003) (discussed *infra* at notes 218-219 and accompanying text); Deciccio v. Columbo, 234 F. Supp. 2d 320, 322-23 (S.D.N.Y. 2002) (confirming award where employees of a defunct firm challenged control person liability); Donald & Co. Sec., Inc. v. Jones, 704 N.Y.S.2d 242, 242 (App. Div. 2000) (confirming award where the firm argued it could not be found liable since no liability imposed on its employees); Yen v. Brown, No. 3:01-CV-2578-L, 2002 U.S. Dist. LEXIS 7350, at *4 (N.D. Tex. Apr. 25, 2002), *amended by* 2002 U.S. Dist. LEXIS 7665 (N.D. Tex. Apr. 29, 2002) (confirming award where individual broker asserted no personal involvement in fraud).

167. *See, e.g.,* Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jaros, 70 F.3d 418, 421 (6th Cir. 1995) (firm argued statute of limitations defense); Merrill Lynch, Pierce, Fenner & Smith v. Millar, 274 F. Supp. 2d 701 (W.D. Pa. 2003) (confirming customer's award and observing that even if court would have decided the ratification issue differently, there was no basis to find manifest disregard); Daugherty v. Wash. Square Sec., 271 F. Supp. 2d 681 (W.D. Pa. 2003) (confirming award despite firm's assertion investor was not a "customer"); Weiss, Peck & Greer v. Robinson, 2003 WL 1396436 (S.D.N.Y. Mar. 2003) (confirming customer's award even though she signed a general release); Universidad Interamericana v. Dean Witter Reynolds, Inc., 208 F. Supp. 2d 151, 154 (D. P.R. 2002) (statute of limitations); Janney Montgomery Scott Inc. v. Oleckna, No. CIV.A.99-4307, 2000 WL 623231, at *6 (E.D. Pa. May 15, 2000) (arbitrators awarded more in damages than value of customer's account); Rosenbaum v. Imperial Capital, 169 F. Supp. 2d 400, 414 (D. Md. 2001) (statute of limitations); Waddle v. LT Lawrence & Co., No. 98C 5015, 1998 WL 901687, at *5 (N.D. Ill. Dec. 17, 1998) (arbitrators awarded more in damages than claimed in statement of claim); Maul v. Aznavoorian, No. C96-2965 TEH, 1997 WL 16313, at *2 (N.D. Cal. Jan. 9, 1997) (remedy may not conform with traditional contract principles); Liberty Sec. Corp. v. Fetcho, 114 F. Supp. 2d 1319, 1323 (S.D. Fla. 2000) (lack of privity); Aragon Fin. Serv. v. Costa, No. 00-8077-CIV-FERGUSON (S.D. Fla. Mar. 29, 2001) (unpublished opinion on file with author) (arbitrators found firm, but not agent, liable); Sunpoint Sec. v. Porta, 192 F.R.D. 716, 720 (M.D. Fla. 2000) (contractual defenses).

168. I have included in this category cases where the court voices the suspicion of vacatur abuse or there are other facts that call into question the bona fides of bringing the motion: the small amount of the claim; the customer had no legal representation at the arbitration; the firm did not provide the court with a transcript of the hearing, without which it is virtually impossible to show "manifest disregard." Categorization inevitably requires subjective judgments; I have tried to give brokers every benefit of the doubt.

using the threat of filing a vacatur motion to settle with the customer for an amount less than the award. As an egregious example, in *Freeman v. Arahill*[169] one of three respondents sharing liability for a $5,000 award in favor of the customer sought vacatur. The customer was represented, both in the simplified arbitration and in the court proceeding, by a law school clinic providing assistance to small investors.

This practice is more than sharp litigation tactics. Brokerage firms and individual brokers owe their customers a duty of fair dealing,[170] an ethical standard that goes beyond legal rules.[171] "Good faith" is the governing principle[172] extending to all business-related conduct on the part of the broker.[173] Moreover, brokers violate their duty by engaging in conduct that undermines the NASD's regulatory functions and discourages customers from using the arbitration system.[174] Since

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See, e.g., Miller v. Flume, 139 F.3d 1130, 1132 (7th Cir. 1998) (while motion to vacate was pending, firm closed operations); *see* subsequent case discussed *supra* notes 53-55 and accompanying text; Perpetual Sec., Inc. v. Tang, 290 F.3d 132, 141-42 (2d Cir. 2002), *remanded to* No. 00 CIV.9389(RO), 2003 WL 1740456, at *1 (S.D.N.Y. Apr. 1, 2003) ($21,000 damages award; remanded for reconsideration of Rule 11 sanctions; on remand, court imposed sanctions); Cohig & Assoc. v. Stamm, 149 F.3d 1190, 1998 WL 339472, at *1-2 (10th Cir. 1998) (pro se investor awarded $20,000 in simplified arbitration proceeding); Lew Lieberbaum & Co. v. Randle, 85 F. Supp. 2d 123, 125-26 (E.D.N.Y. 2000) (pro se customer awarded $50,000; no transcript of arbitration); Papayiannis v. Zelin, 205 F. Supp. 2d 228, 230-31 (S.D.N.Y. 2002) ($40,000 award in simplified arbitration where broker made only a cursory denial; broker's attorney allegedly indicated broker would not pay the award voluntarily); Al-Azhari v. Merit Capital Assoc., No. 99 CIV. 9795 (LAK), 2000 WL 151914, at *3 (S.D.N.Y. Feb. 14, 2000) (firm's "manifest disregard" argument is "weak"; broker's attorney allegedly stated he was under instructions to delay recovery); Commonwealth Assoc. v. Letsos, 40 F. Supp. 2d 170, 172 (S.D.N.Y. 1999) (lack of a complete record); Kruse v. Sands Bros. & Co., 226 F. Supp. 2d 484, 486 (S.D.N.Y. 2002) (firm's "counter-petition to vacate . . . devoid of any argument or legal or factual support"); Nohre v. W.J. Gallagher & Co., No. B151769, 2002 WL 31424914, at *4 (Cal. App. Oct. 30, 2002) (sanctions imposed for frivolous appeal of lower court's award confirmation).

Many of the decisions in this category involve Stratton Oakmont, a notorious "bad firm" that subsequently went into bankruptcy, and its principals and employees; *see, e.g.*, Sav-A-Trip, Inc. v. Belfort, 164 F.3d 1137 (8th Cir. 1999); Sanders v. Gardner, 7 F. Supp. 2d 151 (E.D.N.Y. 1998); Shamah v. Schweiger, 21 F. Supp. 2d 208 (E.D.N.Y. 1998); Porush v. Lemire, 6 F. Supp. 2d 178 (E.D.N.Y. 1998); Card v. Stratton Oakmont, Inc., 933 F. Supp. 806 (D. Minn. 1996); Greening v. Stratton Oakmont, Inc., No. C-95-4288 SI, 1996 WL 61095 (N.D. Cal. Feb. 5, 1996), *aff'd*, 113 F.3d 1241, 1997 WL 222327 (9th Cir. 1997) (unpublished opinion; court affirmed as to individual respondent).

169. No. 111119/01 (N.Y. Sup. Ct. Oct. 18, 2001) (unpublished opinion on file with author). Fordham's securities arbitration clinic provided representation to the claimant.

170. Members "shall observe high standards of commercial honor and just and equitable principles of trade" in the conduct of their business. *See* NASD CONDUCT 2003, *supra* note 27, Rule 2110, *Standards of Commercial Honor and Principles of Trade*.

171. In the Matter of the Application of Timothy L. Burkes, SEC Release No. 34-32142, 1993 WL 119769, at *3 (Apr. 14, 1993), *aff'd mem.*, Burkes v. SEC, 29 F.3d 630, 1994 WL 386349 (9th Cir. 1994).

172. *See* Buchman v. SEC, 553 F.2d 816, 821 (2d Cir. 1977) (stating that "breach of contract is unethical conduct" if done "in bad faith").

173. *See* Henry E. Vail, 52 S.E.C. 339, 342 (1995), *aff'd mem.*, Vail v. SEC, 101 F.3d 37, 39 (5th Cir. 1996).

174. *See* Dept. of Enforcement v. Shvarts, 2000 NASD Discip. LEXIS 6, at *2 (Nat'l Adjudicatory Council, NASD Reg. June 2, 2000) (finding that the broker's failure to comply with a court order requiring payment of attorney's fees and costs to customer was violation of Conduct Rule 2110).

continued NASD membership is conditioned upon prompt payment of customers' awards,[175] brokers are violating their obligations to their customers and NASD by bringing vacatur motions for the purpose of delaying payment.[176] The courts should not provide assistance for this type of activity.

Suggested Reforms

Whether they are acting in good faith or bad, the propensity of firms to bring motions to vacate customer's awards and to argue for expanded judicial review cannot be underestimated. This is a serious attack on the finality of arbitration awards that courts should not encourage. I suggest four reforms to deal with this problem. First, "manifest disregard" should be eliminated as a basis for vacating arbitration awards. If there is a consensus that arbitrators too frequently arrive at results that are wrong on the merits, the appropriate solution is better selection and training of the arbitrators. Second, brokers should be required to post a bond with the appropriate SRO before filing a motion to vacate. This should both deter frivolous motions to vacate and protect the investor whose award remains unpaid. Third, the SROs should take disciplinary action against firms that bring frivolous vacatur motions, as a violation of the firm's duty to deal fairly with its customers. Finally, courts should seriously consider award of sanctions under Rule 11 for frivolous motions to vacate. To date, they have been reluctant to impose Rule 11 sanctions, even when they note the weakness of the broker's vacatur motion.[177]

PART FOUR

I have argued in this Article that there should be minimal judicial involvement in the arbitration process and that some courts, in the face of a firm's aggressive litigation, are exceeding the limits prescribed by the FAA. One's view of the appropriate level of judicial review necessarily depends on one's view of the fairness of the arbitration

175. *See* NASD CODE 2003, *supra* note 19, Rule 10330(h). *See also* NASD Notice to Members 00-55, *NASD Dispute Resolution Will Require Firms to Certify in Writing That They Have Complied With Arbitration Awards Within 30 Days of Receipt* (Aug. 2000), *available at* http://cchwallstreet.com/NASD/notices (last visited July 9, 2003).

176. A failure to pay an arbitration award is a violation of Conduct Rule 2110. *See* NASD Sanction Guidelines (1998 ed.) at 18 (Arbitration Award—Failure to Honor or Failure to Honor in a Timely Manner). *See Shvarts*, 2000 NASD Discip. LEXIS 6, at *37 n.22, 15-17, citing relevant disciplinary decisions.

177. *See* discussion *supra* note 117 and accompanying text.

process. There are good reasons for concern about the proliferation of arbitration as the exclusive remedy for consumer and employment disputes, particularly if the arbitration process is not actually, or is not perceived as, fair.[178] In securities arbitrations the focus should be on whether the process is fair to the investors, not brokerage firms—the repeat players who control the contents of the customer agreement and subsidize the arbitration forums.[179] This issue has two aspects: first, a comparison of arbitration with litigation; and second, the fairness of the SRO forums.

The difficulty in addressing the first issue is that, increasingly since 1987, we have little with which to compare SRO securities arbitration. A 2000 GAO report stated that there was no basis to make any conclusions about the fairness of SRO arbitration proceedings because the caseloads were too small at an independent forum, the American Arbitration Association (AAA), and in the courts.[180] In arbitration investors may be disadvantaged by the availability of less discovery, and awards may be less than what a jury would award.[181] Investors, however, may have an advantage in arbitration since arbitrators are not bound strictly to follow the law, which may impose significant obstacles to recovery.[182] Ultimately, however, this is a question on which reasonable investors' attorneys can and do differ.

How do the SRO forums measure up as fair arbitration forums? There is some empirical evidence suggesting that investors' attorneys find the process at least fair enough not to seek out available alternatives. When SICA initiated a two-year pilot program offering non-SRO alternatives, there were few takers, and the program was discontinued.[183]

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178. *See* Hooters of America, Inc. v. Phillips, 173 F.3d 933, 935 (4th Cir. 1999) (refusing to compel arbitration of employee's sexual harassment claim because the employer set up a process "utterly lacking in the rudiments of even-handedness"); Cole v. Burns Int'l Sec. Serv., 105 F.3d 1465, 1487 (D.C. Cir. 1997) (holding that employer could not require employee to pay any part of arbitrators' fees in arbitrating statutory discrimination claims; also noting that "manifest disregard" assures adequate judicial review of statutory claims); McManus v. CIBC World Markets Corp., 134 Cal. Rptr. 2d 446, 458 (2d Dist. 2003) (finding fee allocation clause in arbitration agreement unenforceable because of risk that employee would have to pay expenses that he would not pay in litigation).

179. The SEC and SRO reforms to make the arbitration forum more judicial have been driven by the recognition that the consent to arbitration is largely fictitious. *See* Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 BROOKLYN L. REV. 1335 (1996).

180. *See* GAO Report, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, GAO/GGD-00-115, at 4-5 (Wash. D.C. June 15, 2000), *available at* http://www.gao.gov (last visited July 9, 2003).

181. Conventional wisdom is that arbitrators are not likely to be swayed by any anti-Wall St. biases of juries because they typically are business people with a familiarity with the securities industry and one arbitrator on the panel is from the industry, *see* discussion *infra* notes 204-208 and accompanying text.

182. *See* Black & Gross, *supra* note 9, at 1035-1040.

183. *See* SICA, *Final Report—Pilot Program for Non-SRO-Sponsored Arbitration Alternatives* (undated) (on file with author); Stephen G. Sneeringer, *A SICA Experiment: Evaluating the Non-SRO Forum Pilot*, SECURITIES ARBITRATION COMMENTATOR, Nov. 2002, at 1.

In addition, an NASD-sponsored survey of participants in its arbitrations over a two-year period provides some evidence that participants found the process fair.[184] An independent study of investors' perceptions about the fairness of the arbitration process, however, is necessary to provide more information on this important question.[185]

Professor Sternlight has identified the following components of fairness in consumer arbitration: reasonable notice that the consumer is entering into an arbitration agreement, an unbiased decision maker, the right to representation by counsel, the right to present evidence, the right to present one's case in a fair geographic forum, the right to adequate discovery, the right to adequate relief, the right to know something of the arbitrator's rationale, and the right to judicial review.[186] In addition, arbitration should cost consumers less than the expense of litigation,[187] particularly since the SROs have cited this as one of the principal benefits of arbitration.[188] How does NASD arbitration measure up under these criteria?[189]

As to some of the above components of fairness, there is consensus that the SRO process is fair.

Reasonable Notice

Of the various complaints about SRO arbitration, notice is not one of them. NASD rules mandate the form and content of the disclosure in the customer agreement about arbitration and its salient characteristics, and require a highlighted statement drawing attention to the

184. *See* Gary Tidwell et al., *Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations* (Aug. 5, 1999), *available at* http://www.nasdadr.com/pdf-text/arb_eval99.pdf (last visited July 9, 2003). Professor Tidwell was the Director of Neutral Training and Development for NASD Regulation at the time of the study. The report analyzes survey results from parties in arbitrations that were closed by hearing between Dec. 1, 1997 and April 1, 1999 (representing a response rate of 10-20% of approximately 2000 cases) and concludes that participants believe their cases were "handled fairly and without bias." *Id.* at 3.

185. *See* Michael A. Perino, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION REGARDING ARBITRATOR CONFLICT DISCLOSURE REQUIREMENTS IN NASD AND NYSE SECURITIES ARBITRATIONS 33-37 (Nov. 4, 2002), *available at* http://www.sec.gov/pdf/arbconflict.pdf (last visited July 9, 2003).

186. Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L. REV. 1, 85-98 (1997).

187. *See* Public Citizen Press Release, *Arbitration More Expensive Than Court—So Costly That Many Victims of Consumer Fraud, Employment Discrimination Give Up* (May 1, 2002), *available at* http://www.citizen.org/pressroom/print_release.cfm?ID=1098 (last visited July 9, 2003).

188. NASD Dispute Resolution: What is Dispute Resolution? (June 10, 2002), *available at* http://www.nasdadr.com/whatdr.asp (last visited July 9, 2003) (touting arbitration as a benefit to parties because it provides "prompt, inexpensive alternatives . . . to litigation in the courts").

189. I focus on NASD arbitration since it handles about 90% of all securities arbitration claims, but the analysis would not be appreciably different for the NYSE.

arbitration clause immediately above the signature line.[190] The more troublesome issue is that customers do not have a choice about what to do with this information because every brokerage firm requires its customers to sign an arbitration agreement as a condition of opening an account. As a policy matter, requiring investors to sign an arbitration agreement as a condition of opening a brokerage account may not raise the freedom of choice issue to the same degree as when employees are required to agree to arbitration as a condition of employment. The Supreme Court made it clear in *McMahon* and *Rodriguez* that it is not receptive to this unfairness argument.[191]

Right to Representation by Counsel; Right to Present Evidence

NASD rules make clear that investors may be represented by counsel,[192] and there is an active and well-qualified securities arbitration bar. While there are legitimate concerns about the difficulties small investors face in obtaining representation,[193] this problem is not unique to arbitration. Under NASD rules, arbitrators have full authority to decide procedural matters, including admissibility of evidence[194] and the number of hearing sessions.[195]

Right to Present a Case in a Fair Geographic Forum

NASD conducts hearings at fifty locations throughout the United States,[196] and the hearing site is determined by the customer's residence

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190. *See* NASD CONDUCT 2003, *supra* note 27, Rule 3110(f), *Books and Records*. It is ironic that the Supreme Court struck down on preemption grounds a state statute that provided comparable notice in consumer agreements containing an arbitration clause, *see* Doctor's Assocs. v. Casarotto, 517 U.S. 681, 683 (1996).

191. For the Supreme Court's rejection of this argument in another consumer context, see Carnival Cruise Lines v. Shute, 499 U.S. 585, 595 (1991) (upholding clause in passenger ticket contract requiring litigation of all disputes in Florida), *overruled by* 46 App. U.S.C.A. § 183c (2003) (disallowing forum-selection clauses in passenger tickets). For a different approach, *see* Kloss v. Edward D. Jones & Co., 54 P.3d 1 (Mont. 2002) (holding that customer agreement was contract of adhesion and not within customer's reasonable expectations; remanding for consideration of factors addressing unconscionability; also finding that broker had fiduciary duty to explain arbitration clause).

192. *See* NASD CODE 2003, *supra* note 19, Rule 10316.

193. *See* SEC Press Release, *SEC Announces Pilot Securities Arbitration Clinic to Help Small Investors* (Nov. 12, 1997), *available at* http://www.sec.gov/news/pressarchive/1997/97-101.txt (last visited July 9, 2003) (small investors express concerns about difficulty in obtaining counsel to represent them in arbitration).

194. *See* NASD CODE 2003, *supra* note 19, Rule 10323.

195. *See* NASD CODE 2003, *supra* note 19, Rule 10315. In contrast to NASD practice, a contractual limitation on the length of arbitration hearings in an employee's discrimination claim was questioned, *see* Brooks v. Travelers Ins. Co., 297 F.3d 167, 169-70 (2d Cir. 2002).

196. "NASD Dispute Resolution Establishes New Hearing Location in Newark, New Jersey," *available at* http://www.nasdr.com/news/pr2003/release_03_043.html (last visited Nov. 4, 2003).

at the time of the transaction.[197] Firms cannot include language in their customer agreements that purport to dictate the hearing location.[198]

Right to Adequate Relief

NASD rules do not limit the authority of arbitrators to award damages,[199] and customer agreements cannot limit, directly or indirectly, this authority.[200] News reports indicate that customers' awards are getting larger,[201] and while there continue to be skirmishes about the availability of punitive damages[202] and attorney's fees,[203] increasingly arbitrators are awarding them.

The remaining fairness components require additional discussion.

Unbiased Decision-Maker

NASD arbitration panels generally consist of two members who are not affiliated with the securities industry and one industry-affiliated member.[204] Major post-*McMahon/Rodriguez* NASD reforms have increased the independence of the non-affiliated members and allowed the parties greater involvement in the selection of arbitrators.[205] The SEC and the SROs have not, however, seriously re-examined the inclusion of an industry member on every panel, and some investors' attorneys believe that this practice builds in a pro-industry bias.[206] Not all investors' attorneys share this opinion, however; some believe that industry expertise can be advantageous to a customer.[207] Before the

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197. *Id.* at 14.

198. *See* NASD Notice to Members 95-16, *supra* note 29 and accompanying text.

199. NASD recently withdrew a proposed rule that would have capped punitive damages awards. *See* Re: SR-NASD-97-47 Withdrawal (May 9, 2003) *available at* http://www.nasdadr.com/pdf-text/rf97_47_wd.pdf (last visited July 9, 2003).

200. See *Mastrobuono*, discussed *supra* notes 12-14 and accompanying text; NASD Rule 3110(f), discussed *supra* notes 27, 188 and accompanying text; NASD Notice to Members 95-16, discussed *supra* notes 29, 85 and accompanying text.

201. *See* Ruth Simon, *With Wall Street on Defensive, Claims Against Brokers Surge*, WALL ST. J., May 27, 2003, at A1.

202. *See* discussion *supra* notes 152-59 and accompanying text.

203. *See* discussion *supra* notes 160-62 and accompanying text.

204. *See* NASD CODE 2003, *supra* note 19, Rule 10308(b)(1)(B).

205. Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendments Nos. 3 and 4 to Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to the Selection of Arbitrators in Arbitrations Involving Public Customers, 63 Fed. Reg. 56670 (Sec. Release No. 24-40555) (Oct. 22, 1998).

206. *See* Perino, *supra* note 185, at 30-31.

207. David E. Robbins, SECURITIES ARBITRATION PROCEDURE MANUAL § 10-23 (5th ed. 2001).

AAA essentially ceased operating as a securities arbitration forum,[208] it also classified securities arbitrators as neutral or industry,[209] so the practice is not unique to the SRO forums. In short, arbitrator expertise as compared to judicial impartiality is a debate for which there are respectable arguments on both sides.[210]

Right to Adequate Discovery

Post-*McMahon/Rodriguez* reforms have expanded the availability of discovery to parties. These efforts culminated with the Discovery Guide, a consensus document developed by NASD and representatives of both the industry and investors' bar that sets forth expectations of what parties are entitled to in discovery.[211] Discovery in NASD arbitration, concededly, is less than that available in litigation, most notably with the absence of depositions except in extraordinary circumstances. Limitations on discovery are viewed as a greater disadvantage for customers, because brokers control much of the information necessary for customers to prove their case. The benefits of arbitration, on the other hand, as a more efficient and less expensive alternative to litigation, obviously diminish with increased discovery. This is another issue where reasonable attorneys can argue about the trade-off.

Right to Know Something of the Panel's Rationale

Awards are required to be in writing[212] and must include "a summary of the issues, . . . the damages and other relief requested, the damages and other relief awarded and a statement of any other issues resolved."[213] All awards are publicly available.[214] Arbitrators, however, typically do not provide reasons in the awards. In the post-*McMahon/Rodriguez* reforms, the SEC argued that arbitrators should provide some

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208. Effective July 1, 1999, AAA suspended its securities arbitration rules; thereafter, any securities disputes at AAA will be arbitrated under its commercial arbitration rules. *See* American Arbitration Association, *Supplementary Procedures for Securities Arbitration*, *available at* http://www.adr.org/index2.1.jsp?JSPssid=16235&JSPsrc=upload/livesite/focusArea/commercial/securities_rules.html (last visited July 9, 2003).

209. For a comparison of NASD and AAA rules, see Cheryl Nichols, *Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias*, 15 OHIO ST. J. ON DISP. RESOL. 63, 81-87 (1999).

210. *See* Perino, *supra* note 185, at 42-43, for a summary of the arguments.

211. *See* Self-Regulatory Organizations; Order Granting Approval to Proposed Rule Change by National Association of Securities Dealers, Inc., Creating a Discovery Guide for Use in NASD Arbitrations, 64 Fed. Reg. 49256 (Sec. Release No. 34-41833) (Sept. 10, 1999).

212. *See* NASD CODE 2003, *supra* note 19, Rule 10330(a).

213. *Id.* at 10330(e).

214. *Id.* at 10330(f).

explanation for their awards; SROs resisted this, asserting it would change the fundamental nature of arbitration.[215] The debate continues, as some commentators continue to advocate for reasoned awards.[216] In deciding motions to vacate, courts sometimes make a point of noting the absence of reasoning in an award, perhaps suggesting a distrust of the process because of this.[217]

As a practical matter, NASD arbitrators are unlikely to spend much time composing awards unless they are provided compensation for doing so. Even a brief explanation requires careful and thoughtful drafting, for a poorly expressed or incomplete explanation may render the award vulnerable under the manifest disregard standard. *Hardy v. Walsh Manning Securities, Inc.*[218] nicely illustrates this problem. In that case the firm and its former CEO sought to vacate an award in the customer's favor that found both parties "jointly and severally liable . . . based on principles of respondeat superior." The district court confirmed the entire award even though the CEO, as an employee, could not be found liable under respondeat superior, since it found substantial evidence in the record that he was personally involved in the wrongdoing. The Second Circuit, however, vacated the award with respect to the CEO and directed a remand to the arbitration panel for clarification of the grounds for imposing liability on the individual. The majority opinion emphasized that "substantial financial liability should not be imposed upon an individual without a clear basis in law."[219]

Currently, NASD provides arbitrators with an honorarium based on the time they spend in hearings and not for other tasks—however time-consuming—that do not require a hearing session with the parties.[220] Requiring arbitrators to provide reasons for their decisions, therefore, will increase the cost of arbitration. Is there a benefit that makes the cost worthwhile? My own view is that reasoned awards serve a purpose

215. This debate is described in Black & Gross, *supra* note 9, at 996-1003.

216. *See, e.g.,* Hayford, *supra* note 124, at 443.

217. The most striking example of this (in an employment discrimination arbitration) is *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197, 203-04 (2d Cir. 1998) (vacating an award in favor of the firm that provided no explanation, in the face of what the court thought was strong evidence of age discrimination).

218. 341 F.3d 126 (2d Cir. 2003).

219. *Id.* at 134. On remand, the arbitration panel clarified that it imposed liability on the individual because he was a controlling person with supervisory authority and because he actively participated in the fraud. The panel intended to impose respondeat superior liability only on the firm. Hardy v. Walsh Manning Sec., Arbitrator's Response (Nov. 10, 2003) (copy on file with author).

220. NASD arbitrators are paid a $200 honorarium for each hearing session (no more than 4 hours); a business day typically consists of two hearing sessions, and the Chair receives an additional $75 per day. *See* NASD CODE 2003, *supra* note 19, IM-10104 (Arbitrators' Honorarium) and Rule 10332(b) (Schedule of Fees for Customer Disputes). These rates are lower than those at other commercial arbitration forums; *see* Cole v. Burns Int'l Sec. Serv., 105 F.3d 1465, 1481 n.8 (D.C. Cir. 1997) (stating that "fees of $500 or $600 per hour are not uncommon").

if one wishes to create a system where they are used as precedent[221] or where they are routinely reviewed by the courts. Since I believe both practices antithetical to arbitration, I oppose requiring arbitrators to state their reasoning in awards.

Others argue that there are more intangible benefits of reasoned awards. Some assert that parties "deserve" an explanation,[222] a recognition that parties may well be dissatisfied with a system that decides major decisions in their lives without explanation. Professor Hayford argues that the need for an explanation may be driving many vacatur motions and that reasoned awards could reduce their number.[223] Based on my analysis of why firms bring motions to vacate,[224] I am skeptical that reasoned awards would abate the firms' challenges.

Arbitration Costs

Considerable concern has been expressed about whether arbitration is truly a less expensive alternative to litigation for the consumer. The D.C Circuit held, in *Cole v. Burns International Security Services*,[225] that employees bringing statutory discrimination claims could not be required to pay any part of the arbitrator's fees because litigants do not have to pay judges. Moreover, the court expressed doubt in general about whether beneficiaries of statutory rights should ever have to pay arbitrators' fees.[226] Subsequently, in *Green Tree Financial Corp. - Alabama v. Randolph*,[227] the Supreme Court recognized that high arbitration costs could prevent consumers from vindicating their statutory rights, but refused to deny enforceability of an arbitration agreement on this ground because the consumer did not establish those costs.[228] After *Green Tree* the circuits have developed tests for determining excessive arbitration costs, principally in the context of employment disputes.[229] Generally, they have rejected *Cole*'s per se approach in favor of a case-

221. *See* El Dorado Tech. Serv., Inc. v. Union Gen. De Trabajadores de Puerto Rico, 961 F.2d 317, 321 (1st Cir. 1992); *but see* Wallace v. Buttar, *supra* note 139, that cited an arbitration award as precedent without explanation.

222. DAVID E. ROBBINS, SECURITIES ARBITRATION PROCEDURE MANUAL, at 13-14 (5th ed. 2001).

223. Hayford, *supra* note 124, at 472.

224. *See* discussion *supra* notes 146-167 and accompanying text.

225. 105 F.3d 1465, 1483-85 (D.C. Cir. 1997); *see also* McManus v. CIBC World Markets Corp., 134 Cal. Rptr. 2d 446, 457-58 (2d Dist. 2003).

226. *Cole*, 105 F.3d at 1484. Other circuits have rejected the per se rule against fee-splitting arrangements; for a review of the law both pre- and post- *Green Tree*, see generally Musnick v. King Motor Co. of Fort Lauderdale, 325 F.3d 1255 (11th Cir. 2003).

227. 531 U.S. 79, 90 (2000), *aff'd* 244 F.3d 814 (11th Cir. 2001).

228. *Green Tree*, 531 U.S. at 91.

229. *See Musnick*, 325 F.3d at 1259.

by-case analysis set forth in *Bradford v. Rockwell Semiconductor Systems, Inc.*[230] This analysis focuses on "the claimant's ability to pay, . . . the expected cost differential between arbitration and litigation, . . . and whether that cost differential is so substantial" that it would deter arbitration.[231] Some district courts have enjoined arbitration of consumer disputes, finding that consumers have met their burden under *Green Tree* of establishing that prohibitive arbitration costs would deter them from pursuing federal statutory claims.[232]

Could an investor challenge SRO arbitration on grounds of excessive costs? Federal courts have not recognized a concern for arbitration costs outside of the area of federal statutory claims,[233] thereby excluding from consideration investors that assert only common-law claims against their brokers. At NASD, investors are required, upon commencement of a claim, to pay a nonrefundable filing fee that varies according to the amount of the claim,[234] as well as a hearing session deposit that also varies with the amount of the claim.[235] Fees may be waived upon a showing of hardship,[236] and arbitrators, at the conclusion of the hearing, have the authority to allocate the cost of the hearing sessions among the parties in any way they see fit.[237] The costs can be considerable. On the other hand, claimants may benefit substantially from lower attorney costs in arbitration, as discovery is more limited in arbitration, depositions are rarely conducted, and motion practice is less frequent.[238] An independent comparison of the costs to investors between arbitration and litigation is necessary before conclusions, even tentative ones, can be made. To date at least, investors' *Green Tree* challenges to SRO arbitration have not been well-received.[239]

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230. 238 F.3d 549, 556 (4th Cir. 2001).

231. *Id.* at 556.

232. *See, e.g.,* Hurdle v. Fairbanks Capital Corp., No. 02-2788, 2002 U.S. Dist. LEXIS 18357, at *21-23 (E.D. Pa. Sept. 17, 2002) (finding that arbitration fee of $750 would be prohibitive, since the court had previously found the consumer could not afford a $150 court filing fee); Arnold v. Goldstar Fin. Sys., Inc., No. 01 C 7694, 2002 U.S. Dist. LEXIS 15564, at *34-37 (N.D. Ill. Aug. 22, 2002) (finding that a $750 filing fee plus one-half of estimated $3600 arbitrator's fee was prohibitive, compared to $150 court filing fee).

233. *See, e.g.,* Brown v. Wheat First Sec., Inc., 257 F.3d 821, 825 (D.C. Cir. 2001) (distinguishing *Cole*).

234. The minimum filing fee is $25 for a claim of $1,000 or less; the maximum is $600 for claims of more than $3 million. *See* NASD CODE 2003, *supra* note 19, Rule 10332.

235. For three-member panels, the hearing session deposit ranges from $600 to $1,200. *See id.*

236. *See* NASD CODE 2003, *supra* note 19, Rule 10332(a).

237. *Id.* at 10332(c).

238. Many investors' attorneys do not charge their clients on a hourly basis, but collect their fees on a contingency basis, as a percentage of the recovery, so savings of attorney time may not directly affect the cost to the investor.

239. *See* Ritch v. Eaton, No. CIV.A.02-7689, 2002 WL 32107628, at *3 (E.D. Pa. Dec. 9, 2002) (finding that a $1425 filing fee, compared with a $97.50 court filing fee, was not prohibitive; customer had substantial investment portfolio, and the comparison did not take into account other litigation costs).

Right to Judicial Review

As discussed above,[240] the FAA provides limited judicial review of arbitration awards to assure that the process was fair. In my view, increased judicial review is only warranted if one has reasonable concerns about the fairness of the arbitration process. While in the four areas just discussed, there is a need for ongoing debate about whether the current system meets the standards of fairness to which investors are entitled, industry representatives do not have grounds to argue that they need additional judicial protection.

CONCLUSION

What accounts for the increased judicial tendency to involve itself in the securities arbitration process? First, it may reflect a continuing anti-arbitration bias on the part of the lower courts. As discussed earlier,[241] courts uniformly take an unduly narrow view of arbitrability issues that arbitrators can decide. In addition, some courts are reluctant to allow arbitrators to decide legal issues.[242] The development of the "manifest disregard" standard as a ground for vacatur also suggests judicial ambivalence toward arbitrators' having the final authority to decide the merits of a dispute.[243] Lingering anti-arbitration bias is in sharp contrast with the attitude of the Supreme Court, which shows no indication of putting a halt to its pro-arbitration policy that gives broad authority to arbitrators to decide both legal[244] and factual issues.[245]

Second, to the extent that courts are responding to legitimate fairness concerns raised in the context of arbitration of employment or other consumer disputes,[246] the transfer of these concerns to arbitration of customer-broker disputes is unwarranted. The SEC and the SROs have worked hard to make the process fair to customers; while the task is not

240. *See* discussion *supra* notes 94-109 and accompanying text.

241. *See* discussion *supra* notes 42-63 and accompanying text.

242. *See* discussion *supra* notes 58-60, 65-73 and accompanying text.

243. *See* discussion *supra* notes 110-127 and accompanying text.

244. *See, e.g., McMahon, supra* note 2 and accompanying text; *Rodriguez, supra* note 3 and accompanying text; Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 26 (1991) (collecting cases). *See also* Green Tree Fin. Corp. v. Bazzle, 123 S. Ct. 2402 (2003) (5-4) (holding that whether contracts forbid class arbitration was a question for the arbitrator); PacifiCare Health Sys., Inc. v. Book, 123 S. Ct. 1531, 1536 (2003) (holding that arbitrators can interpret contractual limitation on remedies).

245. *See, e.g.,* Major League Baseball Players Ass'n v. Garvey, 532 U.S. 504, 509 (2001) (holding that arbitrator's "improvident, even silly" fact-finding is not a basis to refuse to confirm award, quoting United Paperworks Int'l Union, AFL-CIO v. Misco, Inc., 484 U.S. 29, 39 (1987)).

246. *See* discussion *supra* note 176 and accompanying text.

over, the brokerage industry has no grounds to assert that it is being treated unfairly.

Finally, courts unfortunately may be subconsciously perpetuating the anti-investor tendencies reflected in the decisions of the Supreme Court in the 1970s and 1980s[247] and in decisions of the lower federal courts that constructed obstacles to investors' judicial remedies in the courts.[248] As customer awards are getting larger,[249] judicial discomfort with large investors' verdicts may be reasserting itself in the arbitration forum. If so, the lower courts insufficiently appreciate the Supreme Court's trend of pro-arbitration, pro-investor decisions from *McMahon* through *Howsam*.

Increased judicial involvement in the securities arbitration process generally benefits the brokerage firms and works to the disadvantage of investors. First, it increases the delays and the expense of the process, costs that brokerage firms are generally better able to bear. Second, investors are more likely to benefit from equitable, rather than legalistic, resolution of their disputes. Arbitration is an equitable forum, and arbitrators should be permitted to do equity, with judicial interference kept to a minimum. If there is a consensus that arbitrators are applying too much equity and should be applying legal standards on a more uniform basis, then the solution is for the SROs to select and train better arbitrators.

Finally, all participants would benefit from continued improvements made to the securities arbitration process through the SEC and SRO rule-making process, which solicits input from all interested parties. Increased judicial involvement, however, is not likely to result in the improvement of the securities arbitration process from the standpoint of investors. Courts should implement *Howsam*'s vision of arbitration as a "fair and expeditious resolution" of disputes.

247. *See* discussion *supra* note 5.
248. *See* Black & Gross, *supra* note 9, at 999-1005.
249. *See* Simon, *supra* note 201.