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Making Securities Arbitration Work

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MAKING SECURITIES ARBITRATION WORK

*Norman S. Poser**

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I. INTRODUCTION

Arbitration is widely regarded by the legal community as a useful method of alternative dispute resolution. Agreements to arbitrate future disputes are enforceable under federal and state law. The federal courts have repeatedly declared that Section 2 of the Federal Arbitration Act (the "FAA"),¹ which requires that agreements to arbi-

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1. 9 U.S.C. § 2 (1994). Section 2 provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

trate be enforced to the same extent as other contracts, reflects a strong federal policy in favor of arbitration.² The Supreme Court has stated that where a contract contains an arbitration clause, there is a presumption of arbitrability: "[A]n order to arbitrate the particular grievance should not be denied unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute. Doubts should be resolved in favor of coverage."³ Where an arbitration agreement is ambiguous, the FAA's policy favoring arbitration requires that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration."⁴

In the 1987 case of *Shearson/American Express, Inc. v. McMahon*,⁵ the Supreme Court, reversing a policy established four decades earlier, held that agreements to arbitrate future claims that might arise under the federal securities laws were enforceable.⁶ Today, most brokerage firms require their customers to sign standard-form printed agreements containing arbitration clauses as a condition of opening an account, and most customer-broker disputes are subject to arbitration agreements.

If arbitration is to accomplish its paramount goal of relieving court congestion and enabling disputes to be resolved speedily and economically, it must be separate and largely independent from the judicial system.⁷ The standard justification for the existence and usefulness of arbitration as an alternative system of dispute resolution is that it is a quicker and cheaper method of resolving disputes than litigation. Courts have adopted this view; they claim that they usually defer to decisions by arbitrators.⁸ Nev-

2. See, e.g., *Perry v. Thomas*, 482 U.S. 483, 489 (1987); *Moses H. Cone Mem. Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983) ("Section 2 [of the FAA] is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural policies to the contrary.").

3. *AT&T Technologies, Inc. v. Communications Workers of Am.*, 475 U.S. 643, 650 (1986) (quoting *Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 582-83 (1960)).

4. *Mercury Constr. Corp.*, 460 U.S. at 24-25.

5. 482 U.S. 220 (1987).

6. *Id.* at 237-38.

7. Courts often state that arbitration is an independent system of dispute resolution. See, e.g., *Titan/Value Equities Group, Inc. v. Superior Court*, 35 Cal. Rptr.2d 4, 7 (Ct. App. 1994).

8. In fact, some commentators have criticized judicial deference to arbitrators on the ground that it makes the arbitrators nonaccountable to anyone. See, e.g., Martin H. Malin & Robert F. Ladenson, *Privatizing Justice: A Jurisprudential Perspective on Labor and Employment Arbitration from the Steelworkers Trilogy to Gilmer*, 44 HASTINGS L.J. 1187, 1232-33 (1993).

It has also been pointed out that the securities arbitration process "has incorporated too many characteristics of civil litigation, thereby undermining what many commentators believe are the essential advantages of arbitration—speed and low cost." SECURITIES ARBITRATION REFORM, REPORT OF THE ARBITRATION POLICY TASK FORCE TO THE BD. OF GOVERNORS OF THE NAT'L ASS'N OF SEC. DEALERS, INC. 7 (Jan. 1996) (David S. Ruder, Chairman) [hereinafter RUDER REPORT]. See also Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1105-07 (1993). Litigation-like procedures, such as clearer procedures for obtaining prehearing discovery, have been established in order to introduce a greater degree of fairness into the arbitration process. The author wrote three years ago (and still believes): "What is emerg-

ertheless, too often they have been willing to decide issues that are more properly left to the arbitrators.

One would expect that the widespread use of arbitration as an alternative method for the resolution of disputes between investors and their brokers would have reduced the amount of court litigation in this area. Customer-broker disputes have not, however, been moved out of the courts. On the contrary, there has been a proliferation of litigation in the federal courts in securities cases, much of it having little to do with the underlying dispute. Investors often have to fight costly and time-consuming legal battles in court before their claims can be heard by arbitrators, or they have to litigate in order to get their awards confirmed. The fact that parties who signed an agreement to arbitrate future disputes find themselves forced to litigate collateral issues tends to defeat the unique advantages of arbitration.

The existence of extensive arbitration-related litigation thus raises the question whether arbitration can realistically be regarded as a method of alternative dispute resolution. Collateral litigation in securities cases has in fact made arbitration not an alternative form of dispute resolution to which parties may turn, but an additional form which they often do not reach until they have engaged in extensive litigation. If arbitration is to enable parties to resolve their differences with speed, economy, informality, privacy, and finality, then the ability of arbitrating parties to also resort to the courts must be reduced to a minimum.

The underlying issue is the question of what is meant by the term arbitrability. Under the FAA, the question of whether a dispute is arbitrable is presumptively for the court, not the arbitrators, to decide.⁹ Thus, if a party contends that the dispute is covered by an arbitration agreement, the statute gives the party the right to petition the court to determine whether the parties executed a valid arbitration agreement and whether the dispute falls within the scope of that agreement. If the court answers both questions affirmatively, it must order the parties to arbitrate the dispute. At that point, the court's role is at an end. Once the dispute is submitted to the arbitrators, they and not the court have the authority to decide all procedural and substantive issues, subject only to the very limited judicial review that the court may exercise after the arbitrators have handed down their award.¹⁰

Thus, where parties have signed an arbitration agreement, whether or not a particular issue may be submitted to a court for decision often depends on whether that issue is characterized as an issue of arbitrability, to be decided by the court, or a procedural or substantive issue that is part of the dispute, to be decided by the arbitrators. In this Article, I will

ing is a new compromise between the competing social goals of investor protection and the efficiency, privacy, and finality of arbitration." *Id.* at 1111.

9. *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920, 1922-24 (1995).

10. The FAA permits the trial court to vacate an arbitration award if, inter alia, the arbitrators have "exceeded their powers." 9 U.S.C. § 10(a)(4). This ground for judicial review also raises a question of arbitrability. See *infra* text accompanying notes 77-78.

argue that a narrow definition of arbitrability will best accomplish the goals of arbitration, by limiting the role of the courts so that the primary goal of arbitration—resolving disputes with the maximum degree of speed and economy—can be accomplished.

II. THE BACKGROUND OF SECURITIES ARBITRATION

There are two principal types of forums for securities arbitration: the self-regulatory organizations (SROs)¹¹ and the American Arbitration Association (AAA).¹² The SROs that have arbitration facilities are the National Association of Securities Dealers (NASD), seven stock exchanges,¹³ and the Municipal Securities Rulemaking Board (MSRB).¹⁴ The NASD, of which virtually all brokerage firms are required to be members,¹⁵ handles the vast majority of SRO arbitration cases (5419 cases were filed with it in 1993); while the New York Stock Exchange (NYSE) (where 809 cases were filed in 1993) is a distant runner-up; and the other SROs are far behind.¹⁶

SRO arbitration has a long history. The NYSE¹⁷ has provided facilities for arbitrating disputes between its members at least since 1845.¹⁸ In the early days, arbitration was conducted on an ad hoc basis:

When a dispute arose between two members, the parties could request a committee to hear the facts and adjudicate the case. Generally, the cases involved disputes over deliveries or some disagreement regarding a specific transaction. In some instances,

11. In many but not all respects, the arbitration rules and procedures of the SROs closely follow the Uniform Code of Arbitration (UCA), developed by the Securities Industry Conference on Arbitration (SICA). The UCA was adopted by the principal SROs in 1980 and has been amended several times since then. Constantine N. Katsoris, *The Level Playing Field*, 17 FORDHAM URB. L.J. 419, 429 (1989).

12. Parties may agree to submit existing or future disputes to arbitration either by named arbitrators or by arbitrators appointed by a method set forth in the agreement. Such private arbitration clauses are rarely used in agreements between brokerage firms and their customers or employees. As early as 1935, the Securities and Exchange Commission took the position that the New York Stock Exchange should encourage its members to offer customers a standard arbitration agreement. Deborah Masucci & Robert S. Clemente, *Securities Arbitration at Self-Regulatory Organizations: New York Stock Exchange, Inc., and National Association of Securities Dealers, Inc.—Administration and Procedure, in SECURITIES ARBITRATION 1994*, at 47, 51 (PLI Corp. Law & Practice Course Handbook Series No. 851, 1994) [hereinafter Masucci & Clemente].

13. These are the American Stock Exchange (Amex), Boston Stock Exchange (BSE), Chicago Board Options Exchange (CBOE), Chicago (formerly Midwest) Stock Exchange (CSE), New York Stock Exchange (NYSE), Pacific Stock Exchange (PSE), and Philadelphia Stock Exchange (PhSE).

14. The MSRB is an SRO established by the SEC pursuant to § 15B(b)(1) of the 1934 Act. 15 U.S.C. § 78o-4(b)(1).

15. Section 15(b)(8) of the 1934 Act, 15 U.S.C. § 78o(b)(8).

16. In 1993, the NASD accounted for 82.6% of all securities arbitrations filed. Forty-eight cases were filed with the Amex, none with the BSE, 15 with the CBOE, one with the CSE, 30 with the MSRB, 199 with the PSE, and 40 with the PhSE. SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, REPORT NO. 8 25-29 (1994).

17. From 1817 to 1863, the NYSE was called the New York Stock & Exchange Board.

18. See generally New York Stock Exchange Archives (1817-present) [hereinafter NYSE Archives].

the committee had power to make a judgment and to award damages.¹⁹

The NYSE Constitution of 1869 not only provided for arbitration of "all claims and matters of difference" between members but also gave nonmembers the right to arbitrate disputes with members if they agreed to abide by the rules of the Exchange. These rules provided that all decisions of the NYSE Arbitration Committee were final, except for appeals to the Exchange's Governing Committee.²⁰ In 1925, five years after New York enacted the nation's first arbitration legislation,²¹ the NYSE Arbitration Committee adopted a simple set of arbitration rules, including a requirement that nonmember claimants sign a standardized submission agreement, which included the rules governing the preparation and filing of pleadings and the conduct of hearings.²² Beginning about 1936, parties in NYSE arbitrations began to be represented by counsel.²³

The NASD first offered arbitration facilities to the public in 1968, on a voluntary basis only. Disputes could be arbitrated only if all parties agreed to arbitrate after the dispute arose. In 1972, arbitration became mandatory for NASD members: Public customers could require brokers who were NASD members to arbitrate securities controversies by virtue of the NASD's arbitration rules.²⁴ Thus, the rules of the two principal

19. 1 Arbitration Committees 1845-1869, Inventory of Records of the New York Stock & Exchange Board 7 (on file with the NYSE Archives). An early NYSE arbitration involved a dispute about a contract for the sale of one hundred shares of New York & Erie Railroad Company stock. The buyer refused to pay, claiming that the stock that the seller offered to deliver was a different class of stock than he had contracted to buy. *Rawdon v. Winthrop* (Nov. 5, 1845) (on file with the NYSE Archives). Another arbitration involved a claim by a seller against his broker that the broker had not executed the sales at the best possible prices. *S. Jaudon & Co. v. Edwards* (May 15, 1847) (on file with the NYSE Archives). It appears likely that the latter arbitration was between a nonmember and a member.

20. The Arbitration Committee, consisting of nine members, was charged with the duty to investigate and decide all claims and matters of difference arising between members of the Exchange and to adjudicate such claims against members by nonmembers, when such nonmembers agreed to abide by the rules of the New York Stock Exchange. The decision of this Committee was final in all cases, except (1) where a member of the Committee referred the case to the Governing Committee of the Exchange; and (2) in cases involving a sum of \$2500 or over, when either party could appeal, within ten days, to the Governing Committee for final adjudication.

The Chairman of the Arbitration Committee was authorized to receive a fee of \$15 in each case, to be paid by the losing party. NYSE CONST., art. III, § 7 (1869) (on file with the NYSE Archives).

21. Chapter 72 of the Consolidated Laws of New York became law on April 19, 1920. New York Arbitration Law is now Article 75 of the Civil Practice Law and Rules. N.Y. CIV. PRAC. L & R art. 75 (McKinney 1980 & Supp. 1996).

22. Minutes of the NYSE Arbitration Committee (Dec. 8, 1925) (on file with the NYSE Archives).

23. See, e.g., *Tameling v. Carter*, Minutes of the NYSE Arbitration Committee (Feb. 20, 1935) (on file with the NYSE Archives) (nonmembers of the NYSE who were represented by counsel unsuccessfully tried to persuade the Arbitration Committee to hear their case); Minutes of NYSE Arbitration Committee (Mar. 10, 1936) (two NYSE member firms were permitted to be represented by counsel at hearings of their controversy before the Committee).

24. Letter from Susie Dippel, NASD Arbitration/Mediation Department, to the author (June 3, 1996) (on file with author).

SROs required their members to arbitrate disputes with customers, but customers had the option, at the time the dispute arose, of arbitrating or litigating in court.

Brokerage firms used written agreements in order to require their customers to arbitrate future disputes arising out of their relationship. In 1953, however, the Supreme Court held in *Wilko v. Swan*²⁵ that agreements to arbitrate future disputes under the federal securities laws were unenforceable.²⁶ In *Wilko*, the Court was called upon to decide whether an agreement between a brokerage firm and its customer to arbitrate any future disputes barred the customer from suing under Section 12(2) of the Securities Act of 1933 (the "1933 Act")²⁷ which gives the buyer of a security a right of rescission against a seller who sold securities through a misstatement or omission of a material fact.²⁸ The Court decided that Section 14, the 1933 Act's nonwaiver provision, invalidated the arbitration agreement.²⁹ It held that one of the rights that an investor could not waive was the right to have a claim heard in federal court.³⁰

Wilko thus carved out an exception to the requirement of the FAA that agreements to arbitrate be enforced on the same basis as other contracts.³¹ In *Wilko*, the Court resolved a conflict between two desirable social policies: (1) the speed and economy of arbitration; and (2) the protection of the rights of investors against persons with superior bargaining power.³² The Court decided the issue in favor of protecting investors.³³

For more than thirty years after *Wilko*, the lower federal courts routinely assumed that the decision applied not only to claims under the 1933 Act but equally to claims under the 1934 Act, which contains a nonwaiver

25. 346 U.S. 427 (1953), *overruled by* Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989).

26. *Id.* at 438.

27. 15 U.S.C. § 771(a)(2) (1994).

28. For a description of Section 12(2), see NORMAN S. POSER, BROKER-DEALER LAW AND REGULATION: PRIVATE RIGHTS OF ACTION 231-34 (1995).

29. *Wilko*, 346 U.S. at 434-35. Section 14 provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void." 15 U.S.C. § 77n.

30. *Wilko*, 346 U.S. at 435.

31. See 9 U.S.C. § 2.

32. *Wilko*, 346 U.S. at 438.

33. *Id.*

The Court found that '(t)wo policies, not easily reconcilable, are involved in [*Wilko*].' On the one hand, the Arbitration Act stressed 'the need for avoiding the delay and expense of litigation,' and directed that such agreements be 'valid, irrevocable, and enforceable' in federal courts. On the other hand, the Securities Act of 1933 was '(d)esigned to protect investors' and to require 'issuers, underwriters, and dealers to make full and fair disclosure of the character of securities sold in interstate and foreign commerce and to prevent fraud in their sale,' by creating 'a special right to recover for misrepresentation. . . .'

Scherk v. Alberto-Culver Co., 417 U.S. 506, 512 (1974) (quoting *Wilko*, 346 U.S. at 431) (citations omitted).

provision similar to Section 14 of the 1933 Act.³⁴ The 1934 Act regulates the market for the trading of securities. Most federal securities claims by customers against brokerage firms or their employees are brought under the 1934 Act and, particularly, under Section 10(b)³⁵ of the Act and Rule 10b-5³⁶ of the Securities and Exchange Commission (SEC), which prohibit any person from acting fraudulently in connection with the purchase or sale of any security.³⁷ Although the 1934 Act does not expressly authorize a private right of action under Section 10(b) or Rule 10b-5, the federal courts consistently have held that there is an implied right of action, and the Supreme Court has endorsed this view.³⁸ Thus, a customer retains the right to bring his federal securities claims against a brokerage firm in federal court if he so wishes, even if he has signed an agreement with the firm that contains an arbitration clause.³⁹

Even though *Wilko* had held that agreements to arbitrate federal securities disputes were unenforceable, many brokerage firms continued to include in their standard customer agreements arbitration clauses that were not restricted to arbitrable state-law claims. Concerned that the use of such broad arbitration clauses might mislead investors into believing that they had waived their rights to a judicial forum, the SEC in 1983 adopted Rule 15c2-2, which made it a fraud for a broker-dealer to enter into an agreement with a customer that "purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws. . . ."⁴⁰ Although the SEC rescinded rule 15c2-2 in 1987, after the Supreme Court held that such disputes were arbitrable,⁴¹ some arbitration clauses that firms had amended in order to comply with the rule continued to exclude federal securities claims even after *McMahon*. Whether the exception clause continued to be effective depended on its language.⁴² A firm which had, in compliance with Rule 15c2-2, inserted an exception clause into the arbitration clause of its standard-form cus-

34. Section 29(a) of the 1934 Act provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." 15 U.S.C. § 78cc(a).

35. *Id.* § 78j(b).

36. 17 C.F.R. 240.10b-5 (1996).

37. For a discussion of Rule 10b-5 and its applicability to broker-dealers, see POSER, *supra* note 28, at 219-360.

38. See, e.g., *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 (1983); POSER, *supra* note 28, at 234-38.

39. Under the rules of the NYSE and other stock exchanges, customers could elect to arbitrate such disputes. See *supra* text accompanying note 24.

40. 17 C.F.R. § 240.15c2-2(a). See Stephen H. Kupperman & George C. Freeman, *Selected Topics in Securities Arbitration: Rule 15c2-2, Fraud, Duress, Unconscionability, Waiver, Class Arbitration, Punitive Damages, Rights of Review, and Attorneys' Fees and Costs*, 65 TUL. L. REV. 1547, 1553-63 (1991).

41. *Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements*, Exchange Act Release No. 34-25034, 52 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163, at 88,886 (Oct. 15, 1987).

42. See cases discussed in Carroll E. Neesemann & Maren E. Nelson, *The Law of Securities Arbitration*, in SECURITIES ARBITRATION 1994, at 135 (PLI Corp. Law & Practice Course Handbook Series No. 852, 1994).

tomers' agreement for "any claim . . . under the federal securities laws" discovered that under the plain language of the agreement such claims were not arbitrable even after *McMahon*.⁴³ On the other hand, an exception in an arbitration clause for claims under the federal securities laws "to the extent [that they] may be litigated" no longer excluded federal securities claims from arbitration once *McMahon* had been decided.⁴⁴

Meanwhile, the first crack in the *Wilko* doctrine had come in 1974, in *Scherk v. Alberto-Culver Co.*⁴⁵ *Scherk* involved the purchase by an American corporation of three interrelated European business entities from a German citizen living in Switzerland. The purchase agreement was negotiated in the United States and Europe and signed in Austria. The closing was held in Switzerland. The agreement specified that any disputes were to be arbitrated in Paris and that Illinois law should govern the interpretation and performance of the agreement.⁴⁶ A year after the deal closed, the purchaser brought an action against the seller under Section 10(b) and Rule 10b-5 for alleged fraudulent misrepresentations.⁴⁷

The Supreme Court upheld the validity of the arbitration clause, distinguishing the case from *Wilko* on the ground that it involved an international agreement, which implicated policies significantly different from those found controlling in *Wilko*.⁴⁸ In particular, the Court noted that international conflict-of-laws problems might arise, and that in the absence of the arbitration agreement considerable uncertainty existed as to the law applicable to the contract.⁴⁹ Although the Court noted that the dispute arose under the 1934 Act, not the 1933 Act, it neither rested its decision on that distinction, nor did it expressly distinguish *Wilko* on the ground that *Scherk* involved a commercial agreement between two businesses, whereas *Wilko* involved an agreement between a broker and one of its customers.

Despite *Scherk*, the federal courts, following the Supreme Court's mandate in *Wilko*, continued to strike down arbitration agreements governing customers' claims under the federal securities laws.⁵⁰ As late as 1983, Professor Loss, the leading authority on securities regulation, wrote that "the *Wilko* holding applied fully to implied actions."⁵¹ Nevertheless, *Scherk* cast a long shadow into the future; it demonstrated a new predis-

43. See, e.g., *Torrence v. Murphy*, 815 F. Supp. 965, 974 (S.D. Miss. 1993); see also *Kayne v. PaineWebber, Inc.*, 703 F. Supp. 1334, 1338 (N.D. Ill. 1989).

44. See, e.g., *Clark v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 924 F.2d 550, 556 (4th Cir.), cert. denied, 502 U.S. 818 (1991).

45. 417 U.S. 506 (1974).

46. *Id.* at 508.

47. *Id.* at 509. Section 10(b) and Rule 10b-5 apply to the sale of an entire business, if the sale is effected by means of a transfer of securities. See *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985).

48. *Scherk*, 417 U.S. at 515.

49. *Id.* at 515-17.

50. *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 248 (1987) (Blackmun, J., dissenting).

51. LOUIS LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1195 (1983).

position of the Court to uphold the validity of arbitration agreements involving the securities laws.

In 1985, the Supreme Court took another important step toward dismantling the *Wilko* doctrine. In *Dean Witter Reynolds Inc. v. Byrd*,⁵² the Court held that where a brokerage-firm customer has asserted both non-arbitrable federal claims and arbitrable state-law claims involving the same facts and legal issues, the state-law claims must be arbitrated, even though this would require two separate proceedings.⁵³ The Court reasoned that the primary goal of the FAA was to enforce private agreements to arbitrate and that this goal should be given precedence over the secondary goal of encouraging efficient and speedy dispute resolution.⁵⁴ In a concurring opinion that was widely noted at the time, Justice White observed that although the question of whether the *Wilko* doctrine applied to 1934 Act claims was not before the Court, there was "substantial doubt" on this question.⁵⁵ A few months later, the Court in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*⁵⁶ cast additional doubt on the continued viability of the *Wilko* doctrine by upholding the validity of an agreement to arbitrate disputes arising under another federal regulatory statute, the Sherman Act.⁵⁷

In 1987 in *Shearson/American Express, Inc. v. McMahon*,⁵⁸ the Supreme Court, in a 5-4 decision, finally held that all claims brought under the 1934 Act were arbitrable.⁵⁹ According to the majority opinion, the *Wilko* Court had merely stated that the arbitration procedures that existed in 1953 were inadequate to enforce investors' rights under the securities laws.⁶⁰ Since the time of the *Wilko* decision, however, Congress had given the SEC additional powers to review the arbitration procedures of the self-regulatory organizations, and these procedures now gave investors adequate protection.⁶¹ The SEC, which had previously

52. 470 U.S. 213 (1985).

53. *Id.* at 224.

54. *Id.* at 221.

55. *Id.* at 224. After the *Byrd* decision, the First and Eighth Circuits held that *Wilko* did not extend to 1934 Act claims; while the Second, Third, Fifth, Ninth, and Eleventh Circuits held that such claims were not subject to compulsory arbitration. In response to the conflict among the circuits, the Supreme Court agreed to review the decision of the Second Circuit in *McMahon* denying arbitration. See Norman S. Poser, *Arbitrability of International Securities Disputes*, 12 BROOK. J. INT'L L. 675, 679 (1986).

56. 473 U.S. 614 (1985).

57. *Id.* at 640.

58. 482 U.S. 220 (1987).

59. The Court also held, by a unanimous vote, that predispute agreements to arbitrate claims under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961 et seq., were enforceable. *McMahon*, 482 U.S. at 242.

60. *Wilko*, 346 U.S. at 434-35.

61. In 1975, Congress amended § 19 of the 1934 Act, 15 U.S.C. § 78s(b), to give the SEC new oversight powers over the SROs. Under the amended statute:

No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act, and the Commission has the power, on its own initiative, to "abrogate, add to, and delete from" any SRO rule if it finds such changes necessary or appropriate to further the objectives of the Act. In short, the Commission has broad

supported the *Wilko* doctrine of nonarbitrability,⁶² appeared before the Court as an *amicus* in *McMahon* in support of the brokerage firm's position in favor of arbitrability. The Commission's policy shift may well have had a strong, if not decisive, influence on the Court's decision.

As to the nonwaiver provision of the 1934 Act, the *McMahon* Court found that it prohibited the waiver only of substantive provisions of the Act, but not of the jurisdictional section, which "does not impose any statutory duties."⁶³ The Court found it "difficult to reconcile *Wilko*'s mistrust of the arbitral process with this Court's subsequent decisions involving the Arbitration Act."⁶⁴

Because the *McMahon* decision involved the 1934 Act and not the 1933 Act, it did not technically overrule *Wilko*, but, in the words of Professor Jeffrey Stempel, after *McMahon* the *Wilko* doctrine was "the judicial equivalent of a wounded animal limping across the savannah, sure to be attacked."⁶⁵ The lower courts applied *McMahon* retroactively, so that arbitration very quickly became the normal method of resolving customer-broker disputes. Between 1985 and 1993, the total number of arbitrations (including arbitrations between SRO members and between members and their employees) commenced before panels sponsored by the SROs more than doubled, increasing from 2796 to 6561 arbitrations.⁶⁶ In 1995, 6058 arbitrations were filed with the NASD alone.⁶⁷

Two years after *McMahon*, the Supreme Court finally put the wounded animal out of its misery. In *Rodriguez de Quijas v. Shearson/American Express, Inc.*,⁶⁸ the Court concluded that since no relevant distinction existed between the 1933 and 1934 Acts, agreements to arbitrate 1933 Act disputes also were valid.⁶⁹ The Court stated:

authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect statutory rights.

McMahon, 482 U.S. at 233-34 (Blackmun, J., dissenting). Nevertheless, the SEC "neither polices nor monitors the results of [SRO] arbitrations for possible misapplications of securities laws or for indications of how investors fare in these proceedings." *Id.* at 265.

62. As noted earlier, in 1983 the SEC had adopted Rule 15c2-2, which prohibited the practice by brokerage firms of including arbitration clauses covering federal claims in their customer agreements. See *supra* note 40.

63. *McMahon*, 482 U.S. at 228.

64. *Id.* at 231-32.

65. Jeffrey W. Stempel, *Pitfalls of Public Policy: The Case of Arbitration Agreements*, 22 ST. MARY'S L.J. 259, 294 (1990).

66. See Masucci & Clemente, *supra* note 12, at 53.

67. Letter from Susie Dippel, NASD Arbitration/Mediation Department, to the author (June 3, 1996) (on file with the author).

68. 490 U.S. 477 (1989).

69. The Court noted the distinction that the 1933 Act allows concurrent jurisdiction in the federal and state courts, whereas the 1934 Act has exclusive federal jurisdiction; but it stated that this distinction suggests that arbitration agreements, which are "in effect, a specialized kind of forum-selection clause," should not be prohibited under the 1933 Act, "since they, like the provision for concurrent jurisdiction, serve to advance the objective of allowing buyers of securities a broader right to select the forum for resolving disputes, whether it be judicial or otherwise." *Id.* at 483.

“By agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.” To the extent that *Wilko* rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.⁷⁰

Thus, after thirty-six years, the Supreme Court finally buried the *Wilko* doctrine. In *Rodriguez de Quijas*, the Court also held that retroactive application of its ruling was appropriate under the test it had formulated in *Chevron Oil Co. v. Huson*,⁷¹ despite the fact that its decision to overrule *Wilko* “establishes a new principle of law for arbitration agreements under the Securities Act.”⁷² The Court justified retroactive application on the ground that the decision did not produce “substantial inequitable results,” because the plaintiffs did not make any serious allegation that they relied on *Wilko* when they agreed to arbitrate future disputes.⁷³

III. WHY ARBITRATION-RELATED LITIGATION OCCURS

Although many cases that would have been tried in court before the *McMahon* decision are now heard by arbitrators, mandatory securities arbitration has, paradoxically, generated a large volume of litigation, a development that tends to defeat the primary goals of arbitration: its ability to reduce the costs and delays of court litigation. Instead of being an independent alternative to litigation, securities arbitration too often turns out to be just one part of a bifurcated proceeding, which includes both arbitration and litigation. Investors who are willing to submit their claims against their brokers to arbitration, in compliance with the agreement that they signed when they opened their accounts, find that they are required to litigate issues relating to the arbitration before their claims can be heard.

Although brokerage firms led the eventually successful battle for mandatory arbitration, it is the thesis of this Article that many firms fundamentally distrust the arbitral process, and that this distrust has led them to use litigation as a way of limiting arbitrators' authority. In order to understand why this is so, it is necessary to review briefly the differences between the procedures used in a judicial and an arbitral forum.

The securities arbitration rules of the SROs and AAA outline the procedures governing securities arbitrations.⁷⁴ These procedures parallel

70. *Id.* at 481 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985) (citation omitted).

71. 404 U.S. 97 (1971).

72. *Rodriguez de Quijas*, 490 U.S. at 485.

73. *Id.*

74. See NASD CODE OF ARBITRATION PROCEDURE, reprinted in NASD MANUAL at 7501-7632 (1996); AMERICAN ARBITRATION ASSOCIATION, SECURITIES ARBITRATION RULES (1993).

those of court litigation in several respects. Parties have the right to be represented by counsel; their pleadings define the issues to be resolved and provide notice of opposing parties' principal contentions; there is an opportunity for prehearing discovery; at the hearing, the parties introduce oral and written evidence, cross-examine opposing witnesses, and argue their positions before the arbitrators; and, finally, the arbitrators deliberate and issue their decision, which is usually referred to as an "award." There are, however, important differences between arbitration and litigation.

There is little motion practice in securities arbitrations. Most arbitration claims that are not settled go to a hearing. Thus, claims that a trial judge might dismiss before trial for failure to state a claim or on a motion for summary judgment are much more likely to be heard by arbitrators.

Arbitrators are not subject to the kinds of restraints that a trial judge exercises over a jury. There is no judge to instruct the arbitrators on the law. After the arbitration hearing, there are no established procedures for the losing party to obtain a judgment notwithstanding the verdict or a remittitur on the question of damages.

Arbitration procedures are informal and arbitrators are not required to follow the rules of evidence. For example, prejudicial or nonprobative evidence is often admitted at the hearing "for what it is worth."⁷⁵

Arbitrations are secret, and arbitrators seldom write reasoned opinions supporting their awards. Furthermore, awards do not have precedential effect.⁷⁶ The results of arbitrations are therefore far more unpredictable than those of litigation.

Under the FAA, judicial review of arbitral awards is limited to situations where the arbitrators can be shown to be corrupt, biased, or lacking authority.⁷⁷ An arbitrator's decision will not be vacated by a court on the ground that it is based on a mistake of fact or law.⁷⁸ Arbitrators are not

75. Richard S. Bayer & Harlan S. Abrahams, *The Trouble with Arbitration*, 11 No. 2 LITIGATION 30 (1985).

76. Under the prevailing judicial view, an agreement to arbitrate represents a decision to opt out of the public legal system and into a private system that places primary value on dispute resolution. According to this view, the only law that results is the award itself and that law is binding only on the immediate parties. Malin & Ladenson, *supra* note 8, at 1226.

77. 9 U.S.C. § 10.

78. Several circuit courts will vacate an arbitral award if the arbitrators demonstrate "manifest disregard for the law." This judicially created ground for review has been construed narrowly. It clearly means more than error or misunderstanding with respect to the law.

The error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator. Moreover, the term "disregard" implies that the arbitrator appreciates the existence of a clearly governing legal principle but decides to ignore or pay no attention to it. To adopt a less strict standard of judicial review would be to undermine our well established deference to arbitration as a favored method of settling disputes when agreed to by the parties. Judicial inquiry under the "manifest disregard" standard is therefore extremely limited. The governing law alleged to have been ignored by the arbitrators must be well defined, explicit, and clearly applicable. We are not at liberty to set aside an arbitra-

required to follow—or even to know—the law and, unlike trial judges and juries, are virtually unaccountable to any judicial or other supervisory entity.⁷⁹

Thus, in some respects, arbitration resembles the judicial system; in others, it differs. In theory, securities arbitration provides an alternative forum for litigants, which is supposed to offer the advantages of speed, economy, privacy, informality, and finality that the judicial system cannot provide.⁸⁰ Arbitration is also meant to reduce court congestion, offering relief from the “rampant growth of the civil docket in the United States” which has been described as an example of “hypertrophy” or the “overgrowth . . . of an organ or part . . . resulting from unusually steady or severe use. . . .”⁸¹

A review of the cases indicates that much, though by no means all, of the litigation that occurs in customer-broker disputes is initiated by brokerage firms, which have drafted the arbitration agreements and have insisted that their customers sign them. To a large degree, the firms initiate the litigation for the purpose of limiting the authority of the arbitrators or of keeping the dispute out of arbitration. From the firms’ point of view, the independence of arbitrators from strict compliance with legal rules, from supervision by a trial court, and from review by an appellate court creates a risk that a “runaway” panel may unduly favor a claimant. For example, the extensive litigation over the issue of whether arbitrators have authority to award punitive damages probably indicates brokerage firms’ fear that a panel’s award of damages, including punitive damages, to a claimant may be based more on sympathy and general considerations of fairness than on a careful examination of the facts and the law.⁸² As a

tion panel’s award because of an arguable difference regarding the meaning or applicability of laws urged upon it.

Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker, 808 F.2d 930, 933-34 (2d Cir. 1986) (citations omitted). See also Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 706 (7th Cir. 1994).

79. To say we afford great deference to the arbitration panel’s award is an understatement. . . . Indeed no matter how dubious an arbitrator’s decision might appear . . . if the arbitrator did not stray beyond the four corners of the agreement to find the essence of his decision, that arbitrator’s award must be upheld. . . . This is so regardless that error has been committed or that a court would reach a contrary conclusion. The parties are entitled to get what they bargained for—the decision of an arbitrator.

Loughridge v. Allen, No. 93-5099, 1994 WL 258719, at *1 (10th Cir. June 14, 1994). For a discussion of the differences between litigation and arbitration procedures that is highly critical of arbitration, see Bayer & Abrahams, *supra* note 75, at 30-32.

80. The advantages of arbitration are many: it is usually cheaper and faster than litigation; it can have simpler procedural and evidentiary rules; it normally minimizes hostility and is less disruptive of ongoing and future business dealings among the parties; it is often more flexible in regards to scheduling of times and places of hearings and discovery devices. . . .

Allied-Bruce Terminix Companies v. Dobson, 115 S. Ct. 834, 843 (1995) (quoting H.R. REP. NO. 97-542, 97th Cong., 2d Sess., at 13 (1982)).

81. Securities Indus. Ass’n v. Connolly, 883 F.2d 1114, 1116 (1st Cir. 1989), *cert. denied*, 495 U.S. 956 (1990) (quoting WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY 1114 (1981)).

82. See *infra* text accompanying notes 145-46.

result, brokerage firms, while continuing to include arbitration clauses in their customer agreements, have resorted to the courts in an effort to limit the independence and authority of the arbitrators.

As shown in detail in the next part of this Article, arbitration-related litigation often requires a claimant to engage in expensive and time-consuming litigation of procedural issues before his or her claims can be heard by arbitrators, or it may involve a successful claimant in lengthy post-hearing litigation. Whether or not brokerage firms initiate arbitration-related litigation for the purpose of deterring customers from pursuing legitimate claims in arbitration, that undoubtedly is its result. Such litigation runs counter to the principal goal of arbitration: to provide a speedy and economical forum for the resolution of disputes. By definition, it also reduces arbitration to a secondary status as an alternative dispute resolution mechanism, subordinate in crucial ways to the judicial system.

IV. AREAS OF ARBITRATION-RELATED LITIGATION

Arbitration-related litigation covers a gamut of legal issues. Among the most frequently litigated issues are (1) the applicability of the SROs' six-year time-bar (or "eligibility" rule); (2) the authority of arbitrators to award punitive damages; (3) the authority of arbitrators to award attorneys' fees; and (4) questions relating to choice of forum and venue.⁸³

A. SRO TIME-BARS

In general, an arbitrated claim is subject to the same statute of limita-

83. Two other issues that are raised in arbitration-related litigation are beyond the scope of this Article. The first is whether a party that has signed an arbitration agreement has waived its right to arbitrate by litigating a dispute in court. In keeping with the federal policy favoring arbitration, the courts are generally reluctant to find a waiver, even though the party seeking arbitration may have participated in the litigation over a considerable period of time before attempting to enforce the agreement to arbitrate. Under the federal courts' most common formulation, a party seeking to establish waiver must prove that its opponent (1) knew of an existing right to arbitration; (2) acted inconsistently with that right; and (3) prejudiced the other party by these inconsistent acts. *See, e.g., Ritzel Communications, Inc. v. Mid-American Cellular Tel. Co.*, 989 F.2d 966, 969 (8th Cir. 1992); *Van Ness Townhouses v. Mar Indus. Corp.*, 862 F.2d 754, 758 (9th Cir. 1989). In most of the customer-broker disputes where the issue of waiver is raised, it is the customer who is attempting to establish that the brokerage firm waived its right to arbitrate.

The second other litigated issue is whether a customer may use the defense of fraud in the inducement against the brokerage firm's enforcement of the agreement to arbitrate. The Supreme Court has held that the trial court has the authority to decide the issue only if the fraud touches the arbitration clause alone, but that the arbitrators have the authority to decide the issue if the fraud infects the entire contract, including the arbitration clause. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967). The *Prima Paint* doctrine has been applied to other contractual defenses, such as duress, undue coercion, confusion, mutual mistake, overreaching, and unconscionability. *Chastain v. Robinson-Humphrey Co., Inc.*, 957 F.2d 851, 855 (11th Cir. 1992); *Miller v. Drexel Burnham Lambert*, 791 F.2d 850, 854 (11th Cir. 1986). *See also Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu*, 637 F.2d 391, 398 (5th Cir. Unit B 1981) (*Prima Paint* applies to the defense of unilateral mistake); *Hurlbut v. Gantshar*, 674 F. Supp. 385, 391 (D. Mass. 1987) (*Prima Paint* applies to a claim of unconscionability).

tions as would be applicable if the claim were litigated.⁸⁴ The statute of limitations for private claims brought under the Section 10(b) of the Exchange Act and SEC Rule 10b-5, the most common legal ground for claims against broker-dealers under the federal securities laws, is one year after the plaintiff discovered the facts constituting the violation and in any event not more than three years after the violation.⁸⁵ Statutes of limitations for state causes of action in securities cases vary considerably, generally ranging from one to six years.⁸⁶

In SRO arbitrations, the statute of limitations prescribed by law is supplemented by an "eligibility" rule. This rule applies to all claims, including statutory claims such as those brought under the federal securities laws and the RICO statute.⁸⁷ The AAA, however, does not have any such requirement.

The NASD eligibility rule, Section 15 of the NASD Code of Arbitration Procedure (CAP),⁸⁸ provides:

No dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim or controversy. This section shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of competent jurisdiction.⁸⁹

According to the *Ruder Report*, issued in 1996 by a "policy task force" of the NASD, Section 15 has "fostered extensive litigation, created great uncertainty, greatly increased the burdens on the NASD staff, and contributed to erosion of investor confidence in the SRO arbitration forums."⁹⁰ The *Ruder Report* recommended that Section 15 be suspended for a three-year period, during which the NASD should develop motion-practice procedures for the dismissal of time-barred claims before any

84. *Dean Witter Reynolds, Inc. v. McCoy*, 853 F. Supp. 1023, 1031 (E.D. Tenn. 1994).

85. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991). Several post-*Lampf* lower federal court decisions have held that the one-year period begins running at the time the plaintiff is placed on "inquiry notice" of the facts constituting the violation, rather than when he or she actually discovers these facts. *See, e.g., Chance v. F.N. Wolf & Co., Inc.*, No. 93-2390, 1994 WL 529901 (4th Cir. Sept. 30, 1994); *Tregenza v. Great Am. Communications Co.*, 12 F.3d 717 (7th Cir. 1993), *cert. denied*, 114 S. Ct. 1837 (1994). For a discussion of the post-*Lampf* cases, see Lewis D. Lowenfels & Alan R. Bromberg, *SEC Rule 10b-5 and its New Statute of Limitations: The Circuits Defy the Supreme Court*, 51 BUS. LAW. 309, 314-33 (1996). Not all courts, however, have subscribed to the inquiry notice doctrine. *See Douglas v. Tonigan*, 830 F. Supp. 457, 460-61 (N.D. Ill. 1993).

86. *See POSER, supra* note 28, at 405-21, for a discussion of statutes of limitations in securities actions brought against broker-dealers.

87. As to the applicability of the SROs' eligibility requirements to RICO claims, see *PaineWebber, Inc. v. Allen*, No. 93-1575, 1995 WL 8056 (4th Cir. Jan. 10, 1995).

88. This rule has been redesignated as NASD Rule 10304. In May 1996, the NASD renumbered its rules, including those contained in the Code of Arbitration Procedure. Since the judicial opinions cited in this Article refer to Section 15, as well as several other NASD Rules, by their old numbers, the old numbers will be used where necessary for the sake of clarity. The new rule numbers will be cited in the footnotes.

89. The wording of NYSE Rule 603 and Amex Rule 605(a) is identical to that of Section 15.

90. RUDER REPORT, *supra* note 8, at 23.

hearing on the merits.⁹¹ Under this proposal, such motions to dismiss would be decided by the full arbitration panel, rather than by a single member of the panel as under present procedures. The *Ruder Report* recommendation has aroused considerable controversy, and it is unclear at this time (July 1996) whether it will be adopted.⁹²

Section 15 (and its counterparts at the other SROs) has been described as a method that brokerage firms use in order to extinguish otherwise valid claims.⁹³ According to one lawyer (who usually represents plaintiffs in securities arbitrations): “[The eligibility rule is] a technicality that robs a possible defrauded investor of any rights whatsoever to bring a case. . . . It is what gives securities arbitration a bad name.”⁹⁴ Even if the claim is not actually extinguished by the application of the eligibility rule, the firm may dampen the claimant’s desire to pursue his claim by involving him in expensive and time-consuming litigation over the applicability of the rule.⁹⁵

The SROs’ eligibility rules have generated a large amount of litigation, much of it on the question of whether the arbitration panel or the district court has authority to apply the rules. In general, brokerage firms, hoping to dismiss stale claims before they go to arbitration, argue that the question is for the courts to decide, while customers usually take the opposite position. The federal courts of appeals that have considered the question have divided almost evenly. The First, Second, Fourth, Fifth, Eighth, and Ninth Circuits have held that eligibility is a question for the arbitrators to decide;⁹⁶ while the Third, Sixth, Seventh, Tenth, and Eleventh Circuits have held that it is a question for the courts,⁹⁷ as has the

91. *Id.* at 28-29.

92. Michael Siconolfi, *Ruder Proposals Hit Red Tape and Bickering*, WALL ST. J., July 22, 1996, at A7; Richard C. Reuben, *Investors’ Attorneys Find Task Force Report Faulty*, ABA J., Apr. 1996, at 40; *Reactions to Ruder Report*, 8 SEC. ARB. COMMENTATOR 1 (Mar. 1996).

93. See Margaret A. Jacobs, *Brokers to Find It Harder to Delay Clients from Arbitrating Disputes*, WALL ST. J., Aug. 22, 1994, at B6; Margaret A. Jacobs, *Limits on Arbitration Are Assailed as a Catch-22 Trap for Investors*, WALL ST. J., July 14, 1994, at B7.

94. Dominic Bencivenga, *Securities Threshold: Should Judges or Arbitrators Decide Eligibility?*, N.Y. L.J., Nov. 9, 1995, at 5 (quoting David E. Robbins, Esq.).

95. See, e.g., *PaineWebber Inc. v. Hofmann*, 984 F.2d 1372 (3d Cir. 1993). For further discussion of this case, see *infra* text accompanying notes 116-24.

96. *PaineWebber Inc. v. Elahi*, 87 F.3d 589 (1st Cir. 1996); *PaineWebber Inc. v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996); *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 121 (2d Cir. 1991) (“[A]ny limitations defense—whether stemming from the arbitration agreement, arbitration association rule, or state statute—is an issue to be addressed by the arbitrators.”) (emphasis added) (citing *Conticommodity Servs. Inc. v. Philipp & Lion*, 613 F.2d 1222, 1224-25 (2d Cir. 1980)); *Miller v. Prudential Bache Sec., Inc.*, 884 F.2d 128, 130 (4th Cir. 1989), *cert. denied*, 497 U.S. 1004 (1990); *Smith Barney Shearson, Inc. v. Boone*, 47 F.3d 750, 754 (5th Cir. 1995); *FSC Sec. Corp. v. Freel*, 14 F.3d 1310, 1313 (8th Cir. 1994); *O’Neel v. National Ass’n of Sec. Dealers, Inc.*, 667 F.2d 804, 807 (9th Cir. 1982).

97. *PaineWebber Inc. v. Hofmann*, 984 F.2d 1372, 1378 (3d Cir. 1993); *PaineWebber Inc. v. Hartmann*, 921 F.2d 507, 514 (3d Cir. 1990); *Dean Witter Reynolds, Inc. v. McCoy*, 995 F.2d 649, 650 (6th Cir. 1993); *Edward D. Jones & Co. v. Sorrells*, 957 F.2d 509, 512 (7th Cir. 1992); *PaineWebber Inc. v. Farnam*, 870 F.2d 1286, 1292 (7th Cir. 1989); *Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 94-1482, 1996 WL 77815 (10th Cir. Feb.

New York Court of Appeals.⁹⁸

Most courts holding that the arbitrators should decide whether a claim is “eligible” for arbitration under NASD Section 15 view the eligibility requirement as a kind of statute of limitations, which is essentially procedural.⁹⁹ According to this view, the eligibility rule does not raise a question of arbitrability. For example in *PaineWebber, Inc. v. Landay*,¹⁰⁰ the district court pointed out the following:

[There is a distinction] between a) disputes over whether there is any agreement to arbitrate in the first place (“arbitrability”) and b) disputes where a valid arbitration agreement exists but there are secondary questions concerning scope. . . . [A]ll doubts concerning the latter should be resolved in favor of arbitration, and, in fact, do not involve “arbitrability.” . . . Under this reasoning, timeliness disputes generated between parties to valid arbitration agreements should presumptively be resolved through arbitration.¹⁰¹

These courts emphasize the policy of the FAA in favor of enforcement of arbitration agreements and the purpose of arbitration to provide the parties to a dispute with a speedy and relatively inexpensive trial before specialists.¹⁰² Thus, once the court determines that there is a valid arbitration agreement between the parties and that the dispute is covered by the agreement, all questions pertaining to the dispute, including time-bar questions, must be decided by the arbitrators.

The courts that hold that the eligibility question is for the courts rather than the arbitrators to decide focus on the difference between the language of Section 15, which states that stale claims are not “eligible” to be arbitrated and the language of statutes of limitations, which typically require that an action “be commenced” within a certain time.¹⁰³ According to this view, the eligibility of an arbitration claim is not a statute-of-limitations question, to be decided by the arbitrators, but a question of the arbitrability of the dispute, to be decided by the court.¹⁰⁴ Put in other words, these courts view eligibility as a prerequisite to the arbitrators’ jurisdiction.¹⁰⁵ Thus, a claim that is barred by Section 15 is ineligible for arbitration because it falls outside the scope of the parties’ arbitration

23, 1996); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen*, 62 F.3d 381, 383 (11th Cir. 1995).

98. *Smith Barney, Harris Upham & Co. v. Luckie*, 647 N.E.2d 1308 (N.Y. 1995).

99. *See, e.g., O’Neel*, 667 F.2d at 807.

100. 903 F. Supp. 193 (D. Mass. 1995).

101. *Id.* at 200 (citing *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920 (1995)).

102. *Conticommodity Servs. Inc. v. Philipp & Lion*, 613 F.2d 1222, 1224 (2d Cir. 1980); *Prudential Sec., Inc. v. LaPlant*, 829 F. Supp. 1239, 1242 (D. Kan. 1993).

103. *See Hartmann*, 921 F.2d at 513.

104. *But see County of Rockland v. Primiano Constr. Co.*, 51 N.Y.2d 1, 6-7 (1980) (under New York law, whether an arbitration is barred by a statute of limitations is a “threshold question to be resolved by the courts”).

105. *Elahi*, 87 F.3d at 596. (“Five circuits . . . have interpreted the time bar of section 15 to be a substantive eligibility requirement that constitutes a jurisdictional prerequisite to arbitration, and thus for the court to apply.”).

agreement.¹⁰⁶

In the recent case of *PaineWebber, Inc. v. Bybyk*,¹⁰⁷ a divided panel of the Second Circuit held that the applicability of the eligibility rule was for the arbitrators to decide, but the court based its decision on different grounds from those relied upon by other courts that had come to the same conclusion.¹⁰⁸ The *Bybyk* court tacitly accepted that applying the eligibility rule raised the threshold question of arbitrability, and that arbitrability is normally decided by the court, not the arbitrators. The court held, however, that the parties had agreed that questions of arbitrability should be heard by the arbitrators.¹⁰⁹

The importance of *Bybyk* lies in the fact that the parties' agreement was a standard-form customer-broker agreement, many of whose provisions are used in substance by other brokerage firms. In fact, one of the provisions of the agreement on which the court based its conclusion that the parties had agreed to arbitrate the question of arbitrability—a provision stating that “the parties are waiving their right to seek remedies in court”¹¹⁰—is required by an NASD rule to be included in the arbitration clause of every customer agreement.¹¹¹ The other provisions of the agreement on which the *Bybyk* court based its opinion were those stating that (1) “any and all controversies . . . shall be determined by arbitration”; (2) “any arbitration . . . shall be . . . governed by the [FAA]”; and (3) “arbitration shall be governed by the rules of the organization convening the panel [in this case, the NASD].”¹¹² Thus, the Second Circuit held in *Bybyk* that the standard arbitration clause used by broker-dealers defeats the presumption that the court will decide questions of arbitrability and constitutes an agreement that the arbitrators will decide arbitrability, including eligibility questions.¹¹³

106. See, e.g., *McCoy*, 995 F.2d at 650-51; *Hartmann*, 921 F.2d at 511. “As a matter of contract, no party can be forced to arbitrate unless that party has entered into an agreement to do so. Before compelling an unwilling party to arbitrate, § 4 therefore requires the court to engage in a limited review to ensure that the dispute is arbitrable.” *Hartmann*, 921 F.2d at 511.

107. 81 F.3d 1193 (2d Cir. 1996).

108. *Id.* at 1201-02.

109. *Id.* at 1200.

110. *Bybyk*, 81 F.3d at 1200.

111. NASD Rule IM-3110(f)(1)(ii) (formerly NASD Rules of Fair Practice, art. III, § 21(f)(1)(ii)). The other SROs have the same rule. SRO rules provide: “No agreement shall include any condition which limits or contradicts the rules of any [SRO] or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.” See, e.g., NASD Rule IM-3110(f)(4) (formerly NASD Rules of Fair Practice, art. III, § 21(f)(4)).

112. *Bybyk*, 81 F.3d at 1199. *Bybyk* also held that the arbitrators had authority to decide whether the claimant was entitled to attorneys' fees, despite the fact that the arbitration agreement provided that New York law would govern and that New York law provides that attorneys' fees may not be awarded in arbitrations unless the agreement expressly provides. *Id.* at 1202. The court cited the Supreme Court's decision in *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1218-19 (1995), for the rule that a choice of law provision will not be construed to impose substantive restrictions on the parties' rights under the FAA. *Id.*

113. See also *Cowen & Co. v. Technoconsultant Holdings, Ltd.*, No. 96 Civ. 3748(BSJ), 1996 WL 391884 (S.D.N.Y. July 11, 1996) (discussing and following *Bybyk*).

There are also two pragmatic reasons for allowing the arbitration panel to decide the eligibility issue. First, in many securities cases it is difficult or impossible to separate the substantive issues of the case from the question of ascertaining the date of the "occurrence or event" that triggered the claim. Where, for example, the investor claims that the broker was guilty of a continuing pattern of fraud, a full hearing on the underlying facts of the case may be necessary in order to determine when the action accrued. In such cases, "the more efficient resolution is to leave all issues to the arbitrator."¹¹⁴ As one district court stated, "attempts to resolve time-limitation issues will often lead to an entanglement in the merits of the dispute," an involvement that the courts are enjoined to avoid in cases where a valid arbitration agreement exists.¹¹⁵

Second, giving the courts the ability to decide the eligibility issue enables brokerage firms to involve customer-claimants in expensive and time-consuming litigation before their claims can be heard, even if the claims are not properly barred by Section 15. It is possible that some brokerage firms insist on raising the eligibility defense in court for the very purpose of exhausting the claimants' resources and discouraging them from pursuing their claims. This may explain why it is almost invariably the customer who argues that the arbitrators should decide the eligibility question, while the brokerage firm contends that the decision should rest with the court.

The Third Circuit's decision in *PaineWebber Inc. v. Hofmann*¹¹⁶ demonstrates the reality of both of these concerns. Hofmann opened an account with PaineWebber in 1977 and, between 1982 and 1987, made 118 purchases of the stock of EECO, a small California electronics company. In 1987, Hofmann executed a margin agreement that contained an arbitration clause. In 1990, EECO filed for bankruptcy protection and the stock became worthless, and on October 11, 1991, Hofmann filed a demand for arbitration with the NASD.¹¹⁷ Although a majority of the purchases occurred more than six years before the date Hofmann initiated the arbitration, Hofmann claimed that all of his losses could be attributed to "occurrences or events" within six years of the demand for arbitration. Among other things, he argued that his PaineWebber broker had wrongfully advised him not to sell his EECO stock, that PaineWebber had concealed and made misstatements about the risk of holding the stock, and that there had been a "unitary pattern of wrongdoing" extending through 1987.¹¹⁸

In response, PaineWebber asked the NASD Director of Arbitration to

114. *Goldberg v. Parker*, 1995 WL 396568, at *5 (N.Y. Sup. Apr. 12, 1995), *aff'd on other grounds*, 634 N.Y.S.2d 81 (App. Div. 1995).

115. *PaineWebber Inc. v. Landay*, 903 F. Supp. 193, 202 (D. Mass. 1995) (citing *AT&T Technologies, Inc. v. Communications Workers of Am.*, 475 U.S. 643, 649-50 (1986)).

116. 984 F.2d 1372 (3d Cir. 1993).

117. *Id.* at 1374-75.

118. *Id.* at 1375.

dismiss the claim under former NASD Section 15.¹¹⁹ When the Director refused to do so and stated that the time-bar question would be submitted to the arbitrators to decide, PaineWebber brought an action in federal court to stay the arbitration of claims that arose from occurrences or events more than six years before the filing of the arbitration claim. Hofmann moved for summary judgment, which the district court granted, and PaineWebber appealed to the Third Circuit.¹²⁰

The Court of Appeals, following Third Circuit precedent, held that NASD Section 15 operated as a substantive bar, limiting the controversies that the parties had agreed to submit to arbitration. Thus, under the FAA, the court, not the arbitrators, should decide the applicability of Section 15. The court remanded the case, instructing the district court to conduct a hearing to examine each claim individually, not on the merits but only to determine which claims were time-barred and which were not.¹²¹ The arbitrators would then hear the claims that were not time-barred.¹²²

Hofmann demonstrates the opportunities for exhaustion of a weaker opponent that the eligibility requirement provides to a brokerage firm if the court is to determine its application. The customer in this case, having brought his arbitration claims before the NASD and then forced to defend against the injunctive suit in both the district court and court of appeals, would have to return to the district court to litigate the question of the applicability of the NASD time-bar to each claim. Only then would the customer have an opportunity to arbitrate the claims before an NASD arbitration panel. This assumes that there would be no additional court proceedings, either appealing any of the district court's decisions on the time-bar question or raising additional issues.¹²³ Furthermore, as the Third Circuit conceded in *Hofmann*, it may in practice be difficult for the court to rule on the applicability of the eligibility rule without also ruling on the merits of a particular claim.¹²⁴

One implication of the "substantive" view of the eligibility requirement has not been adequately explored. If the court, and not the arbitration panel, is the proper forum to decide that a claim is barred from arbitration by Section 15, the only basis for making this determination is that the dispute falls outside the scope of the parties' arbitration agreement.¹²⁵ This is because a court's sole function under Section 4 of the FAA is to determine whether a valid arbitration agreement exists between the par-

119. Now renumbered NASD Rule 10304.

120. *Hofmann*, 984 F.2d at 1375-76.

121. *Id.* at 1382-83.

122. *Id.* at 1380-82.

123. On remand, the district court determined that some of the claims were not barred by Section 15 and sent these claims to arbitration. After a hearing, the arbitration panel dismissed the claims. Telephone conversation between Emil Bukhman, research assistant to the author, and Michael Slotznick, counsel to the claimant (Mar. 1996).

124. *Hoffman*, 984 F.2d at 1381.

125. See *Cohen*, 62 F.3d at 384 (Section 15 is a "jurisdictional prerequisite to arbitration").

ties and whether the particular dispute is covered by the agreement. If the court decides both questions affirmatively, it is required to order the dispute to arbitration.¹²⁶

It therefore follows that where the court finds a claim to be ineligible under Section 15, the claim falls outside the scope of the arbitration agreement. The claimant, not being bound by an arbitration agreement, should be free to pursue the claim in court, assuming that he is not barred from doing so by a legal statute of limitations or some other disqualification. The arbitration agreement, however, should not prevent the claimant from litigating his claim, because the court has ruled that the arbitrators do not have jurisdiction over the claim, which, being more than six years old, does not fall within the scope of the arbitration agreement.

The above reasoning, however, has been rejected in most instances in which it has been raised,¹²⁷ although no appellate court has considered the question of whether a claim barred from arbitration by Section 15 may be litigated in court. In one case, a district court stated:

There is simply no language anywhere in the Client's Agreement which states that plaintiff may seek relief in federal district court once it has been determined that his claims are not eligible for arbitration. . . . Indeed, for us to find that plaintiff could assert his claims in this forum after having been time-barred from asserting them in arbitration, would only encourage a plaintiff seeking to avoid arbitration to wait six years and then assert his claims in federal district court.¹²⁸

The court's reasoning is not persuasive. If the parties' agreement to arbitrate does not cover claims that are barred by the eligibility rule, there does not seem to be any need for explicit language in the agreement permitting the plaintiff to litigate claims. Moreover, it is unrealistic to suppose that a plaintiff would knowingly wait six years before bringing a claim, just in order to avoid arbitration. A party who did that might run

126. *Houlihan v. Offerman & Co., Inc.*, 31 F.3d 692, 695 (8th Cir. 1994); *Smith Barney, Harris Upham, Inc. v. Robinson*, 12 F.3d 515, 520-21 (5th Cir. 1994).

127. *Calabria v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 855 F. Supp. 172 (N.D. Tex. 1994); *McCoy*, 853 F. Supp. at 1033; *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Shelapinsky*, Civ. A. No. 93-1553, 1994 WL 397123 (W.D. Pa. Mar. 10, 1994); *Piccolo v. Faragalli*, Civ. A. No. 93-2758, 1993 WL 331933 (E.D. Pa. Aug. 24, 1993); *Castellano v. Prudential-Bache Sec., Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,321, at 96,536 (S.D.N.Y. June 19, 1990) (customer not permitted to file arbitration claim with American Arbitration Association after arbitration with NYSE is barred by eligibility rule, on grounds that customer has elected the NYSE forum). *But see Smith Barney, Harris Upham & Co. v. St. Pierre*, No. 92 C 5735 1994 WL 11600 (N.D. Ill. Jan. 4, 1994) (customer whose claims are barred from arbitration by Section 15 is permitted to litigate her claims in court if they are not barred by the legal statutes of limitations); *Prudential Sec., Inc. v. LaPlant*, 829 F. Supp. 1239, 1244-45 (D. Kan. 1993) (customer granted leave to file a counterclaim with respect to any claims that are not barred by Section 15).

128. *Piccolo*, Civ. A. No. 93-2758, 1993 WL 331933, at *2. *See also Conroy v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 899 F. Supp. 1471, 1476 (W.D.N.C. 1995); *Saunderson v. Gary Goldberg & Co.*, 899 F. Supp. 177, 180 (S.D.N.Y. 1995); *Shelapinsky*, Civ. A. No. 93-1553, 1994 WL 397123, at *3.

a very serious risk of having his or her claims time-barred by the applicable statute of limitations (and his or her attorney might run the risk of being sued for malpractice if the claims were time-barred).¹²⁹

On the other hand, in jurisdictions that hold that the applicability of Section 15 is a procedural matter for the arbitration forum to decide, the claimant should not be permitted to litigate any claims that are barred by Section 15. Since the arbitrators (or the NASD Director of Arbitration) have taken jurisdiction over the matter and ruled on the time-bar question, the purposes of arbitration would be undermined if the claimant were allowed "a second bite out of the arbitration apple."¹³⁰

Section 15 and the comparable eligibility rules of other SROs bar the arbitration of any claim brought more than six years after the "occurrence or event" on which the claim is based. This raises the question whether the eligibility rules are subject to the doctrine of equitable tolling that is applicable to statutes of limitations. Under the equitable tolling doctrine, the limitations period does not begin to run until the plaintiff knew or should have known of the wrongdoing that gives rise to his claim.

Most of the courts that hold that eligibility is not a statute of limitations but a substantive question for the court to decide accept the corollary proposition that Section 15 cannot be tolled. The eligibility rule thus "serves as an absolute bar to claims submitted . . . more than six years after the event that gave rise to the dispute," even if the plaintiff could not have known about the fraud or if the defendant fraudulently concealed the fraud from the plaintiff.¹³¹ The courts' reasoning is that since Section 15 is not a statute of limitations but a substantive contractual limitation on the parties' agreement to arbitrate, it is not subject to modification based on equitable considerations.¹³²

The Sixth Circuit, which, like the Third and Seventh Circuits, holds that the courts, not the arbitrators, should decide the eligibility issue, nevertheless permits tolling of the eligibility requirement if the district court finds, under the relevant state law, that the defendant fraudulently concealed the alleged wrongdoing.¹³³ In order for there to be fraudulent concealment, there must be an affirmative act of misrepresentation, unless there is a fiduciary relationship between the parties that gives rise to

129. The Securities Industry Conference on Arbitration has proposed that Section 15 be amended to give investors the express option of going to court if their claims are deemed to be ineligible for arbitration. Siconolfi, *supra* note 92, at A7.

130. *Bakk v. Principal Fin. Sec., Inc.*, 892 F. Supp. 1206, 1209 (D. Minn. 1995).

131. *Farnam*, 870 F.2d at 1292; *Edward D. Jones & Co. v. Sorrells*, 957 F.2d 509, 512-13 (7th Cir. 1992). See RUDER REPORT, *supra* note 8, at 22-23.

132. See *Prudential Sec. v. Moneymaker*, No. Civ.-93-179, 1994 WL 637396 (W.D. Okla. July 14, 1994).

133. *McCoy*, 995 F.2d at 651. See also *Roney & Co. v. Kassab*, 981 F.2d 894, 900 (6th Cir. 1992) (no equitable tolling allowed where the elements of fraudulent concealment (*i.e.*, "some affirmative fraudulent act and an additional act to perpetuate the concealment" are absent)).

an affirmative duty to disclose material facts.¹³⁴ In that case silence or inaction may constitute fraudulent concealment.

Whether or not equitable tolling is permitted, it is necessary to determine the date of the "occurrence or event" that is the basis for the claim. Where the claim is based solely on the customer's single purchase of a security, the occurrence or event is the date of the purchase.¹³⁵ On the other hand, where the event at issue is the defendant's conduct over a period of time, the trial court (in jurisdictions that authorize the court to determine the applicability of Section 15) must make a factual inquiry in order to fix the triggering date.¹³⁶

This task is more easily described than performed. For example, the Third Circuit noted in *Hofmann* that a customer's claim that his brokerage firm fraudulently concealed its representative's wrongdoing can be regarded alternatively as an attempt to toll the time period on claims arising out of the underlying wrongdoing or as an independent cause of ac-

134. *Davis v. Keyes*, 859 F. Supp. 290, 293 (E.D. Mich. 1994). In *Davis*, Judge Feikens, who sixteen years earlier had decided *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951 (E.D. Mich. 1978), a leading case on the fiduciary duties of stockbrokers, held on the basis of *Leib* that a fiduciary relationship did not exist between the customer and broker and that therefore the broker's nondisclosure could not be the basis for a fraudulent concealment claim so as to toll the eligibility period of NASD § 15.

135. *PaineWebber Inc. v. Allen*, No. 93-1575, 1995 WL 8056 (4th Cir. Jan. 10, 1995), *cert. denied*, 116 S. Ct. 52 (1995); *Mutual Serv. Corp. v. Spaulding*, 871 F. Supp. 324, 328 (N.D. Ill. 1995) (where customer challenged suitability of investments, the "occurrence or events" which gave rise to the claims were the initial investments); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Barnum*, 616 N.Y.S.2d 857, 859 (Sup. Ct. 1994) ("[I]n general, the event which triggers the six-year period is the investment in, or the purchase of, the relevant security.") (citing New York cases).

136. In *Hofmann*, the Third Circuit set forth a procedure for determining the occurrence or event:

[T]he first step will be to determine whether the parties intended to submit disputes over the operative occurrence or event, and/or when it occurred, to arbitration. In resolving this question, the court should look to the language of the contract and all relevant extrinsic evidence. . . . In particular, the court may be aided by evidence of the customs and practices in the industry.

. . . .
If the parties intended to submit disputes over what is the relevant occurrence or event, and/or when it occurred, to arbitration, the narrow question of [what constitutes the relevant occurrence or event] should be sent to an arbitrator for initial determination. . . . If the arbitrators determine that the occurrence or event that gave rise to the particular claim occurred more than six years before the filing of arbitration, their inquiry as to that claim is at an end because they have no jurisdiction to consider it on the merits. If, on the other hand, the arbitrators determine that the occurrence or event was within six years of [the customer's] arbitration demand, the arbitrators should go on to rule on the merits of the claim.

If, in contrast, the district court determines that the parties did not intend to submit disputes over the relevant occurrence or event to arbitration, the court will have to determine what was the relevant occurrence or event and when it occurred.

Hofmann, 984 F.2d at 1382-83. This description of the procedure, aside from being complex, is not particularly helpful, since it does not deal with the specifics of customers' claims relating to securities transactions. The procedure was derived from a case involving a labor arbitration, *Morristown Daily Record, Inc. v. Graphic Communications Union, Local 8N*, 832 F.2d 31 (3d Cir. 1987).

tion based on a duty of the firm to its customers to inform them of the wrongdoing.¹³⁷ Similarly, the Eleventh Circuit has stated that if a broker perpetrates a continuing affirmative fraud on customers, such as reporting false values for their investments through bogus statements, the act of sending out the false statements, rather than the initial purchase of the investment, may be the occurrence or event giving rise to determining their claims.¹³⁸ Where a customer claimed that the brokerage firm's representative initially misrepresented the value of his investments and continued furnishing him with monthly account statements that induced him to hold the investments, the district court refused to determine the triggering "occurrence or event" under Section 15 until a factual inquiry could be held.¹³⁹

Some types of fraud necessarily occur over a period of time. For example, determining the triggering date under Section 15 of a claim that a brokerage account was churned may require the court to hold an evidentiary hearing.¹⁴⁰ Similarly, where a customer's claims were not limited to purchases and sales but included claims based on alleged ongoing systemic mismanagement, diversion of funds, misrepresentations, conflict of interest, and self-dealing, a district court held that any such claim that occurred within six years prior to the NASD filing should proceed to arbitration.¹⁴¹

Predictably, some courts have reacted against the harshness of denying equitable tolling and at the same time imposing a bright-line rule that the triggering occurrence or event is the purchase of the security. As one New York trial court stated, in a case involving the allegedly fraudulent sales of limited partnership interests and a continuing pattern of misrepresentation by a broker: "The effect of this interpretation in fraud cases is to reward the unscrupulous broker-dealer and to penalize the unsophisticated investor who does not discover the fraud for more than six years after the investment was purchased."¹⁴² Pointing out that the NASD itself does not take the position that the purchase date is necessarily the event or occurrence that gave rise to the dispute,¹⁴³ the court held as follows:

137. *Hofmann*, 984 F.2d at 1381-82.

138. *Cohen*, 62 F.3d at 385 nn.5-6.

139. *Merrill Lynch, Pierce, Fenner & Smith v. Masland*, 878 F. Supp. 710, 713-15 (M.D. Pa. 1995).

140. In *Merrill Lynch, Pierce, Fenner & Smith v. Barchman*, 916 F. Supp. 845 (N.D. Ill. 1996), the district court stated: "[T]he purchase or sale of any one investment would not of itself trigger the six-year eligibility period on the churning count. Instead the six-year clock began to tick as to each Claimant at the point that the trading activity in his or her account became excessive." *Id.* at 853.

141. *Moneymaker*, No. CIV-93-179, 1994 WL 637396, at *2.

142. *Goldberg v. Parker*, 1995 WL 396568, at *2 (N.Y. Sup. Apr. 12, 1995), *aff'd on other grounds*, 634 N.Y.S.2d 81 (App. Div. 1995).

143. The court quoted the Director of Arbitration of the NASD as follows: "Section 15 does not refer specifically to the purchase date as the time that the six year limitation begins to run. Therefore it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute." *Id.* at *4.

The factual issues underlying the computation of the eligibility periods are too closely intertwined with the substantive issues of fraud and self-dealing . . . to permit the court to rule as a matter of law on which date or dates the events occurred giving rise to respondent's claims.

Rather than the court's holding a hearing on issues of fact, the more efficient resolution is to leave all issues to the arbitrator.¹⁴⁴

This resolution is not only more efficient, but it protects investors who have signed an arbitration agreement and are willing to comply with it from being required to engage in bifurcated proceedings.

B. PUNITIVE DAMAGES

The question whether punitive damages may be awarded in securities arbitrations has generated a large volume of litigation in both federal and state courts. According to the *Ruder Report*, "No subject has generated more widespread controversy or resulted in more polarization between the investor and broker-dealer communities than the appropriateness of punitive damages in securities arbitration."¹⁴⁵ The reason for the extreme sensitivity of the punitive-damages issue is not altogether clear. Arbitrators rarely award punitive damages to investors, and the amount of the punitive damages awarded in these cases is usually only a small fraction of the amount claimed.¹⁴⁶ The vigor with which brokerage firms have contested the authority of arbitrators to award punitive damages is probably due less to any actual measurement of the exposure to liability than to a fear that arbitrators, if told unequivocally that they are free to award punitive damages, might begin to do so as a matter of course. In any event, the issue has been the subject of a large amount of litigation.

Although punitive damages are not permitted in lawsuits brought under the 1934 Act,¹⁴⁷ they are permitted under the laws of most states, and in appropriate cases federal courts will award punitive damages on state-law claims under the doctrine of diversity jurisdiction or pendent jurisdiction.¹⁴⁸ According to the New York Court of Appeals:

[T]here may be a recovery of exemplary damages in fraud and deceit actions where the fraud, aimed at the public generally, is gross and

144. *Id.* at *5.

145. RUDER REPORT, *supra* note 8, at 35.

146. A 1992 report of the Government Accounting Office found that punitive damages were requested in 28% of the securities cases decided at SROs and 48% of the cases decided at the AAA; that SRO arbitrators awarded punitive damages in 12% of the decided cases in which such damages were requested, and AAA arbitrators awarded punitive damages in 9% of the cases in which such damages were requested; and that the median for such awards was 11% of the amount claimed at the SROs and 5% at the AAA. U.S. GEN. ACCOUNTING OFFICE REPORT TO CONGRESSIONAL REQUESTERS PUB. NO. GAO/GGD-92-74, SECURITIES ARBITRATION: HOW INVESTORS FARE 45 (1992).

147. The Securities Exchange Act provides that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." 15 U.S.C. § 78bb(a) (1994).

148. See POSER, *supra* note 28, at 392-95.

involves high moral culpability . . . , where the defendant's conduct evinced a high degree of moral turpitude and demonstrated such wanton dishonesty as to imply a criminal indifference to civil obligations.

Exemplary damages are more likely to serve their desired purpose of deterring similar conduct in a fraud case . . . than in any other kind of tort. . . . [T]hose who deliberately and coolly engage in a far-flung fraudulent scheme, systematically conducted for profit, are very much more likely to pause and consider the consequences if they have to pay more than the actual loss suffered by an individual plaintiff.¹⁴⁹

Although the principal securities-arbitration forums do not explicitly authorize the award of punitive damages by arbitrators, their rules strongly suggest that punitive damages may be awarded. The *NASD Code of Arbitration Procedure* simply states that the award may consist of "damages and other relief,"¹⁵⁰ and the rules of the other SROs use similar language.¹⁵¹ Furthermore, the Arbitrator's Manual published by the Securities Industry Conference on Arbitration (SICA) tells arbitrators that they may award punitive damages.¹⁵² The AAA Securities Arbitration Rules provide that the arbitrator "may grant any remedy or relief that the arbitrator deems just and equitable. . . ."¹⁵³ The courts have taken the position that, to the extent that the NASD Code is silent on the scope of arbitrators' powers, this implies the absence of categorical limitations;¹⁵⁴ and, furthermore, that where the parties agree to arbitration under the rules of a particular forum, and where arbitration issues involve interstate commerce, the FAA gives force to the rules of that arbitration forum.¹⁵⁵ Thus, an agreement between a brokerage firm and a customer to arbitrate future disputes under the rules of an SRO or the AAA includes an implied agreement that the arbitrators may award punitive damages.¹⁵⁶

Plausible arguments can be made both for and against awarding puni-

149. *Walker v. Sheldon*, 179 N.E.2d 497, 492 (N.Y. 1961).

150. NASD Rule 10330(e).

151. NYSE Rule 627; Amex § 613.

152. The issue of punitive damages may arise with great frequency in arbitrations. Parties to arbitration are informed that arbitrators can consider punitive damages as a remedy. Generally, in court proceedings, punitive damages consist of compensation in excess of actual damages and are awarded as a form of punishment against the wrongdoer. If punitive damages are awarded, the decision of the arbitrators should clearly specify what portion of the award is intended as punitive damages, and the arbitrators should consider referring to the authority on which they relied.

SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, *THE ARBITRATOR'S MANUAL* 26-27 (1992).

153. AAA SECURITIES ARBITRATION Rule § 42(c) (1993).

154. *Baravati v. Josephthal, Lyon & Ross, Inc.*, 28 F.3d 704, 709-10 (7th Cir. 1994).

155. *Lee v. Chica*, 983 F.2d 883, 888 (8th Cir.), *cert. denied*, 510 U.S. 906 (1993).

156. Section 4 of the FAA, 9 U.S.C. § 4, confers the "right to obtain an order directing that 'arbitration proceed in the manner provided for in [the parties'] agreement.'" *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 474-75 (1989) (emphasis added).

tive damages in securities arbitrations.¹⁵⁷ Perhaps the strongest argument for giving arbitrators authority to award punitive damages is the strong federal policy, reflected in the FAA, for resolving all doubts about arbitrability in favor of arbitration. Thus, arbitrators should be given a maximum degree of flexibility in fashioning suitable remedies. Second, not to permit arbitrators to award punitive damages in a case where a court would award punitive damages is inconsistent with the principle expressed by the Supreme Court that an agreement to arbitrate should not change investors' substantive rights.¹⁵⁸ Thus, it would be unfair to an investor to deprive him of the right to punitive damages, if punitive damages would be available to him in a court action, just because his brokerage firm requires him to sign an arbitration agreement as a condition of opening a brokerage account.

Third, the threat that punitive damages will be awarded in cases where the defendant's conduct is egregious gives brokerage firms a strong incentive to supervise their salespersons effectively and otherwise to comply with the securities laws. This is especially true, in view of the fact that the claims of many customers against brokers involve alleged fraud, which some authorities regard as a category of undesirable conduct that punitive damages is particularly likely to deter. The deterrent effect of punitive damages, on the responsible party as well as on others, in egregious cases of fraud or abuse of trust will be as great if an arbitration panel imposes the sanction as if a judge or jury imposes it.

Finally, the availability of punitive damages helps enforce the securities laws by giving investors and attorneys a special incentive to press claims where reprehensible conduct is involved, even though the size of the monetary claims may be relatively modest.

Several arguments are likewise made in favor of withholding from arbitrators the power to award punitive damages. First, the absence in arbitrations of any of the restraints on decision-makers that are found in litigation—the ability of the judge to overturn or modify a jury verdict; the development of standards through the writing of reasoned opinions, both as to when punitive damages may be awarded and as to the appropriate amount of punitive damages; and the right of appeal to a higher court—makes the potential award of punitive damages in arbitrations not only unpredictable but unfair.¹⁵⁹ Second, the securities industry takes the position that punishment and deterrence are inconsistent with the pur-

157. For a summary of the arguments pro and con, see RUDER REPORT, *supra* note 8, at 36-38; G. Richard Shell, *The Power to Punish: Authority of Arbitrators to Award Multiple Damages and Attorneys' Fees*, 72 MASS. L. REV. 26, 28-33 (1987); NASD NOTICE TO MEMBERS 94-54 (July 1994) (enclosing the Report of the Subcomm. on Punitive Damages of the NASD Legal Advisory Board).

158. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 481 (1989) ("By agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute. . . ."); *McMahon*, 482 U.S. at 231 ("[T]he streamlined procedures of arbitration do not entail any consequential restriction on substantive rights.").

159. To which investors may retort that it was the securities industry, not investors, who fought for mandatory arbitration, with all of its inherent benefits and drawbacks.

poses of arbitration and that allowing punitive damages inevitably makes arbitrations more complex, expensive, and time-consuming. Third, it is argued that the highly developed enforcement and disciplinary machinery that exists in the securities area reduces any need there may be for punitive damages as a method of deterring wrongdoing.

Finally, those who oppose punitive damages in arbitration contend that the power to punish should belong exclusively to the state, not to an independent panel of arbitrators. This was the rationale used by the New York Court of Appeals in *Garrity v. Lyle Stuart, Inc.*,¹⁶⁰ a case involving the alleged breach of a publishing contract, for holding that arbitrators have no power to award punitive damages, even if agreed upon by the parties.¹⁶¹ In view of the fact that arbitration is often forced on unsophisticated investors by large brokerage firms, it is ironic that the court based its decision in part on the supposition that a party with superior bargaining power might be able to manipulate an arbitration panel in order to gain an award of punitive damages:

Punitive sanctions are reserved to the State, surely a public policy 'of such magnitude as to call for judicial intrusion'. . . . The evil of permitting an arbitrator whose selection is often restricted or manipulatable by the party in a superior bargaining position, to award punitive damages is that it displaces the court and the jury, and therefore the State, as the engine for imposing a social sanction.

. . .

Parties to arbitration agree to the substitution of a private tribunal for purposes of deciding their disputes without the expense, delay and rigidities of traditional courts. If arbitrators were allowed to impose punitive damages, the usefulness of arbitration would be destroyed. It would become a trap for the unwary given the eminently desirable freedom from judicial overview of law and facts. It would mean that the scope of determination by arbitrators, by the license to award punitive damages, would be both unpredictable and uncontrollable. It would lead to a Shylock principle of doing business without a Portia-like escape from the vise of a logic foreign to arbitration law.¹⁶²

Undoubtedly influenced by New York's prohibition of punitive damages awards by arbitrators, many brokerage firms have inserted a New York choice-of-law provision in their customer agreements, regardless of the residence of the customer or the location of the office of the firm that handled the customer's account. A split of authority among the federal courts of appeal developed on the question whether such a choice-of-law provision deprived arbitrators of the authority to award punitive damages.

160. 353 N.E.2d 793 (N.Y. 1976).

161. *Id.* at 794.

162. *Id.* at 795-96 (citation omitted) (quoting *Associated Gen. Contractors v. N.Y. State Chapter, Inc. (Savin Bros.)*, 335 N.E.2d 859, 860 (N.Y. 1975)).

The Second Circuit held that the FAA required private agreements to be enforced according to their terms and that the inclusion of a New York choice-of-law provision implied an intention by the parties to be bound by *Garrity*.¹⁶³ Thus, the parties had by agreement excluded the award of punitive damages from the arbitrators' authority.¹⁶⁴

The Eleventh Circuit held, on the other hand, that a New York choice-of-law clause merely designated the *substantive* law that the arbitrators were required to apply in determining whether the parties' conduct warranted an award of punitive damages, but that New York *arbitration* law (including *Garrity*) had no application in cases arising under the FAA.¹⁶⁵ Similarly, in *Pyle v. Securities U.S.A., Inc.*,¹⁶⁶ a federal district court held that a Colorado statute providing that "unless otherwise provided by law, exemplary damages shall not be awarded in administrative or arbitration proceedings" was preempted by the FAA.¹⁶⁷ The court stated:

[A]bsent an agreement by the parties that state arbitration law should govern, state arbitration law restricting an arbitrator's power to award punitive damages does not apply to an action under the FAA.

. . . [W]hether an arbitrator may award punitive damages is a matter central, not collateral, to the agreement to arbitrate. Moreover, . . . federal, not state law, applies in determining whether an arbitrator may award punitive damages.¹⁶⁸

163. *Barbier v. Shearson Lehman Hutton, Inc.*, 948 F.2d 117, 122 (2d Cir. 1991). See also *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 20 F.3d 713, *rev'd*, 115 S. Ct. 1212; *Fahnestock & Co. v. Waltman*, 935 F.2d 512, 518 (2d Cir.), *cert. denied*, 502 U.S. 942 (1991).

164. *Barbier*, 948 F.2d at 122.

165. *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378, 1388 (11th Cir. 1988). See also *Lee v. Chica*, 983 F.2d 883, 888-89 (8th Cir.), *cert. denied*, 510 U.S. 906 (1993); *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1061-63 (9th Cir. 1991); *Raytheon Co. v. Automated Business Sys., Inc.*, 882 F.2d 6, 10-11 (1st Cir. 1989); *J. Alexander Sec., Inc. v. Mendez*, 21 Cal. Rptr.2d 826, 830 (Cal Ct. App. 1993), *cert. denied*, 114 S. Ct. 2182 (1994).

166. 758 F. Supp. 638 (D. Colo. 1991).

167. *Id.* at 639.

168. *Id.* at 639-40 (citations omitted) (citing *Raytheon*, 882 F.2d at 11-12 n.5). It is not clear from the *Pyle* opinion whether the parties' agreement contained a Colorado choice-of-law clause that did not refer specifically to Colorado arbitration law or whether the agreement did not contain a choice-of-law clause.

It may be questioned whether *Garrity*, a contract case, should be applied automatically in cases involving intentional torts, including securities fraud or other types of broker-dealer abuse of their customers. Judge Posner of the Seventh Circuit raised this question in a case involving a defamation claim by an employee against a brokerage firm:

Occasional statements that punitive damages are disfavored in arbitration . . . must be read in context. Most arbitrations concern contract interpretation, and it is untraditional and still infrequent to award punitive damages for breach of contract. "[T]he traditional unavailability of punitive or exemplary damages in arbitration can . . . be traced to the common law notion that punitive damages are not available in the standard action for breach of contract. . . ." Here we have the unusual case of a tort arbitration, and punitive damages are commonly awarded for certain torts, including defamation. . . .

Baravati v. Josephthal, Lyon & Ross, Inc., 28 F.3d 704, 710 (7th Cir. 1994) (alteration in original) (citations omitted) (quoting MARVIN F. HILL, JR. & ANTHONY V. SINICROPI, *REMEDIES IN ARBITRATION* 436 (2d ed. 1991)). See also *Mulder v. Donaldson, Lufkin & Jenrette, Inc.*, 623 N.Y.S.2d 560, 564-65 (App. Div. 1995).

The policy arguments for and against the award of punitive damages in arbitration must yield, however, to the question whether the parties agreed to allow such an award. In view of the contractual nature of arbitration, "parties are generally free to structure their arbitration agreements as they see fit."¹⁶⁹ The courts have generally assumed that the parties can by agreement either give the arbitrators the authority to award punitive damages or to withhold that authority from them, and that, in the absence of a choice-of-law clause or some other express or implied restriction in the parties' agreement, the FAA does not prevent arbitrators in an SRO or AAA arbitration from awarding punitive damages.¹⁷⁰ These assumptions were reinforced by the Supreme Court's eight-to-one decision in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,¹⁷¹ a case that dealt with but did not finally resolve the controversy over the availability of punitive damages in securities arbitrations.

In *Mastrobuono*, the plaintiffs signed an agreement with Shearson that contained two provisions relevant to the dispute before the court: first, that the agreement "shall be governed by the laws of the State of New York"; and, second, that any controversy arising out of the transactions between the parties shall be settled by arbitration in accordance with the rules of the NASD.¹⁷² The plaintiffs were Illinois residents, the registered representative who serviced the plaintiffs' account worked out of a Shearson branch office in Texas, and "the most significant contacts in this case were with Illinois."¹⁷³ Thus, in the absence of the choice-of-law provision, New York law would not have governed the agreement. The plaintiffs filed arbitration claims, alleging that the defendants had mishandled their account, and a panel conducted hearings in Illinois and awarded the plaintiffs compensatory and punitive damages.¹⁷⁴ Shearson moved to vacate the award of punitive damages on the grounds that the New York choice-of-law provision in the agreement deprived the arbitrators of the authority to award punitive damages.

In analyzing this question, the Supreme Court first observed that if a similar contract, without a choice-of-law provision, had been signed in New York and was to be performed in New York, the laws of New York would apply, even though the contract did not expressly so state:

In such event, there would be nothing in the contract that could possibly constitute evidence of an intent to exclude punitive damages

169. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 479 (1989).

170. See *Baravati*, 28 F.3d at 709. The courts' permitting arbitrators to award punitive damages despite a New York choice-of-law provision "would enforce a provision in an arbitration clause that forbade the arbitrator to award punitive damages." *Id.* (emphasis in original). See *Fahnestock & Co.*, 935 F.2d at 518 ("If the parties had agreed to permit the arbitrators to make [a punitive damages] award, federal arbitration law might require confirmation. . .").

171. 115 S. Ct. 1212 (1995). Justice Stevens wrote the opinion for the majority. Justice Thomas wrote the dissent.

172. *Id.* at 1216-17. The agreement provided, alternatively, that arbitration could be held under the rules of the NYSE or the Amex. *Id.* at 1217.

173. *Mastrobuono*, 20 F.3d at 715.

174. *Id.*

claims. Accordingly, punitive damages would be allowed because, in the absence of contractual intent to the contrary, the FAA would preempt the *Garrity* rule.¹⁷⁵

The Court stated that the New York choice-of-law provision in the agreement might not preclude punitive damages because New York allows its courts, though not its arbitrators, to enter such awards.¹⁷⁶ The choice-of-law provision did not unequivocally exclude punitive damages claims because it might be interpreted to include only New York's substantive rights and obligations, not the State's allocation of power between alternative tribunals.¹⁷⁷ Furthermore, the Court's interpretation of the contract "accords with that of the only decision-maker arguably entitled to deference—the arbitrator."¹⁷⁸

Turning to the arbitration provision, the Court stated that the language strongly implied that a punitive damages award was appropriate.¹⁷⁹ The provision explicitly authorized arbitration in accordance with NASD rules, which indicated that arbitrators may award "damages and other relief."¹⁸⁰ "While not a clear authorization of punitive damages, this provision appears broad enough to at least contemplate such a remedy. . . . At most, the choice-of-law clause introduces an ambiguity into an arbitration agreement that would otherwise allow punitive damages awards."¹⁸¹

In resolving the ambiguity, the Court first cited the federal policy favoring arbitration and mandating that ambiguities as to the scope of the

175. *Mastrobuono*, 115 S. Ct. at 1217. At least one New York trial judge has chosen to ignore the Supreme Court's statement that, in the absence of an agreement to the contrary, the FAA would preempt the *Garrity* rule. The court held that a customer who arbitrated a dispute before the AAA in New York pursuant to the rules of the American Stock Exchange (the "Amex Window") was not entitled to punitive damages. The court stated:

Mastrobuono does not require a contrary result. The decision in *Mastrobuono* was based on the Supreme Court's interpretation of the parties' arbitration agreement. The Court wrote that "the case before us comes down to what the contract has to say about the arbitrability of petitioners' claim for punitive damages." In contrast, the case before me obviously does not involve the interpretation of the parties' contract since there is none.

Dean Witter Reynolds, Inc. v. Trimble, 631 N.Y.S.2d 215, 217 (Sup. Ct. 1995) (quoting *Mastrobuono*, 115 S. Ct. at 1216). In a footnote, the court stated that even if the parties had made an arbitration agreement containing a New York governing-law clause, the court would not be bound to interpret it in the same way as the Supreme Court did in *Mastrobuono*, since the interpretation of contracts is a matter of state law. *Trimble*, 631 N.Y.S.2d at 217 n.4.

Unsurprisingly, other courts have been more willing to follow *Mastrobuono*. See, e.g., *Davis v. Prudential Sec., Inc.*, 59 F.3d 1186, 1189 (11th Cir. 1995); *PaineWebber, Inc. v. Landay*, 903 F. Supp. 193, 204-05 (D. Mass. 1995); *PaineWebber, Inc. v. Richardson*, No. 94CIV-3104(AGS), 1995 WL 236722, at *3 (S.D.N.Y. Apr. 21, 1995).

176. *Mastrobuono*, 115 S. Ct. at 1217.

177. *Id.*

178. *Id.* at 1217 n.4.

179. *Id.* at 1218.

180. The NASD arbitration rules do not explicitly state whether punitive damages may be awarded. In specifying the required contents of the arbitrators' written and signed award, the rules state that the award "shall contain . . . the damages and other relief awarded." NASD Rule 10330(e) (formerly CAP Rule 41(e)).

181. *Mastrobuono*, 115 S. Ct. at 1218.

arbitration clause must be resolved in favor of arbitration.¹⁸² The Court then applied two rules of contractual interpretation in support of its conclusion that the parties' agreement did not rule out punitive damages. First, ambiguous language should be construed against the drafter:

Respondents drafted an ambiguous document, and they cannot now claim the benefit of the doubt. The reason for this rule is to protect the party who did not choose the language from an unintended or unfair result. That rationale is well-suited to the facts of this case. As a practical matter, it seems unlikely that petitioners were actually aware of New York's bifurcated approach to punitive damages, or that they had any idea that by signing a standard-form agreement to arbitrate disputes they might be giving up an important substantive right.¹⁸³

Second, a document should be read to give effect to all its provisions and to render them consistent with each other.¹⁸⁴

We think the best way to harmonize the choice-of-law provision with the arbitration provision is to read "the law of the State of New York" to encompass substantive principles that New York courts would apply, but not to include special rules limiting the authority of arbitrators. Thus, the choice-of-law provision covers the rights and duties of the parties, while the arbitration clause covers arbitration; neither sentence intrudes upon the other.¹⁸⁵

Mastrobuono did not hold that the parties to a customer-broker agreement could not deprive the arbitrators of the authority to award punitive damages if they wished to do so, but rather that it was not clear that the particular agreement between these parties had excluded punitive damages. Since, under the strong proarbitration interpretation that the courts have given the FAA, a party wishing to restrict the scope of an arbitration agreement has the burden of showing that the restriction was the intention of the parties, the agreement's lack of clarity worked in favor of permitting the arbitrators to award punitive damages. In view of the adhesive nature of most customer-broker arbitration agreements and the inequality of bargaining power that typically exists between the parties to such agreements, *Mastrobuono's* application of rules of contractual construction so as to support the customer's position seems fully justified.¹⁸⁶

Mastrobuono left open the possibility, however, that a brokerage firm could draft a standard-form agreement for its customers to sign that would clearly and unequivocally deprive the arbitrators of the authority

182. *Id.* at 1218 n.7.

183. *Id.* at 1219 (footnote omitted).

184. *Id.*

185. *Id.*

186. One writer has taken the position that the *Mastrobuono* decision is "legally insupportable" because it disregards the contractual intent of the parties. Kenneth R. Davis, *Protected Right or Sacred Rite: The Paradox of Federal Arbitration Policy*, 45 DEPAUL L. REV. 65, 98 (1995). Nevertheless, Professor Davis concedes that the decision "serves societal interests" in two ways: First, by increasing the scope of arbitable issues, the decision tends to lighten the judiciary's burden; and, second, it avails injured arbitrating parties the same relief as a court might grant. *Id.* at 99.

to award punitive damages. Such an agreement presumably would be valid and enforceable, assuming that the federal regulators were willing to permit it. *Mastrobuono* thus moved the controversy about punitive damages in arbitrations from the judicial to the regulatory arena.

Soon after the *Mastrobuono* decision, the NASD warned its members that it would be a violation of NASD rules to attempt to limit the authority of arbitrators to make an award, by a governing-law clause or by any other provision in a customer agreement.¹⁸⁷ The NASD pointed out that the agreements used by some member firms contained predispute arbitration provisions that were inconsistent with Article III, Section 21(f) of the NASD Rules of Fair Practice,¹⁸⁸ the rule that specified the contents of such provisions, and it urged members to take prompt steps to ensure that their customer agreements fully complied with the rule.¹⁸⁹ In particular, the NASD cited with approval the SEC's position that Section 21(f) had the force of federal law and that any customer agreement signed after September 7, 1989, the effective date of Section 21(f), was not enforceable if it was inconsistent with this section.¹⁹⁰ Implicit in this warning was the NASD's view that any member who used a customer agreement that deprived arbitrators of the authority to award punitive damages would be in violation of NASD rules.¹⁹¹

Some members of the securities industry reacted with hostility to the NASD's warning, regarding it as an unwarranted attempt to dictate to members the terms of their customer arbitration agreements so as to preserve arbitrators' authority to award punitive damages. One securities lawyer went so far as to suggest that industry members should bring legal action against the NASD for misinterpreting arbitration rules and making rule changes without making a formal rule proposal. NASD officers took the position that its interpretation of Section 21(f) was not a new interpretation.¹⁹²

Several proposals have been made to legislatively or administratively restrict the authority of arbitrators to award punitive damages. In 1993, a

187. *Predispute Arbitration Clauses in Customer Agreements*, in NASD NOTICE TO MEMBERS 95-16 (Mar. 1995) [hereinafter NASD NOTICE]. The NASD Rules of Fair Practice provide: "No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award." NASD Rule IM-3110(f)(4) (formerly NASD Code of Fair Practice, art. III, § 21(f)(4)).

188. Now redesignated NASD Rule IM-3110(f).

189. See *Predispute Arbitration Clauses in Customer Agreements*, *supra* note 187, at 101.

190. The NASD pointed out that the customer agreement in question in *Mastrobuono* was signed by the customer before the effective date of § 21(f). The NASD suggested that a governing-law clause in an agreement signed after that date would not merit the deference that the *Mastrobuono* Court gave to the governing-law clause. *Id.*

191. The *NASD Notice to Members* reminded members that in *Mastrobuono* the U.S. Solicitor General and the SEC argued to the Supreme Court that "NASD Rule 21(f)(4) forbids the inclusion in broker-client arbitration agreements of provisions limiting the ability of arbitrators to award relief that would be available in a judicial forum." NASD NOTICE, *supra* note 187.

192. Michael Siconolfi, *Brokers Advised to Skirt Ruling on Arbitration*, WALL ST. J., May 2, 1995, at C1.

New York bar committee proposed limiting the amount of punitive damages to double, or at most treble, the compensatory damages awarded.¹⁹³ A year later, the report of an NASD advisory committee showed signs of panic concerning the alleged threat of punitive damages. The report made a laundry list of recommendations, including the following: (1) written decisions in all cases of punitive damages awards; (2) a right to appeal such awards; (3) an "offer of judgment" rule, which would require a claimant to pay the respondent's costs if the final judgment awarded was less than the amount of any offer made by the respondent and turned down by the claimant; (4) a "clear and convincing evidence" standard of proof in support of any punitive damages award; (5) a dollar cap of \$250,000 or the same amount as the compensatory damages awarded; (6) a separate proceeding for the determination of punitive damages; and (7) a requirement that most of the punitive damages awarded be paid to the government or the regulators rather than to the claimant.¹⁹⁴ Following the publication of the NASD report, little more was heard about it. Presumably the general lack of acceptance of the report was due both to its almost complete failure to recognize the legitimate interests of defrauded investors and the fact that implementation of several of the recommendations would require amending the FAA and would impose complex legal procedures on arbitration, stripping it of some of its unique advantages of speed and economy.

The *Ruder Report*, reflecting the views of the bar (including former regulators), the securities industry, and academia, took a more even-handed, albeit still restrictive, approach to the subject of punitive damages. Recognizing that punitive damages serve a legitimate public interest, the Report recommended the following: (1) punitive damages should remain available, subject to a cap; (2) the cap should be the lesser of \$750,000 or twice the compensatory damages awarded; (3) an award that includes both compensatory and punitive damages should specify the amount of each and that, where requested by the party against whom the punitive-damages award is rendered, the arbitrators should be required to prepare a written document describing the conduct that gave rise to the award; and (4) punitive damages should be available in arbitration to the same extent as they are available in the courts of the state of the claimant's residence, so that "investors will be no better or worse off than if they had brought their claim to a judicial forum."¹⁹⁵

193. REPORT OF THE COMM. ON ARBITRATION AND ADR OF THE NEW YORK COUNTY LAWYERS' ASS'N (July 12, 1993). This report also proposed a legislative reversal of the *Garrity* rule, judicial review of punitive damages awards, and a requirement that arbitrators awarding punitive damages prepare a written decision stating the reasons for the award.

194. REPORT OF THE SUBCOMM. ON PUNITIVE DAMAGES OF THE NASD LEGAL ADVISORY BOARD (July 1994).

195. RUDER REPORT, *supra* note 8, at 40-46. The Ruder Committee's recommendation for a specific cap on punitive damages, whatever its merits, is inconsistent with its recommendation that punitive damages should be available to the same extent as they are in state courts.

It is too early at the time of this writing (August 1996) to know whether the *Ruder Report's* recommendations on punitive damages will be implemented by the NASD's adoption of new rules and the other SRO arbitration forums and, if such rules are adopted, whether the SEC will approve them.¹⁹⁶ Until this matter is finally resolved, it is likely that litigation over the authority of securities arbitrators to award punitive damages will continue, thus detracting from the ability of arbitral forums to provide investors and brokers with speedy and economical resolution of their disputes.

C. ATTORNEYS' FEES

Under the so-called "American Rule," which is well established in both federal and state courts, each party in litigation pays its own attorneys' fees, unless one of the traditionally recognized exceptions to the rule is applicable.¹⁹⁷ Under the American Rule, a successful party in court litigation cannot collect its attorneys' fees from the losing party in the absence of an express statutory authorization or an enforceable contract to the contrary or unless the losing party willfully disobeyed a court order or conducted litigation improperly, frivolously, or in bad faith.¹⁹⁸

There are two separate questions relating to the award of attorneys' fees in connection with arbitrations. First, do arbitrators have authority to award attorneys' fees? Second, to what extent will a court award attorneys' fees to deter or punish frivolous arbitration-related litigation?

196. The *Ruder Report's* recommendation for a \$750,000 cap on punitive damages has been criticized by both representatives of investors and representatives of brokerage firms. One plaintiffs' attorney told the press that the proposed maximum award "is not even a slap on the wrist for [brokerage firms] and, in most cases, won't have any deterrent value." Richard C. Reuben, *Investors' Attorneys Find Task Force Report Faulty*, A.B.A. J., Apr. 1996, at 40-41 (quoting Theodore G. Eppenstein, a partner of Eppenstein & Eppenstein). But a partner of a law firm that represents brokerage firms stated: "Some think the cap's too high, some might object to the lack of standards." *Id.* at 41 (quoting W. Reese Bader, a partner of Orrick, Harrington & Sutcliffe). In July 1996, the *Wall Street Journal* reported that the Securities Industry Association, the trade group of the securities industry, was seeking a \$250,000 cap. Michael Siconolfi, *Ruder Proposals Hit Red Tape and Bickering*, *supra* note 92, at A7; *SIA Tells NASD It Would Accept Cap on Punitive Damages in Arbitration*, 28 Sec. Reg. & L. Rep. (BNA) 763 (June 14, 1996). The bipartisan criticism may be the sign of a good compromise or an indication that the recommendation is deeply flawed.

197. The leading case stating the American Rule is *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y.*, 421 U.S. 240 (1975). See also *York Research Corp. v. Landgarten*, 927 F.2d 119, 123 (2d Cir. 1991) ("[T]here is a general presumption against fee-shifting in American courts.").

198. *Menke v. Monchecourt*, 17 F.3d 1007, 1009 (7th Cir. 1994) ("Absent statutory authorization or contractual agreement between the parties, the prevailing American rule is that each party . . . pays his own attorneys' fees."); *Smith v. Prudential Sec., Inc.*, 846 F. Supp. 978, 981 (M.D. Fla. 1994) ("Courts in general . . . have been reluctant to grant attorneys' fees in cases where no contractual or statutory basis has been provided for the award of these fees."); *Prudential-Bache Sec., Inc. v. Depew*, 814 F. Supp. 1081, 1082 (M.D. Fla. 1993); see also *Eljer Mfg. v. Kowin Dev. Corp.*, 14 F.3d 1250, 1257 (7th Cir.), *cert. denied*, 114 S. Ct. 2675 (1994); *Tennessee Dep't of Human Servs. v. United States Dep't of Educ.*, 979 F.2d 1162, 1169 (6th Cir. 1992); *Todd Shipyards Corp. v. Cunard Line*, 943 F.2d 1056, 1064 (9th Cir. 1991); *Marshall & Co. v. Duke*, No. 1:94-CV-3494-JE, 1995 WL 714468, at *8 (N.D. Ga. July 27, 1995).

Both questions have been the source of a considerable amount of litigation.

1. Awards of Attorneys' Fees by Arbitrators

While the FAA neither authorizes nor prevents the award of attorneys fees by arbitrators,¹⁹⁹ there is some authority that the American Rule applies only to litigation in court and not to arbitration, thus not constraining arbitrators who wish to award attorneys' fees.²⁰⁰ The key question, however, is not whether arbitrators have inherent power to award attorneys' fees but whether the parties' agreement authorized the arbitrators to make such an award.²⁰¹ Presumably, if the parties did not expressly provide for the award of attorneys' fees in their agreement, it may be inferred that they intended to follow the American Rule. In other words, the American Rule creates a presumption that the parties did not give the arbitrators the power to award attorneys' fees unless one of the exceptions to the rule applies.

The New York Civil Practice Law and Rules do not permit the award of attorneys' fees in arbitrations.²⁰² In *PaineWebber, Inc. v. Richardson*,²⁰³ a district court in New York held that a New York choice-of-law provision in a customer-broker agreement precluded arbitrators from awarding attorneys' fees unless such an award was expressly authorized in the agreement.²⁰⁴

Richardson was decided shortly after the Supreme Court held in *Mastrobuono* that a New York choice-of-law provision in a customer-broker agreement did not foreclose the arbitrators from awarding punitive damages.²⁰⁵ The court distinguished attorneys' fees from punitive damages

199. *PaineWebber, Inc. v. Richardson*, No. 94CIV3104(AGS), 1995 WL 236722, at *3 (S.D.N.Y. Apr. 21, 1995).

200. *Tennessee Dep't of Human Servs.*, 979 F.2d at 1169.

201. See, e.g., *Eljer Mfg.*, 14 F.3d at 1257 (court does not need to decide whether the American Rule applies because the arbitrator's award of attorneys' fees was within his authority).

202. The New York statute provides:

Unless otherwise provided in the agreement to arbitrate, the arbitrators' expenses and fees, together with other expenses, not including attorney's fees, incurred in the conduct of the arbitration, shall be paid as provided in the award. The court, on application, may reduce or disallow any fee or expense it finds excessive or allocate it as justice requires.

N.Y. CIV. PRAC. L. & R. § 7513 (McKinney 1962).

203. No. 94CIV3104(AGS), 1995 WL 236722 (S.D.N.Y. Apr. 21, 1995).

204. "[C]ourts in New York have held that arbitrators do not have the authority to award attorneys' fees unless such an award is expressly authorized in the arbitration agreement." *Id.* at *3. The *Richardson* court stated that its decision would "effectuate the reasoning of [*Smith Barney Harris Upham & Co. v. Luckie*, 647 N.E.2d 1308 (N.Y. 1995)] and *Mastrobuono* in a consistent fashion." *Id.* at *4. In *Luckie*, the New York Court of Appeals held that the FAA did not preempt a New York choice-of-law provision in an agreement containing an arbitration clause. *Luckie*, 647 N.E.2d at 1314. See also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Barnum*, 616 N.Y.S.2d 857, 859 (Sup. Ct. 1994) (N.Y. CIV. PRAC. L. & R. § 7513 prevents the award of attorneys' fees in arbitration, unless they are provided for in the agreement to arbitrate).

205. See *supra* text accompanying notes 171-79.

on the basis of the different expectations of the parties:

[A] party to an agreement cannot under our system of laws ordinarily assume that they [sic] will receive an award of attorneys' fees if that party prevails in a dispute arising from the agreement, absent explicit provision for such an award by separate agreement or by statute, in the same fashion as they might reasonably expect that they would be entitled to recover traditional damages, including punitive damages.²⁰⁶

The court also pointed out a second, very pragmatic distinction between punitive damages and attorneys' fees: the first are awarded only to parties making claims, while the second may be awarded either to plaintiffs or to defendants. The court stated:

[T]o apply *Mastrobuono* literally to the issue of attorneys' fees, though such an approach might benefit [the customer] in this action, would in fact work an injustice upon unsuspecting customers of brokerage firms. It is unlikely that most persons who enter into brokerage customer agreements suspect that they may be liable for the attorneys' fees of the brokerage firm if that firm prevails in an arbitration arising under the customer agreement—the outcome mandated if we were to endorse [the customer's] position.²⁰⁷

Not all courts, however, saw (or were impressed by) the subtle relationship between the *Mastrobuono* decision and the issue of attorneys' fees. Three months after *Richardson*, the threat to a customer of being ordered to pay substantial attorneys' fees of a brokerage firm against whom the customer brought an arbitration claim was made patently clear. In *Marshall & Co. v. Duke*,²⁰⁸ a district court in Georgia upheld an arbitration panel's award of \$634,107 in attorneys' fees in favor of a brokerage firm against several investors who had brought an NASD arbitration against the firm. The court stated approvingly that the panel had based its award of attorneys' fees on three different sources of power.²⁰⁹ First, both parties had affirmatively sought an award of attorneys' fees from the panel. Having agreed to submit all fee issues to arbitration, a party could not now claim that the arbitrators lacked the power to decide these issues.²¹⁰ Second, the NASD rules and Uniform Submission Agreement provide for submission of all disputes by the parties to arbitration, implicitly including disputes over fee awards.²¹¹ Third, the bad-faith exception to the American Rule was applicable to "quasi-judicial" as well as judicial bodies.²¹²

206. *Richardson*, No. 94CIV3104(AGS), 1995 WL 236722, at *4.

207. *Id.*

208. No. 1:94-CV-3494-JE, 1995 WL 714468 (N.D. Ga. July 27, 1995).

209. *Id.* at *5.

210. *Id.*

211. *Id.*

212. *Id.* (citing *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240 (1975)). For a discussion of the issues raised by the *Marshall* case, see Peter W. Schneider, *Awards of Attorneys' Fees and Costs to Prevailing Respondents in Securities Arbitrations*, SEC. ARB. COMMENTATOR, Feb. 1996, at 1 (Mr. Schneider is a partner in Rogers & Hardin, the law firm that represented Marshall & Co.). See also Milo Geyelin, *Ruling in Meritless Lawsuit*

Although few, if any, standard-form customer-broker agreements expressly authorize the award of attorneys' fees, most agreements provide that arbitration will be conducted under the rules of one or more SROs, or under the Securities Arbitration Rules of the AAA. All of these rules include broad remedial provisions, which some courts have construed to authorize the award of attorneys' fees.²¹³ Courts have also held that signing and filing the Uniform Submission Agreement used by the SROs implicitly authorizes the arbitrators to award attorneys' fees.²¹⁴ Furthermore, the *NASD Arbitrators' Manual* advises that a panel may award attorneys' fees in "an exceptional case."²¹⁵ Finally, courts have held that a party who himself requests an arbitration panel to order his opponent to pay his attorneys' fees waives his right to object when the panel orders him to pay his opponent's fees.²¹⁶ In effect, by requesting the arbitration panel to make an award of attorneys' fees, a party tacitly admits the panel's authority to make such an award and thus is prevented from arguing that the panel does not have this authority.

The courts' principal basis for upholding arbitrators' decisions to award attorneys' fees is the deference to be shown to the arbitrators. Arbitrators have broad power to fashion appropriate remedies including the award of attorneys' fees.²¹⁷ Thus, a court will not vacate an arbitral decision to award (or, alternatively, not to award) attorneys' fees unless the complaining party has made a showing that the arbitrators either clearly exceeded their power or acted in a completely irrational manner.²¹⁸ Likewise, the arbitrators' determination of the amount of attorneys' fees to be awarded is a finding of fact, which the court must accept.²¹⁹ In the area of attorneys' fees, as in other areas, the court will defer to the arbitrator's decision on factual and legal questions falling within the arbitra-

Case Seen Sending Message to Investor, Arbitration Case Sends Investors Message, WALL ST. J., Oct. 5, 1995, at B5.

213. See, e.g., *Prudential-Bache Sec., Inc. v. Tanner*, 72 F.3d 234, 242-43 (1st Cir. 1995) (NYSE Rule 629(c), which provides that arbitrators may award costs and expenses of the parties "unless applicable law directs otherwise," authorizes arbitrators to award attorneys' fees); *Marshall & Co. v. Duke*, No. 1:94-CV-3494-JE, 1995 WL 714468 (N.D. Ga. July 27, 1995); see also *Todd Shipyards Corp. v. Cunard Line, Ltd.*, 943 F.2d 1056, 1064 (9th Cir. 1991) (attorneys' fees allowed where arbitration agreement incorporated AAA Commercial Rule 43, which states that the arbitrator may grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the parties' agreement). *But see Prudential-Bache Sec., Inc. v. Depew*, 814 F. Supp. 1081, 1083-84 (M.D. Fla. 1993) (Rule 43 does not authorize arbitrators to award punitive damages, in the absence of an express authorization of such award in the parties' agreement).

214. *Marshall & Co.*, No. 1:94-CV-3494-JE, 1995 WL 714468 (N.D. Ga. July 27, 1995); *First Interregional Equity Corp. v. Haughton*, 842 F. Supp. 105, 112-13 (S.D.N.Y. 1994). The Uniform Submission Agreement states in part: "The undersigned parties hereby submit the present matter in controversy, as set forth in the attached statement of claim . . . to arbitration [in accordance with the rules of the SRO]." *Haughton*, 842 F. Supp. at 112.

215. *Marshall & Co.*, No. 1:94-CV-3494-JE, 1995 WL 714468, at *7.

216. *Id.*; *Glennon v. Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709, at *10 (M.D. Tenn. Dec. 15, 1994); *Haughton*, 842 F. Supp. at 112.

217. *Todd Shipyards*, 943 F.2d at 1064.

218. *Haughton*, 842 F. Supp. at 113; see also *Tanner*, 72 F.3d at 243.

219. *R.M. Perez & Assocs. v. Welch*, 960 F.2d 534, 540 (5th Cir. 1992).

tors' authority, and will confirm the arbitrators' award if it can find a rational basis for it.²²⁰

On the other hand, if the arbitrators has clearly acted beyond their authority, a court will overturn the decision concerning the issue of attorneys' fees. An example of such a case is *Davis v. Prudential Securities, Inc.*,²²¹ where an arbitration panel awarded the plaintiff \$783,684 in compensatory and punitive damages on six of his claims, but ruled that each party should pay its own attorneys' fees. The plaintiff asked the district court to modify the panel's denial of attorneys' fees, arguing that the arbitrators had exceeded their authority because the issue of attorneys' fees had not been submitted to them. Under the then-applicable Florida law, arbitrators had no authority to award attorneys' fees; only the court could do this, in a post-award confirmation proceeding.²²² The Eleventh Circuit held that the district court had erred in confirming the arbitrators' award because the arbitrators had exceeded their powers by deciding the issue.²²³ The Court of Appeals remanded the case to the district court for consideration of the issue of attorneys' fees under the Florida statute.²²⁴

Despite the deference that courts usually exhibit to arbitrators' decisions, they will not confirm an arbitral award of attorneys' fees if they cannot understand it. For example, where a panel awarded a party "all damages and expenses incurred" as a consequence of the other party's failure to discharge certain guarantees, the Second Circuit remanded the case to the district court with instructions to seek clarification from the arbitrators as to whether they meant the word "expenses" to include attorneys' fees.²²⁵ The court declined to give "expenses" a broad reading, citing "the general presumption against fee-shifting in American

220. *Eljer Mfg. v. Kowin Dev. Corp.*, 14 F.3d 1250, 1257 (7th Cir.), *cert. denied*, 114 S. Ct. 2675 (1994); *Thornton v. Shearson Lehman Hutton, Inc.*, No. 92-35116, 1993 WL 425961, at *1 (9th Cir. Oct. 21, 1993) (court's power to review arbitrators' award is limited); *Jeppsen v. Piper, Jaffray & Hopwood, Inc.*, 879 F. Supp. 1130, 1139-40 (D. Utah 1995) (even if arbitrators erred in awarding attorneys' fees under Utah Code, this would be a mistake of fact or law and therefore not subject to review); *Marshall & Co.*, No. 1:94-CV-3494-JE, 1995 WL 714468, at *8 (an award of attorneys' fees will be vacated as "arbitrary and capricious" only if a ground for the award cannot be inferred from the facts of the case); *Shearson Lehman Brothers, Inc. v. Neurosurgical Assocs. of Ind.*, 896 F. Supp. 844, 849-50 (S.D. Ind. 1995) (court will not disturb arbitrators' award of attorneys' fees in case brought under ERISA, since ERISA can be interpreted to allow for attorneys' fees).

221. 59 F.3d 1186 (11th Cir. 1995).

222. The arbitration panel had calculated Davis's compensatory award pursuant to a Florida statute, which, at the time of the arbitration, had been interpreted by the Florida courts so as to compel the court to award attorneys' fees to the "prevailing party unless the court finds that an award of such fees would be unjust." FLA. STAT. ANN. § 517.211(6) (West 1988); *Davis*, 59 F.3d at 1194. In *Davis*, the Eleventh Circuit concluded that the plaintiff clearly was the prevailing party, even though he did not succeed on all of his claims, which were based on alternative theories of liability. *Davis*, 59 F.3d at 1195. The Florida Court of Appeals subsequently held that arbitrators could award attorneys' fees where the parties expressly agreed to submit this issue to arbitration. *Id.* at 1194, 1195 n.10.

223. *Id.* at 1195.

224. *Id.* at 1196.

225. *York Research Corp. v. Landgarten*, 927 F.2d 119 (2d Cir. 1991).

courts."²²⁶

Similarly, a district court in Florida refused to award attorneys' fees under the Florida statute that authorized the court to make such an award, where the arbitration panel did not indicate whether its award of damages to the claimant was based on his statutory claims, which entitled him to attorneys' fees, or on his common law claims, which did not.²²⁷ Because the panel "gave no indication of the type of claim the award was based upon, the predicate has not been laid for this court to award attorneys' fees."²²⁸

2. Awards of Attorneys' Fees in Arbitration-Related Litigation

The award of attorneys' fees incurred in a successful defense of a motion to vacate an arbitration award, or in connection with other arbitration-related litigation, is usually based on the "bad faith" exception to the American Rule. Under this exception, a court may award attorneys' fees against a party who has asserted a frivolous claim, defense, or appeal or who has otherwise abused the litigation process.²²⁹ The award of attorneys' fees is one way that the courts can deter parties (and their attorneys) from initiating unnecessary arbitration-related litigation.

The strong federal policy in favor of arbitration and the limited scope of judicial review of arbitrators' awards under the FAA tend to reduce the courts' willingness to tolerate litigants' attempts to avoid arbitration or to vacate or modify awards. In fact, the Seventh Circuit has established a rebuttable presumption that a party who unsuccessfully challenges an arbitrator's award lacks substantial justification and therefore must pay the opposing side's attorneys' fees.²³⁰

*Widell v. Wolf*²³¹ was a fairly typical customer-broker dispute, in which each party gave the arbitrators a different factual version of certain key events. The customer claimed that the broker had made unauthorized trades in his account despite instructions to stop.²³² The broker argued that the customer should be barred from recovery because he failed to protest promptly after receiving regular account statements.²³³ The cus-

226. *Id.* at 123.

227. *Zate v. A.T. Brod & Co.*, 839 F. Supp. 27, 29-30 (M.D. Fla. 1993).

228. *Id.*

229. See POSER, *supra* note 28, at 387-88.

230. *Central States, Southeast and Southwest Areas Pension Fund v. Sherwin-Williams Co.*, 71 F.3d 1338, 1343 (7th Cir. 1995), *cert. denied*, 116 S. Ct. 1678 (1996). Judicial impatience with groundless opposition to motions to compel arbitration or with groundless appeals from arbitrators' decisions, manifests itself not only in awards of attorneys' fees but also in sanctions under Rule 11 of the Federal Rules of Civil Procedure. Such awards and sanctions may be ordered against attorneys as well as against the parties themselves. See, e.g., *Fanning v. Bear Stearns & Co.*, No. 91C1461, 1991 WL 169057 (N.D. Ill. Aug. 27, 1991); *Robinson v. Dean Witter Reynolds, Inc.*, 129 F.R.D. 15 (D. Mass. 1989). A Rule 11 sanction may take the form of an award of attorneys' fees. *Robinson*, 129 F.R.D. at 22.

231. 43 F.3d 1150 (7th Cir. 1994).

232. *Id.*

233. *Id.* For a discussion of the doctrine of ratification as it applies to unauthorized trading, see POSER, *supra* note 28, at 432-35.

tomer replied that the broker had told him the account statements were erroneous and that he should discard them without even opening the envelopes. Evidently believing the customer's version, the arbitrators awarded him \$57,500.²³⁴

The broker moved the district court to set aside the award, on "public policy" grounds, asserting that the customer had an obligation to read his account statements and point out errors quickly.²³⁵ When the district court dismissed the broker's claim, he appealed to the Seventh Circuit, which affirmed, ruling that the public policy argument was a "thinly disguised attempt to reargue the merits of the claim"²³⁶ and citing the narrow scope of judicial review of arbitral awards.²³⁷ The court also ordered the broker to show cause why he should not be directed to pay the legal fees and expenses reasonably incurred in defense of the appeal, as a sanction for taking a frivolous appeal.²³⁸ The court explained:

Arbitration is supposed to permit quick and cheap decision. Litigation like this defeats that purpose. We have remarked before that awards of attorneys' fees are readily available when one side refuses to accept an arbitrator's award and loses—for the American Rule requires each side to pay its fees in the first round of litigation but does not compel it to pay for a second round attacking the outcome of the first.²³⁹

In a similar case, the Ninth Circuit awarded attorneys' fees and double the amount of its costs and attorneys' fees in both the district court and the appellate court to an investor, where the defeated brokerage firm presented meritless opposition to an award, stating that "[t]here is no reason that the cost of this prolonged and frivolous resistance should be imposed upon [the investor]."²⁴⁰

Attorneys' fees may also be awarded against a party who litigates the issue of arbitrability, or simply attempts to use the courts to avoid arbitration, without a reasonable basis.²⁴¹ In *Fransen v. Terps Limited Liability Co.*,²⁴² the plaintiff brought an action in federal district court under federal and state securities laws. The defendant moved for a stay pending

234. *Widell*, 43 F.3d at 1150.

235. *Id.* at 1151.

236. *Id.*

237. In general, a court may vacate or modify an arbitral award only in cases of corruption or misconduct, or where the arbitrators exceeded their powers. 9 U.S.C. § 10 (1994). Most federal circuits permit the vacation of an award where the arbitrators acted in manifest disregard of the law. See *Advest, Inc. v. McCarthy*, 914 F.2d 6, 8-9 (1st Cir. 1990).

238. *Widell*, 43 F.3d at 1151-52. It is not clear whether the court meant to include only the expenses of defending the appeal from the district court's dismissal of the broker's move to vacate the award, or also the expenses of defending the motion to vacate.

239. *Id.*

240. *Rostad & Rostad Corp. v. Investment Management & Research, Inc.*, 923 F.2d 694, 697 (9th Cir. 1991). See also *First Options of Chicago, Inc. v. Kalin*, No. 94C7243, 1995 WL 340945, at *2 (N.D. Ill. June 2, 1995) ("By asking for district court review of disappointing arbitration awards, disgruntled litigants may be compounding, rather than ameliorating their troubles.").

241. *R.M. Perez & Assocs. v. Welch*, 960 F.2d 534, 540 (5th Cir. 1992).

242. 153 F.R.D. 655 (D. Colo. 1994).

arbitration on the ground that the action was substantially the same as one filed by the plaintiff in state court, where the court had ordered arbitration. The federal court granted the stay, holding that the state court's order had preclusive effect.²⁴³ The defendants moved for attorneys' fees, arguing that the plaintiff's complaint was without factual or legal basis and was simply an attempt to circumvent the state court's judgment.²⁴⁴ The federal court ordered the plaintiff to pay the defendant's attorneys' fees for this "blatant example of forum shopping."²⁴⁵ The court based its order not on the "bad faith" exception to the American Rule, but on a Colorado statute that requires a trial court to "award attorneys' fees if it finds that the prosecution or defense of an action, either in whole or in part, lacked substantial justification."²⁴⁶ The court stated:

[Under the statute, a] claim is substantially groundless if the complaint contains allegations sufficient to survive a motion to dismiss for failure to state a claim, but the allegations are not supported by any credible evidence. Presumably, this statute applies to state law claims heard in federal court.²⁴⁷

Furthermore, attorneys who engage in meritless proceedings on behalf of their clients in an attempt to avoid arbitration or to avoid confirmation of arbitration awards have themselves been ordered to pay the opposing side's attorneys' fees.²⁴⁸

Not all attempts to avoid (or compel) arbitration or to obtain review of arbitrators' awards lack justification. Since the question whether a dispute is arbitrable is usually for the court, not the arbitrators, to decide,²⁴⁹ a party who litigates this question and loses should not be liable for attorneys' fees if his arguments have merit. *O'Connor v. R.F. Lafferty & Co.*²⁵⁰ involved a three-way relationship between a customer, the "introducing firm" that handled her account, and the "clearing firm" that carried her brokerage account on its books.²⁵¹ The customer brought suit against the introducing brokerage firm that handled her brokerage account and its registered representative. The introducing firm moved to compel arbitration on the ground that it was a third-party beneficiary of the agreement between the plaintiff and the clearing firm, although the plaintiff had signed an arbitration agreement only with the clearing firm.²⁵² The district court dismissed some of the plaintiff's claims and

243. *See id.* at 657.

244. *Id.*

245. *Id.* at 660.

246. *Id.* at 657-58 (citing COLO. REV. STAT. § 13-17-101).

247. *Id.* at 658 (citation omitted).

248. *See, e.g.,* First Investors Corp. v. American Capital Fin. Servs., 823 F.2d 307, 310 (9th Cir. 1987) (client and counsel are jointly and severally liable for double costs and attorneys' fees); *Smiga v. Dean Witter Reynolds, Inc.*, 766 F.2d 698, 708 (2d Cir. 1985), *cert. denied*, 475 U.S. 1067 (1986).

249. *See* First Options of Chicago, Inc. v. Kaplan, 115 S. Ct. 1920 (1995).

250. 965 F.2d 893 (10th Cir. 1992).

251. For a discussion of the legal duties of introducing and clearing firms, see POSER, *supra* note 28, at 178-85.

252. *O'Connor*, 965 F.2d. at 900-01.

ordered arbitration of the remaining claims.

The Tenth Circuit reversed the lower court's decision on the arbitration question, holding that an introducing broker cannot enforce an arbitration agreement between an investor and a clearing broker as a third-party beneficiary.²⁵³ The plaintiff requested an award of attorneys' fees, claiming, first, that the introducing firm had moved to compel arbitration on the basis of an agreement to which it was not a party and, second, that the defendants had ignored established law concerning waiver of arbitration which would have precluded its right to arbitration even if it had been a party to the agreement. In denying attorneys' fees to the plaintiff, the court emphasized that the defendants' position, though unsuccessful, was not without some merit:

A split of authority exists as to whether an introducing broker can enforce an arbitration agreement between an investor and clearing broker as a third party beneficiary. Defendants therefore had a reasonable basis upon which to bring their motion to compel arbitration. We hold the motion to compel arbitration was not brought in bad faith, vexatiously, wantonly or for oppressive reasons. Second, although we did not reach the question of waiver, the Defendants persuaded the district court they did not waive their right to arbitration. We refuse to conclude the Defendants' alleged waiver was so obvious that to pursue it subjects defendants to sanctions.²⁵⁴

Similarly, not all unsuccessful attempts to vacate arbitrators' decisions justify the award of attorneys' fees. In *French v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,²⁵⁵ an arbitration panel awarded the plaintiff compensatory damages, interest, and consequential damages. Merrill moved to vacate, contesting the arbitrability of the consequential damages and interest claims. The district court confirmed the award of compensatory damages and interest, but vacated the award of consequential damages as beyond the scope of the matter submitted for arbitration. French appealed the order to vacate, and Merrill cross-appealed. The Ninth Circuit affirmed the confirmation of the award of interest and reinstated the award of consequential damages.²⁵⁶ The appellate court denied the plaintiff's request for attorneys' fees, stating that "[t]hrough ultimately unpersuasive, Merrill Lynch's argument that the interest award should have been vacated or modified was not 'frivolous.' . . . [A]n appeal is frivolous only 'if the result is obvious, or the arguments of error are wholly without merit.'"²⁵⁷ The court further suggested that an appeal from an arbitrator's decision that is of questionable rationality is not frivolous, even though the court confirms the decision because it is not "completely irrational."²⁵⁸

253. *Id.* at 902.

254. *Id.* at 903.

255. 784 F.2d 902 (9th Cir. 1986).

256. *Id.* at 907-09.

257. *Id.* at 909.

258. *Id.*

A challenge to an arbitration award will not justify an award of attorneys' fees if it is based on existing law and is not interposed merely for delay,²⁵⁹ or if the issue raised by the moving party "is a case of first impression with decent arguments on each side."²⁶⁰ In one unusual case, a district court even refused to award attorneys' fees against a disappointed investor who made meritless arguments in attempting to vacate an arbitral award because the court concluded that he raised them in good faith.²⁶¹ The court pointed out that the investor, though a former attorney, was an inactive member of the bar and appeared pro se in the action. "The court also considers that his arguments were made in response to petitioners [sic] motion to confirm and the costs petitioner incurred were largely of its own making in seeking the aid of the court in enforcing the arbitration award."²⁶² This investor must have made a very favorable impression on the court.

D. CHOICE OF FORUM AND VENUE

Controversies over choice of forum have generated considerable litigation. Much of this litigation has involved the efforts of customers to bring their claims before an arbitration panel of the American Arbitration Association and the efforts of brokerage firms to restrict customers to an SRO forum.²⁶³ Although the SEC staff has informally supported the inclusion of the AAA as a choice in arbitration agreements, the Commission does not require firms to offer this choice to their customers.²⁶⁴ As a result, the arbitration clauses of most large firms restrict the choice of forum to two or three SROs.²⁶⁵ Many investors prefer the AAA, despite its higher fees, because it gives the parties more opportunity to select the arbitrators and because of investors' perception that the SRO forums, although supervised by the SEC, are controlled by the securities industry, or as one financial journalist put it, "by the very folks whom

259. *FSC Sec. Corp. v. Freel*, 811 F. Supp. 439, 446 (D. Minn. 1993), *aff'd*, 14 F.3d 1310 (8th Cir. 1994); *see also* *Schmidt v. Finberg*, 942 F.2d 1571, 1575 (11th Cir. 1991).

260. *Central States, Southeast and Southwest Areas Pension Fund v. Sherwin-Williams Co.*, 71 F.3d 1338, 1343 (7th Cir. 1995), *cert. denied*, 116 S. Ct. 1678 (1996).

261. *Drexel Burnham Lambert Inc. v. Pyles*, 701 F. Supp. 217 (N.D. Ga. 1988).

262. *Id.* at 220.

263. Susan Antilla, *At the Bar: Brokerage Firms Steer Dissatisfied Customers Away from Court, But in Only One Direction*, N.Y. TIMES, May 12, 1995, at A29.

264. A state statute that invalidates any arbitration agreement that does not provide for arbitration before the AAA or another "independent nonindustry arbitration forum" has been held to be invalid, on the ground that it comes into clear conflict with the FAA and thus violates the Supremacy Clause of the U.S. Constitution. *Securities Indus. Ass'n v. Lewis*, 751 F. Supp. 205, 208 (S.D. Fla. 1990) (invalidating Florida statute). Such a restriction also violates Section 5 of the FAA, which provides that "[i]f in the agreement provision be made for a method of naming or appointing an arbitrator or arbitrators or an umpire, such method shall be followed. . . ." *Id.*

265. Of ten brokerage firms surveyed by the *New York Times* in 1994, only two included the AAA in arbitration clauses in their customer agreements. Antilla, *supra* note 263, at A29. In 1994, 274 securities arbitrations were filed with the AAA, whereas 5570 were filed with the NASD. George H. Friedman & Florence M. Peterson, *Investors' Choice of ADR Forums May Be Limited*, NAT'L L.J., June 12, 1995, at B15.

they are accusing of cheating."²⁶⁶

The arbitration clause in a typical standard-form customer's agreement used by a brokerage firm allows the customer to choose from among two or more arbitration forums.²⁶⁷ The question of interpreting choice-of-forum clauses in agreements covered by the FAA is governed by federal law.²⁶⁸ The Second Circuit has held that a contractual provision that requires the parties to arbitrate "in accordance" with the provisions of the NYSE Constitution and NYSE rules is not simply a choice-of-law provision but an exclusive selection of a forum.²⁶⁹

Firms that are members of more than one SRO are no longer permitted to use exclusive choice-of-forum clauses. In *Roney & Co. v. Goren*,²⁷⁰ the Sixth Circuit enforced an arbitration agreement that limited the customer to a single forum, that of the NYSE, but the court conceded that the SEC had the authority, as the regulator of the SROs, to require multiple forums.²⁷¹ Less than three months after the *Roney* decision, the SEC exercised its authority by publishing an opinion of its General Counsel stating:

Member[s] of the NYSE, NASD, AMEX or CBOE will not be permitted to limit customers to a single arbitration forum if any SRO to which the member belongs has a conflicting arbitration rule, such as the NASD rule at issue in *Roney*, giving the customer the choice to submit a claim for arbitration to that SRO.²⁷²

The SEC explained that giving the customer a choice among SRO forums is mandated by the SRO rule that prohibits a member firm to make an agreement with a customer that limits or contradicts an SRO rule.²⁷³ A firm that is a member of both the NASD and the NYSE is not permitted to restrict a customer's choice of forum to the NYSE because such a restriction would contradict the NASD rule that makes an NASD arbitration forum available to customers of NASD member firms.²⁷⁴ Under the terms of the SEC release, however, a brokerage firm that is a member of the NASD, but of no other SRO, may limit its customers to the NASD arbitration forum.

Customers' usual preference for the AAA forum has led to the development of various legal strategies for accomplishing this end, even though the brokerage firm's standard-form customer agreement does not

266. *Id.*

267. Having once chosen the forum, the customer is bound by his choice. *Clark v. Kidder, Peabody & Co.*, 636 F. Supp. 195, 197 (S.D.N.Y. 1986).

268. *Weiner v. Gutfreund*, 68 F.3d 554, 559 (2d Cir. 1995).

269. *Id.* at 558-59. Some New York courts have read similar clauses as mere choice-of-law provisions. *Id.*

270. 875 F.2d 1218 (6th Cir. 1989).

271. *Id.* at 1221.

272. SEC Litigation Release No. 12198, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,437, at 80,378 (Aug. 7, 1989).

273. NYSE Rule 637; NASD Rule IM-3110(f)(4). The rule was adopted in 1989 at the behest of the SEC.

274. SEC Litigation Release No. 12198, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,437, at 80,377 (Aug. 7, 1989).

expressly offer the AAA as a choice of forum. The chief such strategy, which can be used if the firm is a member of the American Stock Exchange (Amex), is to invoke the so-called "Amex Window." The Amex Window is a provision in the Amex Constitution that states:

Sec.2 Arbitration shall be conducted under the arbitration procedures of this Exchange, except as follows:

. . . .

(c) if any of the parties to a controversy is a customer, the customer may elect to arbitrate before the American Arbitration Association in the City of New York, unless the customer has expressly agreed, in writing, to submit only to the arbitration procedure of the Exchange.²⁷⁵

Two questions have arisen with respect to the Amex Window: (1) whether an arbitration agreement between a customer and a member firm of the Amex permits the customer to arbitrate before the AAA even though the agreement does not specifically mention the AAA as a forum choice; and (2) whether the phrase "in the City of New York" in the quoted language of the Amex Constitution is a venue provision that requires that the AAA arbitration be held in New York City, or whether the phrase is simply a way of identifying the location of the headquarters of the AAA.

In general, customers have had little success in using the Amex Window to gain access to the AAA forum. The leading case is *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Georgiadis*,²⁷⁶ where the arbitration clause of the options agreement entered into between the customer and the firm provided: "Any controversy . . . shall be settled by arbitration only before the [NASD] or the [NYSE], or an Exchange located in the United States upon which listed options transactions are executed."²⁷⁷ The customer contended that, because the Amex was one of the exchanges referred to in the arbitration agreement (listed options are traded on the Amex), the Amex Window gave him the right to have his claims arbitrated before the AAA. In rejecting this argument the Second Circuit held that the arbitration provision of the Amex Constitution may be superseded by a more specific customer agreement, and that the parties had closed the Amex Window by agreement.²⁷⁸ Citing U.S. Supreme Court decisions that instructed the courts to "rigorously enforce agreements to arbitrate," the court held that a customer agreement can validly modify the arbitration provision of the Amex Constitution.²⁷⁹

275. AMERICAN STOCK EXCHANGE CONST., art. VIII, § 2, reprinted in Am. Stock Ex. Guide (CCH) ¶ 9063 (1989).

276. 903 F.2d 109 (2d Cir. 1990).

277. *Id.* at 111. The agreement clearly permitted arbitration at the Amex, where listed options were traded.

278. *Id.* at 113.

279. *Id.* at 112-13 (quoting *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987), and *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985)). The court distinguished SEC Litigation Release No. 12198 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,437 (Aug. 7, 1989), on the ground that in that release the SEC had prohibited

Georgiadis involved an arbitration clause that gave the customer a choice of having his claims heard “before” certain SROs. In *Cowen & Co. v. Anderson*,²⁸⁰ the customer signed a margin agreement and an option agreement, both of which gave him the choice of having his claims heard in “accordance with the rules, then in effect” of the NYSE, NASD, or Amex.²⁸¹ The New York Court of Appeals found that the “plain language” and “clear meaning” of the agreements permitted the customer to arbitrate before the AAA, because the Amex Constitution defined the term “rules of the Exchange” to encompass the exchange’s Constitution (including its Amex Window provision).²⁸² Resting its decision “upon settled rules of contract law,” the court distinguished *Georgiadis* on the basis of the different language of the agreements in the two cases and stated that the agreements in *Cowen* “do not expressly state that [the customer] is bound to arbitrate [his] claim ‘only before’ the three self-regulatory organizations or that the customer must submit to arbitration in accordance with the procedures of a particular entity.”²⁸³

Most of the decisions, however, refuse access to the AAA through the Amex Window, reasoning that unless the AAA is specifically mentioned in the arbitration agreement the parties have not demonstrated a manifest intent to include the AAA as a forum choice. Access to the AAA through the Amex Window has been denied even where, as in *Cowen*, the language of the agreement permitted the customer to arbitrate *under the rules of the Amex* (as opposed to *before the Amex*). In *Luckie v. Smith Barney, Harris Upham & Co.*,²⁸⁴ the agreements signed by different customers contained both kinds of language: some of the plaintiffs had agreed to arbitrate disputes in accordance with the *rules of the Amex*, while others had agreed to arbitrate *before the Amex*. The Eleventh Circuit held that, under either kind of language, the parties had “closed the AMEX Window by agreement” because they had not expressly agreed to submit disputes to arbitration before the AAA.²⁸⁵ Other courts have held that the Amex Window is a default provision that applies only in the absence of a specific agreement and that the Amex Window is superseded by any arbitration clause that does not include the

arbitration agreements that limit customers to a single SRO arbitration forum, which the agreement in *Georgiadis* did not do. *Georgiadis*, 903 F.2d at 113.

280. 558 N.E.2d 27 (N.Y. 1990).

281. *Id.* at 28 (emphasis supplied).

282. *Id.* at 28-29. The court stated that even if the language of the agreements could be considered ambiguous, the court would construe the language against the brokerage firm because the firm drafted the agreements. *Id.* at 29; see *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212, 1219 (1995) (Brokerage firm that drafted customer’s agreement “could not overcome the common-law rule of contract interpretation that a court should construe ambiguous language against the interest of the party that drafted it.”); see also *Mueske v. Piper, Jaffray & Hopwood, Inc.*, 859 P.2d 444, 449-50 (Mont. 1993) (“Uncertain terms in a contract are to be construed against the party causing the uncertainty.”).

283. *Cowen*, 558 N.E.2d at 29.

284. 999 F.2d 509 (11th Cir. 1993).

285. *Id.* at 513-14.

AAA as an available forum.²⁸⁶ Still other courts have held that the word "rules" in an arbitration agreement that enabled the customer to have his claims arbitrated "in accordance with the rules . . . of . . . the [NYSE, Amex, or NASD]" referred to the arbitration procedures of the three SROs, not to their constitutions or other general provisions for resolving disputes.²⁸⁷

Where an arbitration agreement contains a clause providing for the locus of the arbitration, a district court is required by Section 4 of the FAA to "make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement."²⁸⁸ The Seventh Circuit held in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer*²⁸⁹ that the district court has authority to enforce a situs-selection clause, regardless of whether the agreement actually specifies the hearing site or whether it specifies the arbitration forum and the forum selects the site.²⁹⁰

In those cases where the claimant has succeeded in gaining access to the AAA through the Amex Window, the courts are in disagreement as to whether the term "in the City of New York" in the Amex Window provision is a venue provision or simply a way of describing the location of the principal office of the AAA. If it is the former, a claimant using the Amex Window is required to arbitrate his case in New York City. In *Bear, Stearns & Co. v. Bennett*,²⁹¹ the customer filed a Demand for Arbitration against a brokerage firm with the AAA pursuant to the Amex Window and sought arbitration in Naples, Florida. The brokerage firm filed a petition in federal court in New York to compel arbitration in New York City. The Second Circuit held, first, that forum-selection clauses in arbitration agreements are valid²⁹² and, second, that the term "in the City of New York" as used in the Amex Window provision is a forum-selection clause.²⁹³ Thus, since the agreement specified New York City as the situs for the hearing, neither the AAA nor the arbitrators had authority to determine the situs.²⁹⁴ On the other hand, the Florida Circuit Court has held that the term "in the City of New York" as used in the Amex

286. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. King*, 804 F. Supp. 1512, 1514 (M.D. Fla. 1992).

287. *PaineWebber Inc. v. Pitchford*, 721 F. Supp. 542 (S.D.N.Y. 1989), *aff'd sub. nom. PaineWebber Inc. v. Rutherford*, 903 F.2d 106 (2d Cir. 1990). *But see Prudential Sec., Inc. v. Thomas*, 793 F. Supp. 764, 765-66 (W.D. Tenn. 1992) (access to AAA arbitration facilities available to customer who agreed to arbitrate "in accordance with the rules" of the Amex).

288. 9 U.S.C. § 4 (1994).

289. 49 F.3d 323 (7th Cir. 1995).

290. *Id.* at 330.

291. 938 F.2d 31 (2d Cir. 1991).

292. *Id.* at 32 (citing *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974)).

293. *Id.* (citing *PaineWebber Inc. v. Rutherford*, 903 F.2d 106, 108-09 (2d Cir. 1990)); see also *PaineWebber Inc. v. Pitchford*, 721 F. Supp. 542, 551 (S.D.N.Y. 1989), *aff'd sub nom PaineWebber Inc. v. Rutherford*, 903 F.2d 106 (2d Cir. 1990) (It is clear and unequivocal that the phrase "in the City of New York" is a venue provision. "The Claimants [sic] argument that this phrase is merely intended to state the AAA's headquarters is . . . unpersuasive and unavailing.").

294. *Bennett*, 938 F.2d at 32.

Window is not a situs-selection clause, but merely describes the location of the AAA's main office.²⁹⁵

Forum selection is one area where, despite the supposed economy of arbitration, brokerage firms are able to embroil customer claimants in protracted litigation. In the *Lauer* case, the Lauers, who presumably had been residents of Illinois when they opened their brokerage account, filed an arbitration claim with the NASD, as permitted by the arbitration agreement, and requested a hearing in Florida, where they had relocated. Merrill Lynch requested an Illinois arbitration site. The NASD selected Tampa, Florida and set a date for the hearing, and both sides began pre-hearing discovery. Meanwhile, Merrill Lynch filed an action in federal court in Illinois to compel arbitration there. The Lauers opposed Merrill Lynch's motion and filed their own claim in federal court in Florida to compel arbitration in that state, where the NASD had ruled that the arbitration was to proceed.²⁹⁶ The Illinois district court ruled in Merrill Lynch's favor, and the Lauers appealed to the Seventh Circuit.²⁹⁷

Merrill Lynch's litigation tactics were designed to shift the arbitration hearing to a jurisdiction within the Seventh Circuit, where federal law required the court to withdraw the issues of punitive damages and the NASD eligibility rule from the arbitrators. The Seventh Circuit stated: "The 'whys' of all this forum²⁹⁸ shopping are self-evident: If the Northern District of Illinois decides arbitrability, the Lauers lose a chunk of their claims; if the decision rests with the Northern District of Florida, both punitive damages and potentially stale claims may go to the arbitrator for resolution."²⁹⁹ The court held that, under Section 4 of the FAA,³⁰⁰ only the district court in the forum selected by the parties can issue an order compelling arbitration.³⁰¹ Because the parties had selected a Florida hearing site (they had selected NASD arbitration, and the NASD, pursuant to its own rules, had selected Florida), both the language of the statute and the interests of judicial economy gave the Florida district court the authority to hear the Lauers' claim and any defenses

295. *Joseph v. Prudential-Bache Sec., Inc.*, No. C190-7284, 1991 WL 370135, at *2 (Fla. Cir. Ct. May 1, 1991).

296. *Lauer*, 49 F.3d 323, 325-26 (7th Cir. 1995).

297. *Id.* at 326.

298. The court used the word "forum" to denote both the organization providing arbitration facilities and the location of the hearing. To avoid any confusion, "forum" is used here to mean the organization, while "site," "situs," or "venue" is used to mean the hearing location.

299. *Lauer*, 49 F.3d at 326.

300. Section 4 provides, in pertinent part:

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written agreement for arbitration may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28 . . . for an order directing that such arbitration proceed in the manner provided for in such agreement. . . . The hearing and proceedings, under such agreement, shall be within the district in which the petition for an order directing such arbitration is filed.

Id. at 327 (citing 9 U.S.C. § 4).

301. *Lauer*, 49 F.3d at 327.

or counterclaims that Merrill Lynch might offer. Dismissal of the Illinois suit avoided parallel proceedings and promoted the conservation of judicial resources.³⁰² Nevertheless, the Lauers were required to litigate in two different jurisdictions, on the trial and appellate levels, before they were able to obtain a hearing on the merits of their claims. Whether or not one of Merrill Lynch's purposes in initiating the Illinois litigation was to add greatly to the Lauers' litigation expenses and perhaps to discourage them from pursuing their claim, this was undoubtedly an effect of its strategy.

Finally, in keeping with the overriding goal of the FAA that arbitration agreements should be enforced to the same extent as any other contract, in accordance with the intention of the parties, it has been held that forum-selection clauses can have retroactive effect if the court finds that the parties so intended. In *Dean Witter Reynolds, Inc. v. Prouse*,³⁰³ the customers and the brokerage firm signed a customer's agreement in 1983 that included an arbitration clause permitting the customers to choose from among several forums, including the AAA. In 1987, they signed a new agreement that did not include the AAA as a forum. The court held that the new agreement superseded the old one, even as to transactions that occurred before the signing of the 1987 agreement. The court also rejected the customers' argument that because three other claimants planned to exercise their contractual right to arbitrate their claims before the AAA, concerns for judicial economy and the specter of inconsistent judgments should incline it toward compelling the brokerage firm to arbitrate the customers' claims before the AAA: "[T]he intent of the [FAA] is to enforce private arbitration agreements even at the expense of complex and inefficient dispute resolution, and consequently, we lack the power to consolidate respondents' arbitrations before the AAA in New York City absent an agreement among all the parties authorizing us to do so."³⁰⁴ Furthermore, a party can, by its conduct, waive its contractual right to enforce a forum-selection clause, just as it can waive its right to

302. *Id.* at 330. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. McLeod*, 622 N.Y.S.2d 954 (App. Div. 1995), a Florida resident brought an NYSE arbitration claim by writing to the NYSE's office in New York, requesting arbitration in Florida. The NYSE assigned the claim for arbitration in Florida. Merrill Lynch brought an action in a New York state court to stay the arbitration, and the claimant moved to stay the court proceeding on grounds of inconvenience and lack of personal jurisdiction over him in New York. The New York appellate court held that the customer had not submitted to the jurisdiction of the New York courts by sending her request to arbitrate in Florida to the NYSE "whose designated office for correspondence happened to be located in New York." *Id.* at 956. The court also stated:

In the last analysis, if Merrill Lynch, through its Florida brokerage office, had been so determined to force this Florida client to arbitrate claims in New York, it could easily have provided as much, explicitly, in the customer agreement. Thus, not only contractual principles but also fairness and due process require this proceeding to be dismissed on jurisdictional grounds.

Id.

303. 831 F. Supp. 328 (S.D.N.Y. 1993).

304. *Id.* at 331, 332 n.5 (citing *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218-21 (1985)).

enforce an agreement to arbitrate.³⁰⁵

V. TOWARD A DEFINITION OF ARBITRABILITY

As a form of alternative dispute resolution (ADR), arbitration should be conceived as being separate from and independent of the judicial system. The arbitrability of a dispute is based on the contractual agreement between the parties, not upon legal rules. The parties' agreement determines the scope of the agreement to arbitrate and the rules and procedures under which the dispute will be resolved.³⁰⁶ Once a trial court has ordered a pending case to be submitted to arbitration, the following occurs:

[T]he action at law sits in the twilight zone of abatement with the trial court retaining merely vestigial jurisdiction. . . . During that time . . . , a court may appoint arbitrators if the method selected by the parties fails; grant a provisional remedy . . . , and confirm, correct or vacate the arbitration award Absent an agreement to withdraw the controversy from arbitration, however, no other judicial act is authorized In the interim, the arbitrator takes over. It is the job of the arbitrator, not the court, to resolve all questions needed to determine the controversy.³⁰⁷

The existence of an abundance of arbitration-related litigation makes it clear, however, that arbitration in practice does not even approach being a completely independent system of dispute resolution. To some degree arbitrators are necessarily controlled by the courts. It is not my contention that arbitrators should be entirely free of judicial control. The FAA wisely requires the courts to determine the arbitrability of disputes, since parties cannot and should not be required to arbitrate unless they have agreed to do so, and to vacate arbitral awards if the arbitrators have been guilty of misconduct or have exceeded their powers. Nevertheless, despite the courts' frequent statements that there is a strong federal policy favoring arbitration, they have too frequently been willing to decide issues that are more properly for the arbitrators to decide.

Under the FAA, arbitration and the judicial system intersect at two points: first, the initial determination of arbitrability; and second, judicial review.³⁰⁸ If the issue of arbitrability is raised in a court proceeding, the court³⁰⁹ must temporarily stay the proceeding in order to conduct a lim-

305. *Wall Street Assocs. v. Becker Paribas, Inc.*, 27 F.3d 845, 850 (2d Cir. 1994) (by joining a co-defendant's motion to compel arbitration without taking exception to any of the fora listed in the motion, defendant obligated itself to arbitrate in any forum to which the motion applied).

306. *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 479 (1989).

307. *Titan/Value Equities Group, Inc. v. Superior Court*, 35 Cal. Rptr.2d 4, 7 (Ct. App. 1994) (citations omitted).

308. The court's power to vacate or modify an arbitration award if the arbitrators exceeded their powers, 9 U.S.C. § 10(a)(4), also raises the issue of arbitrability.

309. "Although § 3 refers ambiguously to a suit 'in any of the courts of the United States,' the state courts have almost unanimously recognized that the stay provision of § 3 applies to suits in state as well as federal courts. . . ." *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 26 n.34 (1983).

ited inquiry to determine whether a valid arbitration agreement exists between the parties and whether the specific dispute falls within the scope of that agreement.³¹⁰ The threshold question of arbitrability is for the court, not the arbitrators, to decide, unless the parties agreed to submit the arbitrability question itself to arbitration.³¹¹ On the question of arbitrability, the usual presumption in favor of submitting issues to the arbitrators is reversed, the presumption being that (1) the court will decide the question of arbitrability; and (2) the court should not assume that the parties agreed to arbitrate the question unless there is clear and unmistakable evidence that they did so.³¹² If the court decides the arbitrability question, its inquiry will consist of a four-step analysis, in which it will determine the following: (1) whether the parties have agreed to arbitrate; (2) the scope of the agreement; (3) whether Congress intended the claims to be arbitrable; and (4) whether trial of any remaining nonarbitrable claims should be stayed pending arbitration.³¹³

If the court,³¹⁴ after holding a hearing (with the right to a jury trial) on the issue of arbitrability, is satisfied that the dispute falls within the scope of a valid arbitration agreement, it is required to "make an order directing the parties to proceed to arbitration in accordance with the terms

310. 9 U.S.C. § 3; *Houlihan v. Offerman & Co.*, 31 F.3d 692, 694-95 (8th Cir. 1994).

311. *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920, 1923-24 (1995); *AT&T Technologies, Inc. v. Communications Workers of Am.*, 475 U.S. 643, 649 (1986).

312. *Kaplan*, 115 S. Ct. at 1924. A court may have to decide whether the parties agreed that the arbitrators will decide the question of arbitrability.

313. *Holloway v. Gruntal & Co., Inc.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,361, at 95,863 (S.D.N.Y. Feb. 8, 1993). According to the New York arbitration law, N.Y. CIV. PRAC. L. & R., art. 75, there are three "threshold questions" that a court must resolve on a motion to stay or to compel arbitration: "[W]hether the parties made a valid agreement to arbitrate, whether if such an agreement was made it has been complied with, and whether the claim sought to be arbitrated would be barred by limitation of time had it been asserted in a court of the State." *County of Rockland v. Primiano Constr. Co., Inc.*, 409 N.E.2d 951, 953 (N.Y. 1980) (citations omitted).

314. It is not entirely clear whether §§ 3 and 4 require a state court as well as a federal court to stay proceedings and compel arbitration. "Although § 3 refers ambiguously to a suit 'in any of the courts of the United States,' the state courts have almost unanimously recognized that the stay provision of § 3 applies to suits in state as well as federal courts. . . ." *Moses H. Cone Memorial Hosp.*, 460 U.S. at 27 n.34. But in *Volt Info. Sciences*, the Supreme Court suggested that these procedural sections of the FAA were not applicable in state courts:

While we have held that the FAA's "substantive" provisions—§§ 1 and 2—are applicable in state as well as federal court . . . , we have never held that §§ 3 and 4, which by their terms appear to apply only to proceedings in federal court, see 9 U.S.C. § 3 (referring to proceedings "brought in any of the courts of the United States"); § 4 (referring to "any United States district court"), are nonetheless applicable in state court.

Volt Info Sciences, Inc., 489 U.S. at 477 n.6 (citation omitted). Nevertheless, prior to deciding *Volt Info. Sciences* the California Court of Appeals held that § 4 requires state courts to compel arbitration. More recently, the same court cited *Volt Info. Sciences* for the rule that "the procedural provisions of [§§] 3 and 4 . . . only apply, by their express terms, to proceedings in federal court, and have not been held applicable in state courts." *Strauch v. Eyring*, 35 Cal. Rptr.2d 747, 749 (Ct. App. 1994). The California Court of Appeals concluded that, because § 4 does not apply in state court proceedings, the provision of § 4 assuring the right to a jury trial on the issue of the validity of the arbitration agreement is not applicable. *Id.*

of the agreement.”³¹⁵ The court’s power to order arbitration is not limited to a situation where one party refuses to arbitrate; it extends to a party whose grievance is the other party’s failure to arbitrate under the terms of the agreement, as, for example, where a party refuses to arbitrate in the arbitral forum or location named in the agreement.³¹⁶

The FAA does not define the term “arbitrability.” Thus, arbitrability is as broad or narrow as the number of issues that can be formulated within its terms. Whether the court or the arbitrators should decide the question of the applicability of the NASD eligibility rule, the authority of arbitrators to award punitive damages or attorneys’ fees, or questions of forum and venue, depends largely on whether or not these issues are viewed as issues of arbitrability. If they are arbitrability questions, they should presumptively be decided by the court, not the arbitrators. Thus, the more broadly arbitrability is defined, the more arbitration-related litigation is likely to occur.

Arbitrability can mean several different things. A party may argue that a particular dispute is not arbitrable because there was no agreement to arbitrate; because, although there was an agreement to arbitrate, it did not cover the subject matter of the dispute; or because, although an agreement covered the dispute, the party denying arbitrability did not execute the agreement. All these are clearly questions of arbitrability, which the FAA contemplates will be decided by the court. To allow arbitrators to decide their own jurisdiction would put the cart before the horse, by assuming the answer to the very question that is being posed.

Extending the scope of arbitrability questions beyond these threshold issues circumscribes the discretion allowed to the arbitrators and thereby reduces or destroys the usefulness of arbitration. For example, if the rules of an arbitral forum require that a statement of claim specify the relevant facts and the remedies sought, it would be both absurd and destructive to say that the question whether a statement of claim complies with this requirement is a question of arbitrability and therefore for the court to decide.³¹⁷ Yet to hold, as five circuit courts do, that the SRO eligibility rule raises a question of arbitrability is not much less absurd or much less destructive.

The federal courts are divided on the meaning of arbitrability. On the eligibility question, there not only is a split of authority but the courts differ on their rationale for coming to the same conclusion.³¹⁸ It may seem surprising, therefore, that over thirty years ago the Supreme Court provided a carefully reasoned analysis of the question of which issues should be decided by the courts and which by the arbitrators. In *John*

315. 9 U.S.C. § 4; *Volt Info. Sciences*, 489 U.S. at 474-75; *Houlihan*, 31 F.3d at 695; *Kyung In Lee v. Pacific Bullion (New York) Inc.*, 788 F. Supp. 155, 156 (E.D.N.Y. 1992).

316. *Lauer*, 49 F.3d at 327.

317. See *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Barchman*, 916 F. Supp. 845, 849 (N.D. Ill. 1996).

318. See *supra* text accompanying notes 96-113.

Wiley & Sons, Inc. v. Livingston,³¹⁹ the question before the Court was whether the court or the arbitrator should decide whether procedural prerequisites in a collective bargaining agreement containing an arbitration clause had been met.³²⁰ The union sought to arbitrate certain grievances that it and its members had against the company, whereas the company took the position that the grievances did not fall within the scope of the arbitration clause.³²¹ The company argued that the collective bargaining agreement contained procedural conditions to arbitration, which the union had not met.³²²

Justice Harlan, writing for a unanimous Court, held that the dispute, including the question of whether the procedural conditions had been met, should be submitted to the arbitrator.³²³ The Court's reasoning is so relevant to the questions raised in arbitration-related litigation in securities cases that it is worth quoting at some length:

We think that labor disputes of the kind involved here cannot be broken down so easily into their 'substantive' and 'procedural' aspects. Questions concerning the procedural prerequisites to arbitration do not arise in a vacuum; they develop in the context of an actual dispute about the rights of the parties to the contract or those covered by it.

.....

Doubt whether grievance procedures or some part of them apply to a particular dispute, whether such procedures have been followed or excused, or whether the unexcused failure to follow them avoids the duty to arbitrate cannot ordinarily be answered without consideration of the merits of the dispute which is presented for arbitration. . . . It would be a curious rule which required that intertwined issues of 'substance' and 'procedure' growing out of a single dispute and raising the same questions on the same facts had to be carved up between two different forums, one deciding after the other. Neither logic nor considerations of policy compel such a result.

Once it is determined, as we have, that the parties are obligated to submit the subject matter of a dispute to arbitration, 'procedural' questions which grow out of the dispute and bear on its final disposition should be left to the arbitrator. Even under a contrary rule, a court could deny arbitration only if it could confidently be said not only that a claim was strictly 'procedural,' and therefore within the purview of the court, but also that it should operate to bar arbitration altogether, and not merely limit or qualify an arbitral award. In

319. 376 U.S. 543 (1964).

320. *Id.* at 544. John Wiley & Sons, Inc., the petitioner, was the successor to a company that had signed the collective bargaining agreement. The Court held that Wiley was bound by its predecessor's obligation to arbitrate under the bargaining agreement. *Id.* at 550-51.

321. The union's grievances related to such matters as seniority rights, contributions by the company to a pension plan, severance pay, and vacation pay. *Id.* at 552.

322. The agreement provided for arbitration as the third step of the grievance procedure. Step 1 called for a conference between the affected employee and a representative of the employer, and Step 2 called for a conference between representatives of the employer and the union. *Id.* at 555-56.

323. *Id.* at 558-59.

view of the policies favoring arbitration and the parties' adoption of arbitration as the preferred means of settling disputes, such cases are likely to be rare indeed. In all other cases, those in which arbitration goes forward, the arbitrator would ordinarily remain free to reconsider the ground covered by the court insofar as it bore on the merits of the dispute, using the flexible approaches familiar to arbitration. Reservation of 'procedural' issues for the courts would thus not only create the difficult task of separating related issues, but would also produce frequent duplication of effort.

In addition, the opportunities for deliberate delay and the possibility of well-intentioned but no less serious delay created by separation of the 'procedural' and 'substantive' elements of a dispute are clear. . . . [S]uch delay may entirely eliminate the prospect of a speedy arbitrated settlement of the dispute. . . .

No justification for such a generally undesirable result is to be found in a presumed intention of the parties. Refusal to order arbitration of subjects which the parties have not agreed to arbitrate does not entail the fractionating of disputes about subjects which the parties do wish to have submitted.³²⁴

Although *John Wiley* arose in the context of a labor dispute, its reasoning with respect to the question of arbitrability is readily applicable to securities cases. In fact, Justice Harlan's opinion considers most of the major issues which are discussed in this Article: the federal legislative and judicial policy favoring arbitration;³²⁵ the importance of implementing the contractual intentions of the parties;³²⁶ the futility of attempting to distinguish "procedural" from "substantive" issues involved in the same controversy;³²⁷ the inefficiency of having separate proceedings to decide intertwined questions;³²⁸ and the opportunities for intentional or unintentional delay that would be created by such separate proceedings.³²⁹

The *John Wiley* Court's statement that, once it is determined that the parties have agreed to submit the subject matter of a dispute to arbitration, procedural questions bearing on its final disposition should be left to the arbitrator, seems at least to suggest that the applicability of the SRO eligibility rules is a question for the arbitrators to decide.³³⁰ Yet, curiously, the decisions that take the opposite position do not attempt to distinguish or otherwise deal with *John Wiley*'s strong arguments. Instead, they either ignore *John Wiley* entirely or cite it only for its statement of the general proposition that whether or not a party is bound to arbitrate is a matter to be determined by the court on the basis of the contract

324. *Id.* at 556-58 (emphasis supplied).

325. *Id.* at 548-49.

326. *Id.* at 551 n.4.

327. *Id.* at 556-59.

328. *Id.*

329. *Id.* at 555.

330. *See supra* text accompanying notes 99-102.

between the parties.³³¹

A notable exception is the recent district court decision in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Barchman*.³³² Merrill Lynch, which had been named as a respondent in a securities arbitration asked the court to rule that certain claims were barred by the NYSE eligibility rule; to order the claimants to resubmit their consolidated claims as individual claims; and to order the claimants to amend their Statement of Claim in order to comply with the NYSE Rule requiring specificity.³³³ The district court found *John Wiley* highly relevant to the determination of these questions:

Although courts do resolve the threshold questions of whether a valid arbitration agreement exists and whether the parties have agreed to arbitrate particular issues, both such resolutions being based on the terms of the written arbitration agreement . . . , the seminal case of *John Wiley* . . . makes it clear that courts are not to reach out and micromanage the procedural aspects of arbitration. . . .³³⁴

It is inexplicable that *John Wiley* is cited only one time—and then in passing—in all of the materials tendered by the parties. Claimants' failure to mention the case until almost the end of their final submission is particularly perplexing because *John Wiley* and its progeny . . . provide strong support for Claimants' positions on the consolidation and specificity issues.³³⁵

Following *John Wiley*, the district court held that the issue of consolidation of claims was for the arbitrators to decide.³³⁶ But the court held that Third Circuit precedent required the court, not the arbitrators, to decide the eligibility issue.³³⁷ On the question of the specificity of the Statement of Claim, the court stated that “[v]irtually every case dealing with similar issues has decided that fulfillment of a procedural prerequisite is an issue for the arbitrator. . . .”³³⁸

In *PaineWebber Inc. v. Elahi*,³³⁹ a case decided in July 1996, the First Circuit squarely addressed the question of the meaning of arbitrability.³⁴⁰ The court noted that the Supreme Court had on two previous occasions addressed itself to the issue of whether the court or the arbitrators should

331. See, e.g., *PaineWebber, Inc. v. Hofmann*, 984 F.2d 1372, 1376 (3d Cir. 1993) (citing *John Wiley*, 376 U.S. at 547).

332. 916 F. Supp. 845 (N.D. Ill 1996).

333. NYSE Rule 612 states in part: “The Statement of Claim shall specify the relevant facts and the remedies sought.” *Id.* at 849.

334. *Id.* at 848-49 (citations omitted) (footnote omitted).

335. *Id.* at 848-49 n.6.

336. *Id.* at 857.

337. *Id.* at 858. See *supra* text accompanying notes 97, 103-04.

338. *Id.* at 850. Nevertheless, the court stated that it was “essential that Claimants provide enough detail to enable this Court to determine whether the asserted theories of recovery originated within the six-year eligibility period. . . .” *Id.*

339. 87 F.3d 589 (1st Cir. 1996).

340. The court declined to apply the reasoning of *John Wiley* to the eligibility issue, although it conceded that the *John Wiley* precedent would justify its holding that the arbitrators and not the court had authority to apply the NASD eligibility rule. *Id.* at 601 n.12.

decide whether a dispute is arbitrable.³⁴¹ In the first case, *AT&T Technologies, Inc. v. Communications Workers of Am.*,³⁴² the issue was whether the subject matter of the underlying dispute was expressly made nonarbitrable by the terms of the arbitration agreement.³⁴³ In the second case, *First Options of Chicago, Inc. v. Kaplan*,³⁴⁴ the issue was whether two individuals who had not signed an arbitration agreement in their personal capacities were bound by the agreement.³⁴⁵ In each instance, the Supreme Court held that the question before it was a question of arbitrability, and that questions of arbitrability were presumptively for the court, not the arbitrators, to decide.³⁴⁶

The *Elahi* court reasoned that the two kinds of arbitrability in dispute in *AT&T* and *First Options* established a presumptive limit on the scope of the concept:

Thus, if the parties have (1) entered into a valid arbitration agreement . . . , and (2) the arbitration agreement covers the subject matter of the underlying dispute between them . . . , then we will presume that the parties have made a commitment to have an arbitrator decide all the remaining issues necessary to reach a decision on the merits of the dispute.³⁴⁷

The court explained that this presumption concerning the *definition* of arbitrability was separate from the presumption of *AT&T* and *First Options* and that the court will decide the *arbitrability* of a dispute as follows:

The presumption that we now adopt (*i.e.*, that issues other than (1) the existence of an arbitration agreement between the parties and (2) whether the subject matter of the underlying dispute is within the scope of the arbitration clause are presumptively not “arbitrability” issues) must not be confused with—and in no way diminishes—the presumption . . . that issues of arbitrability are normally to be decided by the courts, not arbitrators.

...
 . . . [W]here the parties have clearly agreed to arbitrate the subject matter of the underlying dispute between them, as the parties have here, it is unlikely that they intended other issues related to the dispute, such as the timeliness of the submission of the claim, to affect the “arbitrability” of the dispute.³⁴⁸

Decisions such as *Barchman* and *Elahi*, which give a narrow meaning to the scope of “arbitrability” issues, are supported by the rules of the

341. *Id.* at 594-95.

342. 475 U.S. 643 (1986).

343. The specific question was whether, under the terms of a collective bargaining agreement, the company's decision to lay off workers when it determined that a lack of work existed was covered by the arbitration clause contained in the agreement. *Id.* at 646.

344. 115 S. Ct. 1920 (1995).

345. The arbitration agreement had been executed by a corporation wholly owned by the two individuals. *Id.* at 1921.

346. *Id.* at 1925-26.

347. *Elahi*, 87 F.3d at 599.

348. *Id.* at 599-600.

NASD, which, under the arbitration clauses that brokerage firms include in their customer-broker agreements, govern the vast majority of securities arbitrations. These rules authorize the arbitrators to resolve most issues relating to the arbitration. The Code of Arbitration Procedure (CAP) provides:

The arbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code and to take appropriate action to obtain compliance with any ruling by the arbitrator(s). Such interpretations and actions to obtain compliance shall be final and binding upon the parties.³⁴⁹

This general rule is supplemented by provisions of the CAP which give the arbitrators express authority to decide particular procedural matters. The arbitrators are authorized to make final decisions concerning the consolidation of claims;³⁵⁰ to rule on requests to amend the pleadings;³⁵¹ to designate the time and place of the hearing;³⁵² to consider prehearing discovery requests;³⁵³ and to determine the materiality and relevance of evidence.³⁵⁴

NASD rules also provide: "No party shall, during the arbitration of any matter, prosecute or commence any suit, action or proceeding against any other party touching upon any of the matters referred to arbitration pursuant to this Code."³⁵⁵ The *Ruder Report* recommended that this rule (formerly Section 6 of CAP) be clarified in order to reduce the amount of arbitration-related litigation:

The Task Force recommends that the NASD clarify or amend Section 6 . . . so that it clearly precludes a party who has entered into a predispute arbitration agreement from seeking court intervention on issues of procedural arbitrability, such as eligibility or statutes of limitations, until after the arbitration award has been entered, and that it enforce the provision. This recommendation should go a long way to address investor criticisms that they are forced to litigate in court in order to maintain their right to arbitrate.³⁵⁶

349. NASD Rule 10324 (formerly § 35 of CAP). See *Elahi*, 87 F.3d at 601 (section 35 "strongly undercuts any argument that the parties intended the § 15 time bar to be an arbitrability issue to be decided only by the courts"); *FSC Sec. Corp. v. Freel*, 14 F.3d 1310, 1312-1313 (8th Cir. 1994) (held that the parties' agreement to have their dispute governed by the NASD Code, including § 35, is a clear and unmistakable expression of their intent to leave the question of arbitrability to the arbitrators). *Accord PaineWebber, Inc. v. Bybyk*, 81 F.3d 1193, 1202 (2d Cir. 1996). But see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cohen*, 62 F.3d 381, 384 (11th Cir. 1995) (section 35 is not clear and unmistakable evidence of the parties' intent to allow the arbitrator to determine the timeliness of the claim); Emil Bukhman, *Time Limits on Arbitrability of Securities Industry Disputes Under the Arbitration Rules of Self-Regulatory Organizations*, 61 BROOK. L. REV. 143, 171 (1995).

350. NASD Rule 10314(d)(3).

351. NASD Rule 10328(b).

352. NASD Rule 10315.

353. NASD Rule 10321. Unresolved discovery issues are decided by a single member of arbitration panel appointed by the NASD Director of Arbitration. NASD Rule 10321(e).

354. NASD Rule 10323.

355. NASD Rule 10106.

356. RUDER REPORT, *supra* note 8, at 32 (footnotes omitted).

Where an investor and a brokerage firm agree to arbitrate any future disputes under the NASD CAP, their agreement thus incorporates the NASD rules requiring that the arbitrators will decide all questions that might arise relating to the matters referred to arbitration and that the parties will not resort to the courts for a ruling on all such questions during the pendency of the arbitration.³⁵⁷ Where a party nevertheless initiates arbitration-related litigation before the arbitrators have entered their award, the court is justified in refusing to decide the issue and referring it to the arbitrators in order to promote both of the two fundamental federal policies concerning arbitration: to resolve any doubts about arbitrability in favor of arbitration,³⁵⁸ and to enforce parties' agreements to arbitrate.³⁵⁹

VI. CONCLUSION

Arbitration-related litigation is an unfortunate anomaly. The purpose of arbitration is to avoid litigation and to offer disputants an alternative forum that is cheaper, faster, and more efficient than litigation in court. Thus, litigation of collateral issues in connection with arbitration results in bifurcated proceedings and tends to defeat the overriding purposes of arbitration.

Much of the arbitration-related litigation that has occurred in recent years in securities cases is initiated by brokerage firms that are defendants in disputes with their customers over the handling of the customers' brokerage accounts. In many of these cases, the reason why the customer brought his or her claim in arbitration rather than in a lawsuit is that the firm required him or her to sign a printed-form agreement containing an arbitration clause at the time the customer opened the brokerage account. Most of these standard-form agreements limit the possible arbitration forums to those established and operated by the securities industry. To subject the customer to the expense and delay of litigating collateral issues, sometimes in trial and appellate courts in more than one jurisdiction, is inconsistent with both the pro-arbitration policy of the FAA and the investor-protection policy of the securities laws, as well as

357. See *Freel*, 14 F.3d at 1312-13; *Elahi*, 87 F.3d at 594 (the NASD Code was incorporated in an arbitration clause that gave the customer the right to select the arbitration forum from among the NASD and several other forums). But see *Bybyk*, 81 F.3d at 1201 (an arbitration agreement that gave the customer the right to select the forum from among the NASD or one of several stock exchanges did not incorporate the NASD Code "beyond all reasonable doubt," even though the customer selected the NASD as the forum). The question raised in *Bybyk* was whether the agreement incorporated the NASD eligibility rule. The court held that, whether or not the Code was incorporated into the agreement, the parties intended to arbitrate the question of arbitrability. *Id.* at 1201-02.

358. *Moses H. Cone Memorial Hosp.*, 460 U.S. at 24-25 ("The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration . . .").

359. *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985) ("The preeminent concern of Congress in passing the [FAA] was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate . . .").

the paramount purpose of arbitration as an alternative to court proceedings.

There are several ways by which the courts can reduce the amount of arbitration-related litigation. One way is to define the term "arbitrability" narrowly. Once a court decides that the subject matter of a dispute falls within the scope of the parties' agreement to arbitrate, all such issues, including the applicability of the NASD eligibility rule, are presumptively questions for the arbitrators to decide, not questions concerned with arbitrability.

Alternatively, where the parties have manifested in their agreement a clear and unmistakable intent to submit the question of arbitrability to the arbitrators, the court should honor that expression of intent, as the Second Circuit did in the *Bybyk* case, and not decide the arbitrability issue itself.

The NASD arbitration rules clearly give the arbitrators the authority to decide all issues relating to the arbitration and expressly prohibit the parties from litigating these issues while the arbitration is pending. Where the parties have agreed to arbitrate under these rules, the courts should implement that agreement by refusing to decide such matters and referring them back to the arbitrators and by awarding attorneys' fees and imposing Rule 11 sanctions against parties and their attorneys who resort to unwarranted arbitration-related litigation. In this way, the courts can further the federal policies of favoring arbitrability of disputes and enforcement of agreements to arbitrate that underlie the FAA.