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FOREWORD

SECURITIES ARBITRATION: A DECADE AFTER *McMAHON*^{*}

Norman S. Poser[†]

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I welcome you to the Brooklyn Law School Symposium on securities arbitration. With a federal appellate judge, a former commissioner of the Securities and Exchange Commission, and a group of distinguished academic scholars in the areas of arbitration and securities law participating in today's program, I am confident that this Symposium will provide a lively and useful discussion.

I will use my introduction to the Symposium to bring to the fore a problem that has not been much discussed by courts or scholars, but which nevertheless threatens to limit the usefulness of securities arbitration.¹ I am referring to the

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¹ Occasionally, judges have expressed concern about the impact on investors of arbitration related litigation. For example: "I remain troubled by the practical effect for respondents—residents of the States of Florida and Virginia—who now have to litigate the brokerage firms' Statute of Limitations defenses in New York

tendency of parties who have agreed to arbitrate their disputes to engage in extended court litigation of issues collateral to the arbitration.

Shearson/American Express, Inc. v. McMahon held that agreements to arbitrate claims under the federal securities laws were enforceable.² At the time, some feared that investors would be treated unfairly when their claims were heard before arbitration panels rather than federal courts; while others believed that the speed and economy of arbitration would benefit brokers and investors alike. Arbitration was expected to provide relief from the "rampant growth of the civil docket in the United States," which Judge Selya has described as an example of "hypertrophy" or the "overgrowth . . . of an organ or part . . . resulting from unusually steady or severe use."³

I do not believe that either the fears or the optimistic claims that were expressed a decade ago have materialized. According to the United States General Accounting Office, there is no evidence of any systematic unfairness to investors in arbitrations.⁴ On the other hand, arbitration has lost some of the speed and economy which are the principal reasons for its existence. Judge Selya discusses this development in his contribution to this Symposium issue.⁵ To some extent, the tendency of arbitration to become more like litigation—and, thus, to take on some of the most undesirable features of litigation—is due to efforts to make arbitration more fair. What is emerging is a compromise between the competing goals of investor protection and the efficiency, privacy and finality of arbitration.⁶

State court before ever reaching the arbitrators' door." *Smith Barney, Harris Upham & Co., Inc. v. Luckie*, 85 N.Y.2d 193, 207, 647 N.E.2d 1308, 1316, 623 N.Y.S.2d 800, 808 (1995) (Kaye, C.J., concurring).

² 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987).

³ *Securities Indus. Ass'n v. Connolly*, 883 F.2d 1114, 1116 (1st Cir. 1989) (quoting WEBSTER'S THIRD INT'L DICTIONARY 1114 (1981)), *cert. denied*, 495 U.S. 956 (1990).

⁴ UNITED STATES GENERAL ACCOUNTING OFFICE, SECURITIES ARBITRATION: HOW INVESTORS FARE 6 (GAO/GGD-92-74) (May 1992) [hereinafter GAO REPORT].

⁵ Bruce M. Selya, *Arbitration Unbound? The Legacy of McMahon*, 62 BROOK. L. REV. 1433, 1445-47 (1996).

⁶ Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1097, 1113 (1993).

The impact of mandatory arbitration on the legal system, and on the respective rights of brokerage firms and investors, has turned out to be more complex than many persons predicted in 1987. In the *McMahon* case itself, a brokerage firm was successful in its attempt to enforce an agreement with a customer to arbitrate future disputes. Conversely, the customer was unsuccessful in his attempt to avoid enforcement of the agreement. In *McMahon*, as in many of the arbitration cases during the 1980s, the investor wanted to try his case in court, while the brokerage firm wanted to arbitrate.

Since 1987, many brokerage firms, including the largest firms, have required their customers to arbitrate all disputes.⁷ Most firms' printed customer agreements contain arbitration clauses, and customers, especially those who wish to open margin accounts or to trade options, have no practical choice but to sign. Arbitration is based on agreement, and nobody can be forced to arbitrate unless he or she has consented to do so. The courts, however, have shown little sympathy for customers who sign an arbitration agreement and later claim that they were induced to sign by fraud⁸ or that the agreement was an unconscionable contract of adhesion.⁹ Professor Speidel's article discusses the consensual basis of arbitration in the world that *McMahon* created.¹⁰

Anyone who even begins to review the large volume of judicial decisions concerning arbitration during the past decade will see that a curious role reversal has taken place. Today, although brokerage firms continue to include arbitration clauses in their customer agreements, it is more likely to be the brokerage firm than the investor who seeks assistance from the courts to limit the role and authority of arbitrators. I am thinking of such important issues as whether arbitrators have the authority to award punitive damages,¹¹ whether an

⁷ GAO REPORT, *supra* note 4, at 28-29.

⁸ See, e.g., *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282, 287 (9th Cir. 1988).

⁹ See, e.g., *Adams v. Merrill Lynch Pierce Fenner & Smith*, 888 F.2d 696, 700 (10th Cir. 1989); *Driscoll v. Smith Barney, Harris, Upham & Co.*, 815 F.2d 655, 658-59 (11th Cir.), *cert. denied*, 484 U.S. 914 (1987); *Coleman v. Prudential Bache Sec., Inc.*, 802 F.2d 1350, 1352 (11th Cir. 1986).

¹⁰ Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent*, 62 BROOK. L. REV. 1335 (1996).

¹¹ See, e.g., *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212

arbitration is time-barred,¹² and whether the arbitration has been brought in the proper forum.¹³ Unfortunately, there has been a proliferation of arbitration-related litigation, tending to defeat the purposes of having arbitration in the first place. Instead of saving time and money by arbitrating, the parties may find themselves engaged in two costly proceedings, one before a court and the other before arbitrators.

Having won the battle for mandatory arbitration, the securities industry has found that it is a mixed blessing. Marc Steinberg makes the point in this Symposium issue¹⁴ that investors today may be better off in an arbitration forum than they would be in court, given the limitations that Congress and the courts have placed on private rights of action under the securities laws. I would add the converse point that brokerage firms often may be better off in court. If we look at the arbitration process, we can see why this is so.

There are no express provisions for motion practice in the securities arbitration rules of the principal arbitration forums: the National Association of Securities Dealers, New York Stock Exchange, and American Arbitration Association. Consequently, claims that a trial judge might dismiss before trial are 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, grant a judgment notwithstanding the verdict or reduce the damages by remittitur. Arbitration procedures are informal and arbitrators are not required to follow the rules of evidence. Arbitrations are conducted in secret, and arbitrators are not required to explain their decisions. Arbitral awards do not have precedential effect. The results of arbitrations are therefore less predictable than in litigation.

Judicial review of arbitral decisions is limited, largely, to arbitrators' corruption or other misconduct.¹⁵ The Federal

(1995).

¹² See, e.g., *PaineWebber, Inc. v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996).

¹³ See, e.g., *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Georgiadis*, 903 F.2d 109 (2d Cir. 1990).

¹⁴ Marc. I. Steinberg, *Securities Arbitration: Better for Investors Than the Courts?*, 62 BROOK. L. REV. 1503 (1996).

¹⁵ 9 U.S.C. § 10 (1994).

Arbitration Act does not permit a court to vacate an arbitrator's decision simply because it is based on a mistake of fact or law.¹⁶ *McMahon* was based on the precept that mandatory arbitration should not alter the substantive rights that the parties would have if they were in litigation. In theory, only the forum changes, not the substantive law. However, because of the narrow scope of judicial review, no mechanism exists to enforce that precept. Thus, unlike trial judges and juries, arbitrators are virtually unaccountable to any judicial or other supervisory entity.

Although many plaintiffs' lawyers would still prefer to bring a case before a jury than before a panel of arbitration, I believe that the special characteristics of arbitration that I have mentioned pose special problems for brokerage firms, which are usually the defendants in disputes with their customers. The lack of predictability of arbitrations and the absence of constraints on arbitrators have been factors behind the efforts of brokerage firms to persuade the courts to limit both the authority of the arbitrators and the scope of matters that are arbitrable.

Some litigation in connection with arbitrations is inevitable, but much of it serves neither the goals of efficient dispute resolution nor of investor protection. In some instances, investors have been required to litigate in more than one federal district, at the trial and appellate levels, before being able to have their substantive claims heard by arbitrators.¹⁷ If arbitration is to fulfill its purpose as a useful alternative dispute resolution mechanism, arbitrators should be given as much authority as possible to decide the collateral issues that arise in the course of arbitration proceedings. Litigation of issues collateral to arbitrations should be discouraged.

The Supreme Court has repeatedly stated that there is a strong federal policy favoring arbitration, and any doubts about the scope of an arbitration agreement must be resolved in favor of arbitration.¹⁸ Nevertheless, arbitrators should not

¹⁶ *Miller v. Prudential Bache Sec., Inc.*, 884 F.2d 128, 130 (4th Cir. 1989).

¹⁷ *See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer*, 49 F.3d 323 (7th Cir. 1995); *PaineWebber, Inc. v. Hofmann*, 984 F.2d 1372 (3d Cir. 1993).

¹⁸ *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983); *see Volt Info. Sciences, Inc. v. Board of Trustees of Leland Stanford Junior*

be placed in the position of deciding the scope of their own jurisdiction. The Federal Arbitration Act requires that a court, not arbitrators, decide the threshold question of whether a dispute is arbitrable.¹⁹ Thus, whether it is for the court or the arbitrators to decide a particular question depends on whether that question is characterized as a question of arbitrability. The broader the definition of arbitrability, the more court litigation there will be on issues relating to arbitrations.

Earlier this year, in *PaineWebber, Inc. v. Elahi*,²⁰ the First Circuit squarely addressed the question of the meaning of arbitrability, and thus defined the respective roles of the court and the arbitrators. The court defined arbitrability narrowly. It held that 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, there is a presumption 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.²¹

Under the *Elahi* rule, issues such as whether an arbitration is time-barred,²² whether the arbitration is held in the proper venue,²³ whether joinder of parties is proper²⁴—resolution of which has been the source of much court litigation in recent years—must be decided by arbitrators. If this salutary decision is followed by other circuits, it will reduce the problem of excessive arbitration-related litigation. This result seems consistent with the purposes of the federal securities laws, investor protection, and those of the Federal Arbitration Act, efficient resolution of disputes and enforcement of agreements to arbitrate.

Univ., 489 U.S. 468, 485 (1989); *Perry v. Thomas*, 482 U.S. 483, 489 (1987).

¹⁹ See 9 U.S.C. §§ 3-4 (1994); *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920 (1995). In *First Options*, the Court also held that arbitrability would be for the arbitrators, not the court, to decide if the parties agreed to arbitrate arbitrability. *Id.* at 1923-24.

²⁰ 87 F.3d 589 (1st Cir. 1996).

²¹ *Id.* at 599.

²² See, e.g., *PaineWebber Inc. v. Bybyk*, 81 F.3d 1193 (2d Cir. 1996).

²³ See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer*, 49 F.3d 323 (7th Cir. 1995).

²⁴ See, e.g., *Drexel Burnham Lambert, Inc. v. Valenzuela Bock*, 696 F. Supp. 957 (S.D.N.Y. 1988).