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Market Solutions to Market Problems: Re-Examining Arbitral Immunity as a Solution to Unfairness in Securities Arbitration

Peter B. Rutledge*

This paper addresses the fairness of securities arbitrations in the United States. A few decades ago, such a topic would have been relegated to the academic hinterlands. For the first fifty years following the enactment of the nation's securities laws, pre-dispute arbitration agreements between investors and the securities industry were not enforceable.[1] In a series of decisions in the late 1980s, the Supreme Court reversed course and held that such disputes were indeed arbitrable.[2] Following those decisions, arbitration quickly became the preferred method of dispute resolution for cases arising under the nation's securities laws, especially disputes between investors and broker-dealers.[3] Between 1990 and 2004, the number of arbitration cases

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* Assistant Professor of Law, Columbus School of Law, Catholic University of America. This paper is an adaptation of a presentation that I made during the Investor Rights Symposium at Pace University Law School.

I would like to thank Dean William F. Fox for supporting this research through the Dean's Research Grant program. Barbara Black, David Lipton and Deborah Masucci provided valuable guidance during the development of this project. Participants at the Investor Rights Symposium, especially Maureen Arellano Weston, provided thoughtful commentary on the paper. Nicole Angarella, a stellar law student, provided excellent research assistance. Steve Young, a research librarian at the Columbus School of Law, supported this project through his unrivaled research skills. Some of these readers are arbitrators themselves, so it is especially important for me to stress that the views expressed herein are my own and not necessarily ones with which my readers agree; nonetheless, they selflessly took the time to review the manuscript and offer objective criticism of the proposal.

I previously developed the theory that animates this essay in another article. *See* Peter B. Rutledge, *Toward a Contractual Approach for Arbitral Immunity*, 39 GA. L. REV. 151 (2004). I am grateful to the editors of the Georgia Law Review for permission to include some of the material used in that article in this essay.

1. Wilko v. Swan, 346 U.S. 427 (1953).

2. *See, e.g.*, Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987); Rodriguez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989). For a concise, informative review of the key Supreme Court precedents in this area, see Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327, 330-35 (1996).

3. *See* Michael A. Perino, Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities

filed at the NASD rose from 3,617 to 8,201.[4]

As securities arbitration grew in popularity, concerns over the fairness of securities arbitration proceedings quickly followed. Indeed, the ink on the Supreme Court decisions had barely dried when Congress tasked the General Accounting Office (GAO) with reporting on the fairness of securities arbitrations.[5]

The empirical premise of the "unfairness" critique has always been hotly contested. The GAO did not find that investors were less likely to prevail in industry-sponsored arbitral fora.[6] More recent empirical research has called into question claims that arbitration is unfair and that arbitration is perceived as unfair.[7] At the recent House subcommittee hearing on securities arbitration, several industry representatives and academics defended the basic contours of the present system.[8] Former SEC Chairman David Ruder noted during his keynote address at the

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Arbitrations 3 (Nov. 4, 2002) [hereinafter *Perino Report*] ("Securities arbitrations are the primary dispute resolution mechanism for disputes involving customers and broker-dealers.").

4. NASD Statistics are available at the organization's website, *see* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=516 (last visited Jan. 5, 2006). The NYSE statistics show a more complex trend for a smaller set of cases. In 2004, 972 cases were filed with the NYSE, an increase of the number of filings in 2000 but a decline compared to 2002 and 2003. *See* Arbitration Statistics, http://www.nyse.com/pdfs/arbstats123104.pdf (last visited Jan. 6, 2006); *see also Perino Report*, *supra* note 3, at 6-7.

5. General Accounting Office, Securities Arbitration: How Investors Fare (1992), *reprinted in* 781 PRAC. L. INST. CORP. 19, 21 (July-Aug. 1992) [hereinafter *GAO Report*].

6. *Id.* at 25-27.

7. See Gary Tidwell, et al., Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations, (Aug. 5, 1999) (copy on file with author) (paper presented at the National Meeting of the Academy of Legal Studies in Business); see also Report of the Arbitration Policy Task Force to the Board of Governors of the National Association of Securities Dealers, Inc., reprinted in 95-96 FED. SEC. L. REP. (CCH) 85, 735 (1996) (finding securities arbitration generally "to be a relatively efficient, fair, and less costly forum for resolution of disputes involving public investors, member firms, and firm employees . . .") [hereinafter Ruder Report]. I recognize some of the limitations of the Tidwell analysis, including the relatively low return rate on their survey and the risk of a skewed sample pool (i.e., those participants displeased with the SRO may be less likely to spend the time filling out a survey on it). These nuances about the state of the data are beyond the scope of this paper.

8. *Review of Securities Arbitration System: Hearing Before the H. Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprise*, 109th Cong. (2005) [hereinafter *Hearings*] (statements of Linda Feinberg, Karen Kupersmith & Michael Perino).

Investor Rights Symposium that securities arbitration is basically "fair."[9]

Regardless of the validity of the "unfairness" criticism, it has nonetheless influenced the debate in two important respects. First, as the GAO noted, regardless of whether securities arbitrations are *actually* fair, it is as important, if not more important, that securities arbitrations be *perceived* as fair. Second, the "unfairness" critique has had a significant effect on the development of the industry. Indeed, at the recent House subcommittee hearing on the fairness of securities arbitration, NASD and NYSE representatives seemed to be bending over backwards to demonstrate how frequently the broker-dealers lost in securities arbitrations and how they had designed procedures to enhance the likelihood that investors would prevail.[10]

Lingering doubts over the fairness of securities arbitrations have led to a variety of reforms since the Supreme Court first held that securities law disputes are arbitrable.[11] For example, doubts about the fairness of the arbitrator nomination process prompted the NASD to reform that process in 1998. Yet each set of reforms appears to be followed by a new set of complaints about the newly reformed system.[12] Even after the 1998 NASD reforms, observers continue to question whether those reforms truly have made the arbitration appointment process fair.[13] Recent hearings on the fairness of securities arbitrations before a House Subcommittee show that reforms have not quelled criticism of the system.[14]

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9. David Ruder, Keynote Address at the Pace Investor Rights Project: Investor Rights Symposium (Mar. 31, 2005).

10. *Hearings*, *supra* note 8 (statements of Linda Feinberg & Karen Kupersmith).

11. *Perino Report*, *supra* note 3, at 9 (noting that "the SROs have regularly revised their procedures over the last fifteen years.").

12. This was true even in the initial aftermath of *McMahon*. Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987). In 1989, the SEC "approved significant changes in SRO rules but made it clear that it continued to have concerns about the process." Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1001 (2002). "In sum, the SEC and SRO have spent considerable time and effort since *McMahon* to amend procedural rules governing securities arbitrations—all in the name of neutrality and fairness." *Id.* at 1005.

13. The NASD recently proposed further revisions to the process of generating arbitrator lists in order to increase the randomness of selection. *See* Self Regulatory Organizations: Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change and Amendment No. 1, Exchange Act Release No. 34-51083 (Jan. 26, 2005), *available at* http://www.sec.gov/rules/sro/nasd/34-51083.pdf.

14. *Hearings*, *supra* note 8 (statements of Public Investors Arbitration Bar Association, William Francis Galvin & Daniel R. Solin).

Most calls to reform securities arbitration suffer from a common flaw—they have relied largely on regulatory solutions without considering the market incentives of the arbitrators. When viewed through an economic lens, the inefficacy of this "regulatory" approach comes as no surprise. Calls for reform rest on a basic premise—that securities arbitration is unfair because the system is "captured" by the industry. If we accept that premise, then regulatory reforms are unlikely to be an effective long-term solution. Such reforms may yield ephemeral results as arbitrators and broker-dealers need time to react to shifting norms. Over the long run, however, economic analysis suggests that they will simply adapt their behavior to the new legal regime and, eventually, new norms will develop that continue to give favored treatment to the repeat players, namely the industry. Efforts to reform the perceived inequities in securities arbitration need a fresh approach.

This essay provides that approach. It applies to the peculiar problem of securities arbitration a theory that I developed in an Article in the *Georgia Law Review*.[15] That Article developed an economic argument against arbitral immunity. It proposed that we strip arbitrators and arbitral institutions of any immunity that they enjoy as a matter of law. In place of that immunity, contractual damages caps and liability waivers would limit the exposure of arbitrators and arbitral institutions.

That same basic model provides a novel, viable and partly efficacious solution to the (perceived) problem of unfairness in securities arbitration. The effects of such a paradigm shift are subtle but important. This model addresses many (but, admittedly, not all) of the most vexing problems about unfairness in securities arbitration. It also better aligns the incentives of arbitrators and arbitral institutions with the "public interest" arguments that underpin calls for greater fairness in securities arbitration.

I develop this argument in four parts. Part I catalogues the various complaints about unfairness in securities arbitration. Part II sketches out the liability model proposed here. Part III explains how this model would address some of the complaints identified in Part I. Part IV explores problems with and limitations on the liability model.

15. Peter B. Rutledge, *Toward a Contractual Approach for Arbitral Immunity*, 39 GA. L. REV. 151 (2004).

I. Complaints

Since the Supreme Court held securities law disputes to be arbitrable, complaints about the fairness of the arbitration proceedings have taken various forms. As Professor Gross noted during her comments at the Investor Rights Symposium, many of these criticisms were on display during the recent House subcommittee hearing on the fairness of securities arbitration.[16] This Part classifies the main areas of complaint—(1) complaints about arbitrator selection; (2) complaints about arbitral procedure; and (3) complaints about arbitral awards. It also analyzes various proposals for addressing those deficiencies and identifies their weaknesses.

Some complaints about fairness concern arbitrator selection. One complaint is that arbitrators are poorly trained. In a recent essay, Steven Caruso argues that arbitrator training programs are inadequate. He finds it "astounding how few of the experienced securities arbitration practitioners know, or have otherwise personally experienced, the actual 'training' that is being provided to these individuals who will be entrusted with the financial or professional lives of their clients."[17] According to Caruso, the deficiencies in training include:

> "little guidance [by the NASD] . . . on the elements of the claims and/or defenses that may be presented."[18]
>
> materials provided by the NYSE did not "provide[] any guidance whatsoever on many of the critical issues that are present in nearly every single customer initiated arbitration dispute."[19]
>
> The NASD requires no continuing education for arbitrators, and the NYSE only requires minimal training.[20]

This combination of circumstances causes Caruso to conclude that "it cannot, in all good conscience, be assumed that the members of any given arbitration panel will have been fairly educated or trained on the facts and circumstances that will be associated with the claims that we

16. Jill Gross, Comments at the Pace Investor Rights Project: Investor Rights Symposium (Mar. 31, 2005) (discussing *Hearings*, *supra* note 8).

17. Steven B. Caruso, *Model Arbitration Instructions: Luxury or Emerging Necessity*, 1440 PRAC. L. INST. CORP. 465, 474-75 (2004); *see also Ruder Report*, *supra* note 7, at 108-10 (calling for additional training of arbitrators in substantive law).

18. Caruso, *supra* note 17, at 475-76.

19. *Id.* at 477.

20. *Id.* at 478.

will be asking them to decide."[21] As a solution, Caruso proposes that the arbitral institutions develop "model arbitration instructions," analogous to model jury instructions, which would guide the arbitrators' deliberations.[22]

A second complaint is that the process of selecting arbitrators is not sufficiently independent, a recurring theme in securities arbitration.[23] For example, in NASD arbitrations, NASD staff traditionally selected arbitrators from lists of "public" and "nonpublic" arbitrators. The difference between the two is that "nonpublic" arbitrators have close personal or professional relationships with the securities industry. Following a review by an Arbitration Policy Task Force, the NASD altered the method of selection (replacing selection by staff with a "list-selection" method) but did not adopt the precise list-selection method recommended by the task force and continued to employ the bifurcated public/nonpublic classification scheme.[24] Even after the NASD adopted those recommendations, some experts continue to claim that arbitration selection still remains unfair, accords too much discretion to NASD staff, and does too little to dispel the perception of industry bias in securities arbitration.[25] Indeed, a recent report on securities arbitration found that "[c]ritics of SRO arbitrations consistently point to the presence of industry arbitrators on arbitration panels and the classification of arbitrators as public or non-public as the primary sources of potential pro-industry bias."[26] Proposals in this area range from eliminating the

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21. *Id.*

22. *Id.* at 479-86.

23. For an exhaustive review of the NASD arbitrator selection process, see Cheryl Nichols, *Arbitrator Selection at the NASD: Investor Perception of a Pro-Securities Industry Bias*, 15 OHIO ST. J. ON DISP. RESOL. 63, 73-127 (1999).

24. *See Perino Report*, *supra* note 3, at 19-20. The Task Force proposed that the NASD switch to a three-list system, consisting of public arbitrators qualified to be chairs, public arbitrators not qualified to be chairs and industry arbitrators. *See Ruder Report*, *supra* note 7, at 95.

25. *See* Nichols, *supra* note 23, at 132-34 (concluding that "[i]n situations where there are questions about the impartiality of a decisionmaker, enhancing procedures to select arbitrators will never be sufficient to assure participants that arbitrators are independent."). Nichols calls for a "truly independent group" such as the American Arbitration Association to administer the selection of arbitrators. *Id.* at 133-34. For a similar view expressed even prior to the 1998 reforms, see Seligman, *supra* note 2, at 344 ("If securities arbitration is to be mandatory, the opportunity for investors to at least preserve the right to arbitration before a nonindustry forum strikes me as the most promising alternative to the Ruder Task Force proposal for what is, in essence, mandatory arbitration."). The NASD recently proposed further revisions to the arbitrator nomination process to increase its randomness. *See Perino Report*, *supra* note 3, at 9.

26. *Perino Report*, *supra* note 3, at 19.

use of nonpublic arbitrators to strengthening the limits on industry participants.

A final complaint concerning arbitrator selection is that arbitrators themselves display a bias towards the securities industry.[27] As Michael Perino and others have observed, the empirical evidence for that bold claim is thin.[28] Nonetheless, this sentiment appears to be the driving force behind California's adoption of rigorous disclosure rules for arbitrations in that state.[29] Under the California rules, which currently are the subject of substantial litigation by the securities industry, a party may disqualify an arbitrator on the basis of a wide array of conflicts.[30] Courts must vacate awards if the arbitrator has failed to disclose a known disqualifying conflict or fails to disqualify himself at a party's request due to such a conflict.[31] Moreover, pursuant to the California law, the Judicial Council adopted a series of Ethics Standards applicable to all contractual arbitrations taking place in that state.[32] Those standards set forth certain disclosure obligations (which may lead to an arbitrator's disqualification) and, if unheeded, can result in vacatur of the award.[33]

A second category of complaints about the fairness of securities arbitration concerns the procedures following the arbitrator's nomination.[34] These complaints take a variety of forms. One complaint is that there is too little discovery in securities arbitration (thereby depriving a plaintiff with a potentially meritorious claim of the

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27. *See* Barbara Black, *The Irony of Securities Arbitration Today: Why Do Brokerage Firms Need Judicial Protection?*, 72 U. CIN. L. REV. 415, 448 (2003) ("[S]ome investors' attorneys believe that [the practice of including an industry representative on SRO panels] builds in a pro-industry bias.").

28. *Perino Report*, *supra* note 3, at 3 ("[T]here is little if any indication that undisclosed conflicts represent a significant problem in SRO-sponsored arbitrations."); *id.* at 34-36 (summarizing data showing that "arbitration participants believe that their arbitrations were fair and impartial."); *see also Ruder Report*, *supra* note 7, at 18 ("[A]lthough many investor representatives claim that SRO sponsored securities arbitration is unfair, neither the independent studies conducted, nor the statistics on the results of customer-broker arbitrations, support this conclusion.").

29. *See Perino Report*, *supra* note 3, at 35 ("The California Ethics Standards are primarily concerned with public perceptions on the fairness of arbitration proceedings.").

30. CAL. CIV. PROC. CODE § 1281.9 (West 2005). On the litigation, see Credit Suisse First Boston Corp. v. Grunwald, 400 F.3d 1119 (9th Cir. 2005); NASD Dispute Resolution, Inc. v. Judicial Council of Cal., 232 F. Supp. 2d 1055 (N.D. Cal. 2002).

31. CAL. CIV. PROC. CODE § 1286.2 (West 1982 & Supp. 2005).

32. CAL. CIV. PROC. CODE § 1281.85 (West 1982 & Supp. 2005); Ethics Standards for Neutral Arbitrators in Contractual Arbitration, CAL. R. CT., Div. VI.

33. CAL. CIV. PROC. CODE § 1286.2 (West 1982 & Supp. 2005).

34. For a good summary of some of the procedural issues in arbitration that have attracted criticism, see Black, *supra* note 27, at 445-49.

documentation necessary to prove his case). Another is that arbitral fees are excessive and outstrip the fees that one would normally bear to commence a lawsuit in the court system.

A third category of fairness-related criticisms concerns the arbitral awards themselves. These criticisms generally take two forms. One type of criticism highlights the form of the award—securities arbitrators, until quite recently, have not been required to provide written opinions (apart from the measly requirements of the SROs) or to provide written reasons for their awards.[35] A second concerns how arbitrators apply the law (to the extent that is discernible in a world where they do not provide reasons for their awards).[36] According to these criticisms, arbitrators do not follow the law, misapply the law or reach unjust results.

Many of the reforms—whether proposed in the literature or implemented by the institutions—have relied largely on regulatory solutions. Each reflects a basic premise—that one set of rules can remedy the shortcomings of another. But as each new wave of reforms is followed by new claims of unfairness and calls for yet new rules, one begins to wonder whether a "regulatory" approach is really the optimal one. Particularly if we accept the oft-heard premise that the arbitral system favors the industry (the repeat player in these disputes), then regulatory reforms are unlikely to be an effective long-term solution. Basic economics suggests that, over time, both the industry and the agencies will adapt their behavior to the new legal regime, which is perhaps precisely why each new wave of reforms is met with academic criticism claiming that the reforms did not go far enough. Rather than simply imposing a rule on arbitrators and institutions in an effort to reach a desirable result, wouldn't it be better if we designed the market in a way to give the players an incentive to reach those results on their own?[37]

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35. *See* Seth Lipner, *Ideas Whose Time Has Come: The Single Arbitrator and Reasoned Awards*, *in* SECURITIES ARBITRATION 2000: TODAY'S TRENDS, PREDICTIONS FOR TOMORROW 659, 661 (David E. Robbins ed., Practising Law Institute 2000). The NASD Board of Governors recently approved an amendment to its Code of Arbitration Procedure giving parties the option of requesting a written explanation for the panel's decision. *See Press Release*, NASD, New Arbitration Rule Requires Award Explanations Upon Investor Request (Jan. 27, 2005), *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013145.

36. For a good summary of these critiques, see Black, *supra* note 27, at 449-51.

37. For other pieces in the scholarly literature that identify how liability rules can harness market forces to produce good results in arbitration, see Maureen A. Weston, *Reexamining Arbitral Immunity in an Age of Mandatory and Professional Arbitration*, 88 MINN. L. REV. 449 (2004); Susan Franck, *The Liability of International Arbitrators: A Comparative Analysis and Proposal for Qualified Immunity*, 20 N.Y.L. SCH. J. INT'L &

The next Part suggests how to harness such market mechanisms to decouple the incentives of the industry parties from the incentives of the arbitrators and arbitral institutions.

II. The Model

The model proposed here depends on stripping away the immunity that arbitrators and arbitral institutions traditionally have enjoyed. All arbitrators, including those in the securities industry, enjoy an absolute immunity from civil actions for damages provided that they perform arbitral acts within their jurisdiction.[38] This immunity is extremely broad and covers a variety of wrongful acts, ranging from legal errors[39] to bad faith misconduct.[40] Arbitral institutions such as the NASD and the NYSE also enjoy a broad immunity from civil action. This also covers a wide range of wrongful acts, ranging from mishandling of the arbitrator's appointment[41] to acting contrary to its own rules.[42]

I propose that we strip arbitrators and arbitral institutions of this immunity. The limitations on an arbitrator's and arbitral institution's immunity from suit should no longer depend on a legal rule imposed as a regulatory matter. Instead, the immunity, if any, should come in the form of contractual liability waivers negotiated between the parties, the arbitrators and where appropriate, the institution. [43] Elsewhere, I have sketched out the economic analysis supporting this model, and, in the interest of brevity, do not repeat that analysis here.[44] Instead, I offer its

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COMP. L. 1, 7-8 (2000); Andrew Guzman, *Arbitrator's Liability: Reconciling Arbitration and Mandatory Rules*, 49 DUKE L.J. 1279 (2000).

38. For a recent decision extending arbitral immunity to the arbitrators and administering institution, see Prudential Bache Secs. (Hong Kong) Ltd. v. NASD Dispute Resolution, Inc., 289 F. Supp. 2d 438 (S.D.N.Y. 2003).

39. *See, e.g.*, Arthur A. Chaykin, *The Liabilities of Mediators: A Hostile Environment for Model Legislation*, 2 OHIO ST. J. ON DISP. RESOL. 47, 66 (1986).

40. 1 MACNEIL ET AL., FEDERAL ARBITRATION LAW: AGREEMENTS, AWARDS AND REMEDIES UNDER THE FEDERAL ARBITRATION ACT § 31:17 (1994 & Supp. 1999).

41. Theile v. RML Realty Partners, 18 Cal. Rptr. 2d 416, 417 (Ct. App. 1993).

42. Olson v. NASD, 85 F.3d 381, 382 (8th Cir. 1996).

43. In practice, parties may be unlikely to negotiate with the arbitrator directly over the immunity rule (though this is perhaps more likely in *ad hoc* arbitration). Instead, any contractual limit on liability likely is to be incorporated by reference to the institutional rules governing arbitration. While some might argue that this will simply amount to a contract of adhesion over which the parties have no choice, this does not follow as a theoretical matter, for, as I explain below, arbitrators and arbitral institutions may choose to compete along this criterion by offering a menu of options to the parties. I am grateful to Barbara Black for her critique of this point.

44. Rutledge, *supra* note 15, at 151.

highlights and explain how it would operate.

I have previously explained that, in thinking about issues of immunity, we should distinguish between two forms.[45] First, there is "legal immunity." Legal immunity means an immunity from civil suits for monetary damages that is imposed by operation of law, regardless of the parties' expectations. In the United States, it provides an absolute bar to liability for the arbitrator and the administering institution, provided that they are performing arbitral acts and acting within their jurisdiction—relatively simple conditions as courts have interpreted them. Second, there is "contractual immunity." Contractual immunity means immunity from civil suit for monetary damages that applies as a result of a term of the arbitrator's mandate, either expressly negotiated with the parties or, more frequently, incorporated into their arbitration agreement by reference to an institution's rules. Most of the major arbitral institutions, including the NASD and NYSE, contain some form of contractual immunity in their institutional rules. My proposal merely requires courts (which are generally the progenitors of arbitral immunity) to strip away "legal immunity." As I discuss below, arbitrators and arbitral institutions remain free to limit their liability through contractual arrangements that cap damages or waive liability to the extent permitted by law.

How would the proposal operate? It would essentially put arbitrators and arbitral institutions on the same level playing field as all other professionals.[46] Has the arbitrator or the arbitral institution acted in a reasonable manner? In making the reasonableness determination, a court may take into account professional norms that influence the reasonableness standard, much as it would do in an ordinary malpractice case.[47]

Consider the simplest case such as the arbitrator's or the institution's breach of an arbitral rule. In the event that the arbitrator failed to heed a rule, the aggrieved party could sue her, a remedy unavailable under current law. Damages, as in any other tort suit, would be tied to the harm suffered by the party and caused by the arbitrator's misconduct. While current law gives the arbitrator little incentive to

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45. *Id.* at 156-58.

46. One of the theoretical justifications for arbitral immunity is that arbitrators are the functional equivalent of judges who themselves are entitled to an absolute immunity from civil suit for monetary damages. *Id.* As I have explained elsewhere, this analogy between arbitrators and judges breaks down on closer comparison.

47. *See* DAN B. DOBBS, LAW OF TORTS HORNBOOK SERIES § 122 (2000).

"take care" that her duties be executed, the proposal here gives her an incentive to exercise greater care in the discharge of her duties.

Now consider a harder case. A variety of doctrines allow arbitrators and arbitral institutions to exercise jurisdiction over non-signatories to an arbitration agreement.[48] Those doctrines are highly controversial, for they derogate from the fundamental principle that arbitration is the product of voluntary contractual relations among the parties to an underlying agreement. Aggressive expansion of those doctrines risks dragging unwitting parties before a tribunal to whose jurisdiction they have not consented and yet whose judgment ultimately may bind them. Under current law, however, arbitral immunity shields the arbitrator and the arbitral institution from liability even if they erroneously concluded that they could exercise jurisdiction over the non-signatory.[49] At present, the only remedy to the aggrieved party may be a vacatur action under the Federal Arbitration Act, which hardly "makes whole" the party who has had to bear the cost of participating in an arbitration to which he did not consent. Under the proposal here, the non-signatory dragged into the arbitration through an unduly aggressive exercise of jurisdiction would have a remedy against the arbitrator and the arbitral institution. Unlike the prior example, any liability waivers would not apply because the non-signatory, by definition, has never consented to the terms of the arbitration. The upshot, then, would be to reduce aggressive expansions of the non-signatory doctrine.

Finally, consider perhaps the most difficult case, an arbitrator who reaches a substantively erroneous result—awarding relief to a party on the basis of an erroneous understanding of the governing legal principle. Here too, the only remedy currently available to the party aggrieved by the decision is vacatur of the award, which may provide the party relief from an adverse judgment but does not provide full relief. The aggrieved party may have had valid counterclaims, which the arbitrator did not credit. Or the party may have been forced to endure a more protracted proceeding than necessary if the arbitrator, applying the correct legal principle, could have resolved the case at an earlier stage (such as non-arbitrability or a statute of limitations defense). Under the proposal here,

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48. For a report on recent decisions in this area, see Barbara Black, *Arbitration Update Survey of Recent Significant (Mostly) Securities Arbitration Decisions Spring 2004*, 1440 PRAC. L. INST. CORP. 61, 73-74 (2004).

49. *See, e.g.*, Intergen N.V. v. Grina, 344 F.3d 134, 144-50 (1st Cir. 2003) (summarizing various theories under which arbitration may have jurisdiction over non-signatories).

the party aggrieved by a substantively erroneous decision would have an action against the arbitrator for that result.

This Part has sketched out the contours of a regime without legal immunity for arbitrators and arbitral institutions. The next Part applies that model to show how it addresses some of the perceived problems of fairness in securities arbitration that were identified in Part I.

III. Benefits of the Model

Part I of this Essay organized critiques about securities arbitration into three basic clusters: (1) complaints about arbitrator selection; (2) complaints about unfair procedures and (3) complaints about erroneous or unjust results. This Part shows how an arbitration regime without immunity effectively addresses the first and third problems and partly addresses the second problem.

Stripping arbitrators and arbitral institutions of their immunity would go far toward addressing complaints about arbitrator selection. To the extent that the complaint concerns the quality and training of arbitrators, a world of potential liability should ensure a stronger pool of arbitrators. Those arbitrators who doubt their abilities or do not train with sufficient seriousness will have a strong disincentive to continue their participation in the industry, for fear of engaging in an act that will result in liability. By contrast, the regime should appeal to those arbitrators with sufficient confidence in their abilities to avoid a "liability producing event."[50] Moreover, institutions, stripped of their immunity, would have a greater incentive to monitor the quality of existing and potential arbitrators, particularly under systems such as the NASD's where the institution is involved in their recruitment and, occasionally, their selection.[51]

Moreover, the prospect of liability could have very salutary effects

50. *See* Guzman, *supra* note 37, at 1303.

51. Theoretically, for similar reasons, the model could be expected to promote competition among arbitral institutions as well. Historically, however, securities arbitration has not been marked by substantial competition among providers. As one veteran observed to me during the Investor Rights Symposium, the NASD is "the only game in town." A few years ago, the NASD tried a pilot project that allowed securities arbitration participants to use other forums. Despite this opportunity, nearly all participants continued to opt for the NASD. In my view, even if the market has not historically proven amenable to competition, removing barriers such as immunity is nonetheless desirable as it creates the conditions to competition and enables future competitors to enter the market more easily. I am especially grateful to Barbara Black for her comments on this point.

for the supply of potential arbitrators. New entrants to the market encounter an obvious "bonding" problem—how can they develop a sufficient reputation for themselves so as to persuade parties and/or arbitral institutions to nominate them? Stripping arbitrators of immunity overcomes this problem.[52] New entrants can compete by offering their services without requiring liability waivers. In essence, they could signal to potential "purchasers" a sufficient confidence in their abilities that they are unlikely to engage in a "liability producing event." The same holds true for arbitral institutions—as they attempt to compete for a share of the "arbitral" or dispute resolution marketplaces, they can seek to differentiate themselves from other providers of dispute resolution services along this axis.

Stripping arbitrators and arbitral institutions of their immunity does a relatively less effective job at addressing the "unfair procedures" problem. It does not affect arbitrator's power to order discovery. Nor does it directly address the complaints about fees. In one respect, however, the proposal here does have a salutary effect on arbitral procedures. It provides a greater incentive for arbitrators and arbitral institutions to ensure that they observe the governing law and rules. As noted above, the current regime of legal immunity protects arbitrators and arbitral institutions even when they have violated their own rules (and a surprising number of reported opinions raise this problem).[53] Stripping them of that immunity provides an incentive for both entities to ensure that their rules (the ones that have been incorporated by reference into the parties' agreement) are in fact observed.

Stripping arbitrators and arbitral institutions of their immunity should improve the quality of awards. As noted above, one of the main critiques of securities arbitration is that securities arbitrators often do not provide written opinions or reasons for their awards.[54] Stripping them of immunity provides them a greater incentive not to ignore these steps. An

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52. *See* Stephen J. Choi, *The Problem With Arbitration Agreements*, 36 VAND. J. TRANSNAT'L L. 1233, 1238 (2003) ("Imposing liability on arbitrators and arbitral institutions . . . provides one possible mechanism of ensuring arbitrator fidelity without resorting to high-cost reputational bonding.").

53. *See* Weston, *supra* note 37, at 491-93.

54. Black & Gross, *supra* note 12, at 991, 1000. Recent proposed changes to the arbitral rules may increase the number of written opinions. *See* Press Release, NASD, New Arbitration Rule Requires Award Explanations Upon Investor Request (Jan. 27, 2005), *available at* http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ss DocName=NASDW_013145; Ethics Standards for Neutral Arbitrators in Contractual Arbitration, CAL. R. CT., Div. VI.

arbitrator who does not provide a written opinion or reasons for his award runs the risk of having to justify that award in a subsequent lawsuit where the basis for his decision is challenged. By contrast, an arbitrator who provides a written opinion and reasons for his award has provided a clearer set of justifications for his decision which, so long as they are defensible, will avoid the suit that challenges whether the arbitrator has discharged his duty.[55] Even if a risk-averse arbitrator believes that he is more likely to avoid liability by not providing a written opinion, the specter of liability still will give the arbitrator a greater incentive to make sure that, before he files his awards, he can justify his ruling if he is called to account for it. Finally, regardless of the arbitrator's incentives, stripping institutions of liability enhances their incentives to police arbitrators' awards for quality before they are filed.[56]

This Part has evaluated whether abolition of the immunity doctrine would effectively address the perceived problems with securities arbitration. The next Part addresses some of the anticipated criticisms of the thesis.

IV. Problems With/Limitations on the Model

The proposal offered here surely will invite criticism. This Part anticipates and responds to some of the most likely critiques. I focus on four: (1) the proposal's effect on the market's viability; (2) its effect on vexatious litigation; (3) the workability of its standard of care; and (4) its effect on review of awards.

The most obvious complaint is that stripping arbitrators and arbitral institutions would simply shut down the industry. The risk of liability would deter arbitral institutions from accepting cases. So too would it deter potential arbitrators from entering the industry.

Such an argument is flawed in several respects. Initially, it is empirically wrong. Securities arbitration is not suffering from a shortage of decision makers.[57] This is unsurprising. Service as an arbitrator provides more benefits than the mere fees that they receive for service. In addition to the fees, arbitrators also derive a host of non-monetary

55. For a discussion of how liability rules can enhance substantive results of awards, see Guzman, *supra* note 37, at 1319-20.

56. I am especially grateful to David Lipton for challenging my arguments on this point.

57. *See* Caruso, *supra* note 17, at 472 ("There are thousands—if not tens of thousands—of individuals who are presently approved to serve as arbitrators at the NASD and NYSE.").

benefits from service: (1) they develop a reputation for expertise that leads to further opportunities to gain clients whom they can represent in subsequent arbitrations; (2) they may develop a reputation for expertise that leads to future appointments as arbitrators either in higher stakes arbitrations or in non-SRO arbitrations where fees are higher; (3) their service may lead to future professional opportunities on task forces, in conferences or other forums which themselves lead to future clients or arbitrator appointments.[58]

At the Investors Rights Symposium, we traced through the implications of this argument in greater detail and came to the conclusion that the model might well replace the current system of a large number of minimally compensated arbitrators with a new system consisting of a cadre of well compensated, professional arbitrators like those who operate in other industries. If we assume that stripping arbitrators of immunity would lead to a net exit from the market, such an exit would constrict the supply of available arbitrators. A reduction in supply would drive up the price of each arbitrator. The more lucrative compensation would give potential arbitrators a greater incentive to take on more cases and, in the long run, lead to a pool of professional, potentially full-time arbitrators. As explained below, these arbitrators also would have a greater incentive to "take care" in the discharge of their duties.

Moreover, the experience of other industries with liability rules suggests that collapse of the industry would not follow. By the logic of this argument, no industry could survive under the specter of liability. Yet, contrary to the argument, most industries—whether lawyers, accountants, or any other profession—thrive despite the specter of liability for their misdeeds.[59] As with any other industry, arbitrators and arbitral institutions can rely on market mechanisms to limit their potential exposure.

The most obvious strategy would be to employ liability waivers, as many industries do. Such waivers would accomplish some of the goals currently achieved by immunity. Yet they would differ from the immunity rule in two respects. First, liability waivers, unlike immunity, would not be absolute—basic principles of tort law teach that such waivers cannot excuse liability for intentional, reckless or, in some cases,

58. On the reputational incentives of arbitrators, see Guzman, *supra* note 37, at 1303.

59. *See* Weston, *supra* note 37, at 510 ("No other private professional exercising difficult discretionary functions or services is so immune.").

grossly negligent torts.[60] Second, the liability waivers, unlike immunity, would not be universal. Either arbitral institutions or, more likely, arbitrators may choose to compete in the market by not requiring liability waiver as a condition for their performance; their willingness to expose themselves to liability thereby functions as a sort of "reputational bonding," which may be particularly important for new entrants.[61]

A second strategy short of liability waivers may be damages caps. One logical cap in the typical SRO arbitration may be to limit damages to the arbitrators' fee. Arbitrators in SRO arbitrations, as opposed to arbitrations before the AAA or ICC, receive relatively modest stipends for their participation in daily hearings.[62] Tying the limit of arbitrators' exposure to the amount of their fee provides a new incentive for arbitrators to "take care" in the execution of their duties while not presenting them with such potential exposure that it far outweighs their "gain" from serving as an arbitrator.

To the extent liability waivers and damages caps do not enable providers adequately to manage their risk, insurance presents a third and final strategy. Such insurance schemes are quite familiar to the professional services industry (consider legal malpractice insurance). Arbitration is a particularly well positioned industry to enter the insurance market. Many arbitrators affiliate with particular institutions (e.g., AAA, NASD, JAMS), and those institutions, working in conjunction with the insurers, could calculate risk premiums for the market participants. Additionally, the insurers would provide an additional bonding mechanism for the industry, as they would have a keen financial interest in assessing the risk that an arbitrator or institution might produce a "liability producing event," much like they currently calibrate health or automobile insurance premiums to the risk factors of a particular insured or class of insureds.[63]

A second criticism about the proposal is that it would induce vexatious litigation. The argument goes as follows: litigants before the tribunal would use the threat of litigation to influence the outcome; a

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60. *See* DOBBS, *supra* note 42, § 212.

61. In this respect, my proposal may well converge with Professor Weston's proposal of qualified immunity. *See* Weston, *supra* note 37, at 449. Our proposals differ in at least one important respect. Where Professor Weston relies on a regulatory rule to achieve this state of affairs, I am willing to rely on the market to decide whether this—or some other—state of affairs is optimal.

62. *Perino Report*, *supra* note 3, at 16.

63. On the effect of liability for the arbitrator's tolerance of risk, see Guzman, *supra* note 37, at 1326-29.

risk-averse arbitrator would be more prone to craft his award in favor of the party more likely to bring a suit; to the extent a party is dissatisfied with the outcome, he may choose to retaliate against the arbitrator through litigation even if such litigation is not meritorious simply in order to extract a settlement. To the extent one believes that securities arbitration is biased in favor of the industry (as the more powerful player), arbitration without immunity is likely to exacerbate the problem by encouraging the industry to employ heavy-handed tactics against uncooperative arbitrators.

Such a criticism is more formidable than the former one, but several responses are possible.[64] First, it would not be in the long-term economic interest of the industry to pursue such a strategy. Vexatious litigation harms the industry, the repeat player in the litigation. A rational arbitrator faced with a vexatious litigant as a party either would decline to hear the case or would demand some type of premium to protect himself against the prospect of a future lawsuit. Such a market response would either force the vexatious litigant to adjust its behavior or eventually drive the vexatious litigant out of the market; no arbitrator would be willing to sit for a case involving such a party.[65]

Second, it is not necessarily in arbitrators' interest to calibrate their award in favor of a particular party. Arbitrators may wish to develop a reputation for independence.[66] Such a reputation carries with it two potential benefits—the opportunity to be named as chairman in future three-arbitrator panels and the opportunity to be named as the sole arbitrator in single-arbitrator panels. In both securities and non-securities arbitration, this degree of independence is a necessary prerequisite for such an appointment. An arbitrator who cultivates too great a reputation as an industry-friendly decision maker runs the risk of being excluded from such potentially lucrative appointments, either as a result of a formal classification or, in the case of SROs, having the investor strike his name from the list of possible arbitrators.

Finally, to the extent that either of the two prior predictions proves wrong (and I recognize that both are subject to empirical testing), courts

64. For one response, see *id.* at 1324-25.

65. A slight variant on this criticism is to claim that the vexatious repeat litigant might not be the industry player but instead a particularly combative member of the highly sophisticated investor-side bar. This presents a different challenge for the model, for the client of the vexatious investor attorney might well bear the cost of her counsel's reputation for litigiousness. Nonetheless, I think that the other responses given in this section may address the problem of the vexatious investor's counsel.

66. *See* Guzman, *supra* note 37, at 1303.

have other tools at their disposal to deter vexatious litigation. Barbara Black identifies a number of these tools in her important essay on the ironic effort by some brokerage firms to use the courts as an antidote to arbitration. These tools include requiring the brokerage firm to post a bond, disciplinary actions by the SRO against a firm that brings a frivolous motion and more aggressive use of Rule 11 sanctions under the FRCP.[67] While Black discusses these tools in the context of deterring industry over-reliance on vacatur actions, the logic of her argument supports use of some of these tools as a mechanism for deterring vexatious litigation by industry parties against arbitrators.

A third criticism is that the standard of care would be unworkable, especially in cases where the gravamen of the complaint against the arbitrator is that he did not correctly apply the law. This line of argument is suggested by an important recent article by Barbara Black and Jill Gross.[68] The argument would run as follows: securities arbitrators do not necessarily follow the law; sometimes, the law is complex; sometimes, arbitrators explicitly depart from the law and apply principles of equity.[69] Stripping arbitrators of immunity lays a trap for them because they may not know *ex ante* exactly what the proper standard of care is and, therefore, even well-meaning arbitrators may fall into a liability trap.

There is some force to this argument, but it overlooks the substantial benefits to be derived through stripping arbitrators of immunity. In a world without immunity, arbitrators have *less* of an incentive to discern precisely the governing law and the scope of their discretion (if any) to

67. Black, *supra* note 27, at 444.

68. *Cf.* Black & Gross, *supra* note 12, at 1006-30. In fairness to Black and Gross, they do not direct this argument at the proposal made here. Indeed, some of their analysis, discussed below, actually supports it. I simply wish to give them special acknowledgement here because their article spawned my thinking about this potential criticism.

69. At the Investor Rights Symposium, some participants took issue with this argument. They claimed that securities arbitration is *better off* because arbitrators do not feel strictly bound to apply the law and instead may appeal to principles of equity and conscience in reaching what they believe to be a just decision. Further conversation led me to conclude that we simply had a philosophical difference here. Contrary to those observers, I do not believe that arbitration inherently contains a license for the private decision maker to depart from the legal principles governing the resolution of the dispute. Certainly, there are cases of arbitrators deciding cases *ex aequo et bono*, but those principles in my view should only apply where the parties expressly have authorized their use. Otherwise, I think arbitration risks becoming unbounded both from the rule of law and from the parties' agreement. I am grateful to Barbara Black for pushing my thinking on this point.

apply equitable principles to resolve the case. Despite the assurances of the Supreme Court in *McMahon*, the "manifest disregard of the law" standard is toothless and, as a consequence, "there is no meaningful review of arbitrator awards to assure arbitrators are applying the law."[70] The specter of liability provides the arbitrator (like any other professional) a powerful economic incentive to "drill down" into the applicable law to ensure that the reasoning supporting his or her decision is airtight—not simply the choice of governing legal principles but also their application. In this respect, far from creating a trap for the arbitrator, a world without immunity can, I submit, be expected to improve the quality of decisions because arbitrators no longer can avoid the thorny issues.[71]

A final, perhaps the strongest, attack on my proposal is that a world without immunity will encourage disgruntled parties to use suits against the arbitrator as the basis for a collateral attack on the award. I previously have answered this criticism in a general context and can advance additional answers in the securities context.[72] Initially, it is important to note that the collateral attack problem only will affect a small subset of cases. It only applies to those cases where a party has a complaint about the substance of the award, not those where the complaint is based on misconduct by the arbitrator or the institutions (such as missing a deadline).[73] Moreover, within that subset, the grounds for vacatur are themselves extremely narrow, and the opportunity for judicial review of the award's substance virtually non-existent (apart

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70. Black & Gross, *supra* note 12, at 1030. On the toothlessness of the manifest disregard standard, see *id.* at 1031-35; *see also* Black, *supra* note 27, at 434-39.

71. There is, I suppose, a collateral problem about an arbitrator acting in good faith and simply being unaware of the governing legal or equitable rule. Those cases, however, are not problematic in my view. To the extent that the party has brought the governing rule to the arbitrator's attention, then it is entirely appropriate to hold the arbitrator accountable if he or she has proceeded to ignore it (as is the case right now in the manifest disregard of the law doctrine). On the other hand, if the parties have not brought the rule to the arbitrator's attention in their briefing, then I believe waiver doctrines should shield the arbitrator. *Cf.* Bel-Ray Co. v. Chemrite (Pty.) Ltd., 181 F.3d 435, 440-41 (3d Cir. 1999). Just as arbitrators cannot be bound by choice-of-law arguments to the extent that parties do not raise them in a timely fashion, so too can it not be "unreasonable" for them not to rely on such rules in crafting their awards.

72. Rutledge, *supra* note 15, at 175-76.

73. As I see these issues, it is only the substantive attacks that present the risk. Other complaints such as missed deadlines or failure to observe the institutional rules do not provide a basis for vacating the arbitral award. As a result, suits on these grounds would not present the collateral attack problem. I am grateful to Barbara Black for pushing my thinking on this point.

from the toothless "manifest disregard of the law" doctrine). Consequently, this criticism only will affect a narrow set of cases where the arbitrator allegedly has engaged in misconduct that might also provide a basis for vacating the arbitral award. Furthermore, as already explained above, a regime with immunity should give arbitrators an incentive to reach more legally defensible results. Finally, to the extent collateral attacks would occur, courts have mechanisms at their disposal to ensure that any suit against the arbitrator does not become satellite litigation against the award. For example, courts may exercise their equitable discretion to stay the suit against the arbitrator until the aggrieved party has completed any vacatur action on the award.

Conclusion

Ever since the Supreme Court held that securities disputes were arbitrable, questions have lingered over the fairness of those arbitrations. In the nearly two decades since the Supreme Court's decisions, observers have proposed, and the industry has implemented, a variety of reforms aimed at addressing actual or perceived unfairness of securities arbitrations. At bottom, however, these proposals remain mired in the belief that one can achieve "fairness" in an industry through regulation rather than market forces. The proposal here—stripping arbitrators and arbitral institutions of their legal immunity from suit—represents one effort at tapping market forces to achieve the desired fairness. Such a result has salubrious effects on the supply of arbitrators, the content of awards, and, partly, the procedures employed in the arbitration. Nor is this proposal simply an academic pipe dream—most of the rules according arbitrators and arbitral institutions' legal immunity derive from judge-made law, and thus can be undone through judicial decision as well.[74] To be sure, such a proposal is controversial and not free from criticism, yet many of those criticisms can be met. Consequently, a world without legal immunity might well yield a net benefit for securities arbitration.

74. *E.g.*, Baar v. Tigerman, 189 Cal. Rptr. 834 (Ct. App. 1983).