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## Arbitration Case Law Update 2012

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**Arbitration Case Law Update 2012**

By

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April 17, 2012

Parties to arbitration agreements sometimes invoke the judicial system to litigate collateral issues arising out of the arbitration process, such as arbitrability of some or all of the claims, arbitrator bias, and award enforcement or vacatur. When deciding these collateral issues arising out of securities arbitration, courts interpret and apply the Federal Arbitration Act (“FAA”).<sup>1</sup> This chapter identifies recent decisions by the Supreme Court under the FAA, as well as selected lower court decisions that could have an impact on securities arbitration practice.

## **I. U.S. Supreme Court**

Since PLI published the Arbitration Law Update 2011 last June, the United States Supreme Court decided three new arbitration cases, two on arbitrability and one on FAA preemption. The Court also dismissed a writ of certiorari in one other case that it had appeared ready to decide.

### **A. Arbitrability**

#### **1. Arbitrability of claims in multi-claim action**

In *KPMG LLP v. Cocchi*,<sup>2</sup> in a *per curiam* opinion, the Court held that, when faced with a motion to compel arbitration of a multi-claim lawsuit, courts must compel arbitration of those claims that are arbitrable even if they find that other claims in the lawsuit are not arbitrable. In that case, a group of limited partnership investors sued (among others) the auditor KPMG, alleging it failed to use proper auditing standards when auditing

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<sup>1</sup> 9 U.S.C. §§ 1 *et seq.* (2010). Because securities arbitration necessarily “involves commerce” (FAA § 2), courts apply the FAA to issues arising out of securities arbitrations. *See* *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002).

<sup>2</sup> 132 S.Ct. 23 (2011).

the financial statements of the limited partnerships.<sup>3</sup> The investors pled in their complaint four distinct causes of action: negligent misrepresentation, professional malpractice, aiding and abetting a breach of fiduciary duty, and violation of the Florida Deceptive and Unfair Trade Practices Act. KPMG moved to compel arbitration of all four claims, citing the arbitration clauses in the auditor services agreement with the partnerships.<sup>4</sup>

The trial court denied the motion to compel, and the Florida District Court of Appeal affirmed, even though its opinion suggests that it concluded that only two of the four claims (negligent misrepresentation and the Florida statutory claim) were nonarbitrable.<sup>5</sup> According to the Supreme Court, the Florida appellate court's opinion "indicates a likelihood that [it] failed to determine whether the other two claims in the complaint [professional malpractice and aiding and abetting a breach of fiduciary duty] were arbitrable."<sup>6</sup> The Court stated, "when a complaint contains both arbitrable and nonarbitrable claims, the Act requires courts to 'compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums.'"<sup>7</sup> Thus, the Supreme Court remanded the case back to the Florida Court of Appeal to

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<sup>3</sup> *Id.* at 24. The three partnerships at issue were invested with Bernard Madoff, and ultimately lost millions of dollars. *Id.*

<sup>4</sup> *Id.* at 25. The arbitration clause provided that "[a]ny dispute or claim arising out of or relating to ... the services provided [by KPMG] ... (including any dispute or claim involving any person or entity for whose benefit the services in question are or were provided) shall be resolved' either by mediation or arbitration." *Id.* (citing audit services agreement).

<sup>5</sup> *Id.* at 25.

<sup>6</sup> *Id.* at 24.

<sup>7</sup> *Id.* at 26, citing *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 217 (1985).

determine whether the remaining two claims should be sent to arbitration.<sup>8</sup>

While this holding may seem unremarkable, one aspect of the *Cocchi* decision raises concern. The *Cocchi* Court heavily cited from *Dean Witter Reynolds, Inc. v. Byrd*,<sup>9</sup> in which it held that a federal district court must compel arbitration of pendent state law claims even if the court asserts jurisdiction over the federal law claims. The *Cocchi* Court quoted the *Byrd* Court's citation to §§3 and 4 of the FAA and the proposition that "the Act leaves no place for the exercise of discretion by a district court, but instead mandates that district courts *shall* direct the parties to proceed to arbitration on issues as to which an arbitration agreement has been signed."<sup>10</sup>

However, the Supreme Court has never held expressly that any section of the FAA other than §2 applies in state court, yet it justified its holding in *Cocchi* based on the language of FAA §§3 and 4, which presumably did not apply in the Florida state courts. *Byrd* came to the Supreme Court through the federal courts, not state courts, and thus, in that case, the district court and ultimately the Supreme Court properly applied §§3 and 4 of the FAA. By citing to this aspect of the *Byrd* Court's holding, the *Cocchi* Court may have suggested (incorrectly, in my view) that FAA §§3 and 4 apply in state court.

## **2. Arbitrability of federal statutory claims**

The Supreme Court also addressed the arbitrability of federal statutory claims in the past year. Since its watershed

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<sup>8</sup> *Id.* at 26.

<sup>9</sup> 470 U.S. 213 (1985).

<sup>10</sup> *Cocchi*, 132 S.Ct. at 25-26 (quoting *Byrd*, 470 U.S. at 218) (emphasis in original).

decision in *Shearson/American Express Inc. v. McMahon*<sup>11</sup> that federal securities law claims are arbitrable, the Supreme Court has held consistently that claims arising under federal statutes are arbitrable as a matter of public policy.

Its January 2012 decision in *CompuCredit Corp. v. Greenwood*<sup>12</sup> was no exception. In *CompuCredit*, the Court resolved a circuit split and held that claims arising under the Credit Repair Organizations Act<sup>13</sup> are arbitrable. The Ninth Circuit had decided in the opinion below that Congress intended to preclude arbitration of claims arising under the CROA, a consumer protection statute, when it provided consumers with a “right to sue” violators of prohibitions in the statute.<sup>14</sup> Because that Ninth Circuit decision conflicted with opinions from the Third and Eleventh Circuits, the Supreme Court agreed to resolve the circuit split.

The Court, in a 6-3 majority opinion authored by Justice Scalia, concluded that the CROA’s requirement that credit repair organizations notify consumers that they “have a right to sue a credit repair organization that violates the Credit Repair Organization Act” does not reflect Congressional intent to preclude arbitration of claims arising under the Act.<sup>15</sup> The Court similarly concluded that the Act’s nonwaiver provision does not preclude the enforcement of an arbitration agreement that waives the right to bring CROA claims in court.<sup>16</sup> These provisions did

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<sup>11</sup> 482 U.S. 220 (1987).

<sup>12</sup> 132 S.Ct. 665 (2012).

<sup>13</sup> 15 U.S.C. § 1679 *et seq.* (“CROA”).

<sup>14</sup> *Greenwood v. CompuCredit Corp.*, 615 F.3d 1204, 1206-07 (9th Cir. 2010).

<sup>15</sup> *CompuCredit*, 132 S.Ct. at 669-70.

<sup>16</sup> *Id.* at 670-71.

not create a consumer’s right to bring a CROA claim in court; it only created a consumer’s right to receive the statutory notice.<sup>17</sup>

What is notable about this decision is that consumers pursue many claims arising under the CROA in class actions, as they typically are too small for consumers to bring them individually. Combined with the Court’s endorsement of class action waivers of consumer protection claims in *AT&T Mobility, LLC v. Concepcion*,<sup>18</sup> *CompuCredit* could eliminate the ability of many consumers to vindicate their CROA statutory rights.

### **B. FAA Preemption**

Another consistent holding in the Supreme Court’s FAA jurisprudence is that FAA §2 – which declares that agreements to arbitrate are “valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract”<sup>19</sup> – preempts state laws that place an arbitration agreement on unequal footing from other contracts.<sup>20</sup>

In February 2012, in a *per curiam* opinion, the Court yet again held that the FAA preempted a state law. In *Marmet Health Care Center, Inc. v. Brown*,<sup>21</sup> the Court ruled that the FAA preempted a West Virginia Supreme Court of Appeals rule that voided as against public policy pre-dispute arbitration clauses in nursing home contracts with respect to negligence claims. Specifically, the West Virginia high court had held in *Brown v.*

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<sup>17</sup> *Id.*

<sup>18</sup> 131 S. Ct. 1740 (2011). See *infra* Part II.A.

<sup>19</sup> 9 U.S.C. §2. The latter phrase of this section is known as the FAA’s “savings clause.”

<sup>20</sup> See, e.g., *AT&T Mobility LLC v. Concepcion*, 131 S.Ct. 1740 (2011); *Preston v. Ferrer*, 552 U.S. 346 (2008).

<sup>21</sup> 132 S.Ct. 1201 (2012).

*Genesis Healthcare Corp.*<sup>22</sup> that, “as a matter of public policy under West Virginia law, an arbitration clause in a nursing home admission agreement adopted prior to an occurrence of negligence that results in a personal injury or wrongful death, shall not be enforced to compel arbitration of a dispute concerning the negligence.”<sup>23</sup> The West Virginia court attempted to distinguish the Supreme Court’s line of FAA preemption cases by carving out an exception for negligence claims deriving from personal injury or wrongful death.

The Supreme Court easily dispensed with the West Virginia high court’s reading of the FAA, reiterating that the FAA displaces any state law that outright prohibits the arbitration of a particular type of claim.<sup>24</sup> However, the Court carefully carved out an option for the state court to apply a contract-neutral state unconscionability doctrine to void the arbitration agreement. “On remand, the West Virginia court must consider whether, absent that general public policy [declaring arbitration clauses in nursing home contracts unenforceable for negligence claims], the arbitration clauses in Brown's case and Taylor's case are unenforceable under state common law principles that are not specific to arbitration and pre-empted by the FAA.”<sup>25</sup>

### C. Waiver

Last term, it appeared the Court was poised to interpret the scope of the waiver defense in arbitration: a claim that one party to an arbitration clause has waived its right to arbitrate based on

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<sup>22</sup> \_\_\_ S.E.2d \_\_\_, 2011 WL 2611327 (W.Va. June 29, 2011).

<sup>23</sup> *Marmet*, 132 S.Ct. at 1203, citing *Brown v. Genesis Healthcare Corp.*, \_\_\_ S.E.2d \_\_\_, 2011 WL 2611327 (W.Va. June 29, 2011), App. to Pet. for Cert. in No. 11–391, pp. 85a–86a.

<sup>24</sup> *Marmet*, 132 S.Ct. at 1203-04.

<sup>25</sup> *Id.* at 1204.



conduct in parallel litigation.<sup>26</sup> In *Stok & Associates, P.A. v. Citibank, N.A.*,<sup>27</sup> the Court had agreed to resolve a circuit split over whether prejudice is a required element of the waiver defense or just another factor for courts to consider.<sup>28</sup> In the opinion below, the Eleventh Circuit Court of Appeals concluded that Citibank had not waived its right to arbitrate a claim brought by Stok & Associates, P.A., because Stok did not make the required showing of prejudice.<sup>29</sup> However, the Court never got a chance to decide the issue, as the parties settled their dispute as the 2011-12 term began and the Court dismissed the writ of certiorari.<sup>30</sup>

## II. Notable Lower Court Decisions

### A. FAA Preemption and the fallout from *AT&T Mobility, LLC*

One year has now passed since the Supreme Court's seminal April 2011 decision in *AT&T Mobility, LLC v.*

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<sup>26</sup> While the waiver test varies slightly among the federal circuits, courts typically consider factors such as: (1) the time elapsed from commencement of litigation to the request for arbitration; (2) the amount and nature of litigation, including substantive motions and discovery; and (3) prejudice to the party opposing arbitration. *See, e.g.*, *Nat'l Union Fire Ins. Co. of Pittsburgh, P.A. v. NCR Corp.*, 376 Fed. Appx. 70, 71 (2d Cir. 2010). A recent D.C. Circuit decision illustrates the vitality of the waiver defense. *Zuckerman Spaeder, LLP v. Aufferberg*, 646 F.3d 919, 924 (D.C. Cir. 2011) ("By this opinion we alert the bar in this Circuit that failure to invoke arbitration at the first available opportunity will presumptively extinguish a client's ability later to opt for arbitration.").

<sup>27</sup> 131 S. Ct. 1556 (2011).

<sup>28</sup> *See generally* Brief Opposing Writ of Certiorari, *Stok & Assocs. P.A. v. Citibank N.A.*, 2011 WL 63537, \*7-14 (Jan. 5, 2011) (explaining that a majority of circuits (nine) required a showing of prejudice, and a minority of circuits (three) did not).

<sup>29</sup> *Citibank, N.A. v. Stok & Associates, P.A.*, 387 Fed. Appx. 921 (11th Cir. 2010), *cert. granted*, 131 S. Ct. 1556 (2011).

<sup>30</sup> *Stok & Assoc.*, 131 S.Ct. 2955 (2011).

*Concepcion*,<sup>31</sup> in which it held that the FAA preempts California’s *Discover Bank* rule, which “classif[ied] most collective-arbitration waivers in consumer contracts as unconscionable.”<sup>32</sup> Arbitration law scholars and practitioners expressed immediate concern that the decision would preclude consumers from pursuing individual, low dollar value claims in any forum.

In fact, numerous decisions from states’ high courts post-*AT&T Mobility* reflect unyielding FAA preemption of state law with respect to the enforceability of arbitration agreements containing class action waivers.<sup>33</sup> Likewise, Professor Sternlight’s analysis of federal court reaction in the six months after the case revealed that most decisions applied the *AT&T Mobility* holding rigorously, despite there being ample grounds for distinction from *AT&T Mobility*.<sup>34</sup>

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<sup>31</sup> 131 S. Ct. 1740 (2011). For a detailed discussion of the case, see Jill I. Gross, *Arbitration Case Law Update 2011*, in SECURITIES ARBITRATION 2011, at 205 (Practising Law Institute 2011).

<sup>32</sup> *AT&T Mobility*, 131 S.Ct. at 1746.

<sup>33</sup> See, e.g., *State of W.Va., ex rel. Richmond Amer. Homes of W. Va., Inc. v. Sanders*, 228 W.Va. 125 (2011) (upholding class action waiver in arbitration clause under *AT&T Mobility* but declaring clause unconscionable on other grounds); *NAACP of Camden County East v. Foulke Mgmt. Corp.*, 421 N.J. Super. 404 (2011) (upholding class action waiver but denying motion to compel arbitration on ground that arbitration provisions lacked mutual assent).

<sup>34</sup> See Jean R. Sternlight, *Tsunami: AT&T Mobility v. Concepcion Impedes Access to Justice*, \_\_ OREGON L. REV. \_\_ (forthcoming 2012), available at <http://ssrn.com/abstract=1924365>, at 6 (concluding that “most courts are rejecting all potential distinctions and are instead applying *Concepcion* broadly as a get out of class actions free card”); see, e.g., *Litmanv. Cellco Partnership*, 655 F.3d 225 (3d Cir. 2011) (holding that New Jersey law voiding as unconscionable class action waivers in consumer agreements was preempted by the FAA); *Kilgore v. KeyBank Nat. Ass’n*, \_\_ F.3d \_\_, 2012 WL 718344 (9<sup>th</sup> Cir. Mar. 7, 2012) (holding that the FAA preempts the California doctrine [*Broughton/Cruz*] prohibiting the arbitration of claims for broad, public injunctive relief).

However, a few federal courts have been more willing to distinguish *AT&T Mobility*, and strike down a class action waiver under the "vindicating statutory rights" doctrine.<sup>35</sup> Under this doctrine, derived from the Supreme Court's pronouncement in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*<sup>36</sup> that "so long as the prospective litigant effectively may vindicate its statutory cause of action in the arbitral forum, the [federal] statute [providing that cause of action] will continue to serve both its remedial and deterrent function,"<sup>37</sup> a disputant can argue that an arbitration agreement is unenforceable because an unfair aspect of the arbitration process would preclude that party from vindicating its statutory rights.<sup>38</sup>

For example, in *In Re American Express Merchants' Litigation*,<sup>39</sup> a purported class action arising under the federal antitrust laws, the Second Circuit Court of Appeals reconsidered, in light of *AT&T Mobility*, its prior decisions that a class action waiver clause in a credit card agreement was unenforceable under the FAA<sup>40</sup> because "enforcement of the clause would effectively

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<sup>35</sup> *E.g.*, *Chen-Oster v. Goldman, Sachs & Co.*, No. 10 Civ. 6950 (LBS) (JCF), 2011 WL 2671813 (S.D.N.Y. July 7, 2011) (in a Title VII action, distinguishing *AT&T Mobility* and refusing to reconsider its holding that an arbitration clause was unenforceable because plaintiffs would not be able to vindicate their statutory rights absent the availability of class proceedings).

<sup>36</sup> 473 U.S. 614 (1985).

<sup>37</sup> *Id.* at 637.

<sup>38</sup> *See Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 92 (2000) (recognizing in *dicta* that, if a party showed that pursuing its statutory claims through arbitration would be prohibitively expensive, and thus it could not vindicate its statutory rights, a court could validly refuse to enforce a pre-dispute arbitration agreement).

<sup>39</sup> 667 F.3d 204 (2d Cir. 2012) ("Amex III").

<sup>40</sup> *See In Re American Exp. Merch. Litig.*, 634 F.3d 187 (2d Cir. 2011) ("Amex II"); *In Re American Exp. Merch. Litig.*, 554 F.3d 300 (2d Cir. 2009) ("Amex I"). The Court of Appeals reconsidered *Amex I* in light of the Supreme Court's subsequent ruling in *Stolt-Nielsen S.A. v. AnimalFeeds Intern. Corp.*, 130 S.Ct. 1758 (2010).

preclude any action seeking to vindicate the [plaintiffs'] statutory rights.”<sup>41</sup> The Court of Appeals found that *AT&T Mobility* did not alter its prior analysis, which rested on a different ground than that of *AT&T Mobility*.<sup>42</sup> Rather, the Court of Appeals recognized, “[h]ere...our holding rests squarely on a ‘vindication of statutory rights analysis, which is part of the federal substantive law of arbitrability.’”<sup>43</sup> Because plaintiffs in this case demonstrated, through expert testimony, that pursuing their statutory claims individually as opposed to through class arbitration would not be economically feasible, “effectively depriving plaintiffs of the statutory protections of the antitrust laws,”<sup>44</sup> the Court of Appeals directed the district court to deny defendant’s motion to compel arbitration.<sup>45</sup>

Litigants, including administrative agencies tasked with enforcing consumer and investor protection laws and regulations, are struggling to find legal means other than the vindicating rights doctrine to counteract the overpowering preemptive force of the FAA. One possible argument is that other federal statutes may trump the FAA and thus limit FAA preemption. For example, the

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<sup>41</sup> *Amex I*, 554 F.3d at 304.

<sup>42</sup> *Amex III*, 667 F.3d at 214 (“What *Stolt-Nielsen* and *Concepcion* do not do is require that all class-action waivers be deemed per se enforceable. That leaves open the question presented on this appeal: whether a mandatory class action waiver clause is enforceable even if the plaintiffs are able to demonstrate that the practical effect of enforcement would be to preclude their ability to bring federal antitrust claims.”).

<sup>43</sup> *Id.* at 213, citing *Amex I*, 554 F.3d at 320.

<sup>44</sup> *Id.* at 217.

<sup>45</sup> *Id.* at 219; see also *Sutherland v. Ernst & Young LLP*, \_\_\_ F.Supp.2d \_\_\_, 10 Civ. 3332, Slip Copy, 2012 WL 130420 (S.D.N.Y. Jan. 17, 2012) (reaffirming an earlier invalidation of an employment agreement waiver that would have precluded putative FLSA collective litigation). A complete analysis of the broader impact of *AT&T Mobility* and the continued vitality of the “vindicating rights” doctrine is beyond the scope of this article. Suffice it to say that the issues are complex, far from settled and unpredictably working their way through the courts.

National Labor Relations Board recently concluded that federal labor law bars class action waivers in labor and employment contracts.<sup>46</sup> Similarly, the Securities Exchange Act of 1934's (SEA) anti-waiver provision may prevent the enforcement of a class arbitration waiver in the securities context.<sup>47</sup>

At least one broker-dealer, FINRA member Charles Schwab & Co., Inc. ("Schwab"), contends that the *AT&T Mobility* doctrine applies in the securities context, and, in October 2011, amended its customer agreement to add a class action waiver to the arbitration clause.<sup>48</sup> The waiver clause forces customers to agree not to bring or participate in class actions or class arbitrations against Schwab. Instead, they must bring their claims "solely in individual capacities."<sup>49</sup>

In response, in early 2012, FINRA Enforcement filed a disciplinary action against Schwab for including the class action waiver.<sup>50</sup> FINRA charges that requiring customers to waive their right to bring or participate in a class action violates NASD Rule 3110(f)(4)(A) and (C), and its successor rules FINRA Rule 2268(d)(1) and (3) (effective Dec. 5, 2011). Those rules prohibit member firms from placing "any condition" in a pre-dispute arbitration agreement that "limits or contradicts the rules of any

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<sup>46</sup> See D.R. Horton, Inc. and Michael Cuda, 357 NLRB No. 184 (Jan. 3, 2012).

<sup>47</sup> See Barbara Black, *Arbitration of Investors' Claims Against Issuers: An Idea Whose Time Has Come?* 75 LAW & CONTEMP. PROB. 107, 126-27 (2012).

<sup>48</sup> SECURITIES ARBITRATION ALERT 2011-38 (Oct. 12, 2011) (reporting that Schwab inserted a new clause entitled "Waiver of Class Action or Representative Action" in its Customer Account Agreements).

<sup>49</sup> *Id.*

<sup>50</sup> Complaint and Request for Expedited Hearing, Department of Enforcement v. Charles Schwab & Co., Inc., Disc. Proc. No. 2011029760201, available at

<http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125516.pdf> (FINRA Office of Hearing Officers Feb. 1, 2012).

self-regulatory organization,” and “limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement,” respectively. FINRA argues that, because Rule 12204(d) of the FINRA Code of Arbitration Procedure for Customer Disputes addresses the manner in which customers can bring and participate in class actions against member firms,<sup>51</sup> the forum rules clearly permit class actions, and Schwab’s class action waiver contradicts Rule 12204.<sup>52</sup>

To attempt to moot the FINRA enforcement action, Schwab simultaneously filed an action in the U.S. District Court for the Northern District of California<sup>53</sup> seeking a declaratory judgment that FINRA “may not enforce its rules regulating broker-dealers in a manner inconsistent with the Federal Arbitration Act as most recently interpreted by [the Court’s decisions in *AT&T Mobility* and *CompuCredit*].”<sup>54</sup> In its complaint, Schwab argues that the FAA trumps FINRA’s rules and “the FAA requires enforcement of class action waivers absent a Congressional command to the contrary.”<sup>55</sup> However, Schwab acknowledges that FINRA’s rules have the “force of federal law” as they are derived from the SEA.<sup>56</sup> As Professor Barbara Black pointed out,

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<sup>51</sup> Likewise, Rule 13204 precludes arbitration of intra-industry class action disputes. See *Gomez v. Brill Secs., Inc.*, 2012 WL 851644 (N.Y. App. Div., 1<sup>st</sup> Dept. Mar. 15, 2012) (refusing to compel arbitration of, *inter alia*, labor law claims by brokerage firm employees that were subject of putative class action).

<sup>52</sup> *Id.*

<sup>53</sup> *Charles Schwab & Co., Inc. v. FINRA*, Complaint for Declaratory and Preliminary and Permanent Injunctive Relief, CV 12-0518 (EDL) (N.D. Cal. Feb. 1, 2012), available at

<http://lawprofessors.typepad.com/files/schwab-complaint.pdf>.

Interestingly, Schwab offered to pay its customers’ arbitration filing fees pending the outcome of its suit.

<sup>54</sup> *Id.*, “Introduction,” p. 2, lines 6-9.

<sup>55</sup> *Id.*, ¶32.

<sup>56</sup> *Id.*, ¶33.

“Schwab fails to acknowledge [sic] (much less address) the argument that the Securities Exchange Act and its anti-waiver clause preempt the FAA.”<sup>57</sup>

Professor Black also updated the procedural status of Schwab’s case:

On Feb. 21, 2012 Schwab filed a motion for preliminary injunction, reasserting its arguments. On Feb. 22, FINRA in turn filed a Motion to Dismiss for lack of subject matter jurisdiction, asserting as its principal argument that Schwab failed to exhaust its administrative remedies under the Exchange Act. The Exchange Act establishes a comprehensive system of regulating broker-dealers, including judicial review of FINRA disciplinary proceedings. Noting the Schwab instituted this judicial proceeding within hours after the disciplinary complaint was served, FINRA argues that Schwab failed to meet the prerequisite for filing a federal law suit -- exhaustion of its administrative remedies. Moreover, Schwab does not assert valid reasons for bypassing the disciplinary proceeding -- either that the disciplinary proceeding is too time-consuming or that the FINRA and SEC adjudicators lack the expertise to address issues outside of securities law or FINRA rules.<sup>58</sup>

It will be interesting to see whether and how Schwab defends against the disciplinary action, as it does appear that the class action waiver provision conflicts with Rule 12204(d). Moreover, in Schwab’s declaratory judgment action, the district court should reject the FAA preemption argument here because (1)

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<sup>57</sup> Barbara Black, “FINRA Seeks to Dismiss Schwab’s Lawsuit Contesting its Rule Prohibiting Class Action Waivers,” Securities Law Prof Blog (Feb. 23, 2012).

<sup>58</sup> *Id.*

FINRA's Rules are federal law, and FAA preemption operates only to preempt conflicting state law; and (2) the SEA trumps the FAA here under the doctrine of implied repeal.<sup>59</sup>

In addition to applying the Supreme Court's latest FAA pronouncements, the federal courts have been busy resolving other issues arising out of arbitration agreements and proceedings. The rest of this article will highlight a few of these important decisions over the past year.

## **B. Defenses to Arbitrability**

Litigation about arbitration often results when one party to a purported arbitration agreement seeks to compel a reluctant party to arbitrate a dispute. In response to the motion to compel, the reluctant party can raise several defenses to the arbitrability of the dispute, including the absence of an enforceable arbitration agreement (due to contract law doctrines or, in FINRA arbitration, the claimant is not a "customer" of respondent), waiver and release. Discussed below are some recent federal court of appeals decisions interpreting these defenses.

### **1. Was there an enforceable arbitration agreement?**

Before a court will grant a motion to compel arbitration under the FAA, it must be satisfied that the disputing parties entered into a valid and enforceable arbitration agreement. The Sixth Circuit held that distributing an employee handbook to new employees that mentions a dispute resolution program does not

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<sup>59</sup> See Black, *supra* note 47.



constitute a binding arbitration agreement, due to lack of mutual assent.<sup>60</sup>

However, even if parties did not directly enter into an arbitration agreement, they may still be able to compel arbitration of claims arising out of an arbitration agreement between signatories. A nonsignatory can compel arbitration of related claims if the claimant alleges the nonsignatory acted as an agent of a signatory.<sup>61</sup> Under those circumstances, the alleged agents may “invoke the benefit of an arbitration agreement executed by their principal even though the agents are not parties to the agreement.”<sup>62</sup>

## **2. Who is a “customer” under FINRA Rule 12200?**

In a FINRA customer-initiated arbitration, in the absence of a pre-dispute arbitration clause, respondents may resist arbitration on the ground that the claimant is not a “customer” of the FINRA member firm within the meaning of FINRA Code of Arbitration Procedure for Customer Disputes Rule 12200. That rule provides that a FINRA member firm must arbitrate a claim if “requested by a customer,” “[t]he dispute is between a customer and a member or associated person of a member; and [t]he dispute arises in connection with the business activities of the member or the associated person . . . .”<sup>63</sup>

The Second Circuit decided two cases in the past year interpreting FINRA Rule 12200 with opposite outcomes. In the

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<sup>60</sup> See *Hergenreder v. Bickford Senior Living Group, Inc.*, 656 F.3d 411 (6<sup>th</sup> Cir. 2011).

<sup>61</sup> See *Thomas v. Westlake*, \_\_ Cal. Rptr. 3d \_\_, 2012 WL 974890 (Cal. Ct. App. 4<sup>th</sup> Dist. Mar. 23, 2012).

<sup>62</sup> *Id.* at \*5.

<sup>63</sup> FINRA R. 12200.

first case, the Second Circuit decided that an issuer who purchases auction-facilitating services for its auction rate securities from a broker-dealer is a “customer” of that broker-dealer within the meaning of FINRA Rule 12200.<sup>64</sup> In the second case, the Court of Appeals ruled that a hedge fund was not a “customer” of a bank/broker-dealer for purposes of a dispute arising out of a credit default swap transaction.<sup>65</sup>

In the closely-watched first case, in which both the Public Investors Arbitration Bar Association and the Securities Industry and Financial Markets Association filed *amici* briefs, the Court of Appeals seemingly opened the door to other disputants who have business relationships with FINRA member firms that are not necessarily investment or brokerage relationships to pursue claims arising out of their relationship in FINRA arbitration.

WVUH is a not-for-profit health consortium that issues bonds to finance capital improvements and other needs. In the 2000s, it issued several bond offerings (totaling \$329 million) structured as auction-rate securities (ARS), where the bonds’ interest rate is set by periodic Dutch auction.<sup>66</sup> UBS Financial Services served as both the lead underwriter and the broker-dealer responsible for setting up the auctions.<sup>67</sup> After the market for ARS collapsed in 2008, WVUH filed a FINRA arbitration claim against UBS alleging fraud in connection with its disclosures about the ARS market.<sup>68</sup>

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<sup>64</sup> See *UBS Financial Services Inc. v. West Virginia University Hospitals Inc.*, 660 F.3d 643 (2d Cir. 2011). The court also decided that FINRA arbitrators should decide the enforceability of a forum selection clause in the parties’ arbitration agreement.

<sup>65</sup> See *Wachovia Bank, N.A. v. VCG Special Opportunities Master Fund, Ltd.*, 661 F.3d 164 (2d Cir. 2011).

<sup>66</sup> *UBS Fin. Servs.*, 660 F.3d at 645.

<sup>67</sup> *Id.* at 646.

<sup>68</sup> *Id.* at 646-67.

UBS took the position that WVUH was not its “customer” under FINRA Rule 12200, and thus it did not have to submit to arbitration on these claims. It sought an injunction from the district court, which was denied.<sup>69</sup> On appeal, the Second Circuit affirmed, and construed FINRA’s Rule 12200 broadly, as it held that a “customer” is not limited to an investor utilizing investment or brokerage services of a broker-dealer, but includes any entity that purchases any services from the broker-dealer.<sup>70</sup>

In the second case, decided five weeks later, Wachovia Bank and its affiliated registered broker-dealer Wachovia Capital Markets (WCM) sought to enjoin a FINRA arbitration brought by the hedge fund VCG Special Opportunities Master Fund against it for damages stemming from a credit default swap (CDS) transaction gone sour.<sup>71</sup> WCM argued that VCG was not its “customer” under FINRA Rule 12200 because it was not a party to the CDS agreements nor had any of its employees negotiated those agreements. The district court rejected that argument and ordered the parties to arbitration.<sup>72</sup>

On appeal, the Court of Appeals reversed, holding that VCG was not a “customer” of WCM in the disputed transaction. Distinguishing *WVUH*, the Second Circuit found that the undisputed facts established that there was no brokerage agreement between VCG and WCM, no employee of WCM negotiated the CDS transaction with VCG, and no WCM employee

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<sup>69</sup> *Id.* at 647.

<sup>70</sup> *Id.* at 650-52. The Supreme Court of Virginia construed the definition even more broadly, holding that a customer under Rule 12200 is any entity that is not a broker or dealer. *See Bank of the Commonwealth v. Hudspeth*, 714 S.E.2d 566, 572 (Va. 2011) (FINRA member and affiliate of bank was “customer” under Rule 12200 for purposes of bank vice president’s compensation claim against bank and could compel arbitration of that claim).

<sup>71</sup> *Wachovia Bank*, 661 F.3d at 166.

<sup>72</sup> *Id.* at 170.

recommended the transaction to VCG.<sup>73</sup> The Court stated “where the parties to the relevant agreements and transactions have expressly disclaimed any sort of advisory, brokerage or other fiduciary relationship, there is no need to grapple with the precise boundaries of the FINRA meaning of ‘customer.’”<sup>74</sup>

### 3. Waiver

Along with the issue of whether prejudice is a required element of the waiver defense (*see supra*, Part I.C), a federal appeals court considered whether a litigant’s filing of an amended complaint revives the opposing party’s previously waived right to compel arbitration. In *Krinsk v. SunTrust Banks, Inc.*,<sup>75</sup> the Eleventh Circuit decided this question as a matter of first impression.

In *Krinsk*, a borrower brought a class action against her lender alleging violations of the Truth in Lending Act and other state laws after the bank terminated her home equity line of credit. After participating for more than six months in the litigation by, *inter alia*, moving to dismiss the complaint, jointly filing a Case Management Report, and opposing a class certification motion, the bank responded to plaintiffs’ filing of an Amended Complaint by moving to compel arbitration pursuant to the arbitration clause in the parties’ loan agreement. The district court denied the bank’s motion to compel arbitration, holding that the bank had waived its right to arbitration by litigating the original complaint.<sup>76</sup>

On appeal, the Eleventh Circuit reversed the order denying the motion to compel arbitration. Following other circuits that had addressed this issue, the Court of Appeals held as a matter of first

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<sup>73</sup> *Id.* at 173.

<sup>74</sup> *Id.* at 174.

<sup>75</sup> 654 F.3d 1194 (11<sup>th</sup> Cir. 2011).

<sup>76</sup> *Id.* at 1200-01.

impression that the filing of an amended complaint can revive a previously-waived right to compel arbitration if the new pleading “unexpectedly changes the scope or theory of the plaintiff’s claims.”<sup>77</sup> Since the amended complaint here was a “vast augmentation of the putative class” and an “unforeseen alteration in the shape of the class,” the bank “should have been allowed to rescind its earlier waiver through its prompt motion to compel litigation.”<sup>78</sup>

Plaintiff’s counsel beware – think twice before amending a complaint if you want to remain in court and you are relying on defendant’s prior waiver of its purported right to compel arbitration by litigating the original complaint.

#### **4. Release**

Another defense to arbitrability is proof that the claims that otherwise would be arbitrable have been released by a settlement agreement. In the securities area, claimants may also be members of a class action involving claims that arguably are related to the arbitration claims. If the class action has been settled, may class members proceed with their related claims in an individual capacity in FINRA arbitration?

The Second Circuit in *In re American Exp. Fin. Advisors Secs. Litig.*<sup>79</sup> addressed this issue. There, John and Elaine Beland brought a FINRA arbitration against Ameriprise and Ronald Miller, an Ameriprise Financial Consultant, alleging various common law claims stemming from Respondents’ alleged mismanagement of the Belands’ account and seeking at least \$1,500,000 in damages.<sup>80</sup> Ameriprise answered that the Belands’

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<sup>77</sup> *Id.* at 1202.

<sup>78</sup> *Id.* at 1204.

<sup>79</sup> 672 F.3d 113 (2d Cir. 2011).

<sup>80</sup> *Id.* at 123.

claims were no longer arbitrable because they had been released by a settlement of a securities class action in the Southern District of New York against Ameriprise and other related entities. That class action alleged various federal and common law claims related to respondents' alleged conflicts of interest and misconduct when providing financial advice to clients.<sup>81</sup> The Settlement Agreement defined "Released Claims" to explicitly exclude "suitability claims unless such claims are alleged to arise out of the common course of conduct that was alleged, or could have been alleged."<sup>82</sup> The Belands had neither opted out of nor claimed a share in the settlement funds of the class action.<sup>83</sup>

After the FINRA arbitration panel denied Respondents' Motion to Stay the arbitration, Respondents moved in the district court (before the same court that had retained jurisdiction over the class action) to enforce the Settlement Agreement with respect to the Belands' arbitration claims. The district court granted the Respondents' motion and ordered the Belands to withdraw their arbitration.<sup>84</sup>

The Court of Appeals reversed the district court's order, in part. After deciding that the arbitrability of the Belands' claims was a matter for a court, not an arbitrator, to decide, the Second Circuit ruled that (1) the Belands were bound by the class action settlement agreement; (2) the class action settlement agreement modified the parties' pre-existing agreement to arbitrate pursuant to FINRA rules; (3) any of the Belands' arbitration claims that were part of the "Released Claims" in the class action settlement were no longer arbitrable; and (4) not all of the Belands' arbitration claims were released by the Settlement Agreement.<sup>85</sup>

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<sup>81</sup> *Id.* at 119-20, 123.

<sup>82</sup> *Id.* at 121.

<sup>83</sup> *Id.* at 123.

<sup>84</sup> *Id.* at 125.

<sup>85</sup> *Id.* at 129-133, 135-39.

Thus, the Belands were permitted to continue with their arbitration with respect to unreleased claims – primarily, suitability claims. Notably, the Belands had not specifically delineated in their Statement of Claim a claim for “unsuitable recommendations.” However, the Court of Appeals stated that “for purposes of this appeal we consider ‘suitability’ to serve more as a general description of the character of potential common-law claims (such as breach of fiduciary duty, breach of contract, fraud, and negligent misrepresentation—all of which the Belands did allege in the FINRA proceedings), rather than a technical term denoting a specific type of section 10(b) claim.”<sup>86</sup> Moreover, the Belands’ suitability claims focused on Respondents’ mismanaging their accounts contrary to their instructions and investment goals, whereas the “released” suitability claims stem from Respondents’ alleged “routine practice of ‘steering American Express clients into [proprietary] funds through one or more managed programs at American Express.’”<sup>87</sup> Thus, the Belands’ suitability claims did not entirely overlap with the Released Claims, and could be arbitrated.

### **C. Arbitral Misconduct**

#### **1. Arbitrator Immunity**

In *Sacks v. Dietrich*,<sup>88</sup> the Ninth Circuit held that FINRA arbitrators were immune from civil liability when they disqualified the plaintiff from being a party representative in a FINRA arbitration. The arbitrators had disqualified the representative

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<sup>86</sup> *Id.* at 136. This definition of suitability squares with the approach of most claimants’ counsel in FINRA arbitration: recommending unsuitable investments is the sales practice violation that forms the basis of the legal cause of action (claim for relief), such as negligence, breach of fiduciary duty or negligent or fraudulent misrepresentation.

<sup>87</sup> *Id.* at 138.

<sup>88</sup> 663 F.3d 1065 (9<sup>th</sup> Cir. 2011).

under FINRA Rule 13208, which bars non-attorneys who have been suspended or barred from the securities industry from representing parties in FINRA arbitration. The purported party representative then sued the arbitrators who had signed the disqualification order in state court for, *inter alia*, tortious interference with contract.<sup>89</sup>

After the case was removed to federal court, the district court granted defendants' motion to dismiss the case under the doctrine of arbitral immunity.<sup>90</sup> That doctrine provides arbitrators with immunity from civil liability for "acts within their jurisdiction arising out of their arbitral functions in contractually agreed upon arbitration hearings."<sup>91</sup> Because the arbitrators properly interpreted and applied FINRA Rule 13208, plaintiff's lawsuit was barred.

## 2. Arbitrator Selection

In *Khan v. Dell*,<sup>92</sup> the Third Circuit Court of Appeals resolved a matter of first impression and ruled that FAA § 5<sup>93</sup>

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<sup>89</sup> *Id.* at 1067-68.

<sup>90</sup> *Id.* at 1068.

<sup>91</sup> *Id.* at 1069 (citations omitted).

<sup>92</sup> 669 F.3d 350 (3d Cir. 2012).

<sup>93</sup> Section 5, "Appointment of Arbitrators or Umpires," provides:

If 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; but if no method be provided therein, or if a method be provided and any party thereto shall fail to avail himself of such method, or if for any other reason there shall be a lapse in the naming of an arbitrator or arbitrators or umpire, or in filling a vacancy, then upon the application of either party to the controversy the court shall designate and appoint an arbitrator or arbitrators or umpire, as the case may require, who shall act under the said agreement with the same force and effect as if he or they had been specifically named therein; and unless otherwise provided in the agreement the arbitration shall be by a single arbitrator.



requires a court to appoint a substitute arbitrator when the arbitrator designated by the parties' agreement was not available. In that case, a consumer class action against a computer manufacturer, the parties' arbitration agreement had named the National Arbitration Forum as the forum to administer arbitrable disputes arising out of the agreement. At the time of the lawsuit, the NAF was subject to a consent judgment with the Attorney General of Minnesota that barred it from administering consumer arbitrations.<sup>94</sup> In response to Dell's motion to compel arbitration, Khan argued that the designation of NAF as the arbitration forum was so integral to the arbitration agreement that the unavailability of the NAF should result in non-enforcement of the arbitration provision.<sup>95</sup>

The Third Circuit, acknowledging the issue was one of first impression in its circuit, surveyed prior decisions in other jurisdictions, and followed the holdings of those courts that permitted a court to appoint a substitute arbitrator under FAA § 5 when the designated one was unavailable rather than voiding the arbitration agreement.<sup>96</sup>

### **3. Evident Partiality**

Losing parties to arbitration awards can move to vacate the award under FAA § 10(a)(2) on the ground of "evident partiality" in the arbitrators. Courts have had difficulty developing a test to evaluate whether an arbitrator has demonstrated "evident partiality," since the Supreme Court's only decision under that section is *Commonwealth Coatings v. Continental Casualty Co.*,<sup>97</sup> and that case yielded plurality and concurring opinions that are

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<sup>94</sup> *Id.* at 352.

<sup>95</sup> *Id.* at 353.

<sup>96</sup> *Id.* at 356-57.

<sup>97</sup> 393 U.S. 145 (1968).

difficult to synthesize. To evaluate a claim of arbitrator bias, courts look to factors such as:

1. the extent and character of the personal interest, pecuniary or otherwise, in the proceeding;
2. the directness of the relationship between the arbitrator and the person he is alleged to favor;
3. the connection of that relationship to the arbitrator; and
4. the proximity in time between the relationship and the arbitration proceeding.<sup>98</sup>

This past year, the Court of Appeals of New York adopted the Second Circuit’s test for “evident partiality.” In *U.S. Electronics, Inc. v. Sirius Satellite Radio, Inc.*,<sup>99</sup> the court held that “evident partiality ‘will be found where a reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration.’”<sup>100</sup> This “reasonable person” standard requires a showing of something more than a mere appearance of bias, but not proof of actual bias.<sup>101</sup> In *U.S. Electronics*, the Court of Appeals declined to vacate the award, stating that “claims of bias, premised on attenuated matters and relationships, are not sufficient.”<sup>102</sup>

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<sup>98</sup> See, e.g., *Scandinavian Reinsurance Co. Ltd. v. Saint Paul Fire & Marine Ins. Co.*, 668 F.3d 60, 74 (2d Cir. 2012) (internal citation and quotation omitted); *ANR Coal v. Cogentrix of North Carolina*, 173 F.3d 493, 500 (4<sup>th</sup> Cir. 1999).

<sup>99</sup> 958 N.E.2d 891, 17 N.Y.3d 912 (N.Y. 2011)

<sup>100</sup> *Id.* at 893, 17 N.Y.2d at 914, citing *Morelite Constr. Corp. v. New York City Dist. Council Carpenters’ Benefit Funds*, 748 F.2d 79 (2d Cir. 1984).

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* at 893, 17 N.Y.3d at 915.

#### D. Manifest Disregard of the Law

Since the Supreme Court's holding in *Hall St. Assoc., L.L.C. v. Mattel, Inc.*<sup>103</sup> that parties to an arbitration agreement cannot contractually expand the judicial grounds of review of an award under the FAA, the circuit courts have split on whether an arbitration panel's "manifest disregard of the law" is a valid ground to vacate an arbitration award. The Supreme Court expressly declined to resolve this split in *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*<sup>104</sup> The circuit split continues, but the Tenth Circuit, which previously had expressly declined to address the issue, did recognize it as a valid ground in the past year. Currently, the circuits stand on this issue as follows:

- The Second, Fourth, Sixth, and Ninth Circuits acknowledge the continued vitality of the "manifest disregard" ground of vacatur.<sup>105</sup>
- The Fifth, Eighth and Eleventh Circuits have expressly ruled that manifest disregard is no longer a valid vacatur ground.<sup>106</sup>

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<sup>103</sup> 552 U.S. 576 (2008).

<sup>104</sup> 130 S. Ct. 1758, 1768 n.3 (2010).

<sup>105</sup> See *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 548 F.3d 85, 94 (2d Cir. 2008), *vacated on other grounds*, 130 S. Ct. 1758 (2010); *Wachovia Securities, LLC v. Brand*, 671 F.3d 472, 482 (4<sup>th</sup> Cir. 2012) ("Although we find that manifest disregard continues to exist as either an independent ground for review or as a judicial gloss, we need not decide which of the two it is because Wachovia's claim fails under both"); *Coffee Beanery, Ltd. v. WW, L.L.C.*, 300 Fed.Appx. 415, 419 (6<sup>th</sup> Cir. 2008); *Comedy Club, Inc. v. Improv West Assocs.*, 553 F.3d 1277, 1290 (9<sup>th</sup> Cir. 2009).

<sup>106</sup> See *Citigroup Global Markets, Inc. v. Bacon*, 562 F.3d 349, 352 (5<sup>th</sup> Cir. 2009); *Medicine Shoppe Intern., Inc. v. Turner Investments, Inc.*, 614 F.3d 485 (8<sup>th</sup> Cir. 2010); *Frazier v. CitiFinancial Corp.*, 604 F.3d 1313, 1324 (11<sup>th</sup> Cir. 2010).

- The First Circuit has addressed “manifest disregard” subsequent to *Hall Street*, but only in *dicta*.<sup>107</sup>
  - The Third and Tenth Circuits have expressly declined to address the issue.<sup>108</sup>

### **E. Attorney’s fees**

Two cases this year demonstrate that the courts of appeal are more than willing to enforce awards of attorney’s fees. In one case, the Ninth Circuit enforced an attorney’s fees clause in a customer agreement against a broker-dealer customer.<sup>109</sup> In the underlying arbitration, Bear Stearns successfully sued Wang to recover an unpaid debt. The district court confirmed the award, and awarded Bear Stearns attorney’s fees incurred in confirming the award. The Ninth Circuit affirmed, rejecting Wang’s argument that the award of attorney’s fees was improper.

Similarly, in an industry employment dispute, a panel of FINRA arbitrators denied Wachovia’s claims for relief against its former broker employees and instead awarded the former employees \$1.1 million in attorney’s fees under the South Carolina Frivolous Civil Proceedings Act.<sup>110</sup> Wachovia moved to vacate the

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<sup>107</sup> See *Kashner Davidson Secs. Corp. v. Mscisz*, 601 F.3d 19, 21 (1st Cir. 2010) (acknowledging that the circuit has “not squarely determined whether our manifest disregard case law can be reconciled with *Hall Street*”).

<sup>108</sup> See *Rite Aid New Jersey, Inc. v. United Food Commercial Workers Union, Local 1360*, 449 Fed. Appx. 126, 129 (3d Cir. 2011) (assuming without deciding that the manifest disregard standard survived *Hall Street*); *Abbott v. Law Office of Patrick J. Mulligan*, 440 Fed. Appx. 612, 620 (10th Cir. 2011) (“in the absence of firm guidance from the Supreme Court, we decline to decide whether the manifest disregard standard should be entirely jettisoned”).

<sup>109</sup> *Wang v. Bear Stearns & Co., Inc.*, 2011 WL 5126341 (9<sup>th</sup> Cir. Oct. 31, 2011).

<sup>110</sup> *Wachovia Secs., LLC v. Brand*, 671 F.3d 472 (4th Cir. 2012).

award on numerous grounds, including the contention that the panel failed to follow the procedural requirements of the FCPA.

The Fourth Circuit affirmed the district court's denial of the motion to vacate. The Court of Appeals held that the panel was not required to follow the procedural requirements of the FCPA, and, even if it was, its failure to follow them did not manifestly disregard the law.<sup>111</sup>

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<sup>111</sup> *Id.* at 479, 483.