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PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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President's Column

By Robert S. Banks, Jr.

The NASD Code of Arbitration Procedure will soon be replaced by a new Code. One of the biggest practical changes will be the introduction of a new category of arbitrator known as the chair qualified arbitrator. Under the proposed code (which is likely to be implemented this year), customers filing arbitrations of over $50,000 will get three lists of arbitrators: industry, public and chair qualified. To be chair qualified, arbitrators must qualify as public, and have sat through two SRO arbitrations to award if they are an attorney, or three arbitrations if they are not. Every panel will include a chair qualified arbitrator.

Requiring chairpersons to have experience has its benefits. No one wants a hearing where the entire panel does not know the rules and cannot control the hearing. In the context of NASD arbitrations, however, repeat arbitrators come with a significant cost. Repeat arbitrators understand that the parties review prior awards when making arbitrator selection decisions. They learn pretty quickly that if they give too many awards of attorney fees (regardless of whether state law requires them), or any award of punitive damages, they risk being stricken by industry counsel in future cases. Conversely, if they give too many awards for the industry, repeat arbitrators will not look good to claimants' counsel. The ideal award history for a repeat arbitrator who wants to continue to serve is an equal number of claimant and respondent awards. Repeat arbitrators understand that, if they want to continue to serve, their award history must appear to be balanced. That understanding influences their decisions.

The award evidence supports this logical hypothesis. The percentage of NASD arbitration hearings that result in some award of damages for customers has averaged 49.8% for the years 2000 through 2005. While it is possible that, as a matter of pure coincidence, only half the cases that were decided had some merit, that is unlikely. It would be difficult to find any other dispute resolution forum involving one class of claimant (e.g., investors) against another class of respondents (e.g., brokerages) in which the outcomes appear equally divided. The more likely explanation for the 49.8% statistic is the repeat arbitrators' desire to appear fair.

The compromising of the arbitration process in this way works to the disadvantage of everyone because it introduces a variable that has nothing whatsoever to do with the merits of the case being decided. And, the system hurts public customers more than the industry. When the respondent achieves a zero award (50.2% of the time), it is an unambiguous win for the firm. But, when a customer gets *some* award (49.8% of the time), it may or may not be a customer victory, depending upon the size of the award in

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comparison to the losses. In fact, one study reported that claimants who get awards receive on average only 60% of the claimed losses.

Compromised awards have an additional aspect of unfairness to investors. I believe that more than 49.8% of the cases that go to hearing have some merit. Before a case is filed, a customer has to feel strongly that they were wronged -- so strongly that they are willing to seek the advice of an attorney, and invest the time and expense required to bring the claim. The lawyers who file most of these cases are experienced. Lawyers are bound by ethical principles that prevent them from filing frivolous claims. And, financial self-preservation plays an important role. Since most arbitrations are filed on a contingency fee basis, claimants' lawyers have to weed out the bad cases if they want to continue to pay their bills. Good lawyers use a fairly extensive evaluation process before deciding whether to file an arbitration. That analysis will often include extensive interviews with the client, a statistical analysis of the account statements, a review of all available documents relevant to the case, an investigation into the advisor's background, and other information bearing on the claim of the potential claimant. In fact, most of us would agree that the analysis phase of the case is one of the most important things that we do. Mistakes are made when the lawyers do not have all the facts when they file a case. But, those cases are most often settled or dismissed (depending on the importance of the previously unknown facts) prior to hearing. Lawyers don't relish trying cases that they are likely to lose. To be sure, some bad cases are nonetheless tried. But, it doesn't happen 50.2 % of the time, as the results suggest.

Of course, many on the industry side say that I am dead wrong, and that most claims are nothing more than greedy and unethical lawyers bringing claims for whining customers who want their financial advisors to be responsible for the vagaries of the market. The industry contends that the vast majority of claims going to hearing have no merit, or they would have resolved them. Even if they were correct, the repeat arbitrator problem would be just as serious. Anything that interferes with the fair resolution of cases on the relevant facts should be anathema to the arbitration process.

The problem of arbitrators being influenced by how their award will reflect on them in future cases exists under the current system, and the only solution is to fundamentally change the way in which arbitrators are selected. Until that happens, it appears that things are going to get worse. The chair qualified rule will magnify the existing problem. PIABA has criticized the proposed rule for a number of reasons, but to me the repeat arbitrator problem is at the forefront. In many cases, investors will be forced to have as their chairperson someone with a strong interest in continuing to serve as an arbitrator. If you have a good case, you can only hope that the chair will judge it on the merits and without regard to how the decision may appear to defense counsel the next time around.

* * * * *

The 15th Annual PIABA Meeting in Tucson from October 27 through 29 will include a session on the new NASD Code that Phil Aidikoff and I will lead. Members can forward their comments on this and other important provisions of the new code to me, and I will try to include them in our discussion. We will also give you a chance to express your comments and concerns during the session.

From The Professor – Some Initial Thoughts on the Supreme Court's Decision in the Buckeye Case -Part 1

By Joseph C. Long

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A funny thing happened to this column on the way to the printer: The Supreme Court issued its opinion in *Buckeye Check Cashing, Inc. v. Cardegna*.[1] Originally, the column was going to discuss the concept that a contract which was found to be void ab initio would also vitiate any embedded arbitration contract. As a result, the investor would have no obligation to arbitrate and could take his case to court.

The void ab initio theory was believed to be an exception to the rule developed in *Prima Paint Corp. v. Flood & Conklin Mfg. Co*.[2] *Prima Paint* held that the arbitrators, rather than a court, would decide a claim that a contract was voidable because of fraud in the inducement if the fraud claim was related to the basic contract and not specifically to the embedded arbitration agreement.

The *Prima Paint* rationale was that the arbitration clause was severable from the main contract. Thus, the arbitration clause continued to be valid, even though the basic contract might be defective. Given this position, it was logical that the arbitrators, not the court, would be the first to rule on the defective nature of the contract in general.

Most attorneys, especially those dealing in securities arbitrations, generalized *Prima Paint* to require *all claims involving the validity of the general contract*, not just claims for fraudulent inducement, to be arbitrated rather than litigated.

The Florida court in *Buckeye*,[3] along with a number of other state[4] and federal[5] courts, disagreed with this generalization of the *Prima Paint* holding. They believed that *Prima Paint* only applied to those contracts which were *voidable* under

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[1] 2006 WL 386362 (U.S. Feb. 21, 2006).

[2] 388 U.S. 395 (1967).

[3] 894 So.2d 860 (Fla. 2005),rev'd 2006 WL 386362 (U.S. Feb. 21, 2006).

[4] *See e.g., Onvoy, Inc. v. SHAL, L.L.C.*, 669 N.W.2d 344 (Minn. 2003)("[A]ll federal circuits seem to have at least accepted a similar rule that courts have juisdiction when one party denies the very existence of the contract." *See also Duryee v. PIE Mutual Ins. Co.*, 1999 WL 744341 (Ohio Ct. App. Sept. 23, 1999) and *Frizzel Constr. Co. v. Gatinburg*, 9 S.W.3d 79 (Tenn. 1999).

Three state cases have applied the void ab initio theory in a securities setting: *Securities America, Inc. v. Rogers*, 850 So.2d 1252 (Ala. 2003); *Michelson v. Voison*, 254 Mich. App. 691, 658 N.W.2d 188 (2003); and *Aste v. Metropolitan Life Ins. Co.,* 312 Ill. App.3d 972, 728 N.E.2d 629 (2000).

[5] *See e.g., Anderson v. Delta Funding Corp.,* 316 F. Supp.2d 554 (N.D. Ohio 2004), and *Bertram v. Beneficial Consumer Discount Co.*, 286 F. Supp.2d 453 (M.D. Pa. 2003). *See Berger v. Cantor Fitzgerald*, 942 F. Supp. 963

state law.[6] If the contract was *void ab initio*, they reasoned that no contract ever came into existence. It is a nullity from the beginning.[7] Under the law of most states, in such case, the severability doctrine can not apply. Since there is no contract from the beginning, the embedded arbitration clause has no independent life. Severing it from the main contract can not breathe life into it. The Supreme Court rejected the Florida court's analysis. It held that all challenges directed at the validity of the basic contract, rather than specifically to the arbitration clause, are to be heard by the arbitrators. It does not matter whether the challenge is based upon a claim that the contract is void or merely voidable. *However, the Court reached this conclusion based upon federal substantive law of arbitration* rather than on state law contracts principals.

Since the Court's decision in *Buckeye* appears, at least on first examination, to undercut the void ab initio argument, I converted the Column into a discussion of the *Buckeye* decision and its possible ramifications for the future. Because of time and space limitations, I decided to break this discussion into two separate parts.

In this issue, I will attempt to address three issues. First, I will examine the *Buckeye* decision to determine what the Court did, and didn't do. Second, I will address the question of whether *Buckeye* is the final word on the subject. Finally, assuming that *Buckeye* is not the end of the debate, I will evaluate the Court's bases for both the concept of a federal substantive law of arbitration, and its decision that severability of the arbitration clause should not turn on whether the underlying contract is void or voidable under state contract law.

In the next issue of the Journal, I will undertake an analysis of the impact of *Buckeye* on arbitration. *Buckeye* leaves many questions unanswered that will have to be addressed by the lower courts. These issues need to be identified and thought about. The initial lower court decisions will be extremely influential in shaping the answers to the remaining questions.

These opinions must be logical and reasoned. Often, such reasoned decisions depend upon adequate research and logical presentation by counsel. Therefore, prior consideration of the issues, rather than a seat of the pants, shoot from the hip, approach, is essential if the investor's point of view is to be adequately presented.[8]

Since the issues involved in *Buckeye* are tangential, at best, to the normal arbitration practice, I think the best method to highlight the issues and the better solutions from the investor's point of view is to go step-by-step through the process. This analysis will be the subject of the next issue's column.

The starting point for this issue's column is an understanding of the *Buckeye* decision itself, and what it said and didn't say.

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[6] "Voidable" contracts are those "where one party was an infant, or where the contract was induced by fraud, mistake, or duerss, or where breach of warranty or other promise justifies the aggrieved party in putting an end to the contract." Rest. (Second) Contracts, §7, cmt. b (1981).

[7] "Void" contracts are those when breached, "the law neither gives a remedy nor otherwise recognizes a duty of performance by the promisor." Rest. 2d, Contracts §7, cmt. a (1981). *See also* 1 Arthur Linton Corbin, Corbin on Contracts §§1.6-1.7 (Joseph M. Perillo ed., rev. ed. 1993). "Void" contracts typically will include those contracts which the law will not enforce as a matter of policy, often because they deal with an illegal subject matter.

[8] Securities arbitration attorneys tend to be parochial when dealing with arbitration. All of us need to realize that securities arbitration is but a small part of the larger arbitration area. As a result, we need to consider arbitration cases outside the securities area in fashioning our arguments and positions.

I. THE BUCKEYE DECISION

The facts in *Buckeye* are fairly simple and straight forward. Buckeye was engaged in making deferred-payment transactions with the general public. In one of these transactions, the consumer would give Buckeye a post-dated check for the amount of cash he wished to receive, plus a specified finance charge. At the same time, the consumer would sign a "Deferred Deposit and Disclosure Agreement." This agreement contained an embedded arbitration clause requiring the consumer to arbitrate any disputes arising out of the transaction.

The plaintiffs in ***Buckeye*** filed a putative class action in the Florida state courts claiming that the finance fees amounted to the charging of a usurious amount of interest in violation of various Florida lending and consumer protection laws. Buckeye responded by filing a motion to compel arbitration. The plaintiffs resisted the motion based upon the fact that these statutes provided that the charging of usurious interest was a criminal offense,[9] and, therefore, against public policy.[10] As a result, the plaintiffs claimed the agreements, including their embedded arbitration clause, were *void ab initio*, and they had no obligation to arbitrate.

The trial court denied Buckeye's motion to compel arbitration. In doing so, it held that a court, rather than the arbitrators, should decide whether the agreements were illegal and void ab initio. Buckeye appealed to the Florida District Court of Appeals with reversal as based upon *Prima Paint*. It concluded that since the consumers did not challenge the arbitration clause, but instead claimed the entire contract, including the arbitration clause, was void, under *Prima Paint*, the arbitration clause was severable and remained enforceable. Therefore, the arbitrators, and not the court, should determine the legality and validity of the contract. On appeal, the Florida Supreme Court, again reversed, holding that, under *Florida state law*, the contract was in violation of Florida public policy, and, therefore, *void ab initio*.

In reversing the Florida Supreme Court, the Court in *Buckeye*, first recognized that there are two separate types of attack on the validity of a contract including an arbitration clause.[11] The first type is a specific challenge to the arbitration clause.[12] The second type challenges the contract as a whole, either as

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[9] Not surprisingly, there is a direct parallel here between the lending and consumer protection acts and the state securities acts. Section 409 of the Uniform Securities Act (1956) makes a violation of the Act a felony offense.

[10] Again, there is a direct parallel with the securities acts. Section 410(f) of the Uniform Act indicates that no one in violation of the Act can "base any suit on the contract."

Note that the prohibition is against the person violating the Act, and not the investor, who is never in violation of the Act. As a result, the investor technically could sue to enforce a contract. This suggests that it was contemplated that a contract in violation of the Act was merely voidable and not void.

This conclusion is consistent with the idea of "selective rescission" where the investor has the option to affirm or ratify some transactions and disavow others. Further, when the investor sues under Section 410, he is not enforcing the contract, but rather his statutory rights.

However, if the transaction includes a provision calling for waiver of compliance with the Act, Section 410(g) specifically makes such provision void, not voidable. Unless such waiver provision can be severed from the main contract under state contract law, it will make the entire contract void.

[11] 2006 WL 386362 at * __________.

[12] In the case of a securities act claim, an example of this type of provision is the anti-waiver found in Section 410(g) of the Uniform Act. The Court, in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), held that a similar

directly affecting the entire contract[13] or, on the ground that the illegality of one provision in the contract makes the entire agreement, including the arbitration clause, invalid.

The consumer's claim in *Buckeye*, the Court finds, is of the second type. The usurious interest claim would void the entire contract. The Court, then, indicates that *Prima Paint* determined that the first of the challenges would be decided by the court, but the second type would be heard by the arbitrators.

The Court also attempts to distinguish between a question as to *validity* of the contract and whether the parties ever ***reached an agreement*** in the first place.[14] As will be seen below, whether this distinction is viable is questionable. In both cases, the ultimate outcome is that there is no valid contract between the parties. In either case, where there is no contract, under Section 4 of the FAA, the court should find there is no valid agreement to arbitrate and refuse to compel arbitration.

The Court stated that Its decisions in *Prima Paint* and *Southland Corp. v. Keating*[15] establish three legal principles which will resolve the present dispute. These legal principles are: (1) That there is a body of substantive federal law under the FAA and that this substantive federal law makes arbitration contracts severable from the underlying general contract; (2) That, "unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator *in the first instance*;"[16] (3) That the federal body of *substantive* arbitration law[17] applies equally

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provision in the California Franchise Investment Law, was pre-empted by the federal substantive law of arbitration.

[13] The Court puts fraudulent inducement in this category. *Id.*

[14] *Id.* at *3, n. 1. In this latter category, the Court puts cases involving (1) whether the consumer signed the contract containing the arbitration agreement, including forged signatures, *see e.g.,* **Chastain v. Robinson-Humphrey Co.**, 957 F.2d 851 (11th Cir. 1992), (2) arbitration agreements included in delivery documents or monthly statements, *see e.g.,* **Rogers v. Dell Computers**, 127 P.3d 560 (Okla. 2005), (3) lack of authority of agent to sign, *see e.g.*, **Sandvik AB v. Advent Int'l. Corp.**, 220 F.3d 99 (3d Cir. 2000) or (4) where the signor lacked the mental capacity to assent, *see e.g.*, **Spahr v. Secco**, 330 F.3d 1266 (10th Cir. 2003). These issues have generally been held to be issues to be resolved by the courts, and not the arbitrators. As will be seen below, the Supreme Court left treatment of these issues as an open question.

[15] 465 U.S. 1 (1984).

[16] 2006 WL 386362 at *4. [Emphasis added.]

[17] Note the stress on the word "substantive." This would lead one to conclude that state procedural provisions still control, at least where they are not in specific conflict with the language of the FAA.

As a result of this position, there will be numerous disputes over whether a particular issue is one of substance or one of procedure. For example, Section 16 covers appeals. It clearly indicates that in federal court, an appeal cannot be taken from an order compelling arbitration. The appeal of this issue has to wait until the arbitration is completed. May state law allow interlocutory appeals of a state trial court's order compelling arbitration?

Similarly, Section 12 of the FAA requires that any notice to vacate an arbitration award must be filed and "served upon the adverse party within three months after an award is filed or delivered." It further provides that if the adverse party is a nonresident of the federal district, service must be made by the United States Marshal of the adverse party's home district. Is this provision procedural or substantive? May a state court deviate from the "within three months" rule or allow some alternative form of service?

to federal and *state* court proceedings.[18]

Then the Court made what may be an extremely important statement:

> *The parties have not requested, and we do not undertake reconsideration of these findings.*[19]

The Court continued:

> Applying [these findings or premises] to this case, we conclude that because respondents challenge the Agreement, but not specifically its arbitration provisions, those provisions are enforceable apart from the remainder of the contract. The challenge should therefore be considered by an arbitrator, not a court.[20]

Thus, the Buckeye decision does not re-examine the three premises drawn from Prima Paint and Southland, the Court merely applies them to a new and different set of facts. In doing so, it does two things. First, it defines the parameters of the federal substantive law of arbitration concerning the severability doctrine. Under the federal severability doctrine, the Court holds that there should be no distinction made between contracts which are void or voidable.[21] The decision can not be read as expressing any opinion as to the legality of the basic contract and its arbitration clause under state contract law. It merely holds that arbitration, and not the courts, is the proper forum for determining this issue.

II. IS BUCKEYE THE FINAL WORD BY THE COURT IN THIS AREA

The answer to the question of whether *Buckeye* is the Supreme Court's final pronouncement on jurisdictional disputes, severability, and FAA's application to state court proceedings, apparently lies in the point of view of the commentator. In the discussion of the *Buckeye* decision in SAC's Weekly Securities Litigation Alert,[22] the commentator, Burton W. Wiand, waxes elegantly the *Buckeye* decision. He claims that *Buckeye* is another of "[t]he Supreme Court's decision[s] [which] continues the line of stronger and stronger decisions upholding the announced federal policy of favoring arbitration."

From my view point, *Buckeye*, while important in settling the severality issue as to void and voidable contracts in the federal substantive law of arbitration, is a rather minor scrimmage in the overall fight to determine the proper role of arbitration in American society and the Congressionally determined reach of the FAA. It does not announce any major new legal principles, but merely extends existing findings or premises to a new factual pattern, i.e. that, under the federal substantive law of arbitration,

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[18] This latter conclusions was reached in the *Southland* case, and, as will be seen below, is itself subject to strong criticism.

[19] 2006 WL 386362 at *4.

[20] *Id.*

[21] This point is confirmed by the Court's statement that:

> We note that neither Prima Paint nor Southland lends support to respondents' reading; as we have discussed, neither case turned on whether the challenge by issue would render the contract voidable or void.

[22] SAC's Weekly Alert For: Securities Litigation SLA 2006-09 at p. 2 (Feb. 27, 2006)(electronic version).

void and voidable contracts will be treated the same.[23] I see in *Buckeye* red flags that the Court is willing to reconsider several of the basic premises of the role of the FAA. The opinion is very carefully crafted and narrow in scope. At the same time, it leaves hints that the Court may not be happy as to the present role of the FAA and a willingness of the Court, in the proper case, to re-examine the entire issue.

I base my prediction on two red flags that I see in *Buckeye*. The first "red flag" is the statement, in Footnote 1, that the Court was not deciding whether the court or the arbitrators would determine whether the investor and the broker-dealer ever entered into an arbitration contract. Rightly or wrongly, the Court considered this to be a separate issue from whether an acknowledged agreement to arbitrate was void under state law.

The second "red flag" I see is the statement found at the beginning of the Court's discussion. The Court first stated what it believed were the controlling principles decided in the earlier *Prima Paint* and *Southland* cases. The Court, then, added the following gratuitous comment:

> The parties have not requested, *and we do not undertake reconsideration of [the] findings of [Prima Paint and Southland].*[24]

To me, the Court is saying: "Appellant, you did not ask the right question, but in a proper case, if the appellant asks the right question, we might reconsider the wisdom of the holdings in both *Prima Paint* and *Southland*."

Support for this position, I believe, is abundant. Justice Scalia, the author of the majority opinion in *Buckeye*, himself thinks that the *Southland* case was improperly decided. In his dissent in *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 284 (1995), he first admitted that he had joined the majority in *Southland* and in *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*[25] However, he noted, as he did in the above quote from *Buckeye*, that in neither of these cases did the parties ask for a reconsideration of *Southland*. In *Allied-Bruce*, he acknowledged that the central theme of the respondent's argument was that *Southland* was wrongly decided.[26] He then concluded:

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[23] In doing so, the Court brushes aside any discussion of common law or state contract law. By fiat, the Court indicates that the common law of contracts as developed by the states is irrelevant. The controlling factor is what furthers the "national Policy favoring arbitration." The holding may be inconsistent with the common law contracts, but that is not a problem because it is making a policy decision, rather than a legal decision. It is creating a body of federal substantive law which is totally independent from state contract law and may be inconsistent therewith. Only the Supreme Court, whose decisions are not subject to further appeal, can create such law by fiat.

Considerations of national policy is an appropriate thing for the Court to consider in cases of Constitutional interpretation, but not in statutory construction. National policy in such cases is determined by the words of the statute and demonstrable Congressional intent. As will be seen below, neither supports the creation of a federal substantive law of arbitration or establishes a National Policy favoring arbitration. While Congress possibly could create such policy and authorize the development of a body of federal substantive law to support it, Congress has not done so, and the Court should not usurp Congress' function.

[24] 2006 WL 386362 at *4. [Emphasis added].

[25] 489 U.S. 468 (1987).

[26] He also noted that the respondent's position was supported by an *amicus* brief signed by 20 states' attorney generals. This number has grown to 42 in the Amicus Brief filed in *Buckeye*. *See* Amicus Brief of Florida et al., 2005 WL 2377361 (Sept. 23, 2005).

> For the reasons set forth in Justice THOMAS' opinion, which I join, I agree with the respondents ... that *Southland* clearly misconstrued the Federal Arbitration Act.

I do not believe that proper application of *stare decisis* prevents correction of the mistake. Adhering to *Southland* entails a permanent, unauthorized eviction of state-court power to adjudicate a potentially large class of disputes. . . .

> I shall not in the future dissent from judgments that rest on *Southland*. I will, however, stand ready to join four other Justices in overruling it, since *Southland* will not become more correct over time....[27]

As discussed below, Justice Thomas also wrote a dissent in *Buckeye*. While Thomas' dissent was short, it re-affirmed his long standing contention that *Southland* was incorrectly decided. His opposition to the *Southland* decision is articulated in his earlier long dissent in *Allied-Bruce.*[28]

His position in *Allied-Bruce* was that Congress cannot pass a statute which attempts to regulate procedure in state court actions. To him, the legislative history of the FAA shows that it was intended to be a procedural statute, controlling only the conduct of the lower federal courts, and not to create a body of substantive federal law. While Congress had the authority to create a body of federal substantive law under the commerce clause, it did not do so when passing the FAA. Such a body of substantive federal law *would be* binding on the state courts.[29] Congress further has the constitutional authority to create and provide operational procedural rules for inferior federal court, but this authority does not extend to imposing such rules on the state courts. This view is also shared by Justice Stevens.[30]

The composition of the Court also seems to indicate a re-consideration of the role of the FAA is possible. Three of the presently sitting Justices, Scalia, Thomas, and Stevens, believe that the *Southland* decision was error,[31] while four, Breyer, Kennedy, Souter, and Ginsburg, are leaning toward supporting it. The remaining two, the Chief Justice and Justice Alito, have not considered the issues.

I am not the only person who thinks that the entire issue is ripe for reconsideration. In an article[32] published *before* the *Buckeye* decision, Professor Reuben noted the inconsistency of the Court's decision in *Prima Paint* and *Southland* and its more recent decisions in *First Options of Chicago, Inc. v. Kaplan*,[33] and *Howsam v. Dean Witter Reynolds, Inc.*[34] He first stated:

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[27] 513 U.S. at 285 (Scalia, J., dissenting).

[28] 513 U.S. at 845-851 (Thomas, J., dissenting). Justice Scalia also joined in this dissent.

[29] *See Testa v. Katt*, 330 U.S. 386 (1947).

[30] *Southland*, 465 U.S. at 18-21 (Stevens, J., dissenting).

[31] Justice Stevens, however, appears to support the conclusion in *Southland* on the basis of changed conditions.

[32] Richard C. Reuben, "First Options, Consent to Arbitrate, And The Demise of Separability: Restoring Access to Justice For Contracts With Arbitration Provisions," 56 SMU L. Rev. 819 (2003), hereinafter "Reuben, ___."

[33] 514 U.S. 938 (2002).

[34] 537 U.S. 79 (2002).

> *Howsam* seems to support the argument that the Court is rethinking, clarifying, and perhaps simplifying the law of arbitrability. The further it moves along such a path toward actual consent to arbitrate, the clearer it becomes how *First Options* "sits uneasily alongside" of *Prima Paint*.[35]

In the closing of his article, Reuben concluded that the Court have to re-visit the entire area and that the *First Options* and *Howsam* approach will prevail. He said:

> The tension between the ... cases is palpable, and calls for a determination by the Supreme Court as to which will prevail. The better view, the view supported by the text and legislative history of the Federal Arbitration Act, the view that enhances rather diminishes rule of law values, the view that appears to be supported by all nine members of the current U.S. Supreme Court.[36]

Obviously, whether these are true "red flags" as to the Court's willingness to re-consider whether there should be a body of federal substantive law of arbitration; whether this body of law, if it exists, should include the severability doctrine; and whether the FAA should control in state court action, or whether my opinion is only wishful thinking, remains to be seen.
On the assumption that the Court will have to re-examine *Prima Paint* and the three basic tenets or findings of it and *Southland* outlined by Justice Scalia in *Buckeye*, a brief discussion of each of these three tenets is in order. This discussion will focus why courts and legal scholars find each logically and legally unsupportable. To use a biblical analogy, the concept of a "national policy of arbitration" created by *Prima Paint* is a house built on sand, not rock, can not last.

III. THE COURTS SHOULD DECIDE IF THE PARTIES EVER AGREED TO ARBITRATE

To me, the issue of who determines whether the parties agreed to arbitrate, given the Court's prior decisions, should be simple. This dispute should be resolved by the Courts and should not be submitted to the arbitrators. This answer, however, appears contrary to popular thinking on the subject.

Most people think that there is a presumption in favor of arbitration. *No such presumption exists. To the contrary, there is a presumption against finding that the parties agreed to arbitrate.* The presumption that people mistakenly based their conclusion on is the presumption that once a contract to arbitrate has been established, there is a presumption that this contract is broad enough to cover the present dispute.[37]

The Supreme Court has taken the position that arbitration is purely contractual.[38] As a result,

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[35] Reuben, at 872.

[36] *Id.*, 883. Of course, the membership of the Court has changed and the *Buckeye* decision has come down, since he wrote these words. What effect these changes will have upon his opinion is, of course, not known. However, Professor Reuben joined with twelve other law professors from around the country, in filing an Amicus Curiae Brief, Brief of Law Professors, 2005 WL 2376815 (Sept. 23, 2005), urging affirmance of the Florida Supreme Court's ruling. He also embraced this position in the January, 2006 article in Trial, Richard C. Reuben, "The Closing Courthouse Door-- When Arbitration Subverts Democracy," 42 Trial 34 (Jan. 2006). In light of the very narrow nature of the *Buckeye* opinion, I doubt that he or the other professors have changed their opinion. *See also* Brief of Wisconsin Law Professors, 2005 WL 2396333 (Sept.23, 2005), urging the overruling of *Southland*.

[37] *See e.g., Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).

[38] *See e.g., Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995).

no person can be forced to arbitrate *unless he or she has entered into a contract to do so.* Under Section 3 of the FAA,[39] this decision must be made by the court. The court can only send a case to arbitration *after it has determined that there is a valid contract to arbitrate.* In making this decision, there is *no presumption of arbitrability. To the contrary, the presumption is that there is no contract to arbitrate.*

The Supreme Court in *First Options of Chicago, Inc. v. Kaplan*,[40] made this conclusion clear when It said:

> This Court, however has ... added an important qualification, applicable when the courts decide whether a party has agreed that arbitrators should decide arbitrability. Courts should *not assume that the parties agreed to arbitrate arbitrability unless there is "clea[r] and unmistakabl[e]" evidence that they did so. [Citations omitted.] In this manner the law treats silence or ambiguity about the question "who (primarily) should decide arbitrability" differently from the way it treats silence or ambiguity about the question "whether a particular merits-related dispute is arbitratible because it is within the scope of a valid arbitration agreement" -- for in respect to this latter question the law reverses the presumption. [i.e., holding that any doubts will be settled in favor of arbitration].*[41]

The above discussion makes clear that the courts, not the arbitrators, should make the decision as to whether the parties have agreed to arbitrate. Further, as *First Options* held, there is a presumption that they did not, absent clear evidence that they did.

IV. THERE SHOULD BE NO FEDERAL SUBSTANTIVE COMMON LAW OF ARBITRATION

That part of the *Prima Paint* decision which has created the greatest debate is that dealing with the severability doctrine. However, there are three other major issues which had to be decided by *Prima Paint* before it could get to the severability issue. These issues are: (1) Congress intended, in passing the FAA, to create "a national policy favoring arbitration;" if so, did Congress intend to enforce that policy by creating a body of federal substantive common law of arbitration; and, (2) if the first two issues are answered in the affirmative, was the action of Congress Constitutional.

Of course, *Prima Paint* concluded the answer was Congress intended to create a "national policy favoring arbitration" and to enforce this policy by the creation of a body of substantive federal common law of arbitration. Further, *Prima Paint* held that Congress could do so under its power to regulate interstate commerce.

These three interrelated decisions were controversial from the day of their announcement. Justice Black took the *Prima Paint* majority to task with a stinging dissenting opinion[42] in which Justices Douglas and Stewart joined.

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[39] 9 U.S.C. §3.

[40] 514 U.S. at 944-945. [Emphasis added.] *See also Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 123 S.Ct. 588 (2002).

[41] 514 U.S. at 944-945. [Emphasis added.] *See also Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 123 S.Ct. 588 (2002).

[42] *Prima Paint*, 388 U.S. at 407-425 (Black, J., dissenting).

First, Justice Black pointed out that the legislative history of the FAA clearly showed that Congress intended only to create a procedural remedy in the federal courts for the enforcement of arbitration contracts. It had no intent to create a substantive body of federal common law of arbitration or a national policy favoring arbitration. He pointed out that these ideas of Congressional intent were pure fiction, created by Judge Media in a Second Circuit opinion, *Robert Lawrence Co. v. Devonshire Fabrics, Inc*,[43] decided some thirty-five years after the adoption of the FAA in 1925.[44]

He then concluded that even, if Congress had intended such a result, the result could not constitutionally stand at the time of the *Prima Paint* decision. He felt that a review of the legislative history of the FAA clearly showed that Congress based the adoption of the FAA primarily not upon the power to regulate interstate commerce as the majority claim, but rather upon Congress' power to create and regulate inferior federal courts.[45] This power, as opposed to Congress' power under the interstate commerce clause,[46] does not support the creation of either a national policy favoring arbitration or a body of federal substantive common law binding on the states or their courts.[47]

Finally, he pointed out, even if Congress had intended to create a body of general federal common law, binding only on the federal courts, such body of general federal substantive common law, could not have survived the later decision in *Erie R.R. v. Tompkins.*[48] As every law student and lawyer knows, *Erie* abolished general federal substantive common law. As Justice O'Connor later said in *Southland*:

> *Erie* denied the federal government the power to create federal substantive common law by virtue of Article III power to control federal court jurisdiction.[49]

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[43] 271 F.2d 402. 410 (2d Cir. 1959), cert. granted, 362 U.S. 909, dismissed, 364 U.S. 801. Judge Medina said:

> Any doubts as to the construction of the [FAA] ought to be resolved in line with its liberal policy of promoting arbitration both to accord with the original intention of the parties and *to help ease the current congestion of court calendars*. Such policy has been consistently reiterated by the federal courts and we think it deserves to be heartily endorsed. [Emphasis added].

The emphasized language one suspects is the real reason the federal courts have pushed arbitration--docket control.

[44] 388 U.S. at 409 (Black, dissenting).

[45] 388 U.S. at 411 (Black, dissenting); *Id*. at 418-419.

[46] The majority held that the commerce clause could support a national policy favoring arbitration and the creation of a body of federal substantive law of arbitration. While this holding has not gone unchallenged, it is generally conceded that Congress does have the power under the commerce clause to create a body of federal substantive common law.

Subsequently, in *Southland*, the Court extended this holding in *Prima Paint* to the pre-emption of state law and made the federal substative law of arbitration binding on the state courts.

[47] *Id*. at 417.

[48] 304 U.S. 64 (1938).

[49] 465 U.S. at 23 (O'Connor, J., dissenting).

Subsequent members of the Court, as well as many legal scholars, have questioned the existence of this national policy favoring arbitration and the wisdom[50] and legality of *Prima Paint* and its progeny in creating a body of federal substantive common law of arbitration. Justices O'Connor and Rehnquist in *Southland*[51] and Justices Thomas and Scalia in *Allied-Bruce*[52] have debunked the legislative history and commerce clause arguments as has many legal scholars including Professor Sternlight.[53] The constitutional basis of the FAA has also come under attack in a series of articles by Professor Schwartz.[54]

V. EVEN IF THERE IS A SEPARATE BODY OF FEDERAL ARBITRATION LAW, SEVERABILITY SHOULD NOT BE PART OF THIS DOCTRINE

The second flaw in the *Prima Paint* case is the creation of the severability doctrine.[55] The

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[50] Professors Sternlight, Jean R., "*Panacea Or Corporate Tool?: Debunking The Supreme Court's Preference for Binding Arbitration*," 74 Wash U.L.Q. 637, 674-697 (1996)(Hereafter "Sternlight, at __"); Schwartz, David S., "*Enforcing Small Print To Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration,*" 1997 Wis. L. Rev. 33; and Reuben, have all questioned whether public policy should favor arbitration in all cases. Reuben points out that arbitration is appropriate when applied to a relatively small close-knit group, such as the diamond industry, *see* Lisa Bernstein, "*Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry,*" 21 J. Legal Stud. 115 (1992), but is *not appropriate for large groups of the general public such as consumers and investors dealing with large corporations such as banks and broker-dealers.* He then concluded:

> [A]s arbitration has evolved in the "new" era of ADR, deference to arbitration is less appropriate because it has come to be more likely to pit one-time litigants against "repeat players," and more likely to involve statutory and other rights rather than matters of industry custom or contractual interpretation and performance. This may be one reason why, after a burst of judicial exuberance, the Court now appears to be settling on a less permissive, more centrist, traditional contract theory.

Reuben, 830. *See also* Sternlight, 677-697; Jeffrey W. Stempel, "*Contracting Access To The Court: Myth or Reality? Boon or Bane?,*" 40 Ariz. L. Rev. 965 (1998); and Margaret M. Harding, "*The Cause and Effect of the Eligibility Rule Securities Arbitration: The Further Aggrieviation of Unequal Bargaining Power*," 46 DePaul L. Rev. 109 (1996).

[51] *Southland Corp. v. Keating*, 465 U.S. 1, 21-36 (O'Connor and Rehnquist, JJ., dissenting).

[52] *Allied-Bruce Terminix Corp. v. Dobson*, 513 U.S. 268, 285-297 (1994)(Thomas and Scalia, JJ., dissenting).

[53] Professor Sternlight said:

> The language of the Court's recent decisions implies that Congress mandated a preference for arbitration over litigation many years ago, and that the Court has subsequently enforced that preference consistently. However, Section II of this Article demonstrates that this preference for arbitration is a myth that has no historical basis.

Sternlight at 641. [Footnotes omitted.] *See also Id*., 642-674.

[54] David S. Schwartz, "*Correcting Federalism Mistakes in Statutory Interpretation, the Supreme Court and the Federal Arbitration Act,*" 67 Law & Contemp. Probs. 5 (1994); *Id*., "*The Federal Arbitration Act and the Power of Congress Over State Courts,*" 83 Ore. L. Rev. 541 (1994); *Id*., "*New Federalism, State Judges As Guardians of Federalism: Resisting the Federal Arbitration Act's Encroachment on State Law*," 16 Wash. U.J.L. & Pol. 129 (2004).

[55] This doctrine is also referred to as the "Severability Doctrine."

essence of this doctrine is that any attack on the main contract, in which the arbitration clause is embedded, based upon state common law of contracts, must be determined by the arbitrators, rather than the court. Only attacks directed directly at the arbitration clause itself will be heard by the courts. The justification for this doctrine is that as a matter of *federal substantive law of arbitration*, not state contract law, the arbitration clause is to be treated as a separate contract severable from the main contract in which it is embedded.[56]

From its inception, this doctrine has been treated with horror by many lawyers and legal scholars alike.[57] Justice Black was so incredulous that he dissented in *Prima Paint* saying:

> The Court holds, what is to me fantastic, that the legal issue of a contract's voidness because of fraud is to be decided by persons designated to arbitrate factual controversies arising out of a valid contract between the parties. And the arbitrators who the Court holds are to adjudicate the legal validity of the contract need not even be lawyers, and in all probability will be nonlawyers, wholly unqualified to decide legal issues, and even if qualified to apply the law, not bound to do so.... [] I am fully satisfied that a reasonable and fair reading of [the FAA's] language and history shows that both Congress and the framers of the Act were at great pains to emphasize that nonlawyers designated to adjust and arbitrate factual controversies arising out of valid contracts would not trespass upon the courts' prerogative to decide the legal question of whether any legal contract exists upon which to base an arbitration.[58]

The doctrine likewise has been criticized by legal scholars.[59] For example, Professor Reuben has undertaken a detailed criticism of *Prima Paint*, based on Justice Black's dissent.[60]

Reuben[61] also indicates that the state courts also have not well received the severability doctrine. He reports that, while 28 states have clearly adopted the severability concept, only 17 have done so without limitation. The remaining 11 states accept severability with some limitation. The most common limitation is that adopted by the Florida court in *Buckeye*

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[56] As noted in the beginning of the column, the severability doctrine can be justified under *state* contract law where the attack on the main contract is that it is voidable, which was the case in *Prima Paint*. However, as the Florida court held in *Buckeye*, it is not supportable under state contract law, if the contract is void, not merely voidable. In latter case, there never was a contract between the parties, so no embedded provision can stand independently.

[57] For example, Alan Scott Rau in his article "The Arbitrability Question Itself," 10 Am. Rev. Int'l Arb. 287, 341 (1999) states that the prospect of arbitrators deciding jurisdiction is "a conceptual horror."

See Richard C. Reuben, "First Options, Consent to Arbitration, and The Demise of Separability: Restoring Access to Justice For Contracts With Arbitration Provisions, 56 SMU L. Rev. 819, 8411 n.131 (2003), collecting articles. Hereinafter "Reuben, at ___."

[58] 388 U.S. at 407 (Black, J., dissented). Black was joined in this dissent by Justices Douglas and Stewart.

[59] See Reuben at 841, n.131, collecting a few of the critical articles.

[60] Reuben at 838-849.

[61] Reuben 852-855. This compilation is more than three years old and the numbers may have changed in the interim.

that the doctrine only applies to "voidable" contracts and not void ones. But he also points out that twenty-three states have either rejected the severability doctrine or have not addressed the issue. Of these, nine have specifically refused to adopt the doctrine as a matter of common law. Reuben, however, does not indicate whether the courts which have adopted the severability doctrine have done so because of the mandate of *Prima Paint* as a matter of federal law or whether they are establishing a state law rule.[62]

VI. THE FAA SHOULD NOT APPLY TO STATE COURT PROCEEDINGS

The idea that the FAA should control actions in state court was first introduced in *Southland Corp. v. Keating.*[63] Relying on the controversial holding in *Prima Paint*, the Court concluded that:

> In enacting Section 2 of the federal [arbitration] Act, Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.[64]

The Court then extended the reach of the FAA to state courts saying:

> [I]t is clear beyond question that if suit had been brought as a diversity action in a federal court, the arbitration clause would have been enforceable. *Prima Paint, supra*. [A different] interpretation given to the Arbitration Act by [a state] court would therefore encourage and reward forum shopping. We are unwilling to attribute to Congress the intent, in drawing on the comprehensive powers of the Commerce Clause to create a right to enforce an arbitration contract and yet make the right dependent for its enforcement on the particular forum in which it is asserted. And since the overwhelming proportion of all civil litigation in this country is in state courts, we cannot believe Congress intended to limit the Arbitration Act to disputes subject only to *federal* court jurisdiction. Such an interpretation would frustrate Congressional intent to place "[a]n arbitration agreement...upon the same footing as other contracts, where it belongs."[65]

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[62] For example, the Oklahoma Supreme Court rejected the severability doctrine as a matter of state law in *Shaffer v. Jeffery*, 915 P.2d 910 (Okla. 1996). However, more recently in *Rogers v. Dell Computer Corp.*, 127 P.3d 560 (Okla. 2005), the court felt compelled to follow *Prima Paint* in a state court case involving the FAA.

[63] 465 U.S. 1 (1984).

[64] 465 U.S. at 10. The basis for this conclusion is the other controversial holding in *Prima Paint* that the FAA was bottomed on the Congressional power to regulate interstate commerce. *Id.*

While there is no question that Congress has such power, it appears pure fiction that Congress intended to exercise that power when enacting the FAA. See Justice O'Connor's stinging dissent, 465 U.S. at 22-36, joined by Justice Rehnquist. Justice Black made a similar stinging attack in his dissent in Prima Paint, 388 U.S. at 407-425, in which Justices Douglas and Stewart joined.

Justice Stevens recognized the fiction of the commerce clause basis for the FAA. However, he justified a national policy favoring arbitration based upon "intervening developments in the law."

[65] 465 U.S. at 15-16 [Footnotes and last citation omitted.]

This result may be good social policy,[66] especially in an age when business wants to make everything uniform and pro-business through federalization of many areas of state law.[67] It also may be in accord with the present thinking of Congress. But it is bad history.[68]

As Justice Black pointed out in his dissent in *Prima Paint*, the arbitration act does not rest upon Congress' power under the Commerce Clause, but rather on its power to provide rules of procedure in the federal courts.[69] Further, as Justice O'Connor and Rehnquist point out in their dissent in *Southland,*[70] it also is contrary to the legislative intent when the FAA was adopted. It is blatant judicial revisionism[71] and social engineering by judicial legislation and fiat. Finally, there is a substantial question as to the Constitutional ability of Congress or the Supreme Court to impose constraints on the state courts.[72]

Justice Stevens recognized the *Southland* decision was fiction when relying on the legislative history of the FAA, but justified the Court's holding by saying:

> Although Justice O'CONNOR'S review of the legislative history of the federal Arbitration Act demonstrates that the 1925 Congress that enacted the statute viewed the statute as essentially procedural in nature, I am persuaded that the intervening developments in the law compel the conclusion that the Court has reached.[73]

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[66] As Professor Reuben states:

> From a policy perspective, Prima Paint's goals of promoting arbitration and securing the jurisdiction of the arbitrator were laudable. But they come at the high cost of precluding judicial access for many parties seeking to have a court, rather than an arbitrator, decide whether a contract in which they have purportedly entered is enforceable as a matter of contract law.

Reuben at 883.

[67] It is much easier to convince one legislative body, Congress, which is philosphically sympathic, than it is to convince fifty state legislatures. From a more cynical point of view, it is much easier and cheaper to "buy" Congress, rather than fifty different legislatures.

[68] Pamela S. Karlan, "*Disarming the Private Attorney General,*" 20-26 (Stanford Pub. Law & Legal Theory, Working Paper No. 36, 2002), discusses the Supreme Court's reluctance to interpret statutes, including the FAA, in light of their historical context.

[69] *Prima Paint*, 388 U.S. at 407-425 (Black, J., dissenting.)

[70] 465 U.S. at 22-36.

[71] *Id.*

[72] *See* Justice Black's dissenting opinion in *Prima Paint. See also* David S. Schwartz, "The Federal Arbitration Act and the Power of Congress Over State Courts," 83 Ore. L. Rev. 541 (2004); David S. Schwartz, "Correcting Federalism Mistakes in Statutory Interpretation: The Supreme Court and the Federal Arbitration Act, 67 Law & Contemp. Prob. 5 (2004); The *Buckeye* Amicus Brief of the Wisconsin Law Professors, 2004 WL 2396333 (Sept. 23 2005) at pp. 12-19.

[73] 465 U.S. at 17.

This dispute is far from over.[74] Forty-two state attorneys generals filed an Amicus Curiae brief in *Buckeye* urging the overruling of *Southland***.**[75] These attorneys generals were joined by a group of Wisconsin law professors.[76] On the Court itself, the objections of Justices Black and O'Connor live on through Justice Thomas, who has dissented on the reach of the FAA to state courts on several occasions.[77] He again dissented in *Buckeye***,** saying:

> I remain of the view that the Federal Arbitration Act ... does not apply to proceedings in state court. ... Thus, in state-court proceedings, the FAA cannot be the basis for displacing a state law that prohibits enforcement of an arbitration clause contained in a contract that is unenforceable under state law.[78]

Like it or not, *Buckeye* is the law of the land until overturned. Therefore, in Part II, we will address the impact of the *Buckeye* decision on the arbitration process itself.

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[74] Joshua R. Welsh, "*Has Expansion of the Federal Arbitration Act Gone Too Far?: Enforcing Arbitration Clauses in Void Ab Initio Contracts,*" 86 Marq. L. Rev. 581 (2001).

[75] *See* Amicus Curiae Brief of Florida et. al., 2005 WL 2477361 (Sept 23, 2005).

[76] Brief of Law Professors, 2005 WL 2376815 (Sept. 23, 2005).

[77] *See Allied-Bruce Terminix Cos. v. Dobson,* 513 U.S. 265, 285-297 (1995)(Thomas, J., dissenting), *Doctor's Associates, Inc. v. Casarotto,* 517 U.S. 681, 689 (1996)(Thomas, J., dissenting), and *Green Tree Fin. Corp. v. Bazzle,* 539 U.S. 444, 460 (2003)(Thomas, J., dissenting).

[78] 2006 WL 386362 at *6-*7 (Thomas, J. dissenting).

PIABA-The Bar Association: Professional Responsibility And The Development Of Ethical Precepts

By Seth Lipner

PIABA is a national bar association that was established in 1990. The main purpose for which PIABA was formed was to level the playing field for aggrieved public investors who are compelled to arbitrate their claims before securities industry self-regulatory organizations ("SROs"). Starting out with a core of five dedicated lawyers, the organization has grown in size and stature. The membership is now nearly 800 attorneys of varying backgrounds and expertise.

During the 15 years of PIABA's existence, the playing field for aggrieved investors has improved, but there is much more that needs to be done. Even as PIABA continues to pursue its goal of making SRO arbitration fair, the rapid growth in membership has changed the organization, presenting PIABA with new challenges.

PIABA is no longer a tightly-knit cadre of experienced specialists. The market crash of 2000 - 2002 brought a large influx of new members. Some are lawyers with long experience in other fields; some are young attorneys starting out; others are in-between. Most of these new members joined in order to learn about the special laws, rules and strategies involved in securities arbitration. As members, they discovered the comradery and sense of purpose that PIABA's founders shared, and sought to instill in others.

PIABA AT A CROSSROAD

As a bar association, PIABA is at a crossroad. Will PIABA continue simply to serve its members as a fountain of information and vehicle to fight the powerful financial-services industry, or will it mature into an organization that also serves the public by raising professional standards and defining and encouraging ethical behavior among its members? As a founding member of PIABA, I would like to see us take both paths.

In the 15 years since PIABA was formed, the legal landscape has changed dramatically. Not only have an individual's substantive rights been curtailed under the guise of "tort reform", but lawyers - even those who represent the physically injured and the downtrodden - have been demonized by political conservatives, some members of the defense bar and selfish corporate interests. That trend and politics, which continue unabated, has undoubtedly affected the arbitrator community. Some arbitrators will inevitably think investor-claimants are just trying to shift responsibility for their own poor judgment. And, unfortunately but undoubtedly, some arbitrators believe that claimants' and their lawyers are predators seeking to cash in by "holding up" deep-pocket corporations.

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Some of the criticism the legal profession receives is deserved. Marketeers posing as lawyers are ubiquitous, sometimes calling themselves "mass tort lawyers". Advertisements and Web sites often imply that the only requirement for making a claim against a brokerage firm is that the investor lost money. Referral mills pollute the landscape. Cookie-cutter claims are filed. Cases are not pursued aggressively. The eagerness to mediate and settle at any cost are palpable. A few lawyers repeatedly pursue pennies-on-the-dollar settlements, assuming that if they can recruit enough "victims", profits will be made for their law firms. The securities industry and the defense bar know it and exploit it.

It should be no surprise that many arbitrators see the same things. Sitting in ever-changing groups of three, arbitrators who are anti-lawyer/anti-plaintiff spread their bad experiences throughout the pool, without ever having to publicly show their bias by not providing reasons for their Awards.

It is an old saw that a few rotten apples (or their attorneys) can spoil the whole barrel. That is why it is the responsibility of all attorneys, and every bar association, to work to eliminate (or at least reduce) professional "rot" by defining (and enforcing) standards of ethical behavior. PIABA has the ability to do just that.

The process of defining and enforcing ethical standards is not an easy job. One approach - both facile and dangerous - is to say it can't be done or to leave the job to others. Neither is acceptable.

PIABA's approach for its first 15 years has, unfortunately, been to leave ethical definition and enforcement to national, state and local bar groups. That approach will not work to either the public's or PIABA's advantage for the next 15 years. The peculiarities of securities arbitration; the special problems of representing aggrieved investors; and, the diversity of PIABA's membership make it important that PIABA take *an active role* in encouraging ethical behavior, thereby elevating the quality of practice and protecting the public from a second professional mishap – inadequate representation.

Dedication to the "profession" - by defining, encouraging and enforcing ethical standards - is needed now more than ever. Only by doing so will the arbitration community see PIABA members as responsible citizens engaged in a noble occupation. Simply put, if it is to continue to be increasingly effective as an organization, The Public Investors Arbitration Bar Association must do more than just educate, advocate and encourage idea-sharing among its members. Through developing and maintaining a high level of professional conduct among its members, PIABA has the power to increase the probability that aggrieved investors will be fully, regularly and justly compensated for their economic injuries.

The purpose of this article is not just to urge PIABA to do more in this area; it is also to begin the process of defining these ethical rules so that the public, the industry, the arbitrators, the regulators, the defense bar - and the members - will see PIABA as a bar association, not just a "trade association" or lobbying group.

What follows, then, is a hoped-for beginning. No one will, or should, believe that the standards set out here are immutable or ideal. They are, literally, a proposal for discussion - and a first draft at that. Discussion, debate, drafting, re-drafting and building a consensus must take place. The "leadership" of PIABA must lead the organization and its members through the process of encouraging a high degree of professionalism, so that the benefits described above can be realized.

With these goals in mind, I offer the following eight ethical principles.[1]

THE PRINCIPLES

1. **PIABA attorneys must "know their case"[2] and must conduct due diligence about a case *before* agreeing to serve as counsel or filing a Claim**. Bad cases hurt everyone, and they fuel the belief that attorneys just want to "hold-up" deep pockets. Cases brought, for example, against respondents not materially involved in the wrongdoing, or cases brought based on incorrect or unprovable allegations, breed cynicism and contempt. While it is never possible to learn "everything" while interviewing clients, much of the needed information and documents are well-defined and usually available from the potential client in a securities arbitration. The list of necessary items is mostly contained in the "NASD Discovery Guide" (a/k/a NASD Notice to Members 99-90). The gathering of tax returns, monthly statements and other financial documents is the minimum level of prudence that should ever be exhibited.

   Every lawyer needs to obtain as many of those documents as are available from the potential client deciding to bring a case. They should be obtained ***before filing a claim***, not simply when discovery begins. The same is true regarding research, when relevant, to validate the theories underlying the claim. Due diligence will help avoid the bringing of cases that suddenly "go bad", by helping to identify problems before they become problems. Effective due diligence requires that extra effort. All PIABA lawyers need to make that effort - every time - before filing an arbitration claim.

2. **PIABA attorneys must not engage in deceptive advertising by overstating the attorney's experience in securities arbitration**. PIABA's existence and growth are attributable, in large part, to the recognition that securities arbitration is a specialized practice requiring specialized knowledge. That statement is not intended to imply that representing investors in arbitration is the legal equivalent of "brain surgery". But there are sometimes highly-specialized if not unusual rules that apply (e.g., the six-year eligibility rule). Special knowledge of the securities industry is required; some savvy with respect to the arbitrator pool and the "players" is needed; and, sometimes arbitration requires lawyering skills different from those used in other types of litigation.

   The reality is that clients of attorneys (like patients of physicians) have scant ability to determine an attorney's actual level of expertise and experience. With the amount of television, radio and Internet advertising by PIABA members (and other lawyers) now dramatically higher than it was 15 years ago, PIABA must act aggressively to protect the public from false or exaggerated advertisements.

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[1] Eight is a good number. In criticizing Woodrow Wilson's 14-Point Plan (following WWI), Prime Minister Clemenceau of France remarked: "14 points? Even God only had 10". Heed is paid to that acerbic comment.

[2] The reference to NYSE Rule 405 is intended to convey a "golden-rule" attitude toward the PIABA lawyer's duty. The potential clients of PIABA members are already aggrieved by the failure of a profession which promises "high standards of commercial honor and just and equitable principles of trade." See NASD section 2110. PIABA lawyers must adhere to even higher standard.

Attorneys who actively seek investor cases through mass media and the Internet must be especially careful not to overreach or deceive - our clientele is often uneducated, unsophisticated and trusting. That is how they suffered financial damages in the first place.

Investor-clients often have little or no experience with lawyers and the legal system and are sometimes unduly impressed by flashy ads and the glib use of jargon on Web sites. Experienced trial lawyers, excellent as they may be, should not suggest, in their advertising, that they are experienced and knowledgeable about this field until they have real experience bringing securities arbitrations **and** in conducting hearings.

In particular, as a minimal assurance of "truth-in-advertising", the use of the terms "specialist" or "expertise" by PIABA members should not be used by attorneys who have conducted fewer than five securities arbitrations through hearing and Award. An advertisement claiming "expertise", where the lawyer has conducted fewer than five cases is deceptive and potentially injurious to the very public which PIABA professes to protect.[3] PIABA can and should police its own, by requiring, for example, submission of advertising material for review in advance of its use by members or their firms.

3. **Referral "mills" must be banned**. The discredited practice of advertising for clients with the intention of referring the case to another law firm must cease. Put differently, the marketers posing as lawyers must be stopped. The practice of advertising and referring is unethical, harmful and possibly illegal. PIABA members should be barred from either being refer-or or refer-ee. Indeed, any association with firms that engage in such conduct should be prohibited for PIABA members, just as association with non-attorney representatives ("NARs") is now prohibited.

4. **PIABA attorneys must read, know and keep current on the Federal Arbitration Act, state arbitration law and the SRO rules, and must participate in "continuing education" in the field**. Arbitration, especially securities arbitration, has its own set of rules. These rules are not tested on bar exams, or even taught in most law schools. Yet knowledge of the laws and rules is essential to success. The temptation, in a busy law practice, to learn as you go, or to rely on others to fill in the gaps as the case progresses, is a disservice to clients. PIABA attorneys, as specialists, must insure that they know special rules before starting out.

   On-the-job learning is not acceptable, and can be avoided, in most instances, simply by reading and studying the NASD arbitration rules, the substantive NASD/NYSE disciplinary rules, and the statutes and regulations pertaining to securities arbitration. Every PIABA member must read and review these rules regularly. PIABA should require that its members annually certify, in writing, that they have done their homework. Such a certification should be a condition imposed on all members, new and old.

   PIABA members should also be required periodically to obtain a certain amount of continuing legal

[3] Five may seem an arbitrary number, but levels of minimal competence usually are.

education credits in the area of securities arbitration.

5. **PIABA attorneys should not use generic/boilerplate Statements of Claim**. Securities arbitration cases are very different from personal injury cases. A personal injury case is (essentially) about two ships passing in the night - it is usually irrelevant where they've been, or where they are going. But securities brokerage cases are almost always "relationship" cases - past history and the direction of travel are highly relevant. One size can never fit all, even though many investors may have been injured by the same wrongdoing.

   Brokerage cases are ***so much*** about detailed facts and documents that a cookie-cutter approach will almost always fail. Unlike a personal injury lawyer, a securities arbitration attorney cannot depend on sympathy for the client or the gravity of the injury to produce a positive result. Every client, and every case is different. Careful development of the facts before the claim-drafting stage is crucial. A shot-gun approach to broker-wrongdoing will always backfire, and arbitrators, who easily become jaded, will become increasingly anti-investor, anti-claimant, and anti-lawyer.

   Case-specific allegations must be made in every Statement of Claim. A lawyer who does not do so is not being professional or effective. PIABA should insure that all its members adhere to this principle.

6. **PIABA attorneys should prosecute cases aggressively and diligently, and be ready to "try" every case that s/he files**. The securities industry relies on a divide-and-conquer strategy, and always look for the lowest common denominator. Attorneys who bring cases just to settle them for "whatever" send the wrong message to the industry, and all others with meritorious claims suffer.

   Case-neglect similarly breeds contempt and arrogance from the securities industry and the arbitrator community. The attorneys who regularly do securities arbitration know that the pond is very small. PIABA can't afford to have any of its members "peeing" in that pond. Winning good cases is hard enough. PIABA members shouldn't make it worse by demonstrating an unmitigated zeal to mediate and/or settle.

7. **PIABA attorney's contingency fees should be based on *net* recoveries, not *gross* recoveries**. Fees computed based on gross recoveries place attorneys in conflict both with clients and the arbitration process. When fees are based on gross recoveries, the attorney has little or no incentive to keep case expenses and disbursements to a minimum, or even at practical levels. When such fees are charged, the economic/efficiency benefits of ADR are not realized.

   Under a percent-of-the-gross arrangement, the attorney often gets more money than the client does. When that happens, the result is an unhappy client who likely will feel that the attorney is no better than the malefactor-broker. If a percent-of-the-gross fee arrangement is presented to an arbitrator, the result may well fuel the arbitrators' belief that the supposedly consumer-minded attorney places his own interests ahead of the client. Percentage-of-the-gross fees are unconscionable; PIABA members should not be permitted to charge them [4] NY Rules of Court, Appellate Division Second

Department, Rule 691.20(e)(ThomsonWest 2005) See, e.g. NY Rules of Court, Appellate Division Second Department, Rule 691.20(e)(ThomsonWest 2005)

8. **PIABA attorneys must speak out about injustice, submit complaints and comments, and recruit fair arbitrators.** It is the responsibility of all PIABA members to work to level the playing field. That means, when appropriate, writing and documenting complaints about arbitrators or SRO staff, submitting comments to the SEC on SRO arbitration-related rule proposals, and interacting with and assisting regulators in prosecuting wrongdoers, even if there is no direct benefit to a particular client.

   While no one complaint or comment will ever create material change, PIABA members must do everything they can to document and communicate instances of unfairness or inappropriate behavior. PIABA members must actively recruit fair, consumer-minded arbitrators, lest the industry, with a potential "ringer" on every panel, control the decision-makers. Expending time on such efforts yields no direct compensation. All PIABA members must think long-term, enabling the organization, with its growing membership, to accomplish real change. Change won't happen unless everyone participates - members can't just look to the "leadership" to do the job.

   Meeting this eighth standard is especially important to members for whom securities arbitration is just a part of their practice. The tendency only to bitch to fellow members and blame the "system" is a complete shirking of responsibility. All PIABA members must do their share if good things are to happen.

BUT CAN PIABA DO IT?

Yes.

Membership in PIABA is a valued and cherished privilege. Members can - no, must - conform to these standards, in order to contribute to the general welfare. Those who don't contribute in this way should have membership privileges curtailed. Clients and potential clients can and should be given copies of these ethical precepts - a kind of "Client's Bill of Rights". The principles should be displayed prominently on the PIABA Web site. Annual certification of compliance by members should also occur.

[4] The Rules of the Appellate Division Second Department, where the author practices, state: "(1) The receipt, retention or sharing of compensation which is in excess of [1/3] shall constitute the exaction of unreasonable and unconscionable compensation in violation of any provisions of the Code of Professional Responsibility, as adopted by the New York State Bar Association, or of any Canon of the Canons of Ethics, as adopted by such bar association, unless authorized by a written order of the court as hereinafter provided. . . .
"(3) Such percentage shall be computed on the net sum recovered after deducting from the amount recovered expenses and disbursements for expert medical testimony and investigative or other services properly chargeable to the enforcement of the claim or prosecution of the action. In computing the fee, the costs as taxed, including interest upon a judgment, shall be deemed part of the amount recovered. For the following or similar items there shall be no deduction in computing such percentages: liens, assignments or claims in favor of hospitals, for medical care and treatment by doctors and nurses, or self-insurers or insurance carriers. . . ."

CONCLUSION

As a mature and established bar association, PIABA needs to do more to define, and thereby raise, the standards and professionalism in this field. Deferral of that responsibility to others can no longer be justified.

Let the debate begin.

An Overview of Equity-Indexed Annuities

By Craig McCann, PhD and Dengpan Luo, PhD

Equity-indexed annuities are complex investments sold by insurance companies that pay investors part of the capital appreciation in a stock index and guarantee a minimum return if the contract is held to maturity. Sales of equity-indexed annuities have soared in recent years despite the impenetrable formulas used to calculate their likely returns. Equity-indexed annuities to date have been regulated by state insurance commissions, rather than by the Securities and Exchange Commission and the NASD. In this note, we provide an overview of equity-indexed annuities. We also sketch how they can be valued. We estimate that between 15% and 20% of the premium paid by investors in equity-indexed annuities is a transfer of wealth from unsophisticated investors to insurance companies and their sales forces.

I. Introduction

Since their introduction in the U.S. in 1995, sales of equity-indexed annuities have grown dramatically. Approximately $25 billion in equity-indexed annuities were sold last year. Equity-indexed annuities are quite similar to equity-participation securities, which are traded on the American Stock Exchange under various brand names. Equity-participation securities guarantee that investors will receive the initial face value of the security plus the increase in the value of a stock or stock index reduced by an annual spread. The correspondence between equity-indexed annuities and equity-participation securities is closely analogous to the correspondence between variable annuities and mutual funds.

Insurance companies add trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to mutual funds and sell them as variable annuities. Insurance companies have added similarly trivial insurance benefits, disadvantageous tax treatment and exorbitant costs to equity-participation securities and sell them as equity-indexed annuities. The primary difference in the correspondence is that repackaging mutual funds as variable annuities doesn't remove investor safeguards whereas repackaging equity-participation securities as equity-indexed annuities has heretofore exempted them from effective securities regulation.

A direct consequence of the difference in regulatory treatment is that investors in unregistered equity-indexed annuities cannot trace back through returns in the markets to the returns their investments will earn. Also, as a result of the lack of SEC and NASD oversight, investors in equity-indexed annuities cannot determine the costs they are

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incurring. Moreover, equity-indexed annuities' complexity makes it virtually impossible even for brokers and agents to properly evaluate the annuities. Salesmen can readily determine though that commissions paid for selling equity-indexed annuities – as high as 10% or 12% – are much larger than commissions paid on mutual funds and variable annuities.

A balanced portrayal of the costs and benefits of any equity-indexed annuity requires a comparison of its likely returns to the likely returns on alternative investments – including the investments the customer currently holds – under reasonable assumptions. Such a comparison need not be overly complicated to be informative as we will show below.

II. Regulation

In 1997, the Securities and Exchange Commission issued a Concept Release requesting comment on the (then) recent advent of equity-indexed annuities. More recently, the Commission warned investors considering buying equity-indexed annuities that "You should fully understand how and equity-indexed annuity computes its index-linked interest rate before you buy."[1]

In August 2005, the NASD issued a Notice to Members on the supervision of the sale of unregistered equity-indexed annuities by registered representatives.[2] The Notice describes some of the potentially misleading marketing claims used to sell equity-indexed annuities and encourages broker-dealers to adopt enhanced supervisory procedures for the sale of equity-indexed annuities by their registered representatives. The Notice tells broker-dealers that any recommendation to liquidate securities to purchase an equity-indexed annuity requires a determination that the equity-indexed annuity was suitable for the investor, even if the annuity is not a registered security. For a broker to determine that an equity-indexed annuity is suitable, he or she must understand the hidden costs generated within equity-indexed annuities' complex structures.

If the NASD applies the principles in Notice 05-50, broker-dealers will no longer be allowed to sell current equity-index annuities. As we explain below, existing equity-index annuities are too complicated for the majority of brokers and retail investors to understand. The complicated structures allow insurance companies to sell investments which are much more costly and much less liquid than available alternative investments. If brokers are required to understand equity-indexed annuities in the same way brokers must understand stocks, bonds or options, equity-indexed annuities must become simpler and more transparent.

The NASD issued an Investor Alert last summer warning potential investors that equity-indexed annuities are complex.[3] Combined with the Notice to Members 05-50, the Investor Alert makes clear that the NASD has determined that registered representatives who recommend that retail investors sell securities including variable annuities in order to buy equity-indexed annuities must do a thorough job explaining the features of the equity-linked annuity. It is also apparent that the NASD believes that broker dealers must supervise registered representatives, who send out sales material on equity-indexed annuities to ensure that the materials are not misleading and that any subsequent sale of an equity-indexed annuity is suitable.

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[1] See *www.sec.gov/rules/concept/337438.txt and* www.sec.gov/investor/pubs/equityidxannuity.htm.

[2] See *Equity-Indexed Annuities* NASD Notice to Members 05-50, August 2005.

[3] See *Equity-Indexed Annuities – A Complex Choice*, NASD Investor Alert, June 30, 2005.

The industry's trade groups are fighting back. In an effort to head off regulation of equity-indexed annuities, the National Association of Insurance and Financial Advisors sent out an Action Alert on November 29, 2005 urging its members to write the NASD and the Securities and Exchange Commission demanding the withdrawal of Notice to Members 05-50. The National Association for Fixed Annuities' December 5, 2005 *The Cry Over Indexed Annuities: Fact or Fiction, NAFA Sets the Record Straight* claims that equity-indexed annuities are not securities, that some equity-indexed annuities are suitable for seniors and that not all equity-indexed annuities have high surrender charges and pay exorbitant commissions.

III. Contract Features

A. Maturity

Equity-indexed annuity contracts pay out at maturity just like zero-coupon bonds but unlike bonds the amount to be received is unknown until maturity. The payout is a function of the general level of price appreciation in the stock market at or shortly before maturity. Other things equal, equity-indexed annuities with longer maturities provide less value to investors than annuities with shorter maturities.

B. Surrender Charge Schedules

Equity-indexed annuities have surrender charges frequently of 10% or 12% and as high as 25% if premium credits are included.[4] The surrender charges usually decline over a period of years. On some contracts, surrender charges last throughout the contract's life, making the contract's cash surrender value less than the premiums paid for many years.

C. Guaranteed Minimum Rates of Return

Equity-indexed annuities do not guarantee that investors won't lose money. They do guarantee a minimum rate of return – typically 3% – but the guaranteed rate is typically much less than the risk free rate of return offered on US Treasury securities with the same maturity as the annuity. Also, the guaranteed rate of return is usually only applied to a fraction of the amount invested and sometimes without compounding. On some contracts, no interest is credited unless the annuity is held to maturity. Holding constant the guaranteed rate of return, the higher the risk-free interest rate, the less valuable equity-indexed annuities are to investors.

D. The Stock Index

Equity-indexed annuities credit the investor a return under certain circumstances based on the change in the level of a stock price index. Most equity-indexed annuities are linked to the level of the S&P 500 Index. A few equity-indexed annuities are linked to other indices. The indexes used are price appreciation indexes and so changes in the level of the indexes do not include the dividends investors would receive if they owned the underlying stocks or stock mutual funds. Exclusion of dividends causes the changes in the S&P 500 Index level used in equity-linked annuities to significantly understate the returns earned by investors in the S&P 500, as dividends have historically accounted for 20% of the returns investors in the S&P 500 stocks have earned.

The higher the dividend yield on the index stocks, the less valuable equity-indexed annuities are to investors. The more volatile the stock index, the more valuable equity-indexed annuities are to investors.

[4] Premium or bonus credits are a gimmick used to sell both variable annuities and equity-indexed annuities. These credits increase the face value of the policy but are completely offset by higher surrender charges and longer surrender periods. These credits fool investors into believing they are getting something for nothing.

E. The Fraction of the Index Change Credited

The participation rate is the fraction of the change in a stock index credited to the investor. Participation rates vary significantly and can be applied to different measures of index level changes. Participation rates are easy to compare but are misleading; a higher participation rate may not mean higher payouts to investors since with equity-indexed annuities all else is seldom held constant. However other things being equal, the higher the participation rate an equity-indexed annuity pays, the more valuable it is.

F. The Method for Measuring Changes in the Stock Index

There are three common formulas, called indexing methods, used to translate changes in the index level into gross returns on the contract.

The point-to-point method measures the increase in the index level from the beginning to the end of the contract's term. If the index level was 1,000 when the contract was purchased and was 1,500 when the contract matured, the point-to-point method records a 50% increase. The point-to-point method is the traditional way to measure, quote and interpret the change in the level of an index.

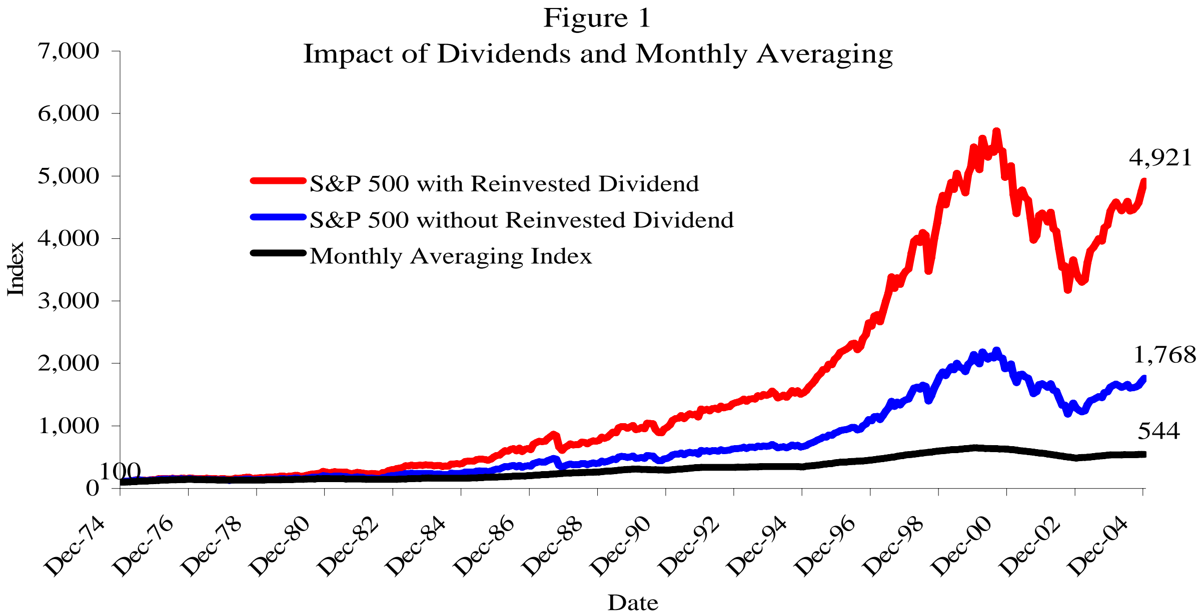
In some contracts, a point-to-point return is calculated at regular intervals, usually the contract's anniversary date, and the index value is reset or ratcheted up to reflect the credited return. If the index level is lower at the end of the contract than it was on some earlier reset date, the reset feature will record an increase that is greater than the simple point-to-point method. For instance, if in our previous example the index had been as high as 1,700 on a reset date the point-to-point with reset method will record a 70%, rather than a 50%, increase.
A more complicated indexing method - the monthly average return method - calculates the increase in the index level from the start of each year to the average month-end level during the year. The base is then reset at the beginning of the next year and the process is repeated until the contract matures. Other things equal, equity-indexed annuities with resets are more valuable than annuities without resets and point-to-point annuities are more valuable than monthly-averaging annuities.

Advocates for equity-indexed annuities claim that the monthly average return method makes the resulting calculated index level changes less volatile and that this reduced volatility makes the return guarantee less costly so the industry can offer investors a higher participation rate on annuities which use monthly averaging. Such statements are misleading since the volatility primarily relevant to the cost of the guaranteed minimum return is the volatility of the underlying stock index.

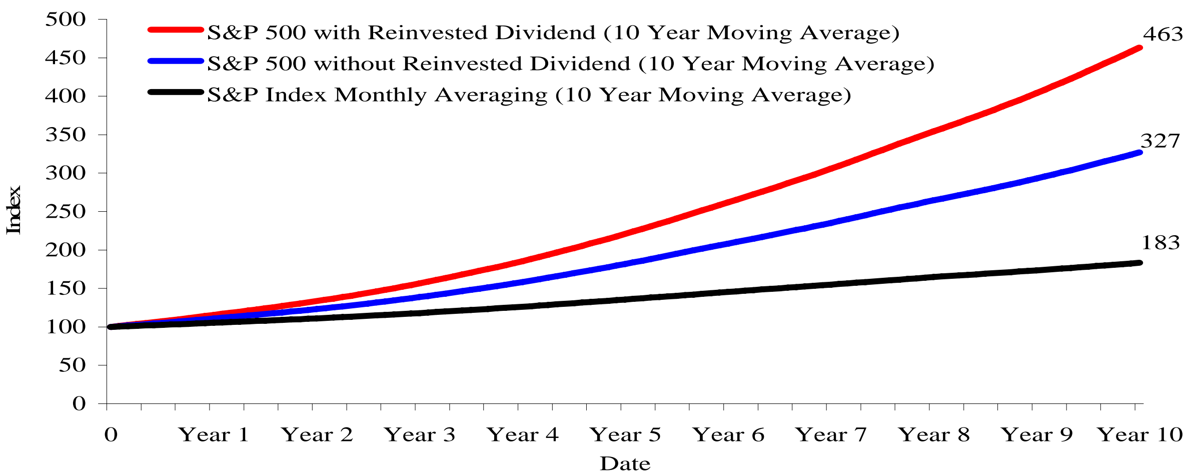
Insurance companies can offer higher participation rates on annuities with monthly averaging rather than point-to-point indexing because monthly averaging systematically understates the increase in the level of the index. The expected index change with monthly averaging will be roughly half the expected change calculated by the traditional point-to-point method. Thus, under the monthly averaging method insurance companies can claim to pay 100% participation of the calculated index level change while only paying 50% of the actual change in the index level.

Figure 1 illustrates the impact of monthly averaging on the calculation of index changes from 1975 to 2004. On December 31, 1974 the S&P 500 closed at 68.56. The top line shows the value of the S&P 500 over time with reinvested dividends. The second line from the top shows the level of the S&P 500 index excluding dividends. As you can see, excluding dividends reduces the return over the 30 year period by 64%. The lowest line shows the value of the index calculated by applying the monthly averaging with annual reset method. Monthly averaging

further reduced the change in the price level of the index by 70% over 30 years.



The impact of monthly averaging is not a phenomenon of the time period covered. We constructed 241 10-year periods by rolling 10 years of data forward one month at a time from 1975 to 2004. The first months' returns, second months' returns and so on were then averaged across the 241 periods. The impact of dividends and monthly averaging on these average returns is illustrated in Figure 2. Excluding dividends reduces the average return over 10-year periods by 29%. Monthly averaging reduces the change in the level of the index by a further 44%. Unsophisticated investors might believe that they will get 100% of the increase from 100 to 463 when in fact they receive only 23% of this increase.



G. Additional Deductions: Spreads, Caps and Fees

The gross credit calculated by multiplying the index change by the participation rate is then sometimes further reduced by an amount called a spread that can be as great as 3%. Thus, two contracts linked to the same index, with the same indexing method and the same participation rate can have significantly different net returns.

Caps are also used to reduce the credited index level changes on some annuities. For example, the increase in a contract's index value under the point-to-point method with annual resets might be capped at 14% meaning that the contract's index value will increase by only 14% in years when the index level increases by more than 14%. The effect of annual caps is dramatic because the average long run return to stocks is heavily influenced by years with unusually high returns. For example, the annualized price appreciation in the S&P 500 from 1975 to 2004 was 10.0%. If we cap the yearly increase at 14%, the resulting series has an annualized appreciation of only 5.5%.

IV. A Simple Comparison

Equity-indexed annuities are touted as excellent investments for investors wanting to participate in market returns without bearing market risk. We can evaluate the industry's claims by directly comparing the value of the point-to-point structure to a simple combination of stocks and Treasury Securities.

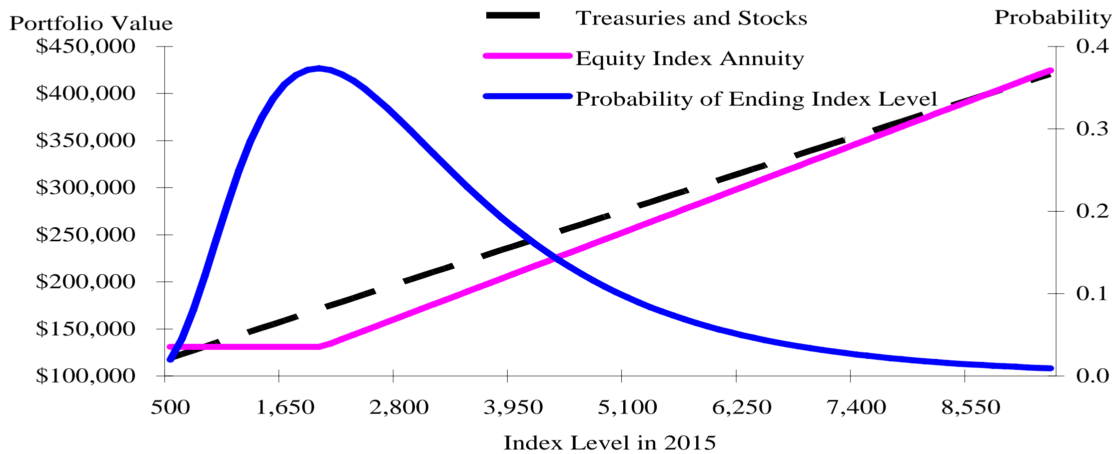
Consider a point-to-point annuity purchased on December 31, 2005 which pays out 50% of the change in the S&P 500 Index over a 10-year term. It guarantees a 3% return, compounded annually, on 90% of the premium paid and the return of the principle if the investment is held until maturity. The annuity has a 10% surrender charge which declines 1% per year. The S&P 500 Index closed on December 30, 2005 at 1,248.29. On December 30, 2015 the annuity will return to the investor $100 plus the greater of $30.95 (i.e. 3% interest on $90 for 10 years) or 50% of the difference between the S&P 500 on December 30, 2015 and 1,248.29. The comparison portfolio consists of $60,000 invested 10-year Treasury strips maturing on December 30, 2015 and $40,000 invested in a low cost S&P 500 Index fund.[5] $60,000 would have purchased $92,628 face value on December 31, 2005 and so the $60,000 Treasuries investment would be worth $92,628 on December 31, 2015 regardless of the level of the S&P500.[6] The $40,000 invested in the S&P 500 Index fund will be worth more or less than $40,000 depending on the total return on the fund. Consistent with historical dividend yields on the S&P 500 companies, we assume that the stocks in the index have an average dividend yield of 2.5%. The value of the equity-indexed annuity and of the stock/cash portfolio as a function of the level of the S&P 500 on December 31, 2015 is plotted in Figure 3. The probability distribution of the S&P 500 Index level in 2015 is also plotted in Figure 3.[7] Except in extremely rare cases, the equity-indexed annuity returns much less to investors than a portfolio of risk-free Treasury securities and large-cap stocks.

[5] We assume the fund has an expense ratio of 0.25%.

[6] The yield to maturity on 10-year strips on December 31, 2005 was 4.39%.

[7] The annual changes in the S&P 500 Index level are assumed to be log-normally distributed with a mean of 10% and a standard deviation of 20%.

Figure 3
Equity Index Annuity and 60% Treasuries / 40% Stock Portfolio
After 10 Years



We performed a Monte Carlo simulation on the two investments pictured in Figure 3 based on realistic assumptions and determined that 96.9% of the time the investor is better off with the Treasury securities and stocks than with the equity-indexed annuity. That is, investors sold this example annuity would be worse off 96.9% of the time, even if they held the annuity to maturity and it performed exactly as designed.

After 10 years, the expected value of the Treasuries and stocks is $219,696 and the expected value of the equity-indexed annuity is $186,265. The $33,431 equity-index annuity shortfall can be broken down into a $219 expected benefit for when the annuity is better and a $33,650 expected cost for when the Treasuries and stock would have been better. The expected cost/benefit ratio is thus a staggering 153 to 1. That is, investors pay $153 in costs for every $1 in benefits relative to the Treasuries and stock portfolio.

Even this comparison is overly generous to the annuity because we have assumed that the contracts were held to maturity and so no surrender charge was applied. In addition, equity-indexed annuities are worse than our illustrations imply because of their disadvantageous tax treatment. The returns earned on equity-indexed annuities are taxed at the investor's marginal income tax rates when the returns are withdrawn. Currently this rate could be as high as 35%. Long term capital gains and dividends for most investors are currently taxed at 15%. Thus investors keep 80 or 85% of the returns earned in the stock index fund but only 65% of the returns paid out of the annuities. If, as seems likely, the before-tax return on the equity-indexed annuity equals about 40% of the before-tax return on index fund, the after-tax return on the equity-indexed annuity will equal only about 30% of the after-tax return on index fund.[8]

[8] Withdrawals from equity-indexed annuities' made before the investor is 59 ½ may be subject to early withdrawal penalties further exacerbating the annuities' underperformance relative to Treasury securities and stock mutual funds.

V. Equity-Indexed Annuity Valuations

In the previous section, we illustrated the payoffs to a typical equity-indexed annuity and an ultra low-risk portfolio of Treasury securities and stocks. These illustrations suggest that typical equity-indexed annuities are a poor investments but don't tell us just how bad they are. We have extended models found in the actuarial science literature using complex mathematical formulas, numerical approximations and Monte Carlo simulations to value real world equity-indexed annuities.[9] Our software allows us to evaluate various equity-indexed annuities and to calculate the likelihood different investors would benefit from an equity-indexed annuity. This ongoing research is the subject of a related technical working paper.

Table 1 presents an example valuation of a 10-year point-to-point equity-indexed annuity guaranteeing a 3 percent return compounded annually on 90% of the initial premium. We assume the risk-free interest rate is 4.5%, the dividend yield on the S&P 500 is 2% and the volatility is 25%. We solve for the "breakeven" participation rate, α, which makes the annuity worth $1 for each $1 the investor pays and find it to be 92% in this example. The forgone dividends plus 8% of the total price appreciation foregone is the "fair" price for the downside protection provided by the equity-indexed annuity's return guarantee.

Table 1
Value of Point-to-Point EIA

Participation Rate	α	**92%**	50%
Guaranteed Return Base (Percentage of Initial Premium)	β	90%	90%
Minimum Guaranteed Return	G	3%	3%
Years to Maturity	T	10	10
Risk-Free Interest Rate	r	4.5%	4.5%
Dividend Yield	δ	2%	2%
Standard Deviation	σ	25%	25%
Investment Value Per Dollar Invested		$1.00	**$0.84**

The last column of Table 1 re-calculates the value of the annuity under the same set of assumptions except we assume a 50% participation rate.[10] A 50% participation rate reduces the value of the annuity by 16%. This 16% is a good estimate of how much wealth is transferred from the investor to the insurance company and broker when the equity-indexed annuity is sold.[11]

There is an interesting fee and expense twist in equity-indexed annuities. Equity-indexed

[9] See Serena Tiong, "Valuing equity-indexed annuities," *North American Actuarial Journal*, 4, pp. 49–170, 2000 and Sebastian Jaimungal, *Pricing and Hedging Equity-indexed Annuities with Variance Gamma Deviates*, working paper, November 2004.

[10] 10-year point-to-point annuities typically have participation rates of around 50%. The insurance companies are effectively keeping the dividends plus 50% of the capital appreciation in exchange for the return guarantee.

[11] This example does not include many features – most of which further reduce the value of the annuity.

annuities do not have explicit annual fees or expense ratios. Instead, the insurance company makes money by giving investors less than a fair share of the increase in the value of the S&P 500 index. In the example above, fair compensation for the downside guarantee is the dividends paid on the underlying stocks plus 8% of the capital appreciation in the S&P 500 index. The insurance company in our example takes the dividends plus 50% of the capital appreciation.

This 42% spread is more valuable to the insurer – and more costly to the investor – the longer the maturity of the equity-indexed annuity. If we change the maturity in our example to 5 years, a contractual 50% participation rate in the capital appreciation compared to the "fair" participation rate of 81% implies a cost to the investor of 8% of their investment. With a maturity of 15 years, a contractual 50% participation rate compared to the "fair" participation rate of 100% implies a cost to the investor of 23%. *See* Table 2.

Table 2
Effect of Maturity on Investment Costs

Years to Maturity	5	10	15
Fair Participation in Capital Appreciation	81%	92%	100%
Investment Costs Per Dollar Invested at 50% Participation	$0.08	$0.16	$0.23

VI. Conclusion

Equity-indexed annuities are complicated investments sold to unsophisticated investors without the regulatory safeguards afforded to purchasers of similar investments. If brokers and agents told investors of the effect equity-indexed annuities' shaving of index returns and extraordinary costs the market for these products would dry up.

Ironically, both the SEC and the NASD caution investors to review and understand the impact on likely returns of the myriad equity-indexed annuity features. No registered rep, insurance broker, or retail investor, and precious few finance PhDs, could understand these products. The net result of equity-indexed annuities' complex formulas and hidden costs is that they survive as the most confiscatory investments sold to retail investors.

Resist Broker's Compelling Arbitration With Non-Signatory Customers

By Charles M. Thompson[1]

Brokerage firms will do most anything they can by hook or crook to keep from having to go before a jury. Even though a "customer" has not signed a contract, it does not stop brokerage firms from attempting to compel arbitration if there is any remote contact by the complaining customer with the firm. Be on the lookout for this type of situation. PIABA members are encouraged to investigate every aspect of the relationship between their customer and the culprit broker and not assume that the case would require arbitration.

To state the obvious, the main reasons that brokerage firms do not want to go into court are:
1) Discovery is open, generally unfettered and expansive,
2) Judges generally know more about the law than arbitrators and will not stand for the b.s. that oftentimes arbitrators will indulge,
3) Judges are not worried about whether they will be selected by the brokerage firm again if they rule in opposition to the firm's whims,
4) In court, brokerage firms are open to the full impact of the law of damages, including mental anguish, attorney's fees and punitive damages more openly than in arbitration, and
5) Most importantly, juries typically will not be as sympathetic with the brokerage firm's wrongdoing as will arbitrators.

This article is hopefully to be used by claimants' attorneys to overcome the anticipated future attempts of brokerage firms in compelling arbitration, even though it is inappropriate when a customer did not sign a contract containing an arbitration clause.

It is undisputed that the run of the mill customer who signs an arbitration clause, except where otherwise exempted by law from arbitration, is by and large caught in the trap of proceeding to arbitration[2]. The FAA requires signatories to contracts containing arbitration clauses to submit any lawful dispute to arbitration. This is normally binding and uncontestable.

However, the FAA does not apply to non-signatories. The reach of the FAA is not boundless. Stock brokerage firms have created arbitration provisions in order to prevent

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[1] Note - Credit cannot possibly be given to the many fellow PIABA members (especially Joe Long), who have shared their knowledge and research for the content of this article. The writer is beholden to all who helped.

[2] For a splendid and scholarly treatise on avoiding arbitration when the putative contract is void *ab initio*, as opposed to merely voidable, see Joe Long, "Ways to Avoid Arbitration", Public Investors Arbitration Bar Associate, 14th Annual Securities Law Seminar, September 29, 2005.

individuals from pursuing claims through the court system. An investor who executes an agreement presumptively binds himself/herself and all contemplated agents and representatives only to the legal arbitration clause as respects the investments of the signatory. It is the ethical duty of the lawyer for a public investor to investigate every reasonable basis to enhance and maximize his/her client's chance of success – even if it means pursuing a case in court rather than arbitration.

I. PRESUMPTIVE RIGHT TO COURT ACCESS U.S. SUPREME COURT RULES AGAINST THIRD-PARTY (NON-SIGNATORY) ARBITRATION ENFORCEMENT

Almost a century ago, the United States Supreme Court observed: "The right to sue and defend in the courts, is the alternative of force. In an organized society it is the right conservative of all other rights, and lies at the foundation of orderly government. It is one of the highest and most essential privileges of citizenship." *Chambers v. Baltimore & Ohio R.R.*, 207 U.S. 142, 148 (1907). See also *BE&K Construction Co. v. NLRB*, __ U.S. __, 122 S.Ct. 2390, 2395-96 (2002) ("'The right to petition extends to all departments of the Government,' and … 'the right of access to the courts is … but one aspect of the right to petition.'"(quoting *California Motor Transport Co. v. Trucking Unlimited*, 404 U.S. 508, 510 (1972)); *Bill Johnson's Restaurants, Inc. v. N.L.R.B.*, 461 U.S. 731, 741 (1983) ("The right of access to the courts is an aspect of the First Amendment right to petition the Government for redress of grievances."); *United Transportation Union v. 10 Michigan Bar*, 401 U.S. 576, 585 (1971) ("Collective activity undertaken to obtain meaningful access to the courts is a fundamental right within the protection of the First Amendment."); *Home Ins. Co. of New York v. Morse*, 87 U.S. 445, 451 (1874) ("Every citizen is entitled to resort to all the courts of the country, and to invoke the protection which all the laws or all those courts may afford [plaintiff]. A man may not barter away his life or his freedom, or his substantial rights."); *Straub v. Monge*, 815 F.2d 1467, 1470 (11th Cir.), cert. denied, 484 U.S. 946 (1987) (Noting that the right to meaningful access to the courts, routinely presented in constitutional and civil rights actions, is likewise applicable to civil cases).
More specifically, in *Equal Employment Opportunity Commission v. Waffle House, Inc.*, 122 S. Ct. 754 (2002), the U. S. Supreme Court refused to enforce an arbitration provision in an employment contract where a Federal agency which was not a party to that employment contract sought to promote the public's interest in preventing discrimination against handicapped workers. In *Waffle House*, the U. S. Court of Appeals for the Fourth Circuit had erroneously followed the same approach proposed by the Defendant - i.e., it treated arbitration clauses as a sort of "super contract". The Fourth Circuit had held that the E.E.O.C. was precluded from seeking victim-specific relief in Court because an arbitration agreement was contained in Mr. Baker's (handicapped employee) employment contract with Waffle House. *Waffle House*, 122 S. Ct. at 759. The U. S. Supreme Court expressly stated that the Fourth Circuit's attempt to balance the policy goals of the FAA against the clear language of Title VII was inconsistent with recent arbitration cases. 122 S. Ct. at 764. Instead, the U. S. Supreme Court directed that while the FAA requires courts to place arbitration clauses on equal footing with other contracts, it does not require arbitration where a governmental agency (a non-signatory) has not agreed to arbitration. *Id.* at 764.

II. APPLICABLE ALABAMA LAW AND GENERAL AMERICAN LAW UPPORT ACCESS TO THE COURTS AS A FUNDAMENTAL RIGHT

The general American rule has universally also recognized the substantive and fundamental right of access to the courts. See Carol Rice, "A Right Of Access To Court Under The Petition Clause Of The First Amendment: Defining The Right", 60 Ohio St.

L.J. 557, 557 (1999) ("This nation has long viewed a person's ability to gain access to court as a fundamental element of our democracy. Chief Justice Marshall in *Marbury v. Madison* described the ability to obtain civil redress as the 'very essence of civil liberty.'").

My home state of Alabama is not unlike all other states, "(a)mong such fundamental rights is the right to civil justice or access to courts."; see *Green v. Austin*, 425 So.2d 411, 414 (Ala. 1982), ("Historically, our state has guarded the basic right of citizens to have open access to our courts."). See also *Ala. Const.* of 1901, § 13; *Fireman's Fund American Ins. Co. v. Coleman*, 394 So.2d 334, 350 (Ala. 1980) (Shores, J., concurring)("The text of § 13 is brief, but it is among the most fundamental of the guarantees against governmental oppression embodied in our state constitution. The language of the provision is not unique. Thirty-seven other states include a similarly-worded provision in their constitutions; indeed, its origins can be traced back to the Magna Charta.").

This writer has successfully defeated an attempt by UBS Paine Webber before the Trial Court in requiring arbitration by a non-signatory customer, whose brother was the original customer of the account. In this writer's case, the broker at UBS in Atlanta called the customer (my client) here in Alabama and devised a scheme whereby this writer's client would invest parts of her IRA holdings on margin through her brother's account which had been legitimately established at UBS in Atlanta. My client never signed anything. The broker proceeded to lose significant sums of money by trading on margin with the IRA as "collateral". UBS filed a Motion to Compel Arbitration and presented its case to the Trial Court as if it was a fundamental requirement that the Alabama customer's case be arbitrated. The Court did not buy it, and UBS has filed an appeal.

Principles of contract law and the Federal Arbitration Act both support the premise that if there is no signature on the contract then there is no contract[3]. No contract-no arbitration. In Alabama our Supreme Court has stated time and time again, the purpose of the FAA is not to make all arbitration agreements universally enforceable (especially to a non-signatore), but the Court has simply reversed "centuries of judicial hostility to arbitration agreements" and to place such agreements "upon the same footing as other contracts." *A.G. Edwards & Sons, Inc. v. Clark*, 558 So.2d 358, 361 (Ala. 1990) (citations and internal quotation marks omitted). In fact, the United States Supreme Court has held that the primary purpose of the FAA is to "make arbitration agreements as enforceable as other contracts, but not more so." *Volt Info. Sciences, Inc. v. Board of Trustees*, 489 U.S. 468, 479 (1989). Thus, the FAA only applies in cases in which the defendant can, according to general principles of contract law, establish that the plaintiff has signed or assented to an arbitration agreement.

Accordingly, the initial inquiry is not whether the FAA makes an arbitration agreement enforceable, but whether a contract between the plaintiff and defendant for arbitration exists at all. See *Thompson-CSF, S.A. v. American Arbitration Assoc.*, 64 F.3d 773, 779 (2nd Cir. 1995) (holding that "arbitration is strictly a matter of contract; if the parties have not agreed to arbitrate, the courts have no authority to mandate that they do so", citing *United Steelworkers of Am. v. Warrior & Gulf Nav. Co.*, 363 U.S. 574, 582 (1960) [wherein the United States Supreme Court emphasized that "a party cannot be required to submit to arbitration any dispute which he has not agreed to submit"]); see also *Volt Info.*, *supra*, 489 U.S. at 479 (holding that arbitration is a matter of consent).

[3] An exception to this general principle is when a non-signatory sues the broker base on a claimed benefit of the original contract, containing an arbitration provision. See following.

In determining whether an arbitration agreement or contract exists, the United States Supreme Court and the state appellate courts have consistently held that courts must apply principles of contract law. *United Steelworkers*, *supra*, 363 U.S. at 582; *Ex parte Jones*, 686 So.2d 1166 (Ala. 1996). That contract law applies in such an instance is of paramount importance. This is because (i) the issue of whether a party consented to arbitration and (ii) the issue whether a specific dispute falls within the scope of an arbitration clause are vastly different. Whether a specific dispute falls within the scope of an arbitration clause is subject to the FAA's pro-arbitration policy or presumption (normally a brokerage firm argues this point and stops). See *Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983) (stating that "any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration"). However, a key point intentionally overlooked by the Defendant/broker is the threshold issue of whether a plaintiff consented to arbitrate a dispute, be it any dispute, which is not subject to such a presumption. As one commentator has simply stated, "the FAA's pro-arbitration policy does not purport to trump state contract principles of law," which as mentioned above, must apply in determining whether an arbitration agreement exists at all. (Jeff DeArman, *Comment, Resolving Arbitration's Non-signatory Issue: A Critical Analysis of the Application of Equitable Estoppel in Alabama Courts*, 29 Cumb. L. Rev. 645, 646 [1999]). Accordingly, the Trial Court must first determine whether an arbitration agreement exists between the parties and only then determine whether the FAA applies.

III. OFTEN TIMES UNDER APPLICABLE PRINCIPLES OF CONTRACT LAW A BROKER/DEFENDANT CANNOT ESTABLISH THAT THE CUSTOMER CONSENTED TO ARBITRATION

Firstly, in deciding whether an investor/plaintiff has consented to arbitration, one must discern on what basis the defendant alleges that the plaintiff agreed to arbitration. Normally, a defendant alleges that the plaintiff signed a contract containing an arbitration clause and therefore is bound by that agreement. Naturally, the claimant's attorney should argue that a non-signatory did <u>not</u> sign the contract, which contains the arbitration provision in question. In fact, except for agents, heirs, etc., third parties are not mentioned nor contemplated in putative contracts containing arbitration clauses. Non-signatories to putative agreements can only be bound to an arbitration agreement under principles of contract law. The general rule is that a non-signatory cannot be compelled to submit to arbitration, because he or she simply did not agree to submit a dispute to arbitration. *Thompson-CSF*, 64 F.3d 776.

However, "a non-signatory party may be bound to an arbitration agreement if so dictated by 'ordinary principles of contract and agency.'" In three separate cases, the Alabama Supreme Court has addressed the issue whether a non-signatory plaintiff can be bound by such an arbitration agreement. See *Colonial Sales-Lease-Rental, Inc. v. Target Auction & Land Co.*, 735 So.2d 1161 (Ala. 1999); *Georgia Power Co. v. Partin*, 727 So.2d 2 (Ala. 1998); and *Ex parte Dyess*, 709 So.2d 447 (Ala. 1997). In each of those cases, the non-signatory plaintiff filed a breach of contract claim against a signatory defendant. Each plaintiff claimed to be a third-party beneficiary of a contract that contained an arbitration clause. Each plaintiff claimed benefits under those contracts. In each of those cases, the Alabama Supreme Court applied the ordinary principles of contract law that "a contract made for the benefit of a third person may, at his election, be accepted and enforced by him" and that any person claiming to be a third party beneficiary of a contract must also "assume the burdens" of the contract. *Georgia Power*, 727 So.2d at 5 (citations and internal quotation marks omitted).

If the Plaintiff does not seek third-party beneficiary status, no "ordinary contract principle" exists which binds her, as a non-

signatore, to the contract. In fact, the only possible way, under contract law, that a non-signatory customer could assent to arbitration is through a third-party beneficiary claim. Without such a claim, no assent exists. Assent is an absolutely essential requirement for a finding that a contract exists with a non-signatore. *Board of Bar Com'rs of Ala. State Bar v. Jones*, 291 Ala. 371, 281 So.2d 267 (1973).

IV. BASIC CONTRACT LAW REPUDIATES ARBITRATION ENFORCEMENT OF A NON-SIGNATORY

Alabama contract law, like all states, essentially requires the parties to have a meeting of the minds, an agreement. See *Shirley v. Lin*, 548 So.2d 1329; *Gray v. Reynolds*, 514 So.2d 973, appeal after remand 553 So.2d 79; *Lawler Mobile Homes, Inc. v. Tarver*, 492 So.2d 297; *Oakes v. Michigan Oil Co.*, 476 So.2d 618. Brokerage firms are "dead in the water" when they try to overcome this basic tenet of Contracts 101. The best that the broker can ask for is the Court somehow to reason that an ambiguity as to the interpretation of the arbitration clause exists. Even if there is an ambiguity in the arbitration clause the broker loses on that point as well. It is axiomatic that ambiguities in contractual provisions are universally to be most strongly interpreted against the scrivener. See *ERA Commander Realty, Inc. v. Harrigan*, 514 So.2d 1329; *Rivers v. Oakwood College*, 442 So.2d 74; *Colonial Baking Co. of Alabama v. Pine Dale, Inc.*, 436 So.2d 856; *Jehle-Slauson Const. Co. v. Hood-Rich Architects and Consulting Engineers*, 435 So.2d 716; and *Lilley v. Gonzales*, 417 So.2d 161. Normally, the plain reading of the contract provision in question does not cause a non-signatory to be susceptible to arbitration, and the construction of contract language according to general contract law prevents the broker from expanding the reach of arbitration as well.

To follow the brokerage firm's argument to require arbitration in all events by a non-signatory could be carried to its logical extreme: Suppose Broker Black Hat had talked Little Old Lady into placing money with him which he never intended to invest in anything. And suppose that he then placed the money in another person's account attempting to launder it, whereupon he then took the money out for himself. Suppose Little Old Lady then attempted to sue him in Court for that activity. The brokerage firm would thereby claim that the activity of Broker Black Hat, although unquestionably illegal, should be pursued through arbitration because Broker Black Hat laundered the money through someone else's account. Outlandish sounding? Sure, but it's taking a brokerage firm's argument to its logical extreme.

V. CONCLUSION

In conclusion, brokerage houses have attempted to expand the reach of arbitration to the point that now borders on the ridiculous. Brokers are forever attempting to get courts and panels to further expand the reach of arbitration and thereby continue to dilute the Court system. To do so would have a severe chilling effect on the judicial process. Such amounts to a significant erosion of the judicial system in favor of arbitration. A line must consistently be drawn by the courts to end the erosion. Simply put, no contract provision is applicable to non-signatories who do not claim a benefit from the contract within which the arbitration clause is embedded.

NASD 10106 – A Toothless Tiger or Protection from Improper Lawsuits by NASD Members

In a new twist on an old theme, Respondents are arguing that they did not agree to arbitrate claims in irrevocable trust accounts that are sent to their trust affiliates. After the arbitration is filed, don't be surprised by a Respondent who starts a court action for a preliminary injunction against the arbitration.

NASD rule 10106 prohibits parties in an NASD arbitration from commencing a lawsuit against the opposing party relating to matters pending in arbitration. But are there any consequences when an NASD member violates NASD 10106 in a dispute with a public customer? 10106 does not designate a remedy. Is there a remedy, that an NASD Panel will impose, that has both a remedial and deterrent effect?

Respondent's court oriented defense to an arbitration claim filed by a public customer against an NASD member are likely to become more commonplace with the greying of America. In one example, Respondent, the broker-dealer, recommended that an elderly couple, open a Charitable Remainder UniTrust ("CRUT"), knowing that the husband was suffering from a fatal disease. When they did, Respondent created a CRUT account with its affiliated trust company and affiliated money manager. Respondent continued to execute the orders for the CRUT account and shared the management fees. Its affiliate assumed responsibility for investment decisions which it delegated to an affiliated money manager.

When the elderly widow filed a claim in arbitration against the NASD member, Respondent argued that it did not agree to arbitrate the CRUT claims. It argued that its trust affiliate, an independent company, was responsible for investment decisions. There was no agreement for Respondent to arbitrate the CRUT claims. Respondent concluded that this was a jurisdictional question that only a court can decide and only a court in the state whose law governs the trust agreement.

Did Respondent agree to arbitrate the CRUT claims? Does Respondent have any responsibility for participating in the unsuitable transactions in the CRUT account?

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The following attempts to summarize the arguments that challenge an NASD member seeking a preliminary injunction to enjoin an NASD arbitration.

Summary of the Argument

Respondent agreed to arbitrate the CRUT account claims in its customer agreement and pursuant to NASD rules. In its customer agreement, Respondent's choice of "any and all controversies" for its arbitration agreement is "inclusive, categorical, unconditional and unlimited,"[1] regardless of the kind of controversy.[2]

Respondent's "any and all controversies" arbitration clause evidences clear and unmistakable intent that the Panel, not the courts, would decide any and all issues arising from this arbitration. By its plain meaning, Respondent's customer agreement confers complete jurisdiction on the Panel. Further, Respondent signed its Uniform Submission Agreement ("USA"), which evidences additional clear and unmistakable intent that the Panel shall decide all issues.[3]

Despite these agreements to arbitrate any and all issues, including the CRUT account claims, Respondent asserts that it reserved its right to go to court. Respondent had no court rights to reserve. When Respondent elected to arbitrate any and all controversies, it forever waived any right it had to go to court.

Even assuming that Respondent's Answer did reserve its rights, Respondent waived any rights it might have had when it participated in the arbitration by demanding discovery about the CRUT account claims.[4] Respondent made its discovery demands in this arbitration *after* submitting its Answer, but *before* commencing its improper lawsuit in Delaware.[5]

The parties' arbitration agreement is valid, irrevocable and enforceable.[6] Respondent cannot unilaterally change the parties' arbitration agreement in its Answer. Both parties must agree to effect any change in the arbitration agreement. Claimant has not agreed to change the arbitration agreement.

The Panel has a duty to enforce agreements to arbitrate and to enforce the NASD rules that prohibit parties from filing lawsuits once the arbitration has begun. Respondent breached its arbitration agreements and violated the NASD's prohibition against lawsuits by commencing and prosecuting its Delaware lawsuit. Respondent violated NASD rule 10106 under aggravating circumstances, which prejudiced an 84 year old widow and violated Respondent's duty of fair dealing with its customers.

II. Respondent's Delaware Lawsuit Violates NASD Rules and Entitles Claimant to Relief

When Respondent signed its submission agreement it agreed that this arbitration is

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1 *PaineWebber v. Bybyk*, 81 F.3d 1193, 1199 (2d Cir. 1996).

2 *Merrill Lynch v. Kirton*, 719 So.2d 201, 204 (Ala. 1998).

3 *Howsam v. Dean Witter Reynolds*, 537 U.S. 79, 86, 123 S.Ct. 588 (2002).

4 *See DeSapio v. Kohlmeyer*, 35 N.Y.2d 402, 406 (1974)(finding waiver where a party submitted discovery demands).

5 See Dean Witter Reynolds v. Fleury, 138 F.3d 1339, 1342 (11th Cir. 1998)(finding waiver where party participates in arbitration).

6 Federal Arbitration Act, 9 U.S.C. §2 – Validity, Irrevocability, and Enforceability of Agreements to Arbitrate.

governed by NASD rules. NASD Rule 10106 strictly prohibits Respondent from commencing or prosecuting its Delaware lawsuit.[7]

Claimant requests the same relief that was granted by another NASD panel confronted with the same violations. In *Yazdani v. Biltmore Securities, Inc.*, the NASD panel found that Respondent Biltmore's state court lawsuits filed against Claimant Yazdani violated NASD Rule 10106.[8] The panel directed the respondents to dismiss their lawsuits within three days and to file proof of the dismissal with the NASD. The panel further cautioned the respondents that if they failed to comply, the panel would refer the respondents to the NASD District Committee for disciplinary action.

This Panel has the authority to grant the same relief that was granted in *Yazdani*. NASD rules empower arbitrators "to interpret and determine the applicability of all provisions under the Code and to take appropriate action to obtain compliance with any ruling. . . ." NASD Rule 10324.[9]

A. Respondent has Violated Additional NASD Rules Requiring Respondent to Arbitrate

Besides NASD Rule 10106, Respondent has violated other NASD rules. NASD IM-10100 provides that Respondent's failure to arbitrate Claimant's claims is conduct inconsistent with just and equitable principles of trade and a violation of NASD Conduct Rule 2110.[10] Respondent also violated NASD Rule 10301, which requires Respondent to arbitrate any customer claim arising from its business.[11]

B. Respondent Violated NASD Rules under Aggravating Circumstances

Respondent's attempts to excuse its misconduct clearly illustrate that Respondent violated NASD Rule 10106 under aggravated circumstances. Aggravating circumstances are facts or situations that relate to a party's misconduct which demand increasing the penalty for the violation.

Respondent's aggravating circumstances include the following:

1. withholding Claimant's customer agreement(s), while denying that there are any agreements to arbitrate the CRUT account claims;

2. denying that it agreed to arbitrate the CRUT account claims and what will be arbitrated, when Respondent agreed to arbitrate "any controversies" between the parties;

3. arguing inconsistent positions before different forums – that Respondent's "any controversies" arbitration agreement is all encompassing in Alabama to compel arbitration, but narrow in Florida and Delaware to avoid arbitration;

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[7] NASD Rule 10106 – Legal Proceedings: "No party shall, during the arbitration of any matter, prosecute or commence any suit, action, or proceeding against any other party touching upon any of the matters referred to arbitration pursuant to this Code."

[8] *Yazdani v. Biltmore Securities, Inc.*, Order of the Panel dated March 22, 1996, NASD Case No. 95-00929. NASD re-numbered Section 6 as NASD Rule 10106.

[9] *Howsam v. Dean Witter Reynolds*, 537 U.S. at 86.

[10] NASD IM-10100(a): "It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member . . . to . . . submit a dispute for arbitration under the NASD Code of Arbitration Procedure as required by that Code."

[11] NASD Rule 10301(a) – Required Submission: "Any dispute, claim or controversy eligible for submission under the Rule 10100 Series between a customer and a member . . . arising in connection with such member. . . shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer."

4. denying that its Uniform Submission Agreement ("USA") referred the CRUT account claims to arbitration after signing its USA which specified that Respondent was agreeing to arbitrate the CRUT account claims; and

5. Falsely stating to the Panel and the Delaware court that Respondent did not participate in this arbitration when in fact it has been voluntarily participating – including filing discovery requests addressed to the CRUT account claims.

Respondent is engaged in improper forum shopping which NASD rules are designed to prevent. Respondent is using this abusive litigation tactic to intimidate an 84 year old widow by putting financial pressure on her.

Each day that Respondent's Delaware lawsuit continues, Respondent is needlessly increasing Claimant's costs. Her Delaware attorney's fees currently exceed $10,000 to defend a lawsuit prohibited by Respondent's arbitration agreements and NASD rules. Respondent's misconduct, along with the aggravating circumstances, clearly deserve and merit the relief and sanctions that Claimant has requested.

III. Respondent Agreed to Arbitrate Claimant's CRUT Account Claims

A. Respondent's Customer Account Agreements

Respondent's arbitration agreement with Claimant states: **"I am agreeing in advance to arbitrate any controversies which may arise with you."**[12] On information and belief, Respondent's customer agreement states further that:

> all controversies which may arise between us, including but not limited to those involving any transaction or the construction, performance, or breach of this or any other agreement between us, whether entered into prior [to], on, or subsequent to the date hereof, shall be determined by arbitration.[13]

This broad arbitration clause is a binding arbitration agreement between the parties which covers the CRUT account claims.

In a similar case, the Alabama Supreme Court specifically concluded that Respondent's arbitration agreement "is sufficiently broad to include any and all controversies between [the parties], regardless of the kind of controversy or the date on which the controversy occurred."[14] In another case, the Alabama Supreme Court agreed with Respondent that "any controversies" in a customer's arbitration agreement for one account required its customer to arbitrate claims arising from a second, separate account – **even though there was no arbitration agreement for the second account**.[15]

Respondent's argument that the same arbitration clause means something different in Alabama than in Florida and Delaware is self-serving and contradictory.[16]

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[12] Respondent only produced the signature pages from its customer agreements with Claimant which include the "any controversies" arbitration agreement. Respondent continues to withhold the text of its customer agreement where, on information and belief, Respondent also agreed to arbitrate "all controversies" between the parties.

[13] *Kirton*, 719 So.2d at 202. As stated above, Respondent continues to withhold its customer agreement.

[14] *Kirton*, 719 So.2d at 204.

[15] *Jones v. Merrill Lynch*, 604 So.2d 332, 339-40 (Ala. 1991)(emphasis added).

[16] The Panel should also note that Respondent's affiliate, Trust Company, is using these same arguments before the Texas Supreme Court to compel arbitration of trust claims where there is no agreement to arbitrate the trust claims. *See In re Merrill Lynch Trust Co.*, Brief on the Merits in Support of Petition for Writ of Mandamus, 2005 WL 226974, *12, Case No. 04-0865 (Tex.).

B. Respondent's Signed Uniform Submission Agreement

As a matter of law, Respondent cannot unilaterally change or revoke its obligation to arbitrate the CRUT account claims. The USA specifically names Claimant's Charitable Trust. When Respondent signed its USA, it knew that it was agreeing to arbitrate the CRUT account claims.

C. As an NASD Member, Respondent Agreed to Arbitrate Any Dispute, Claim or Controversy Arising from its Business

Courts have overwhelmingly held that Respondent's "membership in the NASD, in and of itself, is a written agreement to arbitrate according to NASD submission rules."[17] Those submission rules require Respondent to arbitrate any disputes, claims or controversies with customers arising out of Respondent's business.[18]

1. The CRUT Account Claims Arise out of Respondent's Business

Claimant alleges that Respondent participated or aided in making unsuitable trades in violation of the Florida Investor Protection Act. As part of its business, Respondent entered unsuitable trades for the CRUT account, executed them on national exchanges and markets, placed them in the CRUT account, made commissions and shared fees from the CRUT account and generated account statements with Respondent's logo and Associated Persons' names on the statements.

This is precisely the misconduct that the Florida Investor Protection Act is designed to prevent and punish.[19] Further, Claimant has alleged that Respondent failed to adequately supervise. Courts have specifically found, and Respondent does not deny, that supervision falls squarely within the scope of Respondent's business.[20] Clearly, the CRUT account claims arise out of Respondent's business, since Respondent executed every transaction.

Claimant's theory of liability does not depend on a finding that Respondent made investment decisions – only that Respondent participated or aided in making unsuitable trades.[21] Significantly, Respondent does not deny that these activities are a part of its business. Instead, Respondent has alleged that its affiliate was solely responsible for investment decisions or that its affiliate only affected investment decisions.[22]

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[17] *First Montauk v. Four Mile Ranch*, 65 F.Supp.2d 1371, 1377 (S.D. Fla. *1999); John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48, 55-56 (2d Cir. 2001); *Kidder, Peabody & Co. v. Zinsmeyer Trusts Partnership*, 41 F.3d 861, 863-64 (2d Cir. 1994), *cert. denied*, 117 S.Ct. 609 (1996); *Spear, Leeds & Kellogg v. Central Life Assurance Co.*, 85 F.3d 21 (2d Cir. 1996); *Merrill Lynch v. Hovey*, 726 F.2d 1286, 1288-89 (8th Cir. 1984).

[18] NASD Rule 10301.

[19] *First Union Discount Brokerage Services, Inc. v. Milos*, 744 F.Supp. 1145, 1154-55 (S.D. Fla. 1990), *aff'd*, 997 F.2d 835 (11th Cir. 1993).

[20] *First Montauk*, 65 F.Supp.2d at 1379.

[21] Fla. Stat. §517.211(2). Respondent did not dispute the validity or effect of this statute in its Answer, which now binds Respondent, pursuant to NASD Rule 10314.

[22] The Panel should note that Respondent has altered its position on this issue. In its Answer, Respondent alleged that the Trust account claims concerned investment decisions made solely by Respondent's affiliate. Now, in its Opposition to the present Motion, Respondent has alleged that its affiliate only "effected [sic.] investment decisions," which clearly suggests that Respondent may have either been involved in investment decisions or actually made the investment decisions for the Trust.

IV. Respondent Clearly and Unmistakably Expressed its Intent to Give this Panel Jurisdiction to Decide All Issues

Respondent's "any controversies" arbitration clause and its signed USA evidence clear and unmistakable intent that the Panel would decide all issues in this arbitration. Courts have repeatedly held that either one gives the Panel complete jurisdiction.[23]

Further, Respondent's voluntary participation in this arbitration, including demanding discovery for the CRUT account claims, before commencing its Delaware lawsuit, provides clear and unmistakable evidence that it intended to submit the jurisdiction question to the arbitrators.

A. The NASD Code Empowers the Arbitrators to Decide All Issues – Not the Courts

Respondent's "execution of a USA with the NASD . . . effectively incorporated the NASD Code into the parties' agreement."[24] "This means [Respondent] adopted the entire NASD Code, including [NASD Rule 10324]."[25] Respondent's "adoption of this provision is a 'clear and unmistakable expression of [its] intent" that the arbitrators – not the courts – would decide what claims should be arbitrated.[26]

The United States Supreme Court has held that NASD Rule 10324 exclusively empowers the Panel to interpret and apply all sections of the NASD Code.[27] The Panel has the authority and the obligation to determine whether the CRUT account claims are covered by the arbitration agreement and/or arise from Respondent's business.[28] Respondent waived its right to have a court decide these questions by signing its USA and incorporating the NASD Code into the arbitration agreement.

Respondent's reliance on *Bensadoun*, for the argument that courts decide whether an NASD member must arbitrate, is misplaced.[29] Unlike petitioner in *Bensadoun*, Respondent agreed to arbitrate "any all controversies" in its customer agreement, signed a Uniform Submission Agreement and voluntarily participated in this arbitration, which provided clear and unmistakable intent to abide by the entire NASD Code, including NASD Rule 10324.[30]

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[23] *Howsam*, 537 U.S. at 84; *John Hancock Life Ins. Co. v. Wilson et al.*, 254 F.3d 48, 54 (2d Cir. 2001); Bybyk, 81 F.3d at 1200 ("The parties' broad grant of power to the arbitrators is unqualified by any language carving out substantive eligibility questions . . . for resolution by the courts").

[24] *Howsam*, 537 U.S. at 86 ("Howsam's execution of a Uniform Submission Agreement with the NASD in 1997 effectively incorporated the NASD Code into the parties' agreement").

[25] FSC Securities v. Freel, 14 F.3d 1310, 1312 (8th Cir.1994) (The NASD re-numbered Section 35 of the NASD Code as the current NASD Rule 10324).

[26] *Id.* (emphasis in original).

[27] *Howsam*, 537 U.S. at 86.

[28] *Id.*; *FSC Securities v. Freel*, 14 F.3d at 1312 (holding that where the parties sign uniform submission agreements specifying NASD as the arbitral forum, they have incorporated the NASD Code and agreed that the arbitrators would decide questions of arbitrability).

[29] *Bensadoun v. Jobe-Riat*, 316 F.3d 171, 175 (2d Cir. 2003).

[30] *See Howsam*, 537 U.S. at 86 (finding clear and unmistakable intent where parties signed Uniform Submission Agreement with NASD); *Freel*, 14 F.3d at 1312 (same); *Bybyk*, 81 F.2d at 1200 (finding clear and unmistakable intent where agreement gives a "broad grant of power to arbitrators unqualified by any language carving out substantive eligibility issues . . . for resolution by the courts").

V. Respondent's Answer and Participation Prove that it did not Reserve its Rights to Go to Court

Respondent had no rights to go to court when it agreed to arbitrate "any controversies." Moreover, on information and belief, Respondent's customer agreement states further: **"The parties are waiving their right to seek remedies in court. . . ."**[31] However, assuming Respondent had any such rights, it unequivocally waived those rights by filing its Answer and its discovery demands in this arbitration.

A. Respondent's Answer did not Reserve any Rights

Respondent expressly acknowledged the NASD's jurisdiction over the CRUT account claims. Respondent's Answer specifically called for the NASD to decline the use of its arbitration facilities with respect to the CRUT account claims pursuant to Rule 10301(b).[32] NASD did not, confirming NASD jurisdiction over the CRUT account claims. Respondent's Answer failed to reserve its rights to seek a court order to determine jurisdiction. Respondent cannot ambivalently "note" that it "may also" file a lawsuit in court[33] and call it a reservation of its rights months later.

B. Respondent Waived its Rights by Filing Discovery Demands with the NASD

Respondent also waived its rights when it filed discovery demands with the NASD. Respondent failed to object to, or complain in any way about, the inclusion of the CRUT account claims in its request for discovery.[34]

Respondent's request for discovery sought documents and information directly related to the CRUT account claims. Respondent also requested all documents related to the CRUT account.

Significantly, Respondent defined the relevant time period as commencing in 1993 – three years prior to the first transaction in 1996.[35] The only reference to the year 1996 in the Statement of Claim concerned Respondent's recommendation that Claimant create her Charitable Trust.[36]

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[31] *Kirton*, 719 So.2d at 202. As stated above, Respondent continues to withhold its customer agreement.

[32] NASD Rule 10301(b): "Under this Code, the Director of Arbitration, upon approval of the Executive Committee of the National Arbitration and Mediation Committee, or the National Arbitration and Mediation Committee, shall have the right to decline the use of its arbitration facilities in any dispute, claim, or controversy, where, having due regard for the purposes of the Association and the intent of this Code, such dispute, claim, or controversy is not a proper subject matter for arbitration"; Respondent's Answer, p. 5 ("[P]ursuant to NASD Code of Arbitration Section 10301(b), Respondent respectfully requests that the NASD decline to use its arbitration facilities with respect to the [Trust account] claims and to dismiss the [Trust account] claims").

[33] *Id.*, pp. 2, 5 ("Respondent notes that it may also apply to a court of competent jurisdiction for an Order staying this arbitration").

[34] Respondent's discovery demands did not distinguish between Trust account claims and non-Trust account claims: "The term 'Claim' refers to the Statement of Claim filed by the Claimants in National Association of Securities Dealers, Inc. ("NASD") arbitration" Respondent's First Request, p. 3, ¶11.

[35] "Unless otherwise specified, the scope of this Request is for 'all relevant times,' which is defined as any period three years prior to the first transaction at issue in the [Statement of] Claim through present (1993-2005)." Respondent's First Request for Documents and Information, p. 3, ¶12.

[36] Statement of Claim, ¶24: "Respondent *opened* the Trust Account with an investment objective of Growth & Income in August 1996. . . ." By contrast, the earliest transaction related to Claimant's non-Trust account claims occurred in 1998, when Respondent drafted its Financial Foundation Report for Claimant.

VI. Claimant did not Waive her Right to Arbitrate her CRUT Account Claims before the NASD respondent argues that Claimant "has presented her [CRUT] account arguments to the Court" by filing a Motion to Dismiss and Opening Brief. Respondent's argument is inconsistent with the record before the Panel and the Delaware Court.

Respondent dragged Claimant into Delaware Court. Claimant has contested the Delaware Court's jurisdiction – not the substantive facts of the CRUT account claims. Claimant has done nothing inconsistent with the arbitration of her CRUT account claims at all. As a matter of law, the parties' agreement to arbitrate the CRUT account claims is valid, irrevocable and enforceable.[37]

VII. Epilogue

The Panel granted no relief to Claimant for Respondent's violation of NASD 10106. Next, the Delaware Court denied Respondent's motion for a preliminary injunction. Finally, Respondent's Motion, in arbitration, to Dismiss the CRUT claims was denied by the Panel. The arbitration is proceeding on the merits.

Respondent expected no sanctions for its violation of NASD 10106. So long as NASD members believe that NASD 10106 has no teeth, it will have no deterrent effect. This threatens the purpose of arbitration – a fast, fair and efficient resolution. This writer suggests that NASD use its arbitrator training program to communicate the importance of enforcing NASD 10106 to its arbitrators to insure that this key provision is not undermined by failure to enforce it.

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[37] *Fleury*, 138 F.3d at 1342 (holding that the parties' uniform submission agreements with the NASD were not abandoned after brokerage firm filed for an injunction); Federal Arbitration Act, 9 U.S.C. §2.

Recent Arbitration Awards

By Jason Doss

Jason Doss is an attorney with the law firm of Page Perry, LLC in Atlanta, Georgia and has been a member of PIABA since 2001. His practice focuses almost exclusively on representing private investors in securities arbitrations against brokers and their firms. Mr. Doss graduated from the University of Florida with a B.A. in Environmental Science in 1997. He received his J.D. degree from Florida State University College of Law in May 2002. While at Florida State, he received the Mock Trial Best Advocate Award and the Mock Trial Coaches Award. He is a member of the Florida and Georgia bars.

Douglas Motzer and Cletus Morgan v. Citigroup Global Markets, f/k/a Salomon Smith Barney and Kevin Durkin Purcell
NASD Case No. 04-03815

Claimants alleged that Respondents induced them to retire, choose a lump sum retirement option and invest those funds with Salomon Smith Barney instead of selecting a traditional retirement pension plan, which would have provided them with guaranteed income for the rest of their lives.

After accepting early retirement in 1996, Cletus Morgan and Douglas Motzer were given the option from their employer, Cincinnati Bell, of accepting a guaranteed monthly pension payment for the rest of their life or receiving a lump sum distribution. Both had worked very hard for more than 25 years as technicians for Cincinnati Bell and had never invested in the stock market. They initially decided to go with the guaranteed monthly payment option, until they went to a seminar sponsored by Salomon Smith Barney, n/k/a Citigroup Global Markets, Inc.

At the seminar, Mr. Kevin Purcell, a broker at Salomon Smith Barney, advised them to take the lump sum distribution and exercise their right to withdraw from their IRA(s) prior to turning 59 1/2. In general, once an investor who is younger than 59 1/2 elects to take systematic withdrawals from an IRA, the withdrawal amount cannot be changed.

In 1996, Mr. Motzer was 49 and Mr. Morgan was 50, so each of them had almost a decade to go before they could change the amount of the required distribution each would receive from their IRA plans.

Based on what they were told by Mr. Purcell, Claimants believed they would receive almost double in amount of monthly benefits for the rest of their lives and so they declined the monthly guaranteed option and took the lump sum distribution from their Cincinnati Bell.

From 2000 to 2002, Claimants lost most of their retirement assets.

Claimants asserted the following causes of actions: breach of fiduciary duty, material misrepresentations, failure to supervise, *respondeat superior*, unsuitable recommendations, negligence, breach of contract, and recklessness amounting to fraud under 10b-5 of the

Securities Exchange Act of 1934. The causes of action related to investments in non-investment grade bonds, "B" shares of three mutual funds, Managed High Yield fund, Smith Barney High Yield fund, Kmart preferred stock, Enterasys/Cabletron and Silicon Graphics stock, and mortgaged backed securities.

Claimant Morgan requested $206,000.00 in compensatory damages, interest, $500,000.00 in punitive damages, and costs including attorney's fees. Claimant Motzer requested approximately $275,000.00 in compensatory damages, interest, punitive damages amounting to $500,000.00, attorney's fees and costs.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various affirmative defenses including that the claims were not arbitrable pursuant to Rule 10304 of the NASD Code of Arbitration.

1. The Panel found Respondents liable jointly and severally on claims of breach of fiduciary duty and failure to superior and required Respondents to pay Claimant Motzer the sum of $148,637.00 and Claimant Morgan the sum of $120,900.00 in compensatory damages.

2. The Panel also required Respondents to pay 100% of the forum fees.

The award is significant because the Panel recognized that the cause of action did not accrue until damages occurred. Even though the fraudulent conduct occurred in 1996, losses in the account did not occur until 2001. Therefore, the damages element of the cause of action did not accrue until 2001. In addition, even though the accounts grew in value between 1996 and 2001, the Panel applied the "no netting rule" and did not offset previous gains from the losses.

Claimants' Counsel - Frederick Rosenberg, Roseland, New Jersey and Steele Williams, P.A., Sarasota, Florida.

Respondents' Counsel - Colleen Fitzgerald, Esq., Gray Robinson, Tampa, Florida.

Susan Unger v. McLaughlin Piven, Vogel Securities, Inc., James Cecil McLaughlin, James Michael Kennedy and Edward Thomas Brienza
NASD Case No. 01-03194

Claimant alleged that Respondents mismanaged her account by investing in various growth and technology stocks, which were wholly unsuitable for her investment objectives and risk tolerance.

Claimant asserted the following causes of action: breach of contract, negligence, failure to supervise, and breach of fiduciary duty. The cause of action related to speculative technology based mutual funds, including Future Technology Fund, Family Technology Fund, Munder Net Funds, Pinacle Family of Trust Technology Funds, Davis New York Venture Fund, Alliance Select Technology Portfolio, and Flag Investors Communications Fund.

Claimant requested compensatory damages in the amount of $575,000.00, pre-judgment interest, rescission, attorney's fees, punitive damages, costs and any other relief deemed appropriate.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various affirmative defenses.

1. The Panel found Respondents McLaughlin Piven, James Cecil McLaughlin, James Michael Kennedy and Edward Thomas Brienza liable for compensatory damages in the amount of $448,415.00 plus pre-judgment interest.

2. The Panel awarded attorney's fees in the amount of $9,600.00 pursuant to the Federal Arbitration Act.

The award is significant because the arbitration panel held officers of the corporation and its compliance manager personally liable for the losses. In addition, the arbitration panel awarded market-adjusted damages.

Claimant's Counsel - Darren Blum, Esq., Law Office of Blum and Silver, Plantation, Florida.

Respondents' Counsel - Deborah A. Kelly, Esq. and Joseph D'Elia, Law Offices of Joseph D'Elia, Huntington, New York.

Kim Eckis Andre v. Banc of America Investment Services, Inc. and Michael Degolier
NASD Case No. 04-01055

Claimant alleged that Respondents mismanaged her account by investing insurance proceeds that she received as a result of an accident which left her permanently disabled in a variable annuity and various growth and technology Class B mutual funds. Claimant alleged that the investment recommendations were wholly unsuitable for her investment objectives and risk tolerance. In addition, Claimant alleged that Respondent improperly recommended that Claimant borrow (on margin) against the gains in the variable annuity and mutual funds.

Claimant asserted the following causes of actions: breach of fiduciary duty, breach of contract, common law fraud and misrepresentations, violations of the Texas Securities Act, liability under the Texas Business and Commerce Code, negligent misrepresentation, negligence, unsuitable recommendations, failure to supervise, violation of the Texas Deceptive and unfair Trade Practices Act, and control person liability under the Texas Securities Act.

Claimant requested compensatory damages in the amount of $77,000.00, pre-judgment interest, attorney's fees, punitive damages, costs, and any other relief deemed appropriate.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various affirmative defenses.

The Panel found Respondent Banc of America Investment Services, Inc. liable for compensatory damages in the amount of $27,284.00 and dismissed claims against the broker with prejudice.

The arbitration award is significant because the case involved borrowing against the gains in the variable annuity on margin. Given that the sales practices of variable annuities have been vilified in recent years in part because of the high expenses charged to the customer and high commissions paid to the broker, the recommendation to borrow against gains in the variable annuity seems to be *per se* unsuitable not to mention a unique fact pattern.

Claimant's Counsel - Richard H. Elliot, Esq., Law Office of Richard H. Elliot, Dallas, Texas.

Respondents' Counsel - Jim Parker, Esq., Kuperman, Orr, Rial, & Albers, Austin, Texas.

Michael Kostoff v. Vincent Cervone, Yankee Financial, Inc. and Fleet Securities, Inc.
NASD Case No. 04-04259

Claimant alleged that Respondents mismanaged his account(s) by recommending that Claimant purchase and sell highly speculative shares of stocks including Neomagic, Corp., Metmanage, Inc., Pointe Communications Corp., Pro-Dex, Inc., Cypress Biosciences, Inc. and Netcurrents, Inc. It is important to note that Fleet Securities, Inc. acted in its capacity as a clearing firm.

Claimant asserted the following causes of action: suitability, failure to supervise, negligent misrepresentation, unauthorized trading, churning, *respondeat superior*, fair dealing and breach of fiduciary duty.

Claimant requested compensatory damages in the amount of $114,375.10, punitive damages in the amount of $500,000.00, pre-judgment and post-judgment interest, costs, attorney's fees and any other relief deemed appropriate.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various affirmative defenses.

1. The panel found the clearing firm, Fleet Securities, Inc. liable for compensatory damages in the amount of $114,375.10, plus pre-judgment interest at Florida's statutory rate from June 1, 2001 to the date the award is paid.

2. The Panel also found the clearing firm, Fleet Securities, inc. liable for punitive damages in the amount of $343,125.30 pursuant to sections 517.211, Fla. Stat., 768.72, Fla. Stat., 786.737, Fla. Stat. and 768.725, Fla. Stat.

3. The Panel also issued a reasoned award that provided a detailed explanation for imposing liability on the clearing firm. In sum, the Panel found that the clearing firm liable because it knowingly allowed the introducing broker, Glen Michael Financial, to change its name to Yankee Financial, Inc. and continue to defraud its customers.

4. The Panel also awarded Claimant attorney's fees and costs in amounts to be determined by a court of competent jurisdiction.

This case is significant because the arbitration panel held a clearing firm liable for 100% of the net out of pocket losses plus punitive damages, costs and interest for the wrongdoing of an introducing broker and its registered representative. Clearing firms are generally not held liable for the acts or omissions of an introducing broker, because clearing firms maintain that they provide "back office" functions and, therefore, owe a very limited duty or no duty to the customer. In reality, however, the clearing firm enables introducing brokers and their registered representative to commit wrongdoing because their role as the clearing agent is essential to accomplish the transaction.

Announcements From The PIABA Office

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Upcoming Events:

California Mid-Year Meeting, March 4, 2006,
Crowne Plaza @ LAX. Los Angeles, California.

PIABA Board of Directors Meeting, March 11-12, 2006.
Hyatt Tamaya. Albuquerque, New Mexico

Florida Mid-Year Meeting, May 6, 2006
Sheraton Ft. Lauderdale Airport Hotel.
Ft. Lauderdale, Florida

Midwest Mid-Year Meeting, June 3, 2006
Chicago Marriott O'Hare. Chicago, Illinois

PIABA Board of Directors Meeting, July 15-16, 2006.
The Heathman Hotel. Portland, Oregon.

PIABA 8th Annual Securities Law Seminar. Octoer 25, 2006. Westin La Paloma. Tucson, Arizona.

PIABA 15th Annual Meeting, Octoer 26 - 28, 2006.
Westin La Paloma. Tucson, Arizona.

For more information pertaining to upcoming PIABA meetings, contact the PIABA office or visit the PIABA website at www.PIABA.org.