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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

December 1997 Volume 4 Number 4

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Editor's Notes

The deadline for receiving submissions for the March 1998 issue of the Quarterly is March 5, 1998. All submissions, regardless of length, should be accompanied by a computer disk of the submitted material saved in either Word Perfect or as a text file.

Please send change of address information to Robin Ringo, 1111 Wylie Road, #18, Norman, OK 73069, Phone (888) 621-7484, E-mail: PIABALAW@aol.com.

The PIABA Quarterly is a publication of The Public Investors Arbitration Bar Association (PIABA) and is intended for the use of its members. Statements and opinions expressed are not necessarily those of PIABA or its Board of Directors. Information is from sources deemed reliable, but should be used subject to verification.

Letter From the President

Diane A. Nygaard
THE NYGAARD LAW FIRM
Overland Park, Kansas

Dear Members,

PIABA's annual meeting in Scottsdale was a watershed meeting, and demonstrated that our membership's size and enthusiasm has reached critical mass. PIABA is now recognized as an aggressive organization, working hard to ensure that investors' rights in arbitration are protected. PIABA's members have volunteered their time to promote the efforts of the four committees established, as detailed below.

For those of you who missed the meeting, besides the unselfish sharing of ideas that always takes place among our members, we also discussed several issues of concern to members. To address these concerns, four committees have been established, and are actively at work:

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1. Federal Legislation Committee.
   Chairs: Boyd Page and Rosemary Shockman

This committee is addressing proposed federal legislation which would profoundly affect our practices. The Eshoo-White Bill (H.R 1989) in the House and the Gramm-Dodd Bill (S. 1260) in the Senate, collectively referred to as the "Eshoo-White" Bill, would prohibit state common law and statutory claims in securities fraud cases involving publicly traded securities if 25 plaintiffs are named. Boyd and Rosemary have circulated the bill to all members. We urge you to write your congressional representatives, as well as draft a letter for clients to send opposition to this proposed legislation. As you know, the business community is aggressively pushing the legislation.

In the Senate, the bill is before the Securities subcommittee of the Senate Banking Committee. Senator Phil Grarnm of Texas, a co-sponsor, chairs this subcommittee. Senator D'Amato of New York chairs the Banking Committee, and does not yet support the bill. He is a key figure, and New York attorneys are urged to contact his office.

In the House, the Eshoo-White Bill is before the Finance and Hazardous Materials Subcommittee of the Commerce Committee. Members of the subcommittee who are not sponsors are Diane DeGette (Colorado), Eliot Engel (New York), Tom Manton (New York), Bar Stupak (Michigan) and Ed Markey (Massachusetts). Please send letters to these representatives, particularly if they are from your state.

2. THE NASD/SRO "Level Playing Field" Committee.
   Chairs: Bob Dyer and Jim Beckley

This committee is actively trying to work with the NASD in addressing several existing problems, including the pro-industry training of arbitrators, the poor administration of arbitrators, and the continuing practice of the NASD to find "insufficiencies" in new filings. Deborah Masucci, who recently resigned as head of the NASD's arbitration section, told Rosemary Shockman and me last summer that 70% of all filings are returned as "insufficient", with a letter indicating that the case will be dismissed if the requested information or documents are not furnished within thirty days. The NASD Code of Arbitration Procedure does not establish any such review process, and PIABA is working to ensure that the practice ceases. The NASD and the committee are trying to work together to revise the training materials.

Under Bob Dyer's leadership, PIABA has submitted three rule proposals to the SEC:

1. The first proposal would give investors a right to arbitrate securities disputes before the American Arbitration Association (in PIABA parlance, the NASD window"). In 1987, the SEC urged the Securities Industry Conference on Arbitration to request its member firms to include a provision allowing investors to arbitrate at the AAA, but, instead, the current situation is that none of the 20 largest full service broker-dealers afford customers this right. The 1996 Ruder Report also recommended that the arbitration process needed to be improved in many ways to protect the investor. PIABA argues that the rule should be passed to eliminate the NASD's stranglehold of the securities arbitration process. Under the NASD's control, the arbitration process has become increasingly inefficient and unfair to investors.

2. The second proposed rule gives customers the initial right to elect an all-public panel of three arbitrators in a NASD arbitration. This would eliminate the current rule that requires an industry arbitrator. Under the proposed rule, the NASD, in a complicated case, could appoint an "experienced panel", consisting of one public member, one industry member and one investor member. This rule would balance the potential role of the industry arbitrator.

3. The third rule requires rotational selection of all panel members in customer disputes. This

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would prevent the repeated appointment by the NASD of favored arbitrators, and would further the Ruder Commission's pronouncement that a fairer method of selecting arbitrators is needed. As you know, the "list selection" change we anticipated has yet to be proposed by the NASD.

On the other side of the table, the NASD has submitted three rule changes to the SEC. These became available for public comment. Jim Beckley has done a masterful job filing PIABA's comments to the proposals. Jim and I have written to thc SEC asking for additional time to address these proposals, as comment periods just ended. The SEC has indicated it will continue to accept comments. We urge all PIABA members to review these suggested rule changes involving increased arbitration fees (File No. SR-NASD-97-79), capping punitive damages (File No. SR-NASD-97-47), and changing the eligibility rule (SR-NASD-97-44). Please call Robin Ringo, our extremely efficient administrative director, if you have not received copies of these and please spend some time writing a letter and, most importantly, asking clients to write letters in support of PIABA's proposed rule changes and addressing the NASD's proposals. It is important that letters refer to the File No. (SR, etc.) and be sent to Jonathan Katz, Secretary to the SEC, 450 5th St., NW, Washington, D.C. 20549.

4. Governance and Communications Committee.
   Chairs: Seth Lipner, Cary Lapidus and Jerry Stanley.

The Governance and Communications Committee is working hard to make PIABA's own procedures and intemal communications more efficient. Seth Lipner is chairing the membership subcommittee, addressing membership and dues issues. Cary Lapidus has agreed to work on a website for PIABA, as well as establishing electronic means of communications among members. If you have an e-mail address, please fax it to Robin or e-mail her at: PIABALAW@aol.com. We would like to be able to use e-mail rather than faxing information to members, particularly as to time-sensitive issues. Jerry Stanley will continue his much appreciated work in putting together our PIABA QUARTERLY.

5. The Annual Meeting Committee.
   Chairs: Joe Long and Bill Lapp

The Annual Meeting Committee is planning PIABA's next annual meeting to be held at Disney world in Orlando on October 22-26, 1998.

On behalf of all of us on the Board, I want you to know how much we appreciate your work, ideas, and dedication to the cause of improving the resolution of investor's disputes. PIABA benefits its members and the investors they represent because of the hard work and continuing efforts of its Board and active members. Thank you for your ideas, your volunteering to serve on these committees and for following through with letters and calls on these important rule changes.

Best wishes for a happy and prosperous New Year.

Diane Nygaard

FROM THE PROFESSOR

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DISPOSITIVE MOTIONS

I have become aware that there is a substantial dispute among the PIABA members as to whether the arbitrators can entertain dispositive motions.[1] The purpose of this piece is not as much to try to resolve definitively this dispute as it is to make the membership aware that the NASD, through its arbitrator training materials, has clearly indicated that such dispositive motions may be considered.[2]

Let us turn first to the dispute itself. A reading of the Uniform Arbitration Code reveals no provision directly dealing with dispositive motions. Thus, the Code itself is neutral. It neither authorizes nor prohibits such motions. This neutrality, however, can be viewed in two ways.

It can be argued that such motions are not allowed unless specifically authorized by the Code itself. This conclusion is based upon an analogy to the Federal Code of Civil Procedure which clearly allows such motions, but does so by specific rule provisions. No specific authority means no power on the part of arbitrators to entertain such motions, since arbitrators acquire their power from the contract to arbitrate agreed to by the parties. In the case of NASD arbitrations, the

contract to arbitrate incorporates the Uniform Code of Arbitration.[3]

The counter position is that the Federal Rules are nothing more than a compilation of rules developed by the courts themselves under their inherent authority to control the way in which they do business. As a result, no specific rules are required. The arbitrators have the same inherent power to develop procedures for conducting their business. This inherent power would include the ability to dispose of any claim without hearing evidence on the entire claim. As a result, they can freely consider defenses which would make an evidentiary hearing on the merits of the case unnecessary.[4]

The former position draws some indirect support from Rule 10303 of the NASD Code, which provides:

> Any dispute, claim, or controversy except as provided Rule 10203 (Simplified Industry Arbitration or Rule 10302 (Simplified Industry Arbitration), **shall require a hearing** unless all parties waive such hearing in writing and request that the matter be resolved solely upon the pleadings and documentary evidence. **[Emphasis added.]**

However, a careful reading of this language clearly shows no prohibition against the entertaining of dispositive motions **per se**. It does, however, indicate that, if such motions are appropriate, the disposition of such motions must be at **a hearing by the panel**.

This language, when read in conjunction with Rule 10321 covering Pre-Hearing Proceedings, does, however, appear to resolve several subsidiary issues. First, a pre-hearing proceedings or a pre-hearing conference, by definition, **is not a hearing**.[5] Second, while Rule 10321 allows a pre-hearing conference to be conducted by a single member of the arbitration panel, usually the chairman,[6] there is no provision for the holding of **a hearing** by a single arbitrator. Therefore, a ruling on dispositive motions, if appropriate, will have to be by the full panel.[7]

The problem with Rule 10321 is that it does not define what constitutes a "hearing". Those who argue that the arbitrators can not consider dispositive motions will no doubt claim that a "hearing" means a full-blown evidentiary hearing on the entire claim. The author does not think that this is a fair reading. In a traditional court case, judges will often hold hearings on ancillary or preliminary matters before, or separately from, a full hearing on the merits. Such hearings may or may not involve the evidence, either in the form of live testimony or depositions or affidavits.

The same should be true in the case of arbitrations. This position finds some support in Rule 10332, "Schedule of Fees for Customer Disputes". Section (b) of that Rule states: "A hearing session is any meeting between the parties and the arbitrator(s), including a pre-hearing conference with an arbitrator, which last four (4) hours or less." Thus, a hearing is nothing more than a meeting between the parties and the arbitrators. Such hearing can be the main hearing where the arbitrators take evidence on the claims, or the hearing could be for the purpose of hearing argument, and evidence, if necessary, on a dispositive motion.[8]

Whether the opponents of dispositive motions or I am correct is probably largely academic. As a practical matter, the deciding factor presently is the position taken by the NASD and communicated to the arbitrators. Through its training materials, the NASD is making clear that it believes that the arbitrators have the power to consider dispositive motions.[9]

The NASD Chairperson Course Preparation Guide indicates that the arbitrators will frequently receive three different types of dispositive motions: (1) Challenges claiming that the dispute is ineligible to be arbitrated; (2) Challenges arguing that the claim is barred by the relevant state or federal statute of limitations; and (3) Challenges to appropriateness of the arbitration forum in general.[10] Let us look briefly at each of these motions and see what the NASD instructs the arbitrators about them.

The first of these dispositive motions is a motion to dismiss one or more claims based upon their ineligibility to be arbitrated. This challenge involves the six-year eligibility provision found in old Rule 15.[11]

The Chairperson Guide makes some interesting comments on how these motions should be handled. It first indicates:

> [B]e sure you have all parties' responses on this issue. You would then call the other panel members to discuss the issues.[12]

This makes clear that the whole panel will decide the issue.[13] However, it also suggests that a hearing should not be conducted on this matter, but that the ruling should be submissions.[14] While such practice might be permissible, **if the parties agree**, such practice is inappropriate otherwise. As seen

above, Rule 10303 **requires** a hearing unless such hearing is waived by the parties. Therefore the parties should be able to make an oral presentation to the full panel, if either side requests.

Most federal courts have held that the six-year rule is not a statute of limitations, and therefore can not be tolled.[15] However, the Chairperson's Guide suggests that the same result can be accomplished in a different way. The Guide says:

> You might find that there is a **continuing occurrence or event** giving rise to the dispute. **For example, although a customer purchased stock 10 years ago, you might find that there are allegations of ongoing fraud starting with the purchase, but continuing to date.**[16]

This suggests that "occurrence or event" is not a specific moment in time as many brokerage houses argue, but was intended to be, at least in certain circumstances, a continuing thing. Second, while normally fraud committed after the sale of a security is not actionable under the state or federal securities acts, such after-occurring acts which are part of a continuing fraud are. Finally, each act of fraud should be treated as separate "occurrence or event". This analysis should be extremely important in the remaining tax-shelter cases where the brokerage house fraudulently continued to show the value of the investment at the original purchase price.

The problem here is that normally arbitrability is considered to be an issue for court disposition,[17] based upon the concept that no person should be required to arbitrate unless they have agreed to do so. However, the Supreme court made clear in **First Options v. Kaplan**[18] that the parties may agree to arbitrate "arbitrability" if their intent to do so is "clear and unmistakable". Many federal courts have treated eligibility as an "arbitrability" issue.[19] Several of these courts, then, concluded that the NASD Code[20] does not show a "clear and unmistakable" intent to have the arbitrators resolve the eligibility issue.[21]

However, the recent decision by the New York Court of Appeals in **Smith Barney Shearson, Inc. v. Sacharow,**[22] may change this position radically. In **Sacharow,** the court held that, under New York law, the NASD Code provides a "clear and unmistakable" election to have eligibility determined by the arbitrators.[23] What is impact of the **Sacharow** decision? The answer to this question lies in the resolution of two other questions. First, does state or federal law control in this area? And, second, what is the effect of a New York choice of laws clause?

The first of these questions has not been resolved. A number of federal courts of appeals have **assumed** this to be a federal law question.[24] However, the Supreme Court has indicated that arbitration is a matter of contract and in interpreting the arbitration contract ordinary state contract law principles shall control.[25] This suggests that the New York Court of Appeals decision in **Sacharow** should control over contrary decisions of the federal courts, at least as to New York cases.

The court in **Sacharow** answered the second question. New York substantive law will apply as a result of the choice of law provision. Therefore, under an arbitration agreement with a New York choice of law clause, there is "clear and unmistakable" evidence that the parties intended eligibility to be decided by the arbitrators.

Since most current arbitration clauses contain some form of New York conflict of laws provision, the **Sacharow** decision may have very wide application. As a result, members may expect more dispositive motions of this type in the future.

The second dispositive issue which the NASD feels the arbitrators may receive is a motion to dismiss based upon the running of the statute of limitations. The Chairperson's Guide correctly indicates that this is a separate issue from the six-year eligibility rule.[26] It also makes clear that this motion will have to be considered by the entire panel.[27] Finally, it recognizes that the statute of limitations can be equitably tolled for fraudulent concealment.[28]

The problem with the NASD presentation here is that the Guide **assumes** that statutes of limitation are controlling in arbitration. While the brokerage community would like this to be the case, **it is far from clear that statutes of limitation have any role in arbitration or the arbitrators are bound to follow them**. It is clear that the arbitrators may dismiss on the basis of the statute of limitations, but there is a substantial authority that they are not bound by such statutes.[29] There are two separate lines of authority indicating that statutes of limitation are not controlling in arbitration.[30]

It has long been recognized that statutes of limitation were applicable in actions at law, but were not controlling in equity proceedings. the first line of cases points out that arbitration proceedings are more in the nature of an equity action. As such statutes of limitations are not

binding.[31] The second line of cases takes the position that the language of most statutes of limitations talks in terms of no action being brought after the statutory period. They then conclude that an arbitration proceedings is not an "action" as defined at common law [32] or by statute. [33]

The final dispositive motion that the NASD Guide covers is a challenge to the appropriateness of the arbitration issue here is whether all the parties have consented to arbitration. Since arbitration is a matter of contract, no party can be forced to arbitrate that has not agreed to. [34] The Guide points this out by saying: "Customers who have not agreed to arbitrate their claims may request dismissal of the action in favor of remedies in the courts."[35] It also goes on to point out that all brokers and registered representatives have agreed to arbitration at customer request **even if there is no arbitration clause**.[36] Beyond this doctrines of agency and piercing the corporate veil may be used to bring in additional parties, who have not actually signed arbitration agreements.[37]

The problem here is that whether a person must arbitrate is usually a question for the court.[38] Again, however, like in the case of eligibility in the **Sacharow** case, the issue of arbitrability can be delegated to the arbitrators, **if there is a clear and unmistakable intent to do so.**[39] However, unlike **Sacharow,** this intent can not be found in the NASD Code for non-members because they have not agreed to the Code at this point. However, a petitioner seeking arbitration must **assume** that the respondent will submit to arbitration by filing a submission. The respondent then has three choices. He can seek court review of this issue by filing for an injunction under Section 3 of the Federal Arbitration Act.[40] Second, he can contest, by a special appearance, the panel's authority over him.[41] If the panel rules against him, he can proceed to arbitration under protest, and raise the issue in court at the time of confirmation or by suit vacatur.[42] Finally, he can file his submission agreement and answer. In this later case, the submission of the submission agreement should reflect a "clear and unmistakable" intent by the respondent to submit the issue to the arbitrators. At this point, he would loose his right to seek an injunction or raise the issue on confirmation.

In summary, the field of dispositive motions in arbitration is an area which the PIABA member needs to consider carefully. All the answers are not clear and may not be what the member may believe the answer should be. It is also clear that the arbitrators are not being given the complete and accurate picture by the NASD through its training materials.

[1] The normal dispositive motion will involve one of three issues: (1) the six-year eligibility rule under Rule 10304, (2) the statute of limitations applicable to the individual claims under state or federal law; and (3) arbitrability, i.e. are all parties required to arbitrate. See generally, NASD, Chairperson Course Preparation Guide, Module 1, Lesson 3, pp. 57-80 (Nov. 1996); NASD, Panel Member Course Preparation guide, Module 1, Lesson 3, pp. 57-78 (Nov. 1996). However, other dispositive motions are also possible. For example, there may be issues involving the applicability of res judicata or collateral estoppel. **Id.**

The introduction to the NASD Chairperson Course Preparation, Guide indicates that this Guide contains the same information as the Panel Member Course Preparation Guide, to which additional material has been added which would be helpful to the Chairperson. The additional information appears in bold print. **Id.** at ix. Since the Chairperson Guide is the more expansive document reference henceforth will be to that Guide. These two Course Guides are provided **prior to** the training sessions and the participants are expected to have read them prior to the session.

Members should be aware that the NASD also publishes a number of other publications provided to the arbitrators. At the training sessions, participants are provided either the Chairperson Participant's Guide (Nov. 1996) or Panel Member Participant's Guide (Nov. 1996). These publications do not appear to have much substantive or legal information in them. The NASD also publishes a pamphlet called the Arbitrator's Manual (Oct. 1996). This publication, which appears to be designed as something the arbitrator can carry with them to the arbitration for quick reference, has essentially the same information as the Course Preparation Guide in summary form.

[2] NASD, Chairperson Preparation Guide, Mode 1 Lesson 3, pp. 58 (Nov. 1996) states: "Although arbitration is an informal process, any party may file a **dispositive motion** - - that is, a motion to dismiss all or part of a claim - - **prior to hearing**." [First emphasis on the original.]

[3] See Rule 10201 (a) covering "Required Submission".

[4] They would, however, have to hear evidence on the substance of the defense, unless the facts were not in dispute. For example, in the case of the six-year eligibility rule, the panel would have to determine when the "occurrence or event giving rise" to the claim took place.

[5] This is consistent with the practice of many arbitration panels to reserve ruling on dispositive motions until the first hearing session. NASD, Chairperson Course Preparation Guide 125 (Nov. 1996) indicates preliminary matters such as motions to dismiss are appropriately considered at the opening of the hearing.

The pre-hearing conference, however, is considered a hearing for purposes of calculating hearing session fees under Rule 10332 (b) because that Rule specifically provides so.

[6] NASD, Chairperson Course Preparation Guide 23 (Nov. 1996) states: "In most cases, NASD Regulation will appoint the Chairperson to manage the discovery process.

[7] NASD, Chairperson, Course Preparation Guide 57 states: "Although the arbitrator selected by NASD Regulation can rule on most pre-hearing requests and motions unilaterally, the **entire panel must** consider issues [including ruling on dispositive motions]." [Emphasis added.]

Under Rule 10325 rulings and determinations of the panel are to be by majority vote.

[8] As noted above, in order to avoid having to hold a special hearing on dispositive motions, many panels will defer ruling upon dispositive motions until the main hearing on the merits. Even then, the panel may elect to reserve ruling of the dispositive motion until after the evidence has been presented.

[9] Those members who disagree with this position, need to add this issue to their list of points where the NASD arbitrator material are an inaccurate statement of the law, and notify the NASD of their feelings.

[10] NASD, Chairperson Course Preparation Guide 58 (Nov. 1996).

[11] Now Rule 10304. This rule reads: No dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the **occurrence or event giving rise to the act or dispute, claim or controversy. This Rule shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of competent jurisdiction.** [Emphasis added.]

[12] NASD, Chairperson Course Preparation Guide 58 (Nov. 1996).

[13] This is re-enforced in the discussion of the statute of limitations where the Guide states: "NASD Regulation then informs the requesting party that because the motion is substantive and dispositive, it must be heard by the entire panel." NASD, Chairperson Course Preparation Guide 59 (Nov. 1997).

[14] This conclusion is re-enforced by two other statements in the Chairman's Guide. "If there is a genuine question as to eligibility, ask the parties to brief the issue" **Id.** "The panel should review Rule 10304, the pleadings, motions, and responses." **Id.** at 59.

[15] See e.g., PaineWebber Inc. v. Hoffmann, 984 F.2d 1372 (3d Cir. 1993); Edward D. Jones & Co. v. Sorrells, 957 F.2d 509 (7th Cir. 1992).

[16] NASD, Chairperson Course Preparation Guide 58 (Nov. 1996).

[17] First Options v. Kaplan, 514 U.S. 938, 944 (1995). The Chairperson's Guide acknowledges this by saying: "If your authority to judge the case is unclear, ask the parties to brief the issue further." NASD, Chairperson Course Preparation Guide 59 (Nov. 1996).

[18] 514 U.S. 938, 944 (1995).

[19] See e.g., PaineWebber Inc. v. Hoffmann, 984 F.2d 1372 (3d Cir. 1993); Edward D. Jones & Co. v. Sorrells, 957 F.2d 509 (7th Cir. 1992).

[20] The NASD Code of Arbitration is incorporated in every agreement to arbitrate before the NASD. Rule 10331.

[21] See e.g., Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 78 F.3d 474 (10th Cir. 1996).

[22] 1997 WL 749405 (N.Y. Dec. 4, 1997), discussed in detail elsewhere in this issue.

[23] In reaching this decision, the Court of Appeals sided with the federal First, Second, and Eighth Circuits . PaineWebber, Inc. v. Elahi, 97 F.3d 589 (1st Cir. 1997); PaineWebber Inc. v. Bybyk, 81 F.3d 1193 (2d Cir. 1997); and FSC Sec. Corp. v. Freel, 14 F.3d 1310 (8th Cir. 1994).

[24] See e.g., Cogswell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 78 F.3d 474 (10th Cir. 1996).

[25] See e.g., First Options v. Kaplan, 514 U.S. 938 (1995).

[26] The Guide says: "Even when a claim is filed within the six-year eligibility period provided in the Code, Federal or State law may still preclude a monetary award for events in that same period." NASD, Chairperson Course Preparation Guide 59 (Nov. 1996).

There would seem to be two problems with this statement. First, the NASD is **assuming** that the statute of limitations has application in arbitration. As outlined in detail in the text below, this may not be a valid assumption. Second, the statute of limitations bars any recovery on the claim, not just "monetary awards".

[27] The Guide states: "Just as we saw with issues of eligibility, respondents will generally ask NASD Regulation to dismiss a case based on the relevant statute of limitations. NASD Regulation then informs the requesting party that because the motion is substantive and dispositive, it must be heard by the entire panel." NASD, Chairperson Course Preparation Guide 59 (Nov. 1996).

[28] Id. It should be recognized that fraud is self-concealing and, therefore, also constitutes fraudulent concealment. There are two branches of fraudulent concealment. The most well-known variety is active fraudulent concealment where the respondent actively misleads the plaintiff as to his cause of action. An example of this would be the broker continuing to list the tax-shelter partnerships on the monthly statements at the original purchase price when it is aware that such is not a fair value.

The second is passive fraudulent concealment. This usually comes up when the respondent is in a fiduciary capacity or in a position of "trust and confidence". Obviously, this branch should be available in most broker or registered representative arbitrations because the broker-dealer is the agent of the customer and the registered representative the sub-agent. Under this branch, the client has no duty to investigate until he **actually** discovers the concealment or receives independent information putting him on notice to investigate. The idea is that the client can trust the fiduciary to be honest in his dealings until he receives actual knowledge that the fiduciary is breaching his fiduciary duty.

[29] See e.g., World Brilliance Corp. v. Bethlehem Steel, Co., 342 F.2d 362 (2d Cir. 1965); Skidmore, Owings and Merrill v. Connecticut Gen. Life Ins. Co., 25 Conn. Supp. 76, 197 A.2d 83 (Conn. Super. 1963); City of Worcester v. Park Constr. Co., 361 Mass. 879, 281 N.E.2d 600 (1972).

[30] See generally, Annot. "Statute of Limitations As Bar to Arbitration Under Agreement", 94 A.L.R. 3d 533 (1980).

[31] See e.g., Lewiston Firefighters Assoc. v. City of Lewiston, 354 A.2d 154 (Me.1976); Har-Mar, Inc. v. Thorsen & Thorshov, Inc., 300 Minn. 149, 218 N.W. 2d 751 (1974)

[32] Har-Mar, Inc. v. Thorsen & Thorshov, Inc., 300 Min. 149, 218 N.W.2d 751 (1974)

[33] Son Shipping Co., Inc. v. De Fossse & Tanghe, 199 F.2d 687 (2d Cir. 1952); Skidmore, Owings and Merrill v. Connecticut Gen. Life Ins. co., 25 Conn. Supp 76, 197 A.2d 83 (Conn. Super. 1963); Lewiston Firefighters Assoc. v. City of Lewiston, 354 A.2d 154 (Me. 1976).

[34] See e.g., United States Steelworkers v. Warriorr & Gulf Nav. co., 363 U.S. 574 (1960).

[35] NASD, Chairperson Course Preparation Guide 61 (Nov. 1996).

[36] Rule 10301 (a). The registered representative also agrees by filing a Form U-4 to become registered.

[37] Thomson-CSF, S.A. v. American Arbitration Ass'n, 64 F.3d 773, 776 (2d Cir. 1995); ARW Exploration Corp. v. Aguirre, 45 F.3d 1455 (10th Cir. 1995).

[38] The Guide recognizes this fact when it says: "A party that disagrees with a panel's decision that arbitration is appropriate may file a motion to stay the arbitration in court." NASD, Chairperson Course Preparation Guide 61 (Nov. 1996).

[39] First Options v. Kaplan, 514 U.S. 938, 944 (1995).

[40] 9 U.S.C. §3.

[41] If he does this, this is a clear refusal to arbitrate and the claimant can then go into court to seek an order requiring arbitration under Section 4 of the Federal Arbitration Act, 9 U.S.C. §4. See e.g., American Fuel Corp. v. Utah Energy Dev. Co., 132 F.3d 130 (2d Cir. 1997).

[42] See e.g., ARW Exploration Corp. v. Aguirre, 45 F.3d 1455 (10th Cir. 1995).

News From New York

Submitted by: Seth E. Lipner
DEUTSCH & LIPNER
Garden City, N.Y.

Fenster falls in 15th round!!

Its over. At least I think its over. The New York Court of Appeals ruled on December 4, 1997, that, under both New York law and the FAA, eligibility rule issues are for the arbitrators not the courts. See Smith Barney v. Hause, Smith Barney v. Sacharow (decided together). As you can well imagine, this victory was particularly sweet for us because it was the last battle in what Jim Beckley termed the brokerage industry's "Stalingrad defense" of limited partnership cases. And, of course, the industry had sent in its favorite general, Lawrence Fenster, to lead this last battle. Oh, the agony of defeat.

The cases were simple "who decides" cases where the parties' agreement stated that New York law would govern. The lower court decisions were all over the lot; none offered persuasive reasoning. The Appellate Division had ruled the issue one for the arbitrators, based on an analysis of Mastrobuono, First Options, and Luckie. When the Court of Appeals agreed to hear Smith Barney's appeal, we figured we were probably cooked. New York seemed destined to follow the majority of the circuits which had ruled (a) that eligibility affected arbitrability and (b) that it was therefore a matter for the courts not the arbitrators.

In his brief, Fenster trotted out all the precedent starting with Farnum and Sorrels; we countered with a lengthy polemic about the injustice of the eligibility rule, its arcane historical context, and the unfairness of interpreting the standard-form customer agreement in favor the party who drafted it (the doctrine known as *contra proferentum*). We found it odd that no court had, to our knowledge, decided an eligibility case on that basis, so we thought it worth a shot.

And what a shot it was. The Court of Appeals hammered them. Before it did so, it first adopted some of their arguments. The eligibility rule, they said, does "create a substantive feature that may affect the right and obligation to arbitrate", rejecting the Fifth's Circuit's approach in Boone and the First Circuit's approach in Elahi. The Court then recited the rule of First Options and AT&T, that arbitrability questions are normally for the courts unless the parties have displayed "a clear and unmistakable" agreement to commit the issue to the arbitrators.

So far, the decision followed the majority rule. But the Court then took the path of Bybyk, holding that the parties had displayed the requisite intention to commit the issue to the arbitrators. In so finding, the Court made reference to the "any and all controversies" language of the agreement and NASD Rule 35, saying that "nothing in the NASD Code removes Section 15 from the ambit of Section 35." (quoting from Bybyk).

Needless to say, seeing those words caused us to feel vindicated, since we had been making that argument since the days of Solomon (bad pun). But that wasn't all there was to make our day, so to speak, because the Court of Appeals went on to tell Mr. Fenster and the securities industry, in unusually pointed language, that it did not like their behavior in these cases. In the last paragraph of the decision, Judge Bellacosa, writing for a unanimous Court, let loose:

> Frankly stated, a [ruling for Smith Barney] would curtail or divert [the] progressive and prudent policy favoring arbitration. . . . [I]t would be ironic and anomalous to permit parties from the securities industry, who generally derive benefits from the arbitration method they impose on their thousands of consumers, to elude the comprehensive language of their own industry-drafted arbitration agreements. Having agreed to plenary arbitration,

they should not garner that strategic advantage against their aggrieved or dissatisfied customers.

While we of course took time-out to pat ourselves on the back (you may, of course, keep the congratulatory cards and letters coming in), set out to try to determine the fallout from this decision. Here is our opinion:

1) this decision should have an impact in other jurisdiction because it purports to be a decision as to "New York law", and you know what that means;
2) The Court of Appeals made no attempt to distinguish or limit Mastrobuono, so the punitive damages issue and the Garrity rule are probably dead in New York;
3) The Court distinguished (feebly but significantly) its prior decision in Luckie, stating that New York's policy sending statutory timeliness questions to court is not violative of the FAA, so that case remains intact;
4) We must be especially vigilant to watch the reaction of the firms, i.e. they will try to amend their agreements to be more explicit regarding their ability to make procedural maneuvers that hurt the customers. In this regard, we must keep the heat on the NASD and the SEC to enforce Rule 21(f) of the NASD's Rules of Fair Practice, which limits the ability of the firms to use the customer agreements to limit the rights and remedies available to the parties.
5) Lastly, and in some respects most importantly, the paragraph cited above, coming from such a prestigious court in the industry's back yard, will be a formidable weapon for us to use in the on-going battle against industry-mandated arbitration.

As if all this wasn't enough, in a second ruling, the Court of Appeals laid to rest the ridiculous claim by Kidder Peabody that the AMEX's 6-year rule applied to an AMEX Window arbitration at the AAA. The Court, in a two-paragraph opinion, said that the AMEX 6-year rule is "indisputably, part of a set of rules expressly applicable only to arbitration in the AMEX arbitration forum." Kidder Peabody v. Sanders.

All-in-all not a bad two days in the Court of Appeals! I want to my express my personal gratitude to all those who helped along the way (that basically means all PIABA members).

Georgia Court Affirms Arbitrator's Punitive Damage Award

A Georgia Court affirmed an award of punitive damages in arbitration even though Georgia state law prohibited an award of punitive damages based solely on negligence. Greenway Capital Corporation v. Schhneider, 1997 WL 716819 (Ga. App.)

The Greenway court rejected the brokerage firm's argument which was based on Georgia state law. The court, relying on the preemption of state law by federal law under the FAA, found the Georgia state law was not controlling. Moreover, the court based its finding on the fact that there had been no agreement by the parties to be specifically bound by Georgia state arbitration law.

The court also noted that state courts, when considering an award obtained under the FAA, must apply federal substantive law. Citing Mastrobuono v. Shearson, the court proclaimed that, under the Federal law, an arbitration award of punitive damages was permissible under the NASD Code of Arbitration Procedure even in the face of New York law which bans arbitrators from awarding punitive damages.

Iowa Supreme Court Rules Eligibility Is Arbitrable

In Smith Barney v. Keeney 570 N.W. 2d 75, the Iowa Supreme Court held that the question of whether the customer dispute was barred by the six year limitations period was a question to be determined by the arbitrators rather than the court.

The lower court had considered the Eighth Circuits' ruling in FSC Securities Corp. V. Freel,

14 F. 2d 1310. It rejected Freel, relying on the fact that a majority of Federal Courts have held contrary to Freel, and held that Section 35 of the NASD Code does not commit Section 15 questions to arbitration.

The Keeney court reversed the lower court's ruling and noted that the Federal courts which had found contrary to Freel were relying on AT&T Technologies Inc. v. Communications Workers of America, 1065. Ct. 1415 (1986), which held that arbitrability is usually an issue for the courts "unless the parties clearly and unmistakably provide otherwise". The Keeney court further noted that the decision in AT&T Technologies was based on federal law and the Supreme Courts' interpretation of the Labor Management Relations Act, and that, the federal courts which had carried AT&T over to securities situations, had done so under the commerce clause of 9 U.S.C. §2.

However, since, unlike AT&T, neither party had invoked federal law with respect to the issue of who was to decide arbitrability (Smith Barney had urged the governance of New York law), the Keeney opined that it was left, therefore, to consider the issue using Iowa contract law. Based on the unambiguous language of NASD Code Section 35 and the fact that nothing in the customer agreement provided a basis for excepting Section 15 from the directive of Section 35, the court reversed the lower court and compelled arbitration of the issue of eligibility.

Fourth Circuit Denies Introducing Broker's Use of Clearing Broker Arbitration Agreement

In Arrants v. Buck and F.N. Wolf & Company, 1997 WL 746365 (4th Cor. (Va.)), the Fourth Circuit affirmed the District Court's denial of a motion to compel arbitration made by an introducing broker which was based on a contract between the customer and the clearing broker, Prudential Securities.

Although its name did not appear on the customer's clearing agreement, Wolf argued that because certain codes pertaining to Wolf appeared on the agreement—its branch office and broker numbers—and the circumstances surrounding the signing of the agreement—the Wolf broker actually had the client sign the agreement—that Wolf was actually a party to the agreement.

The Arrants court summarily rejected these arguments and noted that there are only two instances where an introducing broker can take advantage of arbitration clauses in customer-clearing broker agreements: first, when the introducing broker is the agent of the clearing broker; or, second, when the introducing broker is expressly made a third-party beneficiary to the agreement.

Florida District Court Revisits Section 15 Question

The court in Gibraltar Securities Co. V. Bitter, 1997 WL 728086 (M.D. Ha.) was called on to decide the Section 15 question relating to allegations of continuing wrongdoing and whether such allegations can bring otherwise non-arbitrable claims into arbitration.

The Court cited the background of Section 15 cases in the Eleventh Circuit: Merrill Lynch v. Cohen 62 F. 3d 381, (11th Cir. 1995), which held that Section 15 is a substantive eligibility requirement, to be decided by the court rather than an arbitrator; and Smith Barney, Inc. v. Hyland, 969 F. Supp. 719 (M.D. Fla. 1997), which held that in order to proceed in arbitration, the claimant must specifically state what events or occurrences form the basis of the claims and state that such events occurred within the six years preceding the arbitration demand and that "merely alleging that a party engaged in continuous misconduct will not be adequate because it does not set forth specific events or occurrences".

Based on Hyland, the Bitter court allowed claims which had specific allegations of continuing misconduct (e.g., the broker stated that decreased values on statements were keypunch errors; and that a company would get infusion of capital which would restore value), but enjoined the arbitration of any claim outside of six years which did not state specifically what events formed the basis of the claim.

Michigan District Court Allows Claimant to Dismiss NASD Arbitration and File AAA

In Prudential Securities, Inc. v. Harrell, 1997 U.S. Dist. LEXIS 19337, the court was presented with the unusual situation where the claimant filed for an NASD arbitration by signing a Uniform Submission Agreement, subsequently obtained her account agreement which allowed for AAA arbitration, and then dismissed her NASD arbitration to file an AAA arbitration.

The case was made unique by the fact that Prudential never filed an answer to the NASD arbitration, but rather filed in court for a declaratory judgement enjoining and dismissing the arbitration proceedings based on Section 15. After Prudential filed for its injunction, the claimant then dismissed the NASD claim and filed at the AAA. Prudential then sought to enjoin the AAA proceeding.

Prudential argued that the claimant, by signing the submission agreement, had agreed to be bound by the NASD regulations, including the six year eligibility rule. In rejecting Prudential's argument, the court relied on the fact that Prudential had never signed the submission agreement and that, as a result of the filing of the injunction, no activities had occurred in the NASD arbitration. The court likened this situation to that of a civil action in which a plaintiff is allowed to voluntarily dismiss a complaint before a defendant files an answer.

New York State Court Finally Resolves Luckie

The seemingly unending saga of Smith Barney v. Luckie finally came to an end. 1997 N.Y. App. Div. LEXIS 12505.

Smith Barney had sought to stay the original arbitration on the ground that the claims were not timely filed based on the applicable statute of limitations. The lower court denied Smith Barney's petition, without consideration of the statute of limitations, based on its ruling that the parties had agreed to arbitrate "any controversies", and referred the statute of limitations question to arbitration.

The New York Court of Appeals reversed, holding that, because the parties had agreed that their customer disputes would be governed by the laws of the State of New York, and pursuant to New Your law (CPLR §7502[b]), the matter of the statute of limitations was for the court rather than the arbitrators.

The case was then remitted back to the lower court for its decision of the statute of limitations.

The claimants were residents of Florida and the court reasoned then that the claims occurred in Florida. However, because of the New York law clause in the contract, determination of the governing limitations period under New York law required application of New York's borrowing statute (CPLR §202). The borrowing statute dictates that, as between the limitation period applicable under New York law and Florida law (the claimant's state of residence), the shorter limitations period, as to each cause of action, controls.

The court then determined that all claims filed were untimely. As to the securities laws violations, the two-year Florida limitations period barred the claims (the filing was pre-Lampf). As to the conversion claim, the New York three year limitations period, being shorter than the comparable five year Florida statute, barred that claim. As to the remaining claims for breach of fiduciary duty, negligence and misrepresentation, the court also found these claims barred, this time based on the Florida four year limitations periods for each.

New York District Court Awards Attorneys Fees in Title VII Case in Spite of Employment Agreement

In DeGaetano v. Smith Barney, 1997 U.S. Dist. LEXIS 17350 (S.D.N.Y. 11/6/97), the claimant brought a claim in arbitration alleging sexual harassment in violation of Title VII. The arbitration panel awarded damages but specifically denied the claimant's request for punitive damages and attorneys fees. The award specifically stated that attorneys fees and punitive damages were denied because the actions of the defendant fell short of the standard required for the awarding of those damages. The claimant moved to modify the award to include attorneys fees, arguing that failure to award attorneys fees to a "prevailing plaintiff" in a Title VII action was manifest disregard of the law.

The District Court noted that the case was originally compelled to arbitration based on the employment contract signed by the claimant. The contract specifically referred to Smith Barney's "Arbitration Policy" which expressly provided that "Each side shall pay its own legal fees and expenses." The court also that, in contrast to that provision, Title VII allows the court, in its discretion, to allow the prevailing party a reasonable attorneys fee.

In making its decision, the DeGaetano court looked for guidance in the U.S. Supreme Court's pronouncement regarding attorneys fees in a general civil rights case. The High Court had stated that "a prevailing plaintiff should ordinarily recover an attorneys fee unless special circumstances would render such an award unjust". Hensley v. Eckerhart, 103 S. Ct. 1933(1983).

After acknowledging the high standard for upsetting an arbitration award for manifest disregard of the law, the DeGaetano court found that there was "absolutely no showing of special circumstances that would render an award of fees unjust."

The court expressly differentiated this case from a case which was cited by Smith Barney, DiRussa v. Dean Witter Reynolds, 121 F. 3d 818 (2d Cir. 1997). In DiRussa, the Second Circuit upheld an arbitration panel's refusal to award attorney's fees in an action under the Age Discrimination in Employment Act (ADEA), even though the ADEA mandates the awarding of attorneys fees in any judgement for a plaintiff.

The difference between the DiRussa case and the DeGaetano case was, according to the court, that the DiRussa claimant failed to inform the arbitrators of relevant legal standard, and that there was, therefore, no evidence that the arbitrators actually knew of —and intentionally disregarded—the mandatory aspect of the attorneys fee provision.

The DeGaetano court found that the statement of the law in its case was obvious, given the briefing of the parties, and was "capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator."

Lastly, the court commented on the fact that the Smith Barney Arbitration Policy prohibited the award of attorneys fees. The court found that such a policy—in the face of the overriding comprehensive statutory scheme by Congress to deter unlawful employment discrimination—was void as a matter of public policy. Moreover, the court found that the employment agreement, and its mandating arbitration of employment claims, would only be enforceable to the extent that the arbitration preserved the substantive protections and remedies afforded under the federal statutes.

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