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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

March 1998 Volume 5 Number 1

In This Issue...

The PIABA Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

March, 1998

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Editor's Notes

This issue of the Quarterly contains the first installment of a new Joe Long column -- FROM THE PROFESSOR'S BOOK SHELF -- which discusses current arbitration literature.

The deadline for receiving submissions for the June 1998 issue of the Quarterly is June 15, 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.

Letter From the President

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

Dear Members,

PIABA's committees are doing an excellent job of working toward the goals we set at the annual meeting.

1. The Governance and Communications Committee

The committee has received bids for establishing a website, to be run from PIABA's headquarters in Norman, Oklahoma. This has been a priority for this year, and we hope to have it up and running this spring. The website will be structured to allow for communications among our members, so that we can share information about arbitrators, legal issues, and recurring problems with the NASD's management of cases.

The committee has also redrafted the by-laws, providing for a process for election of directors by the membership. Some

In This Issue...

fine-tuning is still being done, but the rules will allow the board to nominate directors, as well as allow for nominations to be placed on the ballot at the request of five or more members, by letter received no later than 10 days before the meeting.

2. The Legislation Committee

The "White-Eshoo" bill has been revised. As currently written, state law claims are preempted in any securities fraud case involving a publicly traded security where 50 or more other persons have filed a similar case. A "class action" is now defined along the lines of Rule 23. SEC chairman Levitt, in an about-face, now supports the legislation, which is set for a vote in late April. PIABA members are urged to write letters, and urge clients to write letters in opposition to the pre-emption of state securities laws. It is of great concern to us because we anticipate that respondents will argue that state law is preempted wherever similar cases have been filed on behalf of 50 or more individuals. If claimants are left with only federal securities law claims, the ability to recover will be severely restricted.

3. The "Level Playing Field" Committee

The NASD has revised the training materials, and we are still working with them to ensure that the new materials are sent to all arbitrators with a strongly-written letter expressing the importance of the changes as to the discussion of damages.

The NASD has, surprisingly, decided to resubmit the proposed rule change limiting punitive damages, and we are still awaiting the submission of the list selection rule change. As to PIABA's proposed rule changes, a committee appointed by the SEC is considering a global restructuring of arbitration, so that it is either voluntary, or claimant can choose to arbitrate in a non-SRO arbitration forum.

I have received a lot of phone calls and letters concerning the NASD's continuing practice of finding "insufficiencies" in filings. These have been forwarded to Linda Fienberg at the NASDR and Kate McGuire at the SEC. Please continue to copy me on administrative and fairness problems you have with the NASD.

4. The Annual Meeting Committee

The program for the Annual Meeting in Orlando October 22-24 will be an excellent one, with speakers drawn from many fields. We will be having "Break out" sessions to give you more choice of speakers and topics. The meeting will address issues of concern to relatively inexperienced counsel, as well as more experienced counsel.

To provide the lowest cost fares for members and families, we have found a travel agent that will provide up to 20% discounts on air and air reservations. The travel agency will also make these discounts available to PIABA members for all travel. We encourage your use, as this will also provide a $5.00 contribution to PIABA for each ticket sold. The agency is Emerald Travel: toll free at 1-800-767-7138, e mail: gemgreen@ic.mankato.mn.us; http://agentsl.worldspan.com/ETM. The contact persons are Julie or Jolene.

I appreciate all the time and commitment that members of PIABA have made towards accomplishing the goals the Board set for the year. We are well on the way to making many positive changes, which will benefit our members and the investing public. I look forward to seeing you all in Orlando.

Sincerely,

Diane A. Nygaard

FROM THE PROFESSOR

by Joseph C. Long
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This Quarter's article is in two parts. I first want to address some new developments in the growing dispute over Dispositive Motions. Second, I want to address what may be a major change in the law as to whether the courts or the arbitrators hear customers' claims of fraud in the inducement of the basic brokerage contract. Conventional wisdom

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based upon **Prima Paint Corp. v. Flood & Conklin Mfg. Co.**,[1] holds that fraud in the inducement claims as to the basic brokerage agreement go to the arbitrators and only fraud in the inducement claims related directly to the arbitration clause are to be heard by the court. This conventional wisdom will have to be reconsidered in light of the holding in **Investment Management & Research, Inc. v. Hamilton**,[2] that **Prima Paint** was **impliedly** overruled by the Supreme Court in **First Options of Chicago, Inc. v. Kaplan**.[3]

I. UPDATE ON DISPOSITIVE MOTIONS

Last Quarter's Column on Dispositive Motions brought to light three things which the readers should be aware of.

A. NASD SCRIPT

First, PIABA Member Scot Berstein sent the author a copy of an NASD script covering "Initial Pre-Hearing Conference Procedure" which it supplies to its arbitrators.[4] Paragraph J of this script has the panel chairman asking the parties whether a Prehearing Conference needs to be scheduled to consider pre-trial motions. The NASD commentary then states:

> "Dispositive motions must be decided by the entire Arbitration Panel and there must be a hearing with a record on any dispositive motion. The Arbitration Panel should decide whether motions will be considered `on the pleadings'[5] or at a Pre-Hearing Conference. Please keep in mind the additional costs to the parties resulting from Pre-Hearing Conferences."

This language appears to clear up three issues. First, it makes clear that the NASD **does believe** that dispositive motions are appropriate in arbitration. Second, it is also clear that the entire panel must consider such motions and that a record must be made. Finally, the last two sentences also appear to indicate that decisions on dispositive motions may be made solely on the briefs and no oral argument need be heard.

B. THE KIMME ARTICLE

The second document to surface is an article, William B. Kimme, "Dispositive Motions In Securities Arbitrations".[6] Mr. Kimme is one of the NASD arbitration staff attorneys in Chicago, and the paper was presented to the Litigation Section of the American Bar Association.[7] Kimme removes any lingering doubt that the NASD believes dispositive motions are appropriate in securities arbitration. He identifies seven types of such motions: (1) motions regarding the appropriateness of arbitration; (2) motions based upon forum selection;[8] (3) statute of limitations motions;[9] (4) motions based upon res judicata or collateral estoppel;[10] (5) summary judgment motions; (6) motions for directed verdict; and (7) motions to dismiss for failure to obey discovery orders.

He also notes that motions to dismiss may be made under former Section 16 of the NASD Arbitration Code. Under this Section, an action can be dismissed upon request of all the parties. More importantly he points out that former Section 16 allows dismissal,[11] **either upon the motion of one of the parties or sui sponte**, where the panel refers the parties to their "remedies provided by applicable law."[12] Kimme elaborates on this section, identifying four situation which he thinks are appropriate uses of this power, two of which are significant to PIABA members.[13]

The first situation covers "cases that involve substantial legal issues for which the establishment of a legal precedent is important."[14] This use of Section 16 would allow the continued development of case law interpreting both the state and federal securities laws. As is well known, there are many issues under both systems which are not clear or are not clear under the law of a particular state. The **Kimme** position suggests that Members should give serious thought to making such request if a major part of their case depends upon statutory language where there is no controlling state or federal precedent.

Kimme second situation is equally intriguing. He says that such motions are also appropriate in "cases in which witnesses or documents essential to a fair and final decision are unavailable."[15] Such motion should be considered when a broker stonewalls and refuses to produce documents clearly within its control. The broker should be given the choice of voluntary compliance with reasonable discovery requests, or be faced with judicial proceedings where such requests are mandatory.

Kimme also addresses two other issues of interest. First, he takes the position,[16] apparently contrary to that taken by the Pre-Hearing Conference script discussed above, that the dispositive motions cannot be ruled on without a hearing unless the parties waive such hearing under former Section 14.[17] Further, he indicates that the panel may **sui sponte** order a hearing on such motions.[18] Finally, he confirms that it is appropriate for the Panel to consider these motions in pre-trial practice, at the beginning of the hearing, or at the conclusion of the evidence.[19]

C. PIABA INITIATIVE

The final development is that the PIABA NASD Committee has decided to develop a formal PIABA position paper. This position paper will take **a position against the use of dispositive motions in arbitration**. PIABA Director Mark Maddox is in the process of drafting this position paper which will be delivered to NASDR. Members who have further information on the use of dispositive motions or wish to have input in developing PIABA's position on this issue should contact either Mark, other members of the NASD committee, the PIABA Office, or the author.

II. FRAUD IN THE INDUCEMENT OF THE ENTIRE BROKERAGE CONTRACT

As noted above, conventional wisdom says that claims of fraud in the inducement of the entire brokerage contract are to be decided by the arbitrators,[20] but claims of fraud in the inducement which are directed specifically at the arbitration clause itself are to be decided by the court. This wisdom is based upon the decision in **Prima Paint Corp. v. Flood & Conklin Mfg. Co.**,[21] where the Court held that Section 4 of the Arbitration Act[22] required court consideration of fraud in the inducement claims directed only at the arbitration clause itself. The Court stated this position, saying:

> "[I]f a claim is fraud in the inducement of the arbitration clause itself—an issue which goes to the `making' of the agreement to arbitrate—the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally."[23]

The logic of this conclusion was questioned from the very beginning. Section 2 of the FAA provides: "A written provision...to settle by arbitration...shall be enforceable save upon such grounds as exist at law or in equity for revocation of any contract." It has always been clear under state law that fraud in the inducement allows the setting aside of a contract. Therefore, fraud in the inducement of the original brokerage contract would seem to allow a court to set the entire brokerage contract aside, including any arbitration agreement which happened to be imbedded in the brokerage agreement. Thus, if the whole contract, including the arbitrator agreement is set aside, there is no contract to arbitrate to which Section 4 can attach.

The logic of this analysis was recognized by Justice Black in his dissent in **Prima Paint**. He argued: "If there has never been any valid contract, then there is not now and never has been anything to arbitrate."[24] Black's argument, however, has been ignored by the Supreme Court,[25] lower federal courts,[26] and the state courts[27] for almost thirty years.

However, the Supreme Court finally revisited the issue of arbitrability in **First Options of Chicago, Inc. v. Kaplan**.[28] In **Kaplan**, the issue was whether the court or the arbitrators were to decide arbitrability. Following the dictates of the Court in **Moses H. Cone Hosp. v. Mercury Constr. Corp.**,[29] that any doubts about the scope of the arbitrability requirement should be resolved in favor of arbitration, the lower court in **Kaplan** following conventional wisdom, held that arbitrators were to decide such issues. The Appellate court disagreed and held the issue was for the courts.

The Supreme Court agreed. It indicated that where the issue was whether arbitration of a particular dispute was within the arbitration clause, there was a presumption based upon **Moses H. Cone,** that the arbitrators should decide the issue. However, where the issue was whether the parties intended to arbitrate at all (i.e. whether there was a valid arbitration clause), this issue was for the courts and not the arbitrators unless the parties "clearly and unmistakably" show an intent to have this issue resolved by the arbitrators. Thus, in the case of the issue of whether there was a valid agreement to arbitrate, the **Cone** presumption is reversed and there is a presumption that the parties **did not intend to arbitrate.** Couple this with the basic concept that a party cannot be required to arbitrate any issue which has not been agreed to, the conclusion is that the court rather than the arbitrators should address the issue of whether there is a valid arbitration contract.

The **Kaplan** court also made another important observation. It said when the issue is arbitrability, including whether the parties agreed to arbitrate at all, the courts generally should apply **ordinary state-law principles that govern the formation of contracts**.

Kaplan did not discuss or even cite **Prima Paint**, much less specifically overrule it. However, almost immediately after the **Kaplan** decision, the court in **Maye v. Smith Barney, Inc.**[30] noted that **Prima Paint** may not have survived **Kaplan**. Subsequently in **Aviall Inc. v. Ryder System, Inc.**,[31] the court spelled out the theory of the implied overruling of **Prima Paint**. It indicated that

the Court's holding in **Kaplan**:

> "Suggests that the related and antecedent issue of whether an agreement to arbitrate is a contract of adhesion, fraudulently induced or otherwise revocable, is an issue for the court as well, because essential to the First Options inquiry is the assumption that an agreement to arbitrate was made voluntarily."[32]

While these cases foreshadowed the holding in **Investment Management & Research, Inc. v. Hamilton**,[33] the statements were dicta as the court did not actually hold that **Prima Paint** had been impliedly overruled.

Foreshadowing is also found in two earlier Alabama cases, **Ex Parte Williams**[34] and **Allstar Homes, Inc. v. Waters**.[35] In **Williams**, the plaintiff claimed that the arbitration clause should have been void because he lacked the mental capacity to make the contract and because of fraud in the inducement of the entire contract. The majority did not reach these issues and merely remanded the case for the trial court to reconsider. Justice Houston in his concurring opinion did address the effect of **Kaplan** on **Prima Paint**. He said:

> "In...**Kaplan**..., the...Supreme Court unanimously held that questions regarding arbitrability are decided by the courts, unless the contract very clearly grants to the arbitrators the power to decide even preliminary issues of arbitrability. Although **Prima Paint**...was not specifically overruled or even mentioned in **First Options,** the reasoning of **First Options** is dramatically opposed to that of **Prima Paint**, so **Prima Paint** and its progeny must give way to **First Options**. Apparently, the current nine Justices...believe that Justice...Black's dissent in **Prima Paint**, which concludes with the following sentence, is the correct understanding of the Federal Arbitration Act: `If there has never been any valid contract, then there is not now and never has been anything to arbitrate.' This is consistent with the words of 9 U.S.C. §2: `A written provision...to settle by arbitration...shall be enforceable save upon such grounds as exist at law or in equity for the revocation of any contract.'
>
> The only reasonable interpretation of **First Options** and of 9 U.S.C. §2 is that all issues of arbitrability must first be determined by the court, including the issue whether the contract very clearly grants the arbitrators the power to decide even preliminary issues of arbitration.[36]

In **Allstar Homes, Inc. v. Waters**,[37] a non-securities case, Waters sought to avoid arbitration by claiming that the contract was one of adhesion and fraudulently induced. Again the court did not directly address the **Prima Paint-First Options** problem. Instead it held that the trial court's order was not a final order. Again, in **dicta**, the majority opinion accepts the **First Options** rejection of the **Prima Painter** conclusion that fraudulent inducement of the entire contract is for the arbitrators. It said:

> The fact that an arbitration agreement may state upon its face that issues of arbitrability will be subject to arbitration is not, standing alone, "clear and unmistakable" evidence that the parties truly intended to agree to such a condition. Arbitration clauses, even ones purporting to encompass the issue of arbitrability, are not self-proving; on the contrary, an arbitration agreement, like any other contract, is subject to generally applicable contract defenses, such as fraud, duress, or unconscionability. **Doctor's Associates, Inc. v. Casarotto**, 517 U.S. 681...(1996). It is well established that the FAA does not require parties to arbitrate a dispute that they did not agree to submit to arbitration, and the trial court must decide whether the parties so agreed.[38]

With this ground work, the Alabama court squarely faced the **Prima Paint-First Options** problem in **Investment Management & Research, Inc. v. Hamilton**.[39] As with several of the

earlier cases, Hamilton claimed that he was fraudulently induced to enter into the brokerage agreement in general, not merely the arbitration clause. He, therefore, claimed the entire agreement **including the arbitration agreement**, was void. As a result, he sought an injunction against being required to arbitrate. The trial court agreed and granted the injunction. On appeal, the Alabama Supreme Court affirmed. It reviewed both **First Options** and **Prima Paint** as well as the cases from the Souther District of New York and its own prior decision, and then concluded:

> **First Options** and its progeny reflect the correct statement of the law in this area: threshold issues of arbitrability must first be determine by the court, unless the contract clearly gives the arbitrator the right to decide arbitrability.[40] The trial court properly denied IMR's motion to compel arbitration [based upon his claim of fraudulent inducement of the entire contract].[41]

Is **Hamilton** the wave of the future or a mere aberration? I think it makes more sense than the **Prima Paint** analysis. But only time will tell whether other courts and the Supreme Court will accept. **Hamilton**.

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1 388 U.S. 395 (1967).

2 1998 Ala. LEXIS 97 (Ala. Sup. Ct. March 20, 1998).

3 514 U.S. 938 (1995).

4 Copies of this script can be secured from either the author or the PIABA Office.

5 [Author's Note.] Paragraph K makes clear that this phase means motion pleadings or briefs submitted by the parties and is not limited to the initial pleading and the answer.

6 The article is dated August 6, 1996.

7 Copies of this article can be secured directly from the ABA Office in Chicago, through the author, or from the PIABA Office.

8 He indicates that the rules are not clear here. Kimme at 6. He first cites **Mihalakis v. Pacific Brokerage Services**, [1991-1192 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,490 (S.D.N.Y.1991), holding at a minimum the first forum would have had to dismiss the action without prejudice. He then cites **Allen v. Interstate Sec., Inc.**, 554 So.2d 23 (Fla. DCA 1989), indicating that once a customer has selected a forum, the customer will not be allowed to file in another arbitration forum after dismissing his action in the first forum.

9 Kimme includes here both state law substantive statute of limitations defenses and Old Section 15 timeliness issues.

10 He indicates that such motions are appropriate based upon prior arbitration, **Prudential Sec. Inc. v. Rawson**, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH)¶98,074 (E.D.Pa.1993), as well as court decisions. **Kelly v. Merrill Lynch, Pierce, Fenner & Smith,** 985 F.2d 1067 (11t6h Cir. 1993). Kimme at 7.

11 Such dismissal Kimme indicates is without prejudice.

12 NASD Code of Arbitration former Section 16.

13 The remaining two are: (1) class actions and (2) shareholder derivative suits.

14 Kimme cites the NASD Arbitrator's Manual at 6 as support for this position.

15 Again, Kimme cites to NASD Arbitrator's Manual at 6 for support.

16 Kimmie at 1.

17 Presently Section

18 Kimmie at 1.

19 Id.

20 See e.g., Ex Parte Lorance, 669 So.2d 890 (Ala.1995).

21 388 U.S. 395 (1967).

22 9 U.S.C. §4

23 388 U.S. at 404.

24 388 U.S. at 425 (Black, J., dissenting.)

25 Moses H. Cone Hosp. v. Murcury Constr. Corp., 460 U.S. 1, 24-25 (1983) (Any doubts about the scope of the arbitrability requirement should be resolved in favor of arbitration).

[26] See e.g., Coleman v. Prudential Bache Sec. Inc., 802 F.2d 1350 (11th Cir. 1986).

[27] See e.g., Jones v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 604 So.2d 332 (Ala. 1991).

[28] 514 U.S. 938 (1995).

[29] 460 U.S. 1, 24-25 (1983).

[30] 897 F. Supp. 100, 106 n.3 (S.D.N.Y. 1995).

[31] 913 F. Supp. 826 (S.D.N.Y. 1996), aff'd without discussion of this point, 110 F.3d 892 (2d Cir. 1997).

[32] Id. at 831, quoted with approval in **Berger v. Cantor Fitzgerald Sec.**, 942 F. Supp. 963, 965 (S.D.N.Y. 1996) and **Allstar Homes, Inc. v. Waters**, So.2d (Ala. 1997). In Berger the parties agreed that the non-enforceability of the arbitration agreement based upon **Mayne** and **Aviall** was for the court. See also **Metropolitan Life Ins. Co.**, 961 F. Supp. 550,554, n. 4 (S.D.N.Y. 1997).

[33] 1998 Ala. LEXIS 92 (Ala. Sup. Ct. March 20, 1998).

[34] 686 So.2d 1110 (Ala. 1996).

[35] 1997 WL 723103 (Ala. Nov. 21, 1997).

[36] 686 So.2d at 1112.

[37] 1997 WL 723103 (Ala. Nov. 21, 1997).

[38] 1997 WL 723103 at *6. See also **Miller v. Flume**, 1998 U.S. App. LEXIS 5762 (7th Cir. Mar. 24, 1998) reaching a similar conclusion, but refusing to re-examine its conclusion in **Edward D. Jones & Co. v. Sorrells**, 957 F.2d 509 (7th Cir. 1992) that former section 35 of the NASD Code did not constitute a clear election to have the arbitrators consider the issue.

[39] 1998 Ala. LEXIS 92 (Ala. Sup. Ct. March 20, 1998).

[40] [Author's Note] Two Justices, including Justice Houston, dissented on the ground that the parties had agreed to arbitrate the issue of arbitrability in this case. The dissents are appear to be following the growing number of cases that holding the NASD rules, especially former Section 35 (Now Rule 10301(a), 1997 NASD Manual: Code of Arbitration Procedure (CCH) ¶7511) **did express** an intent to arbitrate arbitrability. See e.g., **PaineWebber, Inc. v. Bybyk**, 81 F.3d 1193 (2d Cir. 1996) and **FSC Sec. Corp. v. Freel,** 14 F.3d 1310 (8th Cir. 1994). But see **Miller v. Flume**, 1998 U.S. App. LEXIS 5762 (7th Cir. Mar. 24, 1998). The problem with the dissent is that it does not recognize, while the contract language may show and intent to arbitrate arbitrability, that contract language like the rest of the contract is now void ab initio and, therefore, can not control.

[41] Id. at *21. Earlier in **Allstar**, the court indicated, if the doubt is based upon disputed facts, the trial court must summarily go to trial and have the disputed facts determined by a jury. 1997 WL 723103 at *6, citing **Shearson Lehman Bros. v. Crisp**, 646 So.2d at 617. If the facts are undisputed, the trial court can make its decision on the law without reference to a jury. 1997 WL 723103 at *6.

Massachusetts U.S. District Court Refuses to Compel Arbitration of Age and Gender Discrimination Claims

In Rosenberg v. Merrill Lynch, 1998 U.S. Dist. LEXIS 877, the Court dealt with the issue of whether claims of age and gender discrimination and sexual harassment could be compelled to arbitration using the standard Form U-4 arbitration agreement as a basis.

The age discrimination claims fell under the Age Discrimination in Employment Act ("ADEA") 29 U.S.C. §621 and the gender discrimination claim under federal anti-discrimination law (Title VII) 42 U.S.C. §2000e. In its motion to compel arbitration, Merrill Lynch cited Gilmore v. Interstate/Johnson Lane Corp., 111 S. Ct. 1647 (1991), a U.S. Supreme Court case which had upheld the arbitrability of ADEA claims.

However, the Rosenberg Court noted that Gilmore had not addressed the arbitrability of claims brought under Title VII and had left two factual issues as to ADEA to be decided in specific cases: 1) whether the particular arbitral forum was adequate to vindicate the statutory right involved; and 2) whether the agreement to arbitrate was involuntary or unconscionable.

The Court analyzed the shift toward arbitrability and the strong federal policy favoring arbitration agreements. However, the Court noted that this federal policy was made in the setting of business transactions. Moreover, the Court opined that the presumption that arbitration agreements are freely entered into, which exists in a business situation, should not extend to potentially vulnerable plaintiffs who rarely bargain for the conditions of their employ-

ment. The Court further noted the public function of civil rights litigation in bringing discriminatory conduct to light and its crucial role in effecting legal and social changes and the stifling effect which would occur if such litigation was replaced by the non-public arbitrations.

The Court then looked at arbitrability in light of the legislative history of Title VII and noted that Congress, in its adoption of Title VII, had rejected amendments which would have endorsed mandatory arbitration agreements. Also, the Court noted that all of the ADR methods listed in Section 118 are consensual and non-binding, and that the 1991 amendments to Title VII created a new right to a jury trial. The Court concluded that it would not be plausible that the same act would grant a jury trial in one section and then undermine it by allowing mandatory arbitration agreements to take away that same right and refused to order the Title VII claim to arbitration.

The Court then examined the ADEA aspect of the Claim. It considered the adequacy of the NYSE forum to vindicate the ADEA claim. The Court noted the detailed and voluminous critique of the NYSE arbitration system presently by Rosenberg in contrast to the generalized arguments about the inherent incapacity of arbitrators to resolve civil rights claim which had been made in Gilmore. These details included a 1994 GAO study that found that 89% of NYSE arbitrators were men, 97% of them were white, and the average age was 60.

More significant to the Court than the composition if arbitrators was the methodology of appointing the arbitration panel. The Court noted that several courts have refused to enforce arbitration agreements which designate an arbitration panel linked to one party, especially if that party drafted the arbitration agreement.

After considering the norms of arbitral impartiality, the Rosenberg Court found that the NYSE could not meet the minimal standards of arbitral independence. For examples, the Court noted that: the rules of securities arbitration are proposed by SICA, a group comprised of securities industry members by a 2 to 1 margin; the Director of Arbitration appoints arbitrators from a pool of arbitrators appointed by the Chairman of the Board of the NYSE; and, securities industry employees participate in key stages of the arbitral process, including the appointment of the single arbitrator to resolve all pre-hearing issues, and as procedural advisors in off the record discussions between arbitrators.

In the end, the Court pronounced the NYSE forum inadequate to vindicate Rosenberg's ADEA rights, but specifically reserved any opinion as to its effectiveness in vindicating the rights of securities customers.

Illinois Supreme Court Vacates Failure To Award Punitive Damages

In Roubik v. Merrill Lynch, 1998 Ill. LEXIS 345, the Court dealt with the question of the ability of an arbitration panel to award punitive damages and the standard of review on appeal if the arbitration panel failed to award punitive damages.

The time track of this case stratled the U.S. Supreme Court's decision in Mastrobuono. The arbitration itself was pre-Mastrobuono, while the appeal occurred post-Mastrobuono. The arbitrators awarded $500,000.00 in compensatory damages and also found that the Respondent's conduct was such that punitive damages should have been awarded. However, because of the New York choice of law clause in the arbitration agreement, the panel found that it was precluded from making a punitive damage award.

The Claimant sought to confirm the compensatory portion of the award and vacate the denial of punitive damages. Merrill Lynch filed a counter-petition, seeking to have the award confirmed in its entirety. Merrill did not try to distinguish Mastrobuono, but rather contended that the arbitrators award was subject to limited review, and that the arbitrator's decision constituted simply a mistake of law that was not grounds for setting aside the award under the limited review standard.

The Roubik Court agreed with Merrill that the panel's mistake of law would generally not provide grounds to set aside the decision. However, the Claimant countered this argument with its contention that the standard of review was not the controlling issue in the appeal, but rather, that the issue was whether the arbitrators made the proper decision regarding the arbitrability of the punitive damage claim itself.

The Court then quoted Mastrobuono where the Court itself had described the issue in that case as the "arbitrability of punitive damages." The Court then agreed with the Claimant that, because the issue was arbitrability, the standard of review was not limited, but rather that the issues should be considered by the appeals court as a de novo review.

Noting the Seventh Circuit's decision in Smith Barney v. Schell, 53 F. 3d 807, in which that court held that arbitrability was a question for the court to decide, the Roubik Court found that the question of arbitrability was indeed properly to be decided by the courts and not the arbitrator. As a result, the arbitration panel's own decision as to the arbitrability of punitive damages was not to be given deference since under **Schell**, the arbitrators should not have the power to determine their own jurisdiction. The Court then ordered further NASD arbitration to be held on the issue of punitive damages.

[*Ed. Note. It is interesting to note that in this case Merrill Lynch flip-flopped on its usual stance regarding the meaning of NASD Section 35. Here Merrill argued that Section 35 clearly provided that the parties intended that the arbitrators determine all issues including arbitrability—this being the exact opposite position Merrill took regarding the intention of the parties in Section 35 in its now infamous argument that Section 15 arbitrability was a matter for judicial determination.*]

Alabama Supreme Court Refuses to Compel Arbitration of NASD Registered Insurance Agent Claim

In Hagan v. The Minnesota Mutual Life Insurance Company, 1998 Ala. LEXIS 74, the Alabama Supreme Court was faced with the issue of the arbitrability of a claim made by an NASD-licensed insurance agent who brought suit against his insurance employer, claiming both defamation and failure to pay compensation for existing business when he was terminated.

The defendant insurance company filed a motion to compel arbitration based on the U-4 that Hagan had signed with an NASD broker dealer that was a wholly-owned subsidiary of the defendant. The state district court granted the motion relying on the U-4.

The Alabama Supreme Court reversed, relying on the fact that the U-4 expressly incorporates the rules of the NASD, and that the rules of the NASD except from arbitration disputes involving the insurance business of any NASD member which is also an insurance company. The Court noted that the issues involved in this case were strictly involving the agent's insurance activities. The Court also rejected Minnesota Mutual's argument that it could compel arbitration pursuant to § 10101(2), which allows an NASD member to compel arbitration of a dispute with a person associated with a member.

However, the Court itself noted that its decision in Hagan is at odds with other decisions including Armijo v. Prudential Insurance Co., 72 F. 3d 793 (10th Cir. 1995), but observed that in these prior decisions, the NASD rule excluding insurance business from arbitration was not considered.

FROM THE PROFESSOR'S BOOK SHELF

By Joseph C. Long

We are again starting a new feature in the Quarterly. Since the beginning we have digested the new court decisions in the area of arbitration, but we have done nothing to make the reader aware of current developments in the arbitration literature. In this section, we will attempt to do two things. First, we will digest in the same manner as we have done in the past with new cases a limited number of articles we think are the most important. Second, we will try to present a complete list of all new articles dealing with securities arbitration. In this issue we have attempted to go back to January 1995. In future issues we may attempt to go back to 1987 when securities arbitration first became a big item. Hard copy of the listed articles can be obtained from the author.

I would appreciate feed back from the members as to whether this is a helpful and desirable feature which should be continued and whether it would be worthwhile to go back to 1987.

Second Circuit Deems Service of Process Occurs When Put Into Mailbox

Federal law defines service of process by mail under Federal Rule of Civil Procedure 5(b) as occurring "upon mailing." But, what point in time does "upon mailing" happen? Deborah Pines in *Papers Ruled Served When Put in Mailbox Circuit Decision Defines Federal Rule 5(b), 219* ***N.Y.L.J.****, col. 5 (Feb. 10, 1998),* answers this question.

Pines, in reviewing *Greene v. WCI Holdings Corp.*, No. 97-7311, 1998 WL 57655 (2d. Cir. Feb. 1998), defined "upon mailing" as occurring when the envelope is deposited at the Post Office or in a mailbox." In *Greene*, a three-judge panel, found that WCI Holdings Corp. ("WCI") had made timely service of its motion to dismiss. Greene objected to the service because WCI had placed the envelope in a mailbox at 5:30 p.m. on April 2, 1992, the service deadline date. The envelope was not postmarked until the April 3 and Greene did not receive the complaint until April 4.

The *Green* Court rejected the claim of untimely service in adopting a "sensible rule" that appellate courts in the First and D.C. Circuits applied. For example, the First Circuit in *Rivera v. M/T Fossarina*, 840 F.2d 152, 155 (1st Cir. 1988), held that valid service by mail under Rule 5(b) required the pleading or document be placed in an enveloped addressed to the opposing attorney and deposited in a Post Office box. Similarly, the D.C. Circuit in *United States v. Kennedy*, 133 F.3d 53 (D.C. Cir. 1998), held that under Rule 5(b), service is deemed complete at the instant the documents are placed into the hands of a United States Post Office or Post Office box. After all, as Caroline S. Press, the lawyer representing WCI, stated a contrary result, "would require a visit to the post office to insure a paper was postmarked."

The Myth of Confidentiality of Arbitration Proceedings

We have all heard that an advantage of using arbitration is confidentiality. However, parties involved in an arbitration may be surprised to learn of the absence of complete confidentiality. What should parties contemplating arbitrating a claim know about the limits of privacy in an arbitration proceeding?

Bernand Sellier and Hal Shaftel, in *Confidentiality of Arbitration Proceedings*, 217 **N.Y.L.J.** 1, col. 1 (Mar. 13, 1997), warn parties of the lack of confidentiality. Sellier and Shaftel discovered a recent trend in courts overriding private confidentiality agreements where the disclosure of information is perceived as serving the public interest.

If parties enter into confidentiality agreements, a non-party may be able to obtain materials from the arbitration, including testimony at hearings, documentary or other physical evidence, expert reports and briefs or other submissions. Several cases illustrate the effect of confidentiality agreements in arbitration when a non-party seeks to obtain the arbitral materials.

In *Galleon Syndicate Corp v. Pan Atlantic Group, Inc.* (N.Y. App. Div. 1996), a New York State appellate court granted a non-party some access to arbitration materials. The court found the parties to the arbitration had not entered into an explicit confidentiality agreement and that there is no confidentiality privilege concerning materials used in an arbitration proceeding governed by the rules of AAA in the absence of a confidentiality agreement. The court essentially found that nothing prohibited the disclosure of documents generated or exchanged during the arbitration. *Galleon* emphasizes the importance of parties entering into a specific written agreement to protect confidentiality.

The *Galleon* court also distinguished between evidentiary material which is not protected from disclosure regardless of any confidentiality agreement and other types of material which can be protected by an explicit confidentiality agreement.

The authors recognize there is a tension between encouraging the parties to settle and the public interest in having access to this information. They divide arbitration materials into two separate categories. The first category is documents and evidence which exists separate from arbitration. The second is materials generated solely as a result of the arbitration process. The authors would include the following in this latter category: (1) testmony at the arbitration hearing; (2) expert reports; (3) work product; and (4) briefs. Items in the first category should be freely discovered without limitation. Items in the second category normally will not be discoverable absent a shows of "substantial need" or inability to secure the evidence elsewhere. See Samuels v. Mitchell, 155 F.R.D. 195, 200 (N.D. Cal. 1994).

Finally, the authors urge the use of a similar balancing test in the case of information disclosed in a mediation. They feel that normally the mediator should not be required to testify as to what took place at the mediation. See NLRB v. Macaluso, 104 LRRM 2097 (9th Cir. 1980).

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Winning Securities Cases in Mediation

by: Jeffrey Krivis

Most people approach mediation with the best of intentions. They are hopeful that the negotiation will achieve their ultimate goal — to settle the case — and assume that the other side is at the bargaining table for the same purpose. Because of these aspirations, it is not unusual for parties to put all their cards face up on the table and work toward a cooperative solution.

The idea of cooperation is a basic principle in mediation and the focus of its universal appeal. Studies have been conducted demonstrating that cooperation as an affirmative strategy will more likely than not achieve the objectives of mutual gains for all parties.[1] However, litigators in a mediation sometimes encounter adversaries who don't quite see things their way, and approach the process in a much more competitive and sometimes hostile manner.

Under these conditions, an advocate in a mediation must be aware of strategic options that can be used in order to avoid becoming exploited in the negotiation. Fortunately, those options have been studied extensively by educators through game theories such as the well known "Prisoner's Dilemma."[2]

Following extensive computer testing of the Prisoner's Dilemma, Professor Robert Axelrod came to the conclusion that the best strategy for achieving goals through cooperation is a simple process he calls "tit for tat." This strategy proposes that during a negotiation, a party must match the opponent's move either competitively or cooperatively. If your opponent chooses to hit you over the head, you must hit back. If your opponent offers an olive branch, you must offer one back, and so on. Axelrod developed five basic rules to follow in achieving cooperative solutions:

(1) begin cooperatively;
(2) retaliate if the other side is competitive;
(3) forgive if the other side becomes cooperative;
(4) be clear and consistent in the approach;
(5) be flexible.

As a professional mediator, I have found the cooperative approach to be the primary reason cases settle successfully. I have also found that many litigators come to the table assuming they are still at war, and are willing to do anything to win, sometimes creating an imbalance in power with the cooperative advocate. It is with this in mind that I would like to offer some ideas on approaches which have worked in cases I have mediated where one side refuses to cooperate.

Like fishing, the best thing to do if you are an attorney representing a client in a competitive mediation, is to throw out your rod and start reeling them in. Now, what do I mean by "start reeling them in"? The idea is to get one side to *commit to the principle* that they might have more liability and/or damage exposure than they originally thought. Once that occurs, be prepared with additional information demonstrating that you are capable of continued retaliation. At the same time, have the mediator extend a signal that you are prepared to *forgive*, i.e., work cooperatively, provided they acknowledge that exposure exists.

This must be done slowly and strategically, without giving away too much information until you have verified with the mediator that your adversary is beginning to be a believer in your position. This will require a delicate balance by the mediator and, of course, your full and complete trust in the mediator's representations.

The core of this competitive approach is to allow your adversary to take the bait and run with it with confidence. Once they have chewed on the bait for a period of time, then you yank the line in toward the boat. At that point, you have provided your adversary with an excuse to either pay out more or take less than they brought to the table.

Suppose you represent an investor in a securities churning case. The broker has played hardball throughout the dispute, though they are willing to mediate. You are aware of certain information including a voicemail left on your client's machine in which the broker says something completely different than the trades represent. You have not disclosed this information yet to the broker. You are also aware of the fact that the broker has been subject to several other claims of similar nature in the past few years. In fact, you have been in contact with other lawyers who have provided you information concerning certain practices of the broker that you are sure the other side wouldn't want to come out.

During the mediation, you begin cooperatively by offering to openly discuss the issues. In response you receive a lecture in front of your client by your opponent's counsel about what a bad case you have. You ask the mediator to check with the broker's lawyer to see what the claims history is of the broker. Immediately that sparks some interest from the other side, wondering what you are fishing for. They initially resist but it gets them

talking about potential mine fields which they don't want unearthed. The mediator tells you he hasn't learned anything new so you send him back in to force the issue. You also float the name of another case in which the broker has been sued and you ask the mediator to see if the broker would like to discuss that case with the mediator. In essence, you are using the power of the mediator to make statements about the strength of your case without throwing it in the other side's face.

After several rounds of private meetings, you finally tell the mediator to ask the broker if he feels he might have some exposure in this case. When you get a positive signal from the mediator, you start asking for money, while at the same time being "flexible" with your response so that they know the retaliation has worn off.

To put a framework around this approach, consider the following formula when analyzing your approach to responding to a competitive opponent:

1. Opening Statements: Be Firm But Kind

This is your one and only chance to speak directly to the other side without fear of reproach. Some lawyers choose to waive this opportunity, mainly because they are not confident with their communication skills or haven't prepared their case. *Never waive your opening statement.* This is a time for you as an advocate to frame what the issues are, how you view them, and what you expect from the other side. *Open emphatically to the other side* and *show off your preparedness with exhibits.* Instead of discussing money, have a summary of the damages available on one page that you leave with the other side and the mediator upon conclusion of your opening statement.

2. Use Your Client To Tell The Story *If* The Client Will Sell

Invariably the first comment out of the mouth of a competitive opponent will be to size up the credibility of your client. If the client is believable, that theme will run through the entire negotiation, and can be used by the mediator as a closing point to achieve your goals. What makes a client believable? Usually it's a natural ability to communicate pain. If the client seems to be exaggerating in order to fit a square peg in a round hole, don't permit him to speak. If the client comes across in a natural, easily understood manner, have him tell his story. If you choose to have the client speak, make sure he is well prepared in advance of the mediation for questions from both the mediator and counsel for the broker. The more open you allow your client to be to this opportunity to tell his story, the more believable he becomes to the other side. At the same time, discuss with the mediator in advance of the opening session how far he will allow the parties to go with these discussions, and that you request that the mediator monitor the amount of time your client speaks. The fact that you allow him to speak shouldn't give the impression that this is a carte blanche opportunity to be used as a discovery device, but rather a way to signal that you are prepared to begin cooperatively.

3. Collaborate With The Mediator In The Initial Caucus

Generally the mediator will use this time to talk to you about the strengths and weaknesses of your case. While you probably know them by now, oftentimes the mediator can give you a snapshot of your opponent's position in an impartial way that actually allows you to become more objective and therefore more effective as an advocate. Rather than sit back and simply answer questions from the mediator, work together with the mediator by asking what he thinks is the best approach to achieve your goals. Ask the mediator what has worked in other cases where parties were looking to get lots of money from the other side. Get specific examples of techniques the mediator has used. Decide together what might be the most effective technique in your case, realizing that you need to be flexible in the approach. You can't always put a nice neat bow around every case and seal it shut. You need to allow the mediator some ability to size up the other side and determine whether the competitive strategy you discussed would work or whether you should revisit that decision.

4. Consider the Advantages and Disadvantages of Having the Mediator Evaluate The Case

Sometimes the mediator might want to give you advice about the liability of your case, how much you should pay or demand, and so on. This may be useful to you depending on where you are at in the negotiation. Before this happens, consider the upside and downside of moving into an evaluation or advisory opinion.

There are different styles you will find with mediators. One style is facilitative: asking open ended questions, encouraging you to do the talking, drawing out strengths and weaknesses from you, and focusing on underlying interests that might be driving the dispute. The other style is evaluative: giving an advisory opinion about the potential outcome of the case, urging you to follow his advice, twisting arms and pushing and pulling you into submission. One legal commentator

referred to this approach as, "thrashing, bashing and hashing it out."[3] Both styles work. However, the evaluative approach in a competitive negotiation has the added risk of the mediator predicting an outcome that contradicts and discredits what you have told your client about the case. It could, and often does, cause one side or the other to become anchored in the mediator's evaluation and unwilling to negotiate.

Consequently, it is critical to your success that you find out in advance of the session what style or approach the mediator tends to follow. If the mediator leans toward an evaluative approach, the issue becomes timing — when is the most effective time for the mediator to become evaluative. In my experience, an effective strategy is to encourage the mediator to use this strategy toward the end of the negotiation, particularly when you need to get the other side to move off their position.

5. Recognize The Intermediate Step Between Identifying The Issues In the Case And The Final Settlement

So you've made it through the opening session and you are in the first caucus. Your instinct is to cut to the chase and not waste any time. Wrong. Timing is everything in a competitive mediation and your adversary knows it. They will not give you their best dollar early on in the mediation. They feel that the mediator needs to fully understand them so that the mediator will work to achieve the best outcome possible. You probably feel the same. Resist the temptation to force the mediator to show you the money too early in the process. Being flexible and willing to cooperate requires that you allow for some open-minded "communication" of positions and interests. You never know, your client might just feel that he had his day in court.

At the same time, this is the step in the process where you have a chance to send informational messages into the other room through the mediator. Think about the consequences of what you want the mediator to relay to the other side, recognizing that you don't want to lose their attention with unreasonable and outrageous demands.

6. Look For Clues In What The Mediator Tells You

Sherlock Holmes you're not. Columbo maybe. Realize that the mediator is sworn to secrecy. He will not divulge information from the other side without their permission. On the other hand, the mediator uses other communication means in order to encourage you to think about and consider information he just learned from the other side. Listen for the clues and examine their meaning, while respecting the confidentiality of the process.

7. Plan The Exchange of Information

Be strategic about the pace of the process. The mediation is generally broken down into two component parts: (1) the receipt of information; and (2) providing information. You need both to work concurrently in a competitive mediation to achieve your objectives. The method by which you permit information to be disseminated will make the difference between success and failure. One strategy I have seen work is to question the mediator before he leaves the room about what he intends to share with the other side. At the same time, you are sensitive to the importance of assuring that what is shared is what you want shared, and handled in a way that puts the correct spin on your side of the case. That way you will be in a stronger position to anticipate the response and prepare your next move.

8. Committing The Other Side To Your Principles

Assume for discussion that in the churning case above you feel that the conduct of the broker was wilful and subject to punitive damages. By simply asking for punitive damages in the mediation you are likely to experience resistance from the other side. Instead of asking, another effective approach is to ask the mediator to explore the conduct with the other side with an eye toward obtaining their verbal acknowledgment that they might have exposure to punitive if the case goes to arbitration. I have seen numerous cases where the value of settlement increases substantially upon achieving that modest commitment.

9. Control The Use Of Confidential Information

Back to the fishing illustration, the "tit for tat" approach got them hooked at the end of our line, but the problem is, you are still far apart from settlement. You are still aware of additional information about the conduct of the broker which you might be willing to share. Assuming the other side has begun to cooperate, it's time for you to *forgive* by providing the information along with a request for additional money.

10. Learn How To "Dance"

Each negotiation is a series of steps or concessions. The early portions of the mediation are over, your client did well in the opening ses-

sion, and you have finished framing the issues with the mediator. You have started cooperatively, retaliated when your opponent competed by insisting on a high settlement number well out of their reach, you forgave once they acknowledged there was more exposure, and now you are ready to negotiate the real deal.

Sometimes known as distributive bargaining, this is where the pie is divided up. Remember, each time one side gives up something, the other gets something. That means you need to give yourself plenty of room to come down from your initial demand or you will give up too much. Each step in the negotiation requires some form of concession, and is like a "move" in dancing. The first step is usually the biggest—usually you or the other side will offer the most money and it will happen fast. From that point forward you can expect each additional move to take longer and involve a lot less money.

Don't short circuit the dance. Many people at this point get anxious. They start looking at their watches and are hoping the case will be over quickly because they are uncomfortable with the concept of negotiation. They are tempted to tell the other side what their bottom line is and be done with it. This is a mistake. By short circuiting the dance, you will allow your adversary to try to take more from you in the negotiation. For example, if you tell the other side that your bottom line is $50,000, and they were inclined to pay it before you told them, they will likely offer something like $40,000 with the expectation that the mediator will come to the rescue and suggest you split the difference. Short circuiting the dance just cost you $5,000 because you will, in all probability, agree with a split the difference proposal. *Don't respond too quickly to proposals.*

11. Anticipate Internal Bargaining Disputes Within The Defense

During the negotiation, it is safe to anticipate that there will be an internal bargaining dispute between the defense attorney and his client, the client and the home office of the company, the broker and the company, and so on. *Have confidence that the mediator will check this out.* This is your chance to do a little divide and conquer through the use of the mediator.

12. Consider The "Mediator's Proposal" As A Tool To Close The Gap

Don't ever be afraid of an impasse in the negotiations. A good mediator will not let the parties simply walk away without trying to come up with some alternatives. At this point, you might suggest that the mediator make a proposal to settle the case. The proposal would be presented confidentially to each side and only the mediator would know whether it has been accepted by all parties. That way, you don't get punished for making a big move at the end. The other side will only know you made the move if the case settles, which is your goal in the first place. This will also result in the other side moving upward toward your goal because the mediator's proposal is usually a type of compromise that leaves both sides equally unhappy.

Formulas like this are educational models to consider. In the final analysis, you should feel free to utilize the style and approach that has succeeded for you in the past, knowing that you now have some additional tools and insight to draw from in the future. "Tit for Tat" allows you the flexibility to compete in order to avoid being vulnerable, yet cooperate in order to achieve a mutually beneficial and lasting outcome.

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[1] Robert Axelrod, "The Evolution of Cooperation."

[2] In the Prisoner's Dilemma game, there are two players. Each has two choices, namely cooperate or defect. Each must make the choice without knowing what the other will do. The dilemma is that if both defect, both do worse than if both had cooperated.

[3] James Alfini, "Trashing, Bashing and Hashing It Out: Is this the End of Good Mediation"?, 19 Fla St. U. L. Rev. 47 (1991).