Due Process in Securities Arbitration

by Norman B. Arnoff

Due process in securities arbitration is said either not to exist or is so diluted in form and content from what is prevalent in the courthouse that we do not properly focus upon it in our efforts to set and develop standards as well as always to move the process closer to achieving for all who participate the highest ideal of fairness. I advocate that greater clarity in understanding and defining due process in securities arbitration will dynamically motivate as well as cause all of us to improve the process we know to be so essential today to capital market integrity.

The beginning and perhaps the ultimate point of analysis is that due process in securities or any other form of arbitration is centered in the contractual choice of the parties to submit the controversy for resolution to an arbitration forum and the arbitrators, who, by their oath, undertake to honor that choice by according a fundamentally fair process.[1] Due process in securities arbitration at its core is notice and opportunity to be heard on all the issues submitted, fundamental fairness and a shared perception that the process is not affected by corruption and bias, and, in all respects, a fair consequence to the party's choice to submit resolution of its claims and defenses, not to the court, but to an alternate dispute resolution tribunal.

I. 9 U.S.C. §10 and the Definition of Due Process

The definition of due process is sourced in the statutory text of the Federal Arbitration Act ("FAA") and the related case law. It is a law that either gives effect or does not give effect to an arbitration that has taken place, depending upon whether arbitral due process has been accorded.

9 U.S.C. §10 provides that a United States Court in and for the district where the award was rendered may vacate the award where the award was procured by corruption, fraud, or

undue means; where there was evident partiality or corruption in the arbitrators or in any of the arbitrators; where the arbitrators were guilty of misconduct in two specific and defined instances, i.e., upon sufficient cause being shown refusing to postpone the hearing and in refusing to hear evidence pertinent and material to the controversy, "or of any other *misbehavior by which the rights of any party have been prejudiced*"; and where the arbitrators exceeded or imperfectly executed the powers accorded to them when the tribunal was constituted such that "a material, final, and definite award upon the subject matter was not made." 9 U.S.C. §10(a(5) permits a discretionary court remand to the arbitrators after vacation of an award if "the time within which the agreement required the award to be made has not expired."

Thus, the foregoing statutory provisions give full force and effect to the parties' choice to arbitrate and to achieve complete and final resolution. The parties choose arbitration as an alternative to court and obviously have not chosen a panel or any of its members that will be affected by fraud, corruption and bias or who, as arbitrators, will not hear all the evidence that is material and pertinent to the controversy, and who will not properly exercise or will so exceed their powers that a mutual, final and binding award will not be rendered to create complete and final closure. The parties' choice and the central importance of that choice of process that is due them are also given recognition that, in the event the Federal Court vacates an award, in its discretion, it can give further opportunity to the parties and their arbitrators to have the controversy decided by arbitration, provided the panel has not been divested of the power to decide to arbitrate under the agreement.

Nowhere does the statute provide for a judicial review of the proceedings as it relates to the persuasiveness of the evidence presented or the correctness of the arbitrators' rationale in applying legal or equitable principles. If the arbitrators choose to disregard unambiguous law

known to them or brought to their attention, the award will be vacated on the obvious premise that the parties have chosen to have the arbitrators exercise discretion in applying legal principles, but not to ignore that which must, by its clarity, have mandatory application.

II. The Case Law Supports the Definition of Due Process in Securities Arbitration

The case law supports the proposition that submitting parties choose a process to be their due, which is a complete and final resolution in a framework permitting arbitral discretion but not lacking in fundamental honesty or fairness. This core concept of giving effect to the parties' choice as the essence of securities arbitration's due process is evident in the well settled case principles that court review of the arbitrator's award is limited to the disputed issues submitted by the parties and whether the award and its implementation draw their essence from what was submitted under the contract evidencing the parties' agreement to arbitrate.[2] Obviously, an award procured by fraud, corruption, and undue means is not what the parties would have chosen to submit to at the beginning of the process, and, for that reason, court review where such grounds do exist warrants judicial intervention to give effect to that choice.[3] Further, persons who have not chosen to be parties to such dispute resolution cannot be bound because they have not so chosen, although a non-signatory but alter-ego can and does so choose and, here too, the realities of choice are the determining factors.[4]

Another illustration that choice is the defining point of the analysis to determine what is and should be due process in securities arbitration is arbitrator disclosure. Facts and relationships disclosed at inception and throughout cannot be asserted as a basis to challenge an award if a party waives objection to the arbitrator.[5] Further, tactical choices in not presenting evidence relating to claims or defenses similarly cannot be a basis to impeach the award as lacking in due process since the party chose how to present its case.

The development of the law on arbitration awards of punitive damages and whether they should be vacated are the best illustrations of how choice is the definer of the process that is due to the parties in arbitration. Cases yielding different results were decided on the same principle, i.e., the parties' choice of process was given effect. Punitive damage awards were vacated based on choice of law clauses applying state laws that did not permit arbitrators to impose punitive damages, and other cases with similar choice of law clauses held that the clause did not unequivocally exclude punitive damage awards.[6] Choice as the key analytical point, whatever the ultimate result, demonstrates that due process in securities arbitration is not to accord the parties the right to choose, slant, or fix a result but is a choice of a process to arrive at a fair result.

The Supreme Court of the United States has reinforced the key concepts discussed above in recent cases addressing both arbitration and due process. In *C & L Enterprises Inc. v. Citizen Band Potawatomi Indian Tribe of Oklahoma,*[7] the issue was whether the tribe could and did waive sovereign immunity by an arbitration provision in a construction contract. The Court rejected "the Tribe's contention that an arbitration clause is not a waiver of the parties' rights to a court trial of contractual disputes ... the contract specifically authorizes judicial enforcement of the resolution arrived at through arbitration."[8] The Court, in its opinion, captured the essential point, to wit, the choice to arbitrate is a waiver of judicial remedy.

Further, in *Major League Baseball Players Association v. Garvey,*[9] holds essentially that once the parties choose arbitration, the power to decide resides with the arbitrator, not with the courts. The Court held:

> When an arbitrator resolves disputes regarding the application of a contract, and no dishonesty is alleged, the arbitrator's improvident, even silly, fact finding does not provide a basis for a reviewing court to refuse to enforce the award.[10]

While choice is the essence of arbitral due process, it should not be the absolute defining criterion unless fairness and integrity of process are recognized as implicit in the choice. *Green Tree Financial Corp. v. Alabama v. Randolf*[11] stands for the proposition that an arbitration agreement, even a mandatory one, that is silent on arbitration fees and costs is not unenforceable because it fails affirmatively to protect a party from potentially steep arbitration costs. However, we should also look to the concurring and dissenting opinions of four members of the court that substantial up-front cost potential to a consumer effectively compelled into arbitration would essentially deny access to a fair forum. One should only be held to his choice if the process is fair.

Arbitration is supposed to be time and cost effective. However, it should never be so swift as to deny a party a resolution of all the issues submitted. It should never so swift to deny a party an opportunity to present evidence material and pertinent to the controversy or to show the law that is clearly to apply. In *Nelson v. Adams*[12] the United States Supreme Court held that a party cannot be added as a party and adjudged liable simultaneously. The Court wrote that

> ...[t]he party was never afforded a proper opportunity to respond to the claim against him, but was adjudged liable the very first moment his personal liability was legally at issue ... [D]ue process does not countenance such swift passage from pleading to judgment in the pleader's favor.[13]

Paceli v. Phillips Appel & Walden Inc.[14] applied the above-stated principle in the securities arbitration context. A dismissed supervisor was *sua sponte* rejoined by the panel as a party after hearing his testimony as a witness. An award was immediately rendered against him without an intervening opportunity to defend. The award was vacated.

Reform for More Due Process

In recent years, the prevalence of predispute clauses that, in effect, compel the public customer-consumer to arbitrate, increasing caseloads, the carry-over into arbitration of the litigation, pre-McMahon mindset, including the argument of some, but not all, that lawyers should be directly subject to arbitral sanction, securities arbitration has lost its standing as the front runner of alternative dispute resolution. I believe we can re-establish securities arbitration as the highest plane of dispute resolution.

First and foremost, in my view, would be to create within the SRO *independent* review of questions certified by the parties and panels as well as of awards before they become finalized and the arbitrators are divested of their power to decide. The FAA, in providing limited and deferential court review in the context of arbitration-litigation, non-reasoned awards, and regulatory indifference or low priority to what goes on in specific arbitration cases, I believe does not heighten the necessary scrutiny to make sure the process in today's context is "due process." Such independent review by qualified and independent personnel, comparable to administrative law judges, will not only reduce post-award court proceedings, but permit better development of securities law principles in the context where it is most important, i.e., resolution of public customer claims.

Other considerations should be to reduce for public customers the risks of firms and their registered representatives going out of business or formally withdrawing post filing of the Statement of Claim so that public customers face sterile awards. For industry personnel, the process should not be tainted by adverse publicity and broad regulatory campaigns. The open minds of arbitrators should not be adversely impacted. We should be vigilant to preserve the integrity and fairness of process for individuals and firms that may fall into disfavor.

Recognizing that it is choice that can enhance the process, we should emphasize mediation not only as an approach to settlement, but as permitting the parties to customize pre-hearing and hearing procedures for their particular case.

In the last point of our analysis, what should be uppermost in our minds is whether the process we have now and will have in the future will be chosen by all participants, whether public customer or industry personnel, as that which is honest, time and cost efficient, and above all, fair. Chief Judge Benjamin Cardozo once said, "Justice is a concept far more subtle and indefinite that is yielded by mere obedience to a rule; when all is said and done it is a synonym of an aspiration, a mood of exaltation, a yearning for what is fine or high." Keeping this in mind, we will always make sure that whatever role we play in the particular case, we will accord the other participants the process that they have chosen, due process in securities arbitration.

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[1] NASD-DR Disclosure Report and Checklist.

[2] *International Union, United Auto, etc. v. Buhr Machine Tool Corp.* (1974, E.D., Mich.), 388 F. Supp. 1357, 87 BNA LRRM 2412, 75 C.C.H. L.C.P. 10329, *aff'd without opinion* (1975 C.C. 6 Mich. 516 F.2d 901, 90 BNA LRR.

[3] *Parsons v. Blue Ridge-Winkler Textiles*, 517 F. Supp. 422 (1981 E.D. Pa.), 111 BNA LRRM 2643, 96 C.C.H. L.C P. 13949.

[4] *Western Employers Ins. Co. v. Jeffries & Co.*, 958 F.2d 258 (1992, C.A. 9 Cal.), 92 Daily Journal D.A.R. 2787, C.C.H. Fed. Secur. L. Rep. P. 96J63, amd. (1992, C.A. 9), 92 C.D.O.S. 2081.

[5] *San Carlo Opera Co. v. Conley*, 72 F. Supp. 825 (1946, D.C. N..), *aff'd.* 163 F.2d 310 (1947, C.A. 2 N.Y.).

[6] *See, Porush v. Lemire*, 6 F. Supp.2d 178 (E.D.N.Y., 1998), *Stratton Oakmont Inc. v. Nicholson*, 868 F. Supp. 486 (C.C.H. Fed. Secur. L. Rep., P. 98513, E.D.N.Y., 1994.

[7] 532 U.S. 411; 121 S.Ct. 1589; 149 L. Ed.2d 623; 2001 U.S. LEXIS 3374; 69 U.S.L.W. 4290.

[8] *Id.* at 532 U.S. 422 (April 30, 2001).

[9] 532 U.S. 504, 121 S.Ct. 724; 149 L.Ed.2d 740; 2001 U.S. LEXIS 3811; 69 U.S.L.W. 3725 (May 14, 2001).

[10] *Id.* at 503 U.S. 504.

[11] 120 S.Ct. 159 (May 25, 2000)

[12] 529 U.S. 460; 120 S.Ct. 1579; 146 L.Ed.2d 530; 2000 U.S. LEXIS 2991; 68 U.S.L.W. 4311 (April 25, 2000).

[13] 529 U.S. 460.

[14] 1991 W.L. 193507 (E.D. Pa., 1991).

For an excellent discussion and a basis for enhancing the standards for securities arbitration and the culture of fairness that must exist before due process is always a reality; *see*, "The Resolution of Securities Disputes" by Constantine N. Katsons, *Fordham Journal of Corporate & Financial Law,* Vol. VI, Number 2, 2001.