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SR-NASD-2003-158

The Honorable Jonathan Katz,
Secretary, United States Securities and Exchange Commission
450 5th Street N.W.
Washington, D.C. 20549-0609

Re: Proposed Rule 12211

Dear Secretary Katz:

Enclosed is my article that was published in the PLI Program Book for this year's securities arbitration program. It is my comment on the new proposed Rule 12211 for the new customer arbitration code for the NASD. It sets forth my reasons why I believe there is no authority for arbitrators to impose sanctions on non-party attorneys and, more significantly, why I think it would not be sound policy.

I would appreciate your considering the article in connection with the discussion about the proposed rule. Thank you.

Respectfully yours,

Norman B. Arnoff

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Enclosure

ATTORNEY SANCTIONS IN SECURITIES ARBITRATION

by Norman B. Arnoff, Esq.

Attorney Sanctions in Securities Arbitration

The proposed NASD Code of Arbitration Procedure for Customer Disputes extends the arbitrators' sanctioning authority to a party's representative. This is highly problematical if it is intended that arbitrators are to be able to sanction attorneys who represent parties in an arbitration. There is a serious issue whether arbitrators, who are empowered by a contract between parties to arbitrate and the rules that are incorporated into such agreements, have authority to impose sanctions on a non-party to the agreement to arbitrate. There is even a more serious issue whether it is sound to accord arbitrators such authority and whether, if this is the case, the true ends of securities arbitration, i.e., time and cost effectiveness as well as fairness and its perception will be undermined.

The Proposed Rule

Proposed Rule 12211 provides:

12211. **Sanctions**

(a) The panel may sanction a party or a *party's representative* for failure to comply with any provision in the Code, or any order of the panel or single arbitrator authorized to act on behalf of the panel. Unless prohibited by applicable law, sanctions may include, but are not limited to:

- Assessing monetary penalties payable to one or more parties;
- Precluding a party from presenting evidence;
- Making an adverse inference against a party;
- Assessing postponement and/or forum fees, and
- Assessing attorneys' fees, costs and expenses.

(b) The panel may initiate a disciplinary referral at the conclusion of an arbitration.

(c) The panel may dismiss a claim, defense or arbitration with prejudice as a sanction for material and intentional failure to comply with

an order of the panel if prior warnings or sanctions have proven ineffective. (emphasis added)

The NASD explanatory note to the proposed sanction rule states:

Sanctions (Proposed Rule 12211)

Currently, Rule 10305(b), governing the dismissal of proceedings, provides that the "Arbitrators may dismiss a claim, defense, or proceeding with prejudice as a sanction for willful and intentional material failure to comply with an order of the arbitrator(s) if lesser sanctions have proven ineffective." In addition, the NASD Discovery Guide states that "[t]he panel has wide discretion to address noncompliance with discovery orders. For example, the panel may make an adverse inference against a party or assess adjournment fees, forum fees, costs and expenses, and/or attorneys' fees caused by noncompliance."

Proposed Rule 12211 would codify the sanction options available to arbitrators that are described in the Discovery Guide, and extend them beyond the discovery context to apply to noncompliance with any order of the panel or provision of the Code. The proposed rule would also make clear that the panel may sanction a party's representative in egregious situations. Finally, the proposed rule would also allow the panel to dismiss a claim under the same conditions as they may currently, although it would use the term "previous" rather than "lesser" sanctions in order to avoid potential confusion regarding whether a previous sanction was "lesser" or "greater," NASD believes that this rule change will encourage parties to comply with both the Code and with orders of the panel, and will also clarify the authority of arbitrators to ensure the fair and efficient administration of arbitration proceedings when parties fail to do so. (emphasis added)

Proposed Rule 12208, Representation of Parties, provides, as did the other codes, "[a]ll parties have the right to be represented by counsel during any stage of an arbitration" which, if juxtaposed with the language of proposed Rule 12211, seems to ambiguously suggest that there is authority to sanction attorneys.

The Sanctioning Authority of the Courts

The federal courts derive their legitimate sanctioning authority upon attorneys from three basic sources, to wit, their inherent authority to impose decorum and

adherence to their lawful mandates, 28 U.S.C. § 1927 to impose sanctions on attorneys who, in bad faith, multiply the proceedings in an unreasonable and vexatious manner, and the Federal Rules of Civil Procedure, such as Rule 11. These sources of authority are clearly distinguishable from the means by which the arbitrators receive their power, i.e., the agreement to arbitrate.

In *Chambers v. NASCO Inc*[1]. the Supreme Court of the United States described the nature of the Courts' inherent power, as follows:

> It has long been understood that "certain implied powers must necessarily result to our Courts of Justice from the nature of their institution," powers "which cannot be dispensed with in a Court, because they are necessary to the exercise of all others" ... For this reason, "Courts of Justice are universally acknowledged to be vested, by their very creation, with power to impose silence, respect and decorum, in their presence and submission to their lawful mandates" ... These powers are "governed not by rule or statute but by the control necessarily vested in courts to manage their own affairs so as to achieve the orderly and expeditious disposition of cases."[2]

Inherent power, however, only applies to the interstices where statute or rule does not apply. It also only applies when a party has acted in bad faith.[3] As the Supreme Court noted, inherent power is implied power, and from this proposition we can fairly conclude that it is not a power conferred upon arbitrators by parties through an agreement and, *a fortiori*, not on a non-party attorney representing a party.

The statute, 28 U.S.C. § 1927, is also quite restricted in its application, and Courts must be cautious in invoking this statutory power. As one Court noted:

> Sanctions under 1927 can be imposed exclusively against the offending attorneys, not their clients, and "bad faith is the key element in the imposition of § 1927 sanctions" ... "Imposition of sanctions under Section 1927 is highly unusual and requires a clear showing of bad faith."... "Bad faith may be inferred only if actions are so completely

without merit as to require the conclusion that they must have been undertaken for some improper purpose such as delay."[4]

The statute expressly by its terms only applies where the Court requires the attorney to satisfy personally the excess costs, expenses, and attorneys' fees reasonably incurred as a result of bad faith conduct.[5]

The other prong of the tripartite sanctioning authority for the federal courts are the Federal Rules of Civil Procedure, particularly Rule 11, which addresses advocacy through papers filed with the court and advocacy based on those filed papers. Federal Rule of Civil Procedure 11(b) provides:

> By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, ...
>
> (1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation; [and]
>
> (2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law...

Due Process and the Courts' Sanctioning Policies

Before sanctions are imposed by a federal court on an attorney, rigorous requirements have to be satisfied that cannot be justified, nor should they be justified for securities arbitration. In respect to inherent power, "'[i]t is in cases when neither the statute nor the Rules are up to the task, [that] the court may safely rely on its inherent power.'"[6] Inherent power is only used, and cautiously, when there is no alternative and "when a party's 'entire conduct throughout the lawsuit evidenced bad faith and an attempt to perpetrate a fraud on the court.'"[7]

Federal Courts are also either not permitted or severely restricted from imposing sanctions in the absence of textual authority and guidance.[8] Apart from the fact that there is no statute authorizing the imposition of attorney sanctions in arbitration, 28 U.S.C. 1927 also requires a finding of pervasive bad faith and, and, as one court noted, "[t]he only meaningful distinction between a sanction award pursuant to Section 1927 and one pursuant to a court's inherent powers is that 'awards under § 1927 are made only against attorneys or other persons authorized to practice before the courts while an award made under the court's inherent powers may be made against an attorney, a party or both.'"[9]

The imposition of sanctions is a blot on the record of a lawyer and his law firm and for that reason, the Courts are careful in following due process procedures.[10] First and foremost, the Courts make the distinction between what is sanctionable and what lacks ultimate merit.[11] Not every losing claim, defense or argument deserves sanction. It is well settled that "Rule 11 sanctions must be imposed carefully, lest they chill the creativity essential to the evolution of the law."[12]

Courts give counsel explicit warnings when they view the case as bordering on frivolity. Further, when the adversary seeks to impose sanctions, Rule 11's "safe harbor" provisions come into play, i.e., before filing a separate motion for sanctions pursuant to Rule 11, the motion papers must be served on the adversary who has 21 days to withdraw the pleading or paper. Not only are these safeguards adhered to but Courts explicitly record their occurrence. As one Court so noted, "...[t]he motion for Rule 11 sanctions ... [was] served in this case and ...the plaintiff and his attorneys were afforded the opportunity to withdraw the lawsuit before the motion was filed with the

Court...[t]he plaintiff and his attorneys chose not to do so...[and] [t]hus the defendants' motion for sanctions complied with the procedural safeguards of Rule 11."[13]

In a case involving a securities arbitration employment dispute, *Cowle v. Paine Webber Inc.*[14] where the arguments were sanctionable, the procedural safeguards were not met. The Court did not impose sanctions and held:

> Paine Webber moves for sanctions against plaintiff pursuant to Rule 11. While there is substantial merit to the argument that sanctions are appropriate in light of the frivolous nature of most of plaintiffs' arguments, the motion is denied. Paine Webber has failed to comply with the procedural requirements ... of Rule 11 which requires that the motion for sanctions be made separately and not filed until 21 days after service. Here the motion was filed within a day of service by express mail. In addition, the motion did no more than attach a copy of the brief on the application for summary affirmance. Paine Webber did nothing to "describe the specific conduct alleged to violate subsection [Rule 11] (b)." Therefore, Paine Webber's motion for sanctions is denied.[15]

Where Courts *sua sponte* impose sanctions, there must be specific notice and opportunity to be heard by the party or counsel who are subject to sanction before it can be imposed. In *H.D. Brous & Co. Inc. v. Roman M. Mrzyglocki*[16] frivolous arguments were made in a petition submitted to stay an NYSE securities arbitration. The adversary did not move to impose Rule 11 sanctions. The Court, in view of petitioner's counsel's contradictory and baseless arguments, however, considered sanctions. The Court noted:

> Due process requires that courts provide notice and an opportunity to be heard before imposing any kind of sanctions... In the case at bar, the Respondent has not made a motion for sanctions. But I am considering on my own initiative whether Petitioner's attorneys should be sanctioned. In this circumstance, this Court is required "to apprise [Petitioner's counsel] of the specific conduct alleged to be sanctionable" and to give counsel "a reasonable opportunity to respond."...[17]

Not only is specific notice and opportunity to be heard due process in the sanction context, but sanctions need to be explained. In *Dubrowsky v. Estate of Arnold Perlbinder*[18] the Court held:

> The Second Circuit has observed that sanctions may be authorized by any of a number of rules or statutory provisions, or may be permissible on the basis of the court's inherent power. Because the various sources of the court's authority are governed by differing standards ... it is imperative that the court explain its sanctions order "with care, specificity, and attention to the sources of power" ... "Thus, although the award of sanctions is reviewed under an abuse-of-discretion standard ... such award either without reference to any statute, rule, decision, or other authority or with reference only to a source that is inapplicable will rarely be upheld"...[19]

Conclusion

The foregoing described sanction framework demonstrates that, even assuming a lawful authority upon the arbitrators to sanction non-party attorneys, such authority is not suitable for securities arbitration and, certainly, does not accomplish the goals of minimizing time and expense and achieving perceptible fairness. One can envisage two lawyers in a hotly contested arbitration trying tactically to wound the other side and its attorney by claiming frivolous factual and legal arguments, non-lawyer arbitrators trying to discern the validity of such contentions, arbitrators holding a hearing within a hearing to make a decision on the sanctions motion, and then taking the extra time to articulate the rationale for their decision in a context where reasoned awards are the exception. Interposing attorney sanctions in securities arbitration will do severe damage to the process.

This is not to say that arbitrators are then left bereft of remedy. Nor is the client who suffers unjustifiable expenses without remedy. The arbitrators, under the proposed Rule 12211, have a number of ways to manage and control the proceedings. Moreover,

the client who loses a case that he should have won and who incurs additional costs can sue for legal malpractice.[20] Further, If the lawyer's conduct rises to the level of unethical and illegal behavior, the arbitrators, the parties, or counsel can complain to the disciplinary committee or bar association who will then initiate an appropriate inquiry. The term, "party's representative" in proposed Rule 12211 should be only read to mean the corporate representative who attends the hearing on behalf of the legal entity that is a party and not counsel.

Endnotes

[1] 501 U.S. 32, 111 S. Ct. 2133, 115 L.Ed. 27, 1991 U.S. LEXIS 3318.

[2] *Id.* at 501 U.S. 44.

[3] *Jackson v. Davis*, 2000 U.S. Dist. LEXIS 825 (S.D.N.Y. 2000)

[4] *Greenberg v. Chrust,* 297 F.Supp.2d 699, 703, 2004 U.S. Dist. LEXIS 583 (S.D.N.Y. 2004).

[5] *Jackson v. Davis*, 2000 U.S. Dist. LEXIS 825 (S.D.N.Y. 2000)

[6] *Greenberg v. Chrust,* 297 F.Supp.2d 699, 703-704, (2004) U.S. Dist. LEXIS 583 (S.D.N.Y. 2004).

[7] *Id.* at 297 F. Supp.2d 704.

[8] *Pavelic & LeFlore v. Marvel Entertainment Group, A Division of Cadaence Industries Corp. et al.*, 493 U.S. 120, 110 S.Ct. 456,107 L.Ed.2d 438, 1989 U.S. LEXIS 5832.

[9] *Jackson v. Davis*, 2000 U.S. Dist. LEXIS 825 at 18 (S.D.N.Y. 2000)

[10] *Volpe v. Van Den Broek,* 1999 U.S. Dist. LEXIS 2870 (S.D.N.Y. 1999).

[11] *Bonacci v. Lone Star International Energy Inc.*, 1999 U.S. Dist. LEXIS 1564, Fed. Sec. L. Rep. (CCH) at 90.432.

[12] *Jackson v. Davis*, 2000 U.S. Dist. LEXIS 825 at 15 (S.D.N.Y. 2000).

[13] *Gold v. The Last Experience,* 1999 U.S. Dist. LEXIS 3266 at 8 (S.D.N.Y. 1999).

[14] 1999 U.S. Dist. LEXIS 4702, 43 Fed. R. Serv.3d (Calligan) 956 (S.D.N.Y. 1999).

[15] *Id.* 1999 at 15, U.S. Dist. LEXIS 4702.

[16] 2004 U.S. Dist. LEXIS 3095 (S.D.N.Y. 2004).

[17] *Id.* 2004, at 43, U.S. Dist. LEXIS 3095.

[18] 244 B.R. 560, 2000 U.S. Dist. LEXIS 1369 (E.D.N.Y. 2000).

[19] *Id.* 2000 U.S. Dist. LEXIS 1369 at 41-42, 244 B.R. 578.

[20] *Tuckman v. Wachtel*, 2000 A.D.2d 507, 606 N.Y.S.2d 679 (1st Dep't. 1994). See also: *VDR Realty Corp. v. Mintz,* 167 A.D.2d 986, 987, 562 N.Y.S.2d 7, 8 (4th Dep't. 1990).