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The Trojan Horse Revisited

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THE TROJAN HORSE REVISITED

by Constantine N. Katsoris*

The February 2013 Issue of the *Securities Arbitration Commentator (SAC)* includes an article (the Schwab Article) highlighting the recent ruling by a Hearing Panel in *FINRA (Dept. of Enforcement v. Charles Schwab & Co., Inc.*, No. 2011029760201 (Schwab Ruling) dealing with the insertion by Schwab – allegedly contra to FINRA rules – of restrictive language in its customer agreements, providing in part:

> You and Schwab hereby waive any right to bring a class action, or any type of representative action against each other ... You and Schwab waive any right to participate as a class member, or in any other capacity, in any [such] class action ... Neither you nor Schwab shall be entitled to arbitrate any claims as a class or representative action, and the arbitrator(s) shall have no authority to consolidate more than one parties' {sic] claims or to proceed on a representative or class action basis.

Last August, the FINRA Hearing Panel issued a 48-page opinion , which concluded that, although both the Class Action Waiver provision and the Ban against Consolidation, violated FINRA rules, the Class Action Waiver provision was not enforceable, because of overriding provisions of the Federal Arbitration Act (FAA), whereas the Schwab Ban against Consolidation was not so protected and, therefore, was subject to FINRA's prohibition against such a ban.

SAC's Schwab Article then proceeds to present a thorough analysis regarding the soundness of the Hearing Panel's ruling, examining various legal and practical options available to FINRA, the SEC, the Courts and legislators. The Schwab Article – while providing an excellent roadmap as to the issues involved – unfortunately leaves us with lingering doubts as to the future of securities arbitration by concluding:

> Securities arbitration could be radically altered by the introduction of class action waivers into agreements with customers and employees. Class actions would also be radically altered, but not, as some pundits cry, mortally wounded. We have tried to anticipate some such changes in this article. If one truly believes in the flexibility

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> and virtues of arbitration, advantages to both sides – as well as drawbacks – seem likely. At any rate, the question right now is not a policy one; it is a legal one. So far, Schwab's position is the more consonant with the Supreme Court's view of arbitration law and it is worth, therefore, contemplating what this alternative world might be like.

Acknowledging the excellent legal analysis of SAC's Schwab Article, I am nevertheless reminded of an article I wrote in the July 1999 issue of SAC – entitled: *Riding the Trojan Horse Back to* Wilko*?"* (the Trojan Horse Article) – which raises a familiar issue of forcing public investors into arbitration and then unilaterally seeking to restrict their remedies otherwise available in court. It compared the situation to Greek mythology wherein the ancient Greeks, bogged down in a long siege of the City of Troy, decided to build a large hollow wooden horse in which a group of warriors was concealed. The Trojans were tricked into letting this impressive-looking horse within the City walls. At night, the warriors concealed in the horse exited and opened from within the heretofore impenetrable gates of Troy, and the rest is history. This simple scenario of using a seemingly harmless and attractive object or goal as a vehicle to achieve an unrelated, unexpected and often unwelcome result has been replayed many times in history – sometimes by design, sometimes by accident or coincidence, and often in widely divergent circumstances. It would appear that this scenario is sought to be replayed in the dispute resolution arena involving the securities industry and its customers.

Over fifty years ago, many investors with grievances against their brokers resolved their disputes outside of arbitration, despite the fact that arbitration offered the attributes of speed and economy. On the other hand, most investors are presently limited to resolving these disputes in arbitration at Securities Self-Regulatory Organization (SRO) forums. By way of bullet-point explanations, the Trojan Horse Article briefly traced the history of this metamorphosis and examined how this symbol of speed and economy (arbitration) could be used as a vehicle (Trojan Horse) to deprive remedies and relief investors could otherwise receive through other channels (i.e., the Courts), namely:[1]

• 1953 The Supreme Court in *Wilko v. Swan* (346 U.S. 427) – expressing some distrust of arbitration – concluded that Congress' desire to protect investors would be more effectively served by holding unenforceable any pre-dispute arbitration agreements relating to issues arising under the 1933 Act.

• 1976 The New York Court of Appeals in *Garrity v. Lyle Stuart, Inc.* (40 N.Y.2d 354) held that arbitrators lacked authority to award punitive damages, even if agreed to by the parties.

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• 1977 The Securities Industry Conference on Arbitration (SICA) was established to create greater uniformity and clarity in the rules of arbitration at the various SROs for disputes between the securities industry and the public. SICA's deliberations led to the Uniform Code of Arbitration.

• 1985 The Supreme Court in *Dean Witter Reynolds, Inc. v. Byrd* (470 U.S. 213) held that, when an arbitrable claim is joined with a non-arbitrable *Wilko* claim, the claims need not be tried together involuntarily, despite the presence of an arbitration agreement.

• 1987 Expressing greater confidence in the integrity of securities arbitration, the Supreme Court upheld the arbitrability of claims under the Securities Exchange Act of 1934 in *Shearson/American Express, Inc. v. McMahon* (482 U.S. 220).

• 1989 The Supreme Court undid the *Wilko* exception entirely in *Rodriquez de Quijas v. Shearson/American Express, Inc.*, (490 U.S. 477), holding that pre-dispute arbitration agreements would be upheld, even as to issues arising under the 1933 Act.

• Late 1980s Brokerage firms, with greater frequency, began inserting a New York choice-of-law clause in their arbitration agreements, many assuming that the *Garrity* prohibition would be thereby incorporated. Other restrictive clauses appeared, which sought to shorten eligibility requirements, specify arbitration hearing locations, and limit which courts could confirm Awards.

• 1989 SICA amended §31 of its Uniform Code, prohibiting any condition in arbitration agreements that "limits the ability of the arbitrators to make any award." This provision was later added to the rules of the major SROs, including NASD.

• 1991 SICA added Section 28(h) to its Uniform Code, providing that "arbitrator(s) may grant any remedy or relief that arbitrator(s) deem just and equitable and that would have been available in a court with jurisdiction over the matter." This provision was not adopted by the SROs.

• 1995 The Supreme Court in *Mastrobuono v. Shearson Lehman Hutton, Inc.* (514 U.S. 614) upheld an arbitration award of punitive damages by a panel of NASD arbitrators, despite the presence of a New York choice-of-law clause.

• 1995 NASD and NYSE issued a joint notice (Information Memo/Notice to Members 95-16) to their members that they may not include or seek to enforce provisions in customer agreements which can be construed as restricting or limiting the ability of customers to arbitrate or arbitrators' ability to issue awards.

• 1996 The New York Appellate Division in *Mulder v. Donaldson Lufkin & Jenrette* (1 Dept., 224 A.D.2d 125) lifted the *Garrity* prohibition against arbitrators awarding punitive damages.

• 1997 TheNASDsubmitted a 19(b) filing with the SEC seeking approval of the rigid cap rule suggested by the Ruder Report. Significant opposition surfaced as to such filing and it was apparently stalled.

• 1999 NASD filed new rules for the handling of employment disputes which include a provision that the "arbitrator(s) shall be empowered to award any relief that would be available in court under the law." (File No. SR-NASD-99-06).

• 1999 The NASD filed a permissive cap proposal with the SEC, amending the 1997 filing (rigid cap rule). If the SEC approved this proposal, virtually the entire industry would have required its customers to arbitrate their dispute before SRO forums and be subject to the rigid cap rule.

These were the developments that preceded the Trojan Horse Article. The clear message intended to be conveyed by the Trojan Horse Article was that it was unfair to force investors into arbitration and then unilaterally impose rigid limits on their remedies – i.e., a cap on punitive damages that had no relationship to the extent of the injury suffered. Indeed, the conventional wisdom underlying the broad enforcement of arbitration by the Supreme Court in *McMahon* was to facilitate an investor's ability to obtain in arbitration whatever relief was available in court. Restricting that ability undermines the public's perception of fairness of SRO arbitration and returns to the mistrust of *pre-SICA/Wilko* days, when many suggested that the process was *stacked against the public investor.*

The difference between arbitration and courtroom litigation should be procedure, not substance. In resolving future disputes with the securities industry, the public will not accept being forced into an arbitration system where its rights and remedies are unilaterally stripped or limited by non-negotiated form or otherwise adhesive agreements. Simply put, SRO arbitration cannot – under the guise of speed and economy – be used as a Trojan Horse to cherry-pick away claimant's rights. Whatever relief is available in court should generally also be available in arbitration.

Such objectionable restrictions are involved in the Schwab Ruling. As to the Class Action Waiver – since such actions are generally not suitable to or available in arbitration for a variety of reasons – to eliminate that avenue of relief to a claimant through court proceedings is indeed a significant denial. Moreover, the Ban against Consolidation by arbitrators is downright unconscionable, for it would discourage claimants -- even with virtually identical claims -- from seeking relief by imposing upon them unnecessary, unreasonable and duplicative costs. If such restrictive measures are allowed to stand, *for whatever reason,* then perhaps the confidence expressed by the Court in *McMahon* as to the fairness of arbitration will diminish and the Trojan Horse will lead us back to the suspicions of *Wilko* – a scenario to be discouraged by FINRA, the SEC, the Courts and legislators.

ENDNOTE

[1] See also, C. Katsoris: *The Arbitration of a Public Securities Dispute,* 53 Fordham Law Rev. 279 (1984); *Securities Arbitration After McMahon,* 16 Fordham Urban L. J. 3 (1998); *Should McMahon Be Revisited,* 59 Brooklyn L. Rev. 1113 (1994); *The Betrayal of McMahon*, 24 Fordham Urban L. J. 221 (1997); *The Resolution of Securities Disputes,* 6 Fordham J. of Corp. & Fin. Law (2001); *A Life Without SICA,* 2004 SEC. ARB. COMMENTATOR, No. 5 at 1 (July 2004); *Roadmap to Securities ADR,* 11 Fordham J. of Corp & Fin. Law 413 (2006).