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Vacating an Award Based on Arbitrator Misclassification: What are the Pitfalls and Hurdles?

By James L. Komie and Jin-Ho Chung, as published in Bloomberg Law Reports, *Volume 2, Number 6, July 2006.*

I. Introduction

In April 2004, the SEC approved sweeping changes to the definition of non-public arbitrator[1] in NASD arbitrations.[2] In its rule filing, the NASD explained that the changes were designed to "ensure that individuals with significant ties to the securities industry are not able to serve as public arbitrators, ... clarify that compliance with arbitrator disclosure requirements is mandatory ... [and] enhance investor confidence in the fairness and neutrality of NASD's arbitration forum."[3] Similarly, in approving these changes, the SEC emphasized the importance of ensuring that the investing public receives a hearing by a fairly constituted panel of arbitrators.[4]

The April 2004 changes expanded the definition of non-public arbitrator. As a result, arbitrators who previously had been considered public arbitrators were reclassified as non-public arbitrators. These changes to the definitions of public and non-public – coupled with the size of the arbitrator pool and the fact that the NASD must rely on the arbitrators to update their own disclosures – make virtually certain that some arbitrators will be misclassified.

Given the emphasis the SEC and NASD have placed on the classification of arbitrators, what are your options if you discover after an award has been issued that one of the supposed public arbitrators should have been categorized as non-public? The short (and perhaps surprising) answer is that you may be stuck with the award. Courts that have considered this issue, including the United States Court of Appeals for the Fifth Circuit in a recent opinion, make clear that it is extraordinarily difficult to vacate a securities arbitration award on the basis that one of the arbitrators was misclassified. Standing alone, misclassification is not enough to warrant vacatur of an award. Only parties who have acted with due diligence and who can show that the misclassification fits squarely within one of the grounds for vacatur listed in the Federal Arbitration Act[5] (FAA) have a chance to prevail on a petition to vacate.

II. Bulko v. Morgan Stanley DW Inc.[6]

Following the entry of an adverse award against him by an NASD panel, plaintiff Simon Bulko discovered that the non-public arbitrator on the panel had failed to update her disclosures to © Bloomberg 2006. Originally published by Bloomberg, L.P. Reprinted by permission. show that she was no longer a practicing attorney – a change that Bulko believed should have caused her to be reclassified as public. Under NASD rules, an attorney, accountant or other professional who has devoted 20 percent or more of his or her professional work, in the last two years, to clients who are engaged in the securities industry is considered non-public.[7] In 2000, Marybeth Marshall, an attorney who had been registered as a non-public arbitrator since 1994 due to her extensive work in securities law, notified the NASD that she was no longer practicing law full-time, and had taken an "of counsel" position at her law firm. This information was provided to Bulko and Morgan Stanley in 2003 when Marshall was appointed to the panel as a replacement arbitrator. None of the parties objected to Marshall being placed on the panel. In 2004, Marshall disclosed to the NASD (in an unrelated NASD arbitration) that in fact she had not practiced law since 1999, had taken inactive status from the Texas state bar that same year, and that her position as "of counsel" had ended in 2003. The NASD, however, continued to classify Marshall as a non-public arbitrator.

Bulko learned about Marshall's 2004 disclosures to the NASD only after the NASD panel issued an award in Morgan Stanley's favor. Bulko filed a petition to vacate in a federal district court, asking that the award be vacated pursuant to Section 10 of the FAA[8] on the grounds that the panel had exceeded its authority. Specifically, Bulko argued that he was entitled under the NASD Code of Arbitration to a panel consisting of one non-public and two public arbitrators.[9] Since all of the arbitrators on the panel appeared to be public (including Marshall, who Bulko claimed had been erroneously classified as non-public by the NASD), Bulko argued that the panel lacked the authority to render an award against him. The district court agreed with Bulko and vacated the award. Significantly, the district court ruled that Bulko did not waive his right to challenge the award even though he failed to object to the appointment of Marshall since he had had no reason to believe that she was misclassified until *after* the award had been rendered.

The United States Court of Appeals for the Fifth Circuit reversed and reinstated the NASD panel's award. Although arbitrators must be selected according to the contract-specified method, since the agreement between Bulko and Morgan Stanley (i.e., the customer agreement) was not before the court, the court concluded it "[could] not say the customer agreement incorporated NASD Rules."[10] In any event, the court found that the NASD Rules' " *method* for selection was followed" given the NASD Director of Arbitration's broad discretion to "make any decision ... consistent with the purposes of [the NASD arbitration code] to facilitate the appointment of arbitration panels and the resolution of arbitration disputes."[11]

Moreover, the fact that Marshall no longer practiced law did not preclude her from qualifying as non-public. "[T]he NASD Code does not limit non-public arbitrator eligibility to practicing attorneys-at-law. Rather, §10308(a)(4)(C) [of the NASD Code] provides that attorneys, among others, who have devoted a certain amount of their *professional activity* to securities related matters qualify as non-public arbitrators."[12] Accordingly, "it is not clear Marshall's inactivemember- of-the-bar status precludes her from satisfying [NASD Code] §10308(a)(4)(C)'s plain language, even absent the NASD arbitration director's discretion."[13] In short, the court concluded Bulko in fact received a properly composed panel of arbitrators, as determined by the NASD.

Going a step further, the court observed that even if Bulko was correct, Marshall's misclassification was a "trivial departure not warranting vacatur." The court explained:

> Based on her work experience, Marshall fulfilled the purpose of a non-public arbitrator, which is to serve as an industry insider on the arbitration panel. And, as discussed, the NASD continues to classify Marshall as a non-public arbitrator due to that experience. Lacking a specific method-of-selection clause in the relevant contract, and in light of the strong federal policy favoring arbitration contracts, any error in selecting Marshall was trivial.[14]

Finally, although not the basis for its ruling, the court observed that Bulko failed to exercise due diligence. The court stated:

> It is worth noting ... that the parties were aware, pre-arbitration, that Marshall was not practicing law full time. Yet, no party asked for any further information; nor, apparently, did any party independently investigate until post-award. Marshall's disclosure should have put the parties on notice of any potential issue with her qualifications. Likewise, the parties were aware her position with [the law firm she identified] was of counsel, a loosely-defined term that describes a wide variety of arrangements [citing Black's Law Dictionary]. Marshall's of-counsel title did *not* guarantee she was performing any work .... In sum, pre-arbitration, the parties were on notice of any potential claims regarding Marshall's qualifications as non-public arbitrator.[15]

In Bulko, the Fifth Circuit set the bar extraordinarily high for parties who seek to vacate an NASD arbitration award. At the time she was appointed to the panel, Marshall's disclosure clearly gave the impression that she was practicing law at least part-time, even though she had taken inactive status from the state bar nearly four years earlier. The *Bulko* court granted extraordinary deference to the NASD's supposed decision to continue classifying Marshall as a non-public arbitrator, when in fact there was nothing suggesting that the NASD was aware that she had taken inactive status. Moreover, the court's observation in dicta that Marshall's disclosure that she was "of counsel" put the parties on notice of a potential misclassification seemingly imposes a near impossible burden on the parties to show due diligence in investigating the arbitrators' qualifications.

III. The Federal Arbitration Act

Most litigants who challenge an NASD award do so pursuant to the FAA. Section 10 of the FAA provides the grounds for vacating an arbitration award:

> (a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration -
>
> (1) where the award was procured by corruption, **fraud**, or undue means;
>
> (2) where there was **evident partiality** or corruption in the arbitrators, or either of them;
>
> (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or 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; or
>
> (4) where **the arbitrators exceeded their powers**, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.[16]

Courts interpreting Section 10 of the FAA have made clear that "[j]udicial review of an arbitration award is extraordinarily narrow" in light of the strong federal policy in favor of resolving disputes through arbitration.[17] As a result, reviewing courts will resolve all doubts in favor of upholding an arbitral award.[18]

The misclassification of an arbitrator does not fit neatly within any of the FAA's listed grounds for vacatur. As such, most parties seeking vacatur have employed a "throw it against the wall and see what sticks" approach, citing several of Section 10's sub-parts as the grounds for vacating the award. None of the theories have met with much success.

A. Fraud

Some parties have argued that an award entered by a panel consisting of one or more arbitrators that were misclassified must be vacated because the award was procured by fraud. How a misclassification constitutes "fraud" is not clearly articulated. In any event, the standard for proving fraud is extremely high. "The party asserting fraud must establish it by clear and convincing evidence and must show that due diligence could not have resulted in discovery of the fraud prior to arbitration."[19] Further, "in order to protect the finality of arbitration decisions, courts must be slow to vacate an arbitral award on the ground of fraud."[20] Thus, the mere allegation that a misclassification of one or more arbitrators constitutes fraud is insufficient. Rather, the party alleging fraud must be able to plead specific facts from which fraud is the logical or inescapable conclusion. In other words, a litigant must be able to allege specific facts that lead to the conclusion that the arbitrator and/or the NASD intended to commit fraud by misclassifying the arbitrator as public or non-public. Litigants have not been successful in meeting this heavy burden.

B. Arbitrator Bias or "Evident Partiality"

Some public customers have sought to vacate awards on the grounds that a non-public arbitrator misclassified as public is inherently biased in favor of the industry and against them. However, to overturn an award on the grounds of bias or evident partiality, a litigant must demonstrate more than just an *appearance* of impropriety. Rather, "the party alleging such bias 'must establish specific facts which indicate improper motives on the part of the arbitrator, and which establish that the arbitrator's conduct was so biased and prejudiced as to destroy fundamental fairness.'"[21] Thus, for example, the mere fact that a supposedly misclassified arbitrator has personal or familial affiliations with the securities industry does not, by itself, demonstrate bias.[22] Accordingly, the mere fact of misclassification is not enough to prove that an arbitrator was biased.

C. Arbitrators Exceeded Their Powers

Finally, some litigants, such as Bulko, have sought to vacate awards on the grounds that an improperly constituted panel lacks the authority to render a decision and therefore, has exceeded its powers. Although the Fifth Circuit ultimately ruled that the NASD has broad discretion to "make any decision ... consistent with the purposes of [the NASD Code] to facilitate the appointment of arbitration panels and the resolution of arbitration disputes," challenging an award on the grounds that the arbitrators exceeded their authority appears more likely to succeed than arguing that the arbitrators committed fraud or are inherently biased.[23] For example, the district court in *Bulko* vacated the arbitration award on the grounds that the panel of arbitrators exceeded its authority.

IV. The Doctrine of Waiver — Obligation To Investigate Potential Issues Concerning Misclassification

Regardless of which approach a litigant takes in seeking vacatur of an arbitral award, one rule the courts have uniformly agreed upon is that parties must investigate and assert misclassification of an arbitrator with due diligence. Otherwise, they will be deemed to have waived any objection to the misclassification. The Fifth Circuit's comments in *Bulko* about how Bulko was on notice of the misclassification from the arbitrator's disclosure that she was "of counsel" reveals the extent to which courts are willing to go in applying the doctrine of waiver. Even where it was not readily apparent that a misclassification had occurred, courts may nevertheless rule that by failing to investigate, the parties waived their right to object or appeal. For example, in *Bolick v. Merrill Lynch, Pierce, Fenner & Smith, Inc*., the court denied the petition to vacate, in part, on the grounds that plaintiff had received the arbitrator's profile, which contained the basis for her claim that the arbitrator had been misclassified, well in advance of the arbitration hearing. "A party to an arbitration ... 'may not sit idle through an arbitration procedure and then collaterally attack that procedure on grounds not raised before the arbitrators when the result turns out to be adverse.'"[24]

Thus, every party to a NASD arbitration should carefully (and promptly) scrutinize the arbitrators' disclosures. Even if there does not appear to be anything on the face of the disclosures that clearly indicates an arbitrator is misclassified, it is incumbent upon each party to investigate the disclosures further if there is even a *hint* that a misclassification may have occurred. This means asking questions, doing a preliminary investigation, and if necessary, requesting additional time to complete the investigation.

V. Conclusion

Parties attempting to set aside a securities arbitration award have a steep hill to climb unless they have (1) exercised all possible due diligence in investigating arbitrator disclosures and (2) a basis to argue that the misclassification falls within one of the FAA's listed grounds for vacatur. Even then, the case law does not offer much hope that a petition to vacate will be granted. As such, the best practice is to detect misclassification early and seek relief from the NASD before the panel renders an award. Even if the NASD denies relief, a party that has shown such diligence will be in a much better position if a petition to vacate later becomes necessary.

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[1] The NASD Rules use the term "non-public" arbitrator. In practice, such individuals are commonly referred to as "Industry" arbitrators.

[2] Order Granting Approval to a Proposed Rule Change Relating to Arbitrator Classification and Disclosure in NASD Arbitrations, Exchange Act Release No. 34-49573 (Apr. 16, 2004), 69 Fed. Reg. 21871 (Apr. 22, 2004).

[3] Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Arbitrator Classification and Disclosure in NASD Arbitration, Exchange Act Release No. 34-48347 (Aug. 14, 2003), 69 Fed. Reg. 50563 at 50564, 50566 (Aug. 21, 2003).

[4] Exchange Act Release No. 34-49573, *supra* note 2 at 21873.

[5] 9 U.S.C. § 1 et seq.

[6] *Bulko v. Morgan Stanley DW, Inc.*, No. 05-10242, 2006 U.S.App. LEXIS 13322 (5th Cir. May 30, 2006).

[7] See NASD Rule 10308(a)(4).

[8] 9 U.S.C. § 10.

[9] See NASD Rule 10308(b)(1).

[10] Bulko at *8. 1

[11] Id. at *8-9.

[12] Id. at *9 (Emphasis in original).

[13] Id.

[14] Id. at *10-11.

[15] Id. at *11-12 (Emphasis in original).

[16] 9 U.S.C. § 10(a) (Emphasis added).

[17] *Gulf Coast Indus. Worker's Union v. Exxon Co.*, 70 F.3d 847, 850 (5th Cir. 1995).

[18] *Executone Info. Sys., Inc. v. Davis*, 26 F.3d 1314, 1320 21 (5th Cir. 1994).

[19] *Foster v. Turley*, 808 F.2d 38, 42 (10th Cir. 1986).

[20] *Dogherra v. Safeway Stores, Inc.*, 679 F.2d 1293, 1297 (9th Cir. 1982).

[21] *Bolick v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 05-CV-4532, 2006 WL 229038 at *1 (E.D. Pa., Jan. 30, 2006) (quoting *Forest Elec. Corp. v. HCB Contractors*, No. 01-CV-1732, 1995 WL 37586 at *3 (E.D. Pa. Jan. 30, 1995)).

[22] *Bolick* at *2.

[23] *Bulko* at *8-9.

[24] *Bolick* at *2, quoting *Smith, Breslin & Assocs. v. Meridian Mortgage Corp.*, No. 96-CV-424, 1997 WL 158119 at *3 (E.D. Pa. Apr. 7, 1997) (quoting *Marino v. Writers Guild of Am. East, Inc.*, 992 F.2d 1480, 1484 (9th Cir. 1993)). See also *Fazio v. Lehman Brothers, Inc.*, No. 02-CV-157, 2006 WL 290519 at *3 (N.D. Ohio Feb. 7, 2006) (holding that the plaintiffs had failed to exercise due diligence and thereby waived any right to object to the misclassification of an arbitrator where plaintiffs had learned of the apparent misclassification while the defendants' motion to dismiss was still pending, but did not request additional time to investigate the matter or bring the issue to the court's attention).