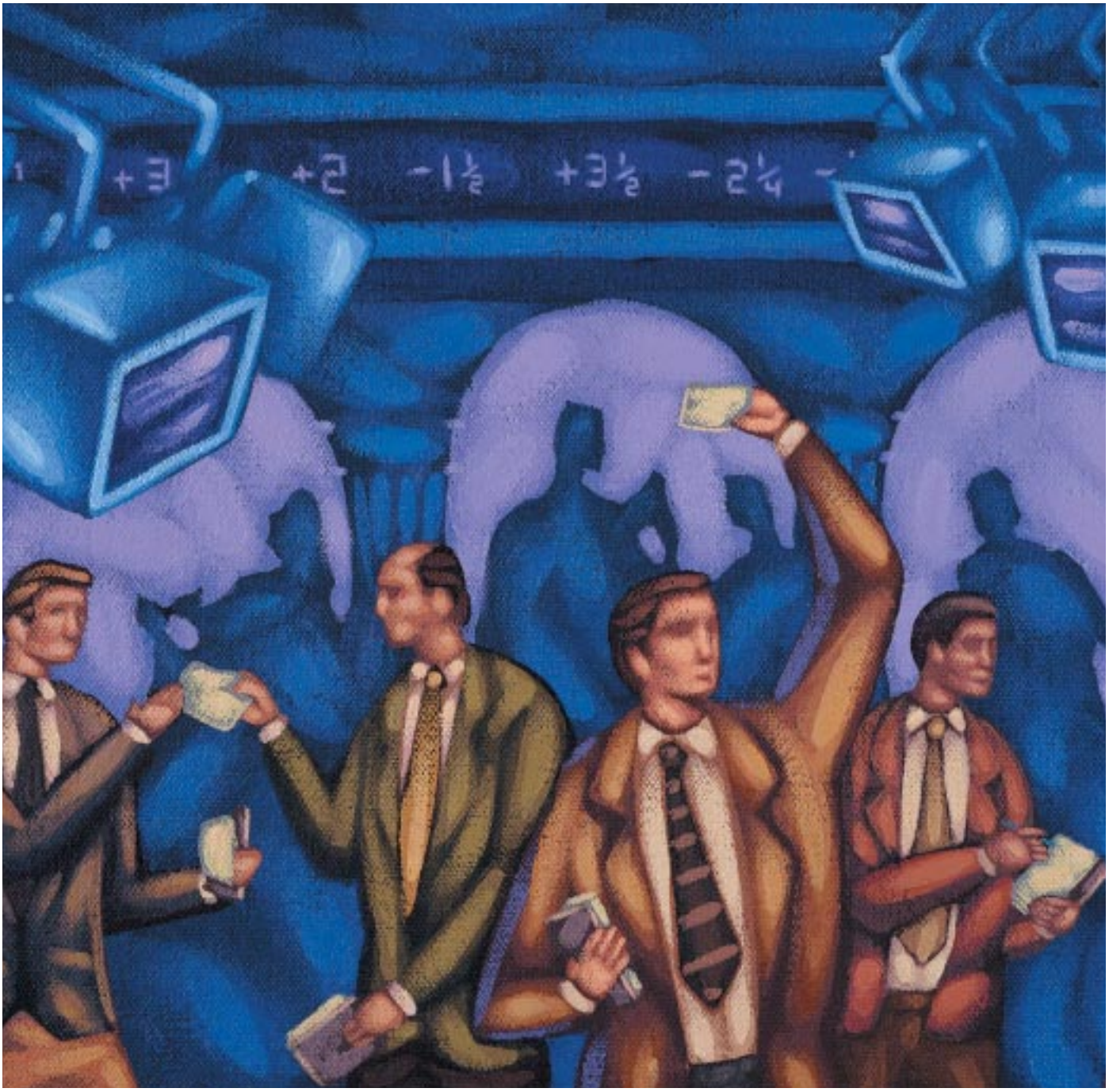
Compelling Arbitration:



Retail Securities Disputes and the Uniform Arbitration Act in Virginia

by Douglas D. Callaway

The summer and fall of 2002 have been a busy period for securities litigation attorneys. The National Association of Securities Dealers (NASD) reported that in March 2003, arbitration filings increased by over 24% from March 2002, representing the fourth consecutive quarterly increase in filings.[1] Since the crash of the technology stocks in the spring of 2000, financial markets generally declined. In addition, with widespread media coverage of alleged corporate fraud, emanating from companies such as Enron, Worldcom and Adelphia, more customers who lost money in their investment accounts consulted with claimant's counsel bringing arbitration claims—even in cases where evidence of broker misconduct was limited.

Description of a Typical Case

A typical securities arbitration brought by a customer against a brokerage firm and/or the broker involves causes of action such as: churning (frequent sales and buying transactions which have the net effect of generating a number of commissions to the broker but not profiting the portfolio of the investor);[2] unsuitability (having the investor place his capital in high risk vehicles that are unreasonable, based on his individual circumstances, and did not meet his investment goals);[3] unauthorized trading (trading in a brokerage account without the solicited authority of the investor or written permission);[4] and timely execution (the trade was not executed in a timely manner, resulting in a loss based on appreciation or depreciation of securities price)[5]—all of which caused a loss of investment profit or opportunity for the investor-claimant. Counsel inexperienced in securities-related claims may take their case to the local circuit court and allege classic breach of contract, breach of fiduciary duty, fraud and misrepresentation claims against the brokerage house. Virginia law regarding arbitration usually prevails over common law action asserted in circuit court.

Agreement to Arbitrate in Customer Account Agreement

Most customer brokerage account agreements state something similar to the following:

> You agree that any controversy arising out of our business or this agreement shall be submitted to arbitration conducted before The New York Stock Exchange, Inc., or any other national securities exchange on which a transaction giving rise to the claim took place (and only before such exchange) or the National Association of Securities Dealers, Inc., as you may elect and in accordance with the rules of the selected organization.

This language constitutes the parties' contractual agreement to the arbitration of disputes.

NASD Rule for Member Firms, the U-4 and Brokers

Both the broker and the brokerage firm (licensed by the NASD and by their member agreement) have agreed and are required to arbitrate their disputes with customers and not seek recovery through the courts. Section 10300 of the *NASD Uniform Code of Arbitration* states:

> (a) Any dispute, claim, or controversy eligible for submission under the Rule 10100 Series between a customer and a member and/or associated person arising in connection with the business of such member or in connection with the activities of such associated persons shall be arbitrated under this Code, as provided by any duly executed and enforceable written agreement or upon the demand of the customer.

In addition, Section IM-10100 of the *NASD Code of Arbitration Procedure* states:

> It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to:
>
> (a) fail to submit a dispute for arbitration under the *NASD Code of Arbitration Procedure* as required by that Code;
>
> . . . Action by members requiring associated persons to waive the arbitration of disputes contrary to the provisions of the *Code of Arbitration Procedure* shall constitute conduct that is inconsistent with just and equitable principles of trade and a violation of Rule 2110.

A licensed broker and brokerage firm agree, pursuant to their licensing agreement contained in section U-4 of their NASD public disclosure, as licensed brokers and firms that:

> I agree to arbitrate any dispute, claim or controversy that may arise between me and my firm, or a customer, or any other person, that is required to be arbitrated under the rules, constitutions, or bylaws of the organizations indicated in Item 10 as may be amended from time to time . . . .

The NASD, as a self-regulatory organization, relies on the integrity of the arbitration process as an efficient and effective scheme of resolving disputes.

Federal Law

Congress, in 1925, recognized and affirmed the contractual agreement to arbitrate disputes by the enactment of the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1925). Section 2 of the act states:

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy

> thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

The Supreme Court of the United States has upheld the Federal Arbitration Act as it applies in securities related litigation. In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987), the court held that the securities industry's self-regulating organizations, ostensibly including the NASD, may supervise arbitration in order to protect statutory rights under the Securities Act of 1934.[6] In subsequent holdings, the court applied the Federal Arbitration Act to be applicable to state court proceedings and in *Saturn Distribution Corp. v. Williams*, 90 F.2d 719 (4th Cir.), the Fourth Circuit held that portions of the Virginia Motor Vehicle Licensing Act, that prohibited arbitration provisions in certain actionable franchising agreements, were pre-empted by the Federal Arbitration Act.[7] Ample federal case law precedent affirms the applicability of the Federal Arbitration Act, as it relates to contractual provisions requiring disputes to be arbitrated.

Virginia Law

Uniform Arbitration Act.

In 1986, the General Assembly adopted the Uniform Arbitration Act (UAA). The essence of the UAA is contained in § 8.01-581.01 of the *Code of Virginia* (1950), as amended, which provides in part:

> A written agreement to submit any existing controversy to arbitration or a provision in a written contract to submit to arbitration any controversy thereafter arising between the parties is valid, enforceable and irrevocable, except upon such grounds as exist at law or in equity for the revocation of any contract.

The UAA, as enacted in Virginia, contains a number of provisions empowering the arbitrators to facilitate arbitration where an agreement to arbitrate fails to specify certain acts. The arbitrators provide for hearing, affirm the right of representation by counsel,[8] provide for discovery,[9] provide for a written award.[10] Most of these issues are addressed by the *NASD Code of Arbitration Procedure*.

Compelling Arbitration under Virginia Law.

With the onset of litigation in circuit court, the brokerage house may find it necessary to submit to court a motion to compel arbitration or plea of arbitration predicated on the provision contained in the parties' brokerage account agreement.

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Section 8.01-581.02 of the *Code of Virginia* (1950), as amended, states in part that:

> A. On application of a party showing an agreement described in § 8.01-581.01, and the opposing party's refusal to arbitrate, the court shall order the parties to proceed with arbitration. However, if the opposing party denies the existence of the agreement to arbitrate, the court shall proceed summarily to the determination of the issue of the existence of an agreement and shall order arbitration only if found for the moving party.
>
> B. On application, the court may stay an arbitration proceeding commenced or threatened on a showing that there is no agreement to arbitrate. Such an issue, when in substantial and bona fide dispute, shall be forthwith and summarily tried and the stay ordered if found for the moving party. If found for the opposing party, the court shall order the parties to proceed to arbitration.

According to the statute, this proceeding is a summary proceeding, which requires the party proponent of arbitration merely to show an agreement to arbitrate. In order to avoid arbitration, the defendant must "deny the existence of an agreement." A party that requests the arbitration forum pursuant to an agreement is entitled to it, even though the other party admits liability within the context of the trial court. The Supreme Court of Virginia has upheld the application of this section in *Piland Corp. v. League Construction Co.,* 283 Va. 187, 380 S.E. 2d 652 (1989).

Defenses to Arbitration

The most successful defense to arbitration is the absence of an agreement to arbitrate. (Often the argument is shown in cases where the brokerage account agreement has not been executed or forged.) A party cannot be compelled to submit to arbitration unless the party has first agreed to arbitration, *Doyle Russell, Inc. v. Roanoke*

Hospital Association, 213 Va. 489, 193 S.E. 2d 662 (1973). The extent of the duty to arbitrate, just as initial duty to arbitrate at all, arises from contractual undertakings.

Parties may allege that arbitration is not warranted where the agreement has been unsigned[11] or contains a forged signature.[12] However, where there is no signature, agreements have been inferred in instances where there exists a course of conduct that demonstrates adherence to an agreement to arbitrate consistent with the contract.[13] Parties have often alleged that the agreement to arbitrate, where produced by acts of fraud, is unenforceable.[14] Attacking a brokerage agreement as a contract of adhesion is another defense, which has generally proved unsuccessful in the common law.[15]

Attacking the Award of the Arbitrators Under the Uniform Arbitration Act in Virginia.

Section 8.01-581.010 of the *Code of Virginia* (1950) as amended, allows a party to move to vacate an award where the award was procured by corruption, fraud or other "undue means;" procured by partiality, corruption or misconduct; the arbitrators exceeded their powers; the arbitrator refused to postpone hearing upon sufficient cause, refused to hear material evidence or otherwise conduct the hearing to substantially prejudice the rights of a party to the hearing provisions of § 8.01-581.02, *supra*; no agreement to arbitrate where a party objected and there exists no adverse ruling by the Circuit Court pursuant to § 8.01-581.02, *supra*.

The parties may move to vacate or confirm the award. The fact that a court of equity or law could not or would not award the relief granted by an award, is not a ground for the refusal to confirm or to vacate an award. The motion to vacate must be made within 90 days of the date of the award. However, fraud, corruption or other undue means allow for a 90-day period that begins to run after knowledge

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of such fraud, corruption or undue means occurs or the party reasonably should have known of such grounds. If the motion to vacate is granted, the circuit court may order a rehearing before new arbitrators are chosen under NASD rules. If the motion to vacate is denied, the court shall confirm the award. In interpreting this section, the United States District Court for the Eastern District of Virginia held that arbitrators do not exceed their powers for the purpose of § 8.01-581.010(3) by admitting hearsay evidence or by interpreting the meaning of the contract. *Farkas v. Receivable Finance Corp.,* 806 F.Supp. 84 (E.D.Va. 1992).

Modification or Correction of the Award.

Upon an application (motion) made within the 90 days time limit following delivery of the award, the court may modify or correct the award on limited grounds. If there is a miscalculation of figures or evident mistake in the description of any person, thing or property referred to in the award; or the arbitrators have awarded upon a matter not submitted to them, and the award may be corrected without affecting the merits of the decision upon the issues submitted; or the award is imperfect in a matter of form, not affecting the merits of the controversy, there are grounds for filing a motion to modify or correct the award. If the motion is granted, the court shall modify and correct the award, as to affect the intent of the award and to confirm it as modified and corrected. Otherwise, the court shall confirm the award as made. A motion to vacate and modify or correct can be made in the alternative.[16]

Confirmation and Judgment Upon an Award.

After receiving an award under NASD rules, an affected firm or broker must tender payment of the award within 30 days of receipt of the award.[17] NASD awards shall bear interest from the date of the award: if not paid within 30 days; if subject to a motion to vacate that is denied; and as specified by arbitrators (usually contract rate). Otherwise, interest shall be assessed at the legal rate prevailing in the state the award was rendered. In Virginia, the legal rate is nine percent per year.[18] Under § 8.01–581.09 of the *Code of Virginia* (1950), as amended, a party, anytime after an award is made, may move to confirm the award and also may move to enter judgment upon the award pursuant to § 8.01-581.012 of the *Code of Virginia* (1950), as amended. § 8.01–581.012, *supra*, states that, "Upon granted an order confirming, modifying or correcting an award, a judgment or decree shall be entered in conformity therewith and be docketed and enforced as any other judgment or decree. Costs for the application and of the proceedings subsequent thereto, and disbursements may be overruled by the court."

Appeals.

The UAA, as enacted in Virginia, allows for appeals from orders entered by the trial court in arbitration matters. Appeals are taken in the same manner and extent as are orders and judgments in a civil action. Appeals may be taken from orders denying application to compel arbitration; granting an application to stay arbitration; confirming or denying an award; modifying or correcting an award; vacating an award without limiting a rehearing, and; a judgment or decree entered pursuant to the provisions of the UAA.[19]

Conclusion

The UAA as enacted in Virginia, with *NASD Rules of Arbitration Procedure,* provide a versatile, tested and fair method of resolving securities related disputes. Prior to filing a cause of action in circuit court, counsel should be certain that the dispute is not arbitable. Arbitration can be an efficient utilization of client resources compared with the procedural and evidentiary issues counsel may encounter in circuit court. As a tool for justice, NASD arbitration should not be disdained or avoided. Counsel should take advantage of all that the forum provides. ⚖

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Endnotes:

1 *Dispute Resolution Statistics*. National Association of Securities Dealers. 21 Apr. 2003. 30 Apr. 2003. **www.nasdadr.com/statistics.asp**

2 *Securities Arbitration Procedure Manual*, David E. Robbins (4th Ed. 2000 Lexis Publishing) § 5-5.

3 *Ibid*, p. 5-9, 5-10.

4 *Ibid*, p. 5-27.

5 *Ibid*, p. 5-37.

6 *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 at 234 (1987).

7 *Saturn Distribution Corporation v. Williams*, 905 F.2d 719 at 723 (4th Cir. 1990). *See also Amchem Products, Inc. v. Newport News Circuit Court Asbestos Cases Plaintiffs*, 264 Va. 89, 563 S.E.2d 739 at 743 (2002).

8 § 8.01-581.04 and § 8.01-581.05 of the *Code of Virginia* (1950), as amended.

9 § 8.01-581.06 of the *Code of Virginia* (1950), as amended.

10 § 8.01-581.07 of the *Code of Virginia* (1950), as amended.

11 *Nemrow v. VMS/Stout Joint Venture*, No. 89 C 5313, 1989 U.S. Dist. LEXIS 13317 (N.D. Ill. Nov. 3, 1989); *Blatt v. Shearson Lehman/American Express, Inc.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) Paragraph 92,976 at 94,796 (S.D.N.Y. Oct. 30, 1986); *First Citizens Municipal Corp. v. Pershing Div. of Donaldson, Lufkin & Jenrette Sec. Corp.*, 546 F.Supp. 884 (N.D. Ga. 1982).

12 *Ventimiglia v. Gruntal & Co.*, No. 88 Civ. 1675 (RJW), 1989 U.S. Dist. LEXIS 12910 (S.D.N.Y. Oct. 31,1989); *Russolillo v. Thomson McKinnon Sec., Inc.*, 694 F.Supp. 1042, 1043 (D. Conn. 1988); *Ketchum v. Almahurst Bloodstock IV*, 685 F. Supp. 786 (D. Kan. 1988); *Donato v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 663 F. Supp. 669, 676 (N.D. Ill. 1987); *Dougherty v. Mieczkowski*, 661 F. Supp. 267,275 (D. Del. 1987).

13 *Grigson v. Creative Artists Agency L.L.C.*, 210 F.3d 524,532 (5th Cir. 2000); *American Fuel Corp. v. Utah Energy Development Co.*, 122 F.3d 130, 133 (2d Cir. 1997); *Thomson-CSF, S.A. v. American Arbitration Ass'n*, 64 F.3d 773, 776-77 (2d Cir. 1995); *Par-Knit Mills, Inc. v. Stockbridge Fabrics Co.*, 636 F.2d 51 (3d Cir. 1980); *McAllister Bros. Inc. v. A & S Transp. Co.*, 621 F.2d 519, 524 (2d Cir. 1980).

14 *C.B.S. Employees Fed. Credit Union v. Donaldson, Lufkin & Jenrette Sec. Corp.*, 912 F.2d 1563, 1568 (6th Cir. 1990); *Great Earth Companies, Inc. v. Simons*, No. 00 Civ. 0967 (NRB), 2000 U.S. Dist. LEXIS 3772 (S.D.N.Y. Mar. 24, 2000) (citing *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045, 1049 (S.D.N.Y. 1988)).

15 *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282, 286 (9th Cir. 1988). *See also* "Arbitration: Which Party Should Bear the Cost" by Matthew B. Kirsner, *Virginia Lawyer*, April 2002.

16 § 8.01-581.011 of the *Code of Virginia* (1950), as amended.

17 Rule 10330(h) of the NASD Code of Arbitration Procedure.

18 § 6.1-330.54 of the *Code of Virginia* (1950), as amended.

19 § 8.01-581.016 of the *Code of Virginia* (1950), as amended.