

**California's New Ethics Standards: A Hot Bed of Controversy
and Conflicting Decisions**

1. Introduction

As a general rule, the arbitrator appointed to hear a given matter is required to disclose conflicts of interest to ensure the fairness and integrity of the process by rendering an objective and impartial decision. Heretofore, a “rule of reasonableness” governed conflicts of interest disclosure, meaning that the arbitrator had a duty to use reasonable efforts to conduct a reasonable inquiry regarding conflicts of interest and to make disclosures to the parties regarding same.¹ This was a relatively subjective standard that most certainly varied on a case-by-case / arbitrator-by-arbitrator basis, and is no longer the rule in California.

Until recently, private arbitration² primarily involved repeat players who were familiar with the arbitration process, the provider organizations and sometimes the arbitrators themselves.³ As such, there were few cases concerning inappropriate arbitrator behavior⁴

¹ Stephen B. Goldberg, Frank E. A. Sander, Nancy H. Rogers, Sarah Rudolph Cole, *Dispute Resolution / Negotiation, Mediation and Other Processes*, (4th ed. 2003) (“ADR Text”), p. 279.

² Arbitration is a form of alternative dispute resolution which is often used in lieu of traditional litigation. It has been defined as “a usually (but not always) private process of adjudication in which parties in dispute with each other choose decision-makers (sometimes one, often a panel of three) and the rules of procedure, evidence, and decision by which their dispute will be decided.” Carrie Menkel-Meadow, *Ethics Issues in Arbitration and Related Dispute Resolution Processes: What’s Happening and What’s Not*, 56 Miami L. Rev. 949, 949 (2002) (“Menkel-Meadow Article”). The term “private arbitration” refers to the process whereby parties agree by contract to voluntarily submit their disputes for resolution by one or more impartial third persons instead of by a judicial tribunal provided by law. Private arbitration “is a procedure for resolving disputes which arise from contract; it only comes into play when the parties to the dispute have agreed to submit to it.” *Herman Feil, Inc. v. Design Center of Los Angeles* (1988) 204 Cal.App.3d 1406, 1414, 251 Cal.Rptr. 895; *Air Line Pilots Ass’n v. Miller* (1998) 523 U.S. 866, 876, 140 L.Ed.2d 1070, 118 S.Ct. 1761. As compared to “judicial arbitration,” where certain types of civil cases can be diverted before trial to “judicial arbitration” under CCP § 1141.10, et seq., private arbitration is very different proceeding. First of all, in judicial arbitration, there is no preexisting agreement by the parties to arbitrate their disputes. Secondly, a judicial arbitration award is not binding on the parties; either may demand a trial de novo by judge or jury. Cal. Code Civ. Proc. § 1141.20.

³ ADR Text, supra, p. 279.

⁴ Id.

because the “players” in that system were familiar with and in many respects self-regulated the process and its participants.

In September 2001, the California Legislature enacted SB 475 to address, among other things, disclosure of arbitrator conflicts of interest by imposing new regulations upon the private arbitration process and its neutrals.⁵ The new law significantly revised the disclosure requirements and procedures for disqualifying arbitrators in private arbitration matters, and went far beyond anything theretofore on the books regulating the private arbitration process. The new law was believed to be necessary due to what the California Legislature perceived to be a lack of public confidence in private arbitration, which perception was at odds with the general purpose of arbitration law which is to “advance arbitration as an alternative to litigation.”⁶ That concern was prompted by the increased use of pre-dispute arbitration clauses in various types of consumer and employment contracts, where the arbitration clauses are embedded in form contracts offered on a “take it or leave it basis,”⁷ thus making the selection of arbitration for dispute resolution an involuntary choice by the consumer party. In consumer advocate circles, the concern was that the party requiring the pre-dispute arbitration clause as a condition to entering into a contractual relationship with another party had too much power because that party

⁵ The new disclosure requirements set forth in California Code of Civil Procedure Section 1281.9 and Standard 7(d) of Division VI of the California Rules of Court are referred to in this paper as the “New Ethics Rules.”

⁶ Roger Alford, *Report to Law Revision Commission Regarding Recommendations for Changes to California Arbitration Law*, 2003 Pepp. Disp. Resol. L. J. 1, 3 (2004) (“*Alford Article*”). Arbitration is generally viewed as an attractive alternative to litigation because it affords parties “with an economical, efficient, confidential, and neutral forum to resolve their contractual disputes,” is generally “a faster means of resolving disputes than litigation,” and provides limited opportunity for judicial review. *Id.*, citing, David B. Lipsky & Ronald L. Seeber, *The Appropriate Resolution of Corporate Disputes: A Report on the Growing Use of ADR by U.S. Corporations* 17, 26 (1998).

⁷ “By requiring customers in adhesionary circumstances to go to a system established and controlled by industry,” the protection for legal rights and the legitimacy and traditional support for arbitration is imperiled. As a result, the private arbitration process “no longer symbolizes the recourse to be bargained for, relatively rapid, efficient, knowledgeable, and fair alternative adjudication; rather, it epitomizes overreaching and the inaccessibility of justice.” Thomas E. Carbonneau, *The Reception of Arbitration in United States Law*, 40 Me. L. Rev. 263, 284 (1988) (“*Carbonneau Article*”).

could choose and impose the arbitration process, define the rules and even select the arbitral forum leading to the potential for unfair advantage over the other party.⁸ In short, the California Legislature thought that its intervention was necessary to even the playing field for consumers.⁹

Even though the impetus for the new standards was concern for unsophisticated or inexperienced consumers forced into arbitration with companies that were intimately familiar with the private arbitration process, the provider organizations and the arbitrators, the new disclosure rules apply to all private arbitrations conducted in California, not just consumer arbitrations, excepting only those arbitrations conducted pursuant to the terms of a public or private sector collective bargaining agreement.¹⁰

SB 475 has been the subject of controversy and debate since it was enacted and the Judicial Council was mandated to adopt disclosure and disqualification requirements that would apply to all neutral arbitrators.¹¹ Controversy and criticism began on the “Blue Ribbon Panel of Experts on Arbitration Ethics” which the Chief Justice of the California Supreme Court

⁸ See, Jay Folberg, *Arbitration Ethics – Is California the Future?* 18 Ohio S. J. on Disp. Resol. 343, 343-347 (2003) (“*Folberg Article*”); see also, ADR Text, *supra*, Ch. 4. “A series of articles published [in 2003] in the San Francisco Chronicle highlighted how arbitration provider organizations promoted the use of pre-dispute arbitration clauses in which they were designated as arbitration providers. Accusations were made about financial ties between provider organizations and repeat users of their services, suggesting favorable outcomes went to those users creating an inflow of cases. The series featured consumer arbitration horror stories, which, along with indignant editorials, added to the sense of public outrage against ‘involuntary’ arbitration.” Folberg Article, *supra*, at 344.

⁹ “Ultimately, it is the absence of negotiation between employers or businesses on the one hand and employees or consumers on the other that causes arbitration critics to treat arbitration agreements with suspicion. Unlike interactions in the collective bargaining context or among merchants (traditional arbitration users), where all parties are regular participants in negotiation and arbitration, only the employer, or big business, or health provider is a ‘repeat player’ in disputes with employees, consumers, or patients.” ADR Text, *supra*, at p. 242.

¹⁰ This means that private arbitrators hearing disputes arising under collective bargaining agreements are not required to comply with the New Ethics Rules even though they are private arbitrators acting within California. This is consistent with the long-standing recognition that disputes arising under collective bargaining agreements are governed by the National Labor Relations Act (29 U.S.C. §§ 151-169) which, in 1935, established the National Labor Relations Board as an independent federal agency to administer the NLRA and implement the national labor policy of assuring free choice and encouraging collective bargaining as a means of maintaining industrial peace. See, National Labor Relations Board website, <http://www.nlr.gov/nlr/about/default.asp>.

¹¹ Folberg Article, *supra*, 18 Ohio St. J. on Disp. Resol. at 345.

appointed to assist the Judicial Council in its task,¹² and started with the abbreviated time frame in which the new ethics standards were adopted which did not allow time for meaningful comment before the rules became effective.¹³ Importantly, although much of the criticism leading to the enactment of SB 475 was directed at the perceived conflicts of interest created by arbitration provider organizations and their repeat customers, the regulation of private organizations is not within the general authority of the Judicial Council,¹⁴ and so SB 475 focused on standards for arbitrators, generally, and not on the specific acts provider organizations could or could not do.¹⁵ Clearly, however, the regulation of private arbitrators has had an impact on the provider organizations with whom the arbitrators are associated.

It is not surprising to find that the controversy and debate concerning the standards for arbitration disclosures and disqualification has continued since the new ethics standards became effective on July 1, 2002. Much of that debate has occurred in civil litigation cases filed in the state and federal courts of California. This paper will survey some of the more significant decisions, examine their holdings, and discuss the uncertainty and other problems attendant to conducting a private arbitration in California.

2. California's New Ethics Rules

In 1961, California adopted the Uniform Arbitration Act¹⁶ which provided for vacatur of a neutral arbitrator's award based upon bias.¹⁷ However, as originally enacted, there were no

¹² Id.

¹³ Id.

¹⁴ Id.

¹⁵ Id. "This assignment created a new role for the [Judicial] Council in the regulation of private professional practice, and it raised questions about delegation to the judicial branch of a legislative function." Id.

¹⁶ Codified at Title 9 of the California Code of Civil Procedure (Cal. C. Civ. Proc. §§ 1280, et seq.).

specific disclosure requirements imposed upon neutral arbitrators.¹⁸ In 1994, California enacted Section 1281.9 of the California Code of Civil Procedure to require specific arbitrator disclosures.¹⁹ As originally enacted, the disclosure requirements under Section 1281.9 were relatively narrow, requiring only disclosure of information concerning arbitrations that involved the same parties or lawyers in the current arbitration where the arbitrator served or was currently serving as a neutral or party arbitrator.²⁰ In 1997, Section 1281.9 was amended to expand those disclosure requirements to include any attorney-client relationship the arbitrator has or had with any party or lawyer and any professional or significant personal relationship the arbitrator, his or her spouse, or minor child living in the household has or had with any party or lawyer.²¹ In 2001, SB 475 amended Section 1281.9 to further expand arbitrator disclosure requirements to include any ground specified for disqualification of judges under Section 170.1 of the California Code of Civil Procedure and any matters required to be disclosed by the ethics standards for neutral arbitrators adopted by the Judicial Council.²²

The “judicial” disclosure requirements contained in Section 170.1 of the California Code of Civil Procedure describe six specific disclosure obligations and one catchall disclosure obligation. Standard 7(d) of the New Ethics Rules details thirteen specific disclosure obligations

¹⁷ An arbitrator’s failure to disclose information indicative of bias constitutes grounds to vacate an award under California Code of Civil Procedure Section 1286.2(a)(1) (“award was procured by corruption, fraud or other undue means”), or Section 1286.2(a)(2) (“corruption in any of the arbitrators”). In this regard, it has long been the rule that a neutral arbitrator must disclose “dealings that might create an impression of possible bias,” and that the failure to do so constitutes misconduct and creates a ground to set aside the award. *Commonwealth Corp. v. Casualty Co.* (1968) 393 U.S. 145, 149, 89 S.Ct. 337, 21 L.Ed.2d 301; *Ray Wilson Co. v. Anaheim Memorial Hospital Ass’n* (1985) 166 Cal.App.3d 1081, 1087, 213 Cal.Rptr. 62.

¹⁸ Alford Article, *supra*, p. 2.

¹⁹ Stats. 1994, c. 1202 (S.B. 1638), § 1.

²⁰ *Id.*

²¹ Stats. 1997, c. 445 (A.B. 1093), § 2.

²² Stats. 2001, c. 362 (S.B. 475), § 5.

and one catchall disclosure obligation. The seven disclosure obligations found in Section 170.1 and the other disclosure requirements contained in Section 1281.9 are, for the most part, mirrored in Standard 7(d).²³ Standard 7(d) then expands upon the “judicial” disclosure requirements to require disclosure of any “professional relationship” the arbitrator or a member of the arbitrator’s immediate family has had with a party or lawyer to the proceeding,²⁴ of any “interest” that the arbitrator or a member of the arbitrator’s immediate family has that “could be substantially affected by the outcome of the arbitration,”²⁵ and of membership in any organization that practices discrimination of any kind.²⁶

Through SB 475 the disqualification procedures theretofore contained in Section 1281.9 were moved to a new code section – Section 1281.91. That section retained the provision for any party to disqualify a neutral arbitrator if he or she fails to make the disclosures required by Section 1281.9(a).²⁷ It also retained the provision for any party to disqualify a neutral arbitrator

²³ Standard 7(d)(12) and Section 170.1(a)(1) require disclosure if the judge / arbitrator has personal knowledge of disputed evidentiary facts concerning the proceeding. Standard 7(d)(7) and Section 170.1(a)(2) require disclosure if the judge / arbitrator has had an attorney-client relationship with any party or lawyer to the proceeding. Standards 7(d)(9) and (10) and Section 170.1(a)(3) require disclosure if the judge / arbitrator has a financial interest in the proceeding or a party to the proceeding. Standard 7(d)(1) and Section 170.1(a)(4) require disclosure if the judge / arbitrator (or a member of his / her extended family) is a party to the proceeding or an officer, director or trustee of a party. Standard 7(d)(2) and Section 170.1(a)(5) require disclosure if the judge / arbitrator (or a member of his / her extended family) is the spouse, former spouse, child, sibling or parent of a lawyer or spouse of a lawyer in the proceeding or if such person is associated in the private practice of law with a lawyer in the proceeding. Standard 7(d)(6) and Section 170.1(a)(8) require disclosure if the judge / arbitrator has a current arrangement for prospective employment or compensated service as a neutral or has had discussions for such prospective employment with a party to the proceeding. Standard (d)(14) and Section 170.1(a)(6) require disclosure of any other matter that might cause a person aware of the facts to reasonably entertain a doubt about the judge/s / arbitrator’s impartiality.

²⁴ CRC, Appendix, Div. VI, Std. 7(d)(8).

²⁵ CRC, Appendix, Div. VI, Std. 7(d)(11).

²⁶ CRC, Appendix, Div. VI, Std. 7(d)(13).

²⁷ Cal. C. Civ. Proc. § 1281.91(a). Like its predecessor (Cal. C. Civ. Proc. § 1281.9(b)), Section 1281.91(a) entitles any party to serve a notice of disqualification within 15 days after the proposed nominee or appointee fails to comply.

on the basis of the disclosures made.²⁸ It likewise retained the provision for waiver of a party's right to disqualify if the if timely notice of disqualification is not made.²⁹

The significant change to the disqualification procedures is found in subsection (d) of Section 1281.91, which added a requirement that a neutral arbitrator must disqualify himself or herself upon demand of any party based upon disclosures made under Section 170.1 of the California Code of Civil Procedure.³⁰ That new section works hand-in-hand with the vacatur provisions found in Section 1286.2 of the California Code of Civil Procedure. As amended in 1993, Section 1286.2 allowed vacatur of an arbitration award if the arbitrator making the award was subject to disqualification upon grounds specified in Section 1281.9 but failed upon receipt of timely demand to disqualify himself or herself as required.³¹ As amended in 2001 by SB 475, the vacatur provisions were expanded to allow vacatur of an arbitration award if the arbitrator making the award failed to make timely disclosures.³² In adding this additional ground for vacatur, the California Legislature stated that the addition of this new subparagraph was intended to be “declarative of existing case law which provides that an arbitration award may be vacated when a neutral arbitrator fails to disclose a matter that might cause a reasonable person to question the ability of the arbitrator to conduct the arbitration proceeding impartially.”³³

²⁸ Cal. C. Civ. Proc. § 1281.91(b)(1). Like its predecessor (Cal. C. Civ. Proc. § 1281.9(c)(1)), Section 1281.91(b)(1) entitles any party to serve a notice of disqualification within 15 days after receipt of the disclosures.

²⁹ Cal. C. Civ. Proc. § 1281.91(c). Like its predecessor (Cal. C. Civ. Proc. § 1281.9(d)), Section 1281.91(c) provides that the right of a party to disqualify a proposed neutral arbitrator shall be waived if the party fails to timely serve the notice required by this section.

³⁰ Cal. C. Civ. Proc. § 1281.91(d). Interestingly, this new section was not written to require mandatory disqualification by the arbitrator based upon disclosures made under the New Ethics Rules.

³¹ Cal. C. Civ. Proc. § 1286.2(a)(f) (redesignated in 2001 as (a)(6) by SB 475).

³² Cal. C. Civ. Proc. § 1286.2(a)(6)(A).

³³ Section 8 of Stats. 2001, c. 362 (SB 475). See, e.g., *Commonwealth*, supra; *Ray Wilson*, supra; *Reed v. Mutual Service Corp.* (2003) 106 Cal.App.4th 1359, 131 Cal.Rptr.2d 524; *Roitz v. Coldwell Banker Residential Brokerage*

SB 475 also added Section 1281.85 of the California Code of Civil Procedure, which delegated authority to the Judicial Council to adopt mandatory ethical standards for all individuals serving as neutral arbitrators in contractual arbitrations held in California and instructed that the Judicial Council do so by July 1, 2002.³⁴ Pursuant to this mandate, in April 2002 the Judicial Council adopted the “Ethics Standards for Neutral Arbitrators in Contractual Arbitration”.³⁵ Along with the statutory amendments created by SB 475, the new arbitrator ethics rules became effective on July 1, 2002 and apply to any person “serving as a neutral arbitrator pursuant to an arbitration agreement.”³⁶

The authority to disqualify an arbitrator based upon his or her failure to make conflict disclosures or the disclosures themselves has been vested with the parties since Section 1281.9 was first enacted in 1994.³⁷ Those disqualification procedures and rights are now codified at California Code of Civil Procedure Section 1281.91(a) and (b)(1). Section 1281.91, enacted pursuant to SB 475, goes further and now imposes an affirmative duty on the part of the neutral arbitrator to disqualify himself or herself if any disclosures are made under the “judicial” disclosure requirements which are now applicable to neutral arbitrators under Section

Co. (1998) 62 Cal.App.4th 716, 73 Cal.Rptr.2d 85; *Ceriali v. AMCO Ins. Co.* (1996) 48 Cal.App.4th 500, 55 Cal.Rptr.2d 685; *Luster v. Collins* (1993) 15 Cal.App.4th 1338, 19 Cal.Rptr.2d 215; *Neaman v. Kaiser Foundation Hospital* (1992) 9 Cal.App.4th 1170, 11 Cal.Rptr.2d 879; *Wheeler v. St. Joseph Hospital* (1976) 63 Cal.App.3d 345, 133 Cal.Rptr. 775.

³⁴ Cal. Code Civ. Proc. § 1281.85(a).

³⁵ The new ethics standards are codified at Division VI of the Appendix to the California Rules of Court.

³⁶ *Id.*

³⁷ As originally enacted, Section 1281.9(b) provided that a neutral arbitrator “shall be disqualified” if he or she failed to comply with the disclosure requirements set forth in Section 1281.9(a) and any party entitled to receive the disclosures served a notice of disqualification within 15 days of the arbitrator’s proposed appointment. Section 1281.9(c) provided that a neutral arbitrator “shall be disqualified” on the basis of his or her disclosures if any party entitled to receive the disclosure serves a notice of disqualification within 15 days after service of the disclosure statement. Stats. 1994, c. 1202 (SB 1638), § 1.

1281.9(a)(1),³⁸ thereby elevating arbitrator ethics to the level of judicial ethics with the stroke of the pen.

3. New Ethics Rules Cases

Since the effective date of the New Ethics Rules in July 2002, there has been a steady stream of cases – some reported and some not – involving the enforceability and application of the new legislation. While California is no stranger to controversy in the arbitration arena,³⁹ the litigation fanfare which has accompanied the New Ethics Rules legislation is unprecedented. As discussed below, the cases fall into four general categories and demonstrate through their conflicting holdings the clouds of controversy and uncertainty that presently hang over private arbitration in California. The four categories are: preemption challenges under federal securities law; preemption challenges under the Federal Arbitration Act (the “FAA”); contract defense challenges under California law; and cases applying the New Ethics Rules by seeking vacatur for failure to comply with the disclosure and disqualification requirements.

A. Federal Securities Law Preemption Challenges

(1) Backdrop

The SEC encourages the use of arbitration in resolving disputes arising out of the securities industry.⁴⁰ In 1987, the Supreme Court held in Shearson/American Express, Inc. v.

³⁸ Cal. C. Civ. Proc. § 1281.91(d).

³⁹ In 1984, the United States Supreme Court was asked to determine whether franchisees’ agreement to arbitrate all disputes with the franchisor was enforceable in the face of the California Franchise Investment Law which provided that franchise disputes were excepted from coverage under the California Arbitration Act and could not be forced to arbitration over the franchisee’s objection. Southland v. Keating (1984) 465 U.S. 1, 79 L.Ed.2d 1, 104 S.Ct. 852. The Supreme Court invalidated the California Franchise Investment Law provision in question (§ 1512) because it selected out arbitration agreements for invalidation on grounds not related to the enforceability of contracts in general.

⁴⁰ Jamie Kent, The Debate in California Over and Implications of New Ethical Standards for Arbitrator Disclosure: Are the Changes Valid or Appropriate?, 17 Geo. J. Legal Ethics 903, 906 (Summer 2004) (the “Kent Article”), citing, Michael A. Pierno, Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations (Nov. 4, 2002).

McMahon,⁴¹ that “claims arising under the Securities Exchange Act of 1934 ... could be submitted to arbitration.”⁴² Pursuant to this support, self-regulatory organizations (“SROs”) regulated by the SEC⁴³ have integrated arbitration into their operations.

Almost immediately after the New Ethics Rules became effective in July 2002, litigation was filed challenging the enforceability of the new disclosure and vacatur requirements as applied to arbitrations conducted by the NYSE, the second oldest national securities exchange in the United States,⁴⁴ and the NASD. As SROs, the NYSE and NASD are part of the comprehensive system of federal regulation of the securities industry. While SROs are subject to oversight by the SEC,⁴⁵ they are nevertheless private organizations. Under the Supremacy Clause, federal law preempts conflicting state law.⁴⁶ Federal regulations issued by an agency within the scope of its congressionally delegated authority are included among the “Laws of the United States” which can preempt state law.⁴⁷ The unique circumstance presented by the cases discussed below is that the arbitration rules at issue were adopted by the SROs – which are private entities – as distinguished from the SEC or some other federal agency.

⁴¹ (1987) 482 U.S. 220, 96 L.Ed.2d 185, 107 S.Ct. 2332

⁴² Kent Article, *supra*, citing, Carbonneau Article, *supra*, 40 Me. L. Rev. at 268.

⁴³ The National Association of Securities Dealers (“NASD”) and the New York Stock Exchange, Inc. (“NYSE”) are SROs registered with the SEC pursuant to 15 U.S.C. § 78a, et seq. (the “Exchange Act”). The NASD is registered under 15 U.S.C. § 78o-3. The NYSE is registered under 15 U.S.C. § 78f.

⁴⁴ 15 U.S.C. §§ 78a, et seq.; *see Mayo*, 258 F.Supp.2d at 1101.

⁴⁵ 15 U.S.C. § 78s; *Austin Mun. Securities, Inc. v. Nat’l Ass’n of Securities Dealers, Inc.* (5th Cir. 1985) 757 F.2d 676, 680.

⁴⁶ U.S. Const., art. VI, cl. 2.

⁴⁷ *City of New York v. FCC* (1988) 486 U.S. 57, 63-64, 100 L.Ed.2d 48, 108 S.Ct. 1637.

Prior to the adoption of the New Ethics Rules, the NYSE and NASD lobbied the California Legislature and Judicial Council for an exemption from the New Ethics Rules.⁴⁸ Those lobbying efforts failed. In response, the NYSE and NASD ceased appointing arbitrators to arbitrations in California as of the July 1, 2002 effective date of the New Ethics Rules because they believed those rules were inconsistent with their respective arbitrator disclosure rules and in conflict with the SRO arbitration programs which are part of a federal regulatory system overseen on a uniform, national basis by the SEC.⁴⁹ Both organizations likewise adopted interim rules, approved by the SEC, which gave customers and associated persons the option to waive application of the New Ethics Rules and proceed with arbitrator appointment under the NASD or NYSE rules or to proceed with arbitration out-of-state.⁵⁰

(2) NASD Case

In addition to the above-described actions, the NASD and NYSE also filed a declaratory relief action in July 2002 seeking a judicial determination that the New Ethics Rules were inapplicable to SRO arbitrations.⁵¹ The NASD case was dismissed on November 12, 2002 without reaching the merits based on the court's conclusion that the Judicial Council and its individual members (sued in their official capacities) were immune from suit in federal court

⁴⁸ Mayo, 258 F.Supp.2d at 1102.

⁴⁹ NASD "Notice to Parties in California Arbitration Matters"; NYSE "Notice to California Investors in Arbitration under NYSE Rules." Professor Menkel-Meadow has written that "perhaps the most important source of 'law' in ethics and standards in the conduct of arbitration is the contract or agreement that establishes the arbitration in the first place." Menkel-Meadow Article, supra, 56 U. Miami L. Rev. at 972. This is because contracts containing pre-dispute arbitration clauses frequently specify which SROs or provider organizations may conduct the arbitration and provides that the proceeding will be governed by the standards of the presiding organization. See, Scherk v. Alberto-Culver Co. (1974) 417 U.S. 506, 519, 41 L.Ed.2d 270, 94 S.Ct. 2449 ("An agreement to arbitrate before a specified tribunal is, in effect, a specialized kind of forum-selection clause that posits ... the procedure to be used in the dispute.")

⁵⁰ NASD Code of Arbitration Procedure, Rule 10100(f); NYSE Arbitration Rules, Rule 600(g).

⁵¹ NASD Dispute Resolution v. Judicial Council of CA (N.D.Cal. 2002) 232 F.Supp.2d 1055.

under the Eleventh Amendment.⁵² That determination thus left the issue to private-party litigation, of which there has been plenty.

(3) Mayo Case

In April 2003, the United States District Court for the Northern District of California decided *Mayo v. Dean Witter Reynolds, Inc.*,⁵³ which addressed the issue of whether the New Ethics Rules apply to SRO arbitrators in California. In *Mayo*, an account holder filed a state court action in March 2001 against an investment company alleging that company's failure to reimburse him for unauthorized ATM withdrawals in violation of the Electronic Funds Transfer Act and state law. The investment company removed the action to federal court and filed a motion to compel arbitration under the Federal Arbitration Act,⁵⁴ which was granted. In February 2002, the account holder commenced arbitration proceedings before the NYSE⁵⁵ by filing a statement of claim and executing a Uniform Submission Agreement.⁵⁶ The arbitration was never convened because, in July 2002, the NYSE informed the plaintiff that it would not appoint an arbitrator in his case because it was temporarily suspending the assignment of all arbitrators in California in response to the New Ethics Rules. Plaintiff then filed a motion seeking to be relieved entirely from his obligation to arbitrate the dispute, which the court construed as a motion for reconsideration on the basis of an intervening change in

⁵² Id. at 1063-1066.

⁵³ (N.D.Cal. 2003) 258 F.Supp.2d 1097.

⁵⁴ 9 U.S.C. §§ 1, et seq. (the "FAA").

⁵⁵ The Client Account Agreement signed by the plaintiff provided for arbitration "only before the New York Stock Exchange, Inc.; the National Association of Securities Dealers, Inc.; or the Municipal Securities Rulemaking Board, as [plaintiff] may elect." *Mayo*, 258 F.Supp.2d at 1099.

⁵⁶ The Uniform Submission Agreement provides that the arbitration "will be conducted in accordance with the Constitution, By-Laws, Rules, Regulations and/or Code of Arbitration Procedure of the sponsoring organization." *Mayo*, 258 F.Supp.2d at 1100.

circumstance:⁵⁷ namely, did the NYSE’s refusal to appoint an arbitration panel that was compliant with the New Ethics Rules constitute a change in circumstances warranting the requested relief?⁵⁸

The court in *Mayo* found that the Exchange Act and its subsequent amendments created “a detailed, comprehensive system of federal regulation of the securities industry,” in which SROs played an important and necessary role.⁵⁹ The court noted that while the SRO arbitration rules and California standards shared “similar goals with respect to disclosure and disqualification,”⁶⁰ the fact of common end did not mean that their means were not conflicting.⁶¹ The court found that the means were conflicting in several regards: that the New Ethics Rules would require arbitrators to disclose information that need not be disclosed under the NYSE or NASD rules;⁶² that application of the New Ethics Rules would require disqualification of arbitrators and vacatur of awards in circumstances where the SRO rules do not;⁶³ and that under the New Ethics Rules, the role of the Director of Arbitration for the NASD and NYSE would be greatly reduced if not totally eliminated.⁶⁴ The court concluded that the “disclosure and disqualification requirements of the SRO arbitration rules are tailored specifically to the

⁵⁷ *Mayo*, 258 F.Supp.2d at 1104.

⁵⁸ *Id.*

⁵⁹ 258 F.Supp.2d at 1108, citing *Swirsky v. Nat’l Ass’n of Securities Dealers* (1st Cir. 1997), 124 F.3d 59, 61.

⁶⁰ 258 F.Supp.2d at 1109.

⁶¹ *Id.*, citing *Crosby v. Nat’l Foreign Trade Council* (2000) 530 U.S. 363, 380, 147 L.Ed.2d 352, 120 S.Ct. 2288.

⁶² Compare Standard 7(d) with NASD Code of Arbitration Procedure, Rule 10312 and NYSE Arbitration Rules, Rule 610.

⁶³ Compare California Code of Civil Procedure Section 1286.2(a)(6) with NASD Code of Arbitration Procedure, Rules 10309-10313 and NYSE Arbitration Rules, Rules 608-611.

⁶⁴ 258 F.Supp.2d at 1110.

specialized nature of securities arbitration and that application of the New Ethics Rules to SROs would exert an “extraneous pull” on the regulatory scheme established by Congress.⁶⁵ The plaintiff thus had no right to require that NYSE or its arbitrators comply with the New Ethics Rules and was not relieved of his contractual obligation to arbitrate the dispute in accordance with its arbitration rules.

(4) Jevne Case

Following close on the heels of the *Mayo* decision, in November 2003 a California court of appeal addressed the issue of whether the New Ethics Rules were preempted by the Exchange Act in *Jevne v. Superior Court*.⁶⁶ In *Jevne*, investors filed an action in state court in the summer of 2000 against a brokerage firm alleging negligence, breach of fiduciary duties and conversion. Defendants responded with a motion to compel arbitration based on the arbitration provision in an agreement relating to one of the investment accounts in issue. The provision required all disputes arising out of the relationship between the parties to be settled through binding arbitration in accordance with the rules and procedures of the NASD. Plaintiffs did not oppose the motion to compel and, in February 2001, the court granted the motion. Thereafter, in May 2001, the parties signed a Uniform Submission Agreement memorializing their agreement to have the arbitration conducted in accordance with NASD rules and overseen by NASD’s Director of Arbitration. During the summer of 2001, the parties selected a three-arbitrator panel and arbitration was commenced in early 2002. In October 2002, one of the arbitrators voluntarily recused himself. By that time, the NASD had stopped appointing arbitrators in NASD arbitrations in California and, accordingly, informed plaintiffs that it would not appoint a

⁶⁵ 258 F.Supp.2d at 1111-1112.

⁶⁶ (2003) 113 Cal.App.4th 486, 6 Cal.Rptr.3d 542, review granted.

replacement arbitrator unless they agreed to waive the New Ethics Rules or agreed to have the arbitration conducted in another state. Plaintiffs would not agree to the waiver and instead filed a motion in the state court for an order setting aside the court's prior order compelling binding arbitration and restoring the matter to the civil trial calendar. Plaintiffs argued that the New Ethics Rules governed the NASD arbitration and that the agreement to arbitrate was no longer enforceable because the NASD refused to proceed with the arbitration without a waiver of the New Ethics Rules. The state trial court denied plaintiffs' motion concluding, in essence, that federal law preempted the New Ethics Rules. Plaintiffs then filed a petition for writ of mandate with the court of appeal which, in turn, issued an order to show cause.

On review by the state court of appeal, one of the issues raised was whether the New Ethics Rules were preempted by the Exchange Act.⁶⁷ Because no California state court had yet addressed this issue⁶⁸ and because of its "far reaching implications for the general public," the court of appeal invited amici curiae briefing from the NASD and NYSE, the SEC, the California Attorney General and the Judicial Council of California on the issue of federal conflict preemption.⁶⁹ In this regard, the court of appeal noted that because Congress has provided for concurrent state regulation of securities,⁷⁰ there was no express or field preemption under the federal securities laws of the New Ethics Rules,⁷¹ and only conflict preemption was implicated in

⁶⁷ 6 Cal.Rptr.3d 542, 547-548.

⁶⁸ Id., fn. 2, citing *Alan v. Superior Court (UBS Painewebber, Inc.)* (2003) 111 Cal.App.4th 217, 231, 3 Cal.Rptr.3d 344, where federal preemption was raised but, because the NASD was not a party in the case and had not filed an amicus curiae brief, the court deferred decision on that issue to other civil actions in which the NASD was an active participant.

⁶⁹ 6 Cal.Rptr.3d 542, 554.

⁷⁰ 15 U.S.C. § 77r.

⁷¹ 6 Cal.Rptr.3d 542, 554, citing, *Roskind v. Morgan Stanley Dean Witter & Co.* (2000) 80 Cal.App.4th 345, 352, 95 Cal.Rptr. 258 (state law remedies and regulations available under California Business and Professions Code Section 17200 supplement federal securities law).

the case.⁷² The court of appeal then found that there was an actual conflict between the New Ethics Rules⁷³ and the NASD rules⁷⁴ concerning arbitrator disqualification. Under Standard 10, an arbitrator is disqualified when a party files a notice with the court, and assuming the arbitrator fails to disqualify himself or herself upon learning the challenge, the superior court will make the ultimate decision on disqualification. In contrast, under the NASD rules, the Director of Arbitration has the final say on any challenge for cause or any determination that a conflict of interest warranting disqualification exists. The court of appeal thus held that there was “no reconciling the conflict between the [New Ethics Rules] and the NASD Rules; it is simply impossible to comply with both of them.”⁷⁵

The court of appeal in *Jevne* also addressed the conflicts between the disclosures required under Standard 7 of the New Ethics Rules⁷⁶ and those required under the NASD rules.⁷⁷ In the court’s view, the New Ethics Rules were “simply more detailed than the NASD disclosure rules, which in itself does not make it impossible for parties, and in particular arbitrators, to comply with both sets of rules;”⁷⁸ that a “difference in drafting philosophy does not present a physical conflict requiring preemption.”⁷⁹ However, the lack of an actual conflict did not end the court’s

⁷² Id.

⁷³ CRC, Appendix, Div. VI, Std. 10.

⁷⁴ NASD Code of Arbitration Rules 10308-10313.

⁷⁵ 118 Cal.App.4th 486, 6 Cal.Rptr.3d 541, 555.

⁷⁶ CRC, Appendix, Div. VI, Std. 7(d).

⁷⁷ NASD Code of Arbitration Rules 10312(a).

⁷⁸ 113 Cal.App.4th 486, 6 Cal.Rptr.2d 542, 558.

⁷⁹ Id. On this point, the court of appeal noted that its conclusion differed from that of the *Mayo* court, but reasoned that the *Mayo* decision only had persuasive value and was not binding precedent for California state court. Id., citing, *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 830, 623 P.2d 165, 171 Cal.Rptr. 604.

inquiry and, ultimately, the court found that Standard 7 “stands as an obstacle to the Exchange Act,” and was thus preempted.⁸⁰

(5) **Grunwald Case**

Most recently, the Ninth Circuit handed down an expedited decision in *Credit Suisse First Boston Corp. v. Grunwald*⁸¹ and held that while NASD arbitrators come within the definition of “neutral arbitrators” under the New Ethics Rules, the Exchange Act preempts application of those rules to NASD-appointed arbitrators. *Grunwald* involved an employment dispute between Scott Grunwald and his former employer, Credit Suisse First Boston (“CSFB”). After CSFB terminated Grunwald, he exhausted CSFB’s internal grievance procedures and participated in a mediation through JAMS/Endispute, which were the initial steps required by CSFB’s dispute resolution program. Grunwald then filed a demand for arbitration with AAA. CSFB successfully obtained a preliminary injunction in district court that enjoined Grunwald from arbitrating before AAA because CSFB’s dispute resolution program required employees registered with NASD – like Grunwald – to arbitrate before an arbitration panel appointed by NASD. Grunwald then filed a demand for arbitration with NASD. Before the NASD appointed Grunwald’s arbitration panel, the New Ethics Rules were adopted and, similar to the facts in *Mayo* involving arbitration before the NYSE, the NASD refused to appoint a panel of arbitrators in California unless Grunwald waived the application of the New Ethics Rules or agreed to an

⁸⁰ Id., citing *Crosby v. Nat’l Foreign Trade Council* supra, 530 U.S. 363, 372, the court of appeal noted that “[p]reemption may be found either where a state law conflicts with a federal law or where the state law stands as an obstacle to the federal law.” (Emphasis in original.) The court went on to note that the SEC had concluded that allowing California arbitrations to be administered under a different set of rules would introduce inconsistency into the process and would thus undermine the national system of SRO arbitrations. In light of the SEC’s “intense oversight” in the area of SRO arbitrations, the court was reluctant to “second guess the SEC’s determination” and felt “compelled to defer to the agency’s judgment.” Id., at 560, citing *Greier v. American Honda Motor Co. Inc.* (2000) 529 U.S. 861, 883, 146 L.Ed.2d 914, 120 S.Ct. 1913; *Cohen v. Wedbush, Noble, Cooke, Inc.* (9th Cir. 1988) 841 F.2d 282, 286.

⁸¹ 2005 WL 466202 (March 1, 2005).

out-of-state arbitration. Grunwald refused to waive the New Ethics Rules and declined the NASD's offer to proceed with arbitration outside California. He then filed a motion with the district court seeking modification or dissolution of the injunction order so that he could re-file his claims in state court or proceed to arbitration before AAA. That motion was denied based on the district court's findings that the New Ethics Rules do not apply to NASD arbitrators and that he could obtain a speedy and expeditious arbitration by submitting to arbitration outside California or by waiving application of the New Ethics Rules. Grunwald took the matter up on appeal to the Ninth Circuit.

On appeal, the Ninth Circuit viewed the issue presented as whether SRO rules can preempt conflicting state laws even though they are rules adopted and enforced by private organizations. On that issue, this was a case of first impression.⁸² The Ninth Circuit concluded that in light of the Ware decision and the 1975 amendments to the Exchange Act, which removed the original statute's requirement that all SRO rules be consistent with "the applicable laws of the State in which [the exchange] is located," the SRO rules approved by the Exchange Commission⁸³ had preemptive force and would preempt the New Ethics Rules if they were found to be in conflict with the NASD arbitration disclosure rules.⁸⁴

⁸² In Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware (1973) 414 U.S. 117, 38 L.Ed.2d 348, 94 S.Ct. 383, the Supreme Court had only suggested by implication that SRO rules can in certain circumstances have preemptive force (conflicting state law "should be preempted by exchange self-regulation 'only to the extent necessary to protect the achievement of the aims of the Securities Exchange Act.'" Id. at 127, quoting Silver v. New York Stock Exchange (1963) 373 U.S. 341, 361, 10 L.Ed.2d 389, 83 S.Ct. 1246.

⁸³ The ultimate approval of a proposed SRO rule reflects the determination by the Exchange Commission that a rule is consistent with the purposes of the Exchange Act. 15 U.S.C. § 78s(b)(2); Shearson/Am. Express, Inc. v. McMahon, supra, 482 U.S. 220, 223 ("No proposed rule change may take effect unless the SEC finds that the proposed rule is consistent with the requirements of the Exchange Act." Additionally, the 1975 amendments to the Exchange Act gave the Exchange Commission the power to abrogate, add to and delete from the rules of any SRO "as the Commission deems necessary or appropriate to insure the fair administration" of the SRO. 15 U.S.C. § 78s(c).

⁸⁴ Grunwald, 2005 WL 477202, p. 7.

The Ninth Circuit found that the New Ethics Rules did conflict with the NASD arbitration disclosure rules and, as such were preempted. First, the court found that the NASD could not simultaneously comply with the disqualification rules of both the NASD and the New Ethics Rules. Under the New Ethics Rules, if an arbitrator fails to make a required disclosure or makes a disclosure which a party finds objectionable, that arbitrator is subject to mandatory and automatic disqualification once a party serves a timely notice of disqualification.⁸⁵ If the arbitrator fails to remove himself or herself from the panel, the arbitration award is then subject to mandatory vacatur.⁸⁶ In contrast, the NASD rules provide that the Director of Arbitration “may” remove an arbitrator if he or she fails to make a required disclosure.⁸⁷ Thus, the New Ethics Rules require disqualification once a party serves a notice of disqualification, while the NASD rules grant discretion to the NASD Director of Arbitration to decide whether an arbitrator should be disqualified.⁸⁸ Application of the New Ethics Rules “would strip the Director of Arbitration of his federally-recognized obligation to make a determination whether an arbitrator should in fact be disqualified.”⁸⁹

Next, the court found that in contrast to the disqualification rules, it was not physically impossible for an arbitrator to simultaneously comply with the New Ethics Rules and the rules governing NASD arbitrations. “Nothing in the NASD Code prevents an arbitrator from

⁸⁵ CRC, Appendix, Div. VI, Std. 10(a)(1).

⁸⁶ Cal. C. Civ. Proc. § 1286.2(a)(6).

⁸⁷ NASD Code of Arbitration Rule 10308(d)(2).

⁸⁸ 2005 WL 477202, p. 11.

⁸⁹ Id.

disclosing more information than is required by the NASD Code's disclosure rule."⁹⁰ The court concluded, however, that the second type of conflict preemption – frustration of purpose – applied and accepted the position of the Commission that the application of the New Ethics Rules to NASD arbitrations “would frustrate the objectives of the Exchange Act.”⁹¹

(6) Conclusion

Disputes arising under customer and employment contracts in the securities industry seem to be directly analogous to disputes arising under collective bargaining agreements because (a) both are governed by federal law representing national policy for important aspects of interstate commerce which should be consistently applied on a nationwide basis, and (b) both have their own government-sanctioned dispute resolution tribunals and rules. Based on the fact that both the state and federal courts which have addressed the issue of federal securities law preemption have concluded that the New Ethics Rules do indeed conflict with NYSE and NASD regulatory scheme established by Congress, it is probably only a matter of time before there is a definitive decision on this issue by the United States Supreme Court and possibly even the California Supreme Court if the California Legislature does not take action to amend the New Ethics Rules to except NASD and NYSE arbitrators from compliance with the new ethics standards. Given the depth of reasoning in the *Mayo*, *Jevne* and *Grunwald* cases discussed above and the “failure of forum” problem discussed in Section 3(C) below, it is surprising that the California Legislature has persisted in this standoff and, to date, has refused to amend the

⁹⁰ Id., citing NASD Code of Arbitration Rule 10312(a) and *North Star Int'l v. Ariz. Corp. Comm'n* (9th Cir. 1983) 720 F.2d 578, 583 (“While the state standards are more stringent than the federal standards, it is possible to comply with both.”)

⁹¹ 2005 W. 477202, p. 12, citing *Medtronic, Inc. v. Lohr* (1996) 518 U.S. 470, 496, 135 L.Ed.2d 700, 116 S.Ct. 2240 (“[b]ecause the [Commission] is the federal agency to which Congress has delegated its authority to implement the provisions of the [Exchange Act], the agency is uniquely qualified to determine whether a particular form of state law ‘stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’”).

New Ethics Rules to grant an exception to neutral arbitrators hearing disputes under the Exchange Act who are appointed by the NYSE or NASD arbitration tribunals.

B. Federal Arbitration Act Preemption Challenges

(1) Backdrop

The FAA was enacted in 1925 and declares a national policy favoring arbitration of disputes.⁹² Its purpose was “to reverse the longstanding judicial hostility to arbitration agreements that had existed at English common law and had been adopted by American courts, and to place arbitration agreements on the same footing as other contracts.”⁹³ In order for an agreement to arbitrate to be subject to the FAA, the agreement itself must involve a “maritime transaction or a contract evidencing a transaction involving commerce.”⁹⁴ The FAA requires courts to enforce arbitration agreements and leaves no room for the exercise of discretion, unless there is a ground to revoke the agreement.⁹⁵ In a series of decisions handed down since 1983, the Supreme Court has construed the FAA as a federal declaration of pro-arbitration public policy that preempts contrary state law.⁹⁶

⁹² *Mastrobuono v. Shearson Lehman Hutton, Inc.* (1995) 514 U.S. 52, 56, 131 L.Ed.2d 76, 115 S.Ct. 1212.

⁹³ *Gilmer v. Interstate/Johnson Lane Corp.* (1991) 500 U.S. 20, 24, 114 L.Ed.2d 26, 111 S.Ct. 1647; *Volt*, supra, 489 U.S. 468, 474..

⁹⁴ 9 U.S.C. § 2. Section 2 of the FAA provides that a written agreement to arbitrate in any contract involving interstate commerce or a maritime transaction “shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.” Section 1 of the FAA then defines “commerce” as “commerce among the several States or with foreign nations, or in any Territory of the United States or in the District of Columbia, or between any such Territory or another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation,” and expressly excludes application to employment contracts of seamen, railroad employees or any other class of workers engaged in foreign or interstate commerce. 9 U.S.C. § 1.

⁹⁵ 9 U.S.C. § 4; *Dean Witter Reynolds, Inc. v. Byrd* (1985) 470 U.S. 213, 218, 84 L.Ed.2d 158, 105 S.Ct. 1238; see also *Circuit City Stores, Inc. v. Adams* (2001) 432 U.S. 105, 112, 149 L.Ed.2d 234, 121 S.Ct. 1302.

⁹⁶ Stephen L. Hayford, *Federal Preemption and Vacatur: The Bookend Issues Under the Revised Uniform Arbitration Act*, 2001 J. Disp. Resol. 67, 68 (“Hayford Article”); see also, *Perry v. Thomas* (1987) 482 U.S. 483, 489, 96 L.Ed.2d 426, 107 S.Ct. 2520 (“Section 2 is a congressional declaration of a liberal federal policy favoring arbitration agreements, notwithstanding any state substantive or procedural rules to the contrary.”).

FAA preemption has been defined by six recent Supreme Court opinions which spring from the Court's earlier opinions in Prima Paint Corp. v. Flood & Conklin Mfg. Corp.,⁹⁷ and Moses H. Cone Memorial Hospital v. Mercury Construction Corp.⁹⁸ In those cases, the Supreme Court stated its belief that the FAA is an exercise of the Commerce Clause authority creating a body of federal substantive law governing arbitration, applicable in both the federal and state courts.⁹⁹ There are two dimensions to the law of preemption:¹⁰⁰ The first concerns state law which is found to conflict with the FAA and is represented by Southland Corp. v. Keating,¹⁰¹ Perry v. Thomas,¹⁰² Allied-Bruce Terminix Cos. v. Dobson¹⁰³ and Doctor's Associates v. Casarotto.¹⁰⁴ The second concerns interpretation of the parties' contractual agreements to arbitrate in the course of determining the effect of those agreements on the state law-FAA preemption interaction,¹⁰⁵ and is embodied in Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University¹⁰⁶ and Mastrobuono v. Shearson Lehman Hutton, Inc.¹⁰⁷

⁹⁷ (1967) 388 U.S. 395, 18 L.Ed.2d 1270, 87 S.Ct. 1801.

⁹⁸ (1983) 460 U.S. 1, 24, 74 L.Ed.2d 765, 103 S.Ct. 927.

⁹⁹ Hayford Article, supra, p. 69.

¹⁰⁰ Id. at p. 69.

¹⁰¹ 465 U.S. 1.

¹⁰² 482 U.S. 483.

¹⁰³ (1995) 513 U.S. 265, 115 S.Ct. 834, 130 L.Ed.2d 753.

¹⁰⁴ (1996) 517 U.S. 681, 116 S.Ct. 1652, 134 L.Ed.2d 902.

¹⁰⁵ Hayford Article, supra, p. 69.

¹⁰⁶ (1989) 489 U.S. 468, 103 L.Ed.2d 488, 109 S.Ct. 1248.

¹⁰⁷ (1995) 514 U.S. 52, 131 L.Ed.2d 76, 115 S.Ct. 121.

The FAA itself contains no express preemptive provisions, nor does it reflect a congressional intent to occupy the entire field of arbitration.¹⁰⁸ Likewise, the FAA does not represent a federal policy of favoring arbitration under a certain set of procedural rules.¹⁰⁹ States are free to establish their own arbitration rules and procedures even where the controversy is governed by federal substantive law.¹¹⁰ State laws concerning arbitration are only preempted to the extent that they conflict with congressional intent to favor the enforcement of arbitration agreements.¹¹¹ In this regard, state laws may be preempted to the extent that they actually conflict with federal law or stand “as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”¹¹²

As a general rule, state laws that single out arbitration agreements for special scrutiny in terms of enforceability or suspect status have been viewed as inhospitable to arbitration and routinely have been found to be preempted under the FAA.¹¹³ State laws that are not anti-arbitration are not automatically preempted under the FAA. In this regard, the Supreme Court has specifically recognized California’s procedures and rules governing arbitration as being

¹⁰⁸ *Volt*, supra, 489 U.S. at 477.

¹⁰⁹ *Id.* at 467-477.

¹¹⁰ *Felder v. Casey* (1988) 487 U.S. 131, 138, 101 L.Ed.2d 123, 108 S.Ct. 2302.

¹¹¹ *Volt*, supra, 489 U.S. at 477.

¹¹² *Id.*, quoting *Hines v. Davidowitz* (1941) 312 U.S. 52, 67, 85 L.Ed. 581, 61 S.Ct. 399; see also *Southland*, supra, 465 U.S. 1, 16; *Perry v. Thomas*, supra, 482 U.S. at 489-490.

¹¹³ See, e.g., *Doctor’s Associates*, supra, 517 U.S. 681 (preempting Montana law which invalidated arbitration agreements unless they contained special notice placed on first page of the agreement); *Allied-Bruce*, supra, 513 U.S. 265, 270 (preempting Alabama law which invalidated predispute arbitration agreements); *Southland*, supra, 465 U.S. 1 (preempting California law which invalidated arbitration agreements between franchisors and franchisees).

“designed to encourage resort to the arbitration process” and not to conflict with “any policy embodied in the FAA.”¹¹⁴

Prior to the enactment of the New Ethics Rules, the law was clear that there was no federal policy favoring arbitration under a certain set of procedural rules; that federal policy was directed at simply ensuring “the enforceability, according to their terms, of private agreements to arbitrate.”¹¹⁵ In the cases discussed below, the courts were asked to determine whether the FAA preempted the New Ethics Rules and thus made them legally ineffective in arbitrations subject to the FAA, potentially reaching far beyond the securities arbitrations discussed in Section A, above.

(2) Mayo Case

As discussed in Section A, above, in April 2003, the United States District Court for the Northern District of California was asked to decide whether the New Ethics Rules apply to SRO arbitrators in California.¹¹⁶ In addition to the preemption challenge under the Exchange Act, the court was also ask to determine whether the New Ethics Rules were preempted under the FAA.¹¹⁷ In ruling on this issue, the court adopted the contract analysis seen in Volt and held that under the FAA, the defendant (Morgan Stanley) had a right to enforce the arbitration agreement according to its terms, which terms provided for arbitration before the NYSE in accordance with

¹¹⁴ Volt, supra, 489 U.S. at 476.

¹¹⁵ Mastrubono, supra, 514 U.S. 52, 66, quoting Volt, supra, 489 U.S. at 476. “Indeed, short of authorizing trial by battle or ordeal or, more doubtfully, by a panel of three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes.” Baravati v. Josephthal, Lyon & Ross, Inc. (7th Cir. 1994) 28 F.3d 704, 709.

¹¹⁶ Mayo, supra, 258 F.Supp.2d 1097.

¹¹⁷ Id. at 1112-1116.

NYSE arbitration rules.¹¹⁸ The court thus determined that application of the New Ethics Rules “would impose inconsistent and conflicting procedural rules upon those specifically agreed upon by the parties.”¹¹⁹ Because such a result is impermissible under the FAA, the court held that the New Ethics Rules “at least as applied here, conflict with the FAA and the federal policy embedded therein.”¹²⁰ On this point, the court rejected the California Attorney General’s argument that the New Ethics Rules do not offend any principle of the FAA because the Supreme Court had previously stated in Commonwealth Coatings Corp. v. Continental Casualty Co.¹²¹ that it could “perceive no way in which the effectiveness of the arbitration process [would] be hampered by the simple requirement that arbitrators disclose to the parties any dealings that might create an impression of possible bias.”¹²² The court found that the New Ethics Rules “do a great deal more than require additional disclosure” and that preemption is not precluded just because the New Ethics Rules and the FAA may share similar goals.¹²³ The turning point in the court’s analysis was the specific agreement of the parties to submit to arbitration before the NYSE in accordance with its rules. Significantly, the court did not determine that the New Ethics Rules conflicted directly with the FAA. The court was careful to limit its ruling to the circumstances and issues presented by plaintiff’s dispute with Morgan Stanley: namely, the terms of those parties’ pre-dispute arbitration agreement.¹²⁴

¹¹⁸ Id. at 1114.

¹¹⁹ Id.

¹²⁰ Id.

¹²¹ (1968) 393 U.S. 145, 21 L.Ed.2d 301, 89 S.Ct. 337.

¹²² Id. at 149.

¹²³ 258 F.Supp.2d at 1114.

¹²⁴ Id. at 1115-1116.

(2) **Jevne Case**

As discussed in Section A, above, in November 2003 the California court of appeal was asked to decide whether the New Ethics Rules apply to SRO arbitrators in California.¹²⁵ Unlike *Mayo*, the court in *Jevne* first addressed whether the New Ethics Rules were preempted under the FAA before addressing preemption under the Exchange Act.¹²⁶ In *Jevne*, it was argued that the FAA preempted the New Ethics Rules because they applied only to arbitration contracts and imposed terms which differed from those in the parties' arbitration agreement. The Court noted that state laws concerning arbitration are only preempted to the extent that they conflict with congressional intent to favor the enforcement of arbitration agreements; that state laws that are not anti-arbitration or antagonistic to the process are not automatically preempted by the FAA even though the state law relates only to arbitration agreements; and that the Supreme Court has previously recognized that California's procedures and rules governing arbitration "are manifestly designed to encourage resort to the arbitral process," do not conflict with "any policy embodied in the FAA" and "generally foster the federal policy favoring arbitration."¹²⁷ The court found that the New Ethics Rules were "consistent with the other California arbitration procedures the *Volt* court endorsed" and rejected the general preemption argument.¹²⁸

It was also argued in *Jevne* that the New Ethics Rules were preempted by the FAA as applied to the facts of that particular case because the New Ethics Rules differ from the NASD arbitration procedures specifically agreed to by the parties in their arbitration agreement. The real parties in interest argued that under the FAA they are entitled to have the arbitration

¹²⁵ *Mayo*, supra, 258 F.Supp.2d 1097.

¹²⁶ 6 Cal.Rptr. 542, 551.

¹²⁷ Id. at 552, citing *Volt*, supra, 489 U.S. at 476.

¹²⁸ Id. at 552, citing *Commonwealth*, supra, 393 U.S. at 149.

agreement enforced according to its terms. The real parties in interest argued that Jevne's efforts to avoid arbitration altogether based on the New Ethics Rules must fail because an arbitration agreement subject to the FAA may be invalidated only on legal or equitable grounds applying to the revocation of any contract.¹²⁹ While the court agreed that some question remained as to whether the New Ethics Rules were preempted as a *matter of fact*, it declined to reach that issue in view of its conclusion that the New Ethics Rules were preempted by the Exchange Act.¹³⁰

4. Conclusion

Jevne and *Mayo* represent two different approaches to the FAA preemption issue and two different outcomes. The *Mayo* decision found preemption under the FAA as a matter of fact, based upon the court's interpretation of and reference to the parties' contract which provided for arbitration before the NYSE in accordance with its rules. In order to enforce the parties' agreement to arbitrate before their selected tribunal, the court had to respect the rules of that tribunal which the court had already found were preempted by the Exchange Act, and in this context found preemption under the FAA. Significantly, the *Mayo* court did not determine that the New Ethics Rules conflicted directly with the FAA. The *Jevne* decision is thus important because it did address the issue of whether the New Ethics Rules conflict directly with the FAA and concluded that they do not, at least with respect to the disclosure requirements.

C. Impossibility and Other Contract Defense Challenges

Under Section 2 of the FAA, an agreement to arbitrate is valid, irrevocable and enforceable, as a matter of federal law, except upon such grounds as exist as defenses to the validity or enforceability of contracts generally. A state law principle that takes it meaning

¹²⁹ Id. at 552, fn. 8, citing 9 U.S.C. § 2; *Southland*, supra, 465 U.S. 1, 10.

¹³⁰ Id. at 552, fn. 8

precisely from the fact that a contract to arbitrate is at issue does not comport with Section 2 of the FAA.¹³¹ In assessing the rights of litigants to enforce an arbitration agreement, the court may not construe that agreement in a manner different from that in which it otherwise construes nonarbitration agreements under state law, nor may a court rely on the uniqueness of an agreement to arbitrate as a basis for holding that enforcement would be unconscionable.¹³²

The first reported decision to address challenges to the New Ethics Rules in the context of contract defense challenges was Alan v. Superior Court (USB Painewebber, Inc.)¹³³ decided in August 2003 by Division 1 of the California Court of Appeal, Second District. In Alan, the court was asked to interpret the arbitration provisions contained in the parties' customer agreement and decide whether the agreement to arbitrate was unenforceable in view of the NASD's refusal to provide an arbitral forum in California: i.e., could plaintiff be excused from his obligation to arbitrate based on NASD's refusal to perform?¹³⁴ The Alan case started with plaintiff bringing a civil action in state court even though the customer agreement required him to arbitrate before NASD, NYSE or another national securities exchange. The customer agreement provided that if the investor failed to select the arbitral forum, the brokerage firm could select the arbitral forum.¹³⁵ In response to the lawsuit, the defendants filed a motion seeking an order compelling the plaintiff to arbitrate the dispute and staying the state court action. Because the plaintiff had

¹³¹ Perry v. Thomas (1987) 482 U.S. 483, 492-493, fn. 9, 96 L.Ed.2d 426, 107 S.Ct. 2520.

¹³² Id.; see also Thomas v. Perry (1988) 200 Cal.App.3d 510, 514-515, 246 Cal.Rptr. 156 (argument that the NYSE rules for selection of an arbitrator are unfair is clearly the type addressed to the uniqueness of an agreement to arbitrate).

¹³³ (2003) 111 Cal.App.4th 217, 3 Cal.Rptr.3d 377.

¹³⁴ Alan, supra, 111 Cal.App.4th 217. The court was also asked to determine that the New Ethics Rules were preempted by federal law. Because the NASD was not a party to the writ proceedings, the court refused to address this argument as raised by defendants. Id. at 231.

¹³⁵ Id. at 220-221.

not selected an arbitral forum, the defendants designated the NASD as the arbitral forum.¹³⁶ The trial court granted defendant’s motion and ordered the plaintiff to proceed to arbitration before the NASD, disregarding plaintiff’s claim that the NASD was no longer appointing arbitrators in California as a result of the dispute concerning the application of the New Ethics Rules to SROs, as discussed in Section 3(A), above.¹³⁷

Without submitting the matter to the NASD, the plaintiff filed a petition for writ of mandate to the California Court of Appeal. Plaintiff’s petition for writ of mandate was granted based on the court’s finding that (a) because the customer agreement required all arbitrations to be conducted in a forum convened by, and subject to the rules of, the chosen SRO, and (b) because the NASD and NYSE were no longer convening arbitrations in California, it was impossible to enforce the agreement to arbitrate because there was a failure of forum.¹³⁸ The court rejected defendants’ argument that the trial court could appoint an arbitrator under California Code of Civil Procedure Section 1281.6¹³⁹ in the absence of the NASD doing so, finding that because the parties agreement to arbitrate designated the NASD as the arbitral forum, only its arbitrators – not an arbitrator outside the NASD – could be appointed to hear the

¹³⁶ Id. at 223.

¹³⁷ Id.

¹³⁸ Id.

¹³⁹ Section 1281.6 of the California Code of Civil Procedure states: “If the arbitration agreement provides a method of *appointing an* arbitrator, that method shall be followed. If the arbitration agreement does not provide a method for appointing an arbitrator, the parties to the agreement who seek arbitration and against whom arbitration is sought may agree on a method of *appointing an arbitrator* and that method shall be followed. In the absence of an agreed method, or if the agreed method fails or for any reason cannot be followed, or when an arbitrator appointed fails to act and his or her successor has not been appointed, *the court* on petition of a party to the arbitration agreement, *shall appoint the arbitrator.*” (Italics added.)

matter in accordance with NASD rules.¹⁴⁰ While acknowledging that it was consistent under both the California Arbitration Act and the FAA for the court to appoint an arbitrator if that was the obstacle to convening an arbitration,¹⁴¹ the court found that its appointment of an arbitrator was “not an adequate alternative to an NASD forum.”¹⁴²

The case was remanded to the trial court to decide whether any out-of-state location selected by NASD was a reasonable and proper forum to hear the dispute. In this regard, the defendants argued that plaintiff had no legitimate grounds to complain about being forced to attend an arbitration in another state because the forum selection clause in the NASD rules allow the NASD to conduct the hearing in any location it chooses.¹⁴³ The court held that defendants’ interpretation of the NASD Code of Arbitration was “open to challenge” because the case law is clear that a court may set aside a forum-selection clause if enforcement would be unreasonable or unjust or if proceedings in the contractual forum would be so gravely difficult and inconvenient that the resisting party would for all practical purposes be deprived of his day in court.¹⁴⁴ The court concluded by remanding the case back to the trial court to decide whether the out-of-state location selected by NASD was proper, stating that “[i]f the out-of-state location is

¹⁴⁰ 111 Cal.App.4th at 224-227, citing, *In re Salomon Inc. Shareholders’ Derivative Lit.* (2d Cir. 1995) 68 F.3d 554 (failure of NYSE forum due to the NYSE’s decision that the disputed should not be arbitrated, which was within its discretion to do).

¹⁴¹ Id. at 228-229, citing, *Brown v. ITT Consumer Financial Corp.* (11th Cir. 2000) 211 F.3d 1217, 1222 (arbitration may proceed in forum not mentioned in arbitration clause where choice of arbitral forum was not an integral part of the agreement); *Lewis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1986) 183 Cal.App.3d 1097, 1107, 228 Cal.Rptr. 345 (dictum stating that arbitral for a contained in arbitration provision were not exclusive arbitral for a; no analysis of whether choice of for a was an integral term of the agreement); *McManus v. CIBC World Markets Corp.* (2003) 109 Cal.App.4th 76, 102, 134 Cal.Rptr.2d 446 (same).

¹⁴² Id. at 229.

¹⁴³ Id. at 230.

¹⁴⁴ Id., citing, *Mitsubishi Motors v. Soler Chrysler-Plymouth* (1985) 473 U.S. 614, 632-633, 87 L.Ed.2d 444, 105 S.Ct. 3346; *Dominium Austin Partners, L.L.C. v. Emerson* (8th Cir. 2001) 248 F.3d 720, 726; *Hayes Children Leasing Co. v. NCR Corp.* (1995) 37 Cal.App.4th 755, 787, fn. 5, 43 Cal.Rptr.2d 650; *Bolter v. Superior Court* (2001) 87 Cal.App.4th 900, 104 Cal.Rptr.2d 888; *Wilmot v. McNabb* (N.D.Cal. 2003) 269 F.Supp.2d 1203.

proper, the dispute should be resolved through arbitration there. If the out-of-state location is not proper, the dispute should be resolved here and ... should be adjudicated in court.”¹⁴⁵

On remand, the trial court concluded: (1) the New Ethics Rules were preempted by federal law; (2) the New Ethics Rules could not be applied retroactively to modify or amend any provision of the client agreements; and (3) by agreeing to arbitrate future disputes before the NASD according to the rules of the NASD, plaintiff prospectively waived the applicability of the New Ethics Rules.¹⁴⁶ The trial court thus renewed its order directing the matter back to arbitration.¹⁴⁷ Plaintiff filed a “Statement of Claim” with the NASD and paid the required filing fee, but the NASD would not assign a location for the hearing unless plaintiff first waived any objection to the location. Plaintiff refused to give such a waiver in order to preserve his right to return to the trial court. Given this deadlock, the NASD closed the case without hearing and without prejudice. Plaintiff then returned to the trial court and filed a motion for reconsideration of the order directing the matter to arbitration, arguing that because the NASD refused to adjudicate the matter absent a waiver, there was a failure of arbitral forum and the case should be tried in court. The trial court granted the motion for reconsideration but, upon reconsideration, concluded that the matter should be arbitrated. However, because the NASD refused to convene an arbitration without a waiver from plaintiff, which plaintiff would not give, the suit was in limbo.¹⁴⁸ Plaintiff then filed a second petition with the California Court of Appeal for a peremptory writ of mandate.¹⁴⁹

¹⁴⁵ Id.

¹⁴⁶ *Alan v. Superior Court* (2005) 2004 WL 293286, page 4 (Not Officially Published).

¹⁴⁷ Id.

¹⁴⁸ Id.

¹⁴⁹ Id. at 5.

In the second appeal, the court rejected defendants' contention that arbitration was required because the trial court had resolved the preemption, retroactivity and prospective waiver issues in their favor because -- despite those rulings -- the NASD "was not influenced" and "still refused to arbitrate the dispute."¹⁵⁰ The appellate court determined that the dispute "is to be tried in court" because the NASD, the forum selected by the defendants, refused to hear the matter and was "not willing to conduct arbitrations in California, absent a signed waiver, until the pending litigation -- in the California Supreme Court, the Ninth Circuit, and possibly the United States Supreme Court -- is final."¹⁵¹ The appellate court concluded that there was thus not "a plain, speedy and adequate remedy at law." The trial court was instructed to vacate the orders compelling arbitration and to restore the case to the civil active list for trial.¹⁵²

Since the Alan case was first reported in 2003, there have been a number of cases, mostly unreported, where plaintiffs sought to avoid their contractual obligations to arbitrate securities disputes through various contract defense attacks similar to that raised in Alan.¹⁵³ The only case to follow Alan was a decision reported by Division 6 of the Second District of the California

¹⁵⁰ Id.

¹⁵¹ Id.

¹⁵² Id. In this regard, the court noted that plaintiff had filed his complaint in September 2002 and that the statistics provided by the Judicial Council showed that during the 2002-2003 fiscal year, 93 percent of all general unlimited civil cases filed in Los Angeles Superior Court reached disposition within two years, and that is was thus "time for this case to be heard." Id. The court also noted that "California has a long established and well settled policy favoring arbitration as a speedy and inexpensive means of settling disputes." Id. at page 2, citing Hightower v. Superior Court (2001) 86 Cal.App.4th 1415, 1431, 104 Cal.Rptr. 209.

¹⁵³ Wilmot v. McNabb, supra 269 F.Supp.2d 1203; Belinsky v. BPM Goldman Financial Design, LLC (Cal.App.1st Dist. 2004) 2004 WL 263250 (Not Officially Published); Chen v. Morgan Stanley DW Inc. (Cal.App.2nd Dist. 2004) 2004 WL 33433 (Not Officially Published); Davis v. Oppenheimer & Co. (Cal.App.1st Dist. 2004) 2004 WL 1053191 (Not Officially Published); Linden v. American Express Financial, Inc. (Cal.App.2nd Dist. 2003) 2003 WL 22430229 (Not Officially Published); Marcus v. Trautman Wasserman & Company, Inc. (Cal.App. 1st Dist. 2004) 2004 WL 2191332 (Not Officially Published); Rodriguez v. Morgan Stanley DW Inc. (Cal.App.4th Dist. 2003) 2003 WL 22089385 (Not Officially Reported); Winberg v. Salomon Smith Barney (Cal.App. 5th Dist. 2004) 2004 WL 292217 (Not Officially Reported).

Court of Appeal shortly after Alan was reported.¹⁵⁴ The balance of the cases have rejected or distinguished Alan on federal law preemption grounds, relying on the decisions in Mayo and Jevne which were reported after the first Alan decision,¹⁵⁵ have granted the brokerage firms' motions to compel arbitration, and have found no problem with the NYSE and NASD rules excepting their arbitrators from compliance with the New Ethics Rules and requiring plaintiffs to waive the New Ethics Rules for an arbitration in California or consent to arbitration in an out-of-state forum.

As applied to securities arbitrations, the “failure of forum” challenges discussed in this section are disconcerting because even though ordered to arbitration, the arbitrations have not been convened and the parties' disputes have not been resolved due to the impasse between the California Legislature and the NASD / NYSE as to whether or not the NASD / NYSE arbitrators should be subject to the New Ethics Rules. This situation is completely at odds with the concept that private arbitration provides the parties with quicker results than what is available in court and with shorter and less costly proceedings. The cases discussed in this section illustrate that the stalemate concerning the application of the New Ethics Rules to securities arbitrations has

¹⁵⁴ Linden v. American Express Financial, supra, 2003 WL 22430229 (order compelling arbitration vacated due to impossibility and impracticability of performance because NASD will not appoint arbitrator without investor waiving compliance with New Ethics Rules; preemption issue not reached because not raised at the trial level).

¹⁵⁵ Wilmot v. McNabb, supra (follows Mayo; no right to arbitrate in California before arbitration panel that is compliant with the New Ethics Rules); Belinsky v. BPM Goldman Financial Design, LLC, supra (no failure of forum; NASD justified in refusing to process plaintiff's claim because plaintiff did not comply with NASD rules for commencing an arbitration); Chen v. Morgan Stanley DW Inc., supra (followed Jevne and Mayo; expressly declined to follow Alan); Davis v. Oppenheimer & Co., supra (no problem with NYSE rules requiring waive of New Ethics Rules and consent to out-of-state forum; New Ethics Rules preempted by federal securities law); Marcus v. Trautman Wasserman & Company, Inc., supra (validates NASD waiver requirements and finds New Ethics Rules preempted by federal securities law); Rodriguez v. Morgan Stanley DW Inc., supra (rejected argument that NYSE and NASD rules that except their arbitrators from compliance with the New Ethics Rules make agreement to arbitrate illegal; motion to compel arbitration granted); Winberg v. Salomon Smith Barney, supra (follows Jevne and Mayo; declines to follow Alan).

had the opposite result: the parties have been involved in costly and protracted legal proceedings and been unable to convene – let alone conclude – their arbitrations.

D. Enforcement and Application

Thus far, there has been only one reported decision in which the New Ethics Rules have been applied, rather than challenged. That case is *Azteca Construction, Inc. v. ADR Consulting, Inc.*,¹⁵⁶ and was decided by the Third District of the California Court of Appeal in September 2004. In *Azteca*, the parties' agreement included a provision for private arbitration of any disputes in accordance with the AAA's then entitled "Construction Industry Dispute Resolution Procedures" (the "AAA Rules"). A dispute arose in October 2002 and ADR served a demand on Azteca Construction for arbitration in accordance with the AAA Rules. Because the parties were unable to agree on a neutral arbitrator from the AAA list, the AAA proposed the arbitrator, an attorney names Paul Taylor. Taylor timely made the disclosures required under the New Ethics Rules in November 2002. In accordance with AAA Rules forbidding any type of direct contact between the arbitrator and the parties or counsel before the arbitration hearing, those disclosures were communicated through AAA.

Taylor's disclosure statement revealed that he had, within the past five years, served as a neutral arbitrator on matters in which ADR Consulting's attorney had represented one or more parties. Taylor also disclosed that in 1985 he had had a prior relationship with ADR Consulting's attorney. Finally, Taylor disclosed that a conflicts check run by the law firm to which he was "of counsel" reported a case in which Azteca Construction was listed as a potential adverse party to one of the law firm's clients on a matter not involving Taylor. In response to Taylor's disclosures, Azteca Construction timely objected to Taylor's appointment via a letter

¹⁵⁶ (2004) 121 Cal.App.4th 1156, 18 Cal.Rptr.3d 142.

sent to AAA. Azteca Construction requested that Taylor be removed as arbitrator based on his disclosed relationship with ADR Consulting's attorney. AAA investigated the objection and determined that Taylor should not be disqualified. It then notified the parties that Taylor's appointment was being reaffirmed.

An arbitration hearing was conducted in March 2003. At the conclusion of the arbitration, Taylor rendered an interim award in favor of ADR Consulting for \$39,140 plus the costs of the arbitration. Azteca Construction again objected to Taylor's appointment as arbitrator and requested that Taylor disqualify himself. AAA again responded to the objection and reasserted its authority under AAA Rule R-20(b) to adjudicate and determine any objection to Taylor's continued service. Taylor then issued a final award in April 2003. Not surprisingly, Azteca Construction responded by filing a petition with the court seeking to vacate the final award, claiming that Taylor was required to disqualify himself upon timely receipt of Azteca Construction's objection based upon Section 1281.91 (b)(1) and (d) and the New Ethics Rules. The court denied the petition based upon its finding that by agreeing to arbitration in conformance with the AAA Rules, which granted AAA conclusive authority over challenges to arbitrators, Azteca Construction had waived the right to disqualify Taylor under the California Arbitration Act provisions.

Azteca Construction appealed and, in a very well reasoned opinion surveying California arbitration law, the trial court was reversed. In reversing the lower court's decision, the Court of Appeal found that the provisions of the California Arbitration Act relating to arbitrator disqualification could not be waived because those statutory provisions were "enacted primarily for a public purpose."¹⁵⁷ In this regard, the Court of Appeal found that AAA Rule R-20(b) "must

¹⁵⁷ Id. at 1167.

yield to the disqualification scheme set forth in sections 1281.9 and 1281.91, for a number of reasons.”¹⁵⁸ Among those reasons was the finding that the neutrality of the arbitrator is of crucial importance to the private arbitration process and that the California Supreme Court has heretofore termed the requirement of a neutral arbitrator “essential to ensuring the integrity of the arbitration process.”¹⁵⁹ The court’s reasoning was sound. Participants who agree to *binding* arbitration are giving up constitutional rights to a jury trial and appeal. Duties of disclosure and disqualification are thus designed to ensure an arbitrator’s impartiality.¹⁶⁰ As stated by the California Court of Appeal in *Britz, Inc. v. Alfa-Laval Food & Dairy Co.*,¹⁶¹ even though state and federal policy favors private arbitration and the AAA is a respected provider of arbitration services, “AAA nevertheless is a business enterprise ‘in competition not only with other private arbitration services but with the courts in providing’ and selling dispute resolution services.”¹⁶² As such, the court found that “[o]nly by adherence to the Act’s prophylactic remedies can the parties have confidence that neutrality has not taken a back seat to expediency.”¹⁶³

Having determined that the New Ethics Rules and right to disqualification for violation of the New Ethics Rules could not be waived, the Court of Appeal was then required to apply the law to the facts presented in the *Azteca* case. The appellate court very simply and succinctly

¹⁵⁸ Id.

¹⁵⁹ Id. at 1168, citing *Armendariz v. Foundation Health Psychcare Services, Inc.* (200) 24 Cal.4th 83, 103, 6 P.3d 669, 99 Cal.Rptr.2d 745, citing *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 825, 623 P.2d 165, 171 Cal.Rptr. 604.

¹⁶⁰ Id., citing Knight, Rutter Group on Arbitration, ¶ 7:13, p. 7-7.

¹⁶¹ (1995) 34 Cal.App.4th 1085, 40 Cal.Rptr.2d 700 (held that “a trial court considering a petition to confirm or vacate an arbitration award is required to determine, de novo, whether the circumstances disclose a reasonable impression of arbitrator bias, when that issue is properly raised by a party to the arbitration).

¹⁶² Id. at 1102. quoting *Merit Ins. Co. v. Leatherby Ins. Co.* (7th Cir. 1983) 714 F.2d 673, 681.

¹⁶³ 121 Cal.App.4th at 1168.

determined that Taylor should have been disqualified before the arbitration began since Azteca Construction had properly and timely exercised its right to remove him under Section 1281.91 of the California Code of Civil Procedure based on his disclosures concerning his prior relationship with ADR Consultants' counsel.¹⁶⁴ In this regard, the Court of Appeal concluded that Azteca Construction could not waive its statutory rights to disqualify an arbitrator by agreeing to submit to arbitration before the AAA. It also found that in resolving Azteca Construction's objection to Taylor, the AAA was required to follow Sections 2381.9 and 2381.91 of the California Code of Civil Procedure.

The Court of Appeal in *Azteca* found that Azteca Construction, as the party challenging the arbitrator's appointment, "had no independent burden to demonstrate that a reasonable person would doubt Taylor's capacity to be impartial. ... The Legislature has already determined that any of the matters required to be disclosed ... necessarily satisfies that standard."¹⁶⁵ It thus concluded that Azteca Construction's timely demand for disqualification of the proposed arbitrator "had the same practical effect as a timely peremptory challenge to a superior court judge" and is automatic.¹⁶⁶ Accordingly, the Court of Appeal reversed the lower court's order denying Azteca Construction's petition to vacate the arbitration award with directions to enter a new order granting the petition to vacate the award.¹⁶⁷

The discussion in the *Azteca* decision about arbitrator disclosures and disqualification is misleading because it starts with a summary of the revisions to "the disclosure requirements and

¹⁶⁴ Id. at 1168.

¹⁶⁵ Id. at 1169.

¹⁶⁶ Id. at 1169-1170

¹⁶⁷ Id. at 1170.

procedures for disqualifying arbitrators” as amended by SB 475¹⁶⁸ and suggests that the disclosure requirements and disqualification procedures at issue in the case were new. They were not. For example, under Section 1281.9(a)(4), Taylor was obligated to disclose the prior cases in which he had served as a neutral arbitrator and in which any of the current parties or their attorneys were involved. Although it has been renumbered over the years, that disclosure requirement has been on the books since Section 1281.9 was originally enacted in 1994. Likewise, the right of a party to disqualify a proposed appointee by serving a notice of disqualification within 15 days after service of the disclosure statement has been on the books since Section 1281.9 was originally enacted, and the right to vacatur where the arbitrator making the award was subject to disqualification but failed, upon receipt of a timely demand, to disqualify himself or herself has been on the books since 1997. What the Azteca decision illustrates is that the concerns which prompted the California Legislature to enact the New Ethics Rules legislation was justified: that AAA, through its rules and its procedures, had supplanted the clear statutory right of the parties to disqualify an arbitrator based upon his or her disclosures.

4. Controversies Created By The New Ethics Rules Case

A. Should Private Arbitrators be Held to the Same Standards as Judges?

With the exception of the Azteca case, what is really interesting about the cases discussed above is that the arguments in those cases centered largely around the ethical standards adopted by the Judicial Council pursuant to California Code of Civil Procedure Section 1281.85 and have not addressed the bigger issue of whether private arbitrators should be held to the same standards of disclosure and disqualification as state court judges, which is what is statutorily mandated

¹⁶⁸ Id. at 1162.

under California Code of Civil Procedure Sections 1281.9(a)(1) and 1281.91(d). It is hard to argue against such disclosure and disqualification standards given the breadth of disputes resolved in arbitral fora which places arbitration on par with the courts in terms of the types of civil disputes heard and decided.

Both federal and state courts are authorized to enforce agreements to arbitrate, and there is a strong public policy in favor of doing so.¹⁶⁹ Nevertheless, until recently, courts were reluctant to enforce pre-dispute arbitration agreements to compel arbitration of claims created by statute, rather than those created by virtue of the parties' contract. This reluctance was based on the courts' view that the legislative intent in creating a statutory right would be frustrated if that right was not effectively enforced, and on the concurrent belief that effective enforcement could only be obtained through the courts. For example, in *Wilko v. Swan*,¹⁷⁰ the Supreme Court expressed concern that arbitrators in statutorily based cases must make legal determinations "without judicial instruction on the law" and that an arbitration award "may be made without explanation of [the arbitrator's] reasons and without a complete record of their proceedings."¹⁷¹ The Supreme Court also noted that the "power to vacate an award is limited" and that "interpretations of the law by the arbitrators, in contrast to manifest disregard, are not subject, in the federal courts, to judicial review for error in interpretation."¹⁷² The Supreme Court

¹⁶⁹ Both the FAA and the Uniform Arbitration Act make agreements to arbitrate specifically enforceable. There is a strong public policy in favor of arbitration as a means of relieving court congestion, and both federal and state courts will interpret agreements to arbitrate broadly and exceptions narrowly. See, e.g., *McMahon*, supra, 482 U.S. 220; *United Steelworkers of America v. Warrior & Gulf Navigation Co.* (1960) 363 U.S. 574, 4 L.Ed.2d 1409, 80 S.Ct.1347; *Madden v. Kaiser Foundation Hospitals* (1976) 17 Cal.3d 699, 552 P.2d 1178, 131 Cal.Rptr. 882.

¹⁷⁰ (1953) 346 U.S. 427, 98 L.Ed. 168, 74 S.Ct. 182.

¹⁷¹ *Id.* at 436.

¹⁷² *Id.*

concluded that in view of these drawbacks to arbitration, the plaintiff's claims under the Exchange Act should not be ordered to arbitration.¹⁷³

In a series of cases beginning in 1985, the Supreme Court has moved away from the *Wilko* standard and adopted a strong pro-arbitration position allowing compelled arbitration of statutory claims. This approach began with the Supreme Court's decision in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,¹⁷⁴ where the Court held that a pre-dispute arbitration clause in a sales agreement would be enforceable for purposes of compelling arbitration of one party's antitrust claims against the other.¹⁷⁵ In 1987, in *Shearson/American Express, Inc. v. McMahon*,¹⁷⁶ the Court held that a pre-dispute arbitration clause contained in an investor's customer agreement with the brokerage firm would be enforceable for purposes of compelling arbitration of the investor's claims against the brokerage firm that it had violated both the Exchange Act and the Racketeer Influenced and Corrupt Organizations Act (RICO). In 1989, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,¹⁷⁷ the Court held that a pre-dispute arbitration clause contained in investors' customer agreements with the brokerage firm would be enforceable for purposes of compelling arbitration of the investor's claims that the brokerage firm had violated the Exchange Act and expressly overruled *Wilko*.¹⁷⁸ In each of these cases, the Supreme Court took the position that while Congress could prohibit the arbitration of statute-based claims, in the absence of clear evidence of such a prohibition in the statute's text or

¹⁷³ Id. at 438.

¹⁷⁴ (1985) 473 U.S. 614, 87 L.Ed.2d 444, 105 S.Ct. 3346.

¹⁷⁵ Id. at 624.

¹⁷⁶ (1987) 482 U.S. 220, 96 L.Ed.2d 185, 107 S.Ct. 2332.

¹⁷⁷ (1989) 490 U.S. 477, 104 L.Ed.2d 526, 109 S.Ct. 1917.

¹⁷⁸ "... *Wilko* was incorrectly decided and is inconsistent with the prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions." Id. at 482.

legislative history, arbitration would be barred only on a showing that there exists an inherent conflict between arbitration and the statute's underlying purpose; that arbitration will not be prohibited on the basis of a generalized suspicion of the capacity of arbitration to protect statutory rights.¹⁷⁹

Despite the strong pro-arbitration bias announced in the aforementioned cases, doubts still remained as to whether the Supreme Court would compel arbitration of statutory claims falling outside the commercial context of those cases. In 1991, in *Gilmer v. Interstate/Johnson Lane Corp.*,¹⁸⁰ the Supreme Court laid most of these doubts to rest. The plaintiff in *Gilmer* had been required by his employer to register with the New York Stock Exchange and his registration application included an agreement to arbitrate any disputes arising out of the termination of his employment. When plaintiff was terminated at age 62, he brought suit in federal district court, alleging violation of the Age Discrimination in Employment Act (ADEA). The employer moved to compel arbitration under Section 4 of the FAA and the Supreme Court held that arbitration should be compelled, concluding that there had been no showing that Congress, in enacting the ADEA, intended to preclude arbitration of claims under that Act.¹⁸¹

¹⁷⁹ “In *Mitsubishi*, ... we recognized that arbitral tribunals are readily capable of handling the factual and legal complications of antitrust claims, notwithstanding the absence of judicial instruction and supervision. Likewise, we have concluded that the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights. Finally, ... there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute.” *McMahon*, supra, 482 U.S. at 232.

¹⁸⁰ (1991) 500 U.S. 20, 114 L.Ed.2d 26, 111 S.Ct. 1647.

¹⁸¹ “Initially, we note that in our recent arbitration cases we have already rejected most of [plaintiff's] arguments as insufficient to preclude arbitration of statutory claims. Such generalized attacks on arbitration ‘res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants,’ and as such, they are ‘far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.’” 500 U.S. at 30.

As a direct result of the Supreme Court's decision in *Gilmer*, there has been an increased interest in the use of mandatory arbitration of many different types of statute-based disputes.¹⁸² This increased use of arbitration is itself quite controversial and focuses on the potential unfairness of imposing binding arbitration on unsuspecting consumers, employees, patients, etc. due to the lack of negotiation between the parties. Given the rapidly expanding use of contract arbitration giving neutral arbitrators decision making authority in civil disputes that is almost equal to that of their judicial counterparts, coupled with the recognition that arbitrations are private proceedings in which there is limited access to judicial review of the proceedings or the arbitrator's decision, the New Ethics Rules are both appropriate and necessary if arbitration is to be perceived as a process that is inherently fair and a reasonable alternative to litigation. It has been held that a dispute resolution process is not an arbitration unless it includes a mechanism for ensuring neutrality in the rendering of the decision.¹⁸³ If arbitrator's are going to have decision making power greater than that afforded judges, whose proceedings are open to the public and whose decisions are subject to several levels of judicial review, then it is submitted that it is reasonable to expect arbitrators to abide by ethics rules that are at least as strict as those followed by their judicial counterparts in order to ensure the neutrality of the decision maker.

¹⁸² ADR Text, p. 242.

¹⁸³ *Cheng-Canindin v. Renaissance Hotel Assocs.* (1996) 50 Cal.App.4th 676, 684, 57 Cal.Rptr.2d 867; *Elliot & Ten Eyck Partnership v. City of Long Beach* (1997) 57 Cal.App.4th 495, 503, 67 Cal.Rptr.2d 140; *Saeta v. Superior Court* (2004) 117 Cal.App.4th 261, 268, 11 Cal.Rptr.3d 610.

B. Should the New Ethics Rules be Invalidated under the Federal Securities Law?

This question calls into issue the friction between the national policy of consistent handling of securities disputes and uniform application of the NASD / NYSE arbitration rules, on the one hand, and the perceived need for greater procedural safeguards in private arbitration given the expanded scope of arbitrability to include statute-based claims and other matters arising outside the context of the parties' commercial agreement, on the other. Based on the discussion in Section 3(A), it would appear that this issue will be resolved in favor of exempting the NASD and NYSE from the New Ethics Rules because those rules, standards and procedures directly conflict with and exert an "extraneous pull" on the regulatory scheme established by Congress for resolving securities industry disputes.

C. Should the New Ethics Rules be Invalidated under the FAA?

As the discussion in Section 3 demonstrates, the case controversies which have arisen to date have focused on the expanded disclosure requirements contained in the New Ethics Rules. What the *Azteca* decision illustrates is that disqualification of an arbitrator is automatic once a timely demand is made based upon an arbitrator's improper disclosures and that vacatur under California Code of Civil Procedure Section 1286.2(a)(6) is mandatory if the arbitrator making the award was subject to disqualification upon a grounds specified in California Code of Civil Procedure Section 1281.91 but failed upon receipt of a timely demand to disqualify himself or herself. It is this aspect of the New Ethics Rules that is starkly at odds with the FAA.

Under the FAA, an arbitrator’s mere failure to disclose a conflict is not a basis to vacate an award. Proof of partiality is required.¹⁸⁴ Since California courts have routinely treated the failure to make disclosures as arbitrator misconduct under California Code of Civil Procedure Section 1286.2(a)(3), Section 1286.2(a)(6) would appear to be superfluous and unnecessary to the protection of the integrity of the private arbitration process.¹⁸⁵ Eliminating Section 1286.2(a)(6) would bring California’s grounds for vacatur in line with Section 10 of the FAA and eliminate this controversial issue.

One authority has predicted that to the extent the California grounds for vacatur departs from the grounds provided under the FAA, “there is a significant potential that litigation will ensue over whether an award involves interstate commerce” and, if so, whether the California grounds for vacatur are preempted by the FAA.¹⁸⁶ Another authority has described such anticipated challenges as the “second generation” of FAA preemption cases involving preemption challenges to state laws that regulate the arbitration process, as distinguished from the “first generation” of cases which involved state laws directed at invalidating the parties’ agreements to arbitrate.¹⁸⁷ While the provisions for vacatur for improper disclosure under California Code of Civil Procedure Section 1286.2 have been recognized as raising the “specter of federal preemption,”¹⁸⁸ the cases which have subjected that code section to preemption

¹⁸⁴ 9 U.S.C. § 10(a)(2); *ANR Coal Co., Inc. v. Cogentrix of North Carolina, Inc.* (4th Cir. 1999) 173 F.3d 493, 499-500; see also *Montez v. Prudential Securities, Inc.* (8th Cir. 2001) 260 F.3d 980, 983 (collecting cases and noting absence of consensus among circuit courts on definition of “evident partiality”).

¹⁸⁵ See, e.g., *Ceriale v. AMCO Ins. Co.*, supra, 48 Cal.App.4th 500 (vacating an award based on common law standard of arbitrator bias); *Michael v. Aetna Life & Casualty Ins. Co.* (2001) 88 Cal.App.4th 925, 106 Cal.Rptr.2d 240 (finding that the vacation of an award for “corruption, fraud and undue means” can include an arbitrator’s failure to make disclosures as required by statute).

¹⁸⁶ Alford Article, supra, p. 29.

¹⁸⁷ Christopher R. Drahozal, *Federal Arbitration Act Preemption*, 79 Ind. L.J. 393 (2004)

¹⁸⁸ Id. at p. 30.

analysis have thus far determined that the FAA does not preempt California's vacatur requirements.¹⁸⁹ Those cases, however, have not dealt specifically with Section 1286.2(a)(6). Given the *Azteca* court's application of Section 1286.2(a)(6) as discussed in Section 3(D), above, it is anticipated that it is only a matter of time before this code section is directly challenged in the courts.

Even if Section 1286.2(a)(6) is challenged on FAA preemption grounds, several authorities have noted that there is an "important caveat to the general rule of FAA preemption" as set forth in the Supreme Court's decisions in *Volt* and *Mastrobuono*.¹⁹⁰ The Supreme Court's focus in those two cases was on the effect of FAA preemption on the choice of law provisions frequently included in commercial contracts. "Plain and simple, in *Volt* the Supreme Court held that the intent of the parties to an arbitration agreement, as expressed in the contract between them, to conduct their arbitration under state law rules effectively trumps the preemptive effect of the FAA."¹⁹¹ The governing state law selected by the parties per their agreement will control even when the selected state law "results in an arbitration conducted in a manner inconsistent with the substantive law of commercial arbitration set out in the FAA."¹⁹²

While FAA preemption is a much more difficult issue to predict with regard to such "back end" issues as confirmation, modification and vacatur of awards, because those issues concern the effectuation of the result of the arbitration "and thereby serve to effectively

¹⁸⁹ See, *Muao v. Grosvenor Props.* (2002) 99 Cal.App.4th 1085, 122 Cal.Rptr.2d 131 (finding that the FAA did not preempt Section 1286.2's procedures for reviewing arbitral awards); *Siegel v. Prudential Ins. Co. of Am.* (1998) 67 Cal.App.4th 1270, 79 Cal.Rptr.2d 726.

¹⁹⁰ Hayford Article, *supra*, 2001 J. Disp. Resol. at 71; Drahozal Article, *supra*, 79 Ind. L. J. 393, 406;

¹⁹¹ Hayford Article, *supra*, 2001 J. Disp. Resol. at 71, citing, *Volt*, *supra*, 489 U.S. at 478.

¹⁹² *Id.*, citing *Volt*, *supra*, 489 U.S. at 479.

culminate enforcement of contractual agreements to arbitrate,”¹⁹³ it is expected that FAA preemption of Section 1286.2(a)(6) is likely at least with respect to contracts involving interstate commerce where there is no choice-of-law provision subjecting the parties to arbitration in accordance with California law.

5. Conclusion

The stated goals of the New Ethics Rules are “to inform and protect participants in arbitration, and to promote public confidence in the arbitration process.”¹⁹⁴ This is a laudable goal, especially since arbitration is a private process that is dependent on public acceptance. The heart of the controversy concerning the New Ethics Rules seems to revolve around the practical inconvenience and cost burden associated with compliance. It is submitted that such a burden goes with the privilege of being empowered to decide parties’ fates by determining the outcome of their disputes with binding finality and limited judicial review. Because arbitration is no longer limited to the commercial disputes arising from the parties’ contracts and has been expanded to include claims that theretofore only could have been heard and decided in the courts, so too should the ethics rules governing neutral arbitrators also be expanded to include disclosures akin to what is required of judges.

While everyone agrees that some level of arbitrator disclosure is in order, there is hearty discord and debate on how much disclosure is necessary, whether can or should be legislated by state statutes and whether the remedy for improper disclosures should be mandatory vacatur. Arbitration reform by way of ethics is a phenomenon that has occurred first in California and will most likely be unsettled for many years while the judiciary, other states and respected

¹⁹³ Id., at p. 75.

¹⁹⁴ CRC, Appendix, Div. VI, Std. 1(a).

arbitration authorities weigh in on these issues. Until that time, private arbitration in California will remain a hot bed of controversy and conflicting decisions which works against the stated purpose of promoting public confidence in the arbitration process.