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Cautionary Lessons from American Securities Arbitration: Litigation versus Arbitration

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attered by having to investigate which States had enacted relevant
ation and its practical effects, thereby undermining one of the primary
oses of the legislation, which is to attract international arbitration to
alia. The deletion of section 29 ensures that a single Australian
monwealth) law will govern all international commercial arbitrations
cted in Australia, unless the parties themselves choose otherwise.

The Editors

Cautionary Lessons from American Securities Arbitration: Litigation v. Arbitration

United States, it is now quite common for lawyers and others to bemoan
is often referred to as 'the litigation crisis.'¹ No less an authority than
Chief Justice Warren Burger has long complained that American courts
become overburdened' by too many lawsuits.² Echoing other
mentators, Burger recommends arbitration as 'a better way to do it.'³ Just
'carpenter's handsaw as replaced by the power saw,'⁴ so is arbitration the
rn power tool to replace litigation in court. Similarly, the Report of the
gious American Bar Association's Commission on Professionalism
mends expanded use of arbitration in lieu of a normal trial before a judge
y jury.⁵

ere should be no rush to judgment favouring arbitration. In the first place,
ot at all clear that there is a litigation crisis in the United States. Criticism
so-called litigation explosion is based more on anecdotal evidence than
l empirical studies. The empirical studies that do exist show that the
ion rate in the United States during the 1970's, for example, is only about
f what it was during the nineteenth century.⁶ American courts may appear
led to the average observer, but we should realise that there are fewer

g., Tribe, *Too Much Law, Too Little Justice: An Argument for DeLegalising America*, Atlantic Monthly, July
79, at p.25; Barton, *Behind the Legal Explosion*, 27 Stanford Law Review 567 (1975).

urger, *Isn't There A Better Way?*, 68 American Bar Association Journal 274, 275 (1982).

at 276.

at 274.

3A Commission on Professionalism, '... In the Spirit of Public Service: A Blueprint for the Rekindling of
wyer Professionalism' (1986). This Report is reviewed in Rotunda, *Lawyers and Professionalism: A
mentary on the Report of the American Bar Association Commission on Professionalism*, 18 Loyola University
Chicago Law Journal 1149-80 (1987). Portions of this present Note are adapted from pp.1162-64 of
at article.

lanter, *What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious
society*, 31 University of California-Los Angeles Law Review 4, 38 (1983).

also, Blum, *Litigation 'Epidemic' in a Teapot?*, 11 National Law Journal 3, col. 1-2, & 16, col. 1-4 (Jan.
, 1989), discussing a report of a new study of 85,000 federal lawsuits by The RAND Corporation.

judges per capita in the United States compared to other western nations.⁷ For example, 28% of all German lawyers are judges, but only 4% of American lawyers are judges; while Germany, a country of 61 million people, has 17,000 judges, the United States, a country of 240 million people, has only 18,000 judges.⁸ If there is a litigation problem in the United States, the problem is not too many lawsuits; it is too few judges, overworked and underpaid.

Nonetheless, it is quite common in the United States for law reformers to urge arbitration in order to decrease the amount of litigation. Before embracing this proposed solution, however, we should take note of some of the misgivings and warnings that others have sounded regarding arbitration. Arbitration has its own pitfalls. As one commentator has remarked, 'arbitrators are, well arbitrary.'⁹ The American experience regarding arbitration of securities law violations should give these reformers some second thoughts.

Arbitration in the United States does not provide the litigant with the protection of rules of discovery, rules of evidence, findings of fact, or conclusions of law.¹⁰

Arbitrators, unlike judges, are discouraged from giving reasons for their decisions. The President of the American Arbitration Association candidly advised, 'Written opinions can be dangerous because they identify targets for the losing party to attack.'¹¹ Arbitration is like sausage: if we knew how it was made, we would be much less confident of the results.

The Supreme Court, in *Shearson/American Express, Inc v McMahon*,¹² recently held that broker-dealers can force their customers who have signed pre-dispute arbitration agreements to arbitrate securities fraud claims brought under Securities and Exchange Commission Rule 10b-5 and Section 10(b) of the Securities and Exchange Act of 1934.¹³

⁷ Bok, *A Flawed System of Law Practice and Training*, 33 *Journal of Legal Education* 570, 571 (1983).

⁸ D. Luban, *Lawyers and Justice: An Ethical Study* 101 (Princeton University Press, 1987).

⁹ Scheibla, *Big Decision, Can You Sue a Broker?*, *Barron's*, Mar. 2, 1987, at 16, col. 3.

For a thorough study and critique of Alternative Dispute Resolution ('ADR'), including a case study of the Neighbourhood Justice Centre in Kansas City, see C. Harrington, *Shadow Justice: The Ideology and Institutionalisation of Alternatives to Court* (Greenwood Press 1985).

¹⁰ See Note, *Federal and State Securities Claims: Litigation or Arbitration*, 61 *Washington Law Review* 245, 260-61 (1986) (securities arbitration does not protect investors and must be 'substantially improved'); Note, *Arbitrability of Claims Arising Under the Securities Exchange Act of 1934*, 1986 *Duke Law Journal* 548 (discussing many flaws that exist in securities arbitration, and explaining how these flaws severely hurt investors).

¹¹ Scheibla, *Big Decision, Can You Sue a Broker?*, *Barron's*, Mar. 2, 1987, at p.33, col. 4. Accord R. Coulson, *Business Arbitration - What You Need To Know* 26 (1980).

¹² 107 S.Ct. 2332 (1987).

¹³ The Supreme Court did not overrule *Wilko v. Swan*, 346 U.S. 427 (1953) on the question whether broker-dealers could force their customers to arbitrate claims under § 12(2) of the Securities Act of 1933, rather than seek relief in federal court. *Wilko* had held that a court cannot compel arbitration of a §12(2) claim even though the customer had signed a predispute agreement to arbitrate. *Wilko* reasoned: 'the protective provisions of the Securities Act require the exercise of judicial discretion to fairly assure their effectiveness.' 346 U.S. at 437. (As this Note went to press, the US Supreme Court by a 5-4 majority overruled *Wilko*: see *Rodriguez de Quijas, et al v. Shearson/American Express Inc.*, No. 88-385 US Supreme Court, 15 May 1989).

The broker-dealer insists on arbitration, while the customer refuses, because both know that securities arbitration favours the broker-dealer. In a securities arbitration, often the chairperson is another stock-broker. We should not be surprised if a broker-dealer is not the most detached, neutral observer to judge his fellow broker-dealer.¹⁴ The broker-dealer who is the arbitrator in one case may well be the respondent in the next case. The so-called independent arbitrators on the securities arbitration panel often are practicing lawyers who represent other broker-dealers and have a similar mind-set.¹⁵ It is not surprising that the defendant seeks compulsory arbitration because the defendant/brokers view that as being in their best interest.

Following the Supreme Court decision in *McMahon*, the securities regulators of various states have tried, by state regulation, to limit the power of brokers to insist that customers agree to arbitrate any disputes growing out of the purchase or sale of stocks, bonds, and other securities. The director of consumer education for the North American Securities Administrators Association has said that there is a laundry list of reasons behind this effort to forbid mandatory arbitration. The most obvious complaints - 'The [arbitration] panels are stacked in favour of the industry, the proceedings are not public and there are no written decisions.'¹⁶

American arbitration decisions are also quite difficult to overturn on appeal, even when one of the arbitrators had a conflict of interest that would have required disqualification of a federal judge.¹⁷ Fortunately, federal courts have mitigated the harshness of that rule by according securities arbitration limited *res judicata* and *collateral estoppel* effects.¹⁸

¹⁴ E.g., Chemerinsky, *Protection Lawyers from their Profession: Redefining the Lawyer's Role*, 5 Journal of the Legal Profession 31, 34 (1980) (lawyers likely to derive their personal beliefs from their professional behaviour; thus, when lawyers represent clients' positions, eventually lawyers adopt clients' attitudes). Cf. Rotunda, *The Combination of Functions in Administrative Actions: An Examination of European Alternatives* 40 Fordham Law Review 101, 102-03 (1971).

¹⁵ Scheibla, *Big Decision, Can You Sue a Broker?*, Barron's, Mar. 2, 1987, at 16, col. 3.

¹⁶ Quoted in, Harlan, *Massachusetts Says Brokers Can't Insist on Arbitration*, Wall Street Journal, Sept. 27, 1988, at p.37, col. 5-6 (midwest edition).

¹⁷ *Merit Insurance Co. v. Leatherby Insurance Co.*, 714 F.2d 673 (7th Cir.), certiorari denied, 464 U.S. 1009 (1983). See also, *Tinaway v. Merrill Lynch & Co.*, 57 U.S.L.W. 2164 (S.D.N.Y., July 28, 1988) (federal court overturns its earlier decision upsetting an arbitration award even though that earlier decision has ruled that the arbitrators had manifested 'evidence partiality' in favour of the broker-dealer).

¹⁸ E.g., *O'Neill v. Merrill, Lynch, Pierce, Fenner & Smith*, 654 F. Supp. 347 (N. D. Ill. 1987), where the federal district court refused to apply collateral estoppel to a previously arbitrated Section 10B-5 fraud claim because it was not clear what standard of proof the arbitrators had applied. The Court noted that because the arbitrators' perfunctory decision and lack of a written opinion revealed nothing about the standard of proof used, it was possible that they did not apply the preponderance of evidence test used in federal securities law.

See also, *Tamari v. Bache & Company (Lebanon) S.A.L.*, 637 F. Supp. 1333, 1337, 1341, 1342 (N.D. Ill. 1986); *Ufheil Construction Company v. Town of New Windsor*, 478 F. Supp. 766, 768-69 (S.D.N.Y. 1979).

See generally, Shell, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, 35 University of California-Los Angeles Law Review 623 (1988).

The tilt in the scales of justice in favour of defendants in cases of securities arbitration may be illustrated by the simple fact that broker-dealers, when they are plaintiffs, prefer to file suit in federal court rather than proceed with arbitration. When the securities dealers and brokers are defendants, their perspective changes and they insist on arbitration of customer complaints, as in *McMahon*. In the year following the October, 1987 stock market crash, when the number of claims for arbitration increased over 329%, many brokers and securities firms found themselves as plaintiffs trying to collect margin money from their customers. Some disgruntled brokers were forced to arbitrate. Brokers accounted for 20% of the arbitration cases filed during the first three months of 1988. In contrast, during all of 1987, brokers were plaintiffs in arbitration cases only 9% of the time. Yet, such figures on the use of arbitration by brokers are misleading. When brokers became plaintiffs, many preferred to file lawsuits in federal court, not arbitration claims before the National Association of Securities Dealers (NASD), because courts offer much more protection. Such brokers made no effort to inform their customers that they could insist on compulsory arbitration in light of the *McMahon* decision.¹⁹

The move to encourage arbitration is not limited to disputes involving federal securities laws. In an effort to reduce expensive litigation, some courts now require the parties to engage in so-called 'mandatory' arbitration, followed by a full trial if either party objects to the arbitration award. At this trial, evidence of the arbitration and the results are inadmissible.²⁰ The hope, apparently, is that this pre-litigation hurdle will encourage settlement. Although these efforts are well-intentioned, they may well result in more expense, not less, and increased delay, not expedition. This new procedure requires the parties to cross an extra hurdle before they reach trial, when the jury verdict really is mandatory and not advisory.

Warren Burger, while Chief Justice, praised those law schools that now offer courses in arbitration, alternative dispute resolution and negotiation, and blamed some of the 'litigation explosion' on those law schools who have not placed sufficient emphasis on the advantages of arbitration.²¹ That viewpoint is,

¹⁹ See, Antilla, *Brokerages Call On Courts to Get Margin Money*, USA Today, March 28, 1988, p. 8B, col. 1. This article noted: 'When you're the culprit and the broker is the plaintiff, brokerages suddenly get more enthusiastic about the prospects of having a day in court - even when the broker and customer previously have agreed to use arbitrators to resolve disagreements.' Cf. Winkler, *Quick & Reilly Ordered to Pay Client \$2 Million in Crash Sellout*, Wall Street Journal, Dec. 1, 1988, at p. C1 & C17 (brokerage house seeks to go to federal court rather than to honour a proceeding before New York Stock Exchange arbitration panel).

²⁰ See, e.g., 15 Bar Report 5 (Wash. D.C. Bar, Feb.-Mar. 1987).

²¹ Burger, *Isn't There a Better Way?*, 68 American Bar Association Journal 274, 275 (1982): 'Law Schools have traditionally steeped the students in the adversary tradition rather than in the skills of resolving conflicts. . . . [T]wo of those 'nonjudicial routs' [to reduce litigation] are arbitration and negotiation, and it is very encouraging to find a new law school [the Law School of the City University of New York] opening with this fresh approach.'

frankly, unsophisticated. When Americans turn to the courts, it is usually not because lawyers, bred to be litigious in American law schools, urge their clients to make mountains out of molehills; on the contrary, empirical studies show that lawyers are not typically the ones pushing their clients to litigate. In the paradigm case the lawyers for both sides urge settlement; it is the clients who want to litigate and reject efforts to compromise.²²

To learn of alternative remedies in law school is, of course, useful, but let us not be naive. Teaching future lawyers about negotiation, settlement and arbitration will not make them less litigious. We law professors simply do not have that much power to change human nature. A recent study of German legal ethics illustrates this simple fact of life. On the surface, German training of lawyers appeared to promote a system much *less* litigious than our own. Yet appearances were deceiving. When one looked below the surface, the study demonstrated that the German legal system was just as litigious as the American system. Germany, like the United States, turns out an enormous number of lawyers each year (though the numbers may be deceiving because Germany, unlike the United States, distinguishes between advocacy and advice). German law heavily regulates fees in an effort to encourage settlement, but, in practice, such regulation has increased lawyer fees and has delayed settlement, because the German lawyers often postpone settlement until the eleventh hour in order to increase their regulated fees. Lawyers in Germany, like lawyers in this country, commonly believe that their legal opponents engage in frivolous motions and frivolous appeals, and in delaying actions.²³ We may look wistfully

²² B. Curran, *The Legal Needs of the Public: The Final Report of a National Survey 229* (American Bar Foundation, 1977) (survey showing that 87% of the respondents agreed with the following statement: 'Lawyers try hard to solve their client's problems without having to go to court'; and 80% agreed with the following statement: 'Most lawyers' work consists of helping clients arrange their affairs so as to avoid future problems and disagreements.').

Compare, for example, American lawyers to Australian lawyers. 'In Australia, 19% of the instances in which a lawyer was consulted in a grievance did not mature into a dispute. The U.S. figure is 24%. In other words, American lawyers are more likely to dampen disputes.' Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious Society*, 31 *University of California-Los Angeles Law Review* 4, 60 (1983). Americans may appear to be more likely to file lawsuits than Australians, apparently because filing is culturally more a part of the settlement process. *Id.* Yet Australians are substantially more likely to engage in an actual dispute. Fitzgerald, *Grievances, Disputes and Outcomes: A Comparison of Australia and the United States*, 1 *Law In Context* 15, 25 (1983).

²³ Luban, *The Sources of Legal Ethics: A German-American Comparison of Lawyers' Professional Duties*, 48 *Rables Zeitschrift* 245, 281, 284 (1984).

to Europe, but when we look more closely, we see ourselves in a mirror.²⁴

Those in the United States who see compulsory arbitration as an elixir for a perceived litigation crisis, should consider the problems carefully before they drink too deeply. Like the American Indians who thought that they were selling the new settlers concurrent hunting rights, but were later startled to learn that they had sold title in fee simple absolute, those who wish to trade-in judicial protections for arbitration may soon learn that they have made a similar bargain.

Professor Ronald D. Rotunda

²⁴ Professor Luban's study concludes: 'German legal ethics is adversarial ethics.' Luban, *supra* at 280. See also *id.* at 207 ('Ultimately, the lesson may be that no system of procedural justice with a private bar can evade the paradox that underlies adversarial ethics - the paradox deriving from the fact that the system of justice creates its own antagonists.') (footnote omitted).