

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

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I. 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 the same.¹ This was a relatively subjective standard that most certainly varied on a case-by-case and arbitrator-by-arbitrator basis and is no longer the rule in California.

Until recently, private arbitration² primarily involved repeat players

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

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 U. MIAMI L. REV. 949, 949 (2002). 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 Ctr. of L.A.*, 251 Cal. Rptr. 895, 898 (Cal. Ct. App. 1988); *Air Line Pilots Ass’n v. Miller*, 523 U.S. 866, 876 (1998). 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.

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

In September 2001, the California Legislature enacted S.B. 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 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. This 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

CIV. PROC. CODE § 1141.20 (2005).

3. GOLDBERG, *supra* note 1, at 279.

4. *Id.*

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*, 4 PEPP. DISP. RESOL. L.J. 1, 3 (2004). “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. SEEGER, *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 of arbitration established and controlled by industry . . . the protection of 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 to judicial 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).

the consumer. 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 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

The impetus for the new standards was a concern for unsophisticated or inexperienced consumers forced into arbitration with companies intimately familiar with the private arbitration process, the provider organizations, and the arbitrators. However, 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

8. See Jay Folberg, *Arbitration Ethics—Is California the Future?*, 18 OHIO ST. J. ON DISP. RESOL. 343, 343-347 (2003); see also GOLDBERG, *supra* note 1, at 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, *supra* note 8, 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.” GOLDBERG, *supra* note 1, 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, *About the NLRB*, available at <http://www.nlr.gov/nlr/about/default.asp> (last visited Feb. 26, 2006).

Senate Bill 475 (S.B. 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 appointed to assist the Judicial Council in its task.¹² The criticism focused on 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 S.B. 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 Therefore, S.B. 475 focused on standards for arbitrators generally—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.

II. 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

11. Folberg, *supra* note 8, at 345.

12. *Id.*

13. *Id.*

14. *Id.*

15. “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. CIV. PROC. CODE §§ 1280, *et seq.* (2005).

17. An arbitrator's failure to disclose information indicative of bias constitutes

As originally enacted, however, there were no 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, S.B. 475 amended Section 1281.9 to expand further 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 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)

grounds to vacate an award under California Code of Civil Procedure Section 1286.2(a)(1), CAL. CIV. PROC. CODE § 1286.2(a)(1) (2005) (“award was procured by corruption, fraud or other undue means”), or Section 1286.2(a)(2), CAL. CIV. PROC. CODE § 1286(a)(2) (2005) (“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 Coatings Corp. v. Cont’l Cas. Co.*, 393 U.S. 145, 149, (1968); *Ray Wilson Co. v. Anaheim Mem’l Hosp. Ass’n*, 213 Cal. Rptr. 62, 66 (Cal. Ct. App. 1985).

18. Alford, *supra* note 6, at 2.

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

20. *Id.*

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

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

23. Standard 7(d)(12) and Section 170.1(a)(1) require disclosure if the judge or 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

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 S.B. 475 the disqualification procedures 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 on the basis of the disclosures made.²⁸ Likewise, it retained the provision for waiver of a party’s right to disqualify if timely notice of disqualification is not made.²⁹

or 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 or 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 or arbitrator (or a member of his or 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 or arbitrator (or a member of his or 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 or 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. CAL. CIV. PROC. CODE §1201.9 (2005); CAL. CIV. PROC. CODE § 170.1.

24. Cal. Rules of Court Div. VI, Std. 7(d)(8) (2005).

25. *Id.* Std. 7(d)(11).

26. *Id.* Std. 7(d)(13).

27. CAL. CIV. PROC. CODE § 1281.91(a). Like its predecessor (CAL. CIV. PROC. CODE § 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.

28. *Id.* § 1281.91(b)(1). Like its predecessor (CAL. CIV. PROC. CODE § 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. *Id.* § 1281.91(c). Like its predecessor (CAL. CIV. PROC. CODE § 1281.9(d)), Section 1281.91(c) provides that the right of a party to disqualify a proposed neutral

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 S.B. 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

S.B. 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, the Judicial Council adopted the “Ethics Standards for Neutral

arbitrator shall be waived if the party fails to timely serve the notice required by this section.

30. *Id.* § 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. *Id.* § 1286.2(a)(f) (redesignated in 2001 as (a)(6) by S.B. 475).

32. *Id.* § 1286.2(a)(6)(A).

33. Cal. Stats. 2001, c. 362 (S.B. 475), § 8; *see* Commonwealth Coatings Corp. v. Cont’l Cas. Co., 393 U.S. 145, 149 (1968); Ray Wilson Co. v. Anaheim Mem’l Hosp. Ass’n, 213 Cal. Rptr. 62, 66 (Cal. Ct. App. 1985); Reed v. Mut. Serv. Corp., 131 Cal. Rptr. 2d 524 (Cal. Ct. App. 2003); Roitz v. Coldwell Banker Residential Brokerage Co., 73 Cal. Rptr. 2d 85 (Cal. Ct. App. 1998); Ceriale v. AMCO Ins. Co., 55 Cal. Rptr. 2d 685 (Cal. Ct. App. 1996); Luster v. Collins, 19 Cal. Rptr. 2d 215 (Cal. Ct. App. 1993); Neaman v. Kaiser Found. Hosp., 11 Cal. Rptr. 2d 879 (Cal. Ct. App. 1992); Wheeler v. St. Joseph Hosp., 133 Cal. Rptr. 775 (Cal. Ct. App. 1976).

34. CAL. CIV. PROC. CODE § 1281.85(a).

Arbitrators in Contractual Arbitration” in April 2002.³⁵ Along with the statutory amendments created by S.B. 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 S.B. 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 1281.9(a)(1),³⁸ thereby elevating arbitrator ethics to the level of judicial ethics with the stroke of the pen.

III. 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

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

36. CAL. CIV. PROC. CODE § 1281.85(a).

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

38. CAL. CIV. PROC. CODE § 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*, 465 U.S. 1 (1984). 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

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 (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 United States Supreme Court held in *Shearson/American Express, Inc. v. 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 Securities and Exchange Commission (SEC)⁴³ 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

enforceability of contracts in general.

40. Jaimie 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 (2004) (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), at <http://www.sec.gov/pdfarbconflict.pdf>).

41. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

42. Kent, *supra* note 40, at 906 (citing Carbonneau, *supra* note 7, 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-u (2005) (the “Exchange Act”). The NASD is registered under 15 U.S.C. § 78o-3 (2005). The NYSE is registered under 15 U.S.C. § 78f (2005).

44. 15 U.S.C. §§ 78a-u; *see Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097, 1101 (N.D. Cal. 2003).

industry. While SROs are subject to oversight by the SEC,⁴⁵ they are nevertheless *private* organizations. Under the Supremacy Clause of the U.S. Constitution, 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.

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

45. 15 U.S.C. § 78s; *Austin Mun. Sec., Inc. v. NASD*, 757 F.2d 676, 680 (5th Cir. 1985).

46. U.S. CONST., art. VI, cl. 2.

47. *City of N.Y. v. FCC*, 486 U.S. 57, 63-64, (1988).

48. *Mayo*, 258 F. Supp. 2d at 1102.

49. NASD, *Notice to Parties in California Arbitration Matters*, available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_009550&ssSourceNodeId=1190 (last visited March 20, 2006); NYSE, *Notice to California Investors in Arbitration under NYSE Rules*, available at http://www.nyse.com/pdfs/cal_notice2.pdf (last visited March 20, 2006). 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, *supra* note 2, 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.*, 417 U.S. 506, 519 (1974), (“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), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=537 (last

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

3. The 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 was in violation of the Electronic Funds Transfer Act and state law.⁵⁴ The investment company removed the action to federal court and filed a motion to compel arbitration under the Federal Arbitration Act,⁵⁵ which was granted.⁵⁶ In February 2002, the account holder commenced arbitration proceedings before the NYSE⁵⁷ by filing a statement of claim and executing a Uniform Submission Agreement.⁵⁸ The arbitration was

visited March 20, 2006); NYSE Arbitration Rules, Rule 600(g), *available at* http://wallstreet.cch.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_9&manual=/nyse/nyse_rules/nyse-rules/ (last visited March 20, 2006).

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

52. *Id.* at 1063-66.

53. *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097 (N.D. Cal. 2003).

54. *Id.* at 1099.

55. Federal Arbitration Act, 9 U.S.C. §§ 1-16 (2005).

56. *Mayo*, 258 F. Supp. 2d at 1099.

57. 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." *Id.*

58. The Uniform Submission Agreement provides that the arbitration "will be conducted in accordance with the Constitution, By-Laws, Rules, Regulations and/or

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.⁵⁹ Plaintiff then filed a motion seeking to be relieved entirely from his obligation to arbitrate the dispute. The court construed plaintiff's motion as a motion for reconsideration on the basis of an intervening change in circumstance:⁶⁰ 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?⁶¹

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.⁶² The court noted that, while the SRO arbitration rules and California standards shared "similar goals with respect to disclosure and disqualification,"⁶³ the fact of common end did not mean that their means were not conflicting.⁶⁴ 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;⁶⁵ that application of the New Ethics Rules would require disqualification of arbitrators and vacatur of awards in circumstances where the SRO rules do not;⁶⁶ and that, under the New

Code of Arbitration Procedure of the sponsoring organization." *Id.* at 1100.

59. *Id.*

60. *Id.* at 1104.

61. *Id.*

62. *Id.* (citing *Swirsky v. NASD*, 124 F.3d 59, 61 (1st Cir. 1997)).

63. *Id.* at 1109.

64. *Id.* (citing *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 380 (2000)).

65. Compare Cal. Rules of Court App. Div. VI, Std. 7(d) (2005); NASD, Code of Arbitration, Rule 10312(a), available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited March 20, 2006); NYSE, Arbitration Rules, Rule 610, available at http://wallstreet.cch.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_9&manual=/nyse/nyse_rules/nyse-rules/ (last visited March 20, 2006).

66. Compare CAL. CIV. PROC. CODE § 1286.2(a)(6) (2005); NASD, Code of Arbitration, Rules 10308 to 10313, available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited March 20, 2006); NYSE, Arbitration Rules, Rules 608-611, available at http://wallstreet.cch.com/nysetools/Exchangeviewer.asp?SelectedNode=chp_1_9&manual=/nyse/nyse_rules/nyse-rules/ (last visited March 20, 2006).

Ethics Rules, the role of the Director of Arbitration for the NASD and NYSE would be greatly reduced if not totally eliminated.⁶⁷ The court concluded that the “disclosure and disqualification requirements of the SRO arbitration rules are tailored specifically to the 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.”⁶⁸ 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. The 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*.⁶⁹ 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.⁷⁰ 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.⁷¹ “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.”⁷² Plaintiffs did not oppose the motion to compel and, in February 2001, the court granted the motion.⁷³ “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.”⁷⁴ During the summer of 2001, the parties selected a three-arbitrator panel and arbitration was commenced in early 2002.⁷⁵ In

67. *Mayo*, 258 F. Supp. 2d at 1110.

68. *Id.* at 1111-12.

69. *Jevne v. Super. Ct. of Los Angeles County*, 6 Cal. Rptr. 3d 542 (Cal. Ct. App. 2003), *review granted and opinion superseded by* 86 P.3d 290 (Cal. 2004), *aff’d* 111 P.3d 954 (Cal. 2005).

70. *Id.* at 546.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.* at 546-47.

75. *Id.* at 547.

October 2002, one of the arbitrators voluntarily recused himself.⁷⁶ By that time, the “NASD had stopped appointing arbitrators in NASD arbitrations in California” and, accordingly, informed plaintiffs that it would not appoint a replacement arbitrator unless they agreed to waive the New Ethics Rules or agreed to have the arbitration conducted in another state.⁷⁷ 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.⁷⁸ 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.⁷⁹ The state trial court denied plaintiffs’ motion concluding, in essence, that federal law preempted the New Ethics Rules.⁸⁰ Plaintiffs then filed a petition for writ of mandate with the court of appeal which, in turn, issued an order to show cause.⁸¹

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.⁸² Because no California state court had yet addressed this issue⁸³ 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.⁸⁴ In this regard, the court of appeal noted that, because Congress has provided for concurrent state regulation of securities,⁸⁵ there was no express or field preemption under the federal securities laws of the New Ethics Rules,⁸⁶

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.* at 547-48.

83. *Id.* at 547 n.2 (citing *Alan v. Super. Ct. (USB Painwebber, Inc.)*, 3 Cal. Rptr. 3d 377, 388-89 (Cal. Ct. App. 2003)). 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.

84. *Id.* at 548.

85. 15 U.S.C. § 77r (2005).

86. *Jevne*, 6 Cal. Rptr. 3d at 554 (citing *Roskind v. Morgan Stanley Dean Witter & Co.*, 95 Cal. Rptr. 2d 258, 262 (Cal. Ct. App. 2000) (state law remedies and regulations available under California Business and Professions Code Section

and only conflict preemption was implicated in the case.⁸⁷ The court of appeal then found that there was an actual conflict between the New Ethics Rules⁸⁸ and the NASD rules⁸⁹ concerning arbitrator disqualification.⁹⁰ “Under Standard 10, an arbitrator is disqualified when a party files a notice with the court, and assuming the arbitrator fails to disqualify him or herself upon learning the challenge, the superior court will make the ultimate decision on disqualification.”⁹¹ 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.⁹² 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.”⁹³

The court of appeal in *Jevne* also addressed the conflicts between the disclosures required under Standard 7 of the New Ethics Rules⁹⁴ and those required under the NASD rules.⁹⁵ 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;”⁹⁶ that a “difference in drafting philosophy does not present a physical conflict requiring preemption.”⁹⁷ However, the lack of an actual conflict did not end the court’s inquiry and, ultimately, the court found that “Standard 7

17200 supplement federal securities law)).

87. *Id.*

88. Cal. Rules of Court App. Div. VI, Std. 10 (2005).

89. NASD, Code of Arbitration, Rules 10308-10313, *available at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited March 20, 2006).

90. *Jevne*, 6 Cal. Rptr. 3d at 554.

91. *Id.* at 555.

92. *Id.*

93. *Id.*

94. Cal. Rules of Court App. Div. VI, Std. 7(d) (2005).

95. NASD, Code of Arbitration, Rule 10312(a), *available at* http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited March 20, 2006).

96. *Jevne*, 6 Cal. Rptr. 3d at 558.

97. *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.*, 623 P.2d 165, 179 (Cal. 1981)).

stands as an obstacle to the Exchange Act,” and was thus preempted.⁹⁸

98. *Id.* (citing *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372 (2000)). In *Crosby*, 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.” *Id.* The court further noted 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. Am. Honda Motor Co. Inc.*, 529 U.S. 861, 883 (2000); *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282, 286 (9th Cir. 1988)).

5. The Grunwald Case

Most recently, the United States Court of Appeals for the Ninth Circuit handed down an expedited decision in *Credit Suisse First Boston Corp. v. Grunwald*,⁹⁹ holding 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.¹⁰⁰ *Grunwald* involved an employment dispute between Scott Grunwald and his former employer, Credit Suisse First Boston (CSFB).¹⁰¹ 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.¹⁰² “Grunwald then filed a demand for arbitration with American Arbitration Association (AAA).”¹⁰³ 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.¹⁰⁴ Grunwald subsequently filed a demand for arbitration with NASD.¹⁰⁵ 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 out-of-state arbitration.¹⁰⁶ Grunwald refused to waive the New Ethics Rules and declined the NASD’s offer to proceed with arbitration outside California.¹⁰⁷ He 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.¹⁰⁸ That motion was denied based on the district court’s findings that the New Ethics Rules do not apply to

99. *Credit Suisse First Boston Corp. v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005).

100. *Id.* at 1121.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.* at 1121-22.

105. *Id.* at 1122.

106. *Id.*

107. *Id.* at 1123.

108. *Id.*

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.¹⁰⁹ Grunwald took the matter up on appeal to the Ninth Circuit.¹¹⁰

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.¹¹¹ On that issue, this was a case of first impression.¹¹² 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 Commission¹¹³ had preemptive force and would preempt the New Ethics Rules if they were found to be in conflict with the NASD arbitration disclosure rules.¹¹⁴

The Ninth Circuit found that the New Ethics Rules did conflict with the NASD arbitration disclosure rules and, as such, were preempted.¹¹⁵ First, the court found that the NASD could not simultaneously comply with the disqualification rules of both the NASD and the New Ethics Rules.¹¹⁶ 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

109. *Id.*

110. *Id.* at 1121.

111. *Id.* at 1125-26.

112. *Id.* at 1128 (citing *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 127 (1973)). In *Ware*, 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.'" *Ware*, 414 U.S. at 127 (quoting *Silver v. NYSE*, 373 U.S. 341, 361 (1963))).

113. 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) (2005). See *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 223 (1987) ("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) (2005).

114. *Grunwald*, 400 F.3d at 1128.

115. *Id.*

116. *Id.* at 1133.

disqualification once a party serves a timely notice of disqualification.¹¹⁷ If the arbitrator fails to remove himself or herself from the panel, the arbitration award is then subject to mandatory vacatur.¹¹⁸ 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.¹¹⁹ 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.¹²⁰ 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.”¹²¹

Next, the court found that in contrast to the disqualification rules, it was not physically impossible for an arbitrator to comply with both the New Ethics Rules and the rules governing NASD arbitrations simultaneously.¹²² “Nothing in the NASD Code prevents an arbitrator from disclosing more information than is required by the NASD Code’s disclosure rule.”¹²³ 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.”¹²⁴

117. *Id.* (citing Cal. Rules of Court App. Div. VI, Std. 10(a)(1) (2005)).

118. *Id.* (citing CAL. CIV. PROC. CODE § 1286.2(a)(6) (2005)).

119. *Id.* (citing NASD, Code of Arbitration, Rules 10308(d)(2), available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited March 20, 2006)).

120. *Id.*

121. *Id.*

122. *Id.* at 1134.

123. *Id.* (citing *North Star Int’l v. Ariz. Corp. Comm’n*, 720 F.2d 578, 583 (9th Cir. 1983) (“While the state standards are more stringent than the federal standards, it is possible to comply with both.”)); see NASD, Code of Arbitration, Rule 10312(a), available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure (last visited March 20, 2006).

124. *Grunwald*, 400 F. 3d at 1136; see also *Medtronic, Inc. v. Lohr*, 518 U.S. 470, 496 (1996) (“Because 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.’”) (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (“Our primary function is to determine whether, under the circumstances of this particular case, [state] law stands as an obstacle to the accomplishment and

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 the 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 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. Background

The FAA was enacted in 1925 and declared a national policy favoring arbitration of disputes.¹²⁵ 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 upon the same footing as other contracts.”¹²⁶ For the FAA to apply, the agreement itself must involve a “maritime transaction or a contract evidencing a transaction involving commerce.”¹²⁷ 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.¹²⁸ In a series of decisions since 1983, the Supreme Court has construed the FAA as a federal declaration of pro-arbitration public policy that preempts contrary state law.¹²⁹

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 Manufacturing Corp.*,¹³⁰ and *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*¹³¹ In those cases, the

125. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 56 (1995).

126. *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24 (1991); *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 474 (1989).

127. 9 U.S.C. § 2 (2005). 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 (2005).

128. 9 U.S.C. § 4 (2005); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 218 (1985); *see also* *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105, 111 (2001).

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

130. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967).

131. *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983).

Supreme Court “stated its belief that the FAA is an exercise of [Congress’s] Commerce Clause authority creating a body of federal substantive law governing arbitration, applicable in both the federal and state courts.”¹³² The law of preemption has two dimensions:¹³³ The first concerns state law which is found to conflict with the FAA¹³⁴ and is represented by *Southland Corp. v. Keating*,¹³⁵ *Perry v. Thomas*,¹³⁶ *Allied-Bruce Terminix Cos. v. Dobson*,¹³⁷ and *Doctor’s Associates Inc., v. Casarotto*.¹³⁸ 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,”¹³⁹ and is embodied in *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*¹⁴⁰ and *Mastrobuono v. Shearson Lehman Hutton, Inc.*¹⁴¹

“The FAA [itself] contains no express preemptive provisions, nor does it reflect a congressional intent to occupy the entire field of arbitration.”¹⁴² Likewise, the FAA does not represent a federal policy of favoring arbitration under a certain set of procedural rules.¹⁴³ States are free to establish their own arbitration rules and procedures even where the controversy is governed by federal substantive law.¹⁴⁴ State laws concerning arbitration are only preempted to the extent that they conflict with congressional intent to favor the enforcement of arbitration agreements.¹⁴⁵ 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.”¹⁴⁶

132. Hayford, *supra* note 129, at 69.

133. *Id.*

134. *Id.*

135. *Southland v. Keating*, 465 U.S. 1 (1984).

136. *Perry v. Thomas*, 482 U.S. 483 (1987).

137. *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995).

138. *Doctor’s Assocs., Inc. v. Casarotto*, 517 U.S. 681 (1996).

139. Hayford, *supra* note 129, at 69.

140. *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468 (1989).

141. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995).

142. *Volt*, 489 U.S. at 477.

143. *Id.* at 467-77.

144. *Felder v. Casey*, 487 U.S. 131, 138 (1988).

145. *Volt*, 489 U.S. at 477.

146. *Id.* (quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941)); *see also* *Southland v. Keating*, 465 U.S. 1, 16 (1984); *Perry v. Thomas*, 482 U.S. 483, 489-

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.¹⁴⁷ State laws that are not anti-arbitration are not automatically preempted under the FAA.¹⁴⁸ In this regard, the Supreme Court has specifically recognized California's procedures and rules governing arbitration as being "designed to encourage resort to the arbitral process" and not to conflict with "any other policy embodied in the FAA."¹⁴⁹

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."¹⁵⁰ In two of the cases discussed below, the courts were asked to determine whether the FAA preempted the New Ethics Rules, making them legally ineffective in arbitrations subject to the FAA. In one of the cases discussed below, the court was asked to determine whether the FAA preempts the mandatory vacatur requirement contained in the New Ethics Rules.

90 (1987).

147. See, e.g., *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681 (1996) (preempting Montana law which invalidated arbitration agreements unless they contained special notice placed on first page of the agreement); *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 270 (1995)

(preempting Alabama law which invalidated predispute arbitration agreements); *Southland v. Keating*, 465 U.S. 1 (1984) (preempting California law which invalidated arbitration agreements between franchisors and franchisees).

148. In cases to which it applies, the FAA has "limited preemptive effect" on state law. *Hedges v. Carrigan*, 11 Cal. Rptr. 3d 787, 791 (Cal. Ct. App. 2004). "The FAA contains no express pre-emptive provision, nor does it reflect a congressional intent to occupy the entire field of arbitration. But even when Congress has not completely displaced state regulation in an area, state law may nonetheless be pre-empted to the extent that it actually conflicts with federal law – that is, to the extent that it 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" *Cronus Invs., Inc. v. Concierge Servs.*, 107 P.3d 217 (Cal. 2005) (quoting *Volt*, 489 U.S. at 477) (citation omitted).

149. *Volt*, 489 U.S. at 476.

150. *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 66 (1995) (quoting *Volt*, 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.*, 28 F.3d 704, 709 (7th Cir. 1994).

2. The 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.¹⁵¹ In addition to the preemption challenge under the Exchange Act, the court was also asked to determine whether the New Ethics Rules were preempted under the FAA.¹⁵² 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 NYSE arbitration rules.¹⁵³ 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.”¹⁵⁴ 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.”¹⁵⁵ 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.*¹⁵⁶ 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.”¹⁵⁷ 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.¹⁵⁸

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

151. *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097 (N.D. Cal. 2003).

152. *Id.* at 1112-16.

153. *Id.* at 1114.

154. *Id.*

155. *Id.*

156. *Commonwealth Coatings Corp. v. Cont’l Cas. Co.*, 393 U.S. 145 (1968).

157. *Id.* at 149.

158. *Mayo*, 258 F. Supp. 2d at 1114.

Ethics Rules conflicted directly with the FAA.¹⁵⁹ 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.¹⁶⁰

3. The 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.¹⁶¹ 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.¹⁶² 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.¹⁶³ 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,"¹⁶⁴ 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,"¹⁶⁵ 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.'"¹⁶⁶ 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.¹⁶⁷

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

159. *Id.* at 1116.

160. *Id.* at 1115-16.

161. *Jevne v. Super. Ct. of Los Angeles County*, 6 Cal. Rptr. 3d 542 (Cal. Ct. App. 2003).

162. *Id.* at 551.

163. *Id.*

164. *Id.* (citing *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 477 (1989)).

165. *Id.* at 552.

166. *Id.* (quoting *Volt*, 489 U.S. at 476).

167. *Id.* (citing *Commonwealth Coatings Corp. v. Cont'l Cas. Co.*, 393 U.S. 145, 149 (1968)).

because the New Ethics Rules “differ from the NASD arbitration procedures [specifically] agreed to by the parties in their arbitration agreement.”¹⁶⁸ The real parties in interest argued that “under the FAA, they are entitled to have the arbitration agreement enforced according to its terms.”¹⁶⁹ The real parties in interest argued that “Jevne’s effort[s] to avoid arbitration altogether based on [the New Ethics Rules] fails because an arbitration agreement subject to the FAA may be invalidated only on legal or equitable grounds applying to the revocation of any contract.”¹⁷⁰ 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 Exchange Act preempted the New Ethics Rules.¹⁷¹

4. The Ovitz Case

As discussed in Section D below, in October 2005, the California Court of Appeal was asked to interpret and apply the disclosure and disqualification standards pertaining to employment by a party or a lawyer for a party while the first arbitration matter was still open and pending in *Ovitz v. Schulman*.¹⁷² The court reached the preemption issue after applying the vacatur provisions set forth in Section 1286.2 of the California Code of Civil Procedure so as to require vacatur of an arbitration award issued after the parties had spent over a year and one million dollars on the arbitration process.¹⁷³ The issue in *Ovitz* was whether the mandatory vacatur provision contained in Section 1286.2(a)(6)(A) was inconsistent with Section 10(a)(2) of the FAA, which requires a showing of evident partiality or corruption of the arbitrators as a condition to granting a vacatur request.¹⁷⁴

168. *Id.* at 552 n.8.

169. *Id.*

170. *Id.* (citing 9 U.S.C. § 2; *Southland v. Keating*, 465 U.S. 1, 10 (1984)).

171. *Id.*

172. *Ovitz v. Schulman*, 35 Cal. Rptr. 3d 117 (Cal. Ct. App. 2005).

173. *Id.* at 119-20.

174. *Id.* at 131. On appeal, the *Ovitz* parties argued that Section 10(a)(2) of the FAA “permits vacating of an arbitration award for inadequate disclosure only if the undisclosed facts create a ‘reasonable impression of partiality.’” *Id.* at 131 (quoting *Schmitz v. Zilveti*, 29 F.3d 1043, 1046 (9th Cir. 1994)). The *Ovitz* parties then argued that this standard preempted Section 1286.2(a)(6)(A) of the California Code of Civil Procedure, which mandates vacatur for “any violation of California’s disclosure obligations, regardless of whether the undisclosed facts create a reasonable impression of partiality.” *Id.*

At the outset of its preemption discussion, the court noted that there is “considerable debate among the federal circuits concerning the proper test of evident partiality under section 10(a)(2).”¹⁷⁵ Understanding that uncertainty, the court opted to follow the Ninth Circuit’s “reasonable impression of partiality” test as the correct definition.¹⁷⁶ That assumption in place, the court held that the answer to the preemption issue lay “in the relevant statutory language of the FAA, the purpose of that legislation, and the parties’ arbitration agreement.”¹⁷⁷ As to the first issue—the relevant statutory language of the FAA—the court found that Sections 10 and 12 specifically reference proceedings in “the United States court” or proceedings involving service “by the marshal of any district” and that such language “strongly suggests that sections 10 and 12 apply only to federal district courts, not state trial courts.”¹⁷⁸

As to the second issue—the purpose of the FAA—the Court found that absent an express preemption provision, the mere existence of federal legislation does not resolve the question of preemption,¹⁷⁹ and courts must also consider the broader objectives of the federal legislation.¹⁸⁰ In this regard, the court noted that the California Supreme Court has stated that “state contract rules generally govern the construction of arbitration agreement” and that “federal policy is simply to ensure the enforceability, according to their terms, of private agreements to arbitrate.”¹⁸¹ The court determined that, by its terms, Section 1286.2(a)(6)(A) of the California Code of Civil Procedure does not undermine the enforceability of arbitration agreements because “[i]t neither limits the rights of contracting parties to submit disputes to arbitration, nor discourages persons from using arbitration.”¹⁸² Section 1286.2(a)(6)(A) merely requires the vacating of an award if the arbitrator

175. *Id.* at 132.

176. *Id.* (citing *Britz, Inc. v. Alfa-Laval Food & Dairy Co.*, 40 Cal. Rptr. 2d 700 710 (Cal. Ct. App. 1995)).

177. *Id.*

178. *Id.* at 133 (citing *Siegel v. Prudential Ins. Co.*, 79 Cal. Rptr. 2d 726 734 (Cal. Ct. App. 1998) (holding that the statutory language of sections 10 and 12 “weighs materially against application . . . to a forum other than the United States District Court of the district in which the award was made”)).

179. *Id.* (citing *Rosenthal v. Great W. Fin. Sec. Corp.*, 926 P.2d 1061, 1068 (Cal. 1996)).

180. *Id.*

181. *Id.* at 134 (quoting *Cronus Invs., Inc. v. Concierge Servs.*, 107 P.3d 217, 222 (Cal. 2005)).

182. *Id.*

fails to timely disclose a ground for disqualification of which he or she was aware.¹⁸³ In so ruling, the court rejected the Ovitz parties' argument that Section 1286.2(a)(6)(A) undermines the entire arbitration process by allowing a party to seize upon a technicality to vacate an arbitration award, finding that in fashioning the disclosure requirements contained in the New Ethics Rules, the Judicial Council "made a reasoned effort to list matters that 'could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial.'"¹⁸⁴ The court also found that, when a court vacates an arbitration award under that section, the undisclosed matter "is one that the Judicial Council (with authority from the legislature) has deemed sufficient to undermine an objective perception of fairness."¹⁸⁵

As to the third and final issue—the inconsistency of the vacatur requirements under Section 1286.2 and the parties' arbitration agreement—the court relied on *Volt*, noting that there is "no federal policy favoring arbitration under a certain set of procedural rules" and that federal policy is simply to ensure the enforceability of private arbitration agreements according to their terms.¹⁸⁶ The court found that the parties' agreement concerning the arbitration was to be determined by applying the objective intent test.¹⁸⁷ In *Ovitz*, there were several indicators that the parties intended Section 1286.2(a)(6)(A) to apply.¹⁸⁸ First, they accepted the arbitrator's appointment subject to all of the disclosure requirements imposed on arbitrators under the California Code of Civil Procedure.¹⁸⁹ Second, the court noted that the arbitrator's disclosure worksheet purported to comply with the New Ethics Rules.¹⁹⁰ Third, and perhaps most importantly, the parties' arbitration agreement

183. *Id.* "Indeed, because it applied to vacating an arbitration award, section 1286.2(a)(6)(A) presupposes that the arbitration agreement has been enforced and the arbitration held. If an award is vacated, the result is not a preclusion of further arbitration, but rather a new arbitration held in accordance with the disclosure requirements." *Id.*

184. *Id.* (quoting CAL. CIV. PROC. CODE § 1281.9(a) (2005)).

185. *Id.* at 135.

186. *Id.* (citing *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 476 (1989)).

187. *Id.* (citing *Founding Members of Newport Beach Country Club v. Newport Beach Country Club, Inc.*, 135 Cal. Rptr. 2d 505, 514 (Cal. Ct. App. 2003) (The objective intent of contracting parties controls contract interpretation, rather than subjective intent)).

188. *Id.*

189. *Id.*

190. *Id.*

provided that the arbitration would be final and binding and that judicial review would be “limited as provided by California Code of Civil Procedure § 1286.2 or other applicable law.”¹⁹¹ The court concluded that, “given the parties’ expectation that California disclosure rules applied, they necessarily understood that the arbitration award could be vacated under section 1286.2(a)(6)(A) for a violation of the disclosure requirements.”¹⁹²

5. Conclusion

While *Mayo* and *Ovitz* reached opposite outcomes on the preemption issue, the turning point in both courts’ reasoning was the specific language of the parties’ agreement. In *Mayo*, the parties contracted to submit to arbitration before the NYSE in accordance with its rules. In *Ovitz*, the parties contracted to submit to arbitration before the AAA in accordance with the New Ethics Rules and the grounds for vacatur set forth in Section 1286.2 of the California Code of Civil Procedure.

With respect to the general preemption issue raised in *Jevne* and *Mayo*, these decisions represent two different approaches to the FAA preemption issue and led to 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. 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

1. Background

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 in law or equity for the revocation of any contract.”¹⁹³ “State law, whether of legislative or judicial origin, is

191. *Id.* at 136.

192. *Id.*

193. *Perry v. Thomas*, 482 U.S. 483, 492 n. 9 (1987) (quoting 9 U.S.C. § 2

applicable if that law arose to govern issues concerning the validity revocability, and enforceability of contracts generally.”¹⁹⁴ “A state-law principle that takes it meaning precisely from the fact that a contract to arbitrate at issue does not comport” with Section 2 of the FAA.¹⁹⁵ 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.¹⁹⁶

2. The Alan Case

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 Painwebber, Inc.)*.¹⁹⁷ 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?¹⁹⁸ 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.¹⁹⁹ The customer agreement provided that, if the investor failed to select the arbitral forum, the brokerage firm could select the arbitral forum.²⁰⁰ In response to the lawsuit, the defendants filed a motion seeking an order compelling the

(2005)); see *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

194. *Perry*, 482 U.S. at 492 n 9.

195. *Id.*

196. *Id.*; see also *Thomas v. Perry*, 246 Cal. Rptr. 156, 158 (Cal. Ct. App. 1988) (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).

197. *Alan v. Super. Ct. of Los Angeles County (USB Painwebber, Inc.)*, 3 Cal. Rptr. 3d 377 (Cal. Ct. App. 2003).

198. *Id.* at 385. 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 388-89.

199. *Id.* at 385.

200. *Id.* at 380-81.

plaintiff to arbitrate the dispute and staying the state court action.²⁰¹ Because the plaintiff had not selected an arbitral forum, the defendants designated the NASD as the arbitral forum.²⁰² 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.²⁰³

Without submitting the matter to the NASD, the plaintiff filed a petition for writ of mandate to the California Court of Appeal.²⁰⁴ 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.²⁰⁵ The court rejected defendants' argument that the trial court could appoint an arbitrator under California Code of Civil Procedure Section 1281.6²⁰⁶ 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 matter in accordance with NASD rules.²⁰⁷ While acknowledging that it was consistent under both the California

201. *Id.* at 382.

202. *Id.*

203. *Id.*

204. *Id.* at 383.

205. *Id.*

206. 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* (emphasis added)."

207. *Alan*, 3 Cal. Rptr. 3d at 384-87 (citing *In re Salomon Inc. Shareholders' Derivative Lit.*, 68 F.3d 554 (2d Cir. 1995) (failure of NYSE forum due to the NYSE's decision that the disputed should not be arbitrated, which was within its discretion to do)).

Arbitration Act and the FAA for the court to appoint an arbitrator if that was the obstacle to convening arbitration,²⁰⁸ the court found that its appointment of an arbitrator was “not an adequate alternative to an NASD forum.”²⁰⁹

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.²¹⁰ 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 allows the NASD to conduct the hearing in any location it chooses.”²¹¹ 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 the forum-selection clause . . . [if] enforcement would be unreasonable and 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.’”²¹² 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 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.”²¹³

On remand, the trial court concluded: (1) the New Ethics Rules were preempted by federal law; (2) the New Ethics Rules could not be

208. *Id.* at 387 (citing *Brown v. ITT Consumer Fin. Corp.*, 211 F.3d 1217, 1222 (11th Cir. 2000) (arbitration may proceed in a forum not mentioned in the arbitration clause where choice of arbitral forum was not an integral part of the agreement); *Lewis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 228 Cal. Rptr. 345, 351 (Cal. Ct. App. 1986) (dictum stating that arbitral for a contained in arbitration provision were not exclusive arbitral fora; no analysis of whether choice of for a was an integral term of the agreement); *McManus v. CIBC World Mkts. Corp.*, 34 Cal. Rptr. 2d 446, 465 (Cal. Ct. App. 2003)).

209. *Id.*

210. *Id.* at 388.

211. *Id.*

212. *Id.* (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.*, 473 U.S. 614, 632-33 (1985); *Dominium Austin Partners, L.L.C. v. Emerson*, 248 F.3d 720, 727 (8th Cir. 2001); *Hayes Children Leasing Co. v. NCR Corp.*, 43 Cal. Rptr. 2d 650, 658 n.5 (Cal. Ct. App. 1995)); *see Bolter v. Super. Ct.*, 104 Cal. Rptr. 2d 888 (Cal. Ct. App. 2001); *Wilmot v. McNabb*, 269 F. Supp. 2d 1203 (N.D. Cal. 2003).

213. *Alan*, 3 Cal. Rptr. 3d at 388.

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.²¹⁴ The trial court thus renewed its order directing the matter back to arbitration.²¹⁵ 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.²¹⁶ Plaintiff refused to give such a waiver in order to preserve his right to return to the trial court.²¹⁷ As a result, the NASD closed the case without hearing and without prejudice.²¹⁸ 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.²¹⁹ The trial court granted the motion for reconsideration, and upon reconsideration it concluded that the matter should be arbitrated.²²⁰ However, because the NASD refused to convene arbitration without a waiver from plaintiff, which plaintiff would not give, the suit was in limbo.²²¹ Plaintiff then filed a second petition with the California Court of Appeal for a peremptory writ of mandate.²²²

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.”²²³ 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

214. *Alan v. Superior Court of Los Angeles County*, No. B178840, 2004 WL 2943286, at *4 (Cal. Ct. App. Dec. 21, 2004, revised Jan. 11, 2005).

215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.*

222. *Id.* at *5.

223. *Id.*

Circuit, and possibly the United States Supreme Court—is final.”²²⁴ The appellate court concluded that there was thus not “a plain, speedy and adequate remedy at law.”²²⁵ The trial court was instructed to vacate the orders compelling arbitration and to restore the case to the civil active list for trial.²²⁶

3. The Alan Case Progeny

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 those raised in *Alan*.²²⁷ The only case to follow *Alan* was a decision reported by Division 6 of the Second District of the California Court of Appeal shortly after *Alan* was reported.²²⁸ The balance of the cases have rejected or distinguished *Alan* on federal law preemption grounds. The courts have relied on the decisions in *Mayo* and *Jevne* which were reported after the first *Alan* decision,²²⁹ have granted the brokerage firms’ motions to compel

224. *Id.*

225. *Id.*

226. *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 it 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 *2 (citing *Hightower v. Super. Ct. of Los Angeles County*, 104 Cal. Rptr. 2d 209, 219 (Cal. Ct. App. 2001)).

227. *Wilmot v. McNabb*, 269 F. Supp. 2d 1203 (N.D.Cal. 2003); *Belinsky v. BPM Goldman Fin. Design, L.L.C.*, No. A104645, 2004 WL 2632550 (Cal. Ct. App. Nov. 18, 2004); *Marcus v. Trautman Wasserman & Co., Inc.*, No. A104187, 2004 WL 2191332 (Cal. Ct. App. Sept. 30, 2004); *Davis v. Oppenheimer & Co.*, No. A102929, 2004 WL 1053191 (Cal. Ct. App. May 11, 2004); *Winberg v. Salomon Smith Barney*, No. F042866, 2004 WL 292217 (Cal. Ct. App. Feb. 13, 2004); *Chen v. Morgan Stanley DW Inc.*, No. B167545, 2004 WL 33433 (Cal. Ct. App. Jan. 7, 2004); *Linden v. Am. Express Fin., Inc.*, No. B162566, 2003 WL 22430229 (Cal. Ct. App. Oct. 27, 2003); *Rodriguez v. Morgan Stanley DW Inc.*, No. D040868, 2003 WL 22089385 (Cal. Ct. App. Sept. 10, 2003).

228. *Linden*, 2003 WL 22430229, at *1 (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).

229. *Wilmot*, 269 F. Supp. 2d at 1207 n.4 (follows *Mayo*; no right to arbitrate in California before arbitration panel that is compliant with the New Ethics Rules);

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.

4. Conclusion

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 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 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

1. Disclosure and Disqualification Generally

As noted in Section 2, above, the Uniform Arbitration Act as originally adopted by California in 1961 provided for vacatur of an arbitrator’s award upon a showing of actual bias. The New Ethics Rules dramatically changed the standard for vacatur of an arbitration award by directly tying the disclosure requirements²³⁰ and the disqualification

Belinsky, 2004 WL 2632550, at *6 (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); *Marcus*, 2004 WL 2191332, at *7 (validates NASD waiver requirements and finds New Ethics Rules preempted by federal securities law); *Davis*, 2004 WL 1053191, at *4 (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); *Winberg*, 2004 WL 292217, at *6 (follows *Jevne* and *Mayo*; declines to follow *Alan*); *Chen*, 2004 WL 33433, at *3-4 (followed *Jevne* and *Mayo*; expressly declined to follow *Alan*); *Rodriquez*, 2003 WL 22089385, at *6 (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).

230. Section 1281.9 of the California Code of Civil Procedure provides that a

standards²³¹ to vacatur. Should an arbitrator not comply with the disqualification requirements set forth in Section 1281.91 of the California Code of Civil Procedure, Section 1286.2(a)(6)(B) provides that any award by the arbitrator *shall* be vacated.²³² If an arbitrator fails to make any of the disclosures required under Section 1281.9 of the California Code of Civil Procedure, Section 1286.2(a)(6)(A) likewise provides that any award by the arbitrator *shall* be vacated.²³³

The primary enforcement mechanism for the New Ethics Rules is thus vacatur irrespective of whether there is evidence of partiality or even an appearance of potential partiality by the arbitrator. The cases discussed below are the only reported cases to date in which the New Ethics Rules have been applied, rather than challenged. Those cases confirm the strict conformance required under the New Ethic Rules on penalty of vacatur, which nullifies the prior arbitration proceedings and sends the parties back to have their matter re-heard and decided by a new arbitrator.

2. The Azteca Case

Azteca Construction, Inc. v. ADR Consulting, Inc.,²³⁴ 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-titled "Construction Industry Dispute Resolution Procedures" (the "AAA

"proposed neutral *shall* disclose all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial" (emphasis added) and then lists six disclosure items, including the ethics standards for neutral arbitrators adopted by the Judicial Council. CAL. CIV. PROC. CODE § 1281.9(a) (2005).

231. Section 1281.91 of the California Code of Civil Procedure provides for *automatic disqualification* of a proposed neutral arbitrator under two circumstances: First, if he or she fails to comply with the disclosure requirements set forth in Section 1281.9 and any party entitled to receive the disclosures serves a notice of disqualification within 15 days after the 10-day deadline for the proposed nominee or appointee to comply with Section 1281.9. Second, if he or she complies with Section 1281.9 but a party entitled to receive the disclosure serves a notice of disqualification within 15 calendar days after service of the arbitrator's disclosure statement. CAL. CIV. PROC. CODE § 1281.91.

232. *Id.* § 1286.2(a)(6).

233. *Id.* § 1286.2(a)(16).

234. *Azteca Constr. v. ADR Consulting, Inc.*, 18 Cal. Rptr. 3d 142 (Cal. Ct. App. 2004).

Rules”).²³⁵ A dispute arose in October 2002 and ADR served a demand on Azteca Construction for arbitration in accordance with the AAA Rules.²³⁶ Because the parties were unable to agree on a neutral arbitrator from the AAA list, the AAA proposed the arbitrator, an attorney named Paul Taylor.²³⁷ Taylor timely made the disclosures required under the New Ethics Rules in November 2002.²³⁸ 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.²³⁹

“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.”²⁴⁰ Taylor also disclosed that in 1985 he had had a prior relationship with ADR Consulting’s attorney.²⁴¹ 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.²⁴² In response to Taylor’s disclosures, Azteca Construction timely objected to Taylor’s appointment via a letter sent to AAA.²⁴³ Azteca Construction requested that Taylor be removed as arbitrator based on his disclosed relationship with ADR Consulting’s attorney.²⁴⁴ AAA investigated the objection and determined that Taylor should not be disqualified. It then notified the parties that Taylor’s appointment was being reaffirmed.²⁴⁵

An arbitration hearing was conducted in March 2003.²⁴⁶ 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.²⁴⁷ Azteca Construction again objected to Taylor’s appointment as arbitrator

235. *Id.* at 144.

236. *Id.*

237. *Id.*

238. *Id.*

239. *Id.*

240. *Id.* at 145.

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.*

247. *Id.*

and requested that Taylor disqualify himself.²⁴⁸ 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.²⁴⁹ Taylor then issued a final award in April 2003.²⁵⁰ 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.²⁵¹ 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.²⁵²

Azteca Construction appealed and, in a very well reasoned opinion surveying California arbitration law, the trial court was reversed.²⁵³ 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."²⁵⁴ In this regard, the court of appeal found that AAA Rule R-20(b) "must yield to the disqualification scheme set forth in sections 1281.9 and 1281.91, for a number of reasons."²⁵⁵ 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."²⁵⁶ 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.²⁵⁷ As stated by

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.* at 143.

254. *Id.* at 149.

255. *Id.*

256. *Id.* at 150 (quoting *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 682 (Cal. 2000)); see *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165, 176 (Cal. 1981).

257. *Azteca*, 18 Cal. Rptr. 3d at 150 (citing *WARREN KNIGHT, EL AL.*,

the California Court of Appeal in *Britz, Inc. v. Alfa-Laval Food & Dairy Co.*,²⁵⁸ 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.²⁵⁹ 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.”²⁶⁰

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 required to apply the law to the facts presented in the *Azteca* case.²⁶¹ The appellate court very simply and succinctly determined that Taylor should have been disqualified before the arbitration began because 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.²⁶² 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.²⁶³ 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.²⁶⁴

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

CALIFORNIA PRACTICE GUIDE: ALTERNATE DISPUTE RESOLUTION ¶ 7:13, at 7-7 (The Rutter Group 2003)).

258. *Britz, Inc. v. Alfa-Laval Food & Dairy Co.*, 40 Cal. Rptr. 2d 700 (Cal. Ct. App. 1995). The California Court of Appeals in *Britz* 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. *Id.* at 710.

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

260. *Azteca*, 18 Cal. Rptr. 3d at 150.

261. *Id.* at 151.

262. *Id.*

263. *Id.*

264. *Id.*

any of the matters required to be disclosed . . . necessarily satisfies that standard.”²⁶⁵ 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.²⁶⁶ 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.²⁶⁷

3. The Ovitz Case

*Ovitz v. Schulman*²⁶⁸ was decided by the Second District of the California Court of Appeal in October 2005.²⁶⁹ *Ovitz* involved an arbitration based upon an employment contract between a joint venture called StudioCanal/APG Venture and Cathy Schulman.²⁷⁰ The employment agreement included a provision for private arbitration before the AAA.²⁷¹ In February 2002, disputes arose between Schulman, on the one hand, and Studio Canal/APG Venture, Michael Ovitz, and several related entities on the other, which led to Schulman’s departure.²⁷² Schulman claimed that she was terminated without cause. The Ovitz parties claimed that Schulman resigned.²⁷³

In September 2002, relying on the arbitration clause contained in Schulman’s employment contract, the Ovitz parties served a demand for arbitration on Schulman and filed a demand with the AAA.²⁷⁴ Schulman disputed AAA’s jurisdiction over her claims against the Ovitz parties and filed a civil lawsuit in the Los Angeles Superior Court in October 2002.²⁷⁵ The Ovitz parties then moved to compel arbitration.²⁷⁶ That motion was granted in December 2002 as to the dispute between Schulman and StudioCanal/APG Venture.²⁷⁷

265. *Id.*

266. *Id.* at 152.

267. *Id.*

268. *Ovitz v. Schulman*, 35 Cal. Rptr. 3d 117 (Cal. Ct. App. 2005).

269. *Id.* at 117.

270. *Id.* at 119.

271. *Id.*

272. *Id.*

273. *Id.*

274. *Id.*

275. *Id.*

276. *Id.* at 120.

277. *Id.*

In January 2003, the Ovitz parties informed the AAA that they and Schulman had agreed upon the appointment of Retired Justice Campbell Lucas as their arbitrator, subject to all of the disclosure requirements imposed by the AAA and the New Ethics Rules.²⁷⁸ On January 14, 2003, the AAA faxed to counsel for both parties the arbitrator's disclosure form.²⁷⁹ Neither party took exception to the arbitrator's disclosures.²⁸⁰

In April 2003, the parties entered into an agreement to submit all of their claims to arbitration in the pending arbitration proceeding between Schulman and StudioCanal/APG Venture.²⁸¹ The arbitration proceeding began on September 8, 2003 and a twenty-three day evidentiary hearing was conducted during the early part of 2004.²⁸² Twenty-one witnesses testified in person, seventeen testified via declaration, and several hundred exhibits were introduced by the parties.²⁸³ On February 26, 2004, following closing arguments, the arbitrator orally ruled against Schulman on all of her claims, ruled in favor of the Ovitz parties on some of their claims and awarded the Ovitz parties approximately \$1.5 million in damages.²⁸⁴ Thereafter, on May 12, 2004, the arbitrator ruled that the Ovitz parties were entitled to \$1,878,739 in attorney's fees and costs.²⁸⁵

On May 27, 2004, after the Ovitz parties had circulated a proposed draft of the award, as instructed by the arbitrator, the AAA faxed a letter to counsel for the parties advising them of new disclosures made by the arbitrator on May 26, 2004, fourteen days after the May 12th ruling, which disclosed the fact that subsequent to his appointment in the Schulman case and before the start of the evidentiary hearing, the arbitrator had accepted appointment in another case involving the same law firm that was representing the Ovitz parties.²⁸⁶ In response to the May 2004 disclosures, Schulman requested the arbitrator's disqualification contending that the arbitrator had violated Sections 1281.9 and 1281.91 of the California Code of Civil Procedure because he had failed to disclose that he would entertain offers of employment

278. *Id.*

279. *Id.*

280. *Id.*

281. *Id.*

282. *Id.*

283. *Id.*

284. *Id.*

285. *Id.*

286. *Id.* at 120-21.

from the law firm representing the Ovitz parties and had failed to update his initial disclosures to disclose his subsequent employment by that Ovitz parties' firm in the second matter.²⁸⁷ The AAA denied Schulman's disqualification request and reaffirmed the arbitrator's appointment.²⁸⁸ Thereafter, when the Ovitz parties sought to confirm the arbitrator's award, Schulman sought to vacate the award pursuant to Section 1286.2(a)(6).²⁸⁹ The Los Angeles Superior Court vacated the award.²⁹⁰ On appeal by the Ovitz parties, the court of appeal affirmed.²⁹¹

The first disclosure problem the arbitrator in the *Ovitz* case had was with his original disclosure worksheet because it did not comply with Standard 12(b).²⁹² Missing from the arbitrator's disclosure worksheet was a declaration that, while the arbitration was pending, the arbitrator would entertain offers of employment or new professional relationships from a party or a lawyer for a party in the pending matter.²⁹³ Having failed to comply with Standard 12(b), the court of appeal construed Standard 12(c) to mean that the arbitrator was precluded from serving as an arbitrator in any other matter involving the parties or any lawyer for the parties until the pending arbitration matter was completed.²⁹⁴

The second disclosure problem the arbitrator in the *Ovitz* case had was with his failure to timely supplement his original disclosures when he accepted the engagement in the subsequent matter involving the Ovitz parties' lawyer.²⁹⁵ Besides being prohibited from serving in the second matter, the court of appeal found that the arbitrator's service in that matter was covered by the disclosure requirements of Standard 7(d)(4)(A)(i)—service “[a]s a neutral arbitrator in another . . . pending noncollective bargaining case [for] a lawyer for a party [to the current arbitration].”²⁹⁶ The court found that under Standard 7(c), the arbitrator was required to make disclosure of his engagement in the second matter within ten calendar days of his appointment, but that he did not do so until nearly three months after the date of the first hearing in the second

287. *Id.* at 121.

288. *Id.*

289. *Id.* at 122.

290. *Id.*

291. *Id.*

292. *Id.*

293. *Id.* at 122-23.

294. *Id.* at 124.

295. *Id.* at 127.

296. *Id.* (quoting Cal. Rules of Court Div. VI, Std. 7(d)(4)(A)(i) (2005)).

matter.²⁹⁷

In affirming the lower court's vacatur of the arbitration award, the court of appeal noted that under the New Ethics Rules, "an arbitrator's failure to comply timely with his or her disclosure obligations risks a severe consequence: the vacating of any arbitration award rendered by the arbitrator."²⁹⁸ The court found that within the time required for disclosure, the arbitrator failed to disclose two grounds of which he was aware that would justify disqualification under the New Ethics Rules: namely, his intent to entertain offers from employment from the parties or their counsel (Standard 12(b)) and his subsequent acceptance of such employment (Standards 7(d)(4)(A)(i) and 7(c)).²⁹⁹ Accordingly, the court of appeal found that these failures *required* that the arbitration award be vacated in accordance with Section 1286.2(a)(6)(A) of the California Code of Civil Procedure.³⁰⁰

4. Conclusion

The *Azteca* and *Ovitz* cases are bookend decisions with respect to vacatur under the New Ethics Rules: *Azteca* addressed the issue in the context of a disqualification request made at the outset of the arbitration. *Ovitz* addressed the issue in the context of a disqualification requested made after the arbitration had been concluded. Both involved arbitrations before the AAA in which the disqualification requests were denied, thereby prompting formal judicial proceedings to vacate the arbitration awards.

Azteca is instructive because it illustrates that a party challenging an arbitrator's appointment no longer has an independent burden to show that there are facts or circumstances which cast doubt on the arbitrator's capacity to be impartial; that through legislative mandate, the matters required to be disclosed under the New Ethics Rules satisfies that burden. To obtain disqualification, all a party need do is serve a request for disqualification within fifteen days of the arbitrator's disclosures and that request must be granted. The parties—not the arbitration tribunal and not the arbitrator—control disqualification.

Ovitz is likewise instructive because it illustrates the continuing nature of an arbitrator's disclosure obligation and, for full-time

297. *Id.*

298. *Id.*

299. *Id.* at 128.

300. *Id.*

arbitrators, sheds light on the disclosures mandated under Standard 12(b): namely an affirmative declaration at the outset that the arbitrator has an intent to entertain employment in other matters by the parties and the lawyers for the parties in the pending matter. *Ovitz* also demonstrates that when an arbitrator fails to adhere to the disclosure requirements, that action on his or her part jeopardizes the whole arbitration and gives rise to mandatory vacatur irrespective of the time and expense the parties have incurred in the process. The arbitrator—not the arbitration tribunal—is responsible for conforming to the disclosure requirements set forth in the New Ethics Rules and, again, the parties—not the arbitration tribunal or the arbitrator—control the disqualification issue.

IV. 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* and *Ovitz* cases, 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* 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.³⁰¹ Nevertheless, until recently, courts were reluctant to enforce pre-dispute arbitration agreements to compel arbitration of claims created by statute,

301. 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* *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987); *United Steelworkers of Am. v. Warrior & Gulf Navigation Co.*, 363 U.S. 574 (1960); *Madden v. Kaiser Found. Hosps.*, 552 P.2d 1178 (Cal. 1976).

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*,³⁰² 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."³⁰³ 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."³⁰⁴ The Supreme Court concluded that in view of these drawbacks to arbitration, the plaintiff's claims under the Exchange Act should not be ordered to arbitration.³⁰⁵

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.*,³⁰⁶ 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.³⁰⁷ In 1987, in *Shearson/American Express, Inc. v. McMahon*,³⁰⁸ 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).³⁰⁹ In 1989, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,³¹⁰ the Court held that a pre-dispute arbitration clause

302. *Wilko v. Swan*, 346 U.S. 427 (1953).

303. *Id.* at 436.

304. *Id.* at 436-37.

305. *Id.* at 438.

306. *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985).

307. *Id.* at 624.

308. *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

309. *Id.* at 220-21.

310. *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

contained in investors' customer agreements with the brokerage firm would be enforceable for purposes of compelling arbitration of investors' claims, which alleged that the brokerage firm had violated the Exchange Act—thus, expressly overruling *Wilko*.³¹¹ 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 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.³¹²

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.*,³¹³ 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.³¹⁴ When plaintiff was terminated at age sixty-two, he brought suit in federal district court, alleging violation of the Age Discrimination in Employment Act (ADEA).³¹⁵ 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.³¹⁶

311. *Id.* at 482. “*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 484.

312. *McMahon*, 482 U.S. at 232 (“In *Mitsubishi*, . . . we recognized that arbitral tribunals are readily capable of handling the factual and legal complexities 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.”).

313. *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991).

314. *Id.* at 20.

315. *Id.*

316. *Id.* at 30. “Initially, we note that in our recent arbitration cases we have already rejected most of [plaintiff’s] arguments as insufficient to preclude

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.³¹⁷ 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 granting 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 of 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* arbitration unless it includes a mechanism for ensuring neutrality in the rendering of the decision.³¹⁸ 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.

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

arbitration of statutory claims. Such generalized attacks on arbitration 'rest 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.'" *Id.* (citing *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477, 481 (1989)).

317. See GOLDBERG, *supra* note 1, at 242.

318. *Saeta v. Super. Ct.*, 11 Cal. Rptr. 3d 610, 614 (Cal. Ct. App. 2004); *Elliot & Ten Eyck P'ship v. City of Long Beach*, 67 Cal. Rptr. 2d 140, 144 (Cal. Ct. App. 1997); *Cheng-Canindin v. Renaissance Hotel Assocs.*, 57 Cal. Rptr. 2d 867, 872 (Cal. Ct. App. 1996).

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 controversies which have arisen to date have focused primarily on the expanded disclosure requirements contained in the New Ethics Rules in the context of securities arbitrations. As discussed in the *Azteca* and *Ovitz* cases, however, the bigger issue seems to be the mechanism for enforcing an arbitrator's disclosure obligations: namely vacating the award and forcing the parties to start all over when an arbitrator fails to comply with the disclosure requirements or fails to withdraw upon receipt of notice of disqualification from one of the parties to the arbitration.

As discussed in Section 3(D), an arbitrator's mere failure to disclose a conflict is not a basis to vacate an award under the FAA. Proof of evident partiality is required.³¹⁹ Because 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.³²⁰ 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.³²¹

319. 9 U.S.C. § 10(a)(2) (2005); *ANR Coal Co., Inc. v. Cogentrix of N.C., Inc.*, 173 F.3d 493 499-500 (4th Cir. 1999); *see also* *Montez v. Prudential Sec., Inc.*, 260 F.3d 980, 983 (8th Cir. 2001) (collecting cases and noting absence of consensus among circuit courts on definition of "evident partiality").

320. *See, e.g.,* *Michael v. Aetna Life & Cas. Ins. Co.*, 106 Cal. Rptr. 2d 240 (Cal. Ct. App. 2001) (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); *Ceriale v. AMCO Ins., Co.*, 55 Cal. Rptr. 2d 685 (Cal. Ct. App. 1996) (vacating an award based on common law standard of arbitrator bias).

321. One authority has predicted that to the extent the California grounds for vacatur depart from the grounds provided under the FAA, "there is a significant potential that litigation will ensue over whether an award involves interstate commerce." Alford, *supra* note 6, at 29. Another authority has described such

The *Ovitz* case, while well-reasoned and persuasive, is most likely not that last word on the issue of preemption concerning Section 1286.2(a)(6), which has been recognized as raising the “specter of federal preemption.”³²² It is anticipated that there will be further challenges to the vacatur requirements set forth in Section 1286.2(a)(6) of the California Code of Civil Procedure. As to those challenges, 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*.³²³ 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.”³²⁴ 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.”³²⁵

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 culminate enforcement of contractual agreements to arbitrate,”³²⁶ it is expected that FAA preemption of Section 1286.2(a)(6) will continue to be a fact-specific dispute and turn upon whether the parties’ agreement to arbitrate contains a choice-of-law provision or a specific reference to the New Ethics Rules as governing their arbitration.³²⁷

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

322. Alford, *supra* note 6, at 30.

323. Drahozal, *supra* note 320, at 406; Hayford, *supra* note 129, at 71.

324. Hayford, *supra* note 129, at 71 (citing *Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ.*, 489 U.S. 468, 478 (1989)).

325. Hayford, *supra* note 129, at 72 (citing *Volt*, 489 U.S. at 479).

326. Hayford, *supra* note 129, at 75.

327. The cases which have subjected Section 1286.2(a)(6) of the California Code of Civil Procedure section to preemption analysis have thus far determined that the FAA does not preempt California’s vacatur requirements. *See Ovitz v. Schulman*, 35 Cal. Rptr. 3d 117 (Cal. Ct. App. 2005); *Muao v. Grosvenor Props.*, 122 Cal.

V. 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.”³²⁸ This is a laudable goal, especially because arbitration is a private process that is dependent on public acceptance. One aspect 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.

The more troubling aspect of the controversy concerning the New Ethics Rules is the mechanism the legislature has chosen for enforcing the disclosure requirements. The disqualification/vacatur requirements of the new law place all of the power in the hands of the parties. Disqualification is no longer a matter to be reviewed by an independent third party, such as a judge or case manager. It is now something that a party to arbitration has a right to require *of the proposed or appointed arbitrator*, subject to the penalty of vacatur if the arbitrator (a) fails to make full disclosures or (b) fails to disqualify himself or herself upon request of any party to the arbitration. Under the circumstances witnessed in the *Ovitz* case, where the parties spent over a year and more than a million dollars in attorney’s fees and costs, there is obvious exposure to those persons who offer themselves out for employment in private arbitration matters. Disclosures are now serious business which, if not handled correctly at the outset and during the course of any engagement, will undermine the arbitration process.

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 it can or should be legislated by state statutes and

Rptr. 2d 131 (Cal. Ct. App. 2002) (finding that the FAA did not preempt Section 1286.2’s procedures for reviewing arbitral awards); *Siegel v. Prudential Ins. Co.*, 79 Cal. Rptr. 2d 726, 776 (Cal. Ct. App. 1998).

328. Cal. Rules of Court App. Div. VI, Std. 1(a) (2005).

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 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.