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Arbitration News

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UNITED STATES

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US Court of Appeals for the Second Circuit decides that courts have the power to stay arbitration under the Federal Arbitration Act

In early 2011, in *Republic of Ecuador v Chevron Corporation*,[1] the US Court of Appeals for the Second Circuit (which includes New York), declined to decide whether, as a matter of law, courts have the power under the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the 'New York Convention')[2] or the Federal Arbitration Act (FAA)[3] to order a stay of arbitration. Instead, the Second Circuit merely affirmed the lower court's denial of a stay. On 3 November 2011, the Second Circuit directly addressed this significant issue in *Ameriprise Financial Services, Incorporated v Beland (in re American Express Financial Advisors Securities Litigation)*,[4] holding that courts have the power to stay an arbitration in order to give effect to the parties' agreement not to arbitrate, as a corollary to the power to compel arbitration when the parties have agreed to arbitrate.

The underlying class action litigation

In 2004, plaintiffs brought several class action lawsuits in the US District Court for the Southern District of New York against American Express Financial Services and American Express Financial Advisors (later spun off from American Express Company as Ameriprise Financial Services and Ameriprise Financial Advisors). The disputes centered on allegations of conflicts of interest in directing client investments into mutual funds that had paid kickbacks to American Express.[5] The class actions were consolidated, and then settled in 2007, with a class of 2.8 million members certified for purposes of settlement. Part of the settlement, as the notice sent to class members indicated, included a broad release of the class members' claims. That broad release, however, included a carve-out for 'suitability claims' – claims alleging that a broker had recommended securities that were unsuitable for the client's investment objectives – not related to the claims concerning the mutual funds. Class members who did not opt out of the settlement were bound by it, even if they did not submit a claim.[6] The Southern District of New York retained exclusive jurisdiction over matters relating to the class action and the settlement, including the enforcement of the settlement agreement.[7]

Factual background to the case at bar

John and Elaine Beland are retired farmers in Illinois, with limited education. They received a substantial inheritance in 2004 and invested it with an Ameriprise broker. According to the Belands, the broker defied their request to invest their nest egg conservatively. Instead, they alleged, the broker invested in (i) risky mutual funds holding junk bonds or small-cap or start-up funds; and (ii) small-cap technology stocks, resulting in substantial losses. The Belands received notices about the class actions and the settlement, but ignored them, allegedly on the advice of their Ameriprise broker; they neither filed a claim nor opted out of the class.[8] The Belands claimed losses in the order of US$1.8m relating to the trust monies they inherited and a related charitable trust.

In 2008, the Belands commenced an arbitration before the Financial Industry Regulatory Authority (FINRA) for a range of claims including breach of fiduciary duty, self dealing, mishandling their assets, fraud and negligent misrepresentation.[9] Ameriprise and the broker answered in the arbitration and sought a stay of arbitration

from the arbitration panel on the basis of the release in the class action.[10] The panel denied the motion and scheduled a hearing on the merits.

Before the hearing could take place, Ameriprise and the broker moved in the district court to enforce the class action settlement against the Belands. The district court ultimately sided with Ameriprise and enforced the settlement against the Belands, finding that their claims fell within the release and that they were not excused from opting out of the class. The district court ordered the dismissal of their FINRA complaint with prejudice.[11] The Belands appealed.

The court determines arbitrability of the dispute

The appeals court first examined whether the Belands were bound to the settlement agreement and, after considering the notices given to class members and the Belands' arguments that their failure to opt out was the result of 'excusable neglect', found them bound to the settlement.

Given that the Belands were bound by the release in the settlement, the main question in the case, the court said, was whether any of the Belands' claims survived the release. The threshold question, however, was whether the district court or the arbitrators should make that determination; that is, whether the question of arbitrability was to be determined by the court or the arbitrators.

Arbitration is a matter of contract, and the parties' intentions determine whether they can be required to arbitrate. Under the FAA, 'any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration'.[12] Questions of arbitrability are for the court to determine unless the parties have 'clearly and unmistakably provid[ed] otherwise'.[13]

Here, the appeals court determined that the parties had not 'clearly and unmistakably' provided for the arbitrators to decide arbitrability, and arbitrability was therefore a question for the court to determine. This was so for three reasons: the terms of the settlement agreement brought into question whether the parties had a remaining agreement to arbitrate at all; Ameriprise's membership in FINRA, while mandating arbitration, did not mandate the arbitration of arbitrability; and the district court explicitly retained exclusive jurisdiction over matters related to the class action and the settlement agreement.[14]

Having determined that arbitrability was for the courts to determine, the appeals court proceeded to decide the issue. As to claims released in the settlement, the court found that the settlement agreement provided that the district court would have exclusive jurisdiction. In addition, the settlement agreement contained a merger clause that provided that it 'supersede[d] all prior understanding, communications and agreements with respect to the subject of this Settlement'. The appeals court held that these provisions of the settlement agreement constituted a revocation of the parties' existing agreement under FINRA's rules to arbitrate in respect of claims related to the settlement agreement.[15]

The court found that the Belands' claims in the FINRA arbitration included both claims that had been released in the settlement agreement (allegations relating to steering clients into mutual funds that had paid kickbacks) and those that had not been released (such as claims of not managing the Belands' accounts conservatively). The non-released claims were subject to arbitration, and the released claims were not.[16]

The court partially stays the arbitration

Having determined that part of the Belands' FINRA complaint could go forward, but part of it was barred, the appeals court could not avoid the question of whether it actually had the power to give effect to its determination – that is, whether it could order a stay of the arbitration in respect of the claims that the parties had not agreed to arbitrate. Section 3 of the FAA provides for a stay of court proceedings of issues referable to arbitration under a written agreement. Section 4 of the FAA gives courts the power to compel arbitration. The FAA is silent, however, on the question of courts' power to stay arbitration, and the Second Circuit had never squarely confronted this specific question. The appeals court looked to prior case law from the Second Circuit that largely skirted the issue, as well as cases from other federal appeals courts, to come to the conclusion that as much as the FAA provides a means to enforce parties' agreement to arbitrate, it offends 'neither the letter nor the spirit' of the FAA to stay arbitration where the parties have not agreed to arbitrate.[17] The court held:

> 'If the parties to this appeal have not consented to arbitrate a claim, the district court was not powerless to prevent one

> party from foisting upon the other an arbitration process to which the first party had no contractual right […]. It makes little sense to us to conclude that district courts lack the authority to order the cessation of an arbitration by parties within its jurisdiction where such authority appears necessary in order for a court to enforce the terms of the parties' own agreement, as reflected in a settlement agreement. We decline to do so here.'[19]

The appeals court remanded the case to the district court to issue an order staying only the released claims; the non-released claims were permitted to go forward.

The effect of the decision

The court's opinion resolves a vexatious problem for the practitioner – how to avoid an arbitration when there is not (or at least where there is a tenable argument that there is not) a binding arbitration agreement between the parties. Previously, a party challenging the existence of a valid arbitration agreement could either appear and raise the issue in the arbitration, or not appear in the arbitration and face either a motion to compel arbitration in court or potentially risk default in the arbitration. Parties in the Second Circuit now have a clear right to seek to stay the arbitration and obtain a judicial determination of the issue. On the other hand, this ruling also affords parties a means to delay the arbitration process by potentially emboldening them to involve the courts. Above all, the Second Circuit's ruling underscores the need for parties to make explicit in their contract documents whether they intend for a court or arbitrators to determine the issue of arbitrability.

Notes

* Celinda Metro, an associate at Seward & Kissel, assisted in the research and preparation of this article.

1 638 F.3d 384 (2d Cir 2011) See Bruce G Paulsen & Jeffrey M Dine, 'US Court of Appeals for the Second Circuit declines to stay Chevron's arbitration against Ecuador,' *Arbitration News*, September 2011, at 137.

2 June 10, 1958, 21 UST 2517.

3 9 USC §§ 1–307 (2006).

4 No 10-3399, 2011 US App LEXIS 22209, at *71-72 (2d Cir, 3 November 2011).

5 Ibid. at *5-7.

6 Ibid, generally at *7-12.

7 Ibid. at *12.

8 Ibid. at *15-16.

9 Ameriprise is a FINRA member. Its 'membership constitutes an agreement to arbitrate disputes under FINRA's rules'. Ibid at *28 (citing *UBS Fin Servs Incorporated v W Va Univ Hosps*, 660 F.3d 643, 649 (2d Cir 2011); see FINRA Code of Arbitration Procedure for Customer Disputes § 12200. Similar rules apply with respect to other financial industry self-regulatory organizations. See New York Stock Exchange Rule 600(a); Chicago Board Options Exchange Rule 18.1.

10 See above, note 4 at *16-20.

11 Ibid at *20-26.

12 Ibid at *30 (citing *Moses H Cone Mem'l Hosp v Mercury Constr Corp*, 460 US 1, 24-25 (1983)).

13 Ibid at *39 (quoting *AT&T Techs, Inc v Commc'ns Workers of Am*, 475 US 643, 649 (1986)).

14 Ibid at *40-42.

15 Ibid at *48. FINRA Rule 12200, which applies to customer disputes against FINRA members, such as the claims brought by the Belands, provides that the parties must arbitrate where there is a written agreement to do so or the customer has requested arbitration. The settlement was a revocation of the Belands' agreement. The result might have been different in an industry dispute, under FINRA Rule 13200, concerning disputes as to which all the parties are FINRA Members and/or Associated Persons, where arbitration is mandatory even without additional agreement.

16 Ibid at *60-65.

17 Ibid at *70 (quoting *Societe Generale de Surveillance, SA v Raytheon European Mgmt & Sys Co*, 643 F.2d 863, 868 (1st Cir 1981)).

18 Ibid at *71-72.