

# FIFTH CIRCUIT FINDS ARBITRATION AWARD VALID DESPITE QUESTIONS AS TO QUALIFICATIONS OF NON-PUBLIC ARBITRATOR

By Isaac Villarreal\*

Recently, in *Bulko v. Morgan Stanley*,<sup>1</sup> the U.S. Fifth Circuit Court of Appeals reviewed a summary judgment of the Northern District of Texas. The district court's ruling had vacated an arbitration award on the grounds that a non-public arbitrator on a three-person panel was not properly qualified, and thus the arbitration panel had acted outside the scope of its authority. Upon review, the Fifth Circuit reversed and rendered judgment, reinstating the arbitration panel's award.<sup>2</sup>

As required by a customer agreement and pursuant to National Association of Securities Dealers (NASD) rules, Bulko initiated NASD arbitration against Morgan Stanley in a dispute stemming from Bulko's stock-market loss of approximately \$16 million within a fourteen-month period.<sup>3</sup> NASD rules provide that a three-member panel consisting of one non-public and two public arbitrators must hear any matter whose amount in controversy exceeds \$50,000.<sup>4</sup> A non-public arbitrator is defined as an attorney, accountant, or other professional who has devoted twenty percent or more of his or her professional work, in the last two years, to clients engaged in the securities industry.<sup>5</sup>

In a letter dated October 14, 2003, after the original three-member panel had been designated, the NASD advised the parties that the designated non-public arbitrator had withdrawn. The non-public arbitrator would be replaced by Mary Beth Marshall, or the parties could proceed with only the two public arbitrators.<sup>6</sup> Neither party objected to Marshall.<sup>7</sup>

In her application to become a NASD arbitrator in 1994, Marshall had stated that she was a shareholder with a law firm and that her practice consisted mostly of commercial litigation, with an emphasis on securities law.<sup>8</sup> Her 1994 disclosure form stated that half of her practice was securities work. The form also imposed a duty on Marshall to inform the NASD of any changes to her answers to its questions.<sup>9</sup>

In 2000, Marshall informed the NASD that she was no longer practicing law full-time (information given to the parties in the letter dated October 14, 2003).<sup>10</sup> After the panel had decided the matter in Morgan Stanley's favor, Bulko discovered that Marshall, in fact, had not practiced law since 1999 because she had taken inactive status with the State Bar of Texas that year.<sup>11</sup> Bulko contested the award, asserting that the panel acted outside the scope of its authority because it was not properly constituted.<sup>12</sup> The district court agreed with Bulko's assertion,

concluded that Marshall was not qualified to serve as a non-public arbitrator, granted Bulko summary judgment, and directed the dispute to be heard by another panel.<sup>13</sup>

On appeal, the sole issue before the Fifth Circuit was whether the district court erred in vacating the award by determining that the panel acted outside the scope of its authority.<sup>14</sup> The Fifth Circuit reasoned that because an arbitration agreement is a contract, arbitrators must be selected pursuant to the method contractually provided.<sup>15</sup> Generally, courts do not hesitate to vacate an award when an arbitrator is not selected according to the contract-specified method.<sup>16</sup>

The court provided examples of instances where a court has determined that an arbitration award should be nullified for failure to abide by a contract-specified method of choosing an arbitrator. For example, in *Brook v. Peak Int'l Ltd.*,<sup>17</sup> the arbitration contract required the American Arbitration Association (AAA) to submit a list of nine names as potential arbitrators and instructed the parties "alternately to strike names from the list until only one remained."<sup>18</sup> Instead, the AAA provided a list of fifteen arbitrators and told the parties to strike the unacceptable names and then rank by preference the "remaining candidates."<sup>19</sup> Because AAA's actions clearly deviated from the contractually stated selection method, the arbitration award was properly vacated.<sup>20</sup>

The court distinguished the facts in *Bulko* from those in *Brook* (and other cases) in that the parties and/or arbitration entity did not deviate from the contract provisions. In fact, the parties got exactly what they contracted for. The parties' Uniform Submission Agreement provided that "the arbitration will be conducted in accordance with...[NASD] Rules...and/or NASD Code of Arbitration Procedure . . . ."<sup>21</sup> Under those rules, the NASD director of arbitration has discretion, when appointing arbitrators, to "make any decision...consistent with the purposes of [the NASD arbitration code] to facilitate the appointment of arbitration panels and the resolution of arbitration disputes."<sup>22</sup> The court reasoned, "in the absence of a specific agreement to the contrary, determining Marshall's qualifications and eligibility is a matter left to the NASD."<sup>23</sup> Thus, because the agreement (contract) did not have a specific method-of-selection clause, appointing Marshall as the panel's non-

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public arbitrator was not a departure from the agreement between Bulko and Morgan Stanley.<sup>24</sup>

While the court held that the determination of Marshall's qualifications and eligibility should be left to the NASD, it took a step further and concluded that even if Marshall's selection contradicted the parties' agreement, it was a trivial departure at most, and did not warrant vacatur.<sup>25</sup> The court noted that Marshall's work experience fulfilled the purpose of a non-public arbitrator, which is to serve on the arbitration panel as an industry insider

Morgan Stanley argued that even if Marshall failed to meet the qualifications to act as the non-public arbitrator, Bulko's failure to raise the issue pre-award served as a waiver of his opportunity to object to Marshall's serving as a non-public arbitrator. The court did not answer Morgan Stanley's argument because it determined that the district court erred in vacating the award.<sup>26</sup> The court did, however, note that the parties were on notice of the potential issue regarding Marshall's qualifications because both parties were informed that Marshall was not practicing law full-time.<sup>27</sup> As both parties were put on notice of Marshall's qualifications pre-arbitration, the court believed the parties should have taken it upon themselves to independently investigate and provide any objection to Marshall's serving as the non-public arbitrator pre-award.<sup>28</sup>

The Fifth Circuit Court of Appeals reversed the summary judgment and rendered judgment for Morgan Stanley, reinstating the arbitration award.<sup>29</sup>



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## ENDONOTES

<sup>1</sup> Bulko v. Morgan Stanley, 450 F.3d 622 (5<sup>th</sup> Cir. 2006).

<sup>2</sup> *Id.* at 627.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*; see NASD Code of Arbitration Procedure § 10308(a)(4)(C)6 (amended 1984).

<sup>6</sup> *Bulko*, 450 F.3d at 623.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 623-24.

<sup>11</sup> *Id.* at 624.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 625 (citing *Brook v. Peak Int'l Ltd.*, 294 F.3d 668, 672 (5<sup>th</sup> Cir. 2002)).

<sup>16</sup> *Id.* (citing *Brook*, 294 F.3d at 673).

<sup>17</sup> 294 F.3d 668 (5<sup>th</sup> Cir. 2002).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Bulko*, 450 F.3d at 625.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.* at 626 (citing *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 85 (2002), which held that NASD, not court, determines the application of NASD rules because NASD has more expertise).

<sup>24</sup> *Bulko*, 450 F.3d at 626.

<sup>25</sup> *Id.*

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 627.

## Hope

*By Krantol Northic*

*Hope is the sweet, sweet scent of flowers in the morning  
Hope is the cool gentle breeze on a warm summer's day  
Hope is the knowledge of stability from a son in mourning  
Hope is the bright shining light keeping darkness at bay  
Hope is the calming warmth during a cold winter  
Hope is the determination of an athlete on the track  
Hope is the potential of a newborn baby  
Hope is the love between you and me  
Hope springs eternal*