ERRONEOUS TRIAL COURT RULING REMAINS ON THE BOOKS BECAUSE OF PROCEDURAL FLUKE: EXAMINING PUNITIVE DAMAGES AND STATE COURT JURISDICTION TO CONFIRM FINRA AWARDS

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I. INTRODUCTION

This article explores a recent New York trial court ruling that could have severe consequences for securities arbitration. In April 2011, a FINRA arbitration[2] panel rendered an award against Michael Sloane, awarding William Copperill compensatory and punitive damages related to his investment account once under Sloane's control.[3] In February 2012, New York Supreme Court Justice, Stephen Bucaria, initially confirmed the FINRA award, but deleted the punitive damages portion.

Then, in November 2012, the court *sua sponte* vacated its February decision, asserting it lacked subject-matter jurisdiction and should never have confirmed any portion of Copperill's award.[4] The court based this decision on an erroneous assumption that Copperill's arbitrators predicated their award on Securities Exchange Act ("Exchange Act") violations, over which federal courts possess exclusive jurisdiction.[5] Copperill appealed to New York's Second Department. However, before the Second Department heard

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2. FINRA, the Financial Industry Regulatory Authority, is the "largest independent securities regulator in the U.S." and "operates the largest dispute resolution forum in the securities industry." FINRA, "About FINRA" (Aug. 16, 2013), available at http://www.finra.org/AboutFINRA/.

3. *See* Copperill v. Shapiro, No. 09-07046 (FINRA Arbitration Awards Online, Apr. 5, 2011), http://finraawardsonline.finra.org/search.aspx?.

4. *See generally* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060 (N.Y. Sup. Ct. 2012).

5. *Id*. at *7–8. Justice Bucaria was unclear as to which section of the Exchange Act he believed Copperill's arbitrators predicated their award, referring only generally to the "Securities Exchange Act."

argument, Sloane filed for bankruptcy, staying the appeal. As a result, the trial court's November remains viable precedent.

The November decision sets an unsightly precedent in large part because Copperill's arbitrators quite obviously predicated their award exclusively on FINRA Rule violations[6] and New York common law claims. The November decision effectively rules that New York courts lack the subject-matter jurisdiction necessary to confirm any FINRA award, so long as an award deals with substance remotely resembling Exchange Act subject matter or FINRA Rule violations. To the extent this decision becomes accepted precedent, those seeking confirmation of FINRA awards may find themselves without a forum, unable to confirm their awards in either federal or state court.[7]

This article focuses primarily on summarizing several of the obvious problems with the November decision.[8] We also explain why the initial February decision relating to punitive damages was erroneous. Lastly, we explore some of the more nuanced jurisdictional issues raised by the November decision. This article equips attorneys with sufficient defenses should they confront the arguments found in either of the two decisions.

II. BACKGROUND

Copperill is a retired New York City firefighter who placed much of his savings with Sloane for purposes of prudent investment. After Sloane mishandled the investment account, Copperill brought a FINRA arbitration action, alleging: fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, failure to supervise, and breach of good faith and fair dealing.[9] At no point did Copperill allege violations of the Exchange Act or any other federal law.

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6. FINRA Rule violations when brought by private parties do not invoke the Exchange Act; they do not constitute private causes of action and are thought of as contract violations. *See infra* section III.B.3.

7. *See infra* section III.B.5.

8. As New York is one of the securities centers of the world, decisions from its courts are often considered persuasive and require close scrutiny. Thus, while this article focuses mostly on New York law and procedure, its implications are broad.

9. *See Copperill*, No. 09-07046, at *1. Though Sloane was the named party in the confirmation proceeding, Copperill also brought claims against the brokerage firm Westrock Advisors, Inc. and one Andrew Shapiro. *Id*.

In April 2011, three FINRA arbitrators unanimously awarded Copperill approximately $490,000, representing compensatory damages, disgorgement, interest, attorneys' fees, and $211,592.11 in punitive damages.[10] In rendering their award, the arbitrators cited almost exclusively FINRA Conduct Rules and New York court cases.[11] Only once did the arbitrators cite federal law, and they did so merely to provide additional support for their authority to award punitive damages.[12]

In or around December 2011, Copperill sought confirmation of his FINRA award pursuant to New York CPLR Article 75. New York Supreme Court Justice, Stephen Bucaria, confirmed the award in February 2012 but deleted the punitive damages portion.[13] In deleting the punitive damages, the court wrote only that punitive damages violate public policy. Neither Copperill nor Sloane appealed this February decision.

Soon after the February decision, Copperill began an enforcement proceeding against Sloane, also before Justice Bucaria.[14] During the course of this enforcement proceeding, the court asked *sua sponte* for briefing on the issue of subject-matter jurisdiction related to its initial February confirmation of the FINRA award. Parties briefed the issue by November 2012, some eight months after the February decision.

On November 28, 2012, the court issued an opinion fully vacating its February decision, stating that it lacked the subject-matter jurisdiction necessary to confirm any aspect of Copperill's FINRA award.[15] This November decision rested primarily on the court's misunderstanding and misapplication of *FINRA v. Fiero*,[16] a 2008 New York Court of Appeals case that deals not with confirmation of arbitration awards, but with actions brought by FINRA Regulation to enforce sanctions against its associated persons. In addition, the court conflated statutory grounds for confirmation of

10. *See id*. at *2–4.

11. *See id*. at *2–3.

12. *Id*. at *3 (citing Mastrobuno v. Shearson Lehman Hutton, 514 U.S. 52 (1995)). For more discussion of punitive damages, see *infra* section III.A.

13. *See* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *3 (N.Y. Sup. Ct. 2012).

14. *See supra* note 2 and accompanying text.

15. *See Copperill*, 20212 N.Y. Misc. at *7–8.

16. 882 N.E.2d 879 (N.Y. 2008).

an award with those needed to modify or vacate an award, an issue we explore below.[17]

Though the trial court correctly noted that, under *Fiero*, a state court does not have jurisdiction to confirm an action brought *by* FINRA pursuant to the Exchange Act, the court failed to recognize the inapplicability of *Fiero* to cases involving private litigants.

Having observed that only courts of the United States have jurisdiction to hear Exchange Act violations, the court then framed the dispositive issue as one turning on "whether the award is based upon a violation of the [] Exchange Act."[18] Although Copperill never alleged Exchange Act claims, the court concluded that the arbitrators predicated their award on at least one Exchange Act violation.[19] In support thereof, the court first provided the following erroneous conclusions of law:

> The FINRA arbitration award does not expressly state which of the causes of action were sustained in finding for the customer. Nevertheless, the court notes that fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, and failure to supervise are all [] Exchange Act violations. *See* FINRA Rule 12000 et seq available at www.finra.complinet.com, viewed on November 21, 2012.[20]

Next, the court erroneously concluded that Copperill's FINRA "award of disgorgement and punitive damages . . . makes clear that the arbitrators found one or more [] Exchange Act violations."[21]

Because it assumed the arbitrators predicated Copperill's award on Exchange Act violations, and that Copperill's common law claims were merely Exchange Act claims by another name, the court determined that it lacked subject-matter jurisdiction. In rationalizing its decision, the court described how the lack of state court jurisdiction precluded it from conducting a necessary review of the award for "irrationality," something the parties had not raised in the first instance.[22] The court nevertheless believed it

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17. *See infra* section III.A.1.

18. *Copperill*, 2012 N.Y. Misc., at *7.

19. *Id*. at *8.

20. *Id*. at *7–8.

21. *Id*. at *8.

22. *See id*. at *6.

was required to review the "merits of the Exchange Act claims" that it concluded were at issue in Copperill's award.[23]

For all of these reasons, the court vacated its February confirmation decision. Its opinion instructs that Copperill seek confirmation in federal court, the only court it believed had jurisdiction to confirm the award.[24] Copperill appealed the decision to New York's Second Department Appellate Division in December 2012. Before the appeal was heard, however, Sloane filed for bankruptcy, forcing a stay on the appeal. As a result, the trial court's November decision remains as a precedent.

This is an unfortunate result. As this will article show, the court's November decision was both bad law and bad policy. It is based on a misunderstanding of relevant New York case law, the role of FINRA arbitration, and the procedural mechanisms for confirming arbitration awards. If other courts follow this precedent, federal courts would be inundated with petitions to confirm even the most trivial of state common law claims, which, aside from forcing federal courts to deal with a host of new and unwanted claims, could drastically raise the cost of confirmation proceedings. In any event, federal courts would be unlikely to exercise jurisdiction over these claims, as we show below. Indeed, this article spells out exactly why the trial court's February and November decisions are both mistaken. The article also provides insight for practitioners who must work alongside the specter of these unfortunate cases.

III. WHY THE DECISIONS ARE ERRONEOUS

A. THE COURT'S FEBRUARY DECISION RELATED TO PUNITIVE DAMAGES WAS ERRONEOUS.

The court was wrong to vacate Copperill's award for punitive damages. First, it did not follow the proper procedure for considering the demand to vacate punitive damages. Second, having heard the demand, it was incorrect to hold that an award of punitive damages violated public policy.

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23. *Id*.

24. *Id*. at *8.

1. The court was incorrect in considering Sloane's demand.

The court's February decision modified Copperill's arbitration award by deleting punitive damages. Sloane demanded the deletion of punitive damages in his answer to Copperill's confirmation petition, which Copperill filed more than ninety days after Copperill's arbitrators rendered their decision. The preliminary question is therefore whether the trial court was correct in hearing Sloane's demand at all.

New York law governing arbitration provides that "an application to vacate or modify an award may be made by a party within ninety days after [the award's] delivery to him"[25] and may do so "only upon the grounds enumerated [in CPLR section 7511] for vacating or modifying arbitration awards." [26] The law further provides that applications [27] during the confirmation proceeding must be made by motion.[28] Unless, on a party's application, the court modifies or vacates the award for one of the causes in CPLR 7511, the court must confirm the arbitration award.[29] The court may not *sua sponte* vacate an award.[30]

Under CPLR 7511, the court shall *modify* the award if (1) there is a miscalculation or mistake in the description of anything referred to in the award, (2) the award is based on a matter which was not submitted to arbitration, or (3) the "award is imperfect in a matter of form, not affecting the merits of the controversy."[31] The court may only *vacate* the award if:

> (1) the rights of a party were prejudiced by corruption, fraud or misconduct in procuring the award, or by the partiality of the arbitrator; (2) the arbitrator exceeded his or her power or failed to make a final and definite award; or (3) the arbitration suffered from an unwaived procedural defect. Even where the arbitrator makes a

25. N.Y. C.P.L.R. 7511(a) (MCKINNEY 2012).

26. Vilceus v. N. River Ins. Co., 150 A.D.2d 769, 769–70 (N.Y. App. Div. 2d 1989).

27. Application include demands for modification or vacatur of an arbitration proceeding.

28. *See* N.Y. C.P.L.R. 7502(a)(iii).

29. *See* N.Y. C.P.L.R. 7510; *but see generally* Sawtelle v. Waddell & Reed, Inc., 304 A.D.2d 103 (N.Y. App. Div. 1st 2003) (discussing the constitutional due process limits of punitive damage awards).

30. *See* Boggin v. Wilson, 14 A.D.3d 523, 524–25 (N.Y. App. Div. 2d 2005).

31. *See* N.Y. C.P.L.R. 7511.

> mistake of fact or law, or disregards the plain words of the parties' agreement, the award is not subject to vacatur "unless the court concludes that it is totally irrational or violative of a strong public policy" and thus in excess of the arbitrator's powers.[32]

The above language based on CPLR Article 75 appears to allow modification or vacatur only upon motion and only upon the enumerated grounds listed in CPLR 7511. However, some New York courts, including the Second Department and at least one district court in the Second Circuit, hold that "[w]hile an aggrieved party has only [ninety] days within which to move to vacate or modify an arbitration award, such a party may elect not to make a motion and, instead, raise the objection [in an answer] when the successful claimant moves to confirm the award," despite the fact that the ninety day limit has passed.[33]

Here, Sloane made his December 6, 2011 demand for modification by answer rather than motion and did not make it within ninety days of the delivery of the April 5, 2011, arbitration award. On first glance the demand appears to be improperly before the court under the plain language of CPLR Article 75.[34] Nevertheless, because the Second Department currently permits applications for modification by answer after ninety days from award delivery, the trial court would likely have been correct to review this

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32. Hackett v. Milbank, 654 N.E.2d 95, 100 (N.Y. 1995).

33. *See Vilceus*, 150 A.D.2d at 769–70 (internal citations omitted); Local 205 v. Day Care Council, 992 F. Supp. 388, 394 (S.D.N.Y. 1998); *In re* Sutorius, 166 Misc. 2d 465, 468 (N.Y. Sup. Ct. 2d 1995). Courts allowing modification or vacatur in response to CPLR 7510 motions to confirm have based their decisions on rulings from cases decided under CPA section 1463, the predecessor to CPLR Article 75, or other laws. These courts do not consider the statutory requirements of CPLR 7502 (application must be made by motion), CPLR 7510 (court must confirm award except on application by party under CPLR 7511), or CPLR 7511 (application for modification or vacatur must be made within ninety days of award). *See, e.g.*, *Vilceus* 150 A.D.2d at 769–70 (citing Katz v. Uvegi, 18 Misc. 2d 576 (N.Y. Sup. Ct. 1959)); State Farm Mut. Auto. Ins. Co. v. Fireman's Fund Ins. Co., 121 A.D.2d 529 (N.Y. App. Div. 2d 1986) (citing Morris v. Government Employees Ins. Co., 95 Misc. 2d 696 (N.Y. Civ. Ct. 1978)). Whether the holdings of these courts have merit under the statutory language of CPLR article 75 is beyond the scope of this article.

34. *See* N.Y. C.P.L.R. 7502(a)(iii), 7511 (stating that application for modification must be made by motion and within ninety days of delivery of award).

application for modification had the demand asserted grounds for modification under CPLR 7511.[35]

In this case, however, Sloane's demand to modify did not contain any grounds for modification or vacatur based on CPLR 7511, nor did it allege the punitive damages to be violative of public policy.[36] The court was therefore incorrect in considering Sloane's demand at all.

2. The court's deletion of punitive damages based on public policy was erroneous.

Even if Sloane's answer had properly stated grounds for modification, the court would still have been mistaken in modifying the award as violative of public policy.

Although the New York Court of Appeals holds that the award of punitive damages in arbitration is against public policy (the "*Garrity* rule"),[37] the Supreme Court of the United States holds that where a contract calls for arbitration according to NASD Rules, and NASD Rules specify that arbitrators can consider punitive damages as a remedy, the *Garrity* rule does not apply.[38] In other words, the Supreme Court determined that the national policy favoring arbitration supports enforcing a punitive damages award where such award is within the scope of the parties' agreement.[39]

Here, the pre-dispute arbitration agreement governing the account in question requires that controversies be determined by arbitration according to the prevailing NASD Rules. Thus, the arbitrators' award of punitive damages was not against public policy and the court was erroneous in its modification of the award.

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35. *See, e.g.*, *Vilceus* 150 A.D.2d at 769–70 (stating that applications for modification may be made in answer, but only on grounds enumerated under CPLR 7511).

36. *See id.*

37. *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 794 (N.Y. 1976).

38. *See* Mastrobuono v. Shearson, 514 U.S. 52, 56–64 (1995). NASD is the predecessor to FINRA.

39. *See id.* at 64.

B. THE COURT'S NOVEMBER DECISION ON SUBJECT-MATTER JURISDICTION WAS ERRONEOUS.

There are several reasons why the court was incorrect in holding that New York courts lacked subject-matter jurisdiction to confirm Copperill's award. These reasons are discussed in detail below.

1. Fiero does not apply to this case whatsoever.

The court based its decision in large part on the New York Court of Appeals case *FINRA v. Fiero*.[40] However, *Fiero* does not apply to the facts here at all.

In *Fiero*, FINRA's (then NASD's) Department of Enforcement began a disciplinary proceeding against Fiero, the sole employee of the Fiero Brothers, a NASD member firm, for launching a "bear raid" to drive down the price of securities held by another NASD member. The raid ultimately caused the target member to financially collapse.[41] A NASD disciplinary panel found that Fiero engaged in illegal short sales, extortion, and market manipulation; assessed approximately a $1 million fine, plus costs; and expelled Fiero Brothers from NASD membership.[42] The decision was affirmed by NASD's National Adjudicatory Council.[43] NASD then brought a proceeding in state court to enforce the judgment against Fiero, which was granted.[44]

On appeal, however, the New York Court of Appeals reversed, holding that the lawsuit fell under the Exchange Act and that, therefore, a state court had no subject-matter jurisdiction.[45]

The court in Copperill seems to interpret *Fiero* as making the confirmation of all FINRA arbitrations matters of exclusive federal law.[46]

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40. *See* 882 N.E.2d 879 (N.Y. 2008).

41. *Fiero*, 882 N.E.2d at 880.

42. Nat. Ass'n of Sec. Dealers v. Fiero, 2006 N.Y. Misc. LEXIS 9293, at *2 (N.Y. Sup. Ct. 2006) (original trial court decision).

43. *Id*. at *3.

44. *Fiero*, 882 N.E.2d at 880.

45. *Id*. at 881–82.

46. *See* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *3–5 (N.Y. Sup. Ct. 2012).

For instance, it cites FINRA "Rule 12000, et seq.," for the proposition that "fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, and failure to supervise are all [] Exchange Act violations."[47] This is a very strange interpretation of FINRA 12000 et seq., which is not a substantive rule, but a chapter of rules outlining only FINRA Arbitation procedures.[48] Indeed, Rule 12000 does not so much as mention the Exchange Act. Moreover, the substantive FINRA Rules, to which Rule 12000's procedures apply, involve familiar common-law state claims, such as fraud or misrepresentation,[49] negligence by way of unsuitable investing,[50] and breach of fiduciary duty.[51] None of these claims necessarily involve federal law.[52]

By citing to Rule 12000, it seems that the trial court glossed over the dispositive distinction between FINRA as a forum for private arbitration of securities disputes and FINRA as a federal self-regulatory body under the oversight of the SEC. FINRA serves as a forum for private arbitrations; exercises "the authority to enforce the requirements of the Exchange Act;" and serves as "the primary regulator of the broker-dealer industry."[53]

Fiero, quite unlike the case here, was entirely about FINRA as a regulator of industry misconduct. The *Fiero* court itself made clear that the issue there concerned only an "*action to enforce a penalty* imposed . . . *as a result of disciplinary proceedings* provided for by the [] Exchange Act for violations of the [] Exchange Act and its implementing rules."[54] The case had nothing to do with private plaintiffs who bring actions in the FINRA forum, and there is no hint in the *Fiero* decision that the Court of Appeals thought its decision would apply to non-regulatory matters. Because *Fiero* concerned only federal regulation of broker-dealers, it was perfectly valid for the state

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47. *Id*. at *7–8.

48. *See* FINRA Rule 12000, Code of Arbitration Procedure for Customer Disputes, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096.

49. FINRA Rule 2020.

50. FINRA Rule 2111.

51. FINRA Rule 2060.

52. *See* FINRA Rules 12200–01 (listing when the parties must and when they may arbitrate under the FINRA arbitration code).

53. Rosenberg v. Metlife, Inc., 8 N.Y.3d 359, 366 (N.Y. 2007).

54. FINRA v. Fiero, 882 N.E.2d 879, 882 (N.Y. 2008) (emphasis added).

court there to refuse confirming a penalty, the basis of which entirely depended on the Exchange Act.

The facts here are entirely distinct from *Fiero*. Copperill is private person—not a federal regulator—who asserted time-honored, state-law tort claims[55] against a broker-dealer and its Associated Persons. Copperill only used FINRA as an arbitration forum because FINRA was the forum specified in the account agreement with his broker. Indeed, brokerage contracts are free to specify FINRA as an arbitration forum.[56] Accordingly, there was no issue of federal law being raised, making the application of *Fiero* totally mistaken.

The fact is, New York courts have continued confirming awards similar to those involved here in the years since *Fiero* was decided.[57] This should come as no surprise; for the courts to have done anything else would have made the sleepy *Fiero* decision into a truly revolutionary one.[58] If *Fiero* really means what the New York trial court interpreted it to mean, then it would have totally changed the way that both federal and state courts have traditionally confirmed FINRA arbitration awards.

To hold that FINRA awards involving garden-variety common-law claims may only be confirmed in federal court would radically overturn the system for confirming arbitrations as it has existed for years. As a practical matter, the federal courts would be burdened with a host of new, unwanted claims, mainly centered around such bland tort issues as those brought here.

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55. *See* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *1 (N.Y. Sup. Ct. 2012).

56. *See, e.g.*, Cowen & Co. v. Anderson, 76 N.Y. 2d 318, 321–22 (N.Y. 1990) (allowing securities disputes to be arbitrated in a number of forums, as specified in the original contract, and including NASD arbitration).

57. The cases so confirming are extensive. But, for a representative sample, see Irina Aronson Irrevocable Trust v. Bretton, 2011 N.Y. Misc. LEXIS 3557 (N.Y. Sup. Ct. 2011); Walzer v. Muriel Siebert & Co., 31 Misc. 3d 1240(A) (N.Y. Sup. Ct. 2011); Cantor Fitzgerald Sec. v. Refco Sec., LLC, 2010 N.Y. Misc. LEXIS 3595 (N.Y. Sup. Ct. 2010); D.B. Toy Prods., Inc. v. Sky Capital, LLC, 2010 N.Y. Misc. LEXIS 2473 (N.Y. Sup. Ct. 2010); D. Weckstein & Co. v. Trinity Bui, 2009 N.Y. Misc. LEXIS 5816 (N.Y. Sup. Ct. 2009).

58. The "Shepardize" tool on Lexis Nexis shows that only 16 individual decisions (excluding the later federal appeals in the *Fiero* case) have cited *Fiero*. One of those decisions is *Copperill* itself. If *Fiero* were really as important of a case as Justice Bucaria believed, one would expect a lot more than 15 other citations.

Indeed, federal courts would not even have jurisdiction to review such claims.[59]

2. FINRA Rules and the use of FINRA's forum do not compel the conclusion that the Exchange Act is at play.

One theme running through the court's November decision suggests that FINRA arbitration necessarily invokes the Exchange Act.[60] However, materials from FINRA and the Securities Exchange Commission both make clear that use of FINRA does not compel the conclusion that the Exchange Act is at play. "[FINRA] arbitrators are not bound to follow the substantive law . . . that govern[s] litigation"—substantive law such as the Exchange Act.[61] FINRA aims to "protect investors by prohibiting agreements that would limit the ability of any investor to file any claim in arbitration or that limits the power of arbitrators to make any award. For example, arbitrators can and do award punitive damages in favor of investors."[62]

Like was the case here, parties typically agree to FINRA arbitration through an arbitration clause signed at the inception of the parties' relationships.[63] When parties agree to FINRA arbitration, they agree to "giv[e] up the right to sue each other in court," and they recognize "that arbitration awards are generally final and binding."[64] FINRA registered "Member Firms" and "Associated Persons" working for the firms further agree to conform their "business activity" to FINRA Rules, which are wholly distinct from the conduct scheme outlined in the Exchange Act.[65] Of course,

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59. *See infra* section III.B.5.

60. *See, e.g.*, Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *7–8 (N.Y. Sup. Ct. 2012).

61. Statement on Key Issues, Securities and Exchange Commission Investor Advisory Committee (May 17, 2010), http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-finra.pdf.

62. *Id.*

63. An Outline of the FINRA Arbitration Process for Customer-Broker Disputes, Smiley Bishop & Porter LLP, http://www.sbpllplaw.com/2011/04/an-outline-of-the-finra-arbitration-process-for-customer-broker-disputes/ (last visited April 26, 2013).

64. *See, e.g.*, Customer Agreement, Koonce Securities, Inc., http://www.koonce.net/applications/CUSTOMER_AGREEMENT.pdf (last visited April 26, 2013)

65. *See* How Does FINRA Differ From the SEC?, INVESTOPEDIA, http://www.investopedia.com/ask/answers/112.asp (last visited April 26, 2013).

FINRA itself does not become a party to these arbitrations; FINRA merely provides the forum for arbitration.[66]

The court's assumption that FINRA's Rules and forum necessarily equate to Exchange Act violations is preposterous. Nothing in FINRA's or the SEC's material so much as suggests FINRA arbitrators are bound by the Exchange Act when rendering their awards.

Sloane had agreed in writing to FINRA arbitration and to FINRA's "business activity" standards. The FINRA Dispute Resolution arbitrators—who are not employed by FINRA—found in their wide discretion that Sloane breached his duties, and Copperill's award should have been confirmed in full.[67]

3. All of Copperill's claims were predicated on state law and FINRA Rules.

It is clear that Copperill's arbitrators did not invoke the Exchange Act or any other federal law while rendering their award. The court thus had no grounds for dismissing based on subject-matter jurisdiction.

In arbitration, Copperill brought the following claims, all of which constitute New York common law claims and FINRA Rule violations: fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, failure to supervise, breach of duty of good faith and fair dealing, and unjust enrichment.[68] While some of these claims could theoretically constitute an element of a 10b-5 action under the Exchange Act, everything on the record reflects that Copperill alleged either FINRA Rule violations or New York common-law claims, not Exchange Act claims.[69] The record further reflects that the arbitrators applied only FINRA Rules and New York common law in rendering their award.

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66. *See* FINRA's Dispute Resolution Process, FINRA, http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p117486.pdf (last visited April 26, 2013).

67. *See* Arbitrator Selection, FINRA, http://www.finra.org/ArbitrationAndMediation/Arbitration/Process/ArbitratorSelection/index.htm (last visited April 26, 2013).

68. *See* Copperill v. Shapiro, No. 09-07046, at *1 (FINRA Arbitration Awards Online, Apr. 5, 2011), http://finraawardsonline.finra.org/search.aspx?.

69. *See* 17 C.F.R. 240.10b-5.

First, all of Copperill's claims at arbitration constitute New York common law claims.[70] Second, all of Copperill's claims at arbitration constituted FINRA Rule violations,[71] which as stated above, are conduct schemes wholly distinct from those outlined in the Exchange Act.[72]

Third, the record reflects that Copperill's arbitrators applied only FINRA Rules and New York common law in rendering their award, not any statute under the Exchange Act. Nowhere did Copperill plead an Exchange Act violation, and nowhere did the arbitrators' final decision cite the Exchange Act. The arbitrators' final decision cited only FINRA Rules and New York

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70. *See, e.g.*, MBIA Ins. Corp. v. Countrywide Home Loans, Inc., 87 A.D.3d 287, 297 (N.Y. App. Div. 2011) (recognizing breach of the duty of good faith and fair dealing as a cause of action but dismissing on other grounds); Scalp & Blade, Inc. v. Advest, Inc., 309 A.D.2d 219, 220 (N.Y. App. Div. 2003) ("[W]e hold that in a case such as this, involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages is . . ."); Montoya v. Cousins Chanos Casinos, LLC, 2012 WL 118475, at *5 (N.Y. Sup. Ct. 2012) (analyzing common-law claims for mismanagement and unjust enrichment within securities context). In addition to constituting common-law claims, many of Copperill's allegations also constitute actions under New York statutory law. *See, e.g.*, N.Y. GEN. BUS. LAW § 339-a (McKinney 2012) (covering fraudulent and negligent transactions in securities).

71. *See, e.g.*, FINRA Rule 2020 (encompassing fraud and misrepresentation); FINRA Rule 2060 (recognizing a fiduciary duty owing from brokers to clients); NASD Rule 2510 (encompassing unauthorized trading as well as excessive trading (often referred to as churning)); FINRA Rule 2010 (encompassing good faith and fair dealing as well as negligence and unjust enrichment).

72. *But see* Laufer v. Rothschild, 143 A.D.2d 732, 733–45 (N.Y. App. Div. 1988) (suggesting FINRA Rules create causes of action within the exclusive jurisdiction of federal courts). Laufer, however, is unpersuasive for a number of reasons. First, the case has faded into obscurity, having not been cited since 1995. Second, the overwhelming majority of case law directly contradicts it. *See, e.g.*, Smith Barney, Inc. v. Painters Local Union No. 109 Pension Fund, 976 F.Supp. 1293, 1296 (D.Neb.1996) (remanding the case because, *inter alia*, no federal question jurisdiction exists for a violation of NASD rules); Raymond James & Assoc. v. NASD, Inc., 844 F.Supp. 1504, 1507 (M.D.Fla.1994) ("[T]he NASD rules themselves do not give rise to federal question jurisdiction."); *In re* Application of Prudential Sec. Inc., 795 F.Supp. 657, 659 (S.D.N.Y.1992) (remanding case for lack of subject-matter jurisdiction: "NASD rules are established and enforced by a private association and do not give rise to federal question jurisdiction.").

court cases.[73] The arbitrators made no mention whatsoever of the Exchange Act. There is no body of securities law which presumes an Exchange Act violation from the use of everyday, common-law terminology. The court was wrong to determine that Copperill's award implicated the Exchange Act.

4. The court erroneously reasoned that disgorgement and punitive damages can only result from Exchange Act violations.

In its November opinion, the court concluded that Copperill's FINRA "award of disgorgement and punitive damages . . . makes clear that the arbitrators found one or more [] Exchange Act violations."[74] This notion that only Exchange Act violations can result in disgorgement and punitive damages is bizarre. Disgorgement is merely "the act of giving up something (such as profits illegally obtained) on demand or by legal compulsion."[75] Punitive damages are "damages awarded in addition to actual damages when the defendant acted with recklessness, malice or deceit."[76]

While it is true that the word disgorgement may be used in association with Exchange Act violations, courts regularly use the word as it relates to any number of common-law claims.[77]

Similarly, punitive damages are available in almost every area of intentional tort law, not just Exchange Act violations.[78] In fact, although at least one court has gone the other way,[79] there was a recent period when

73. Copperill v. Shapiro, No. 09-07046 (FINRA Arbitration Awards Online, Apr. 5, 2011), http://finraawardsonline.finra.org/search.aspx?. The arbitrators' final award did cite one United Stated Supreme Court case, but this case was only cited in further support of the arbitrators' authority to award punitive damages. *See id.*

74. Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *8 (N.Y. Sup. Ct. 2012).

75. BLACK'S LAW DICTIONARY 501 (8th ed. 2004).

76. *See id.* at 418.

77. *See, e.g.*, S. Shore Neurologic Ass'n, P.C. v. Ruskin Moscou Faltischek, P.C., 32 Misc.3d 746, 747 (N.Y. Sup. Ct. 2011) (discussing disgorgement of attorneys' fees).

78. *See, e.g.*, Don Buchwald & Assoc. v. Rich, 281 N.Y.S.2d 8, 8 (N.Y. App. Div. 2001) (describing when punitive damages are appropriate) (citing Swersky v. Dreyer & Traub, 219 A.D.2d (N.Y. App. Div. 1996)).

79. *See generally Sheldon v. Vermonty*, 2004 WL 1730348 (10th Cir. 2004) (suggesting that 10b-5 violations may sometimes result in punitive damages).

courts stated in unanimity that Exchange Act violations (especially 10b-5 violations) could not produce punitive damages.[80]

5. Copperill could not confirm his award in federal court.

In dismissing Copperill's motion for confirmation, the court instructed Copperill to seek confirmation in federal court. But because the issues underlying Copperill's arbitration award are matters of state law and because the parties are not diverse, the federal courts have no jurisdiction to confirm Copperill's award. The court's determination that it lacked subject-matter jurisdiction over the arbitration award left Copperill with no recourse.

The federal courts have jurisdiction to confirm an arbitration award only when there is diversity of citizenship or a federal question, or where a case concerns admiralty or maritime law.[81] Here, all parties are citizens of New York, and there is no admiralty or maritime issue contemplated, so the federal courts do not have jurisdiction unless there is a federal question.

For federal question jurisdiction to exist, it is not sufficient that the controversy in question could involve a federal law. Rather, under the well-pleaded complaint rule, federal questions arise only when an issue of federal law appears on the face of a complaint.[82] In the case of arbitration, however, it is the complaint submitted to arbitration, not the motion to confirm, that must plead a federal cause of action.[83]

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80. *See, e.g.*, Flood v. Miller, 2002 WL 1135932, at *3 (9th Cir. 2002) ("[T]he Securities Act of 1934 disclaims punitive damages in securities actions."); Boguslavsky v. Kaplan, 159 F.3d 715, 721 (2d Cir. 1998) ("[P]unitive damages are unavailable under the 1934 Act"); Flaks v. Koegel, 504 F.2d 702, 706 (2d Cir. 1974) (holding that punitive damages are unavailable under § 10(b) and the regulations promulgated thereunder).

81. *See* 28 U.S.C. §§ 1331-1333. The FAA does not constitute a grant of jurisdiction to federal courts. Dorn v. Dorn's Transp., Inc., 562 F.Supp. 822, 824 (S.D.N.Y. 1983).

82. *See* Louisville v. Mottley, 211 U.S. 149, 152 (1908). "As a general rule, absent diversity jurisdiction, a case will not be removable if the complaint does not affirmatively allege a federal claim." Beneficial Nat. Bank v. Anderson, 539 U.S. 1, 6 (2003).

83. *See Dorn*, 562 F.Supp. at 824 (holding that the FAA does not convey subject-matter jurisdiction on the federal courts). *See also* Vaden v. Discover Bank, 556 U.S. 49, 70 (2009); *Vaden* asserts the "look through" principle, under which federal courts look to the controversy underlying the dispute in arbitration to determine subject-matter jurisdiction. *See id.*

Here, because Copperill did not allege a federal claim in his complaint submitted to arbitration, the federal courts have no jurisdiction over this controversy.[84] The New York court's failure to accept jurisdiction over the Copperill's confirmation motion thus abandoned Copperill in limbo, with no forum in which to confirm his award.

Such a result runs directly counter to the national policy in favor of arbitration reaffirmed in *Mastrobuono* because, among other things, it causes complainants to lose confidence in the courts' abilities to enforce an arbitration judgment.[85]

IV. ANALYZING JURISDICTION TO CONFIRM FINRA AWARDS PREDICATED ON EXCHANGE ACT CLAIMS

Although all claims in this case were pled as state law causes of action,[86] it is probable that the state courts would have jurisdiction to confirm Copperill's arbitration award even if it was predicated on Exchange Act violations.

A. LEGAL SCHOLARSHIPS SUGGESTS THAT ARBITRATION AWARDS PREDICATED ON THE EXCHANGE ACT CAN BE CONFIRMED IN STATE COURTS.

Noted securities-law expert Thomas Lee Hazen writes that, even though the Exchange Act vests exclusive jurisdiction in federal courts, "the policies favoring arbitration and freedom of contract with regard to pre-dispute arbitration agreements *might validate the selection of a state court* pursuant to the Federal Arbitration Act." [87] This kind of jurisdiction is to be distinguished from direct state litigation of an Exchange Act claim, which would clearly be barred by the "exclusive federal jurisdiction" element of the

84. *See supra* section III.B.3. (discussing that the causes of action in Copperill's complaint were all matters of state law).

85. *See* 514 U.S. at 56.

86. *See supra* section III.B.3.

87. THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, VOL. 2, 139 (6th ed. 2009) (emphasis added).

Exchange Act.[88] Hazen gives his conclusion tentatively, as the case law on this precise issue is sparse. However, at least one New York court has confirmed an arbitration award predicated on an Exchange Act claim, indicating that state courts do in fact have such power.[89]

B. THE FEDERAL ARBITRATION ACT SUPPORTS STATE COURTS CONFIRMING ARBITRATION AWARDS, EVEN WHEN THE AWARDS ARE PREDICATED ON THE EXCHANGE ACT.

The FAA mandates that "[a] written provision in . . . a contract evidencing a transaction involving commerce [among the several states] to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable . . . ."[90] "Section 2 of the FAA, which does bind the state courts . . . 'carries with it duties [to credit and enforce arbitration agreements] indistinguishable from those imposed on federal courts by FAA §§ 3 and 4.'"[91] Section 3 compels federal courts to stay trial proceedings pending arbitration where there is a valid agreement to arbitrate.[92] Section 4 allows a party aggrieved by another's refusal to arbitrate under a valid arbitration agreement to petition federal courts for an order directing arbitration.[93]

In addition to binding the state courts to credit and enforce arbitration agreements, the FAA substantiates "a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway." [94] Consistent with the policy that supports applying sections 3 and 4 of the FAA to the state courts, section 9 should also bind the state courts in compelling confirmation. Section 9

88. *Id*. at 379.

89. Baker v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 2012 N.Y. Misc. LEXIS 1123, at *3–4, 13 (N.Y. Sup. Ct. 2012). Note that this case also involved state law claims of unsuitability, common-law fraud, breach of fiduciary duty, breach of contract, negligence, and other similar common-law claims.

90. *See* 9 U.S.C. §§ 1–2 (2012).

91. Vaden v. Discover Bank, 556 U.S. 49, 71 (2009).

92. *See* 9 U.S.C. § 3 (2012).

93. *See* 9 U.S.C. § 4.

94. Hall Street Assocs. v. Mattel, 552 U.S. 576, 588 (2008).

requires courts to confirm arbitration awards on application of a party to the award, unless modifying or vacating under enumerated grounds.[95]

C. COURTS ARE SEVERELY LIMITED IN MAKING SUBSTANTIVE INQUIRIES INTO ARBITRATION AWARDS, THUS MOOTING MANY JURISDICTIONAL ISSUES.

A proceeding to confirm an arbitration award under CPLR section 7510 does not in itself permit a substantive inquiry into the basis of the award.[96] A court is compelled to confirm an award unless the opposing party demands modification or vacatur for grounds that are enumerated in CPLR 7511.[97] Where the opposing party does not demand modification or vacatur, there is thus no opportunity for substantive inquiry.[98] Therefore, many New York court confirmations of FINRA awards pursuant to CPLR section 7510 should not violate the exclusive federal jurisdiction clause of the Exchange Act even when Exchange Act claims underlie the award.[99]

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95. *See* 9 U.S.C. § 9

96. *See supra* section III.A.1. (discussing the procedure under which New York courts confirm, modify, and vacate arbitration awards).

97. *See id.*

98. *See id.*

99. *See id. Shearson/American Express v. McMahon* determined that section 29 of the Exchange Act (prohibiting waiver of substantive obligations imposed by the Exchange Act) is not violated by agreements to arbitrate conflicts in FINRA arbitration, despite the existence of section 27 of the Exchange Act (giving exclusive jurisdiction to the federal courts to resolve conflicts arising thereunder). *See* 482 U.S. 220 at 228 (1987).

> What the antiwaiver provision of § 29(a) forbids is enforcement of agreements to waive "compliance" with the provisions of the statute. But § 27 itself does not impose any duty with which persons trading in securities must "comply." By its terms, § 29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act. Because § 27 does not impose any statutory duties, its waiver does not constitute a waiver of "compliance with any provision" of the Exchange Act under § 29(a). . . . [W]here, as in this case, the prescribed procedures are subject to the Commission's § 19 authority, an arbitration agreement does not effect a waiver of the protections of the Act.

Id. at 234. Because an agreement to arbitrate under FINRA Rules does not impinge upon the restrictions of Exchange Act sections 27 and 29, FINRA

Moreover, even when an opposing party does demand modification or vacatur, a state court could confirm the award without conducting an inquiry into Exchange Act law. For example, at least one federal court has recognized that not all grounds for review of arbitration awards require an inquiry into the underlying law:

> In contrast to grounds of review that concern the arbitration process itself—such as corruption or abuse of power—review for manifest disregard of federal law necessarily requires the reviewing court to do two things: first, determine what the federal law is, and second, determine whether the arbitrator's decision manifestly disregarded that law.[100]

Thus, while "manifest disregard" may require a substantive inquiry, a review for abuse of power[101] or corruption does not.[102] A review for abuse of power or corruption, therefore, would not necessarily violate section 27 of the Exchange Act if conducted by a state court.

V. CONCLUSION

The New York trial court's *Copperill* decisions were both bad law and bad policy. The decisions were bad law because they were based on a misreading of the *Fiero* case as well as misunderstandings of the Exchange

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arbitration agreements are enforceable under the Federal Arbitration Act even when they pertain to Exchange Act claims. *See id.* at 238.

100. *See* Greenberg v. Bear, Stearns & Co., 220 F.3d 22, 27 (2d Cir. 2000) (emphasis added) (abrogated in part on other grounds by *Vaden*, 556 U.S. 49). *Greenberg* relied on *Westmoreland Capital Corp. v. Findlay* for the principle that the presence of Exchange Act violations underlying an agreement to arbitrate does not create federal question jurisdiction, and to that extent it is abrogated by *Vaden*. *See* Westmoreland Capital Corp. v. Findlay, 100 F.3d 263 (2d Cir. 1996); *Vaden*, 556 U.S. at 70; *supra* note 83.

101. "*Abuse* of power" is not a ground for review under the FAA or CPLR section 7511, but both the FAA and CPLR section 7511 list "*exceeding*" power, which is presumably synonymous, as grounds for vacatur of an award. *See* 9 U.S.C. § 10(a)(4); N.Y. C.P.L.R. 7511(b)(1)(iii).

102. *See Greenberg*, 220 F.3d at 27. "Under certain federal decisions, an arbitration may be reviewed to determine whether it was made in 'manifest disregard' of law. The New York Court of Appeals has, however, not recognized such grounds . . . ." Banc of Am. Sec. v. Knight, 4 Misc. 3d 756, 759 (N.Y. Sup. Ct. 2004).

Act, the role of FINRA arbitration, and the procedural mechanism for confirming arbitration awards, even when those awards involve Exchange Act claims. The decisions were bad policy because to deny state-court review of such garden-variety arbitration procedures would be to flood federal courts with a host of unwanted and unneeded claims—claims federal courts likely would not hear anyway.

Nevertheless, once Sloane filed for bankruptcy, those who oppose the decision lost the opportunity for appellate review. As a result, the unfortunate decisions remain on the books.

We hope that this article will provide material for practitioners who must navigate these difficult concepts and who, some day, may help to toss *Copperill* on the ash heap of history.