Ethics in Discovery: Court, A Backdrop for Arbitration

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I. Introduction

The fair and zealous representation of each and every client, regardless of forum, is of vital importance, and requires attorneys to competently pursue discovery in an ethical manner. In New York, attorneys are subject to the Rules of Professional

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Conduct, which apply to the same extent in arbitration proceedings before FINRA as they do when practicing in New York State and Federal Courts before a judge.

However, all too often in the seemingly faster and looser world of arbitration it may at times appear that attorneys do not respect these important duties and conduct rules. Some attorneys appear to become emboldened by the absence of a judge and take liberties that they likely would not otherwise take were they operating in a more traditional courtroom setting. The discovery process is one area of practice where this problem arises time and time again.

The first section of this article will address the existing ethical obligations relating to discovery under the New York Rules of Professional Conduct and their application in the courts. The second section will compare the existing FINRA guidelines for appropriate discovery practices. Finally, this article will touch on the discovery abuses seen in the practice of securities arbitrations including electronic discovery.

II. The NY Rules of Professional Conduct and Their Application in Discovery

The New York State Legislature amended its rules of professional conduct in 2009 regulating attorneys' conduct before tribunals. The rules, now termed the New York Rules of Professional Conduct ("Rules"), brings the State's archaic Code of Professional Responsibility ("Code") more in line with the ABA Model Rules. In typical style, New York has attempted to blaze its own path by borrowing heavily from the Code's language in order to create a hybrid bridging the best of the Code and the Model Rules.

Rules 3.3 and 3.4[2] speak specifically to issues that arise during the discovery process (known as "disclosure" in New York State Court parlance). Pertinent provisions of Rule 3.3 require that a lawyer shall not knowingly:

> (1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

[2] An in depth comparison is beyond the scope of this article, but it is worth noting that NY Rules of Professional Conduct 3.3 and 3.4 borrow language (and therefore application case law) from Code 7-102, 7-105, 7-106, 7-108 and 7-109. For a comprehensive comparison, please refer to: http://www.nysba.org/Content/NavigationMenu/ForAttorneys/ProfessionalStandardsforAttorneys/CorrelationtableofnewNYrules.pdf (last accessed March 22, 2012).

> (3) offer or use evidence that the lawyer knows to be false…

Rule 3.3(a). Relatedly, Rule 3.4 requires that a lawyer shall not:

> suppress any evidence that the lawyer or the client has a legal obligation to reveal or produce; advise or cause a person to hide or leave the jurisdiction of a tribunal for the purpose of making the person unavailable as a witness therein; conceal or knowingly fail to disclose that which the lawyer is required by law to reveal; knowingly use perjured testimony or false evidence; participate in the creation or preservation of evidence when the lawyer knows or it is obvious that the evidence is false; or knowingly engage in other illegal conduct or conduct contrary to these Rules.

Rule 3.4(a)(1)-(6).

Failure to abide by these Rules of professional conduct can result in disqualification, as reported in one recent case, or suppression of documents or information obtained by offending behavior. *See, e.g.*, *Forward v. Foschi*, 27 Misc.3d 1224(A) *18, 911 N.Y.S.2d 692 (NY Sup. Ct. 2010) (plaintiff's counsel was not disqualified for failing to turn over privileged documents, but those

documents obtained by plaintiff by wrongly accessing defendant's email were suppressed as a discovery sanction).

New York Courts do not limit sanctions upon attorneys for only conduct perpetuated within the State's borders. Proceedings may also be brought in a "reciprocal proceeding" if an attorney has been disciplined in a different jurisdiction. *See, e.g., In re Graziano*, 87 A.D.3d 283, 926 N.Y.S.2d 147 (2d Dep't 2011) (New York registered attorney was barred from practice for one year where he was found guilty of violating, *inter alia*, failing to disclose a material fact to a tribunal, failing to disclose fact necessary to correct misapprehension, engaging in conduct involving dishonesty, fraud, deceit, or misrepresentation, and engaging in conduct prejudicial to the administration of justice); *In re Stahl*, 72 A.D.3d 218, 895 N.Y.S.2d 338 (1st Dep't 2010). Similarly, Courts may apply their own conduct rules and penalties even when attorneys work out of other states. *See, e.g., In re Munroe*, 89 A.D.3d 1, 932 N.Y.S.2d 11 (1st Dep't 2011) (attorney licensed in New York and Massachusetts and working out of Massachusetts was still subjected to New York's heightened conduct penalties).

III. FINRA's Guidelines for Discovery Practices

A. FINRA Code of Arbitration Procedure Provides the Arbitrators with the Power to Only Sanction Parties for Abuse of the Discovery Process, Not Their Attorneys

FINRA advises arbitrators that they should be aware of the potential for discovery abuses. Specifically, arbitrators should consider whether a party is using "the discovery process to harass and burden their opponent" and utilize the "tools available for addressing failures to comply with discovery rules." *See* FINRA Arbitrator's Guide.

The FINRA Code of Arbitration Procedure ("FINRA Code") specifically provides for the imposition of sanctions against parties for discovery abuses at the arbitrators' discretion. Specifically, FINRA Rule 12511(a) provides:

> (a) Failure to cooperate in the exchange of documents and information as required under the [FINRA] Code may result in sanctions. The panel may issue sanctions against any party in accordance with Rule 12212(a) for: [f]ailing to comply with the discovery provisions of the [FINRA] Code, unless the panel determines that there is

> substantial justification for the failure to comply; or [f]rivolously objecting to the production of requested documents or information.

The FINRA Code also provides arbitration panels more significant powers if the imposition of sanctions proves ineffective. Subpart (b) of Rule 12511 provides:

> The panel may dismiss a claim, defense or proceeding with prejudice in accordance with Rule 12212(c) for intentional and material failure to comply with a discovery order of the panel if prior warnings or sanctions have proven ineffective.

FINRA has instructed arbitrators that the sanctions they may impose include:

> 1. Assessing monetary penalties payable to one or more parties;
> 2. Precluding a party from presenting evidence;
> 3. Making an adverse inference against a party;
> 4. Assessing postponement and/or forum fees; and
> 5. Assessing fees, costs and expenses, or attorneys' fees caused by noncompliance.

Discovery, Abuses & Sanctions Training and Exam (2011), FINRA Dispute Resolution (2011).

FINRA does not have jurisdiction over the attorneys who represent parties in the forum. In February of 2008 edition of the Neutral Corner, FINRA addressed the question "[i]s it ever appropriate to sanction an attorney representative for egregious acts during an arbitration proceeding?" Noting that "FINRA does not have jurisdiction over an attorney representative" and that nothing in the FINRA Code "explicitly allows arbitrators to sanction an attorney," FINRA advises arbitrators that "it is never appropriate to sanction an attorney representative." The Neutral Corner, Volume 2 (February 2008). Yet, this does not mean that this forum should be treated by attorneys as a "Wild West" free-for-all. Arbitrators still have, and should be reminded of, their authority to refer an attorney's egregious conduct to the appropriate State bar disciplinary committees at their discretion.

B. NASD Recognizes the Need to Combat Discovery Abuse in Arbitration

All parties to arbitration, including member firms, have a long-standing duty to cooperate in the exchange of documents

requested by parties or listed on applicable Document Production Lists within the specified time. This duty, including compulsory production of, or objection to, the production of documents listed in the FINRA Discovery Guide, is what allows arbitration to be an efficient and effective method of resolving customer disputes. However, the discovery process has become the subject of abuse.

Since at least 2002, FINRA and its predecessor, the NASD, have recognized that despite the authority of the arbitrators to impose sanctions, the arbitration forum had become a forum in which discovery abuse was on the rise. The reason for this is unclear, but was recognized publicly by the NASD in 2003 due to the increase in monetary sanctions being handed down by arbitration panels. *See* FINRA Notice to Members ("NTM") 03-70 (November 6, 2003). The NASD and FINRA have responded over the years by encouraging parties, specifically member firms, to cooperate more in discovery and reminding arbitrators that they should take an affirmative approach to moderating the discovery between the parties and that they have the power to sanction parties.

In November of 2003, the NASD issued NTM 03-70 which "remind[ed] members of their duty to cooperate in the arbitration discovery process." Coinciding with the release of NTM 03-70, then NASD Vice Chairman and President of Regulatory Policy, Mary Shapiro released a statement that "[a]ny firm found abusing the arbitration process, including discovery, will face disciplinary action." *NASD Reminds Firms of Obligations to Provide Information Without Delay in Arbitrations*, NASD News Release (November 6, 2003). Specifically, the NASD stated that they were issuing NTM 03-70 to

> (1) remind members and associated persons of that duty; and
> (2) notify them that NASD Dispute Resolution will continue to monitor compliance with its discovery rules, and will refer perceived abuses to NASD Regulatory Policy and Oversight for disciplinary review.

In doing so, the NASD clearly indicated that it would not tolerate discovery abuses.

The NASD's concern was sparked by the apparent belief that for some parties, "noncompliance with their duty to cooperate in the discovery process . . . [was] a routine and acceptable part of

arbitration strategy." *Id*. Also concerning was the apparent failure of monetary sanctions to deter these practices. In response, the NASD reminded firms that the arbitrators do have the authority to sanction parties above and beyond monetarily, in the form of dismissal of claims and/or defenses and making disciplinary referrals. Taking this one step further, the NASD instituted a new practice of raising all potential discovery abuses to the Director of Arbitration and the President of NASD Dispute Resolution.

Five years later in February of 2008, FINRA released The Neutral Corner, Volume 2, which provided guidance to arbitrators regarding the discovery process. Specifically, FINRA instructed arbitrators to "be firm when managing the exchange of discovery between the parties." Arbitrators were also encouraged to remind the parties that they could be sanctioned and to specifically remind member firms that they could be subject to disciplinary action if they fail to comply with an arbitrator's order. The Neutral Corner, Volume 2. Raising the ante for member firms who habitually abuse the system is the authority vested in FINRA to suspend or terminate FINRA membership for the abuse of the arbitration

process, including discovery. *See Discovery, Abuses & Sanctions Training and Exam,* FINRA Dispute Resolution (2011).

FINRA members and associated persons may even find themselves held in violation of FINRA Conduct Rules, specifically Rule 2210, as a result of improper conduct in arbitration. Rule 2110 mandates that "[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade." IM-10100 provides that

> It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Nasdaq Rule 2110 for a member or a person associated with a member to: . . . (c) fail to appear or to produce any document in his possession or control as directed pursuant to provisions of the NASD Code of Arbitration Procedure.

Failure to comply with an arbitration panel's discovery order has been deemed sufficient to find a violation of Rule 2110 in the past. *See NASD Dept. of Enforcement v. Josephthal & Co., Inc.,* NASD Complaint No. CAF000015 (May 6, 2002) ("*Josephthal*").

IV. Discovery Abuses in FINRA Arbitrations

A. Examples of Sanctions for Discovery Abuse in FINRA Arbitrations

Although the power to go so far as to terminate FINRA membership for discovery abuses is available, the sanctions actually imposed in practice are overwhelmingly less severe. Based on a finding that a member firm "intentionally concealed documents," an NASD arbitration panel assessed a firm more than $10,000 in sanctions and $2,500 in attorneys' fees. Another member firm was also sanctioned $10,000 for its failure to produce documents as required by the panel chairperson. A different claimant was awarded $2,750 in attorneys' fees as a sanction for a firm's failure to produce discoverable documents, while two others were awarded $3,000 and $7,000, respectively, as sanctions against firms that failed to cooperate in discovery. *See* FINRA NTM 03-70.

In October of 2003, an NASD panel sanctions a firm $10,000 for each day it failed to comply with the panel's discovery order. *See NASD Reminds Firms of Obligations to Provide Information Without Delay in Arbitrations, supra*. A 2009 decision ordered another firm to pay $10,000 in sanctions for discovery abuse, which included asserting to claimants that

requesting information did not exist, while simultaneously providing it to a FINRA principal investigator. *David Wolfson Living Trust UAD 4/2/90 v. Stockcross Financial Services, Inc.*, FINRA Case No. 09-01512 (December 16, 2009). In May of 2011, a firm was sanctioned $80,000 for failure to cooperate in the discovery process, including failure to comply with Rule 12514. *See Wiborg v. Pacific West Securities, Inc.*, FINRA Case 10-02818 (June 23, 2011). That panel also threatened to preclude the firm from presenting evidence if the sanction was not paid. *Id*.

While it appears that most sanctions are levied against respondent firms, claimant customers are not immune from sanctions for discovery abuse. In July of 2010, a FINRA arbitration panel awarded a member firm $15,000 in sanctions against the customer for failing to comply with the panel's discovery order.

B. National Adjudicatory Council Upholds NASD Arbitration Panel Sanctions

Firms that have been subject to a regulatory sanction stemming from misconduct in arbitration have the opportunity to appeal to the National Adjudicatory Council ("NAC"); however, this is a difficult process as illustrated in 2002. On May 6, 2002, the NAC upheld an NASD Regulatory hearing panel's decision to sanction a member firm in the form of a censure and a $10,000 fine. *Josephthal & Co., Inc., supra*. In addition to performing select other functions, the NAC is an NASD committee that hears appeals in disciplinary matters. In its decision to affirm the hearing panel's decision, the NAC stated: "we strongly support an arbitrator's authority under [former] Arbitration Rule 10322 to order the production of any document in a party's control and we disapprove of a party that participates in arbitration but seeks to reserve for itself the option to disobey rulings issued by an arbitrator." *Id*.

This decision stemmed from the defiance of an arbitration panel's order in a 1999 proceeding against two public customers by Josephthal & Co., Inc. During the evidentiary hearings, the

claimants requested that a memorandum prepared by the law firm of Morgan, Lewis & Bockius be produced, and made a motion to the panel to compel the same. Josephthal & Co., Inc. objected, citing the attorney-client privilege. After some debate, the Panel ordered Josephthal & Co., Inc. to produce the memorandum for *in camera* review by the Panel, who would then make the determination as to any attorney-client privilege issues. Believing that even this *in camera* review would waive the attorney-client privilege, Josephthal & Co., Inc. refused to comply with the Panel's order.

Following an award for the claimants, the Panel recommended the issue to NASD Regulation. After a hearing on the matter, an NASD Regulation panel held that the "firm had violated just and equitable principles of trade when it failed to comply with an arbitration panel's order to produce a document." *Id*. In failing to produce the memorandum for in camera review, Josephthal & Co., Inc. was held to have violated NASD Conduct Rule 2110, justifying the monetary and censure penalties. *Id*.

An attorney practicing in this area must be mindful of the advice given to a client during an arbitration proceeding. Even

though an attorney cannot be sanctioned, the client can be sanctioned and, in the case of a FINRA member or associated person, could potentially be subject to a disciplinary proceeding that may result in a censure, fine, suspension or even a permanent bar.

V. Electronic Discovery's Growing Role in Arbitrations

Now, most businesses perform tasks on computers, and each computer program stores various types of data (sometimes termed electronically stored information, or "ESI"[3]) about the documents and information kept and created during the normal course of business. Information, such as who created, edited or destroyed documents can be vital to your discovery process. As a result, electronic discovery has become a growing frontier in litigation, and the rules of procedure governing such discovery, both for practice before New York State and Federal Courts, have recently been amended to accommodate for such discovery. While FINRA's rules do not specifically referring to electronic discovery,

[3] *See Tener v. Cremer*, 89 A.D.3d 75, 931 N.Y.S.2d 552 (1st Dep't 2011) (noting that 22 N.Y.C.R.R. § 202.12(c)(3) permits courts to establish methods and scope of electronic discovery).

they nevertheless consider electronic discovery within the purview of "documents." *See* FINRA Regulatory Notice 11-17 (*Revised Discovery Guide and Document Production Lists for Customer Arbitration Proceedings*), page 3.

Of course, the initial issue is not obtaining electronic discovery, because to do that, one only needs to ask.[4] But what happens if you are only given .pdf's or .tif's rather than "native format" documents, such as Word, Excel, PowerPoint, etc. documents? The conversion of native files to such "image" files could amount to destruction or spoliation of discoverable information, namely, electronic discovery. While New York State courts have noted that "electronic discovery raises a series of issues that were never envisioned by the drafters of the CPLR," *see, e.g., 915 Broadway Assocs. LLC v. Paul, Hastings, Janofsky*

[4] If one asks, they should be mindful that Federal and State laws may differ as to who is obligated to pay for such discovery. *See, Response Personnel, Inc. v. Ashchenbrenner*, 77 A.D.3d 518, 909 N.Y.S.2d 433 (1st Dep't 2010) (charging ESI costs on the requestor); *but see, Waltzer v. Tradescape, LLC*, 31 A.D.3d 302, 819 N.Y.S.2d 38 (1st Dep't 2006) (shifting cost to the producer where the cost of ESI is less significant, such as where ESI is readily available); *Zubulake v. UBS Warburg, LLC*, 217 F.R.D. 309, 317-318 (S.D.N.Y. 2003) (placing cost of discovery, including searching for, retrieving and producing ESI on the producing party).

& Walker, LLP, 34 Misc.3d 1229(A) *6 (N.Y. Sup. Ct. Feb. 16, 2012), the Appellate Division, First Department has held that

> On a motion for spoliation sanctions involving the destruction of electronic evidence, the party seeking sanctions must establish that (1) the party with control over the evidence had an obligation to preserve it at the time it was destroyed; (2) the records were destroyed with a culpable state of mind; and (3) the destroyed evidence was "relevant" to the moving party's claim or defense.

Ahroner v. Israel Discount Bank of New York, 79 A.D.3d 481, 482, 913 N.Y.S.2d 181 (1st Dep't 2010) (noting that "a culpable state of mind" can be found with ordinary negligence). Thus, one only needs to ask, and then make the argument that such discovery was "relevant" to the party's claim or defense.

Such spoliation has led New York Courts to apply discovery sanctions to e-discovery issues common in the paper discovery world, including, among others, adverse inferences. *See, e.g., VOOM HD Holdings LLC v. EchoStar Satellite LLC*, --- N.Y.S.2d ---, 2012 N.Y. Slip Op. 00658, 2012 WL 265833, *5 (1st

Dep't 2012); *Holme v. Global Minerals and Metals Corp*., 90 A.D.3d 423, 934 N.Y.S.2d 30 (1st Dep't 2011).

VI. Conclusion

The arbitration is under review by legislators and regulators alike, so if FINRA member firms and industry participants want to keep arbitration as a viable method of dispute resolution, it is important that the arbitration playing field be level and fair. Practitioners should always keep in mind that a key component of such equity and balance is the dutiful execution by attorneys of their ethical obligations during the pre-hearing discovery process.