

1990

## Just Saying No: Avoiding Predispute Agreements to Arbitrate in Securities Cases

Jim Parks

Follow this and additional works at: <https://scholarship.law.missouri.edu/jdr>



Part of the [Dispute Resolution and Arbitration Commons](#)

---

### Recommended Citation

Jim Parks, *Just Saying No: Avoiding Predispute Agreements to Arbitrate in Securities Cases*, 1990 J. Disp. Resol. (1990)

Available at: <https://scholarship.law.missouri.edu/jdr/vol1990/iss1/6>

This Comment is brought to you for free and open access by the Law Journals at University of Missouri School of Law Scholarship Repository. It has been accepted for inclusion in Journal of Dispute Resolution by an authorized editor of University of Missouri School of Law Scholarship Repository. For more information, please contact [bassettcw@missouri.edu](mailto:bassettcw@missouri.edu).

## COMMENT

# JUST SAYING NO: AVOIDING PREDISPUTE AGREEMENTS TO ARBITRATE IN SECURITIES CASES

### I. INTRODUCTION

When a would-be investor attempts to gain access to the securities markets, she will usually be required to sign an agreement to arbitrate any disputes arising out of the brokerage contract.<sup>1</sup> These predispute agreements to arbitrate are in and of themselves contracts.<sup>2</sup> If such contracts are valid, an investor will be forced to forego litigation in favor of arbitration.<sup>3</sup> On May 15, 1989, in the case of *Rodriguez de Quijas v. Shearson/American Express, Inc.*,<sup>4</sup> the United States Supreme Court held that predispute agreements to arbitrate claims under the Securities Act of 1933<sup>5</sup> (hereinafter referred to as the "1933 Act") are valid and enforceable.<sup>6</sup> When coupled with the Court's earlier decision in *Shearson/American Express, Inc. v. McMahon*,<sup>7</sup> which held that predispute agreements to arbitrate under the Securities Exchange Act of 1934<sup>8</sup> (hereinafter referred to as the "1934 Act") were valid and enforceable,<sup>9</sup> it appears that all predispute agreements to arbitrate under the securities laws are presumptively valid and must be enforced according to their terms. Consequently, the number of securities cases that go to arbitration will likely increase. Brokerage houses favor arbitration.<sup>10</sup> The above decisions make arbitration more generally available. Thus, one can expect brokerage houses to implement and enforce predispute agreements to arbitrate.

Each year the number of security cases that are submitted to arbitration increases.<sup>11</sup> After the *McMahon* decision, the number of securities claims arbitrated increased as the Court upheld predispute agreements to arbitrate under the 1934 Act.<sup>12</sup> In response to the Supreme Court's decision in *de Quijas*,

---

1. Heinemann, *Arbitrability Of Claims Arising Under The Securities Exchange Act Of 1934*, 1986 DUKE L.J. 548, 549.

2. T. HAZEN, *THE LAW OF SECURITIES REGULATION* § 14.4, at 533 (1st ed. 1985) (Supp. 1988). See also H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924) ("Arbitration agreements are simply matters of contract..."); Fletcher, *infra* note 10 at 101.

3. See *infra* notes 4 and 7.

4. *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 109 S. Ct. 1917 (1989).

5. 15 U.S.C. §§ 77(a)-77(aa) (1982) [hereinafter the Securities Act].

6. *De Quijas*, 109 S.Ct. at 1919-1922.

7. 482 U.S. 220 (1987).

8. 15 U.S.C. §§ 78(a)-78(kk) (1982).

9. *McMahon*, 482 U.S. at 236.

10. Fletcher, *Learning To Live With The Federal Arbitration Act - Securities Litigation In A Post-McMahon World*, 37 EMORY L.J. 99, 122 (1988).

11. Kaisoris, *The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 280 n.7 (1984).

12. Shell, *Arbitration and Corporate Governance*, 67 N.C.L. REV. 517 (1989).

upholding predispute agreements to arbitrate under the 1933 Act, brokerage houses are likely to repeat the *McMahon* pattern and move to arbitrate securities disputes arising under the 1933 Act at an increased rate.<sup>13</sup>

This Comment will explore the current state of securities arbitration and will examine the advisability of arbitration in a securities context. In addition, this Comment will consider avenues of relief open to the securities plaintiff who is seeking to avoid arbitration.

## II. THE FEDERAL POLICY OF ARBITRATION AND ARBITRABILITY

### A. Arbitration

Alternative dispute resolution (hereinafter referred to as "ADR") has grown rapidly in popularity as both lawyers and litigants seek alternatives to litigation.<sup>14</sup> The judicial system currently incorporates ADR through the use of out of court settlements. This use of out-of-court settlements disposes of 90% of all cases without adjudication.<sup>15</sup> Unfortunately, 85% of attorneys express dissatisfaction with this informal process.<sup>16</sup> The most commonly cited reasons for dissatisfaction include delay in reaching settlement, expense and stress.<sup>17</sup>

In contrast to litigation and the use of out-of-court settlements, ADR generally, and arbitration specifically, is quick and cost effective.<sup>18</sup> Arbitration usually takes from four to six months and costs about one third as much as litigation from start to finish.<sup>19</sup> Consequently, arbitration is an appealing method of resolving disputes, in that it reduces the time, expense and stress associated with litigation.<sup>20</sup> In addition, as arbitration removes cases from the court system, court dockets become less crowded.

Historically, Congress has favored arbitration as a method of alternative dispute resolution.<sup>21</sup> Giving expression to its preference in 1925, Congress enacted the Federal Arbitration Act (hereinafter referred to as the "FAA").<sup>22</sup>

13. *Id.*

14. Edwards, *Alternative Dispute Resolution: Panacea or Anathema*, 99 HARV. L. REV. 668 (1986).

15. *Id.* at 670 n.8.

16. *Id.* at 670.

17. *Id.*

18. *See supra* note 11, at 282-283.

19. Fletcher, *Privatizing Securities Disputes Through The Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 458 (1987).

20. Note, *The Arbitrability of Federal Securities Claims: Wilko's Swan Song*, 42 U. MIAMI L. REV. 203, 224 (1987).

21. Note, *Federal And State Securities Claims: Litigation Or Arbitration?*, 61 WASH. L. REV. 245, 247 (1986) (citing H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924)).

22. 9 U.S.C. §§ 1-14 (1982).

### B. *The Federal Arbitration Act*

The FAA was enacted in 1925 in response to pressure by the business community for an alternative to litigation.<sup>23</sup> The Act was intended to reduce historic judicial hostility toward arbitration.<sup>24</sup> Congress felt that the FAA would help reduce the costs associated with litigation and would help clear congested court dockets.<sup>25</sup> The broad language of the FAA thus embodies a strong federal policy in favor of arbitration (hereinafter referred to as the "mandate of the FAA").<sup>26</sup>

The FAA carries out its mandate by making all agreements to arbitrate, "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>27</sup> By its terms, the FAA applies only to transactions in interstate commerce.<sup>28</sup> However, interstate commerce has been defined so broadly that almost all securities transactions will fall within the definition.<sup>29</sup> The FAA creates a presumption of arbitrability, one that must be overcome by a party seeking to avoid arbitration.<sup>30</sup>

The presumption of arbitrability is particularly important where the presumption is not rebutted and the arbitrator renders a decision. This is so, because the grounds for judicial review of the arbitrator's decision are extremely limited.<sup>31</sup> Under the FAA there are only four grounds for overturning an arbitrator's decision:

- (1) There was an undisclosed relationship between an arbitrator and a party or his counsel affecting the arbitrator's impartiality or appearance of impartiality;
- (2) The arbitrator was corrupt;
- (3) The arbitrator failed to schedule or conduct the hearing in a fair and judicious manner;
- (4) The arbitrator granted relief which he was not authorized to grant under the arbitration contract.<sup>32</sup>

Unless one of these four grounds is shown to exist, the arbitrator's decision will stand. Therefore, failure to rebut the presumption renders one subject to an arbitration proceeding from which the right to appeal is limited to a narrow

---

23. Note, *The Preclusive Effect Of Arbitral Determinations In Subsequent Federal Securities Litigation*, 55 *FORDHAM L. REV.* 655, 659 (1987).

24. *Sherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-11 (1974).

25. *Legg, Mason & Co. v. Mackall & Coe, Inc.*, 351 F. Supp. 1367, 1372 (D. D.C. 1972).

26. *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

27. 9 U.S.C. § 2 (1982).

28. *Id.*

29. 9 U.S.C. § 1. See also *Fletcher*, *supra* note 19, at 402 (1982).

30. See *supra* note 10, at 109.

31. 9 U.S.C. § 10 (1982).

32. See *supra* note 11, at 290-91. See also 9 U.S.C. § 10 (1982).

spectrum. Absent misconduct on the part of the arbitrator, her decision will be final. This should not be a cause for concern if the arbitration process, including the initial agreement to arbitrate, is fundamentally fair to all parties.<sup>33</sup>

### C. *The Mandate of the FAA*

The language of the FAA is broad and its mandate, as interpreted by the courts, is no less expansive.<sup>34</sup> In a line of cases running from 1967 to 1987 the United States Supreme Court has given an expansive interpretation to the FAA.

(1) In the first of these cases, *Prima Paint v. Flood & Conklin Mfg. Co.*,<sup>35</sup> the Supreme Court upheld the constitutionality of the FAA.<sup>36</sup> The FAA was challenged on the ground that Congress may not "fashion federal substantive rules to govern questions arising in simple diversity" under the doctrine of *Erie R. Co. v. Tompkins*.<sup>37</sup> The Court reshaped the inquiry to be, "[W]hether Congress may prescribe how federal courts are to conduct themselves with respect to subject matter over which Congress plainly has power to legislate."<sup>38</sup> The Court answers the question in the affirmative, noting federal authority over interstate commerce and admiralty.<sup>39</sup> Holding clear federal authority to create a substantive law of arbitrability, the Court found the Act to contain a presumption of arbitrability.

(2) In *Moses Cone Memorial Hosp. v. Mercury Constr. Corp.*,<sup>40</sup> the Supreme Court broadly construed the FAA, finding a presumption in favor of arbitration.<sup>41</sup> The Court states:

The FAA establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an alleged allegation of waiver, delay or a like defense to arbitrability.<sup>42</sup>

The presumption established in *Moses* operates to place a party seeking to avoid arbitration in the position of rebutting an unusually strong presumption, with no explicit guidance as to how this should be done. The Court's next decision

33. See *infra* note 111 and accompanying text.

34. See *supra* notes 27-30 and accompanying text.

35. 388 U.S. 395 (1967).

36. *Id.* at 404-5.

37. *Id.* at 405 (citing 304 U.S. 64 (1939)).

38. *Prima Paint*, 388 U.S. at 405.

39. *Id.* (citing H.R. REP. NO. 96, 68th Cong., 1st Sess. 1 (1924)); S. REP. NO. 536, 68th Cong., 1st Sess. 3 (1924).

40. *Moses*, 460 U.S. at 1.

41. *Id.* at 24-25.

42. *Id.*

interpreting the FAA provides no answers to the *Moses* problem, but further expands the reach of the Act.

(3) In the case of *Southland Corp. v. Keating*,<sup>43</sup> the Supreme Court expands the reach of the FAA into state courts.<sup>44</sup> The California Supreme Court held that anti-waiver provisions of that state's Franchise Investment Law prohibited arbitration.<sup>45</sup> The United States Supreme Court found the California law to be in conflict with the FAA.<sup>46</sup> The Court held that the FAA overrides state law, where such state law conflicts with the FAA.<sup>47</sup> In so doing, the Court expands upon its holding in *Prima Paint*, that the FAA created substantive federal law, by relying on the Supremacy Clause of the United States Constitution to extend the mandate of the FAA.<sup>48</sup>

(4) In 1985, the Court answered the question left open in *Moses* as to how one rebuts the presumption of arbitrability. The Court in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,<sup>49</sup> established the principle that "unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue," courts must strictly enforce arbitration agreements.<sup>50</sup> The analysis under *Mitsubishi* involves a determination of whether the agreement to arbitrate was broad enough to encompass consideration of the statutory claims and then whether Congressional intent exists to preclude arbitration.<sup>51</sup> If either criterion is met, the presumption established in *Moses* is overcome and arbitration can be avoided.<sup>52</sup>

(5) In the same term that *Mitsubishi* was decided, the Court decided *Dean Witter Reynolds, Inc., v. Byrd*.<sup>53</sup> *Byrd* reiterates many of the Court's prior statements involving the broad mandate of the FAA in promoting arbitration, but in a context that significantly advances that mandate. The Court reiterates its holding in *Moses* that where there is doubt concerning the validity of an arbitration

---

43. 465 U.S. 1 (1984).

44. *Id.* at 16. See also Note, *Punitive Damages In Securities Arbitration: The Unresolved Question of Pendent State Claims*, 37 CATH. U.L. REV. 1113, 1117 (1988).

45. *Id.* at 4-5.

46. *Id.* at 17.

47. *Id.* at 16. See also *Perry v. Thomas*, 482 U.S. 483, 488-490 (1987).

48. *Id.* at 16. The Supremacy Clause reads: The Constitution and the Laws of the United States which shall be made in Pursuance thereof...shall be the supreme Law of the Land and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding. U.S. CONST. art. VI.

49. 473 U.S. 614 (1985).

50. *Id.* at 628.

51. *Id.*

52. In *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 224-227 (1987) the Court held that the burden of persuasion is on the party attempting to prove a Congressional exception to the FAA.

53. 470 U.S. 213 (1985).

agreement, that doubt should be resolved in favor of arbitration.<sup>54</sup> The Court also {presaged}??? the *Mitsubishi* test, noting that the FAA represents a Congressional policy that favors arbitration and that such policy cannot be overridden "absent a countervailing policy in another federal statute."<sup>55</sup>

The *Byrd* Court expands the scope of the FAA by abolishing the intertwining doctrine. The intertwining doctrine holds that where non-arbitrable federal claims are intertwined with arbitrable state claims, a court in its discretion can choose to litigate all the claims in federal court, despite any agreement to arbitrate.<sup>56</sup> The court in abolishing the intertwining doctrine specifically notes that considerations of judicial economy cannot override the mandate of the FAA. Inefficient "piecemeal" proceedings are required.<sup>57</sup> Those claims subject to valid agreements to arbitrate must go to arbitration, even when to do so would be inefficient.

This line of cases establishes the sweeping breadth of the FAA. It is in light of this mandate that predispute agreements to arbitrate securities disputes must be considered. The party seeking to avoid a predispute agreement to arbitrate in their brokerage contract will have to overcome a presumption of arbitrability, embodied in substantive federal law, by showing an explicit intent on the part of Congress to exempt the transaction. The enforceability of predispute agreements to arbitrate securities disputes has tracked the expansion of the FAA.

### III. SECURITIES ARBITRATION

In a line of cases running from 1953 to 1989 the United States Supreme Court has ruled on the enforceability of predispute agreements to arbitrate securities disputes.<sup>58</sup> These rulings have reflected the expansion of the FAA's mandate favoring arbitration.

#### A. *The Wilko Case and its Erosion*

(1) The first significant case in the area of securities arbitration is the Supreme Court's decision in *Wilko v. Swan*.<sup>59</sup> The case arose out of a predispute agreement to arbitrate a security claim under section 12(c)<sup>60</sup> of the 1933 Act.<sup>61</sup> The Court held that predispute agreements to arbitrate under the 1933 Act are unenforceable.<sup>62</sup> The Court reasons that three factors combined to create a special right under section 12(c) of the 1933 Act, thus exempting such claims from

54. *Id.* at 221.

55. *Id.*

56. *Id.* at 216-217.

57. *Id.* at 217-221.

58. *See supra* note 10, at 99.

59. 346 U.S. 427 (1953).

60. 15 U.S.C. § 711 (1982).

61. *Wilko*, 346 U.S. at 427.

62. *Id.* at 435-436.

the FAA. First, under section 12(c) of the 1933 Act scienter need not be proven.<sup>63</sup>

Second, plaintiffs are given a choice between federal and state forums.<sup>64</sup> Finally, section 14<sup>65</sup> of the 1933 Act prohibits any waiver of compliance with the Act.<sup>66</sup> In addition, the *Wilko* Court was motivated in part by the perceived inability of arbitration procedures to protect the investor.<sup>67</sup>

Due to the substantial similarity between section 14 of the 1933 Act and section 29(a) of the 1934 Act,<sup>68</sup> lower courts in the wake of *Wilko* applied the *Wilko* Doctrine to 1934 Act claims as well.<sup>69</sup> The net effect of the decision in *Wilko* was to make all securities claims non-arbitrable. Under the *Wilko* Doctrine all predispute agreements to arbitrate would be unenforceable.

(2) The Supreme Court began to cut back on the *Wilko* Doctrine in 1974. In *Scherk v. Alberto-Culver Co.*,<sup>70</sup> the Court was faced with a predispute agreement to arbitrate a securities dispute under section 10b-5<sup>71</sup> of the 1934 Act.<sup>72</sup> While the decision in *Wilko* and its progeny should have disposed of the case, it did not, as the Court found a crucial distinction between *Wilko* and *Sherk*. *Sherk* involved an international securities transaction which the Court found to be fact determinative.<sup>73</sup> The Court, citing considerations of comity and certainty,<sup>74</sup> held that predispute agreements to arbitrate securities disputes were valid and enforceable in an international transaction.<sup>75</sup> *Sherk* marks the beginning of *Wilko*'s erosion.

(3) The next case in the Court's retreat from *Wilko* is *Dean Witter Reynolds v. Byrd*.<sup>76</sup> As noted earlier, *Byrd* confronted the problem of arbitrable state claims joined with nonarbitrable federal securities claims under the 1934 Act.<sup>77</sup> For the first time the FAA and the Securities Acts of 1933 and 1934, as interpreted by *Wilko* met head on, and the FAA won. The Court in abolishing the

---

63. 15 U.S.C. § 711 (1982).

64. 15 U.S.C. § 77v(a) (1982).

65. *Id.* at § 77n.

66. *Wilko*, 346 U.S. at 427-433.

67. *Id.* at 433-435.

68. 15 U.S.C. § 78cc(a) (1982).

69. *See supra* note 20, at 209 (citing cases). *See also* note 11, at 297 (citing cases where the *Wilko* doctrine was applied to sections 5 and 17 of the 1933 Act).

70. 417 U.S. 506 (1974).

71. 15 U.S.C. § 78j(b) (1982).

72. *Sherk*, 417 U.S. at 508-509.

73. *Id.* at 517-518.

74. *Id.* at 518-519.

75. *Id.* at 519-520.

76. *Supra* note 52 and accompanying text.

77. *Sherk*, 417 U.S. at 214.

intertwining doctrine read the FAA to mandate the arbitration of arbitrable claims, even when joined with nonarbitrable federal claims.<sup>78</sup>

(4) The first of the Supreme Court's landmark securities cases was *Shearson/American Express, Inc., v. McMahon*.<sup>79</sup> Under the 1933 Act, causes of action are expressly granted,<sup>80</sup> while under the 1934 Act they are implied<sup>81</sup>. As noted above, lower courts had applied *Wilko* to causes of action under the 1934 Act, holding such predispute agreements to arbitrate are unenforceable.<sup>82</sup> In *McMahon*, the Court distinguishes between the treatment of express claims under the 1933 Act and the implied claims arising under the 1934 Act. The Court addresses the question of the validity of predispute agreements to arbitrate implied causes of action under the 1934 Act, finding such claims arbitrable.<sup>83</sup>

The *McMahon* decision overturned the *Wilko* progeny which applied the *Wilko* Doctrine to 1934 Act cases. After *McMahon*, predispute agreements to arbitrate under the 1934 Act are enforceable.<sup>84</sup> The decision also laid the groundwork for the eventual complete overruling of *Wilko*. The *McMahon* Court notes that the inability of arbitration to protect the investor was central to the decision in *Wilko*. The Court further notes that arbitration has progressed since the time of *Wilko* in 1953. The Court found current arbitration procedures adequate to protect the investor.<sup>85</sup> While holding 1934 Act claims arbitrable, the Court declined to overrule *Wilko*, as the arbitrability of 1933 Act claims was not before the Court.

(5) In *Rodriguez De Quijas v. Shearson/American Express, Inc.*,<sup>86</sup> the Court addressed the question of the arbitrability of claims under section 12(2) the 1933 Act.<sup>87</sup> In this second landmark case, the Court overturned *Wilko*.<sup>88</sup> The Court held that predispute agreements to arbitrate under the 1933 Act were enforceable.<sup>89</sup> The Court notes the line of cases establishing the mandate of the FAA and applies the *Mitsubishi* test to the 1933 Act,<sup>90</sup> finding the *Wilko* Doctrine wanting. The Court further notes the plaintiff's failure to demonstrate why arbitration was an inappropriate forum for the resolution of 1933 Act claims or to demonstrate how the predispute agreement to arbitrate in question was

78. *Id.* at 221.

79. 482 U.S. 220 (1987).

80. 15 U.S.C. § 78j(b) (1982); 17 C.F.R. § 240.10b-5 (1986).

81. 15 U.S.C. §§ 77(a)-77(aa) (1982).

82. *Supra* note 66 and accompanying text.

83. *McMahon*, 482 U.S. at 236.

84. *Id.*

85. *Id.* at 230-232.

86. 109 S. Ct. 1917 (1989).

87. *Id.* at 1919. Section 12(2) provides civil liability for anyone who offers or sells a security in violation of the Section 5 timing rules.

88. *De Quijas*, 109 S. Ct. at 1919.

89. *Id.*

90. *Id.* at 1920-1921.

adhesive.<sup>91</sup> It would seem that after *McMahon* and *De Quijas* all predispute agreements to arbitrate securities claims, whether under the 1933 or 1934 Act, are enforceable.

### B. *The Post De Quijas Cases*

Immediately after the United States Supreme Court's decision in *De Quijas*, lower courts interpreted the holding as both compelling enforcement of predispute agreements to arbitrate in securities cases and as expanding the mandate of the FAA. Two cases are illustrative.

#### (1) *Brown v. Dean Witter Reynolds, Inc.*<sup>92</sup>

The plaintiff in *Brown* asserted claims under the 1933 and 1934 Acts. He attempted to avoid arbitration on several grounds. He argued that the Supreme Court's decisions in *McMahon* and *De Quijas* should not be applied retroactively to a brokerage contract entered into before the decisions were handed down; that there was a waiver of the predispute agreement to arbitrate; and that a lack of meaningful discovery prevented him from challenging the arbitration agreement.<sup>93</sup> The Eleventh Circuit denied each of the plaintiff's arguments and held the predispute agreement to arbitrate enforceable.<sup>94</sup>

It is interesting to note that the *Brown* court gives retroactive effect to the decisions in *McMahon* and *De Quijas*. More interesting, however, is that a lack of discovery is no bar to enforcement. By excluding meaningful discovery in an arbitration context the court has placed a thumb on the scales of justice. If, as the court notes, "The party opposing arbitration bears the initial responsibility of informing the court of its opposition [to the predispute agreement to arbitrate],"<sup>95</sup> and yet cannot conduct discovery, how is the burden of rebutting the presumption of validity of the predispute agreement to arbitrate to be met? The answer appears to be, not easily. Court sanctioned lack of discovery prevents the party opposing arbitration from gaining the information the same court demands to rebut the presumption of arbitrability. Fundamental fairness would seem to suggest that the party opposing arbitration be given the opportunity to discover the information necessary to overcome the presumption. That arbitration is compelled in such a situation is telling. The federal policy favoring arbitration must be broad indeed.

#### (2) *Securities Indust. Assoc. v. Connolly*<sup>96</sup>

---

91. *Id.* at 1921.

92. No. 13404 (11th Cir. Sept. 1, 1989) (LEXIS Genfed library, Cir. file).

93. *Id.*

94. *Id.*

95. *Id.*

96. No. 13081 (1st Cir. Aug. 31, 1989) (LEXIS, Genfed library, Cir. file).

At issue in *Connolly* was a Massachusetts statute that regulates predispute agreements to arbitrate. The statute requires that brokerage firms (1) not require, "individuals to enter PDAA's as a nonnegotiable condition precedent to account relationship," (2) "order the prohibition brought conspicuously to the attention of the prospective customers," and (3) provide "written disclosure of the 'legal effect of the pre-dispute arbitration contract'." The statute was held to be invalid under the preemption doctrine as it conflicted with the FAA.<sup>97</sup>

Under the preemption doctrine the state regulation is preempted by the FAA if the two statutes are in conflict.<sup>98</sup> *The Connolly* interpreted *De Quijas* as indicating that Congress' intent to mandate the enforceability of arbitration agreements must be fully protected.<sup>99</sup> The court reasoned that the FAA forbids States from regulating arbitration any more strictly than an ordinary contract.<sup>100</sup>

The decision in *Connolly* is striking. That the FAA represents a substantive body of federal law on arbitration is beyond dispute.<sup>101</sup> That the federal law of arbitration established in the FAA overrides contrary state law under a preemption analysis is established.<sup>102</sup> That the FAA prohibits states from regulating predispute agreements to arbitrate is novel.

The FAA attempts to place predispute agreements to arbitrate on an equal footing with other contracts,<sup>103</sup> it does not prohibit states from regulating such contracts.<sup>104</sup> The Massachusetts statute does not prohibit the use of arbitration.<sup>105</sup> It merely requires safeguards to ensure investor protection.<sup>106</sup> The statute prevented contracts of adhesion and requires informed consent on the part of the investor.<sup>107</sup> *The Connolly* court's decision seems to pave the way for brokers to utilize contracts of adhesion, whereby investors will unknowingly waive the right to access a judicial forum. Further, it prohibits states from regulating to prevent such conduct. In light of *Connolly*, states may not regulate where such regulation would involve any potential conflict with the FAA.

#### IV. APPROACHES TO SECURITIES ARBITRATION

The historical development of the FAA mandate (enforcing agreements to arbitrate) and the parallel development of the enforceability of predispute agreements to arbitrate in securities cases, leave the party seeking to avoid arbitration in a difficult and perhaps insupportable position. *McMahon* and *De*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. See *supra* note 24 and accompanying text.

102. See *supra* note 43 and accompanying text.

103. See *supra* notes 2 and 95.

104. See *supra* note 22.

105. MASS. REGS. CODE tit. 950, §§ 12.204 (G) (1) (a)-(c) (1978).

106. See *supra* note 95.

107. *Id.*

*Quijas* seem to indicate that all predispute agreements to arbitrate in brokerage contracts are enforceable.<sup>108</sup> However, a careful analysis of *De Quijas* and the FAA leaves some room for hope that predispute agreements to arbitrate may yet be avoided in securities cases. Four approaches seem to be available for the party seeking to avoid arbitration:

- (1) Challenging the Appropriateness of Arbitration;
- (2) Arguing that Predispute Agreements to Arbitrate are Contracts of Adhesion;
- (3) Asserting Undecided Statutory Claims;
- (4) Asserting Traditional Contract Defenses.

#### A. *The Appropriateness of Arbitration*

If arbitration is fundamentally fair to all parties, predispute agreements to arbitrate should be enforced according to their terms.<sup>109</sup> Unfortunately, this may not be the case. The Court in *McMahon* felt that arbitration had progressed since the *Wilko* decision in 1953.<sup>110</sup> However, the dissent questions the adequacy of arbitration, as the Securities and Exchange Commission (hereinafter referred to as SEC) does not have sufficient oversight, noting that the SEC lacks the ability to specifically review arbitration proceedings.<sup>111</sup>

The arbitration system used in the securities industry is the product of industry and SEC cooperation.<sup>112</sup> The parties to a securities arbitration agreement may choose either to arbitrate under the auspices of one of the self regulatory organizations (hereinafter referred to as SROs), such as the New York Stock Exchange, or the American Arbitration Association (hereinafter referred to as AAA).<sup>113</sup> The SEC has no oversight over the AAA, but does possess oversight over the SROs.<sup>114</sup> The SEC seeks, through its oversight, to strengthen the legitimacy of securities arbitration.<sup>115</sup> However, this oversight over the SROs does not include the ability to overturn an arbitration award.<sup>116</sup>

---

108. See *supra* notes 78-90 and accompanying text.

109. *McMahon*, 482 U.S. at 230-232.

110. *Id.* at 240-242.

111. *Id.* at 262.

112. See *supra* note 14, at 681.

113. Note, *Punitive Damages In Securities Arbitration: The Unresolved Question of Pendent State Claims*, 37 CATH. U.L.REV. 1113, 1129 (1988).

114. *McMahon*, 482 U.S. at 230-232.

115. See generally Fletcher, *supra* note 10, at 136. (SEC seeks to increase its oversight capabilities as some courts preface their decisions on the adequacy of arbitral procedures).

116. *Supra* note 112, at 1129. The four factors are:

- (1) There was an undisclosed relationship between an arbitrator and a party or his counsel affecting the arbitrator's impartiality;
- (2) The arbitrator was corrupt;
- (3) The arbitrator failed to schedule or conduct the hearing in a fair and judicious manner; and

This inability to review arbitral decisions becomes critical when one realizes that the courts are almost equally unable to review an arbitral decision. The FAA lists four grounds upon which an arbitrator's decision can be overturned.<sup>117</sup> In addition, the Supreme Court has allowed an arbitration award to be overturned for manifest disregard of the law.<sup>118</sup> Absent egregious behavior by the arbitrator, the arbitration award will be unassailable.

It is argued that to allow greater review of arbitration awards would be to lose the benefits of arbitration as an unsuccessful party would immediately appeal.<sup>119</sup> This is not the case. Allowing more liberal review of arbitration does not destroy the efficacy of the arbitration process as the decision, if appealed, would be admissible as evidence in the later proceeding.<sup>120</sup>

With no meaningful review of the arbitration award available, the investor must accept the rough justice of arbitration. Discovery rules do not apply in arbitration,<sup>121</sup> though arbitrators do have subpoena powers.<sup>122</sup> Arbitrators are not bound by the rules of evidence.<sup>123</sup> Arbitrators are not bound by principles of substantive law.<sup>124</sup> Arbitrators are not bound by *stare decisis*.<sup>125</sup> Arbitrators need not state their reasons for an award, nor are they required to make written findings of fact.<sup>126</sup> The rationale given for this truncated procedure is that arbitration is intended to be quick and efficient.<sup>127</sup>

"But surely the mere resolution of a dispute is not proof that the public interest has been served."<sup>128</sup> The Securities Acts are intended to provide protection to purchasers of registered securities<sup>129</sup> and to promote investor confidence.<sup>130</sup> Congress, in enacting the Securities Acts, established a policy of protecting investors through specific statutory mechanisms. Yet arbitrators are

(4) The arbitrator granted relief which he was not authorized to grant under the arbitration clause.

117. 9 U.S.C. § 10 (1982).

118. *Wilko*, 346 U.S. at 436-437.

119. Bruff, *Public Programs, Private Deciders: The Constitutionality of Arbitration in Federal Programs*, 67 TEX. L. REV. 441, 477 (1989); *See also* Katsoris, *supra* note 11, at 291 n.84.

120. *See supra* note 23, at 687.

121. *Foremost Yarn Mills, Inc. v. Rose Mills, Inc.*, 25 F.R.D. 9, 11 (E.D. Pa. 1960).

122. *Burton v. Bush*, 614 F.2d 389, 390 (4th Cir. 1980).

123. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 203 n.4 (1956);

*National Post Office Mailhandlers Union v. United States Postal Serv.*, 751 F.2d 834, 841 (6th Cir. 1985).

124. *University of Alaska v. Modern Constr., Inc.*, 522 P.2d 1132, 1140 (Alaska 1974).

125. M. HILL & A. SINICROPI, *EVIDENCE IN ARBITRATION* 1, 40-41 (1980).

126. *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 598 (1960).

127. *Sobel v. Hertz, Warner & Co.*, 469 F.2d 1211, 1214 (2d Cir. 1972).

128. *Supra* note 14, at 676-678.

129. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 383 (1983).

130. *Supra* note 19, at 460 (citing *King v. Sussex Justices*, 1 K.B. 256, 259 (1924)).

not competent to deal with statutory claims.<sup>131</sup> An arbitrator's authority is purely contractual.<sup>132</sup> Public policy concerns are beyond the pale of an arbitrator's purview.<sup>133</sup>

Equally, much arbitration is conducted by the SROs.<sup>134</sup> To allow "those the law seeks to regulate to delimit public rights and duties. . . [is] real reason for concern."<sup>135</sup>

Where the legislature has established strict standards, allowing arbitration to lessen those standards runs counter to the rule of law.<sup>136</sup> It would seem fundamentally unfair to allow organizations made up of brokers to decide complaints made against brokers.

As "[t]he primary purpose of the securities laws is to protect investors who are not able to protect themselves,"<sup>137</sup> it might be argued that the time has come for an unsophisticated investor exception to the *De Quijas* Doctrine. Namely, that the federal policy of protecting investors embodied in the 1933 and 1934 Acts is a countervailing federal policy<sup>138</sup> which should override the FAA where one of the parties to an agreement to arbitrate is an unsophisticated investor; the very type of investor the Securities Acts were designed to protect. The FAA should not be construed to demand arbitration where one of the parties is unsophisticated, as to do so allows a private decision-maker to delimit federal rights. *De Quijas*, if applied broadly, will undermine Congress' intent to protect the unsophisticated investor, as embodied in the 1933 and 1934 Acts. The right to a federal forum under the Securities Acts is rendered nugatory by allowing mandatory arbitration.<sup>139</sup>

The argument is made, however, that predispute agreements to arbitrate are merely forum selection devices.<sup>140</sup> Here again, this is not the case. An arbitration clause is not a mere forum selection device. "To the degree that arbitration alters the combination of remedies and sanctions afforded by state law, it modifies substantive law in ways unintended by the drafters of the Federal Arbitration Act and interferes with the contractual expectations of parties to an arbitration agreement."<sup>141</sup>

---

131. *Barrentine v. Arkansas-Best Freight Sys.*, 450 U.S. 728, 743 (1981); *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 57 (1974); *McDonald v. City of W. Branch*, 466 U.S. 284, 290 (1984) ("[A]lthough arbitration is well suited to resolving contractual disputes... it cannot provide an adequate substitute for a judicial proceeding in protecting federal statutory and constitutional rights. . . .").

132. *Barrentine*, 450 U.S. at 744; *Alexander*, 415 U.S. at 53-54.

133. *Id.*

134. See *supra* note 112.

135. See *Edwards*, *supra* note 14, at 676.

136. *Id.* at 677.

137. *Fletcher*, *supra* note 19, at 427.

138. *Id.* at 428.

139. *Heinemann*, *supra* note 1, at 552.

140. *Fletcher*, *supra* note 19, at 410-11.

141. Note, *supra* note 112, at 1114-1115.

Punitive damages provide a ready example. Punitive damages are unavailable under securities arbitration.<sup>142</sup> "[T]o the extent that arbitral considerations excludes punitive awards, the process sacrifices both systemic efficiency and investor protection,"<sup>143</sup> and weakens "deterrence of already outrageous conduct on Wall Street by reducing or eliminating potential exposure to punitive liability."<sup>144</sup> "[A] denial of punitive damage awards arguably interferes with arbitrations function of providing a substantially equivalent forum for dispute resolution."<sup>145</sup> At best if arbitration is merely a forum selection device, it is an inappropriate and ineffective one, as the efficacy of arbitration to resolve questions of federal rights is suspect due to the inherent procedural limitations of the arbitral process.<sup>146</sup>

The *De Quijas* Court citing *Wilko* notes; "There is nothing in the record before us, nor in the facts of which we can take judicial notice, to indicate that the arbitral system . . . would not afford the plaintiff the rights to which he is entitled."<sup>147</sup> Thus, the burden falls on the plaintiff seeking to avoid arbitration to show why arbitration should not be compelled. By demonstrating the inappropriateness of arbitration to deal with federal rights under the Securities Acts, a plaintiff might avoid arbitration. The courts should not compel arbitration of securities disputes until arbitration has been improved.<sup>148</sup>

#### B. *Predispute Agreements to Arbitrate are Contracts of Adhesion*

An adhesion contract arises when a party must accept or reject a contract without an opportunity to negotiate the terms.<sup>149</sup> If such a contract of adhesion runs counter to a parties expectations or is oppressive, unconscionable or against public policy it will be unenforceable.<sup>150</sup> If an adhesion contract removes all choice, in that a party has no alternative but to sign the contract, the contract should be per se unenforceable as against public policy.

It is often said that to gain access to the securities markets an investor will have to sign an agreement to arbitrate.<sup>151</sup> If this is strictly accurate, an argument could be made that the predispute agreements to arbitrate are adhesive in nature and ought not to be enforced on that ground, as they are oppressive, unconscionable and against public policy.<sup>152</sup> In an attempt to ascertain the truth

142. *Id.* at 1120. Punitive damages are unavailable for federal claims but are available for violations of state securities laws.

143. *Id.* at 1114.

144. *Id.* at 1127.

145. *Id.*

146. Note, *supra* note 23, at 666-67.

147. *De Quijas*, 109 S. Ct. at 1921.

148. Note, *supra* note 21, at 261.

149. *Katsoris*, *supra* note 11, at 306.

150. *Id.* at 307.

151. *Id.* at 292; See also *supra* note 21, at 245.

152. See *supra* note 21, at 259 n.107 (citing a case finding no adhesion).

or falsity of such claims, this author in preparing this Comment conducted a survey of leading brokerage houses to determine to what extent access to the securities markets is predicated on signing a predispute agreement to arbitrate.

The results of this telephone survey indicate that 100% of brokerage houses require a customer to sign a predispute agreement to arbitrate where the customer is opening a margin account. The universal reason given for this requirement is that, as margin accounts involve an extension of credit by the brokerage house to the customer, the brokerage houses desire an expeditious forum for resolving disputes where their capital is being used. In cash accounts the situation is in flux.

Currently, approximately 50% of the brokerage houses surveyed require that a customer sign a predispute agreement to arbitrate when opening a cash account. While cash accounts involve no extension of credit to the customer by the brokerage house, the trend is towards including predispute agreements to arbitrate in cash accounts. Many of the brokers surveyed, indicated that the industry was moving toward requiring predispute agreements to arbitrate in cash accounts.<sup>153</sup> In those brokerage houses that require predispute agreements to arbitrate in cash accounts,<sup>154</sup> several such requirements had been instituted within the last year.

The results of the survey are as follows:

**BROKERAGE HOUSES REQUIRING  
 PREDISPUTE AGREEMENTS TO ARBITRATE**

<u>FIRM</u>	<u>MARGIN</u>	<u>CASH</u>
A.G. Edwards	Yes	No
Charles Schwab	Yes	Yes
Dean, Witter, Reynolds	Yes	No
Edward D. Jones	Yes	Yes
Goldman, Sachs & Co.	Yes	Yes
Kidder, Peabody & Co.	Yes	Yes
Merrill Lynch	Yes	No
Paine Webber	Yes	No
Shearson, Lehman, Hutton	Yes	Yes
Smith Barney	Yes	No

The possibility that predispute agreements to arbitrate are adhesive in nature when looking at the securities industry as a whole or are adhesive in any single case raises, beyond the contract argument, serious questions of a constitutional nature. The Seventh Amendment of the United States Constitution guarantees the right to a jury trial.<sup>155</sup> Arbitration does away with judicial niceties in favor of a more efficient method of dispute resolution,<sup>156</sup> including a jury.<sup>157</sup> The

153. These brokers include: Charles Schwab; Shearson Lehman, Hutton; A.G. Edwards; Dean, Whitter, Reynolds; and Edward D. Jones.

154. These brokers include: Kidder, Peabody & Co. and Shearson, Lehman, Hutton.

155. U.S. CONST. art VII.

156. See *supra* text this Comment, at § IV(A): The Appropriateness of Arbitration.

right to a jury trial can be waived, but such waiver must be voluntary and knowing.<sup>158</sup>

In order for arbitration to be binding and not run afoul of the Seventh Amendment right to a jury trial, the predispute agreement to arbitrate must be entered into voluntarily and knowingly. The investor can waive his right, but there needs to be choice and knowledge of the significance of the act to make the waiver meaningful.<sup>159</sup> If the contract is classically one of adhesion, there is by definition no choice and thus an argument that the predispute agreement to arbitrate is violative of the Seventh Amendment and ought not be enforced.

In light of the author's research, it would seem that there is a strong argument that predispute agreements to arbitrate in brokerage contracts are adhesive. 100% of all margin accounts and 50% of all cash accounts require such agreements, if one is to gain access to the securities markets. Thus in 75% of all cases, if a customer wishes to purchase or sell securities, she will have to sign a predispute agreement to arbitrate or be barred from entering the market through a brokerage house.

In *De Quijas*, the Court notes "[a]lthough petitioners suggest that the agreement to arbitrate here was adhesive in nature, the record contains no factual showing sufficient to support that suggestion."<sup>160</sup> The court's statement appears to leave open the possibility that a successful showing that a predispute agreement to arbitrate was adhesive could lead to a different result, namely avoidance of the predispute agreement to arbitrate.<sup>161</sup>

### C. Asserting Undecided Statutory Claims

The cause of action in *De Quijas* was a section 12(2) claim under the 1933 Act.<sup>162</sup> As this was the only section before the court, a narrow interpretation of the decision could limit the holding to section 12(2).<sup>163</sup> Section 17<sup>164</sup> would technically remain available to a party seeking to avoid arbitration, its arbitrability undecided by the Court in *De Quijas*.

Unlike 12(2), 17(a) grants no express private rights, nor does the section grant a forum choice; further, the plaintiff must prove willfulness.<sup>165</sup> Nevertheless, some courts have found an implied cause of action under section 17(a), while

157. See generally *supra* note 113.

158. Edwards, *supra* note 14, at 674.

159. *Supra* note 21, at 255.

160. *De Quijas*, 109 S.Ct. at 1921.

161. See *supra* note 21, at 259.

162. 15 U.S.C. § 771(2) (1982); *De Quijas*, 109 S. Ct. at 1919.

163. But see *Brown*, No. 13404 (11th Cir. Sept. 1, 1989) (LEXIS Genfed library, Cir. file); *supra* note 92 and accompanying text.

164. 15 U.S.C. § 77(q) (1982).

165. *Id.*

others have not.<sup>166</sup> The split in the circuits would seem to make such an issue ripe for certification by the Supreme Court.

For the party seeking to avoid a predispute agreement to arbitrate, section 17(a) is one avenue of attack, albeit a weak one. One must be in a jurisdiction allowing the private cause of action and one must overcome the inherent weaknesses in a 17(a) argument. Because 17(a) does not include the special protections of section 12(2), it will be harder to satisfy a court that the *Mitsubishi* test is met (that Congress intended to create an exception to the FAA).<sup>167</sup> Further, 17(a) does not protect against broker fraud but only protects purchasers of securities.<sup>168</sup> In light of the expansive reading given *De Quijas*,<sup>169</sup> success in avoiding a predispute agreement to arbitrate by framing ones complaint as a 17(a) violation is highly problematic.

#### D. Asserting Traditional Contract Defenses

The FAA makes all agreements to arbitrate, "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>170</sup> The last quoted clause would allow a party seeking to avoid a predispute agreement to arbitrate to plead contract defenses, as predispute agreements to arbitrate are contracts.<sup>171</sup>

Such defenses would include arguments that the predispute agreement to arbitrate was unconscionable as a contract of adhesion.<sup>172</sup> Additional arguments might be made that the predispute agreement to arbitrate was fraudulently entered into, that there was no valid offer and acceptance of the terms of the predispute agreement to arbitrate, mistake, misunderstanding or that predispute agreement to arbitrate was an unauthorized modification of the contract not within the contemplation of the parties.<sup>173</sup> These and other contract arguments have rarely been argued and are beyond the scope of this Comment, but might have some viability.

---

166. For Circuits upholding a private cause of action see, *Berger v. Bishop Inv. Corp.*, 695 F.2d 302, 305 (8th Cir. 1982); *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978); *Newman v. Prior*, 518 F.2d 97 (4th Cir. 1975); *Surowitz v. Hilton Hotels Corp.*, 342 F.2d 596 (7th Cir. 1965), *rev'd on other grounds*, 383 U.S. 363 (1966). *But see In re Wash. Pub. Power Supply Sys. Sec. Lit.*, 823 F.2d 1349, 1353-1357 (9th Cir. 1987); *Landry v. All Am. Assurance Co.*, 688 F.2d 381, 389-391 (5th Cir. 1982).

167. See *supra* note 49 and accompanying text.

168. See *Fletcher*, *supra* note 10, at 132.

169. See *Brown*, No. 13404 (11th Cir. Sept. 1, 1989) (LEXIS Genfed library, Cir. file); *supra* note 92 and accompanying text.

170. 9 U.S.C. § 2 (1982).

171. See *T. HAZEN*, *supra* note 2, H.R. REP. NO. 96.

172. See *supra* text this Comment, at § IV (B): Predispute Agreements To Arbitrate Are Contracts of Adhesion.

173. See *Zenaida v. Drexal Burnham Lambert*, No. 10434 (D. Minn. May 24, 1989) (LEXIS, Genfed library, Dist. file).

## V. CONCLUSION

The Supreme Court's recent decisions in the field of securities arbitration leave little apparent room for a party opposed to arbitration. Yet, such opposition may be justified by the inherent inefficiencies of the arbitral process. The party seeking to oppose arbitration in the wake of the *De Quijas* decision must be prepared for an up hill battle. However, careful analysis of the FAA and the *De Quijas* decision leave room for hope. One can hope that securities arbitration will be improved to afford investors the protection Congress sought to afford them in the 1933 and 1934 Acts. Until such time, arbitration of securities disputes should not be compelled.

JIM PARKS