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An Up-to-Date Review of Judicial, Legislative, and Regulatory Developments in Arbitration with Financial Institutions

Mahlon M. Frankhauser

Linda M. Gardner

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AN UP-TO-DATE REVIEW OF JUDICIAL,
LEGISLATIVE, AND REGULATORY DEVELOPMENTS
IN ARBITRATION WITH FINANCIAL INSTITUTIONS

MAHLON M. FRANKHAUSER
AND
LINDA M. GARDNER*

TABLE OF CONTENTS

Introduction..... 584

PART I

JUDICIAL PRECEDENTS

A. *What Claims are Arbitrable?*..... 586
 1. The McMahon Decision 586
 2. The Rodriguez Decision 587
 3. Retroactive Application of McMahon and Rodriguez 589
 4. Other Securities Laws Claims 591
B. *Stay of Court Proceedings Pending Arbitration*..... 592
 1. Intertwining Doctrine Rejected 592
 2. Post-Byrd Developments..... 592
 3. Judicial Decisions..... 593
C. *Appealability of Orders Granting or Denying a Stay*..... 595
 1. Amendment to Federal Arbitration Act..... 598
D. *Challenges to Arbitration Agreements and Other Contractual
 Issues* 599
 1. Forum That Should Rule on the Challenge..... 599
E. *Arbitration Awards* 607
 1. Punitive Damages 607
 2. Judicial Review of Awards: In General..... 609
 3. Judicial Review: Decisions 609
F. *The Preclusive Effect of Arbitration Awards* 612

PART II

RECENT REGULATORY AND LEGISLATIVE DEVELOPMENTS

A. *Arbitration Reform Efforts of the SEC and the Securities
 Industry*..... 614
 1. SEC Initiative..... 614

* Mahlon M. Frankhauser is a partner and Linda M. Gardner is an associate in Lord Day & Lord, Barrett Smith, Washington, D.C.

2. SICA Response and Reform Activity.....	614
3. Arbitrability of Class Actions and Other Complex Claims...	618
B. <i>Legislative Proposals</i>	620
1. SEC Response to Proposed Legislative Reform	621
2. Regulatory and Legislative Reform at the State Level.....	622
C. <i>Industry Reform Efforts Relating to the Content and Disclosure of Arbitration Clauses</i>	624
Conclusion	625

Enacted in 1924, the Federal Arbitration Act¹ established a "federal policy favoring arbitration"² by providing that agreements to arbitrate are valid, irrevocable, and enforceable or unenforceable on the same grounds as any contract.³ Despite this federal policy, the securities industry for many years has encountered resistance from the courts. Only recently, the Securities and Exchange Commission ("SEC")⁴ and the Supreme Court have expressed confidence in the fairness of arbitration proceedings,⁵ to a great extent because of the SEC's relatively new, increased oversight authority and congested judicial dockets.⁶

Notwithstanding this resistance, the securities industry, which considers arbitration as a quick, inexpensive, and fair means of dispute resolution, has made extensive use of arbitration pursuant to securities exchanges' constitutions, by-laws, and rules mandating arbitration of intra-industry disputes and those arising between a firm and its registered personnel.⁷ Arbitration agreements also have been included in many broker-customer agreements.⁸ The Supreme Court's 1987 decision in *Shearson/American*

1. The Federal Arbitration Act, 9 U.S.C. §§ 1-15 (1970).

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

3. See The Federal Arbitration Act, 9 U.S.C. § 2 (1970).

4. See Brief for the Securities and Exchange Commission as *Amicus Curiae* at 13-21, *Shearson/American Express Co. v. McMahon*, 482 U.S. 220 (1987).

5. Although a federal policy favoring arbitration was established in the 1920s, courts (including the Supreme Court) for many years thereafter remained distrustful of the arbitration process and often cited "congressional intent" in support of decisions to override this policy. See *Wilko v. Swan*, 346 U.S. 427 (1953).

6. See Brief for the Securities and Exchange Commission as *Amicus Curiae* at 16, *Shearson/American Express Co. v. McMahon*, 482 U.S. 220.

7. Letter from members of the security industry to Rep. Edward Markey (D-Mass.) (Aug. 8, 1988) (available from Wash. & Lee L. Rev.).

8. In October 1987, the SEC's Division of Market Regulation undertook an examination by written questionnaire of 65 broker-dealers "to learn their current policies and practices with respect to the use of predispute arbitration clauses for retail customers." Summary of Staff Findings With Respect To The Use of Predispute Arbitration Cases, Division of Market Regulation, Securities and Exchange Commission, at 1 (June 2, 1988) (available from Wash. & Lee L. Rev.). The 65 broker-dealer firms, which account for approximately ninety percent of all customer trading accounts in the United States, included 25 of the largest New York Stock Exchange ("NYSE") member firms, the 20 largest member firms of the National Association of Securities Dealers, Inc. ("NASD"), which are not members of the NYSE, and a cross-section of other NASD firms. *Id.* On June 2, 1988, the SEC's staff reported its

*Express Co. v. McMahon*⁹ and the very recent decision in *Rodriguez de Quijas v. Shearson/American Express Co.*¹⁰ now firmly establish arbitration as the primary dispute resolution forum for securities broker-customer disputes and should lead to the expanded use of arbitration agreements by most of the financial services industry.¹¹

This article examines the many new judicial, regulatory, and legislative developments which have occurred in the area of arbitration and the many unsettled issues which will give rise to future litigation.

PART I JUDICIAL PRECEDENTS

A court entertaining a motion to stay a judicial proceeding and compel arbitration under the Arbitration Act must perform four tasks:

[F]irst, it must determine whether the parties agreed to arbitrate;
[S]econd, it must determine the scope of [the] agreement;
[T]hird, if federal statutory claims are asserted, it must consider whether Congress intended those claims to be nonarbitrable; [and]
[F]ourth, if the court concludes that some, but not all of the claims in the above action are subject to arbitration, it must determine whether to stay the remainder of the [judicial] proceedings pending arbitration.¹²

Recent judicial decisions illustrate the analysis and conclusions of courts deciding these issues.

findings. With respect to margin and option accounts, virtually all of the firms surveyed required their customers to execute predispute arbitration agreements. *Id.* at 3. Approximately 39% of the firms surveyed required predispute clauses for cash accounts. *Id.* at 5.

The use of arbitration as a forum for dispute resolution is also pervasive in other business arenas. Arbitration has been used widely as an alternate forum for the resolution of disputes arising in the construction business and in controversies arising under international trade agreements. Recently, arbitration clauses have begun to appear in the agreements governing various types of banking transactions including some loan agreements. This move on the part of the banking industry is a major departure from past practices because the banking community, to a great degree, had reservations about arbitration panels and preferred to rely upon the courts to enforce detailed agreements. The prior non-use of arbitration by the banking industry also can be traced to an additional cause: bankers did not have a strong incentive to reduce litigation costs because their agreements provided that the lender was responsible for the payment of all costs incurred in the enforcement of the agreement and in collection of sums due thereunder. *See Butler, Arbitration in California Banking*, 19 *REV. FIN. SERV. REG.* 189 (Nov. 2, 1988).

9. 482 U.S. 220 (1987).

10. 109 S. Ct. 1917 (1989). Justice Kennedy delivered the Court's 5-4 decision in which Chief Justice Rehnquist and Justices White, O'Connor, and Scalia joined. Justice Stevens, joined by Justices Brennan, Marshall, and Blackmun, dissented.

11. *See Butler, supra* note 8, at 189-94 (discussing expanded use of arbitration by financial institutions).

12. *Creative Securities Corp. v. Bear Stearns & Co.*, 671 F. Supp. 961, 965 (S.D.N.Y. 1987).

A. What Claims Are Arbitrable?

1. The McMahon Decision

Prior to the United States Supreme Court's decision in *McMahon*, the enforceability of predispute agreements between firms and their customers was uncertain at best. In fact, judicial distrust of arbitration proceedings and the reluctance of courts to enforce arbitration agreements despite the strong federal policy favoring arbitration was reflected in decisions such as *Wilko v. Swan*.¹³

In 1953, the Supreme Court in *Wilko* held that predispute agreements to arbitrate claims arising under section 12(2) of the Securities Act of 1933 ("33 Act") were unenforceable.¹⁴ While acknowledging the strong federal policy favoring arbitration of disputes, the Supreme Court, nonetheless, declared arbitration proceedings to be an inappropriate forum for the resolution of disputes arising under the '33 Act and expressed fear that the "effectiveness in [the] application [of the provisions of the '33 Act] is lessened in arbitration as compared to judicial proceedings."¹⁵

To support this conclusion, the Court found that the 1933 Act "was drafted with an eye to the disadvantages under which buyers labor"¹⁶ and that section 14 of the '33 Act reflected the congressional intent "to put buyers of securities covered by [the] Act on a different basis from other purchasers."¹⁷ In light of this assessment, the Court concluded that because section 12(2) allows an investor to select a judicial forum in which to assert his claim, and section 14 precludes a waiver of this provision, a predispute agreement to arbitrate section 12(2) claims is unenforceable.¹⁸

Because section 29(a) of the Securities Exchange Act of 1934 ("Exchange Act" or "'34 Act") is virtually identical to section 14 of the '33 Act, the lower federal courts quickly extended the reasoning in *Wilko* to predispute agreements to arbitrate claims arising under section 10(b) of the Exchange Act and SEC Rule 10b-5.¹⁹ This thirty-year pattern was disrupted when the Supreme Court in *McMahon* refused, in a five-four split decision, to extend the holding of *Wilko* to predispute agreements to arbitrate claims under the Exchange Act.²⁰ The Court, however, declined to expressly overrule the holding of *Wilko*.²¹ As a result of *McMahon*, claims based on alleged violations of the Exchange Act and RICO were subject thereafter to arbitration.²²

13. 346 U.S. 427 (1953).

14. *Wilko v. Swan*, 346 U.S. 427, 438 (1953).

15. *Id.* at 435.

16. *Id.*

17. *Id.*

18. *Id.* at 438.

19. *Shearson/American Express Co. v. McMahon*, 482 U.S. 220, 225 n.1 (1987).

20. *Id.* at 238.

21. *Id.* at 234.

22. *Id.* at 238, 242.

Rejecting arguments that predispute agreements to arbitrate constitute a waiver of federal securities law provisions in derision of congressional intent, the *McMahon* court offered an explanation for the reasoning behind the *Wilko* Court's ruling:

. . . the reasons given in *Wilko* reflect a general suspicion of the desirability of arbitration and the competence of arbitral tribunals—most apply with no greater force to the arbitration of securities disputes than to the arbitration of legal disputes generally. It is difficult to reconcile *Wilko*'s mistrust of the arbitral process with this Court's subsequent decisions involving the Arbitration Act. . . . Indeed, most of the reasons given in *Wilko* have been rejected subsequently by the Court as a basis for holding claims to be nonarbitrable.²³

2. The Rodriguez Decision

In the wake of *McMahon*, a split occurred among the lower federal courts with respect to the arbitrability of claims arising under the '33 Act.²⁴ With the *McMahon* Court specifically declining to overrule the *Wilko* decision, a number of courts continued to recognize *Wilko* as controlling and, therefore, held that '33 Act claims were not arbitrable.²⁵ However, an

23. *Id.* at 231.

24. Decisions holding that '33 Act claims are not arbitrable include: *Chang v. Lin*, 824 F.2d 219, 222 (2d Cir. 1987); *Ketchum v. Prudential-Bache Securities, Inc.*, 685 F. Supp. 786, 792 (D. Kan. 1989); *Araim v. Paine Webber, Inc.*, 691 F. Supp. 1416, 1418 (N.D. Ga. 1988); *Pompano-Windy City Partners Ltd. v. Bear Stearns & Co.*, 1988 W.L. 122014 (S.D.N.Y. 1988); *McCowan v. Dean Witter Reynolds, Inc.*, 682 F. Supp. 741, 744 (S.D.N.Y. 1987); *Schultz v. Robinson-Humphrey/American Express Co.*, 666 F. Supp. 219, 220 (M.D. Ga. 1987); *Continental Serv. Life and Health Ins. Co. v. A.G. Edwards & Sons*, 664 F. Supp. 997, 1001 (M.D. La. 1987); *Goldberg v. Drexel Burnham Lambert, Inc.*, No. 83-C-8586 (N.D. Ill. Dec. 16, 1987); *Helfricht v. Jeffries & Co.*, No. 85-0466 (D.N.J. Oct. 14, 1987); *Johnson v. O'Brien*, 420 N.W.2d 264, 267 (Minn. App. 1988). In *Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 841 F.2d 508, 512 (3d Cir. 1988), the court, in *dicta*, appeared to affirm this result, stating that "[a]s long as *Wilko* stands in the Supreme Court, agreements to arbitrate claims under the Securities Act of 1933 will remain unenforceable, but that is the only rule *Wilko* now stands for."

Decisions holding that '33 Act claims are arbitrable include: *Reed v. Bear Stearns & Co.*, 698 F. Supp. 835 (D. Kan. 1988); *Ryan v. Liss, Tenner & Goldberg Securities Corp.*, 683 F. Supp. 480 (D.N.J. 1988); *Kavouras v. Visual Products Systems, Inc.*, 680 F. Supp. 205 (W.D. Pa. 1988); *Aronson v. Dean Witter Reynolds, Inc.*, 675 F. Supp. 1324 (S.D. Fla. 1987); *De Kuyper v. A.G. Edwards & Sons*, 695 F. Supp. 1367 (D. Conn. 1987); *Rosenblum v. Drexel Burnham Lambert, Inc.*, 700 F. Supp. 874 (E.D. La. 1987); *Staiman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 673 F. Supp. 1009 (C.D. Cal. 1987).

25. See cases cited *supra* note 24. As a result of *McMahon*, the court in *Schultz v. Robinson-Humphrey/American Express Co.*, 666 F. Supp. 219, 220, (M.D. Ga. 1987), observed:

One, the Supreme Court specifically chose not to overrule the *Wilko* decision. While announcing that *Wilko* stands only for the proposition that a waiver of

increasing number of lower courts found that the *McMahon* court totally undermined the *Wilko* rationale and, in so doing, its *raison d'être*.²⁶ Indeed, the Fifth Circuit noted that "*McMahon* undercuts every aspect of *Wilko v. Swan* . . . a formal overruling of *Wilko* appears inevitable—or, perhaps, superfluous."²⁷

The split in the lower federal courts was resolved in May 1989 in *Rodriguez*. Petitioners again were Shearson customers who had signed standard customer agreements providing for the arbitration of any controversy arising out of or relating to their customer accounts except where such agreement to do so is unenforceable under federal or state law.²⁸ Alleging unauthorized, fraudulent transactions in securities, the plaintiffs asserted claims under the '33 Act and the '34 Act.²⁹ The district court, following *Wilko*, ordered all of the claims, except those asserted under the '33 Act, to arbitration.³⁰ On appeal, the Fifth Circuit reversed the district court, finding that post-*Wilko* Supreme Court decisions had rendered *Wilko* obsolete.³¹ On *certiorari*, petitioners asked the United States Supreme Court

judicial forum is barred when arbitration is inadequate to protect the substantive rights at issue, it did not state that its conclusion in *Wilko* would now be different given its finding in *McMahon* that arbitration procedures are now reliable. . . .

Second, the legislative history cited in *McMahon* appears to strongly suggest that, unlike for The Exchange Act, a ratification by Congress of the *Wilko* decision as it relates to the nonarbitrable nature of Section 12 claims has been made. Thus, Congress' intent to make Section 12 claims nonarbitrable is clearer than it was for claims arising under The Exchange Act.

Finally, the distinctions between a Section 12(2) action and a 10(b) action may militate against an extension of the *McMahon* decision to a Section 12(2) claim. . . .

26. See cases cited *supra* note 24. The Court in *Staiman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 673 F. Supp. 1009, 1011 (C.D. Cal. 1987), summarized this viewpoint:

First, the anti-waiver provision in the 1933 Act are [sic] nearly identical to the anti-waiver provision in the 1934 Act. . . . Now that the *McMahon* Court has held that parties agreeing to arbitration do not waive a substantive provision of the 1934 Act when they forego the right to a judicial forum, . . . the nearly identical anti-waiver provision in the 1933 Act should be similarly construed.

Second, the *McMahon* Court severely restricted the holding of *Wilko* as barring waiver of a judicial forum only where arbitration is inadequate to protect the substantive rights at issue. . . . [Plaintiff] has made no showing whatsoever that his 1933 Act claims, . . . would be inadequately protected in arbitration. This court reads *McMahon* as requiring such a showing.

Third, the *McMahon* Court noted the expanded oversight authority exercised by the Securities and Exchange Commission over the national securities exchanges and held that it can no longer be assumed that a complainant's rights could not be vindicated through arbitration. . . . *McMahon* held that an arbitration held pursuant to the identical NYSE procedures did not effect a waiver of the 1934 Act. A similar conclusion is compelled for claims under the 1933 Act.

27. *Noble v. Drexel Burnham Lambert, Inc.*, 823 F.2d 849, 850 n.3 (5th Cir. 1987).

28. *Rodriguez de Quijas v. Shearson/American Express Co.*, 109 S. Ct. 1917, 1918 (1989).

29. *Id.*

30. *Rodriguez de Quijas v. Shearson/Lehman Brothers Inc.*, 845 F.2d 1296, 1297 (5th Cir. 1988).

31. *Id.* at 1299.

to determine the arbitrability of claims asserted under section 12(2) of the '33 Act and, further, if such claims were found to be arbitrable, to determine if a reversal of *Wilko* should be given retroactive effect.³²

While severely criticizing the Fifth Circuit and other courts for renouncing *Wilko* prematurely on their own authority,³³ the Supreme Court overruled *Wilko* in another five-four decision.³⁴ According to the *Rodriguez* Court, "*Wilko* was incorrectly decided and is inconsistent with prevailing uniform construction of other federal statutes governing arbitration agreements in the setting of business transactions."³⁵ The Court described *Wilko* as having "fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes."³⁶

Explaining the reversal, the Supreme Court found that section 14 of the '33 Act does not "prohibit agreements to arbitrate future disputes of securities"³⁷ and that the *Wilko* Court's earlier finding in this connection "rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be-complainants."³⁸

The inconsistency that would result if the "decisions in *Wilko* and *McMahon* continue[d] to exist side by side"³⁹ also influenced the Court's decision. In light of the precepts of *McMahon*, the *Rodriguez* Court declared:

Their inconsistency is at odds with the principle that the 1933 and 1934 Acts should be construed harmoniously because they 'constitute interrelated components of the federal regulatory scheme governing transactions in securities.' . . . In addition, the inconsistency between *Wilko* and *McMahon* undermines the essential rationale for a harmonious construction of the two statutes, which is to discourage litigants from manipulating their allegations merely to cast their claims under one of the securities laws rather than another.⁴⁰

3. Retroactive Application of *McMahon* and *Rodriguez*

The *McMahon* decision was silent on whether the ruling should have retroactive application. As a result, the lower federal courts were left to grapple with that issue.⁴¹

32. *Rodriguez*, 109 S. Ct. at 1918.

33. *Id.* at 1921.

34. *Id.* at 1922.

35. *Id.*

36. *Id.* at 1920.

37. *Id.*

38. *Id.*

39. *Id.* at 1922.

40. *Id.*

41. Decisions applying the holding of *McMahon* retroactively include: *Peterson v. Shearson/American Express Co.*, 849 F.2d 464 (10th Cir. 1988); *Cohen v. Wedbush Noble Cooke, Inc.*, 841 F.2d 282 (9th Cir. 1988); *Fox v. Dean Witter Reynolds, Inc.*, 826 F.2d 1059 (4th

Some courts refused to apply *McMahon* to claims that were filed before that decision on the basis of the waiver doctrine. The Fifth Circuit's opinion in *Noble v. Drexel Burnham Lambert, Inc.*,⁴² however, is illustrative of the approach taken by courts granting retroactive application of *McMahon*. The *Noble* case arose in the context of an appeal of an order staying litigation of the plaintiff's Exchange Act claims pending arbitration of the state law claims (all claims were based on the same conduct). On its *own motion*, the court applied the *McMahon* holding retroactively,⁴³ observing that although "[t]he usual rule is that federal cases should be decided in accordance with the law existing at the time of the decision,"⁴⁴ case-by-case exceptions are made "when a change in the law is unfairly disruptive of a litigant's course of conduct or reasonable expectations."⁴⁵ In determining whether the retroactive application would create undue prejudice, the *Noble* court applied the three-prong test set forth in *Chevron Oil Co. v. Huson*:⁴⁶ (1) *McMahon* did not establish an entirely new principle of law; (2) federal policy favors retroactive application; and (3) retroactive application does not alter the plaintiff's substantive rights, and the plaintiff would not have refused to sign the customer agreement if he had known Exchange Act claims would have been subject to arbitration.⁴⁷ The court further noted that because the case had not yet gone to trial, retroactive application of *McMahon* "should not be unduly burdensome to the litigants."⁴⁸

Cir. 1987); *Chang v. Lin*, 824 F.2d 219 (2d Cir. 1987); *Noble v. Drexel Burnham Lambert, Inc.*, 823 F.2d 849 (5th Cir. 1987); *Nesslage v. York Securities, Inc.*, 823 F.2d 231 (8th Cir. 1987); *Ketchum v. Prudential-Bache Securities, Inc.*, 710 F. Supp. 300 (D. Kan. 1989); *Williams v. E.F. Hutton & Co., Inc.*, 1988 W.L. 15242 (D.D.C. 1988), *aff'd.*, 871 F.2d 1150 (D.C. Cir. 1989); *Gilmore v. Shearson/American Express Co.*, 668 F. Supp. 314 (S.D.N.Y. 1987); *Goldberg v. Drexel Burnham Lambert, Inc.*, 1987 W.L. 31604 (N.D. Ill. 1987); *Helfricht v. Jeffries & Co.*, 1987 W.L. 124777 (D.N.J. 1987).

42. 823 F.2d 849 (5th Cir. 1987).

43. *Noble v. Drexel Burnham Lambert, Inc.*, 823 F.2d 849, 850 (6th Cir. 1987).

44. *Id.* at 850 (quoting *Saint Francis College v. Al-Khazraji*, 481 U.S. 604, 698 (1987)).

45. *Id.* at 850 (citing *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971)).

46. 404 U.S. 97, 106-07 (1971).

47. *Noble*, 823 F.2d at 850-51. As the *Noble* court stated:

First, *McMahon* "establish[es] a new principle of law . . . by overruling clear past precedent" of this Circuit. . . . On the other hand, *McMahon* does not come out of the blue; in one aspect, it builds logically on an unswerving line of Supreme Court cases expanding the reach of arbitration agreements and affirming the importance of the Arbitration Act in the face of judicial hostility and the usual objections. . . . Second, the strong federal policy in favor of arbitration—and the absence of any federal policy favoring securities litigation—suggests that the rule should be applied retroactively. Third, as to the equities in this particular case, Mr. Noble has the usual claim of unfairness bestowed on any litigant when the rules are changed against him in the middle of the game . . . ; we simply could not accept any claim that he would not have entered into these non-negotiable pre-printed agreements had he realized that 1934 Act claims would turn out to be arbitrable. Moreover, *McMahon* alters only the forum for resolving this dispute and not Mr. Noble's substantive rights.

Id.

48. *Id.* at 851.

The issue was put to rest by the *Rodriguez* decision where the Supreme Court squarely addressed the issue.⁴⁹ The Court applied the customary rule of retroactive application—that the law announced in the Court's decision controls the case at bar.⁵⁰ Using the *Chevron* guidelines, the Court ruled that:

Although our decision to overrule *Wilko* establishes a new principle of law for arbitration agreements under the Securities Act, this ruling furthers the purposes and effect of the Arbitration Act without undermining those of the Securities Act. Today's ruling, moreover, does not produce "substantial inequitable results," *id.* at 107, 92 S. Ct. at 355, for petitioners do not make any serious allegation that they agreed to arbitrate future disputes relating to their investment contracts in reliance on *Wilko's* holding that such agreements would be held unenforceable by the courts. Our conclusion is reinforced by our assessment that resort to the arbitration process does not inherently undermine any of the substantive rights afforded to petitioners under the Securities Act.⁵¹

4. Other Securities Laws Claims

Claims Under Sections 15 and 20 of the Exchange Act. The Ninth Circuit in *Badart v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* found no distinction between claims arising under section 10(b) of the Exchange Act and those arising under sections 15 and 20 of the Exchange Act.⁵²

Investment Adviser Act Claims. The Arizona Court of Appeals ruled in *Rocz v. Drexel Burnham Lambert, Inc.* that if a private right of action exists under the Investment Advisers Act, federal law permits arbitration of the claim.⁵³ The court rejected the plaintiff's contention that Congress intended to make an exception to the Arbitration Act for claims brought under the Investment Advisers Act and ordered the plaintiff's claims to arbitration.

State Securities Law Claims. The Federal Arbitration Act created federal substantive law which preempts state law prohibiting arbitration of certain claims.⁵⁴ Allegations of violations of state securities law have been held arbitrable pursuant to the Federal Arbitration Act.⁵⁵

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

50. *Id.* at 1922.

51. *Id.*

52. *Badart v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 823 F.2d 333 (9th Cir. 1987).

53. *Rocz v. Drexel Burnham Lambert, Inc.*, 154 Ariz. 462, 743 P.2d 971 (1987).

54. See *Southland Corp. v. Keating*, 465 U.S. 1 (1984); *Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 841 F.2d 508 (3d Cir. 1988); *Sager v. Dist. Ct. for Second Jud. Dist.*, 698 P.2d 250 (Colo. 1985).

55. See *Doctors Assoc., Inc. v. McCrory*, 501 So. 2d 126 (Fla. Dist. Ct. App. 1987) (holding that allegations of violations of Florida securities laws arising out of franchise agreement were arbitrable pursuant to Federal Arbitration Act).

B. Stay of Court Proceedings Pending Arbitration

1. Intertwining Doctrine Rejected

In *Dean Witter Reynolds, Inc. v. Byrd*⁵⁶ the Supreme Court addressed the complexities created when a complaint joins an arbitrable state law claim with a nonarbitrable federal claim arising out of the same transaction. Prior to the 1985 *Byrd* decision, several circuits had developed an "intertwining doctrine" in refusing to refer arbitrable claims to arbitration:

When arbitrable and nonarbitrable claims arise out of the same transaction, and are sufficiently intertwined factually and legally, the district court . . . may in its discretion deny arbitration as to the arbitrable claims and try all the claims together in federal court.⁵⁷

The *Byrd* Court observed that while many courts acknowledge the strong federal policy in favor of enforcing agreements, courts have not compelled arbitration because of the need to preserve and protect courts' exclusive jurisdiction over federal securities claims as well as for the sake of efficiency, such as avoiding redundant, bifurcated proceedings.⁵⁸ Rejecting this reasoning, the *Byrd* Court unanimously decided "that the Arbitration Act requires district courts to compel arbitration of pendent arbitrable claims when one of the parties files a motion to compel, even where the result would be the possibly inefficient maintenance of separate proceedings in different forums."⁵⁹ The Court noted that the overriding goal of the Arbitration Act was not "to promote the expeditious resolution of claims," but to ensure "judicial enforcement of privately made agreements to arbitrate."⁶⁰

2. Post-Byrd Developments

As a result of the Federal Arbitration Act and the *Byrd* decision, a court must stay litigation of all claims subject to arbitration, but has discretion whether to stay or proceed with the nonarbitrable claims.⁶¹ A court, therefore, must decide whether to stay judicial proceedings pending arbitration of related claims under the circumstances of the case.

56. 470 U.S. 213 (1985).

57. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 216-17 (1985) (citing *Belke v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 693 F.2d 1023 (11th Cir. 1982)); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 334-37 (5th Cir. 1981); *Cunningham v. Dean Witter Reynolds, Inc.*, 550 F. Supp. 578 (E.D. Cal. 1982).

58. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 217 (1985).

59. *Id.*

60. *Id.* at 219.

61. See *Continental Serv. Life and Health Ins. Co. v. A.G. Edwards & Sons, Inc.*, 664 F. Supp. 997, 1001 (M.D. La. 1987); *Chang v. Lin*, 824 F.2d 219, 222 (2d. Cir. 1987); *Schultz v. Robinson-Humphrey/American Express Co.*, 666 F. Supp. 219 (M.D. Ga. 1987).

Because there have been varying interpretations of *Byrd* by the lower courts, there has been no uniform response where some but not all of the claims are subject to arbitration. One court has ordered a stay of the remaining judicial proceedings pending arbitration,⁶² while other courts have opted to allow the arbitration and federal court litigation to proceed apace.⁶³ Courts, however, more frequently have denied motions seeking a stay of the litigation of nonarbitrable federal claims pending arbitration of related arbitrable claims.⁶⁴ This permits the parties to utilize broad federal discovery which is not available in arbitration and, in a few "efficient" federal districts, to obtain a trial of the facts before a hearing is held in the arbitration.

3. Judicial Decisions

'33 Act Claims. Prior to *Rodriguez*, the nonarbitrability of '33 Act claims provided the backdrop against which varying judicial interpretations of *Byrd* were displayed. The anti-arbitration Second Circuit ruled in *Chang v. Lin* that "arbitration and federal litigation should proceed simultaneously absent compelling reasons to stay the litigation."⁶⁵ The court agreed with Justice White's concurring opinion in *Byrd*:

Once it is decided that [litigation of federal securities claims and arbitration of pendent state claims] are to go forward independently, the concern for speedy resolution suggests that neither should be delayed. While the impossibility of the lawyers being in two places at once may require some accommodation in scheduling . . . the heavy presumption should be that the arbitration and the lawsuit will each proceed in its normal course.⁶⁶

The *Chang* court found no evidence in the record to rebut the "heavy presumption" against the deferral of plaintiff's then non-arbitrable claims arising under the '33 Act, and reversed the district court's ruling which stayed the litigation of those claims pending arbitration of pendent state claims.⁶⁷

In *Schultz v. Robinson-Humphrey/American Express Co.* however, the district court ordered a stay of the federal court proceedings pending the

62. *Schultz v. Robinson-Humphrey/American Express Co.*, 666 F. Supp. 219 (M.D. Ga. 1987).

63. See *Chang v. Lin*, 824 F.2d 219 (2d Cir. 1987); *Creative Securities Corp. v. Bear Stearns & Co., Inc.*, 671 F. Supp. 961 (S.D.N.Y. 1987), *aff'd*, 847 F.2d 834 (2d Cir. 1988); *Peterson v. Shearson/American Express Co.*, 849 F.2d 464 (10th Cir. 1988); *Continental Serv. Life & Health Ins. Co.v. A.G. Edwards*, 664 F. Supp. 997 (M.D. La. 1987).

64. See *supra* note 63.

65. *Chang*, 824 F.2d at 223.

66. *Id.* at 223 (quoting *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 225 (1985) (White, J., concurring)).

67. *Id.*

outcome of arbitration.⁶⁸ Upon review of the relevant case law, the court was of the view that *Byrd* did not stand for the following proposition:

[t]hat a district court is absolutely prohibited from staying its proceedings pending resolution of the arbitration matters. Rather, *Byrd* merely requires that the district court must make a case-by-case decision as to whether a stay would be in the interest of both efficiency and judicial economy.⁶⁹

The court reviewed the plaintiff's claims arising under section 12(2) of the '33 Act and found those claims insubstantial compared to the arbitrable claims, and ordered a stay of the proceedings on the section 12(2) claims pending the outcome of arbitration.⁷⁰

Class Actions. The issue of bifurcated proceedings also can arise in connection with class actions. For example, the court in *Kronfeld v. Advest, Inc.*⁷¹ compelled the plaintiffs' claims to arbitration while acknowledging that other members of the class would be allowed to proceed in a judicial forum.⁷² In *Kronfeld* the plaintiffs were buyers of public utility bonds issued to fund the development of nuclear power plants. The plaintiffs argued that the complexity of the claims and the prospect that identical claims of other buyers who did not sign customer agreements containing arbitration provisions would be litigated in different forums precluded the use of arbitration.⁷³ Rejecting the plaintiffs' arguments, the court, citing *McMahon*, said that the arbitrability of Exchange Act and RICO claims has been established conclusively⁷⁴ and that the plaintiffs' mistrust of the arbitration process was repudiated expressly by the Supreme Court in *McMahon*.⁷⁵ Further, the holding of *Byrd* rendered unpersuasive the plaintiffs' claim of judicial inefficiency.⁷⁶

Choice of Law Clauses. In *Volt Information Sciences, Inc. v. Trustees of the Leland Stanford Junior Univ.*⁷⁷ the Supreme Court recently held that the Federal Arbitration Act does not preempt a state law permitting a court to stay arbitration in certain situations where the parties have agreed that their contract, including the arbitration agreement therein, is to be governed by that state's law.⁷⁸

68. *Schultz v. Robinson-Humphrey/American Express Co.*, 666 F. Supp. 219, 221 (M.D. Ga. 1987).

69. *Id.* at 210 (citing *Sevinor v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 807 F.2d 16 (1st Cir. 1986)).

70. *Schultz*, 666 F. Supp. at 221.

71. 675 F. Supp. 1449 (S.D.N.Y. 1987).

72. *Kronfeld v. Advest, Inc.*, 675 F. Supp. 1449, 1452-53 (S.D.N.Y. 1987).

73. *Id.*

74. *Id.* at 1452.

75. *Id.* at 1453.

76. *Id.*

77. 109 S. Ct. 1248 (1989).

78. *Volt Information Sciences, Inc. v. Trustees of the Leland Stanford Junior Univ.*, 109 S. Ct. 1248, 1254-56 (1989).

The parties in *Volt* had agreed to arbitrate all disputes arising out of the contract, and that the contract would be governed by the law of "the place where the Project is located," namely California.⁷⁹ When a compensation dispute arose, the defendant moved to compel arbitration. Pursuant to a California statute, the plaintiff objected to arbitration.⁸⁰ The defendant's motion to compel arbitration was denied by the state trial court. The decision was affirmed by the California Court of Appeals, which found that even though the parties' contract involved interstate commerce, such contracts are generally governed by the Federal Arbitration Act, and that the Federal Arbitration Act does not provide for the type of relief set forth in the California statutes. Nonetheless, the Supreme Court found that application proper.⁸¹ Acknowledging that the Federal Arbitration Act preempts state laws which render agreements to arbitrate unenforceable,⁸² the Court found that "[i]t does not follow . . . that the federal law has preclusive effect in a case where the parties have chosen in their [arbitration] agreement to abide by state rules."⁸³ To so require would "force the parties to arbitrate in a manner contrary to their agreement."⁸⁴

The Supreme Court, in affirming the California Court of Appeals' decision, held that the right to compel arbitration under the Federal Arbitration Act occurs only in cases where the parties have agreed to arbitrate, whereas in *Volt* the parties agreed that the contract and the arbitration clause therein would be governed by California law which permitted the stay of arbitration in certain circumstances.⁸⁵ The Court further found that the statute did not undermine the federal policy favoring arbitration by rendering unenforceable agreements to arbitrate, but rather concerned the conduct or procedure of arbitration.⁸⁶

C. *Appealability of Orders Granting or Denying a Stay*

In the past, orders denying or granting a stay of judicial proceedings pending arbitration were reviewable on appeal as either:

- 1) injunctions under 28 U.S.C. section 1292(a)(1);
- 2) collateral orders under *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541 (1949);
- 3) final decisions under 29 U.S.C. section 1291;
- 4) permissive appeals under 28 U.S.C. section 1292(b); or
- 5) by writ of mandamus.⁸⁷

79. *Id.* at 1251.

80. *Id.*

81. *Id.* at 1252.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.* at 1253.

86. *Id.* at 1253-1254.

87. *Jolley v. Paine Webber, Jackson & Curtis, Inc.*, 864 F.2d 402, 403 (5th Cir. 1989).

A recent Supreme Court decision⁸⁸ and an amendment to the Federal Arbitration Act⁸⁹ impact the appealability of orders granting or denying a stay of judicial proceedings pending arbitration.

In March 1988, the Supreme Court in *Gulfstream Aerospace Corp. v. Mayacamas Corp.* overruled the *Enelow-Ettelson* doctrine, declaring it "in the modern world of litigation, a total fiction, . . . unsound in theory, unworkable and arbitrary in practice, and unnecessary to achieve any legitimate goals."⁹⁰ Under the doctrine, an order by a federal court staying or refusing to stay its own proceedings was appealable under 28 U.S.C. section 1291(a)(2) as a grant or denial of an injunction if the order was made "in a historically legal action on the basis of a historically equitable defense or counterclaim."⁹¹ While the *Gulfstream* holding "prevents interlocutory review of district court orders on the basis of historical circumstances that have no relevance to modern litigation," the Court pointed out that appellate jurisdiction could be asserted under 28 U.S.C. sections 1291, 1292(a)(1), and 1292(b), as well as by application for writ of mandamus.⁹²

Subsequent to the *Gulfstream* decision, several decisions have addressed the appealability of orders granting or denying a stay of judicial proceedings pending arbitration. The Seventh Circuit in *Crist v. Miller*⁹³ dismissed the appeal of the defendants who were seeking reversal of a district court order which denied a stay in judicial proceedings pending the outcome of arbitration.⁹⁴ The defendants argued that the order was appealable under the collateral order doctrine.⁹⁵ While acknowledging that "the Supreme Court left open the possibility that the denial of a motion to stay judicial

88. *Gulfstream Aerospace Corp. v. Mayacamas Corp.*, 108 S. Ct. 1133 (1988).

89. Judicial Improvements & Access to Justice Act of 1988, Pub. L. No. 100-702, § 1019, 102 Stat. 4642, 4670-71 (1988).

90. *Gulfstream*, 108 S. Ct. at 1142.

91. *Id.* at 1139.

92. *Id.* at 1142. According to the *Gulfstream* Court:

This holding will not prevent interlocutory review of district court orders when such review is truly needed. Section 1292(a)(1) will, of course, continue to provide appellate jurisdiction over orders that grant or deny injunctions and orders that have the practical effect of granting or denying injunctions and have 'serious, perhaps, irreparable, consequence.' . . . As for orders that were appealable under § 1292(a)(1) solely by virtue of the *Enelow-Ettelson* doctrine, they may, in appropriate circumstances, be reviewed under the collateral order doctrine of § 1291, . . . and the permissive appeal provision of § 1292(b), as well as by application for writ of mandamus. Our holding today merely prevents interlocutory review of district court orders on the basis of historical circumstances that have no relevance to modern litigation. (internal citations omitted.)

Id. at 1142-43.

93. 846 F.2d 1143 (7th Cir. 1988).

94. *Crist v. Miller*, 846 F.2d 1143, 1144 (7th Cir. 1988).

95. *Id.* Under the collateral order doctrine, a non-final order will be "deemed final for purposes of appeal under 28 U.S.C. § 1219, if it (1) conclusively determines an issue (2) separate from the merits of the litigation, and, if postponing review until there is a final judgment in the litigation would (3) irrevocably harm the appellant." *Id.* at 1144.

proceedings might in a particular case be appealable as a collateral order,"⁹⁶ the *Crist* court declined jurisdiction because the defendants "made only a perfunctory effort to show that the denial of their application for stay was a collateral order."⁹⁷ Judge Posner observed that defendants made no showing that the arbitrability issue would not be effectively reviewed if a final judgment were entered for the appellees. The Court stated that if upon review the court determined that the appellants had a valid contractual right to arbitrate the claims, the judgment would be set aside and the matter referred to arbitration.⁹⁸ Posner acknowledged that:

[t]here will be wasted motion, no doubt, but that is always true when a sound defense interposed early in a litigation is erroneously rejected. It is the price we pay for a final judgment rule. The exceptions to the rule are narrow, and do not include mere inconvenience to a party wanting to take an interlocutory appeal.⁹⁹

The First Circuit in *Isabel Romeu Vda de Fuertes v. Drexel Burnham Lambert, Inc.*¹⁰⁰ also dismissed an appeal from an order directing arbitration and denied a petition for *mandamus*. Citing *Gulfstream*, the First Circuit in *de Fuertes* concluded that it had no jurisdiction to review the order referring the case to arbitration because the ruling was not a denial of an injunction under 28 U.S.C. section 1292(a)(1) nor reviewable under the collateral order doctrine.¹⁰¹ Quoting from the *Crist* opinion, the court acknowledged that inconvenience may result if the lower court's decision was in error, but that "is the price of the final judgment rule and does not constitute irreparable harm."¹⁰²

The Second Circuit also has addressed the appealability of an order denying or granting a stay pending arbitration of a dispute. In *McDonnell Douglas Finance Corp. v. Pennsylvania Power & Light Co.*¹⁰³ Pennsylvania Power & Light Company ("PPL") moved for a stay of proceedings pending compelled arbitration. The district court denied PPL's motion and PPL subsequently appealed.¹⁰⁴ The Second Circuit initially rejected the appeal on several grounds.¹⁰⁵ Citing *Gulfstream* the court explained that the order was not appealable under 28 U.S.C. section 1292(a) nor any of the other procedures outlined in *Gulfstream*, with the exception of the permissive

96. *Id.* at 1144.

97. *Id.*

98. *Id.*

99. *Id.*

100. 885 F.2d 10 (1st Cir. 1988).

101. *Isabel Romeu Vda de Fuertes v. Drexel Burnham Lambert, Inc.*, 885 F.2d 10, 11 (1st Cir. 1988).

102. *Id.* at 12.

103. 849 F.2d 761 (2d Cir. 1988).

104. *McDonnell Douglas Finance Corp. v. Pennsylvania Power & Light Co.*, 849 F.2d 761 (2d Cir. 1988).

105. *Id.* at 764.

appeal provision of section 1292(b).¹⁰⁶ The Second Circuit, therefore, remanded the case to determine whether the appeal should be certified under 28 U.S.C. section 1292(b) "as a controlling question of law as to which there is a substantial ground for a difference of opinion and that immediate appeal would materially advance the litigation."¹⁰⁷ Subsequently, the district court certified the appeal, and the Second Circuit, finding that the narrow scope of the particular agreement to arbitrate did not cover disputes arising out of claims regarding the good faith of PPL, affirmed the district court's order denying a stay of proceedings pending arbitration.¹⁰⁸

The Fifth Circuit in *Jolley v. Paine Webber, Jackson & Curtis, Inc.*¹⁰⁹ dismissed the plaintiff's appeal from the district court's order staying proceedings pending arbitration. The Fifth Circuit stated that under *Gulfstream*:

[T]he only appellate jurisdiction over an order granting or denying a stay pending arbitration, entered as part of a continuing proceeding where the district court retains jurisdiction, would be found in a permissive appeal under § 1292(b) or a writ of mandamus.¹¹⁰

The Fifth Circuit in *Jolley* concluded that it lacked jurisdiction over the matter because the district court denied the plaintiff's motion for a section 1292(b) certification, and the plaintiff did not seek a writ of mandamus.¹¹¹

1. Amendment to Federal Arbitration Act

The appealability of arbitration-related orders also was addressed in recent legislation. Effective November 19, 1988, Congress amended the Federal Arbitration Act by adding section 15 on appeals.¹¹²

106. *Id.*

107. *Id.* at 765.

108. *McDonnell Douglas Finance Corp. v. Pennsylvania Power & Light Co.*, 858 F.2d 825, 833-34 (2d Cir. 1988).

109. 864 F.2d 402 (5th Cir. 1989) (supplementary opinion No. 88-3179) (affirming result of earlier decision stating that recent amendment to Federal Arbitration Act did not change result).

110. *Jolley v. Paine Webber, Jackson & Curtis*, 864 F.2d 402, 405 (5th Cir. 1989).

111. *Id.*

112. Federal Arbitration Act, 9 U.S.C. § 15 (1988) provides:

Appeals

(a) An appeal may be taken from—

(1) an order—

(A) refusing a stay of action under section 3 of this title,

(B) denying a petition under section 4 of this title to order arbitration to proceed

(C) denying an application under section 206 of this title to compel arbitration

(D) confirming or denying confirmation of an award or partial award, or

(E) modifying, correcting, or vacating an award;

(2) an interlocutory order granting, continuing, or modifying an injunction against

Observing that "the new section clarifies congressional intent regarding appealability of arbitration orders,"¹¹³ the Fifth Circuit in *Turboff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹¹⁴ summarized the language of the section as intending to:

Permit interlocutory appeals of orders favoring litigation over arbitration while precluding our jurisdiction to review an interlocutory order that either: (1) stays an action in court pending arbitration, (2) directs or compels arbitration, or (3) refuses to enjoin an arbitration governed by the Federal Arbitration Act.¹¹⁵

The court noted, however, that section 15 still permits an appeal taken "from final judgments concerning arbitration or pursuant to a 28 U.S.C. § 1292(b) certificate."¹¹⁶ Finding that the new section does not affect substantive rights, but merely "introduces procedural changes to the enforcement of arbitration clauses," the court applied section 15 retroactively to the plaintiff's appeal of an order staying proceedings pending arbitration of his claims.¹¹⁷

D. Challenges to Arbitration Agreements and Other Contractual Issues

The validity of arbitration agreements is frequently challenged by customers (and their counsel) who would prefer to litigate their claims in the federal courts. Some of the more common arguments advanced are discussed below as well as the appropriate forum in which such issues should be decided.

1. Forum That Should Rule on the Challenge

Inducement by Fraud. When a customer challenges the validity of an agreement to arbitrate (*i.e.*, that the contract, including the agreement to arbitrate, was obtained by fraud), a threshold question is raised: In what forum must such a challenge be asserted and decided?

an arbitration that is subject to this title; or

(3) a final decision with respect to an arbitration that is subject to this title.

(b) Except as otherwise provided in section 1292(b) of title 28, an appeal may not be taken from an interlocutory order—

(1) granting a stay of any action under section 3 of this title;

(2) directing arbitration to proceed under section 4 of this title;

(3) compelling arbitration under section 206 of this title; or

(4) refusing to enjoin arbitration that is subject to this title;

Judicial Improvements & Access to Justice Act of 1988, Pub. L. No. 100-702, § 1019, 102 Stat. 4642, 4670-71 (1988).

113. *Turboff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 867 F.2d 1518, 1520 (5th Cir. 1989).

114. 867 F.2d 1518 (5th Cir. 1989).

115. *Turboff v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 867 F.2d 1518, 1520 (5th Cir. 1989).

116. *Id.*

117. *Id.* at 1521.

Section 4 of the Arbitration Act requires courts to direct the parties to proceed to arbitration "upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not an issue. . . ." ¹¹⁸ However, if there is a genuine issue of fact relating to the making of the agreement to arbitrate, the Arbitration Act provides the right to a jury trial on the issue. ¹¹⁹

For example, the Supreme Court held in *Prima Paint v. Flood & Conklin Mfg. Co.* that "if the claim is fraud in the inducement of the arbitration clause itself—an issue that goes to the 'making' of the agreement to arbitrate—the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of contract generally." ¹²⁰

Forgeries on customer agreements, which result in doubt being cast upon the customer's intent ever to arbitrate claims, ¹²¹ and misrepresentations by broker-dealers relating to the signing of the arbitration agreement, ¹²² are examples of issues on which courts order trials. On the other hand, claims alleging unconscionability, coercion, or confusion in signing the contract—issues going to the formation of the entire contract—are to be determined by an arbitrator. ¹²³

Some courts have adopted a broad reading of *Prima Paint* and have sent to arbitration claims of inducement by fraud that arguably related to both the principal agreement and the arbitration clause in general. ¹²⁴ The court in *Rush v. Oppenheimer & Co. Inc.*, however, criticized this result in a well-reasoned opinion. ¹²⁵ According to the *Rush* court, "the relief that *Prima Paint* and the [Federal Arbitration] Act provide investors from the fraudulent procurement of their assent to arbitration would be illusory if the federal court did not retain jurisdiction over claims that statements pertaining to the underlying agreement were fraudulent with respect to the arbitration agreement. . . . *Prima Paint* requires a federal court to resolve allegations of fraud that pertain to both the principal agreement as a whole and the arbitration agreement in particular." ¹²⁶

The Unconscionable Agreement. Generally, an adhesion contract is one printed on a standard form by a party who holds a position of power so superior relative to the other party that it is effectively capable of imposing

118. 9 U.S.C. § 4 (1970).

119. *Id.*

120. *Prima Paint v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403-04 (1967).

121. *Russolillo v. Thomson McKinnon Securities, Inc.*, 694 F. Supp. 1042 (D. Conn. 1988); *Dougherty v. Mieczkowski*, 661 F. Supp. 267 (D. Del. 1987); *Blatt v. Shearson Lehman/American Express Co.*, No. 84 Civ. 7715-CSH (S.D.N.Y. July 16, 1985).

122. *Rush v. Oppenheimer & Co., Inc.*, 638 F. Supp. 872 (S.D.N.Y. 1986).

123. *Coleman v. Prudential-Bache Securities, Inc.*, 802 F.2d 1350, 1352 (11th Cir. 1986).

124. *See, e.g.*, *Bitkowski v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 833 F.2d 1011 (6th Cir. 1987); *Bhatia v. Johnston*, 818 F.2d 418 (5th Cir. 1987); *Coleman v. Prudential-Bache Securities, Inc.*, 802 F.2d 1350 (11th Cir. 1986).

125. *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045 (S.D.N.Y. 1988).

126. *Id.* at 1053.

terms.¹²⁷ The party challenging the contract must overcome a strong presumption of validity.¹²⁸ This issue would be determined by a court or arbitration panel on the basis of the same analysis as the inducement by fraud challenge to the arbitration agreement. Where courts have entertained claims that the arbitration agreement is a contract of adhesion, court decisions have turned on specific facts, and courts have applied a variety of theories to support their conclusions.¹²⁹

Although some industry-generated form contracts are regarded with suspicion, courts normally will not reexamine and reform agreements merely to avoid inequitable results. A few courts have thrown out contracts that do not fall within the reasonable expectation of the parties, while others will set aside agreements only if "unduly oppressive or unconscionable."¹³⁰

Faulty Execution of the Agreement. Another common argument advanced by a customer attacking the validity of an arbitration agreement focuses on the absence or authenticity of his signature. However, section 2 of the Arbitration Act *only* requires the arbitration agreement to be in writing, and "[i]t is well settled that an agreement to arbitrate need not be signed by the party to be enforceable."¹³¹ For example, in *Schena v.*

127. *Pierson v. Dean Witter Reynolds, Inc.*, 742 F.2d 334, 339 (7th Cir. 1984). *See, e.g.*, *M/V American Queen v. San Diego Marine Constr. Corp.*, 708 F.2d 1483, 1489 (9th Cir. 1983); *Chandler v. Aero Mayflower Transit Co.*, 374 F.2d 129, 135 n.11 (4th Cir. 1967).

128. *Finkle v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505, 1512 (S.D.N.Y. 1985).

129. *See, e.g.*, *Cohen v. Wedbush Noble Cooke Inc.*, 841 F.2d 282 (9th Cir. 1988) (stating that state law adhesion contract principles may not be invoked to bar arbitrability of disputes under Arbitration Act); *Pierson v. Dean Witter Reynolds, Inc.*, 742 F.2d 334, 339 (7th Cir. 1984) (stating that arbitration clause must not be commercially unreasonable and adhering party must not have had reasonable opportunity to understand clause); *Finkle v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505, 1512 (S.D.N.Y. 1985) (clause not within reasonable expectations of party or clause is within reasonable expectations of party but is unduly oppressive, unconscionable, or against public policy); *Reynolds Securities, Inc. v. Macquown*, 459 F. Supp. 943 (N.D. Pa. 1978) (must show valid public policy reason for refusing to enforce arbitration agreement entered into by consenting legally competent persons); *Arkoosh v. Dean Witter & Co.*, 415 F. Supp. 535, 544 (D. Neb. 1976) (plaintiff failed to present evidence that he would be denied right to present evidence in arbitration proceeding or that arbitration agreement seriously altered his expectations).

130. *See Nesslage v. York Securities, Inc.*, 823 F.2d 231, 234 (8th Cir. 1987) ("[t]he use of a standard form contract between two parties of admittedly unequal bargaining power does not invalidate an otherwise valid contractual provision. To be invalid the provision at issue must be unconscionable.") (quoting *Webb v. R. Rowland & Co.*, 800 F.2d 803, 807 (8th Cir. 1986), and citing *Surman v. Merrill Lynch, Pierce, Fenner & Smith*, 733 F.2d 59, 61 n.2 (8th Cir. 1984)); *Hurlbut v. Gantshar*, 674 F. Supp. 385, 389 (D. Mass. 1987) (agreement to arbitrate disputes before independent panel of arbitrators of customer's choosing, even though imposed by terms of standard form contract, is not unconscionable); *Hall v. Prudential-Bache Securities, Inc.*, 662 F. Supp. 468 (C.D. Cal. 1987) (use of standard form contract was not inherently unfair or evidence that agreements were products of contract of adhesion).

131. *Blatt v. Shearson Lehman/American Express Co.*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,976, at 94,796 (S.D.N.Y. Oct. 31, 1986). *See, e.g.*, *Creative Securities Corp. v. Bear Stearns & Co.*, 671 F. Supp. 961, 965 (S.D.N.Y. 1987); *First Citizens Mun. Corp. v. Pershing Div. of Donaldson Lufkin & Jenrette Securities Corp.*, 546 F. Supp. 884, 887 (N.D. Ga. 1982); *Starkman v. Seroussi*, 377 F. Supp. 518, 520 (S.D.N.Y. 1974). *See also*

PaineWebber, Inc., the court granted the defendant's motion to compel arbitration despite the plaintiff's claims that the signature on one of two client agreements, both of which contained arbitration provisions, was forged.¹³² The plaintiff did not dispute the validity of the signature on an earlier dated agreement. Similarly, in *First Citizens Municipal Corp. v. Pershing Division of Donaldson Lufkin & Jenerette Corp.*,¹³³ the customer opposed the defendant's motion to compel arbitration on the grounds that the defendant never signed and returned the customer agreement containing the arbitration provision. The court rejected this argument, finding that, by their conduct, the parties had adopted the agreement.

Nonexistence of the Customer Agreement. There have been cases where the plaintiff opposed the defendant's motion to compel arbitration on the grounds that no document evincing the intent of the broker and customer to arbitrate could be produced. The courts have come down on both sides of this issue. In *Tilton v. Prudential-Bache Securities, Inc.*,¹³⁴ the court refused to compel arbitration because the defendant was unable to produce the original agreement or a copy containing the clause. Similarly, the court in *Nicholas A. Califano, M.D., Inc. v. Shearson/Lehman Brothers, Inc.* held that the arbitration clause in the customer agreement for the personal account of the president of the corporate plaintiff did not apply to the plaintiff's corporate account.¹³⁵ Though Califano opened an account at Shearson in the corporation's name, Shearson had no record of sending the agreement, and no such agreement was executed specifically for the corporate account. The court held that, even assuming Califano had received the agreement for the corporate account, the corporation could not be bound by the agreement without having signed it. In *Creative Securities Corp. v. Bear Stearns & Co.*, however, the court compelled arbitration of the dispute between the parties even though the standard customer agreement containing the arbitration provision could not be located.¹³⁶

Breach of Fiduciary Duty to Explain the Arbitration Clause. Plaintiffs frequently assert that brokers owe a duty to their customers to explain the significance of the arbitration clause. The court in *Rush v. Oppenheimer & Co., Inc.*, however, held that "brokers are not required as a matter of law to disclose or explain arbitration clauses to their customers."¹³⁷

A/S Custodia v. Lessin Int'l, Inc., 503 F.2d 318, 320 (2d Cir. 1974); Fisser v. International Bank, 282 F.2d 231, 233 (2d Cir. 1960); *In re AAAcon Auto Transp., Inc., & Teafatiller*, 334 F. Supp. 1042, 1043 (S.D.N.Y. 1971).

132. *Schena v. PaineWebber, Inc.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,517, at 97,300 (D. Mass. Aug. 24, 1987).

133. *First Citizens Mun. Corp. v. Pershing Div. of Donaldson Lufkin & Jenrette Securities Corp.*, 546 F. Supp. 884 (N.D. Ga. 1982).

134. *Tilton v. Prudential-Bache Securities, Inc.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,241, at 96,170 (S.D.N.Y. Mar. 24, 1987).

135. *Nicholas A. Califano, M.D., Inc. v. Shearson Lehman Bros., Inc.*, 690 F. Supp. 1354 (S.D.N.Y. 1988).

136. *Creative Securities Corp. v. Bear Stearns & Co.*, 671 F. Supp. 961 (S.D.N.Y. 1987).

137. *Rush v. Oppenheimer & Co.*, 681 F. Supp. 1045, 1052 (S.D.N.Y. 1988). *See also*

Waiver of the Right to Arbitrate. Like any contractual right, a party may waive his right to arbitrate a dispute. In *Nesslage v. York Securities, Inc.*, the Eighth Circuit held that “[i]n view of the strong federal policy in favor of arbitration, ‘any doubts concerning . . . waiver, delay or a like defense to arbitrability’ should be resolved in favor of arbitration.”¹³⁸ The party asserting waiver bears a heavy burden of proof.¹³⁹ To determine if a party has waived the right to arbitrate, courts will consider the following factors:

- (1) whether the party’s actions are inconsistent with the right to arbitrate;
- (2) whether the litigation machinery has been substantially invoked and the parties were well into preparation of a lawsuit before the party notified the opposing party of an intent to arbitrate;
- (3) whether a party either requested arbitration enforcement close to the trial date or delayed for a long period before seeking a stay;
- (4) whether a defendant seeking arbitration filed a counterclaim without asking for a stay of the proceedings;
- (5) whether important intervening steps [*e.g.*, taking advantage of judicial discovery procedures not available in arbitration] had taken place; and
- (6) whether the delay affected, misled, or prejudiced the opposing party.¹⁴⁰

Courts recently have had to address the waiver question when deciding whether to apply retroactively the holding of *McMahon*. Typically in such cases, a party will seek to compel arbitration of claims which arose before *McMahon* and, therefore, were non-arbitrable. In *Peterson v. Shearson/*

Cohen v. Wedbush Noble Cooke Inc., 841 F.2d 282 (9th Cir. 1988); Pierson v. Dean Witter Reynolds, Inc., 742 F.2d 334, 339 (7th Cir. 1984); Rush v. Oppenheimer & Co., 638 F. Supp. 872 (S.D.N.Y. 1986); Adams v. Merrill Lynch, Pierce, Fenner & Smith, Inc., [1985-86 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,328, at 92,173 (W.D. Okla. Sep. 20, 1985); Pelzman v. Paine Webber, Jackson & Curtis, Inc., [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,408, at 96,336 (D.D.C. July 12, 1983).

138. *Nesslage v. York Securities, Inc.*, 823 F.2d 231, 234 (8th Cir. 1987) (quoting *Moss H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983)). See also *Patten Securities Corp. v. Diamond Greyhound & Genetics, Inc.*, 819 F.2d 400 (3d Cir. 1987); *Fraser v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 817 F.2d 250 (4th Cir. 1987); *Fisher v. A.G. Becker Paribas, Inc.*, 791 F.2d 691, 694 (9th Cir. 1986); *Kayne v. PaineWebber, Inc.*, 684 F. Supp. 978, 980 (N.D. Ill. 1988); *Buy-Rite Costume Jewelry, Inc. v. Albin*, 676 F. Supp. 433 (D.R.I. 1988); *Gilmore v. Shearson/American Express Co.*, 668 F. Supp. 314 (S.D.N.Y. 1987); *Drexel Burnham Lambert, Inc. v. Warner*, 665 F. Supp. 1549 (S.D. Fla. 1987); *Norden v. E.F. Hutton & Co.*, 739 P.2d 914 (Colo. App. 1987).

139. *Fisher v. A.G. Becker Paribas, Inc.*, 791 F.2d 691, 694 (9th Cir. 1986).

140. *Peterson v. Shearson/American Express Co.*, 849 F.2d 464, 467-68 (10th Cir. 1988) (citing *Reid Burton Constr., Inc. v. Carpenters Dist. Council of S. Colo.*, 614 F.2d 698, 702 (10th Cir. 1980), *cert. denied*, 449 U.S. 824 (1980)). See also *Ketchum v. Prudential-Bache Securities, Inc.*, 710 F. Supp. 300 (D. Kan. 1989); *Ketchum v. Almahurst Bloodstock IV*, 685 F. Supp. 786 (D. Kan. 1988).

*American Express Co.*¹⁴¹ and *Kayne v. PaineWebber, Inc.*¹⁴² the courts ruled that because the claims arising under the federal securities laws and RICO were not arbitrable at the time the complaint was filed, the parties had not waived their right to compel arbitration. In *C.D. Anderson & Co., Inc. v. Lemos*,¹⁴³ however, the court held that the broker waived the right to litigate the claim in a federal court because the broker had submitted federal securities law and RICO claims to arbitration. The court, therefore, found that it did not have to decide whether *McMahon* should be applied retroactively. The broker in *Lemos* had argued against the retroactive application of *McMahon*, and contended that the claims had been submitted to arbitration when they were not arbitrable at that time and, therefore, could not have waived the right to litigate the claims in court.

Impact of SEC Rule 15[c]2-2. In 1983 the SEC adopted Rule 15[c]2-2 “. . . in order to address regulatory concerns arising from the inclusion in standard form customer agreements of predispute arbitration clauses (*i.e.*, agreements requiring customers to submit to arbitration all future disputes).”¹⁴⁴ The rule required insertion in customer arbitration agreements language disclosing the potential nonapplicability of arbitration to federal securities claims.¹⁴⁵ The SEC, in adopting the rule, was responding to existing case law including *Wilko* and lower federal court decisions extending *Wilko* to ‘34 Act claims.¹⁴⁶ The SEC found that the inclusion of predispute agreements to arbitrate in customer contracts “without disclosure of their inapplicability to federal securities claims was misleading, thus constituting a ‘fraudulent, manipulative or deceptive act or practice within the meaning of the Exchange Act.’”¹⁴⁷

As a result of the *McMahon* ruling, the arbitrability of ‘34 Act claims no longer were questioned, while doubts relating to the continuing nonarbitrability of ‘33 Act claims were voiced. Recognizing the impact of *McMahon*, the SEC rescinded Rule 15[c]2-2 on October 15, 1987,¹⁴⁸ admitting that the rule was “no longer appropriate in light of case law developments.”¹⁴⁹ Subsequent to the rescission of Rule 15[c]2-2, courts split on the effect to be given arbitration provisions containing the language formerly required. Some courts have applied retroactively the rescission of the rule, declaring

141. 849 F.2d 464 (10th Cir. 1988).

142. 684 F. Supp. 978 (N.D. Ill. 1988).

143. 832 F.2d 1097 (9th Cir. 1987).

144. Securities Exchange Act Release No. 25,034, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163, at 88,886 (Oct. 15, 1987).

145. Securities Exchange Act Release No. 20,397, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,452, at 86,356 (Nov. 18, 1983).

146. Securities Exchange Act Release No. 25,034, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,163, at 88,886-87 (Oct. 15, 1987).

147. *Id.* at 88,887 (quoting Securities Exchange Act Release No. 20,397, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,452, at 86,356 (Nov. 18, 1983)).

148. *Id.*

149. *Id.*

that the language of the notice is no longer a bar to the arbitration¹⁵⁰ and, thus, avoided deciding issues relating to violations of the rule. An opposite conclusion was reached, however, in a recent New York case, *Gugliotta v. Evans & Co., Inc.*¹⁵¹ In *Gugliotta* the defendants moved to stay the proceedings and to compel arbitration pursuant to an arbitration provision in the account opening documents. The court found preliminarily, however, that the language used in the arbitration provision did not fully comply with the standard set forth in the then in force Rule 15[c]2-2. According to the court, the issue was “. . . whether despite the rescission of the rule after the lawsuit was filed, a broker who violated the [rule] . . . should be permitted to take advantage of its wrongdoing.”¹⁵² Initially, the court observed that “[a]greements to arbitrate are governed by settled principles of contract law, and a party to such an agreement ‘may assert general contract defenses’ to an action seeking to enforce an arbitration agreement.”¹⁵³ Furthermore, “[t]he law is clear that agreements contrary to public policy are void and unenforceable.”¹⁵⁴ While noting that the *McMahon* decision and the rescission of the rule had led some courts, such as the Fifth Circuit, to apply the rescission of the rule retroactively, the court refused to compel arbitration where one of the parties had acted in defiance of the prior rule.¹⁵⁵

In contrast, another court was unconcerned with retroactive application of the rule’s rescission because the rescission did not impair substantive rights¹⁵⁶ and rejected the contention that the required Rule 15[c]2-2 notice became a part of the customer’s agreement.¹⁵⁷ The court found extensive support in authorities for the concept that “the rule is merely a procedural mechanism” and “does not create or preserve rights to litigate in federal court, and does not alone prevent arbitration of federal securities claims.”¹⁵⁸

It should be noted, however, that the language required by former Rule 15[c]2-2 has been given teeth by several courts despite the rescission of the rule and the holding of *McMahon*.¹⁵⁹ For example, in *Brick v. J.C. Bradford & Co.* the court denied a motion to compel arbitration of a customer’s claims under section 10(b) of the Exchange Act because the customer agreement contained language (pursuant to the SEC rule) prohibiting arbi-

150. See *Cohen v. Wedbush Noble Cooke Inc.*, 841 F.2d 282 (9th Cir. 1988); *Adrian v. Smith Barney, Harris, Upham & Company, Inc.*, 841 F.2d 1059 (11th Cir. 1988); *Villa Garcia v. Merrill Lynch, Pierce, Fenner & Smith*, 833 F.2d 545 (5th Cir. 1987).

151. 690 F. Supp. 144 (E.D.N.Y. 1988).

152. *Gugliotta v. Evans & Co., Inc.*, 690 F. Supp. 144, 146 (E.D.N.Y. 1988).

153. *Id.* (citing *Southland Corp. v. Keating*, 465 U.S. 1, 16 n.11 (1983)).

154. *Id.*

155. *Id.* at 147. *Id.*

156. *Ketchum v. Prudential-Bache Securities*, 685 F. Supp. 786 (D. Kan. 1988).

157. *Id.*

158. *Id.* at 795.

159. *Leicht v. Bateman Eichler, Hill, Richards, Inc.*, 848 F.2d 130 (9th Cir. 1988); *Ahrberg v. Colton*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,910, at 90,066 (W.D. Okla. 1988); *Brick v. J.C. Bradford & Co.*, 675 F. Supp. 1251 (D.D.C. 1987).

tration of any claim for which a “. . . remedy may exist pursuant to any expressed or implied right of action under the federal securities laws. . . .”¹⁶⁰ The court refused to conclude that the language in the customer agreement had been included simply to give the notice required by Rule 15[c]2-2.¹⁶¹ Similarly, in *Leicht v. Bateman Eichler, Hill, Richards, Inc.*¹⁶² the Ninth Circuit found that the language of the arbitration provision gave the customer “. . . the option to resolve his federal securities disputes through litigation rather than arbitration” and “[a]bsent any evidence that the parties intended otherwise, we should uphold the ordinary meaning of language in a contract.”¹⁶³

Choice of Arbitration Forum. In *Roney & Co. v. Goren*¹⁶⁴ the Sixth Circuit affirmed an order of the district court staying arbitration of a customer’s fraud claim pending before the NASD and compelling arbitration of her claims before the NYSE pursuant to an arbitration clause in an executed customer agreement.¹⁶⁵ The clause provided that any dispute must be arbitrated solely under NYSE rules. The court rejected contentions that the clause violated both the anti-waiver provision of the Exchange Act and the NASD’s requirements that a member arbitrate before the NASD upon demand of the customer.¹⁶⁶ The court also rejected the SEC’s views expressed in an *amicus curiae* brief that the contract provision was not enforceable because it “attempts to override the SRO (NASD) rules that govern broker-dealers and their associated persons, and because enforcement of the provision would undermine customer protections of the SRO arbitration system.”¹⁶⁷ The SEC argued that allowing the customer to select “the most efficient and economical arbitration forum”¹⁶⁸ effectuates an important underlying policy of the SRO arbitration system.

The Sixth Circuit concluded that limiting the arbitration forum available to a customer did not constitute a waiver of a substantive obligation of the Exchange Act¹⁶⁹ and that the enforcement of the customer agreement “upholds the Federal Arbitration Act’s specific purpose of ‘reversing centuries of judicial hostility to arbitration agreements . . . [by] plac[ing] arbitration agreements upon the same footing as other contracts.’”¹⁷⁰ Addressing a customer’s right, pursuant to SRO rules, to select a particular arbitration forum, the Sixth Circuit observed that “the customer is equally free to

160. *Brick*, 675 F. Supp. at 1254.

161. *Id.*

162. 848 F.2d 130 (9th Cir. 1988).

163. *Leicht v. Bateman Eichler, Hill, Richards, Inc.*, 848 F.2d 130, 133 (9th Cir. 1988).

164. 875 F.2d 1218 (6th Cir. 1989).

165. *Roney & Co. v. Goren*, 875 F.2d 1218, 1219 (6th Cir. 1989).

166. *Id.*

167. See Brief for the Securities Exchange Commission as *Amicus Curiae* at 4, *Roney & Co. v. Goren*, 875 F.2d 1218 (6th Cir. 1989).

168. *Id.* at 16.

169. *Roney & Co.*, 875 F.2d at 1220.

170. *Id.* at 1221 (quoting *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-511 (1974) (quoting H.R. Rep. No. 96, 68th Cong., 1st Sess. 1, 2 (1924))).

agree to limit his recourse to a particular forum,"¹⁷¹ and emphasized that "[t]his decision upholds federal policy favoring arbitration without doing significant injury to customer freedom of choice or the protections of the Exchange Act."¹⁷²

In a release following the Sixth Circuit's decision in *Goren*, Daniel Goelzer, the General Counsel of the SEC, expressed the SEC's view that the decision's significance is limited by recently approved SRO rule changes¹⁷³ which provide that "[n]o agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award."¹⁷⁴ Thus, a member of the SROs would not be permitted to limit customers to a particular arbitration forum if it would be in derogation of a rule of a SRO of which it is a member.¹⁷⁵

E. Arbitration Awards

1. Punitive Damages.

The perception that punitive damages are rarely, if ever, awarded by arbitrators is one of the elements fueling the current controversy raging over the securities industry's use of predispute arbitration agreements.¹⁷⁶ It appears, however, that this perception, even if previously correct, may have to be altered because the award of such damages may become more commonplace in arbitration.

First, federal and state arbitration statutes do not expressly prohibit arbitrators from hearing claims for punitive damages.¹⁷⁷ Second, arbitrators are not prohibited by the rules of the securities self-regulatory organizations ("SROs") from hearing claims for punitive damages or awarding punitive damages. In fact, Edward Morris, Arbitration Director of the New York Stock Exchange (NYSE), recently remarked at the New York Institute of Finance Conference that he has informed NYSE's arbitrators to award punitive damages if punitive damages are appropriate.¹⁷⁸ Similarly, the new

171. *Id.* at 1221.

172. *Id.*

173. SEC Litigation Release No. 12,198 (Aug. 7, 1989) (available from Wash. & Lee L. Rev.).

174. New York Stock Exchange Rule 637; National Association of Securities Dealers Rules of Fair Practice § 21; American Stock Exchange Rule 427; Securities Exchange Act Release No. 26,805, [Current] Fed. Sec. L. Rep. (CCH) ¶84,414, at 80,099 (May 10, 1989); Chicago Board of Options Exchange rule 18.35; Securities Exchange Act Release No. 27,093 (Aug. 2, 1989). The Municipal Securities Rulemaking Board, the Pacific Stock Exchange, and the Midwest Stock Exchange also have submitted proposed rule changes to the SEC that would add an identical provision to their respective arbitration rules. SEC File No. SR-MSRB-88-5; SR-PSE-88-7; SR-MSE-88-11.

175. 175 SEC Litigation Release No. 12,198 (Aug. 7, 1989).

176. Morris, *Punitive Damages in Securities Arbitration*, 21 REV. SEC. & COMM. REG. 167 (1988) [hereinafter Morris].

177. *Id.*

178. Sec. Reg. & L. Rep. (BNA) No. 3, at 100-02 (Jan. 22, 1988).

arbitration rules of the American Arbitration Association ("AAA"), an organization which regularly sponsors securities arbitration, do not specifically address the issue of an arbitrator's authority to award such damages.¹⁷⁹ Rather, arbitrators at the AAA as well as those of the National Association of Securities Dealers (NASD) have requested briefs from the parties to the arbitration when the issue of arbitrator authority to award the parties to the arbitration when the issue of arbitrator authority to award such damages arises.¹⁸⁰

Finally, an emerging trend in recent case law points to the increased availability of punitive damages in arbitration. While it is clear that punitive damages are not available for violations of the Exchange Act,¹⁸¹ *Garrity v. Lyle Stuart, Inc.*¹⁸² has been cited frequently as authority for decisions holding that an arbitrator is prohibited from including punitive damages in an award for common-law or state statutory claims. The New York Court of Appeals, when explaining this result, stated that not only did the arbitrator not have the authority to make such an award, but an award which imposes punitive damages even though agreed upon by the parties, was violative of public policy and, thus, could be vacated.

Arrayed in opposition to the *Garrity* decision, however, is a line of cases which ultimately have found that an arbitrator may award punitive damages in a matter governed by the Federal Arbitration Act *unless a federal policy* exists prohibiting an award of such damages or some express *contractual limitations* on the arbitrator's authority to award punitive damages.¹⁸³ Parties, of course, are free to exclude from arbitration consideration of punitive damages or RICO treble damages in their arbitration agreements. However, such claims then could be pursued in judicial forums.

The award of RICO damages by arbitrators also should not be open to question. As noted earlier, the *McMahon* court ruled that claims arising under RICO are arbitrable. It, therefore, would seem that if RICO claims are not excluded from arbitration agreements, consideration of such damages should be permitted whether RICO damages are considered remedial or punitive in nature because RICO provides a *federal* cause of action and is not to be governed by state law.¹⁸⁴

179. Morris, *supra* note 164, at 168.

180. *Id.*

181. See *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969).

182. 386 N.Y.S.2d 831 (1976). See also *Tinaway v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 692 F. Supp. 220, 226 (S.D.N.Y. 1988) (citing *In re Energy Systems Equip. Leasing Securities Litig.*, 642 F. Supp. 718, 744 (E.D.N.Y. 1986)).

183. See *Bonar v. Dean Witter Reynolds, Inc.*, 835 F.2d 1378 (11th Cir. 1988); *Raytheon Company v. Automated Business Systems*, No. 89-0895 (D. Mass. Dec. 6, 1988); *Duggal International Inc. v. Sall Mettal, B.V.*, No. 84 C.V. 7170 (S.D.N.Y. 1986); *Willoughby Roofing & Supply Co. v. Kajima Intern.*, 598 F. Supp. 353 (1984); *Willis v. Shearson/American Express Co.*, 569 F. Supp. 821 (M.D.N.O. 1983).

184. *Faircloth v. Jackie Fine Arts, Inc.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,781, at 98,677-78 (D.S.C. Mar. 30, 1988).

2. Judicial Review of Awards: In General

An arbitration award is presumed to be valid¹⁸⁵ and the scope of judicial review is narrow.¹⁸⁶ It may be modified or vacated by a court on very limited grounds.¹⁸⁷ Section 10 of the Arbitration Act provides that awards may be set aside where:

- a) the award was procured by corruption, fraud, or undue means;
- b) there is evidence of partiality or corruption on the part of the arbitrators or either of them;
- c) the arbitrators were guilty of misconduct in refusing to postpone the hearing upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any misbehavior by which the rights of any party may have been prejudiced; or
- d) the arbitrators exceeded their powers or imperfectly executed them that a mutual, final, and definite award upon the subject matter was not made.¹⁸⁸

In addition to the statutory provisions, a non-statutory ground for *vacatur* of an arbitration award was noted by the Supreme Court in *Wilko*, for example, if the arbitrator's decision was rendered in "manifest disregard of the law."¹⁸⁹

3. Judicial Review: Decisions

The Second Circuit has warned that "... [o]verly technical judicial review of arbitration awards would frustrate the basic purposes of arbitration: to resolve disputes speedily and to avoid the expense in delay of extended court proceedings."¹⁹⁰ However, it is also clear that "... [f]or judicial review to be meaningful, an arbitration award cannot be absolutely immune from scrutiny."¹⁹¹ As one court observed, "[w]hile arbitration awards generally receive deferential review by the courts, deference is not

185. *Ouziel v. Shearson Lehman Brothers, Inc.*, No. 86-CV-1822, 1988 U.S. Dist. LEXIS 3037 *4 (E.D.N.Y. 1988) (citing *Gunther v. San Diego & Arizona Eastern Railway Co.*, 382 U.S. 257 (1965)); *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1956); *Wilko v. Swan*, 346 U.S. 427 (1953); *Burchell v. Marsh*, 58 U.S. 540 (1854).

186. *Synergy Gas Co. v. Sasso*, 853 F.2d 59 (2d Cir.), *cert. denied*, 109 S. Ct. 559 (1988).

187. *Sargent v. Paine Webber, Jackson & Curtis*, 674 F. Supp. 920, 922 (D.D.C. 1987).

188. 9 U.S.C. § 10 (1970). A notice of motion to vacate, modify or correct an award must be served within three months after the award is filed or delivered. 9 U.S.C. § 12 (1970). In this connection, *see O.R. Securities, Inc. v. Professional Planning Assoc., Inc.*, 857 F.2d 742 (11th Cir. 1988) (holding that proper manner for challenging arbitration award is in form of motion as provided in Fed. R. Civ. P. 7(b)).

189. *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953).

190. *Federal Commerce & Nav. Co. v. Kanematsu-Gosho, Ltd.*, 457 F.2d 387, 389 (2d Cir. 1972).

191. *Sargent*, 674 F. Supp. at 924 (citing *Siegel v. Titan Indus. Corp.*, 779 F.2d 891, 894 (2d Cir. 1985)).

abdication."¹⁹² Against this framework, courts have conducted reviews of the following issues.

Evidentiary Issues. The courts generally have held that arbitrators are permitted to determine the materiality and relevance of any evidence that is proffered, are not bound by any formal rules governing the admission of evidence, and the failure to follow evidentiary rules is not a grounds of *vacatur*.¹⁹³

Clarification of Arbitration Awards. The lack of specificity in arbitrators' rulings and the resultant effect on a court's ability to review an award has resulted in *vacatur* and remand to the arbitration panel for a full explanation of the method by which damages were computed. One court has explained:

[I]t is entirely appropriate for a district court to direct arbitrators to explain their awards. This method avoids any judicial guessing as to the rationale behind the award. Remands do not constitute judicial invasion of the arbitrators province but rather serve to give the parties what they bargained for—a clear decision from the arbitrators.¹⁹⁴

In *Tinaway v. Merrill Lynch & Company, Inc.*, the court initially granted the plaintiff's motion to vacate the award on the grounds of "evident partiality" toward the defendant and retained jurisdiction over the matter.¹⁹⁵ The court could not find in the arbitrators' decision a ground from which the amount of the award could be inferred and, thus, inferred partiality toward the defendant on the basis of the arbitrators awarding only five percent of the amount allegedly lost. In a subsequent decision, however, the *Tinaway* court reversed its earlier holding in light of *McMahon*, stating that its prior conclusion that personal bias could be shown by means other than pecuniary interest or some actual relationship between the parties in cases alleging federal securities violations was no longer valid.¹⁹⁶ The court also concluded that an examination of the record did not support a determination that the arbitrators acted with *manifest disregard for the law*.

The SEC, of course, has no authority to dictate the scope of judicial review of arbitration decisions. However, the SEC has recommended to the Securities Industry Conference on Arbitration ("SICA") that its Uniform Code be amended ". . . to provide for sufficient records for appellate courts to use for their review using the developing 'manifest disregard standard.'"¹⁹⁷

192. *Id.* at 923.

193. *See Swink & Co. v. Norris & Hirschberg, Inc.*, 845 F.2d 789 (8th Cir. 1988); *Ouziel v. Shearson Lehman Bros., Inc.*, 1988 U.S. Dist. LEXIS 3037 (E.D.N.Y. 1988).

194. *Sargent*, 674 F. Supp. at 924.

195. *Tinaway v. Merrill Lynch & Co.*, 658 F. Supp. 576 (S.D.N.Y. 1987).

196. *Tinaway v. Merrill Lynch & Co.*, 692 F. Supp. 220 (S.D.N.Y. 1988).

197. *See Letter from Director of the SEC's Division of Market Regulation to members of SICA* (Sept. 10, 1987) (transmitting staff recommendations which had been endorsed by the SEC staff) (available from Wash. & Lee L. Rev.).

The SEC also has made significant recommendations that, in operation, would provide courts with many more specifics about the nature of awards and the specific issues upon which arbitrators rule.¹⁹⁸ These recommendations, if implemented, would impact on the consideration given to arbitrators' decisions in later proceedings involving the same issues.

Awards Rendered in "Manifest Disregard of the Law." The Supreme Court in *Wilko v. Swan* opined in *dictum* that the arbitrators' "manifest disregard of the law" in rendering an award could constitute a nonstatutory ground for vacating an arbitration award.¹⁹⁹ The *Wilko* court, however, did not set forth the factors that would establish "manifest disregard of the law." In fact, one court has mused ". . . [t]hat elusive, non-statutory ground for vacating an arbitration award is just as often described in terms of what it is not as what it is."²⁰⁰ In *Merrill Lynch, Pierce, Fenner & Smith v. Bobker* the Second Circuit provided a very limited test for *vacatur* on that basis:

. . . [a]lthough the bounds of this ground have never been defined, it clearly means more than error or misunderstanding with respect to the law. The error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator. Moreover, the term 'disregard' implies that the arbitrator appreciates the existence of a clearly governing legal principle but decides to ignore or pay no attention to it. To adopt a less strict standard of judicial review would be to undermine our well established deference to arbitration as a favored method of settling disputes when agreed to by the parties. Judicial inquiry under the 'manifest disregard' standard is therefore extremely limited. The governing law alleged to have been ignored by the arbitrators must be well defined, explicit, and clearly applicable. We are not at liberty to set aside an arbitration panel's award because of an arguable difference regarding the meaning or applicability of laws urged upon it.²⁰¹

Confirmation of Awards. Section 9 of the Arbitration Act provides for confirmation of an award in a court if so provided by the parties in the

198. *Id.*

199. *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953).

200. *DeAngelis v. Shumway*, 1987 U.S. Dist. LEXIS 8927 *6 (S.D.N.Y. 1987).

201. *Merrill Lynch, Pierce, Fenner & Smith v. Bobker, Inc.*, 808 F.2d 930, 933-34 (2d Cir. 1986).

Other cases interpreting the concept include *Swink & Company, Inc. v. Norris & Hirschberg, Inc.*, 845 F.2d 789 (8th Cir. 1988); *French v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 784 F.2d 902 (9th Cir. 1986); *Siegal v. Titan Indus. Corp.*, 779 F.2d 891 (2d Cir. 1985); *A/S Sijestad v. Hideca Trading, Inc.*, 678 F.2d 391 (2d Cir. 1982); *Kurt Orban Co. v. Angeles Metal Systems*, 573 F.2d 739 (2d Cir. 1978); *DeAngelis v. Shumway*, 1987 U.S. Dist. LEXIS 8927 (S.D.N.Y.); *Svoboda v. Negey Assoc.*, 655 F. Supp. 1329 (S.D.N.Y. 1987); *Maidman v. O'Brien*, 473 F. Supp. 25 (S.D.N.Y. 1979).

agreement to arbitrate.²⁰² In a recent decision, a federal district court which had ordered the proceedings in a lawsuit stayed and compelled arbitration held that courts retain jurisdiction to affirm a binding award which had been entered in another district.²⁰³

Enforcement of Awards Against Brokers. Customers have the support of the SROs in enforcing securities arbitration awards because if the broker-dealer does not pay an award promptly, the SRO can impose sanctions. The threat of sanctions against a securities firm generally makes it unnecessary for the customer to confirm the arbitration award in court or to seek judicial remedies in order to receive payment.

F. *The Preclusive Effect of Arbitration Awards*

The preclusive effect of awards has become an important and hotly debated issue with the prospect of continued, bifurcated proceedings in class actions arising under the Exchange Act, where some members have not signed arbitration clauses. Generally, courts have been unwilling to give arbitration awards preclusive effect. For example, a recent New York court has stated:

Although some arbitration proceedings have been given preclusive effect, the Supreme Court has . . . been unwilling to hold that arbitration proceedings are always entitled to *res judicata* or collateral estoppel effect. . . . [T]he Supreme court cautioned that, in fashioning the preclusion rules for arbitration proceedings, the nature of the federal rights and the protection afforded them in an arbitration must be considered.²⁰⁴

The terms collateral estoppel and *res judicata* often are used interchangeably. Each doctrine, however, produces a different preclusive effect. Under the doctrine of *res judicata* (claim preclusion), "a final judgment on the matter of an action precludes the parties or their privies from relitigating issues that were or could have been raised in that action."²⁰⁵ Further, "*res judicata* applies to claims for or defenses to recovery that were available at

202. Section 9 of the Arbitration Act provides:

If the parties in their agreement have agreed that a judgment of the court shall be entered upon the award made pursuant to the arbitration, and shall specify the court, then at any time within one year after the award is made any party to the arbitration may apply to the court so specified for an order confirming the award, and thereupon the court must grant an order unless the award is vacated, modified, or corrected. . . .

9 U.S.C. § 9 (1970).

203. *Wing v. J.C. Bradford & Co.*, 678 F. Supp. 622 (N.D. Miss. 1987) (citing *NII Metal Serv., Inc. v. ICM Steel Corp.*, 514 F. Supp. 164 (N.D. Ill. 1982)); *Smiga v. Dean Witter Reynolds, Inc.*, 766 F.2d 698 (2d Cir. 1985), *cert. denied*, 475 U.S. 1067 (1986).

204. *Cullen v. Paine Webber Group*, 689 F. Supp. 269, 276 (S.D.N.Y. 1988) (citing *McDonald v. City of West Branch*, 466 U.S. 284 (1984) and *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985)).

205. *Allen v. McCurry*, 449 U.S. 90, 94 (1980).

the time of the earlier litigation, even if they were not raised or determined in that proceeding."²⁰⁶ The elements of *res judicata* include identity of parties, an identity of the cause of action, and a full and fair opportunity to litigate the matter.²⁰⁷

On the other hand, collateral estoppel (issue preclusion) will be applied to estop a party from relitigating issues which were decided in an earlier proceeding. Before the doctrine will be applied, the following general prerequisites must be met:

- a) identity of issues;
- b) actual litigation of the issue in a prior litigation proceeding;
- c) the determination of the issue in the prior litigation or proceeding must have been a critical and necessary part of the judgment in the earlier proceedings; and
- d) the party against whom the earlier decision is asserted, must have had a full and fair opportunity to litigate the issue in the earlier proceedings.²⁰⁸

Accordingly, *res judicata* differs from collateral estoppel because *res judicata* bars only the relitigation of identical claims between the same parties or their privies. Collateral estoppel, however, bars the relitigation by a party to a prior litigation only of a previously decided issue. While some courts have given preclusive effect to arbitration awards in subsequent court proceedings even where the underlying claim involves the federal securities laws,²⁰⁹ others have refused because the nature of the award is unclear.²¹⁰

206. *Cullen*, 689 F. Supp. at 276 (citing *Brown v. Felsen*, 472 U.S. 127, 131 (1979)).

207. *Id.* at 278 (citing *Nevada v. United States*, 463 U.S. 110, 1130 (1983) and *Montana v. United States*, 440 U.S. 147, 153-54 (1979)).

208. *Artman v. Prudential-Bache Securities, Inc.*, 670 F. Supp. 769, 773 (S.D. Ohio 1987).

209. *See Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352 (11th Cir. 1985) (in context of bifurcated proceeding, court estopped customer from relitigating issues decided in arbitration proceeding that were necessary for plaintiff to prove predicate acts to establish RICO claim); *Ryan v. Liss, Tenner & Goldberg Securities Corp.*, 683 F. Supp. 480 (D.N.J. 1988) (because issues already had been determined in state forum, investors were precluded by doctrine of collateral estoppel from relitigating in federal court validity and applicability of arbitration agreement); *Hammerman v. Peacock*, 654 F. Supp. 71 (D.D.C. 1987) (court found that arbitration panel, in deciding customer's state claims, effectively resolved identical factual issues underlying customer's section 10(b) claims against firm and account executive handling account, and it, therefore, was appropriate to give collateral estoppel effect to arbitrators' decision). *See also Cullen v. Paine Webber Group, Inc.*, 689 F. Supp. 269 (S.D.N.Y. 1988).

210. *See Blunt Ellis & Loewi, Inc. v. Giles*, 845 F.2d 131 (7th Cir. 1988); *Hybert v. Shearson Lehman/American Express Co., Inc.*, (N.D. Ill. 1988). *See also Artman v. Prudential-Bache Securities Inc.*, 670 F. Supp. 769 (S.D. Ohio 1987) (because arbitration award gave no information under which court could determine whether underlying federal securities claims actually were litigated in arbitration proceeding, decision could not be given preclusive effect); *O'Neill v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 654 F. Supp. 347 (N.D. Ill. 1987) (court was unwilling to estop plaintiff from relitigating issues previously submitted to arbitrators because court could not determine what in fact was decided by arbitrator); *Wing v. J.C. Bradford & Co., Inc.*, 678 F. Supp. 622 (N.D. Miss. 1987) (because arbitration decision did not elaborate on findings, decision could not have collateral estoppel effect).

PART II

RECENT REGULATORY AND LEGISLATIVE DEVELOPMENTS

A. Arbitration Reform Efforts of the SEC and the Securities Industry

1. SEC Initiative

The *McMahon* Court was influenced strongly by the SEC's pro-arbitration *amicus curiae* brief²¹¹ which emphasized the SEC's "... sweeping authority over the rules adopted by SROs relating to arbitration of customer disputes, including the power to mandate the adoption of any additional rules it deems necessary to ensure the adequacy of an SRO's arbitration system."²¹² Following *McMahon*, the expectation of a greater volume of SRO-sponsored arbitrations and the perception of a need for improvements in the process (based on an eighteen month review of securities industry sponsored arbitration) led the SEC's Division of Market Regulation, with SEC approval, to issue to SICA a series of recommendations which would "enhance not only the actual fairness of the proceedings, but the public's perception of their fairness."²¹³

2. SICA Response and Reform Activity.

Pursuant to the SEC's request, SICA, on December 14, 1987, issued a response to the SEC's recommendations.²¹⁴ While expressing agreement with

211. Shearson/American Express Co. v. McMahon, 482 U.S. 220, 223 (1987).

212. Brief for SEC as *Amicus Curiae* at 16, Shearson/American Express Co. v. McMahon, 482 U.S. 220 (1987).

213. Letter from Richard G. Ketchum, Director of Division of Market Regulation of SEC, to members of the Securities Industry Conference on Arbitration ("SICA") (Sept. 10, 1987) (available from Wash. & Lee L. Rev.). SICA consists of representatives of the securities self-regulatory organizations ("SROs") and the public. In the letter, the SEC recommended that:

1. Lawyers, accountants and others who regularly provide services to the securities industry be disqualified as public arbitrators;
2. Improvements be made in arbitrator training and evaluation of the performance of arbitrators;
3. Investigations by the SROs and disclosure of the background of arbitrators in advance of hearings be broadened to permit the parties to exercise their peremptory and for cause challenges to the arbitrators;
4. SROs should do more to preserve an adequate record for courts to use when they review arbitral awards;
5. Summary disclosures be required of the amount of and the legal reasoning supporting the rulings on damages claimed as well as those actually awarded, the names of the arbitrators, and whether each concurred with or dissented from the award; and
6. SROs need to expand existing procedures in order to provide both for the resolution of discovery disputes by either the chairman or full panel prior to the hearing, and for prehearing conferences and preliminary hearings for cases that are sufficiently complex to warrant such procedures.

Id.

214. Letter from SICA to Richard G. Ketchum, Director of the Division of Market Regulation of SEC (Dec. 14, 1987) (available from Wash. & Lee L. Rev.).

many of the SEC's suggestions,²¹⁵ SICA questioned the wisdom of several key recommendations.

In the months following its initial response, SICA engaged in extensive reform activity directed toward addressing the major concerns raised by the SEC. As a result of this activity, several sections of the Uniform Code of Arbitration (the "Code") were revised. The SROs largely adopted those revisions and submitted the proposed rule changes to the SEC. On May 16, 1989, the SEC approved the proposed rule changes submitted by the New York Stock Exchange, the National Association of Securities Dealers, and the American Stock Exchange.²¹⁶ As discussed below, among the primary areas targeted for reform are the selection, classification and disclosures required of arbitrators; evaluation of arbitrators; unavailability of arbitrators; the publication of arbitration awards; rehearing conferences and discovery issues; the handling of complex cases; and the content and disclosure of arbitration clauses in customer agreements.

Classification and Disclosures of Arbitrators. In an effort to ensure that the public as well as the SEC regards SRO-sponsored arbitration as a fair and impartial forum, SICA has adopted revisions in the Code sections that address the selection, classification and disclosures required of arbitrators who serve on panels.

Classification of Arbitrators. Section 8(a)(1) of the Code provides that a majority of the nonintra-industry panels will be "public" arbitrators, unless the public customer requests otherwise. In response to the SEC's concerns relating to the "absence of clear guidelines for qualifying public arbitrators . . . and the inclusion in the pool of public arbitrators of persons with clear affiliations with the securities industry,"²¹⁷ SICA has developed criteria set forth in amended Code Section 8(a)(2) that delineate whether an arbitrator will be "deemed as being from the securities industry."²¹⁸ At least one SRO, the New York Stock Exchange, has formulated even stricter guidelines for the classification of arbitrators.²¹⁹

Disclosures Required of Arbitrators. The SEC, in its September 1987 letter, recommended that section 11 of the Code be amended to provide specific guidelines relating to the scope of disclosures required of arbitra-

215. *Id.*

216. 54 Fed. Reg. 21144 (1989).

217. Letter to SICA, *supra* note 213, at 2.

218. Pursuant to the Uniform Code of Arbitration ("U.C.A."), § 8(a)(2)(1988), an arbitrator will be deemed as being from the securities industry if he or she:

1. is a person associated with a member, or broker-dealer, government securities broker, government securities dealer or registered investment adviser, or
2. has been associated with any of the above within the past three (3) years, or
3. is retired from any of the above, or
4. is an attorney, accountant or other professional who devoted twenty (20) percent or more of his or her professional work effort to securities industry clients within the last two years.

219. See NYSE, *Guidelines for the Classification of Arbitrators*, in *BROKER DEALER INSTITUTE 772* (1988) (Practicing Law Institute).

tors.²²⁰ In response, SICA in June 1988 amended section 11 to impose upon an arbitrator a continuing duty to disclose any direct or indirect financial or personal interest in the outcome of the arbitration as well as any existing or past financial, business, professional, family or social relationship which are likely to affect impartiality or which might reasonably create an appearance of partiality or bias.²²¹

Disciplinary History of Arbitrators. Regular checks on the disciplinary record of arbitrators are considered by the SEC to be of great importance.²²² SICA also advocates close scrutiny of arbitrators' backgrounds and a review of the disciplinary history of all present and newly enrolled arbitrators. The arbitrator profile of some of the SROs, for example, the New York Stock Exchange, has been amended to include questions about the arbitrator's disciplinary history.²²³

Notice of Selection of Arbitrators. In the past section 9 of the Code provided that the names and business affiliations of the arbitrators be submitted to the parties at least eight business days prior to the date of the initial hearing session.²²⁴ SICA revised section 9 in June 1988 to further provide that employment histories for the past ten years of each arbitrator assigned to the case as well as the information disclosed pursuant to section 11 also be made available.²²⁵ A party is permitted to make further inquiries to the Director of Arbitration concerning the background of any arbitrator.²²⁶

Unavailability of Arbitrators. Sections 9 and 12 of the revised Code address the unavailability of arbitrators due to physical disability, death, or any other reason.²²⁷ In the event an arbitrator becomes unable to serve prior to the first hearing session, the new section 9 requires the Director of Arbitration to fill any vacancy on the panel.²²⁸ If the vacancy occurs after the first hearing session, new section 12 permits the remaining arbitrators to continue the hearing unless a party objects to such continuation within five days of notification of the vacancy.²²⁹ The Director of Arbitration, upon the party's objection, must appoint a new panel member to fill the vacancy.²³⁰ Prior to this revision, a vacancy resulted in a *de novo* hearing unless both parties consented to a continuation of the matter with the remaining arbitrators.²³¹

220. Letter to SICA from SEC, *supra* note 213, at 5-6.

221. U.C.A. § 11(a)(1), (a)(2) and (c) (1988).

222. Letter to SICA from SEC, *supra* note 213, at 3.

223. See NYSE, *Arbitrator Profile*, *supra* note 219, at 773-74.

224. See U.C.A. § 9 (1978).

225. See U.C.A. § 9 (1988).

226. *Id.*

227. See U.C.A. §§ 9, 12 (1988).

228. *Id.* at § 9.

229. *Id.* at § 12.

230. *Id.*

231. See U.C.A. § 12 (1978).

Evaluating Arbitrators. Currently, arbitrators are evaluated by SRO staff and other arbitrators, and SROs are expected to investigate any complaint received concerning an arbitration.²³² In a September 1987 letter to SICA, the SEC recommended a reform of the arbitrator evaluation procedures and proposed the development of a written evaluation system.²³³ Questionnaires "seeking evaluations of arbitrator competence, preparedness, and fairness," completed by parties, their counsel, and other arbitrators, would constitute the basis of the system.²³⁴

SICA initially disputed the SEC's call for reform of current procedures and stated its concern that further evaluation would discourage qualified individuals from serving.²³⁵ SICA also questioned whether results received from post-arbitration reports would not be skewed because all parties would not necessarily fill out the questionnaires.²³⁶ As part of its reform efforts, however, SICA has selected the arbitrator evaluation program of the Chicago Board of Options Exchange as a pilot for the industry. The SICA evaluation program consists of a questionnaire seeking the reaction of parties to the entire process.

Prehearing Conferences and Discovery Issues. Upon review of SRO procedures for prehearing discovery, the SEC perceived a need for the development of additional procedures which would formally "provide both for the resolution of discovery disputes by either the chairman or full panel prior to the hearing and for prehearing conferences and preliminary hearings for cases that are sufficiently complex to warrant such procedures."²³⁷

Acknowledging the insufficiency of existing procedures, provisions which will facilitate the exchange of documents and information between parties prior to the arbitration proceeding were approved by SICA members in June 1988.²³⁸ Under section 20 of the revised Code, a "party may serve a written request for information or documents upon another party twenty (20) business days or more after service of the Statement of Claim by the Director of Arbitration, or upon filing of the Answer, whichever is earlier." Requests for information must be satisfied or objected to within thirty (30) calendar days from the date of service unless the requesting party grants an extension. Any response to objections must be served on all parties and filed with the Director of Arbitration within ten (10) calendar days of receipt of the objection (if the party's information request is unsatisfied, then upon the written request of the party, the dispute will be referred by the Director of Arbitration to either a prehearing conference or a selected arbitrator). All parties are to serve on each other copies of documents in their possession and to identify the witnesses that they intend to present at the hearing.

232. Letter to SEC from SICA, *supra* note 214, at 4.

233. Letter to SICA from SEC, *supra* note 213, at 5.

234. *Id.*

235. Letter to SEC from SICA, *supra* note 214, at 4.

236. *Id.*

237. Letter to SICA from SEC, *supra* note 213, at 9.

238. *See* U.C.A. § 20 (1988).

Failure to do so will result in the exclusion from the arbitration of such documents or witnesses. However, documents or identification of witnesses intended for use at cross-examination or rebuttal are not required to be served. Section 20 of the Code also provides for more formalized procedures for prehearing discovery conferences. A prehearing discovery conference may be called at the request of either party in the arbitration or at the discretion of an arbitrator or the SRO's Director of Arbitration.²³⁹

Publication of Arbitrators' Awards and Need for Written Opinions. In connection with the publication of arbitrators' decisions, SICA member organizations and the American Arbitration Association historically have not provided written statements explaining the basis of a decision. The SEC, however, has urged the sponsors of arbitration proceedings to summarize and make public the results of such proceedings.²⁴⁰

In SICA's initial response to the SEC's recommendations, SICA challenged the need for a written opinion in every arbitration matter and stated that such a requirement would hinder rather than enhance the arbitration process. SICA expressed the belief that such a requirement "will serve little utility and may mislead parties regarding an arbitrator's track record."²⁴¹ SICA, nonetheless, suggested that a list of cases detailing the general subject matter of each case, the amount of the claim and award, and the names of the arbitrators be maintained. The names of the parties would be deleted, but dismissals on jurisdictional grounds would be noted. SICA did not favor public availability of such a list and argued that only parties and their counsel to pending cases should have access to the list. SICA also did not support retroactive application of the proposed change.²⁴²

On July 28, 1988, Section 29 of the Code was amended by adding two new paragraphs, 29(e) and 29(f). The amendments not only incorporated the provisions of the initial SICA proposal, but enlarged the scope of the material to be disclosed.²⁴³

3. Arbitrability of Class Actions and Other Complex Claims.

The SEC concluded upon its review of SRO arbitration procedures that "special guidelines for the administration of large and complex cases are needed."²⁴⁴ In July 1988, this view was reiterated by SEC Chairman David Ruder in testimony before a House subcommittee conducting hearings on proposed arbitration-related legislation in which Ruder responded to questions related to the adequacy of arbitration as a forum for class actions and other complex actions. Concern was expressed during the hearing that the rights of parties who had signed a mandatory predispute agreement

239. See U.C.A. § 20(b)(4) (1988).

240. Letter to SICA from SEC, *supra* note 213, at 8.

241. Letter to SEC from SICA, *supra* note 214, at 6.

242. *Id.*

243. See U.C.A. §§ 29(e), (f) (1988).

244. Letter to SICA from SEC, *supra* note 213, at 12.

would be abridged if arbitration of complex matters were required. In response, Ruder suggested that the securities industry should develop rules that would allow investors who had signed predispute arbitration agreements access to the courts where complex claims are involved.

Currently, sections 1 and 5 of the Code permit arbitrators and SROs to exercise discretion in this area. Section 1 allows SROs to decline jurisdiction over a matter, while section 5 permits arbitrators, acting in their own discretion, to dismiss proceedings and "refer the parties to remedies provided by law."²⁴⁵ In response to Ruder's comments, SICA is studying the issue and has requested input from the ABA's Committee on SRO Relations and the ABA Task Force on Securities Arbitration. Views received to date as to the advisability of rule changes which would permit access to the courts in certain circumstances belie a lack of consensus on the most appropriate action to take.

A threshold question to be resolved is whether complex claims should be heard by arbitrators at all. However, the trend is for courts to find arbitration panels capable of resolving complex disputes.²⁴⁶ The development of adequate administrative procedures to handle complex matters such as prehearing conferences would aid the disposition of complex matters, but whether such procedures would undermine the very nature of arbitration must be considered.

If arbitrators are to decline to hear "complex" claims and refer such claims to the courts, the SROs must provide some guidance to the parties and the arbitrators and not rely on the discretion of a particular panel. The types of cases that perhaps should be remitted include: class actions, where all members of the class have not agreed to arbitrate; claims that also include claims against third parties who have not signed predispute arbitration agreements; and cases (including class actions) that require extensive discovery from third parties (including issuers) in order to render substantial justice.

Of greatest concern to those considering this issue are class actions, where it is often found that many, but not all of the claimants and defendants may be a party to an arbitration agreement. In those situations, a bifurcated proceeding will result, permitting some parties to conduct extensive discovery and litigate their claims in court, while other parties will be compelled to arbitrate without the benefit of those same procedures. Enforcing arbitration in such situations will require certification of separate classes—those subject to arbitration and those not—which have essentially the same claims. The exclusion of class actions *per se* from arbitration, however, is not appropriate because some class actions may involve intra-industry parties, all of which either would be subject to an agreement and would be required by the rules of the SRO to arbitrate or the nature of the claim would not require discovery from third parties.

245. See U.C.A. §§ 1, 5 (1980).

246. *Kronfeld v. Advest, Inc.*, 675 F. Supp. 1449, 1452-1453 (S.D.N.Y. 1987).

A compromise position which the securities industry should consider and which may be satisfactory to the SEC and Congress would prohibit a broker from declining to open a cash account if the customer refused to sign an arbitration agreement. Because many class actions involve claims relating to syndicated new offerings, such offerings may not be transacted through a margin account because credit cannot be extended to new offerings by syndicate members pursuant to section 11(d) of the Exchange Act. This would exempt most complex class actions that require discovery from third parties from mandatory arbitration.

There is always the possibility that difficulties will arise if rigid criteria for remittance are developed and, therefore, the effort should be directed at providing arbitrators with a list of considerations that should be reviewed prior to making a decision to decline jurisdiction. Another suggested alternative envisions a system that would rely upon the recommendations of a litigation counsel retained by the SRO. The expert would review cases and then suggest to the arbitrators which cases should be remitted.

B. Legislative Proposals.

Because the practice of requiring customers to agree to the arbitration of future disputes as a condition of doing business with a broker-dealer is perceived in some quarters as "anti-consumer," a nonpartisan call for legislative reform was heard in the 100th Congress. Consequently, legislation cosponsored by Representatives Rick Boucher (D-Va.), John D. Dingell (D-Mich.), Chairman of the Energy and Commerce Committee, and Edward J. Markey (D-Mass.), Chairman of the Telecommunications and Finance Subcommittee, was introduced on June 30, 1988.

The bill, House Resolution 4960, would have amended section 15(c) of the Securities Exchange Act of 1934 and "provide[d] for the fair, equitable, and voluntary arbitration of customer-broker disputes."²⁴⁷ To be known as the "Securities Arbitration Reform Act of 1988," the bill, at the outset, would have prohibited the use of predispute arbitration agreements between the customer and broker-dealer unless such agreement was entered into by the customer on a voluntary and informed basis.²⁴⁸ Furthermore, the SEC would be required to promulgate rules to enforce that requirement. The SEC rules, at a minimum, would have had to require a separate signature page for arbitration agreements, forbid the assessment of an additional fee upon those customers who choose not to sign the arbitration agreement, and include a prominent disclosure clause on the effects of signing the arbitration agreement.²⁴⁹ The bill also would have amended sections 6(b) and 15A(b) of the Arbitration Act, which address the duty of the SROs to provide rules to ensure "fair, equitable and expeditious resolution of con-

247. H.R. 4960, 100th Cong., 2d Sess., 134 CONG. REC. 2,233-2235 (1988).

248. *Id.* at 2234.

249. *Id.*

troversies and disputes."²⁵⁰ To accomplish this goal, the bill would have required, at a minimum, SRO rules that would make available adequate discovery, ensure the selection of an impartial panel, provide the customer with the arbitrators' biographical data, and mandate a written summary of the arbitrators' award.²⁵¹

It has been observed that the legislation as drafted revealed the sponsors' one-sided approach to the issues presented therein and a collective lack of knowledge about the arbitration process in general.²⁵² First, the Uniform Code of Arbitration always has provided that a majority of the panel be from the public sector. Second, arbitrators always have been empowered to order discovery and depositions, and with the recent amendment of section 20 of the Code, more formal guidelines will ensure greater compliance by the parties to such requests. Third, one of the advantages of arbitration is that disputes can be resolved quickly, inexpensively, and with finality. Written opinions only would encourage appeals and undermine the system. Finally, biographical data about the arbitrators currently is being provided pursuant to section 9 of the Code, thus making this proposal unnecessary.

A consensus could not be reached among the subcommittee members to proceed with the bill before the SEC received reports from the SROs on their reform activities. Thus, House Resolution 4960 died in subcommittee. Similar legislation, however, may be reintroduced in the 101st Congress.

1. SEC Response to Proposed Legislative Reform.

On July 7, 1988, the SEC met to consider a two-part recommendation concerning predispute arbitration agreements. One of the staff recommendations proposed legislation similar to a provision in House Resolution 4960 that would prohibit broker-dealers from making the signing of a predispute arbitration agreement by the customer a condition of doing business. An alternate staff recommendation would direct each SRO that currently provides arbitration forums to consider using its own rulemaking authority to achieve the same objective. Neither recommendation was acted on because the SROs and industry representative had assured the SEC that actions would be taken to address shortcomings in the system. During the subsequent subcommittee's hearings on the bill, Chairman Ruder stated that legislation is premature and that he would prefer to allow necessary changes to be made via the flexible approach of rulemaking through the SROs with SEC approval.

On the next day, the SEC, however, sent letters to the SROs requesting a review of current practices with respect to predispute arbitration clauses in options, margin, and cash accounts.²⁵³ The SROs were directed to file

250. *Id.*

251. *Id.*

252. Hoblin, *SECURITIES ARBITRATION: PROCEDURES, STRATEGIES, CASES 9* (Supp. 1988).

253. Letter from David S. Ruder, Chairman of SEC to all SRO's requesting study of predispute arbitration clause (July 8, 1988).

alternatives to the SEC's staff proposal for legislation by October 15. At the present time, the SEC staff is reviewing these submissions.

2. Regulatory and Legislative Reform at the State Level.

With federal legislation banning mandatory arbitration of securities disputes stalled in a House subcommittee, regulatory and legislative efforts moved rapidly at the state level. Massachusetts became the first state to promulgate regulations banning mandatory predispute arbitration agreements. In July 1988 the Massachusetts Securities Division proposed amendments to its broker-dealer regulation. The major thrust of the proposed regulation gave the customer of a brokerage firm the choice of whether or not to sign a predispute arbitration clause. Further, under the regulation, a broker-dealer may not condition the opening of an account upon the signing of an arbitration provision.²⁵⁴

The North American Securities Administrators Association (NASAA) voiced support of the proposal. An internal NASAA survey indicated that sixteen states that give regulators the power to adopt rules barring mandatory arbitration (and thus avoiding the legislative process) would consider similar restrictions on mandatory arbitration during the next six months. The sixteen states include Alaska, Colorado, Florida, Georgia, Idaho, Indiana, Iowa, North Dakota, Ohio, Oregon, Pennsylvania, South Dakota, Tennessee, Virginia, Washington and Wisconsin.²⁵⁵

Representatives of the securities industry registered their opposition to the proposal on numerous grounds. The president of the Securities Industry Association ("SIA"), Edward O'Brien, challenged the proposals as being preempted by the Federal Arbitration Act, thereby leaving "no room for a state legislative effort to subvert a private party's right to enter into binding predispute arbitration agreements."²⁵⁶ Another representative from the industry observed that the present system was efficient and cited the lack of any evidence that proves that the system is in fact unsatisfactory. Industry representatives also attacked the false impression that customers, who would prefer to litigate their claims, are denied access to the securities markets by

254. The general requirements and purposes of this regulation were stated in the filing prepared by the Securities Division of the Office of the Secretary of State of Massachusetts:

The regulation defines as a 'dishonest or unethical practice in the securities business' the requirement by a broker-dealer that a Massachusetts customer sign a mandatory predispute arbitration contract as a basis for doing business with the broker. It also requires that the broker conspicuously notify the customer of this requirement and requires that the legal consequences of signing such an agreement be explained to the customer. The purpose of the regulation is to provide the customer with a meaningful choice prior to making a decision to sign the agreement.

Regulation Filing prepared by the Office of the Secretary of State of Massachusetts, Securities Division, at 1 (Sept. 22, 1988).

255. News Advisory of North American Securities Admin. Assoc., at 1 (Sept. 22, 1988) (available from Wash. & Lee L. Rev.).

256. 20 Sec. Reg. & L. Rep. (BNA), No. 30, at 11219 (July 29, 1988).

mandatory predispute agreements. According to industry representatives, a recent SEC survey revealed that most brokerage houses do not require cash customers to sign the agreements. The securities industry also noted that margin account customers who wished to avoid mandatory predispute agreements could borrow funds from the bank rather than from a brokerage house.

On September 22, 1988, however, Massachusetts Secretary of State, Michael Connolly, announced in Washington, D.C. the adoption of the regulation.²⁵⁷ Representative Edward Markey (D-Mass.), who was present when Connolly made his announcement, applauded Massachusetts' effort to ban mandatory predispute agreements and urged other states to take similar action. Markey said that he intended to "continue the fight to return to investors their right to a day in court in the 101st Congress. . . ."²⁵⁸

Industry response to the announcement of Massachusetts' new state regulation was swift. On September 23, 1988, the SIA and ten broker-dealers filed a complaint seeking declaratory and injunctive relief.²⁵⁹ Moving rapidly to rule on the challenge prior to the new regulation's effective date, January 1, 1989, the court, on December 19, 1988, granted the plaintiffs'

257. MASS. REGS. CODE tit. 950, § 12.204 (1988), as amended by adding a new subsection, 12.204(a)(2)(G), reads in its entirety as follows:

G. *Dishonest or unethical practices in the securities business.*

1. *Broker-dealers.* Each broker-dealer shall observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business. Act and practices, including but not limited to the following, are considered contrary to such standards and constitute dishonest or unethical practices which are grounds for denial, suspension or revocation or registration or such other action authorized by law:

a. Requiring on or after January 1, 1989, that a customer located in Massachusetts, other than a customer that is an institutional investor or financial institution specified in 950 CMR 14.401(e), execute either a mandatory pre-dispute arbitration contract or a customer agreement containing a mandatory pre-dispute arbitration clause that is a non-negotiable precondition to effecting transactions in securities for the account of the customer or opening a securities cash account or margin account by the customer with such broker-dealer;

b. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory predispute arbitration contract or a customer account agreement containing a pre-dispute arbitration clause where the contract or agreement fails to conspicuously disclose that the execution of the contract or agreement cannot be made a non-negotiable precondition to the opening by the customer of a securities account with the broker-dealer;

c. Requesting on or after January 1, 1989, that a customer located in Massachusetts execute either a mandatory pre-dispute arbitration contract or a customer account agreement containing a pre-dispute arbitration clause without fully disclosing to the customer in writing the legal effect of the pre-dispute arbitration contract or clause;

d. Being found by a court of competent jurisdiction to have violated M.G.L. c.93A in connection with the sale of securities; and

e. Being temporarily or permanently enjoined by any court of competent jurisdiction from violating M.G.L. c.93A in connection with the sale of securities.

258. 20 Sec. Reg. & L. Rep. (BNA), No. 37, at 1436 (Sept. 23, 1988).

259. Securities Industry Assoc. v. Connolly, 703 F. Supp. 146 (D. Mass. 1988).

motion for summary judgment and enjoined the enforcement of the regulations. Agreeing with the rationale espoused by the SIA, Judge Woodlock ruled:

. . . Massachusetts Blue Sky Authorities are without power to enforce [the prospective regulations]. The . . . arbitration regulations are not merely state law supplementation concerning matters collateral to the validity and enforceability of arbitration agreements. Rather, they go to the heart of the process of forming contracts to arbitrate. In doing so, they single out arbitration agreements for more demanding standards than are imposed by the general law of contracts in Massachusetts. Consequently, I . . . declare the Massachusetts securities arbitration regulations pre-empted by the Federal Arbitration Act.²⁶⁰

The Commonwealth of Massachusetts appealed the decision. On August 31, 1989, the First Circuit affirmed the district court's decision and found that the regulations were preempted by the Federal Arbitration Act.²⁶¹

C. Industry Reform Efforts Relating to the Content and Disclosure of Arbitration Clauses.

The SEC in its September 1987 letter did not address the content and disclosure of predispute agreements to arbitrate in customer agreements. SICA, however, has responded to federal and state legislative efforts addressing the use of such agreements and has developed a proposed disclosure rule that would require the highlighting of not only the arbitration clause, but of specific language disclosing the effects of a customer's agreement to arbitrate disputes.²⁶²

260. *Id.* at 147.

261. *Securities Industry Assoc. v. Connolly*, No. 89-1022 (1st Cir. Aug. 31, 1989).

262. At its September 19, 1988 meeting, the following rule was approved by SICA: *Requirements When Using Pre-dispute Arbitration Agreements with Customers*

- (1) Any pre-dispute arbitration clause shall be highlighted and shall be immediately preceded by the following disclosure language which shall also be highlighted:
 - (a) Arbitration is final and binding on the parties.
 - (b) The parties are waiving their right to seek remedies in court, including the right to jury trial.
 - (c) Pre-arbitration discovery is generally more limited than and different from court proceedings.
 - (d) The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of rulings by the arbitrators is strictly limited.
 - (e) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.
- (2) Immediately preceding the signature line, there shall be a statement that the agreement contains a predispute arbitration clause which statement shall be initialed by the customer.
- (3) A copy of the agreement containing any such clause shall be given to the

CONCLUSION

In light of *Rodriguez*, arbitration is now the primary dispute resolution forum in the securities industry. As a result, the arbitration rules and procedures of SROs will come under even greater scrutiny. It is unlikely that the 101st Congress will adopt legislation because the SROs appear to be making many, if not all, of the changes at which House Resolution 4960 was directed. However, these changes and others that are likely to be mandated will make arbitration a far more formal dispute resolution forum. It also is highly probable that courts will develop additional theories on which to base a wider scope of review of arbitration awards.

customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(4) No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.

(5) The requirements of this section shall apply only to new agreements signed by an existing or new customer of a member after. . . .

Minutes of the Meeting of the Securities Industry Conference on Arbitration, at 1-3 & attachment B (Sept. 19, 1988) (available from Wash. & Lee L. Rev.).

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