Rodriguez de Quijas v. Shearson/American Express, Inc.: The Enforceability of Predispute Arbitration Clauses in Brokerage Firm Contracts

I. INTRODUCTION

In the literary world of poetry and novels, a scarlet "A" represents the act of adultery. In the legal world of securities regulation the "scarlet letter" represents an entirely different taboo. Many investors believe the "scarlet letter" should be worn by brokerage firms that incorporate predispute arbitration clauses in their customer account investment agreements.[1] In the twentieth century, however, people do not wear scarlet letters. Times have changed. We are currently living in a society where many taboos either have been accepted or no longer exist. With the decision of *Rodriguez de Quijas v. Shearson/American Express, Inc.*[2] the United States Supreme Court took the opportunity to eliminate one more legal taboo: the belief that disputes involving the sale of securities can only be competently resolved in a court of law and not by arbitration.

The purpose of this Note is to examine the Supreme Court's decision in *Rodriguez* and its impact on the arbitration of securities law disputes. The Note is organized into four parts. Part I is a general introduction to the relevant legislative and caselaw background of arbitrating securities disputes. Part II discusses the evolution of arbitrating securities disputes in the recent Supreme Court and circuit court decisions that led to the Court's granting certiorari to *Rodriguez*. Part III is a close examination of the Supreme Court's decision in *Rodriguez* and its ramifications in

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1. In July 1988, the North American Securities Administrators Association [NASAA] proposed a model rule that would restrict mandatory arbitration. NASAA stated that it intended to accomplish two goals with its model rule: (1) ban mandatory arbitration as a precondition for participation by individuals buying securities, and (2) balance the needs and rights of the securities industry and the investors. The proposed model rule called for the prohibition of all predispute clauses in written customer agreements and that all arbitration agreements be set out in a document separate from the standard written customer agreement. NASAA Securities Arbitration Reform Proposal, at 1. Massachusetts passed legislation, to become effective January 1, 1989, that would require brokers to provide Massachusetts investors with a choice in the signing of arbitration clauses when they entered into customer agreements. On December 19, 1988, the U.S. District Court of Massachusetts enjoined the Secretary of State of Massacusetts from enforcing the security regulations. The court held that the Massachusetts regulations were preempted by the Federal Arbitration Act and that they violated the supremacy clause of the Constitution of the United States. Securities Indus. Assoc. v. Connolly, 703 F. Supp. 146, 147 (D. Mass. 1988).

2. Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S. Ct. 1917 (1989), *vacating as moot*, 845 F.2d 1296 (5th Cir. 1988).

the securities industry. Finally, this Note concludes in Part IV that predispute arbitration agreements are properly enforceable in claims arising out of the Securities Exchange Act, and that the Supreme Court's decision in *Rodriguez* to overrule previous precedent against arbitrating securities disputes[3] was correct.

II. BACKGROUND

A. *The Federal Arbitration Act*

In order to understand the impact that arbitration has had on securities litigation, an understanding of the Federal Arbitration Act (FAA) and its creation is paramount.[4] Arbitration is nothing new. Judicial history describes American courts as clinging to the English courts' traditional aversion to arbitration, which consider it an usurpation of judicial power.[5] In 1925, Congress took its first deliberate step toward establishing a strong federal policy in favor of arbitration by enacting the FAA.[6]

Sections two and three of the FAA bear directly upon predispute arbitration agreements. Section two of the FAA provides that a written provision in a contract to arbitrate any dispute arising out of that contract shall be deemed "valid, irrevocable, and enforceable" to the same extent as any other provision of that contract, subject only to certain jurisdictional limitations.[7] Congress' intent behind this language was to codify

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3. Wilko v. Swan, 346 U.S. 427 (1953); *see infra* notes 13-20, 60-73 and accompanying text.

4. Federal Arbitration Act, ch. 213, 43 Stat. 883 (1925) (codified as amended at 9 U.S.C. §§ 1-14 (1982)).

5. Scherk v. Alberto-Culver Co., 417 U.S. 506, 510-11 n.4 (1974); Malcolm & Segall, *The Arbitrability of Claims Arising Under Section 10(b) of the Securities Exchange Act: Should Wilko Be Extended?*, 50 ALB. L. REV. 725, 728 (1986). *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1024-25 (2d ed. 1988). "In England before the Companies Act of 1900 the courts honored stipulations that bound the purchasers to waive the statutory liabilities as long as the stipulations were not too ["tricky."] Since the turn of the century, however, this ready means of evasion has been unavailable in England . . . ."

6. 9 U.S.C. § 2 (1982). *See also* Scherk v. Alberto-Culver Co., 417 U.S. 506, 510 (stating that the Federal Arbitration Act, enacted in 1925, reversed centuries of judicial hostility toward arbitration agreements). Congress wanted to find a method to promote arbitration because of the congestion in the courts. Precedent was too firmly entrenched to be overturned by the judiciary, so legislation [the FAA] was enacted. H.R.REP. No.96, 68th Cong., 1st Sess. 1-2 (1924).

7. 9 U.S.C. § 2 (1982):

> A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and

the common law duty of courts to enforce the terms of a valid contract.[8] In fact, the congressional committee that adopted the FAA explained:

> Arbitration agreements are purely matters of contract, and the effect of the bill is simply to make the contracting party live up to his agreement. He can no longer refuse to perform his contract when it becomes disadvantageous to him. An arbitration agreement is placed upon the same footing as other contracts, where it belongs.[9]

According to the FAA, federal courts may not exercise any discretion when determining whether there is a valid written agreement that governs a claim for arbitration.[10] The reviewing court may only decide whether a valid arbitration agreement exists between the parties and whether the claim before the court is in fact governed by the agreement.[11] If a federal court determines that a valid agreement exists, it must compel arbitration and stay court proceedings pending arbitration.[12]

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enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

8. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 220 n.7 (1985) (The FAA "creates no new legislation, grants no new rights, except a remedy to enforce an agreement in commercial contracts. . . .") (quoting 65 CONG. REC. 1931 (1924)).

9. H.R. REP. No.96, 68th Cong., 1st Sess., 1-2 (1924).

10. 9 U.S.C. §§ 3-4 (1982) (The FAA mandates that courts "shall" direct the parties to arbitrate issues covered by the arbitration agreement).

11. 9 U.S.C. § 4 (1982). *See* Miller v. Drexel Burnham Lambert, Inc., 791 F.2d 850, 854 (11th Cir. 1986) ("[A] court may not order arbitration until it is satisfied that a valid arbitration agreement exists. . . . Any claim of fraud, duress, or unconscionability in the formation of the arbitration agreement is a matter for judicial consideration. . . . Allegations of unconscionability in the contract as a whole, however, are matters to be resolved in arbitration."); *See, e.g.*, Galt v. Libbey-Owens-Ford Glass Co., 376 F.2d 711 (7th Cir. 1967).

12. 9 U.S.C. § 3 (1982):

> If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court . . . upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had.

Section 4 requires the court to decide the arbitrability of a claim and "upon being satisfied that the making of the agreement for arbitration or the failure to comply therewith is not in issue, the court shall make an order directing the parties to proceed to arbitration in accordance with the terms of the agreement." *See also* Sterk, *Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense*, 2 CARDOZO L. REV. 481, 488 (1981).

B. *The Supreme Court's Treatment of the FAA*

In 1953, the Supreme Court continued to harbor reservations about the applicability of the FAA. Its decision that year in *Wilko v. Swan*[13] reflected the Court's suspicion of the competence of arbitral tribunals and the desirability of arbitration.[14]

In *Wilko*, the Supreme Court faced an issue that required it to decide whether a dispute under section 12(2) of the Securities Act of 1933[15] (Securities Act), clearly arbitrable under the FAA, should be resolved by arbitration or by a court. The Court was confronted with two different Acts with "[t]wo policies, not easily reconcilable:" the desire to provide "an opportunity generally to secure prompt, economical and adequate solution to controversies" under the FAA on the one hand, and the desire to protect the rights of investors under the Securities Act on the other.[16] The FAA states that written arbitration agreements are valid and enforceable, and therefore, a court must comply with the arbitration agreement and stay any trial of the issues referable to arbitration.[17] On the other hand the Securities Act expresses the intention of Congress to void any agreement that waives compliance with any provisions of the Securities Act.[18]

The Court ultimately resolved this policy conflict in favor of the Securities Act.[19] The Court's rationale was that the statutory right to select a judicial forum was the kind of "provision" that Congress "must have intended" to be nonwaivable, and that the customer's agreement to arbitrate future disputes arising under the Securities Act was therefore void.[20]

Since *Wilko*, however, more recent Court decisions have amplified the full intent and focus of the FAA.[21] The Court has judicially recognized the existence of a "national policy favoring arbitration,"[22] and this national policy is what has caused an increasing number of courts to finally understand and enforce the strong congressional intent favoring arbitration agreements.[23] Many cases decided by the Supreme Court involved

13. Wilko v. Swan, 346 U.S. 427 (1953).
14. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 232 (1987).
15. *See infra* notes 39-48 and accompanying text.
16. Wilko v. Swan, 346 U.S. 427, 438.
17. *See supra* notes 4-12 and accompanying text.
18. 15 U.S.C. § 77n (1982).
19. Wilko v. Swan, 346 U.S. 427, 434-37.
20. *Id.*
21. *See, e.g.*, Southland Corp. v. Keating, 465 U.S. 1, 6-7 (1984); Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1 (1983).
22. Southland Corp. v. Keating, 465 U.S. 1, 10.
23. *See* Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 221 (1985).

arbitration issues, and consequently, in order to protect Congress' desire to enforce valid arbitration agreements, the Court created significant substantive law in defining the FAA.

In 1983, the Court in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*[24] affirmed its disapproval of the judiciary's past hostility toward arbitration as an alternative to the courts. The Court in *Moses H. Cone* held that a federal court was required by the FAA to compel arbitration even though a prior suit was pending in a state court for a declaratory judgment that the dispute was not subject to arbitration.[25] The Court's ruling was based on the rationale that the FAA represents a "liberal federal policy favoring arbitration agreements" which creates a liberal "body of federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the [FAA]."[26] In addition, the Court asserted that "the [FAA] establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. . . ."[27]

Relying on its rationale in *Moses H. Cone*, the Supreme Court later decided in *Southland Corp. v. Keating*[28] that the FAA preempted state courts from limiting arbitration. In *Southland*, the Court overturned a California state court decision that the arbitration agreement at issue could not be enforced because a California statute existed that invalidated such arbitration agreements.[29]

In 1985, the Court in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*[30] held in favor of arbitration in two very important circumstances. The Court's opinion first established that claims founded upon statutes can be arbitrated.[31] Justice Blackmun in his opinion for the majority stated, "[t]he [FAA] provides no basis for disfavoring agreements to arbitrate statutory claims by skewing the otherwise hospitable inquiry into arbitrability."[32] This analysis was then reinforced by the Court's rejection of the respondent's argument that claims under the antitrust laws should be resolved in a court based on public policy concerns. The Court held that antitrust claims can be resolved by arbitration even

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24. Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 3.
25. *Id.*
26. *Id.* at 24.
27. *Id.* at 24-25. ("[The FAA] *requires* piecemeal resolution when necessary to give effect to an arbitration agreement." *Id.* at 20. (footnote omitted) (emphasis in original)).
28. Southland Corp. v. Keating, 465 U.S. 1 (1984).
29. *Id.* at 3. "Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void." *Id.* at 10 (quoting CAL. CORP. CODE § 31512 (West 1977)).
30. Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985).
31. *Id.* at 614-15.
32. *Id.* at 627.

though "[t]he treble-damages provision wielded by the private litigant is a chief tool in the antitrust enforcement scheme, posing a crucial deterrent to potential violators."[33]

In *Shearson/American Express, Inc. v. McMahon*,[34] the Court in 1987 held that its decision in *Wilko* "was expressly based on the Court's belief that a judicial forum was needed to protect the substantive rights created by the Securities Act" and that arbitration was inadequate to enforce those rights.[35] Thus, the Court held in *McMahon* that *Wilko* must be read as barring waiver of a judicial forum only where arbitration is inadequate to protect and enforce the statutory rights at issue.[36] In the Court's review of the arbitrability of claims under the Securities Exchange Act of 1934 (Exchange Act), it decided it could no longer justify the *Wilko* Court's doubts concerning the effectiveness of arbitration: "[T]he mistrust of arbitration that formed the basis for the *Wilko* opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time."[37]

Given the Court's position in *McMahon*, it appeared that if *Wilko* were read as barring arbitration of all Securities Act claims, lower courts would continue to apply a rule which the Court carved away to practically nothing. That situation compelled many courts to reconcile *Wilko* and *McMahon* by concluding that the Court in *McMahon* intended to preclude arbitration of Securities Act claims only where there was a showing that arbitration could not adequately protect those claims.[38]

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33. *Id.* at 635. The *Mitsubishi* Court set out to reinforce the arbitration policies and to quiet the fear of arbitration set out in *Wilko*. The Court stated: " 'We are well past the time when judicial suspicion of the desirability of arbitration and the competence of arbitral tribunals should inhibit enforcement of the Act. . . .' " Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 226 (1987) (quoting Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 626-27). *Accord* Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24 (1983) (the FAA "is a congressional declaration of a liberal federal policy favoring arbitration. . .[and] questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration"); Southland Corp. v. Keating, 465 U.S. 1, 10 (1984) (in passing the FAA, "Congress declared a national policy favoring arbitration. . .[that] mandated the enforcement of arbitration agreements"); Scherk v. Alberto-Culver Co., 417 U.S. 506, 510-11 (1974). *See also* Wilko v. Swan, 346 U.S. 427, 439 (1953) (Frankfurter, J., dissenting) ("[t]here is nothing in the record. . .to indicate that the arbitral system. . .would not afford the plaintiff the rights to which he is entitled") (footnote omitted).

34. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220.

35. *Id.* at 228.

36. *Id.*

37. *Id.* at 233.

38. The Fifth and Tenth Circuit Courts of Appeals have stated that the rationale underlying *McMahon* renders agreements to arbitrate § 12(2) claims presently enforceable. *See* Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir.), *reh'g en banc denied*, 850 F.2d 1582 (1988) (per curiam); Peterson v. Shearson/American Express, Inc., 849 F.2d 464, 466 (10th Cir. 1988); DeKuyper v. A. G. Edwards & Sons, Inc., 695 F.

C. *The Securities Act of 1933*

In direct response to the 1929 stock market crash, Congress enacted federal legislation to regulate the sale of securities and to require complete disclosure in the registration of securites with the Securities and Exchange Commission (SEC).[39] The Securities Act was designed to protect the investing public from any imbalance in information between a company selling its securities and the investor.[40] Primarily, the Securities Act regulates the issuers, underwriters, and dealers engaged in the sale of securities.[41] The safeguards of the Securities Act require the seller of securities to file a registration statement with the SEC and to make full disclosure of all material facts surrounding the offering.[42] Section 12(2) of the Securities Act extends its investor protection by creating express liability for the sale of securities by means of false or misleading information.[43] This provision grants the investor a right to recover against a broker if there was any fraud committed or misrepresentations made by the broker during a sale.[44]

Section 12(2) is enforced by means of section 22(a) of the Securities Act, which is a jurisdictional provision that allows an investor to seek enforcement of a section 12(2) claim in any court of competent jurisdiction.[45] This right provides the investor with all the advantages normally

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Supp. 1367 (D. Conn. 1987), *aff'd upon reconsideration*, N-85-529 (EBB) (D. Conn. Nov. 23, 1988); Kavouras v. Visual Prod. Sys., Inc., 680 F. Supp. 205 (W.D. Pa. 1988); Hallal v. Merrill Lynch, Pierce, Fenner & Smith, Inc., No. 88 C 2405 (N.D. Ill. Dec. 13, 1988); Ryan v. Liss, Tenner & Goldberg Securities Corp., 683 F. Supp. 480 (D.N.J. 1988).

39. *See* S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). *See, e.g.*, Note, *Mixed Arbitrable and Nonarbitrable Claims in Securities Litigation: Dean Witter Reynolds, Inc. v. Byrd*, 34 CATH. U.L. REV. 525, 531-32 (1985).

40. Wilko v. Swan, 346 U.S. 427, 431 (1953).

41. *Id.*; Reader v. Hirsch & Co., 197 F. Supp. 111, 113-14 (S.D.N.Y. 1961).

42. Wilko v. Swan, 346 U.S. 427, 431. The Securities Act states that any person who . . . offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court or competent jurisdiction . . . ." 15 U.S.C. § 77l(2) (1982).

43. Section 12(2) provides the investor with a "special right" to recover for misrepresentation by the seller of a security; *see also* Wilko v. Swan, 346 U.S. 427, 431.

44. 15 U.S.C. § 77l(2).

45. 15 U.S.C. § 77v(a). Any suit brought under the Securities Act may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

afforded in an action brought in federal court, including a broad choice of venue and the availability of nationwide service of process.[46] Section 12(2) also implements three significant modifications to common law actions for fraud and misrepresentation: (1) it provides a statutory cause of action; (2) it gives a damaged buyer a wide choice of forum and venue, both state and federal; and (3) it changes the burden of proof from the buyer to the seller.[47] Finally, to further protect the investing public, the Securities Act ostensibly voids any attempt to circumvent or waive any of its provisions.[48]

D. *Securities Exchange Act of 1934*

The Exchange Act expands the federal regulation of the sale of securities in the Securities Act.[49] The Exchange Act regulates the markets in which securities are traded subsequent to their initial sale in an attempt to protect investors against stock price manipulation.[50] For instance, section 10(b) of the Exchange Act makes it unlawful for a seller of any security to engage in any fraudulent or deceitful practice.[51] Moreover, the Exchange Act prohibits the employment of untrue statements of material fact or the failure to state a material fact necessary to make a statement not misleading in light of the circumstances in which it was made during the sale of any security.[52]

The Supreme Court has stated that the Exchange Act and the Securities Act should be considered together; they should be read as one whenever possible.[53] There are, however, significant differences in the policy

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46. *Id.*; Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 224-25 (1985) (White, J., concurring).

47. 15 U.S.C. § 77v(a) (1982).

48. 15 U.S.C. § 77n. *See* A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38 (1941).

49. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1982).

50. H.R. REP. No. 1838, 73d Cong., 2d Sess. 33 (1934); *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

51. 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

52. *Id.*; *see generally* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-201 (discussion of scienter requirement in an action for damages under § 10(b)).

53. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 727-30 (1975). (Both of the Acts constitute interrelated components of a federal regulatory scheme for securities); *see*

and statutory construction of the two Acts. For instance, the language in the two Acts is different. In the Exchange Act, neither section 10(b) nor rule 10b-5, promulgated thereunder, has an express provision for a statutory cause of action.[54] Both section 10(b) and rule 10b-5 provide only that it is unlawful to engage in the proscribed conduct.[55] Thus, a private cause of action for a purchaser who has allegedly been injured by a violation of section 10(b)'s provisions must be judicially implied.[56] Section 12(2) of the Securities Act, however, expressly provides for a private cause of action.[57]

While the Exchange Act is intended to protect the public, its primary focus is on the creation and maintenance of an efficient and orderly capital market.[58] The Exchange Act manifested Congress' fear that U.S. capital, needed by the depression era economy, would be driven offshore unless action was taken to stabilize the U.S. securities markets.[59]

III. Treatment of Arbitration in the Courts

A. *Wilko v. Swan*

In 1950, the plaintiff in *Wilko* signed a contract with a securities brokerage firm that contained a predispute arbitration clause.[60] In 1951, after the stock purchased by the plaintiff was sold at a loss, the plaintiff filed a complaint alleging that he had been induced by his broker to

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also S.E.C. v. Kaplan, 397 F. Supp. 564 (E.D.N.Y. 1975); Brown v. Gilligan, Will & Co., 287 F. Supp. 766 (S.D.N.Y. 1968).

54. Comment, *The Case for Domestic Arbitration of Federal Securities Claims: Is the Wilko Doctrine Still Valid?*, 16 Sw. U.L. Rev. 619 (1986).

55. 17 C.F.R. § 240. Rule 10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) to employ any device, scheme, or artifice to defraud,
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> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

56. *See, e.g.*, Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985) (White, J. concurring); *see generally* Ruder, *Civil Liability Under Rule 10b-5*, 57 Nw. U.L. Rev. 627 (1963).

57. 15 U.S.C. § 77(a) (1982); *see supra* notes 42-44 and accompanying text.

58. 15 U.S.C. § 78b (the statute's stated purpose is "to remove impediments to and perfect mechanisms . . . to ensure maintenance of fair and honest markets . . . .")

59. S. Rep. No. 47, 73rd Cong., 1st Sess. 1 (1933).

60. Wilko v. Swan, 346 U.S. 427, 429 (1953).

purchase 1,600 shares of stock based on false representations made by the broker and that he suffered a loss on his investment as a result of the broker's misrepresentation and other omissions of information.[61] The plaintiff brought his claim for damages under section 12(2) of the Securities Act in the district court.[62] The defendants moved to stay a trial on the merits of the action pursuant to section 3 of the FAA.[63]

The district court[64] denied the stay pending arbitration and the Second Circuit Court of Appeals reversed.[65] The Supreme Court in turn reversed the court of appeals and held in a seven-to-two decision that the arbitration agreement was void under section 14 of the Securities Act.[66] The Court reasoned that section 14 represented the congressional intent to prohibit forum selection agreements such as predispute arbitration clauses.[67] The Court's decision seemed to be based on the belief that arbitration was deficient and thus not capable of protecting the rights afforded by section 12(2) of the Securities Act. The *Wilko* Court believed that arbitrators were not capable of making "subjective findings on the purpose and knowledge of an alleged violat[ion] of [section 12(2) and cannot make legal conclusions] without judicial instruction on the law."[68] The Court also stated that arbitration in and of itself was an inadequate method of protecting statutory rights because an arbitration award may be made without a complete record of the arbitration proceedings.[69] Finally, the Court was not satisfied that the grounds for judicial review of an arbitration award were sufficient because the power to vacate the award is limited and it cannot be appealed.[70]

Thirty-six years ago, *Wilko* stood for the proposition that a predispute agreement to arbitrate an express cause of action under section 12(2) was void.[71] Since 1953, however, the Supreme Court's decisions involving securities arbitration have represented a continuous reassessment of its

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61. *Id.*

62. *Id.* at 428.

63. *Id.* at 429 (citing 9 U.S.C. § 3 (Sup. V 1952)) (current version at 9 U.S.C. § 3 (1982)).

64. Wilko v. Swan, 107 F. Supp. 75 (S.D.N.Y. 1952).

65. Wilko v. Swan, 201 F.2d 439 (2d Cir. 1953).

66. Wilko v. Swan, 346 U.S. 427, 438 (1953). Section 14 provides "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or the rules and regulations of the [Securities and Exchange] Commission shall be void."

67. Wilko v. Swan, 346 U.S. 427, 438.

68. *Id.* at 435-36.

69. *Id.* at 436.

70. *Id.* at 436-37.

71. Fletcher, *Privatizing Securities Disputes Through the Enforcement of Arbitration Agreements*, 71 MINN. L. REV. 393, 405 (1987).

position in *Wilko*.[72] The Court's primary rationale for upholding arbitration is that arbitration is appropriate under certain circumstances based on the FAA. Presently, the Court's interpretation of section 12(2) of the Securities Act prohibits only predispute agreements waiving substantive liability.[73]

B. *Scherk v. Alberto-Culver Co.*

The Supreme Court began chipping away at *Wilko* in *Scherk v. Alberto-Culver Co.*[74] In *Scherk*, the American company Alberto-Culver decided to expand its overseas operations by purchasing a German enterprise and its trademarks.[75] The two companies negotiated and signed a contract whereby Scherk guaranteed that the trademarks were unencumbered.[76] In addition, the contract contained an arbitration clause referring all controversies or claims to the International Chamber of Commerce in Paris, France.[77]

Within a year after the agreement, Alberto-Culver discovered that the trademarks were subject to substantial encumbrances and sought to rescind the contract.[78] When Scherk refused the rescission, Alberto-Culver sued in federal court alleging misrepresentations in violation of rule 10b-5 of the Exchange Act.[79] Scherk sought to stay the federal court proceedings pending arbitration pursuant to the agreement.[80] The district court entered an order refusing to stay arbitration and the Seventh Circuit Court of Appeals affirmed, relying on *Wilko*.[81] The Supreme Court ultimately reversed, holding that "[t]he exception to the clear provisions of the FAA carved out by *Wilko* is simply inapposite to a case such as the one before us."[82]

In its analysis, the Supreme Court distinguished *Wilko* by creating a special niche for predispute arbitration agreements in the international arena.[83] The Court explained that the "crucial difference" between *Scherk* and *Wilko* was the fact that *Scherk* involved an international

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72. *Id.* at 408.
73. *Id.* at 405.
74. Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974).
75. *Id.* at 508.
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at 509.
80. *Id.*
81. *Id.* at 510.
82. *Id.* at 517.
83. *Id.* at 510-16.

agreement. Such a contract involves considerations and policies of communication, comity, fairness, and commerce significantly different from those found controlling in *Wilko*.[84] This type of international agreement precludes the possibility that one of the parties will be forced to press his claim in an inconvenient or hostile forum, or a forum unfamiliar with the subject matter of the dispute.[85]

After *Scherk*, trial courts usually ignored the Court's distinction between the express rights under the Securities Act and the implied rights in the Exchange Act and continued to apply *Wilko* to implied rights of action cases.[86] These lower courts interpreted *Scherk* as carving out a very narrow exception to *Wilko*.[87]

C. *Dean Witter Reynolds, Inc. v. Byrd*

The congressional policy favoring arbitration under the FAA found further support in the Supreme Court's 1985 decision in *Dean Witter Reynolds, Inc. v. Byrd*.[88] In 1981, A. Lamar Byrd invested $160,000 in securities through Dean Witter Reynolds, Inc. Before purchasing the securities, Byrd signed Dean Witter Reynolds' standard Customer's Agreement which stated that "[a]ny controversy between you and the undersigned arising out of or relating to this contract or breach thereof, shall be settled in arbitration."[89]

Seven months after Byrd made the investment, the value of his account dropped more than $100,000.[90] Byrd filed a complaint against Dean Witter in federal court alleging violations of sections 10(b), 15(c), and 20 of the Exchange Act, and various state law provisions.[91] These securities violations were the alleged result of several incidents. First, Byrd alleged that the Dean Witter Reynolds agent traded in his accounts without Byrd's prior consent; that the transactions executed within Byrd's account were excessive; and that the status of his account had

84. *Id.* at 515.

85. *Id* at 516.

86. As one commentator has observed, lower courts' repeated attempts to limit *Scherk* have "grossly misconstrued both the majority opinion in that case and the inclinations of the present Supreme Court. Judicial attempts to limit *Scherk* generally have taken two forms. First, some courts state that *Scherk* carved out a narrow exception to the *Wilko* doctrine for international agreements." Fletcher, *supra* note 71, at 412.

87. *Id.*

88. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985).

89. *Id.* at 215.

90. *Id.* at 214.

91. Exchange Act §§ 78j(b), 78o(c), and 78(t) (1982).

been misrepresented to him. Finally, Byrd alleged the agent acted with Dean Witter Reynolds' knowledge, participation, and ratification.[92]

Dean Witter Reynolds filed a motion to sever and compel the state law claims and to stay arbitration of those claims pending resolution of the federal court action.[93] Seemingly, as though relying on the *Wilko* doctrine, Dean Witter Reynolds failed to make any attempt to compel arbitration of the Exchange Act claims.[94] This failure to compel arbitration resulted in the issue not being properly before the Court.[95]

The district court and the Ninth Circuit Court of Appeals denied the motion to compel arbitration, and applied the doctrine of "intertwining."[96] This doctrine applies to situations in which arbitrable and nonarbitrable claims in the same transaction are factually and legally interrelated. Thus, because the claims cannot easily be separated, they are heard together before one court.[97] In a unanimous opinion, the Supreme Court reversed and rejected the doctrine of "intertwining" in strong language that affirmed the FAA mandate that predispute arbitration agreements be enforced.[98] The Court believed the "intertwining" doctrine to be inconsistent with the FAA because the FAA requires "piecemeal" litigation if both arbitrable and nonarbitrable claims are present.[99]

D. *Shearson/American Express, Inc. v. McMahon*

The final case in this line of securities arbitration decisions is *Shearson/American Express, Inc. v. McMahon.*[100] In *McMahon*, Eugene and Julia McMahon, the respondents, were customers of Shearson/American Express, Inc. under a customer agreement that required any controversy relating to their accounts to be arbitrated.[101] In October 1984, the

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92. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 214.

93. *Id.* at 215.

94. *Id.*

95. *Id.* at 215-16 n.1.

96. *Id.* at 216. Applied in the Fifth, Ninth, and Eleventh Circuits, the doctrine of "intertwining" precluded arbitration of otherwise arbitrable claims when a sufficient degree of intertwining was shown. These courts justified application of the intertwining doctrine upon the judicial efficiency achieved by avoiding bifurcated proceedings. *See, e.g.*, Raiford v. Buslease, 745 F.2d 1419 (11th Cir. 1984).

97. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 216-17 (1985).

98. *Id.* at 217. The Court relied heavily on its decision in Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp. as follows: "[The FAA] *requires* piecemeal resolution when necessary to give effect to an arbitration agreement." Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 20 (1983) (emphasis in original).

99. Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213, 217 (citing Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 20-21).

100. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987).

101. *Id.* at 222-23. The arbitration clause provided:

McMahons filed a complaint in district court against Shearson/American Express, Inc. and its registered representative handling their accounts, alleging violations of section 10(b) and rule 10b-5 of the Exchange Act and the Racketeer Influenced and Corrupt Organizations Act (RICO).[102] The district court judge determined that the McMahons must arbitrate all claims except the RICO claim.[103] On cross appeals, the Second Circuit reversed in part, and affirmed in part, holding that neither the Exchange Act nor the RICO claims were arbitrable.[104]

Justice O'Connor, speaking for the five-to-four majority, refused to apply the rationale behind *Wilko* in denying arbitration to claims arising under the Exchange Act because the *Wilko* Court's interpretation of the antiwaiver provision of the Securities Act was based on the Court's mistrust of arbitration.[105] The majority found it "difficult to reconcile *Wilko*'s mistrust of the arbitral process with this Court's subsequent decisions involving the [FAA]."[106]

Another very important part of the Court's rationale was its interpretation of the arbitrability of the Exchange Act claims.[107] In *Wilko*, the Court stated that the antiwaiver provision of the Securities Act prohibited waivers of one's rights to a judicial forum.[108] The *McMahon* Court, however, established that this was a misreading of the antiwaiver provision of the Securities Act, and that in fact, both the Securities Act and the Exchange Act do nothing more than prohibit waivers of substantive liability under the Acts.[109] This interpretation of *Wilko* made it easy for the Court to decide *McMahon* and was dispositive when it subsequently decided *Rodriguez*.

Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules, then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I may elect.

102. Shearson/American Express, Inc. v. McMahon, 618 F. Supp. 384 (1985).

103. *Id.*

104. Shearson/American Express, Inc. v. McMahon, 788 F.2d 94 (2d Cir. 1986).

105. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 228:

The conclusion in *Wilko* was expressly based on the Court's belief that a judicial forum was needed to protect the substantive rights created by the Securities Act. . . . *Wilko* must be understood, therefore, as holding that the plaintiff's waiver of the "right to select the judicial forum" . . . , was unenforceable only because arbitration was judged inadequate to enforce the statutory rights created by section 12(2).

106. *Id.* at 229-30 (Blackmun, J., concurring in part and dissenting in part).

107. *Id.* at 229.

108. *Id* at 228-29.

109. *Id* at 229.

E. *Circuit Split Since McMahon*

The continued viability of *Wilko* was called into question by several lower courts since the Court's opinion in *McMahon* seemed to undermine *Wilko's* rationale. The courts were left to choose between the rationales of *Wilko* and *McMahon*, and then cross their fingers and hope they made the correct choice. In *Chang v. Lin*,[110] the Second Circuit Court of Appeals followed the rationale in *Wilko* and refused to enforce a predispute arbitration clause in a customer agreement between the plaintiffs and Merrill Lynch, Pierce, Fenner & Smith. In the Second Circuit's decision, the court explained that although the Supreme Court had questioned the *Wilko* doctrine in its *McMahon* opinion, until the Supreme Court officially overruled *Wilko*, the Second Circuit would continue to refuse to enforce of predispute arbitration clauses under section 12(2) of the Securities Act.[111] The Third Circuit Court of Appeals came to the same conclusion in its decision in *Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[112]

These two appellate court decisions directly contradicted the Fifth Circuit's decision in *Rodriguez*. The court in *Rodriguez* believed that the *McMahon* decision mandated the enforcement of valid predispute arbitration agreements under section 12(2) of the Securities Act because "*McMahon* undercuts every aspect of *Wilko*" and "a formal overruling of *Wilko*, appears inevitable —or, perhaps, superfluous."[113] The Fifth Circuit was not alone. The Tenth Circuit, in *Peterson v. Shearson/American Express, Inc.*, also recognized that applying the rationale in *McMahon* to section 12(2) claims renders predispute arbitration agreements valid and enforceable.[114] Notwithstanding *Wilko*, the court of appeals stated in *Peterson* that "[i]n *McMahon*, the Supreme Court essentially overruled *Wilko* . . . [i]n so doing, the Court recognized arbitration as an acceptable method of dispute resolution under the [Exchange Act]."[115]

A direct conflict among the circuit courts as to whether *McMahon* or *Wilko* presently governs the enforceability of agreements to arbitrate section 12(2) claims clearly existed. The circuit courts, as well as district and state courts, continued to hold that either the rationale underlying

110. Chang v. Lin, 824 F.2d 219 (2d Cir. 1987).
111. *Id.* at 222.
112. Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 841 F.2d 508 (3d Cir. 1988).
113. Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1298 (5th Cir 1988) (citing Noble v. Drexel, Burnham, Lambert, Inc., 823 F.2d 849, 850 n.3 (5th Cir. 1987)).
114. Peterson v. Shearson/American Express, Inc., 849 F.2d 464 (10th Cir. 1988).
115. *Id.* at 466.

McMahon presently governs the securities arbitration, or that *Wilko* controls until the Supreme Court expressly overrules the case.[116] Without the Supreme Court's definitive resolution of this issue in *Rodriguez*, courts all over the country would have continued to contradict one another and litigants would have continued to forum shop and be unaware of what their rights really were under section 12(2) of the Exchange Act.

F. *Considerations for the Court in Rodriguez*

1. *Legislation Since McMahon.* Individual investors are skeptical about participating in capital markets they perceive to be dominated by institutions and insiders, believing the markets may even be rigged against them.[117] Investor confidence has been at an all-time low after the events of October 1987, and the attendant rise in market volatility. As a result, the Supreme Court knew that its decision in *Rodriguez* would send signals to both the small individual investor and the broker.

The Court's decision to apply *McMahon*'s rationale to claims under section 12(2) of the Securities Act may be interpreted by individual investors to mean that there is no longer a safe place for them in the capital market. An estimated 4,100 investors filed for arbitration of securities laws claims in 1987.[118] This was up from an estimated total of 800 investors who sought similar relief in 1980.[119] Arbitration was therefore up by more than 500 percent since 1980. This increase was the direct result of two key events: (1) the October 1987 stock market "crash," and (2) the *McMahon* decision in June 1987.[120] The market crash was estimated to result in at least a fifty percent increase in arbitration filings, and the *McMahon* decision was hailed by the securities industry as a "green light" for brokerage firms to include mandatory arbitration clauses in practically all written customer agreements.[121] It is clear that there is a very important need for a workable arbitral system in the securities industry.

Among state legislatures, Massachusetts was the first to respond to this national rise in securities arbitration. Shortly after the Supreme Court announced its *McMahon* decision, the Massachusetts Secretary of

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116. Respondents' Brief at 7; Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296.

117. *How Investors Can Avoid the Bind of Binding Arbitration*, Money Magazine, Sept. 1988, at 27.

118. North American Securities Arbitration Association [NASAA] Briefing Paper: Oversight of Securities Arbitration (June 1988), at 1; *see supra* note 1.

119. *Id.*

120. *Id.*

121. *Id.* at 1-2.

State proposed legislation that was to become effective on January 1, 1989.[122] Under this proposed law, the state of Massachusetts, acting under its Blue Sky law authority over brokers and dealers in securities, sought to control the circumstances under which a broker may require a noninstitutional customer located in Massachusetts to arbitrate disputes between them.[123] Massachusetts believed that arbitration was very important, especially for settling complaints that deal with small amounts. Massachusetts also believed, however, that arbitration should be a voluntary system; one that is fair, impartial, and open to public scrutiny, in addition to being inexpensive, accessible, and efficient.[124]

Before Massachusetts had a chance to see its new law take effect, the United States District Court in Massachusetts, on December 19, 1988, enjoined the Massachusetts Secretary of State from enforcing the statute.[125] The district court held that the Massachusetts law was preempted by the FAA and that it violated the supremacy clause of the Constitution of the United States.[126]

In response to *McMahon* and the attempted Massachusetts legislation, the North American Securities Arbitration Association (NASAA) developed a securities industry arbitration reform proposal. NASAA assigned to an Ad Hoc Arbitration Committee (Committee) the task of evaluating the operation, efficiency, and fairness of securities arbitration.[127] This Committee would recommend changes in the current securities arbitration system, and would create a proposed model regulation for future attempts at state securities legislation.[128] Modifications of broker-customer agreements and supervision of the arbitral process are steps which must be taken now to insure the protection of investors in the future. It is very possible that the Supreme Court took these post-*McMahon* developments into consideration when it decided *Rodriguez*.

2. *Arbitration: Settling For Less?* Critical to the arbitrability issue are the comparative advantages and disadvantages inherent in arbitration for the plaintiff-investor. Arbitration has many positive aspects. Generally, it is more time and cost efficient than traditional litigation because it eliminates the burdensome technicalities of litigation, such as the extremely high cost, the extensive motion filings, the long wait for trial, and the

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122. MASS. REGS. CODE TIT. 950, § 12:204(a)(2)(G)1.a-c (proposed Sept. 21, 1988) (held to be preempted by Federal Arbitration Act in Securities Indus. Assoc. v. Connolly, 703 F. Supp. 146 (D.Mass. 1988).

123. *Id.*

124. *Id.*

125. Securities Indus. Assoc. v. Connolly, 703 F. Supp. 146.

126. *Id.*; *see supra* note 1.

127. NASAA Securities Arbitration Reform Proposal (June 1988).

128. *Id.*

frustration commonly experienced by both sides.[129] These are advantages to both the broker and the investor. Another advantage of arbitration is that the parties themselves can decide a hearing date, and once a hearing date is set, most arbitrations are completed within a relatively short period of time.[130] Finally, an arbitrator knowledgeable in securities laws can be selected by the parties, and this in turn can save them the extra time and expense of educating a judge inexperienced in securities matters.[131]

A disadvantage of arbitration is that movement away from a federal forum to an arbitral forum may produce a very different final result on the same set of facts. Arbitration is a procedure that lacks a jury and a judge's written opinion.[132] Arbitrators are not bound by the rules of evidence and judicial review of an arbitrator's award is very limited.[133] Even with these disadvantages, however, the arbitration procedure still tends to resemble a trial. Both parties can call and cross-examine witnesses under oath.[134] In addition, parties can have a transcript of the hearing made and subpoena documents just as in a court proceeding.[135]

The securities industry has established a structure for arbitration so that the enforcement of contracts to arbitrate securities disputes will not dilute the protection of investors under the securities laws. Under the supervision of the SEC, the securities exchanges and the National Association of Securities Dealers, Inc. (NASD) provide arbitration facilities for disputes between investors and brokers.[136] In addition, the securities exchanges and the NASD each have permanent arbitration staffs and constitutions with detailed rules of arbitration procedures.[137]

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129. Robbins, *A Practioner's Guide to Securities Dispute Resolution*, 535 PRACTICING L. INST. 17, 22-26 (1986).

130. *Id.*

131. *Id.*

132. *See, e.g.*, 2 Am. Stock Ex. Guide (CCH); 2 N.Y.S.E. Guide (CCH) §§ 2600-38; UNIFORM CODE OF ARBITRATION; Bernhardt v. Polygraphic Co. of America, 350 U.S. 198, 203 (1956).

133. Bernhardt v. Polygraphic Co. of America, 350 U.S. 198, 203-04.

134. *See, e.g.*, 2 Am. Stock Ex. Guide (CCH) §§ 9546, 9551(B); 2 N.Y.S.E. Guide (CCH) § 2625; UNIFORM CODE OF ARBITRATION §§ 15-16, 26.

135. *See infra* note 141.

136. Brief for the Securities Industry Association as *Amicus Curiae* in Support of the Petition, Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir. 1988), at 8.

137. *Id.*; *see, e.g.*, Constitution of the New York Stock Exchange, Inc., Art. VIII, 2 N.Y.S.E. Guide (CCH) §§ 1351-57; Rules 600-634 of the New York Stock Exchange, Inc., 2 N.Y.S.E. Guide (CCH) §§ 2600-34; Code of Arbitration Procedure of the National Association of Securities Dealers, Inc., N.A.S.D. Manual (CCH) §§ 3701-43; Arbitration Rules of the American Stock Exchange, Inc., 2 Am. Stock Ex. Guide (CCH) §§ 9540-951J.

The SEC retains the jurisdiction to monitor the fairness of arbitration proceedings.[138] This jurisdiction allows the SEC to regulate arbitration procedures prescribed by self-regulatory organizations that enforce the rights of investors.[139] Furthermore, in order to avoid allegations of bias among the arbitrators toward the securities industry, the stock exchanges and the NASD keep permanent lists of available arbitrators.[140] These lists include senior securities industry personnel, lawyers, and other professionals with experience in the field.[141] Finally, the arbitration rules require panels of arbitrators to include members of the public.[142] These rules are reinforced with a safeguard that requires arbitrators to disclose any business affiliation with any of the parties involved in the dispute.[143] If there is a hint of conflict of interest, the arbitrator is automatically disqualified for cause.[144]

IV. RODRIGUEZ DE QUIJAS V. SHEARSON/AMERICAN EXPRESS, INC.

A. *Facts*

The petitioners in *Rodriguez* were four individual first-time investors.[145] In 1982, they began a financial relationship with Shearson/Leh-

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138. Securities Exchange Act, 15 U.S.C. §§ 78s (1982).

139. Brief of the Securities and Exchange Commission as *Amicus Curiae*, Shearson/ American Express, Inc. v. McMahon, 482 U.S. 220 (1987), at 8.

140. *See, e.g.*, Panel of Arbitrators 1986-1987, 1 Am. Stock Ex. Guide (CCH) §§ 157-59; N.A.S.D. Manual (CCH) § 3702; *see also* Brief of the Securities Industry Association as *Amicus Curiae*, in Support of the Petition, Rodriguez de Quijas v. Shearson/Lehman Bros. Inc., 845 F.2d 1296, at 9.

141. *Id.*

142. *See, e.g.*, 2 Am. Stock Ex. Guide (CCH) § 9541 (Rule 601); N.A.S.D. Manual (CCH) § 3719; 2 N.Y.S.E. Guide (CCH) § 2607 (Rule 607); UNIFORM CODE OF ARBITRATION § 8. These rules also require a majority of "public" arbitrators (i.e., unaffiliated with member firms) in disputes between public customers and member firms unless customer requests otherwise.

143. *See, e.g.*, 2 Am. Stock Ex. Guide (CCH) § 9542(f) (Rule 602(f)); N.A.S.D. Manual (CCH) § 3723; 2 N.Y.S.E. Guide (CCH) § 2610 (Rule 610); UNIFORM CODE OF ARBITRATION § 11.

144. *See, e.g.*, 2 Am. Stock Ex. Guide (CCH) § 9542(f) (Rule 602(f)); N.A.S.D. Manual (CCH) § 3723; 2 N.Y.S.E. Guide (CCH) § 2610 (Rule 610); UNIFORM CODE OF ARBITRATION § 11.

145. The four complaints filed by petitioners in the district court were consolidated for the purposes of appeal. The arbitration orders of the district court and court of appeals were identical for all four complaints. Brief for Respondent at 2 n.2, Rodriguez de Quijas v. Shearson/ Lehman Bros., Inc., 845 F.2d 1296 (5th Cir. 1988). The petitioners claim in their brief on the merits that no explanation was given to them about the customer agreement, which was allegedly presented to them face down with only check marks indicating where to sign. In addition, petitioners alleged that they frequently complained to the Shearson broker about the monthly investment statements because they were unintelligible

man Brothers, Inc. [hereinafter "Shearson"], and one of its financial consultants, Jon Grady Deaton.[146] Upon opening their brokerage accounts with Shearson, the petitioners were each asked to sign a Customer Agreement with Shearson. Each of these agreements contained a predispute arbitration provision which stated that should any dispute arise pertaining to the petitioners' accounts with Shearson, it would be settled by arbitration.[147]

In 1985, the petitioners all suffered financial losses as a result of alleged excessive unauthorized trading in their accounts and by false statements and omissions of material facts in the advice given to them by the Shearson broker.[148] The Rodriguez de Quijas family lost approximately $190,000; Mary Grace Norman lost approximately $38,000; Adelina Trapero lost $100,000; and Gene and Gertrude Griffin lost $80,000.[149] The petitioners filed individual complaints against Shearson and its broker Deaton in the U.S. District Court for the Southern District of Texas.[150] The complaints alleged violations of sections 12(2) and 17(a) of the Securities Act, sections 10(b), 15(c)(1), and 15(c)(2) of the Exchange Act, and rules 10b-5, 15cl-2, 15cl-4, and 15cl-6 promulgated thereunder, RICO, as well as common law claims of misrepresentation, fraud, and breach of contract.[151] Shearson moved to compel arbitration pursuant to the arbitration clause contained in each of the Customer Agreements and in accordance with the FAA.[152]

These individual suits were consolidated before the district court.[153] The district court granted Shearson's motion to stay proceedings pending

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to them. They were told to simply trust the broker. Brief for the Petitioners at 2-3, Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296.

146. Jon Grady Deaton, a defendant below, was not a party to the appeal before the Fifth Circuit or to Supreme Court proceeding because default judgments were entered against him in the district court. Brief for Petitioner at 3, Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296.

147. The arbitration agreements were entered into by the parties pursuant to § 3 of the Federal Arbitration Act, 9 U.S.C. § 1 (1982). The predispute arbitration clauses in the customer agreements were stated as follows:

> Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts, to transactions with you for me or to this agreement or the breach thereof, shall be settled by arbitration in accordance with the rules then in effect, of the National Association of Securities Dealers, Inc. or the Boards of Directors of the New York Stock Exchange, Inc. and/or the American Stock Exchange, Inc. as I [the customer] may elect.

Rodriguez, 845 F.2d 1296, 1297 n.2.

148. Rodriguez de Quijas v. Shearson/American Express, Inc., 845 F.2d 1296, 1297.

149. *Id.*

150. Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., No. B-85-360 (S.D.Texas filed Nov. 18, 1986).

151. *Id.*

152. *Id.*

153. *Id.*

arbitration of all the petitioners' claims except the claims under the Securities Act.[154] The district court judge based his decision not to enforce the arbitration clause with respect to the Securities Act claims entirely on *Wilko*.[155]

In the appeal of this case, the Fifth Circuit Court of Appeals confronted the issue of whether predispute arbitration agreements can be litigated under section 12(2) of the Securities Act.[156] In its very brief analysis, the court of appeals reversed the decision of the district court. The court relied on *McMahon*[157] and concluded that the Supreme Court's majority opinion in *McMahon* mandated enforcing a valid agreement to arbitrate claims.[158] The court of appeals in *Rodriguez* believed that similarities in the language of sections 10(b) of the Exchange Act and 12(2) of the Securities Act and the *McMahon* decision collectively undermined *Wilko*, thus precluding *Wilko's* application to *Rodriguez*.[159] Therefore, the court of appeals found section 12(2) claims to be arbitrable, notwithstanding the earlier contrary precedent of *Wilko*.[160] On November 14, 1988, the Supreme Court granted certiorari to hear *Rodriguez*.

B. *Majority*

On May 15, 1989, in a five-to-four split, the Supreme Court affirmed the Fifth Circuit's decision to apply the rationale of *McMahon* to claims brought under the Securities Act.[161] On behalf of the Court's majority, Justice Kennedy held that predispute agreements to arbitrate claims were enforceable under section 12(2) of the Securities Act,[162] and more

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154. Rodriguez de Quijas v. Shearson/American Express, Inc., No. B-85-360 (S.D. Tex. filed Nov. 18, 1986). The district court ruled that the petitioners' § 10(b) claims under the Securities Exchange Act of 1934 were arbitrable, but that their § 12(2) claims under the Securities Act of 1933 were not. The court's decision to arbitrate the § 10(b) claims was based on Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987), which held that agreements to arbitrate asserted under § 10(b) of the 1934 Act and RICO were enforceable.

155. *See supra* notes 13-20, 60-73 and accompanying text. *Wilko* held that an agreement to arbitrate a § 12(2) claim under the Securities Act of 1933 was prohibited by § 14 of the Act, as an agreement to waive the jurisdictional provision of the Act.

156. Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296 (5th Cir.), *reh'g en banc denied*, 850 F.2d 1582 (1988) (per curiam). The court of appeals denied petitioners' motion for an *en banc* rehearing of its opinion of June 22, 1988.

157. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220.

158. Rodriguez de Quijas, v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1298-99.

159. *Id.*

160. *Id.*

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

162. *Id.*

importantly, that federal courtrooms were no longer the exclusive judicial forums for resolving such disputes. Consequently, this holding culminated in what was ultimately the beginning of the end of *Wilko*.[163]

The Supreme Court's decision in *Rodriguez* analyzed the conclusions it had made in *Wilko* concerning its interpretations of the Securities Act, and why those conclusions no longer justify its outcome in *Wilko*. The Court agreed with the Fifth Circuit that the Court's subsequent decisions reduced *Wilko* to "obsolescence."[164] The Court stated that the legislative history and case decisions surrounding its interpretation of the Securities and Exchange Acts since *Wilko* made it impossible for the Court to support its decision in *Wilko* any longer.[165] For example, since the Court's decision in *Wilko* twenty-six years earlier, the SEC's authority to oversee and regulate arbitration procedures has expanded.[166] Moreover, the strong language of the FAA establishes that arbitration is an alternative method of dispute resolution which provides the same protection investors are afforded under the Securities Act.[167] Therefore, under this holding, all cases involving predispute agreements to arbitrate are enforceable without undermining the substantive rights that protect investors under the Securities and Exchange Acts.[168]

Before disposing of *Wilko*, the Court explained the two main reasons for its original holding in favor of the Securities Act rather than the FAA. First, it found that because the Securities Act offered a variety of judicial forums, the "right" to choose a forum was a valuable feature of the Securities Act that should be protected.[169] This right, as translated by the Court, meant that the right to choose a court did not also include the right to choose an arbitral forum.[170] The Court stated that the second reason for its decision in *Wilko* was that an arbitration did not resemble a trial closely enough to be considered a judicial forum under the Securities Act.[171] The Court admitted it had been insecure about the

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163. *Id.* at 1920.

164. *Id.* at 1919 (citing Rodriguez de Quijas v. Shearson/Lehman Bros., Inc., 845 F.2d 1296, 1299 (5th Cir. 1988)).

165. *Id.* at 1922 ("It also would be undesirable for the decisions in *Wilko* and *McMahon* to exist side by side.").

166. *Id.* at 1921 (citing Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 231-34 (1987)).

167. *Id.* at 1921 (Section 2 of the FAA grants relief where a party opposing arbitration can show that the arbitration agreement was the result of fraud or overwhelming economic power that would make the contract revocable); *see also* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S 614, 627 (1985)).

168. Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S.Ct. 1917, 1921 (1989).

169. *Id.* at 1919.

170. *Id.*

171. *Id.*

arbitral system in 1953, and this insecurity influenced its ultimate conclusion that arbitration could not sufficiently protect the investors' rights.[172]

Upon reviewing reasons in conjunction with the rationale of past decisions, the Court concluded that *Wilko* was an example of England's past judicial hostility toward arbitration.[173] Cases since *Wilko*, however, demonstrate the erosion of this hostility, and a shift by the Court in the direction of arbitration. The Court recognized that "[b]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial forum."[174]

Upon this realization, the Court changed its focus to the distinctions it made in *Wilko* between substantive and procedural provisions of the Securities Act.[175] The Court stated that it had improperly focused on whether a provision was waived by the parties, and that the Court's approach should have focused on what kind of provision was being waived and whether the investor remained on equal footing with the seller.[176] According to section 14 of the Securities Act, substantive provisions, such as who has the burden of proof, cannot be waived; otherwise, the purpose of the Act would falter.[177] The procedural provisions, however, such as service of process and venue, can be properly waived without harm to the investor.[178] The investor is still on equal footing with the seller because of the safeguard of concurrent jurisdiction.[179] Moreover, the Court relied on its other decisions to enforce predispute arbitration clauses under other federal statutes.[180]

The *Rodriguez* majority wanted to maintain the legal maxim of consistency. However, so long as *Wilko* and *McMahon* continued to coexist, there could be no consistency in securities law.[181] Investors would be able to continue to forum shop between courts and arbitral forums depending

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172. *Id.*

173. *Id.*

174. *Id.* (citing Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985)).

175. *Id.*; *see* Wilko v. Swan, 346 U.S. 427 (1953).

176. Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S.Ct. 1917, 1920 (1989).

177. *Id.*

178. *Id.* (There is no sound basis for construing the prohibition in § 14 on waiving "compliance with any provision" of the Securities Act to apply to these procedural provisions.)

179. *Id.*

180. *Id.*

181. *Id.* at 1922.

upon the securities act under which they filed their claim. The Supreme Court knew that something had to give, and that something was *Wilko*.

C. *Dissent*

Unlike Justice Blackmun's strong dissent in *McMahon*,[182] Justice Steven's dissenting opinion in *Rodriguez* was brief and almost apathetic.[183] Rather than reiterating the majority's faulty analysis, as was done in *McMahon*,[184] the dissent in *Rodriguez* simply expressed that it knew that it had finally lost the securities arbitration war on policy grounds. The dissent still believed that the Court's interpretation of a congressional Act in *Wilko* twenty-six years earlier was sound, and that although many strong arguments existed in favor of arbitration, all of them combined still could not create enough weight to overturn precedent.[185]

The dissent still believes it is 1953, and it still harbors deeply rooted judicial hostility toward arbitration. But, as stated at the introduction of this Note, times have changed considerably since *Wilko*, and arbitration is a result of the times. The majority in *Rodriguez* and *McMahon* based a substantial amount of its rationale on the fact that arbitration is not what it used to be. The Court emphasized that "[t]o the extent that *Wilko* rested on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants, it has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes."[186] It seems clear that the Supreme Court is finally ready to not only allow arbitration under the Securities and Exchange Acts, but to encourage it.

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182. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 242 (1987) (Blackmun, Brennan, & Marshall, JJ., dissenting in part).

183. Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S.Ct. 1917, 1922 (1989) (Blackmun, Brennan, Marshall, & Stevens, JJ., dissenting).

184. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 243-50. The *McMahon* dissent identifed three faults in the majority's opinion. First, that *Wilko* was read too narrowly, and that it properly stood for the fact that the text and legislative history of the Securities Act are why claims should be excluded from the FAA, not because of general problems with arbitration; second, that the problems of securities industry bias and arbitration procedure still existed; and third, that congressional amendments to the Exchange Act subsequent to the *Wilko* decision demonstrated Congress' approval of *Wilko* on Exchange Act claims.

185. Rodriguez de Quijas v. Shearson/American Express, Inc., 109 S.Ct. 1917, 1923.

186. *Id.* at 1920.

V. CONCLUSION

The ramifications of the *Rodriguez* decision are significant because it is now evident that the Court no longer harbors the fear of arbitration it had in *Wilko*.[187] In the wake of *Rodriguez*, the predispute agreement to arbitrate is enforceable for claims arising under both the Securities Act and the Exchange Act. Similarities between the two Acts, along with the Court's current favorable attitude toward arbitration, indicated that the Court in *Rodriguez* would overrule *Wilko*. Moreover, the similar language found in the two Acts, as well as their common goal of investor protection, further supports the conclusion that *Wilko*'s rationale should no longer apply. It seems clear that if arbitration is an adequate and fair forum for the resolution of Exchange Act and RICO claims, it should also be an adequate and fair forum for claims arising under the Securities Act.

Jean Rowley Robertson

187. Shearson/American Express, Inc. v. McMahon, 482 U.S. 220, 243. The dissenting opinion in *McMahon* recognized that "the Court effectively overrule[d] *Wilko*."