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SYMPOSIUM

CONTRACT THEORY AND SECURITIES ARBITRATION: WHITHER CONSENT?

Richard E. Speidel[†]

INTRODUCTION

This paper explores the role of consent in securities arbitration.¹ It examines the consensual underpinnings of the con-

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¹ By securities arbitration I mean both the contract to arbitrate between a customer and a broker-dealer and the arbitration rules and processes of a cognizant self regulating organization ("SRO"), such as the National Association of Securities Dealers ("NASD"). See Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183 (1996); see also IAN R. MACNEIL, RICHARD E. SPEIDEL & THOMAS J. STIPANOWICH, *FEDERAL ARBITRATION LAW: AGREEMENTS, AWARDS AND REMEDIES UNDER THE FEDERAL ARBITRATION ACT* ch. 13 (1994 & Supp. 1996); *New York Stock Exchange, Inc. Symposium on Arbitration in the Securities Industry*, 64 FORDHAM L. REV. 1121 (1995). These rules are incorporated by reference in the contract and regulated by the Securities Exchange Commission ("SEC"). Under the Securities Act of 1934, 15 U.S.C. § 78 (1994), a broker-dealer must register with the SEC and a self regulating organization. The SEC has power to regulate broker-dealers but has delegated some of that power to the SROs. Thus, broker-dealers registered with an SRO must submit to the rules of the SRO. The SRO, which performs a mix of private and public responsibilities, must be approved by the SEC and is subject to SEC oversight. Thus, SROs must file proposed rules, including arbitration rules, with the SEC, and no rule or rule change is approved unless it is consistent with the Securities Act. The SEC may take the initiative to abrogate, to add or to delete an SRO rule. 15 U.S.C. § 78d-f (1994). Although the line is difficult to draw, the courts have held that an SRO's actions when conducting or administering a securities

tract to arbitrate disputes arising between private parties—customers and broker-dealers—in a regulated industry.²

By consent I mean both an agreement to arbitrate, expressed in a signed writing, and the power of the parties to agree on the scope and nature of the arbitration process. Arbitration law, whether federal or international, requires a written agreement to arbitrate.³ The concern is how that agreement is manifested and validated and the content of the contract to arbitrate existing and future disputes.⁴

There are two sides to the consent coin. One side involves the power of private parties to create the contract to arbitrate,

arbitration are private rather than government action. See *Glennon v. Dean Witter Reynolds, Inc.*, No. 3-93-0847, 1994 WL 757709 (M.D. Tenn. Dec. 15, 1994), *aff'd*, 83 F.3d 132 (6th Cir. 1996); *First Heritage Corp. v. National Ass'n of Sec. Dealers, Inc.*, 785 F. Supp. 1250 (E.D. Mich. 1992). For a more detailed discussion, see Stephen J. Ware, *Employment Arbitration and Voluntary Consent*, 25 HOFSTRA L. REV. 83, 145-55 (1996). I will not discuss arbitration between employees and broker-dealers. See, e.g., Ware, *supra*, at 145-55; Developments in the Law: *Employment Discrimination*, 109 HARV. L. REV. 1670, § VI *Mandatory Arbitration of Statutory Employment Disputes* (1996). Nor will I discuss whether nonsignatories of a written agreement are, nevertheless, bound to arbitrate. See II MACNEIL, SPEIDEL & STIPANOWICH, *supra*, ch. 18.

² For the most recent regulatory phase, see Symposium, *The Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 975 (1996).

³ See 9 U.S.C. § 2 (1994): A "written provision . . . to settle by arbitration . . . or an agreement in writing to submit to arbitration . . . shall be valid, irrevocable, and enforceable . . ." United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *Id.* §§ 201-08.

⁴ Arbitration has three important characteristics: (1) agreement to the process by the parties; (2) adjudication by private arbitrators of the dispute after the parties have an opportunity for a fair hearing; and (3) finality of the award on the merits. See I MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 2.1.3; see also Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. REV. 81, 84-88 (1992) (arbitration characterized by private proceedings, subordination of substantive law, informal procedures, finality, expertise and lack of jury); Richard E. Speidel, *Arbitration of Statutory Rights Under the Federal Arbitration Act: The Case for Reform*, 4 OHIO ST. J. ON DISP. RESOL. 157, 158-67 (1989) (classic model of arbitration). The objective is to produce a system that is "cost effective, procedurally consistent, and fair, and capable, as a matter of course, of producing outcomes that are accurate and correct." Stephen Hayford & Ralph Peeples, *Commercial Arbitration in Evolution: An Assessment and a Call for Dialogue*, 10 OHIO ST. J. ON DISP. RESOL. 343, 414 (1995). The factors involved in choosing among arbitration and other methods of dispute resolution are analyzed in Robert A. Baruch Bush, *Dispute Resolution Alternatives and the Goals of Civil Justice: Jurisdictional Principles for Process Choice*, 1984 WIS. L. REV. 893; see Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996) (empirical study of arbitration practice in a particular industry).

state its terms, select arbitration rules and control administration of the process. How far may the parties go without running into the limitations of public policy? The other side—the darker side—involves the scope of freedom from contract which arises in the so-called contract of “adhesion.” How far may one party with superior bargaining power go to require arbitration, define the terms of the contract to arbitrate and control the procedures and processes of arbitration?⁵ It is fair to say that securities arbitration is located on the dark side of the arbitration coin, since the contract to arbitrate is essentially a contract of adhesion.

The contract to arbitrate securities disputes, as well as disputes arising under most commercial contracts, is governed by the Federal Arbitration Act (“FAA”).⁶ Thus, the requirement and role of consent must be assessed within this legislation, enacted by Congress in 1925, and interpreted by the Supreme Court and the other federal courts. This rich, complex and often controversial body of law creates the framework within which consent issues arise and are resolved. As we shall see, federal arbitration law celebrates the bright side of the consent coin when enforcing the contract to arbitrate and provides broad power to structure the arbitration process by agreement. On the darker side, however, the Court has interpreted the FAA in a manner that avoids validity and public policy questions. Power to regulate adhesion contracts and other disputes over arbitrability is left to Congress, the SEC and, under limited circumstances, to the states. The “freedom to contract” side of the consent coin, therefore, has flourished under the FAA while the darker side has been largely ignored.⁷

⁵ Questions of “freedom to” and “freedom from” contract are pervasive in the law of contracts. See Richard E. Speidel, *Afterword: The Shifting Domain of Contract*, 90 NW. U. L. REV. 254, 258-61 (1995).

⁶ 9 U.S.C. §§ 1-16.

⁷ The theme of increased contract enforcement by the Supreme Court at the expense of public policy and other defenses is identified and criticized in G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CAL. L. REV. 433 (1993). For other critiques of contract law in the Supreme Court, see Jean Braucher, *The Afterlife of Contract*, 90 NW. U. L. REV. 49, 61-69 (1995) (stating that Court has emitted a “blinding fog” of free market ideology that seems to have obscured reality); Daniel Farber, *The Ages of American Formalism*, 90 NW. U. L. REV. 89, 95-106 (1995).

*Shearson/American Express, Inc. v. McMahon*⁸ was an important milestone for securities arbitration on the enforcement side of the consent coin. There, the Supreme Court held that claims arising under the Securities Act of 1934 were arbitrable under the terms of a "broad" arbitration clause⁹ and, shortly thereafter, held that claims arising under section 14 of the Securities Act of 1933 were also arbitrable.¹⁰ Securities arbitration and the role of consent, however, are still in transition.

The nature of the transition and current problems are captured and assessed in the so-called Ruder Report, published in January 1996.¹¹ After reviewing and assessing the Ruder Report, Dean Joel Seligman concluded that consent in securities arbitration is a "legal fiction" and that "mandatory arbitration" is a more accurate characterization.¹² Although this assessment may overstate the problem, it pinpoints a clear trend. At a time when the post-*McMahon* Supreme Court is extolling the virtues of arbitration contract enforcement, the role and importance of consent in securities arbitration has withered.

Because important issues of public policy are involved, the question after Ruder is whether consent should be revitalized as a primary factor in securities arbitration or whether an unabashedly public law model of securities arbitration should

⁸ 482 U.S. 220, *reh'g denied*, 483 U.S. 1056 (1987).

⁹ The written arbitration clause in *McMahon* provided: "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." *Id.* at 223.

¹⁰ *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989) (overruling *Wilko v. Swan*, 346 U.S. 427 (1953)). These developments are treated in II MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, at 16-30.

¹¹ NATIONAL ASSOCIATION OF SECURITIES DEALERS, SECURITIES ARBITRATION REFORM: REPORT OF THE ARBITRATION POLICY TASK FORCE (1996) [hereinafter RUDER REPORT]; see Joel Seligman, *The Quiet Revolution: Securities Arbitration Confronts the Hard Questions*, 33 HOUS. L. REV. 327 (1996). For commentary on the Seligman article, see Brandon Becker, Commentary, 33 HOUS. L. REV. 369 (1996); John C. Coffee, Jr., Commentary, 33 HOUS. L. REV. 376 (1996); Richard E. Speidel, Commentary, 33 HOUS. L. REV. 385 (1996). For a summary of securities arbitration law prior to the Ruder Report, see Mahlon M. Frankhauser, *Arbitration: The Alternative to Securities and Employment Litigation*, 50 BUS. LAW. 1333 (1995).

¹² See Seligman, *supra* note 11, at 330, 339-46.

be developed by the SROs under a more aggressive SEC oversight. In short, should the SEC and the SROs intervene even more to insure fairness in the terms of the contract to arbitrate and to regulate the arbitration process? Unless the role of consent can be revitalized, the answer to this question is yes.

I. SUPREME COURT INTERPRETATION OF THE FAA: THE FRAMEWORK FOR CONSENT

In securities arbitration, the parties sign a written contract which contains a written arbitration clause that is quite broad: The parties typically agree that "all controversies which may arise between us, including but not limited to those involving any transaction or the construction, performance, or breach of this or any other agreement between us, whether entered into prior, on, or subsequent to the date hereof, shall be determined by arbitration."¹³ If a dispute arises and one party attempts to initiate arbitration, the other party might raise four consent (or arbitrability) related defenses under section 2 of the FAA:¹⁴ (1) there was no agreement in writing to arbitrate anything (the formation question); (2) the dispute involved or the remedy awarded was not within the scope of the written agreement to arbitrate (the scope question); (3) the written agreement to arbitrate was induced by fraud or duress, was entered by mistake, or was unconscionable (the validity defense); and (4) although the dispute is otherwise arbitrable, it was not suitable or appropriate for arbitration (the public policy exception). If a party is successful on any ground, arbitration will not be compelled.¹⁵

¹³ See SECURITIES INDUSTRY CONFERENCE ON ARBITRATION, UNIFORM CODE OF ARBITRATION §§ 1(a), 31 (1994).

¹⁴ FAA § 2 provides:

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

9 U.S.C. § 2 (1994).

¹⁵ Arbitrability issues may be raised by the petitioner's motion to compel arbitration under FAA § 4, 9 U.S.C. § 4, or to stay litigation pending arbitration un-

The Supreme Court has provided a purposeful, pro-enforcement interpretation of the FAA that has limited the viability of these defenses. Because *McMahon* is an important part of this process, the enforcement tale bears a brief retelling.¹⁶

First, the Court has interpreted the FAA to create and implement an "emphatic federal policy in favor of arbitral dispute resolution"¹⁷ and a "substantial federal concern for the enforcement of arbitration agreements."¹⁸ Except for disputes over whether the parties agreed to permit the arbitrators to decide questions of arbitrability,¹⁹ this liberal policy works as a tie breaker in interpretation and other disputes. It reflects a judgment that arbitration, on balance, is more efficient than litigation in resolving disputes²⁰ and that the federal contract to arbitrate should be enforced. But the Court has frequently stated that the preeminent concern of the FAA is to place pri-

der FAA § 3, 9 U.S.C. § 3. The issue may also be raised by a motion to enjoin arbitration or a motion for a declaratory judgment.

¹⁶ For a more detailed overview, see Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, SUP. CT. REV. 331 (1996); Stephen L. Hayford, *Commercial Arbitration in the Supreme Court 1983-1995: A Sea Change*, 31 WAKE FOREST L. REV. 1 (1996).

¹⁷ *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 631 (1985). The Court in *McMahon* stated that the FAA established a "federal policy favoring arbitration" and required that agreements to arbitrate be rigorously enforced. *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 226 (1987) (quoting *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 2 (1983)).

¹⁸ *Quackenbush v. Allstate Ins. Co.*, 116 S. Ct. 1712 (1996).

¹⁹ See *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920, 1925 (1995), where the Court held that the question whether a party had agreed to arbitrate anything other than disputes over the scope of an arbitration agreement was not aided by a "strong arbitration-related policy favoring" arbitration. The basic objective in disputes over contract formation is to enforce arbitration agreements according to their terms and "not to resolve disputes in the quickest manner possible, no matter what the parties' wishes." *Id.*; see *Leadertex v. Morganton Dyeing & Finishing Corp.*, 67 F.3d 20, 27-29 (2d Cir. 1995); *Alamria v. Telcor Int'l, Inc.*, 920 F. Supp. 658, 662-64 (D. Md. 1996) (restating FAA arbitrability principles). For a critique of the "presumption of arbitrability" prior to *First Options*, see Jonathan R. Nelson, *Judge-Made Law and the Presumption of Arbitrability*: David L. Threlkeld & Co. v. Metallgesellschaft Ltd., 58 BROOK. L. REV. 279 (1992).

²⁰ It also reflects an implicit judgment that civil court dockets are clogged and that arbitration is one way to deal with the problem. See *Shell*, *supra* note 7, at 517. *Shell* argues that if judicial economy is the tail that wags the arbitration dog, it ill serves the notion that courts, not arbitral tribunals, are the primary institution for dispensing public justice.

vate contracts to arbitrate "upon the same footing as other contracts."²¹ The liberal policy, therefore, is employed primarily to facilitate the equal enforcement objective.

Second, unless the parties have expressly agreed otherwise, federal courts rather than arbitrators decide questions of arbitrability raised by attacks on the arbitration clause itself. All other questions, including aspects of procedural arbitrability, are for the arbitrators if within the scope of the agreement to arbitrate.²² Thus, the courts rather than the arbitrators are usually in control of the enforcement process.

Third, the Court has interpreted the broad arbitration clause to include all claims related to the contract, including federal and state statutory claims designed to regulate the contract for the benefit of a class of protected persons, such as consumers or franchisees.²³ Unless the parties have agreed to exclude the regulatory claim, or Congress has clearly reserved the dispute for adjudication in court, the matter will be referred to arbitration.²⁴ This is the holding of *McMahon* where securities arbitration claims are involved. Lurking beneath this outcome is the Court's assumption that arbitrators are capable of deciding statutory claims and that such claims are appropriate for arbitration. The Court's justification for this conclusion is that unless Congress has stated otherwise, the nature of the claim is irrelevant since adjudication is simply shifted

²¹ *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1974) (quoting H.R. REP. NO. 96, 68th Cong., 1st Sess. 1, 2 (1924)); see *Doctor's Assocs., Inc. v. Casarotto*, 116 S. Ct. 1652, 1656 (1996).

²² This is the *Prima Paint* doctrine of "separability." *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967); see I MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 15.2-15.3.

²³ See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S. 614, 627-28 (1985). In rejecting a claimed presumption against including statutory claims in a broad arbitration clause, the Court refused "to color the lens through which the arbitration clause is read." *Id.* at 628; see generally Edward Brunet, *Arbitration and Constitutional Rights*, 71 N.C. L. REV. 81 (1992) (doubting compatibility of classical arbitration and constitutional rights); Edward M. Morgan, *Contract Theory and the Sources of Rights: An Approach to the Arbitrability Question*, 60 S. CAL. L. REV. 1059 (1987) (doubting arbitrability of "public policy" rights).

²⁴ See *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 24-27 (1991) (re-stating the principles).

from a court to an arbitral panel: The parties do not forego substantive rights, they simply submit them for resolution in an "arbitral, rather than a judicial, forum."²⁵

Fourth, the Court has interpreted the FAA's scope as coextensive with the power of Congress to regulate interstate commerce.²⁶ It has consistently held that within this broad scope, a state law that discriminates against or treats the federal contract to arbitrate differently from other contracts is preempted. Thus, a state statute that excludes state created claims otherwise within the scope of the federal contract to arbitrate from arbitration,²⁷ or state arbitration law that is inconsistent with federal arbitration law²⁸ or imposes different conditions on the enforceability of contracts to arbitrate than are imposed on other contracts, is not enforceable.²⁹ This preemption doctrine protects the enforceability of the federal contract to arbitrate, as interpreted by the Court, and effectively neutralizes state regulation of arbitration contracts subject to the FAA.³⁰

Fifth, defenses to arbitrability under the so-called "savings clause" of FAA section 2, such as fraud, duress, mistake and unconscionability, or disputes over interpretation are to be determined by the courts under applicable general, nondiscriminatory state law. There is no federal common law for these validity defenses. Thus, a federal court must find and apply the applicable state law of, say, unconscionability, unless that law discriminates against the federal arbitration contract. In short, the fact, meaning and quality of consent underlying the federal contract to arbitrate are determined by generally applicable state law.³¹

²⁵ See *id.* at 26 (quoting *Mitsubishi*, 473 U.S. at 628).

²⁶ *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265 (1995).

²⁷ *Southland Corp. v. Keating*, 465 U.S. 1 (1984) (FAA creates a substantive rule applicable in state and federal courts and forecloses state legislative attempts to undercut the enforceability of arbitration agreements by withdrawing an included claim from arbitration); see *Perry v. Thomas*, 482 U.S. 483 (1987) (FAA preempts state legislation that permits wage collection action to be maintained without regard to existence of private agreement to arbitrate).

²⁸ See *Dobson*, 513 U.S. 265 (1995) (holding that state legislation refusing to enforce an agreement to arbitrate future disputes was inconsistent with and, thus, preempted by FAA § 2).

²⁹ *Doctor's Assocs., Inc. v. Casarotto*, 116 S. Ct. 1652 (1996) (state statute singling out contract to arbitrate for higher standards for disclosure preempted).

³⁰ The preemption doctrine has been harshly criticized by the commentators. See, e.g., Shell, *supra* note 7, at 482-86.

³¹ State law is relevant to three questions that arise under FAA § 2: (1) for-

Finally, to date, the Court has not squarely considered the scope of review of a final arbitration award where statutory or regulatory claims are involved. Under section 10(d) of the FAA, an award may be vacated "where the arbitrators exceeded their authority, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter was not made."³² This covers many excesses of consent by arbitrators. Otherwise, the scope of review under FAA section 10 is quite narrow,³³ and the oft mentioned non-statutory defense of

mation of the contract to arbitrate; (2) interpretation of the contract to arbitrate; and (3) defenses to the enforcement of the contract to arbitrate the "savings" clause in FAA § 2. Subject to the "liberal" policy favoring arbitration, the courts should apply general principles of nondiscriminatory, applicable state law to each question. The Court's explanation of how defenses to contract enforcement under the "savings" clause should be treated follows these lines. The Court concedes that a party "may assert general contract defenses such as fraud to avoid enforcement of an arbitration agreement." *Southland*, 465 U.S. at 16 n.11. As *Mitsubishi* put it: "[C]ourts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for the revocation of any contract.'" *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S. 614, 627 (1985). In *Perry*, the Court distinguished between the enforcement of the contract to arbitrate, which was a matter of federal law, and defenses under the "savings" clause, which are a matter of state law: "Thus, state law, whether of legislative or judicial origin, is applicable if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally." 482 U.S. at 493 n.9. This distinction was followed in *First Options of Chicago, Inc. v. Kaplan*, 115 S. Ct. 1920 (1995): The court must apply ordinary state law principles that govern contract formation, with a higher degree of consent where the question of "who" is to decide arbitrability is raised. *Id.* at 1924. The distinction between general principles of state law and discriminatory principles was tested in *Doctor's Associates*, where state law denied enforcement only to arbitration contracts where notice of arbitration was not typed in underlined capital letters on the first page of the contract. 116 S. Ct. 1652 (1996). Since the parties did not agree that state arbitration law should govern, the Court, relying on *Southland* and *Perry*, held that the state discriminatory regulation was preempted. *Id.* at 1656. In *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995), on the other hand, the court applied nondiscriminatory and applicable state contract law to assist in interpreting an ambiguous contract. In holding that the agreement did not exclude punitive damages from the arbitrator's remedial powers, the Court also factored in the "liberal" federal policy favoring arbitration.

³² See IV MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 40.5.

³³ Restated, the grounds to vacate an award under FAA § 10 are limited to cases where: (1) the award was procured by "corruption, fraud, or undue means"; (2) there was "evident partiality or corruption" in the arbitrators; (3) the arbitrators were guilty of misconduct or misbehavior that prejudiced the rights of any party; and (4) the arbitrators exceeded their powers to so imperfectly execute them that a "mutual, final and definite" award was not made. 9 U.S.C. § 10 (1994).

"manifest disregard of law" has not received an authoritative interpretation by the Court.³⁴ The potential for that review, however, seems to have appeased some critics of the Court's purposeful, one-track approach to disputes over arbitrability.³⁵ For example, suppose the parties agree that the arbitration is governed by New York arbitration law and New York law has a special rule precluding punitive damages in arbitration. An award of punitive damages might be vacated under FAA section 10 if the arbitrator exceeded its authority (i.e., applied Illinois law) and under the "manifest disregard" standard if the arbitrator knew about the special New York preclusion and chose to ignore it. Otherwise the merits are insulated from the judicial review.

In sum, *McMahon* is simply one piece of the Court's purposive interpretation of the FAA which exalts consent in creating, defining and enforcing the federal contract to arbitrate. Under a broad arbitration clause, all disputes, including those arising under state and federal regulatory legislation, are within the scope of the contract to arbitrate and are appropriate for arbitration. On the other hand, state law that withdraws state created claims from arbitration or regulates the validity of the federal contract to arbitrate in a discriminatory manner is preempted, and federal statutory or constitutional claims are arbitrable unless Congress has specifically excluded them from arbitration. With state regulation effectively neu-

³⁴ In *First Options of Chicago*, the Court, in dictum, went out of its way to note that "manifest disregard of the law" was a nonstatutory ground to vacate an award. This is a "very narrow standard of review," and the award will be confirmed if the Court "can find any line of argument that is legally plausible and supports the award." *Merrill Lynch, Pierce, Fenner & Smith v. Jaros*, 70 F.3d 418, 421 (6th Cir. 1995); see *Shearson/American Express Inc. v. McMahon*, 482 U.S. at 232, where the Court mused: "Finally, we have indicated that there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute." See Michael P. O'Mullan, *Seeking Consistency in Judicial Review of Securities Arbitration: An Analysis of the Manifest Disregard of the Law Standard*, 64 *FORDHAM L. REV.* 1121 (1994); see also Stephen L. Hayford & Scott B. Kerrigan, *Vacatur: The Non-Statutory Grounds for Judicial Review of Commercial Arbitration Awards*, 51 *J. DISP. RESOL.* 22 (1996).

³⁵ For example, for purposes of *Honda Motor Co. v. Oberg*, 512 U.S. 415 (1994), the Sixth Circuit has recently held that the availability of review for manifest disregard of the law is a "meaningful review" of punitive damage awards. *Glennon v. Dean Witter Reynolds, Inc.*, 83 F.3d 132, 138-39 (6th Cir. 1996).

tralized and Congress apparently reluctant to exercise its prerogative to exclude claims, the power to create and enforce the federal contract to arbitrate is, as a practical matter, unrestricted.³⁶ To what extent, then, do the parties have broad power to shape and control the arbitration process to which they have both manifested assent?

II. POWER TO CONTRACT: THE *VOLT* CASE

Within this protected environment, the Court has polished the bright side of the consent coin in arbitration under the FAA. In *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University*,³⁷ the Court held that the parties could, if they intended, choose state law, including its arbitration law, to govern a contract to arbitrate otherwise within the scope of the FAA. In choosing California law under a broad choice of law clause, the parties intended to be bound to a provision in the arbitration law permitting a stay of arbitration pending litigation, even though there was no such provision in the FAA. Without the choice of California law, the provision would probably have been preempted by the FAA. Among other things, the Court stated that "arbitration under the Act is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit."³⁸ Private ordering, then, is permitted and encouraged in the expansive area between state preemption by the FAA and congressional inaction.

In the absence of coercion and the like, two questions remain after *Volt*: (1) how far can the parties go in exercising

³⁶ On the state preemption question, Paul D. Carrington has complained that the "Court has . . . transmogrified the 1925 Act to preempt the state law that it was enacted to protect Thus, even state legislatures are disempowered to provide that the laws they enact may be enforced in court notwithstanding adhesion contract clauses calling for arbitration." Paul D. Carrington, *ADR and Future Adjudication: A Primer on Dispute Resolution*, 15 REV. LITIG. 485, 501 (1996).

³⁷ 489 U.S. 468 (1989). For a perceptive comment, see Arthur S. Feldman, *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University: Confusing Federalism with Federal Policy Under the FAA*, 69 TEX. L. REV. 691 (1991).

³⁸ *Volt*, 489 U.S. at 479.

their power to contract under the FAA?, and (2) how clear must they be when attempting to do so? Both will be treated in this Section.

A. *Power to Contract*

In *Doctor's Associates, Inc. v. Casarotto*,³⁹ a case where there was no choice of law clause, the Court stated what appears to be the guiding spirit of *Volt*:

Volt involved an arbitration agreement that incorporated state procedural rules, one of which, on the facts of that case, called for arbitration to be stayed pending the resolution of a related judicial proceeding. The state rule examined in *Volt* determined only the efficient order of proceedings; it did not affect the enforceability of the arbitration agreement itself. We held that applying the state rule would not "undermine the goals and policies of the FAA" . . . because the very purpose of the Act was to "ensur[e] that private agreements to arbitrate are enforced according to their terms."⁴⁰

How far can the parties go in developing a tailor-made contract to arbitrate under the FAA?⁴¹ Assuming that there is some written agreement to arbitrate,⁴² the lower courts have pushed the *Volt* principle to the edge of federal policy favoring enforcement. The arbitration agreement can limit the scope of the agreement to arbitrate⁴³ and select the administering institution and the applicable procedural rules. In addition, the agreement can exclude certain statutory claims,⁴⁴ specify the details of the arbitral process, including the selection of arbitrators,⁴⁵ confer broad remedial powers on the arbitrators,⁴⁶

³⁹ 116 S. Ct. 1652 (1996).

⁴⁰ *Id.* at 1656-57.

⁴¹ Suppose, for example, the parties agreed that an agreement to arbitrate future disputes arising under the contract was not enforceable; or that state arbitration law requiring conspicuous and clear language before an agreement to arbitrate is enforceable and should apply?

⁴² See *In re A.H. Robbins Co.*, 42 F.3d 870, 875 (4th Cir. 1994) (parties in class action agree to arbitrate dispute).

⁴³ See *McMahan Co., L.P. v. Forum Capital Mkts., L.P.*, 35 F.3d 82, 86 (2d Cir. 1994) (claim for misappropriation of assets was within scope of arbitration agreement).

⁴⁴ See, e.g., *Wolf v. Gruntal & Co.*, 45 F.3d 524, 527 n.3 (1st Cir. 1995) (agreement excludes federal securities law claims); *accord*, *Wiepking v. Prudential-Bache Sec. Inc.*, 940 F.2d 996, 998 (6th Cir. 1991); *Blue Gray Corps I & II v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 921 F.2d 267, 269 (11th Cir. 1991).

⁴⁵ See *Universal Reinsurance Corp. v. Allstate Ins. Co.*, 16 F.3d 125, 129 (7th

choose the situs for arbitration and the applicable substantive law, and spell out the conditions for enforceability of the award. Even without *Volt*, the power to contract in these situations is clear.

The *Volt* principle, however, has been extended to agreements expanding the FAA's grounds for judicial review and vacation of arbitral awards. Thus, in *Gateway Technologies, Inc. v. MCI Telecommunications Corp.*,⁴⁷ the court enforced an agreement permitting the courts to review an award for errors in law even though that sort of review would not be available under FAA section 10 or the "manifest disregard of law" exception. Since the agreement in *Gateway* was clear and otherwise enforceable, the court concluded that it was supported by *Volt* even though it limited the finality of awards under FAA section 10.⁴⁸

Despite the enforcement limitation expressed in *Casarotto*, the parties under *Volt* should be able to choose state law that conflicts or is inconsistent with the FAA and which, without such an agreement, would otherwise be preempted. For example, if the parties can agree to limit arbitration to existing rather than future disputes, or to exclude certain claims arising under state law, or to grant the arbitrator remedy power not available under the FAA, they should be able to choose state law that accomplishes those same objectives.⁴⁹ For ex-

Cir. 1994) (arbitrator selection procedure), *reh'g denied*, No. 92-1559, 1994 U.S. App. LEXIS 4828 (7th Cir. Mar. 16, 1994).

⁴⁶ Raytheon Co. v. Automated Business Sys. Inc., 882 F.2d 6, 11 n.5 (1st Cir. 1989) (discussing punitive damages under American Arbitration Association ("AAA") rules).

⁴⁷ 64 F.3d 993 (5th Cir. 1995); *accord*, Collins v. Blue Cross Blue Shield of Mich., 916 F. Supp. 638 (E.D. Mich. 1995); Fils Et Cables D'Arcier De Lens v. Midland Metals Corp., 584 F. Supp. 240 (S.D.N.Y. 1984).

⁴⁸ The court noted that arbitration "is a creature of contract" and after reviewing relevant decisions of the Supreme Court, concluded: "Because these parties contractually agreed to expand judicial review, their contractual provision supplements the FAA's default standard of review and allows for de novo review of issues of law embodied in the arbitration award." *Gateway*, 64 F.3d at 996-97. This reasoning, however, was rejected in *Lapine Technologies Corp. v. Kyocera Corp.*, 909 F. Supp. 697 (N.D. Cal. 1995), an international arbitration. The court limited *Volt* to agreements varying or providing for arbitration procedures, not cases where the FAA itself was expanded. According to the *Lapine* Court, agreements of this sort are against public policy because they detract from the speed and finality of arbitration.

⁴⁹ See *Ekstrom v. Value Health, Inc.*, 68 F.3d 1391, 1395-96 (D.C. Cir. 1995)

ample, suppose the arbitration agreement clearly provided that: (1) the arbitrator has power to award punitive damages; (2) the availability of punitive damages on the merits is determined by New York law; or (3) a court may review an arbitrator's punitive damage award for errors of law. All three of these provisions are potentially enforceable by a court if arbitration truly is a creature of contract. Thus, within that broad area where the power to contract can coexist with the liberal policy favoring enforcement, the rhetoric of "freedom to arbitrate" is alive and well under the FAA.

B. Interpretation

It is one thing to have power to contract and quite another to exercise that power in a balanced and clear manner. Consider punitive damages and the *Mastrobuono*⁵⁰ case. Under New York law, arbitrators, as a matter of public policy, do not have power to make punitive damage awards.⁵¹ Under the FAA, however, the arbitrators apparently have such power if the parties so agree.⁵² The potential for federal preemption of state arbitration law on punitive damages therefore clearly exists. Under a broad reading of *Volt*, however, the conflict can be avoided if the parties agree either to permit the arbitrators to award punitive damages or to deny that power.

In *Mastrobuono*, a securities arbitration case, the investor signed a written, standard form that contained a broadly worded clause choosing New York law. The clause did not clearly say "New York arbitration law" and did not mention punitive damages. Even though the choice of law agreement was no more precise than that in *Volt*,⁵³ the Court found an ambigu-

(choice of Connecticut arbitration law means that motion to vacate award must be filed within 30 days even though FAA permits 90 days to file); see also *Olde Discount Corp. v. Tupman*, 1 F.3d 202, 215 (3d Cir. 1993) (Rosen, J., concurring), cert. denied, 510 U.S. 1065 (1994).

⁵⁰ *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995); see Kenneth R. Davis, *Protected Right or Sacred Rite: The Paradox of Federal Arbitration Policy*, 45 DEPAUL L. REV. 65 (1995).

⁵¹ *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 355, 353 N.E.2d 793, 794, 386 N.Y.S.2d 831, 832 (1976); see Aaron J. Polak, *Punitive Damages in Commercial Contract Arbitration—Still an Issue After All These Years*, 10 OHIO ST. J. ON DISP. RESOL. 41 (1994).

⁵² This power was confirmed in *Mastrobuono*, 115 S. Ct. at 1216.

⁵³ The dissent of Justice Thomas makes much of this point. *Id.* at 1219

ity in the contract and, in a process that drew upon general state law principles applicable to the interpretation of standard form contracts and the "liberal" policy, construed the agreement not to incorporate the New York arbitration limitation. Thus, the preemption problem was avoided through an interpretation process that construed ambiguous standard form contracts against the drafter, the broker-dealer. But the power of the parties clearly to include or deny punitive damage awards under the FAA was not questioned. The issue was simply the clarity with which the power to contract was exercised.⁵⁴

In sum, *Volt* and *Mastrobuono* speak directly to the power of the parties to deal with punitive damages and other terms in the contract to arbitrate securities disputes under the FAA. In the absence of federal regulatory restraints, the arbitrator may be granted or denied power to award punitive damages by a clearly expressed term in the contract. Whether that term is a well drafted choice of law provision or a more specific term is immaterial.

III. CONTRACTS OF ADHESION: THE DARK SIDE OF ARBITRATION

As *Mastrobuono* reveals, most contracts to arbitrate in the securities industry have the characteristics of adhesion contracts.⁵⁵ These "take it or leave it" contracts to arbitrate raise

(Thomas, J., dissenting).

⁵⁴ Where *Mastrobuono* leaves us depends upon how one reads *Volt*. Professor Davis, for one, criticizes the Court in *Mastrobuono* for coloring the interpretation process with an implicit antipathy to the New York punitive damage rule but, under *Volt*, would not enforce a clear agreement to adopt state law that conflicts with the FAA. See Davis, *supra* note 50, at 73, 81-85. Others view *Mastrobuono* as an interim defense against contracts of adhesion, but would not deny the power to adopt conflicting state law by clear agreement. See Heather J. Haase, *In Defense of Parties' Rights to Limit Arbitral Awards Under the Federal Arbitration Act: Mastrobuono v. Shearson Lehman Hutton, Inc.*, 31 WAKE FOREST L. REV. 309 (1996); Note, *Punitive Damages Under the Federal Arbitration Act*, 109 HARV. L. REV. 269 (1995).

⁵⁵ These characteristics include: (1) non-unique and repeated terms appear in standard forms; (2) the standard terms are prepared primarily for the benefit of the drafter; (3) the standard terms are likely to be unexamined and not easily understood at the time of the agreement; and (4) the drafter is in a position to insist that the other party "take it or leave it" without bargaining. See II MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 19.3.3. A contract with adhesion characteristics, however, may be enforceable unless it inflicts "substantive

two questions: (1) how far can one party go in requiring arbitration of any and all claims arising under the investment contract and imposing other terms in the contract to arbitrate, such as a choice of law clause selecting law favorable to the broker-dealer?; and (2) if such an agreement is enforceable, to what extent are statutory and other regulatory claims of the adhering party which are adjudicated by the arbitrator insulated from judicial review? If the answers are dictated simply by the pro-enforcement rhetoric of *Volt* and the finality provisions of section 10 of the FAA, then serious public policy questions are presented, both as to investor protection against abuse of bargaining power and the wisdom of insulating regulatory claims created by state and federal law from judicial review.

A. *Adhesion Contracts to Arbitrate Securities Disputes Are Enforceable*

Based upon the current case law, it is highly unlikely that "unconscionability or adhesion doctrine [will] result in the unenforceability of an arbitration clause."⁵⁶ Putting aside the rare and inevitably unsuccessful challenge to the arbitration clause on grounds of fraud, duress or mistake,⁵⁷ a party desiring to win an unconscionability defense who objectively assents⁵⁸ to a standard form arbitration clause must establish

unfairness on the weaker party" or because its terms are not "within the reasonable expectations of that party, or contrary to public policy." *Aviall, Inc. v. Ryder Sys.*, 913 F. Supp. 826, 831 (S.D.N.Y. 1996), *aff'd*, No. 96-7285, 1997 WL 160765 (2d Cir. Mar. 27, 1997). For discussion of other Supreme Court decisions where adhesion contracts were involved, particularly *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991), *superseded by* 46 U.S.C.A. app. § 183c (West Supp. 1996), see *Shell*, *supra* note 7, at 460-62; *Braucher*, *supra* note 7, at 61-68.

⁵⁶ II MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 19.3.1, at 19:26.

⁵⁷ II MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 19.2; see Jonathan E. Breckenridge, *Bargaining Unfairness and Agreements to Arbitrate: Judicial and Legislative Application of Contract Defenses to Arbitration Agreements*, 1991 ANN. SURV. AM. L. 925; Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131, 1189-92 (1995) (California retrenchment in use of unconscionability in arbitration disputes).

⁵⁸ The most common form of objective assent, although not required by the FAA, is a signature on a contract containing an arbitration clause or on the arbitration clause itself. Consent to arbitration may also be by conduct. See II MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 17.7.3. Assuming that the assenting party has an opportunity to review the standard form and that there are no validity defenses, the intention in fact of the assenting party is irrelevant.

that he or she was: (1) unfairly surprised by the arbitration clause and its effect or, if there was disclosure, denied an adequate choice because there were no realistic market alternatives; and (2) disadvantaged because the arbitration clause or the contemplated arbitration process was unduly favorable to the other party.⁵⁹ In securities arbitration, this is a difficult burden to sustain.

A recurring judicial pattern has emerged on the path to enforceability under the "savings" clause of FAA section 2. First, although the Court has stated that under the FAA the courts must remain "attuned" to the risk of fraud or coercion, it has also said that the fact of unequal bargaining power alone is not enough to invalidate the federal contract to arbitrate.⁶⁰ What more is necessary apparently depends upon the facts of each case and the application of nondiscriminatory state law.⁶¹ For example, it is proper for the SEC to protect against unfair bargains by regulating the SROs and the content of securities arbitration contracts and procedures. It is improper, however, for the State of Montana or any state to single out the federal standard form contract to arbitrate for special protection against unfair surprise.⁶² That "special protection," if not applicable to every adhesion contract, is pre-empted.

For example, there is no requirement that the assenting party intend to assume an obligation to arbitrate, even though that may be a plausible theoretical position. See, e.g., Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986). Rather, objective assent coupled with a preferred outcome (here arbitration) is a dominant theme in Supreme Court adjudication. See G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CAL. L. REV. 433 (1993).

⁵⁹ See *Sosa v. Paulos*, 924 P.2d 357 (Utah 1996), for a recent summary of the principles. Most courts require an absence of "meaningful choice" together with a term which is "unreasonably favorable" to the other party. Since an arbitration term is normally balanced (i.e., it does not necessarily favor either party), under the "together with" test it would be enforceable if assented to without fraud or mistake, even if there was no meaningful choice.

⁶⁰ For a summary, see *supra* text accompanying note 33.

⁶¹ See *Webb v. InvestaCorp*, 89 F.3d 252, 257 (5th Cir. 1996) (arbitration clause not unconscionable under nondiscriminatory Texas law).

⁶² In *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265 (1995), the Court, speaking through Justice Breyer, noted that Congress had consumers in mind when enacting the FAA, but concluded, in dictum, that the best way to protect consumers was in general state regulation of standard form or unfair contracts, not just regulation where arbitration is involved.

Second, the objective of the standard arbitration form clause is favored under the FAA. On the face of it, there is no attempt by one party to impose an unreasonable term on the other. Both parties contract out of the judicial forum, with its procedural protections and right to a jury trial,⁶³ and agree to arbitration with its strengths and weaknesses. There is no obvious disadvantage to either party, especially where the substantive terms in the arbitration clause are not unreasonably favorable to the stronger party.⁶⁴

Third, except in unusual circumstances,⁶⁵ the risk of unfair surprise is placed upon the party who assents to a standard form containing an arbitration clause. The adhering party has a duty to read the standard form,⁶⁶ and the stronger party has no duty to disclose or discuss the arbitration clause.⁶⁷ Again, as the Court's decision in *Doctor's Associates, Inc. v. Casarotto*⁶⁸ clearly indicates, state law aimed at eliminating fraud or unfair surprise only in arbitration contracts is pre-

⁶³ Clearly, some type of informed consent to arbitration is necessary to waive the constitutional right to a jury trial. Outside of the arbitration context, courts require a "knowing and intentional" waiver of the right to a jury trial. Relevant factors include the clarity and prominence with which the language is expressed, the sophistication of the parties, whether they are represented by counsel, and their relative bargaining power. See *Luis Acosta, Inc. v. Citibank, N.A.*, 920 F. Supp. 15, 18 (D.P.R. 1996) (discussing authorities). Inside arbitration, however, the "jury trial waiver" issue is rarely raised. The assumption is that if there is assent to a written, broad arbitration clause, the right to a jury trial is waived, despite the absence of one or more factors. See Brunet, *supra* note 23, at 102-13.

⁶⁴ In *Golenia v. Bob Baker Toyota*, 915 F. Supp. 201, 204 (S.D. Cal. 1996), the court stated: "Although it is not inconceivable that an arbitration clause might be written in such a way as to favor one side, the clause in this case applies equally to both parties: both give up the right to trial by jury and agree to abide by the procedures described. Neither state nor federal law would find such a clause unenforceable." In general accord, see *Doctor's Assocs., Inc. v. Stuart*, 85 F.3d 975, 980-81 (2d Cir. 1996); *Hoffman v. Aaron Kamhi, Inc.*, 927 F. Supp. 640, 643 (S.D.N.Y. 1996) (arbitration clause not unconscionable simply because one party drafts it); *Haluska v. RAF Fin. Corp.*, 875 F. Supp. 825, 828 (N.D. Ga. 1994); *Bevere v. Oppenheimer & Co.*, 862 F. Supp. 1243, 1249-50 (D.N.J. 1994).

⁶⁵ In *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 115 S. Ct. 1212 (1995), the Court, using nondiscriminatory state law, construed ambiguous language in a standard form against the drafter.

⁶⁶ See, e.g., *Houlihan v. Offerman & Co.*, 31 F.3d 692, 695-96 (8th Cir. 1994); *Snap-On Tools Corp. v. Vetter*, 838 F. Supp. 468 (D. Mont. 1993).

⁶⁷ In *Gouger v. Bear, Stearns & Co.*, 823 F. Supp. 282, 286-88 (E.D. Pa. 1993), the court rejected the argument that a broker had any duty to identify or explain a choice of law clause contained in a standard form arbitration agreement.

⁶⁸ 116 S. Ct. 1652 (1996).

empted by the FAA. Special notice requirements designed to increase information in adhesion contracts must be applicable to contracts generally, not just the federal contract to arbitrate.⁶⁹

Fourth, if there is no unfair surprise, the content of the form is clear and arbitration is favored by the law, the fact that the adhering party had no power to bargain with the stronger party is not significant. There is still a choice to "leave it," and in most cases that choice is not oppressive. Although not fully explored by the courts, the assumption is that the investor can, after comparative shopping, find a broker-dealer willing to open a similar investment account without an arbitration clause. Thus, even if an investor cannot open a margin account with any broker-dealer without agreeing to arbitration, the choice to leave it and the possibility that similar accounts can be arranged without arbitration protect the clause from attack.⁷⁰

Finally, if the adhering party can demonstrate that the proposed arbitration rules or processes are not impartial—that they favor the stronger party—the arbitration might be enjoined.⁷¹ But this possibility is rare indeed, especially if neutral and respected agencies such as the AAA are selected or, in

⁶⁹ *Id.* at 1656; *accord*, *Soil Remediation Co. v. Nu-way Envtl., Inc.*, 476 S.E.2d 149 (S.C. 1996) (South Carolina law preempted).

⁷⁰ There are few instances where this dimension of unconscionability has been satisfied. *See, e.g.*, *Henningson v. Bloomfield Motors, Inc.*, 161 A.2d 69, 84-94 (N.J. 1959) (automobile manufacturers have oligopolistic control of new car warranty content); *see also* *Weaver v. American Oil Co.*, 276 N.E.2d 144, 147 (Ind. 1971) ("The weaker party, in need of the goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly [natural or artificial] or because all competitors use the same clauses."). Despite the valiant dissent of Justice Stevens, the argument was rejected in *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585 (1991) (forum selection clause); *see* *California Grocers Ass'n, Inc. v. Bank of America*, 27 Cal. Rptr. 2d 396 (Cal. Ct. App. 1994) (competition for fees charged by San Francisco banks). In securities arbitration, we must know whether a customer can obtain a margin account from a broker-dealer without an arbitration clause. Can larger investors, such as mutual funds, bargain to exclude arbitration? Are arbitration clauses required in cash accounts and, if so, to what extent? How easy is it for a customer to finance a cash account without an arbitration clause by opening a bank line of credit? What about the practices of discount brokers? No authoritative study has been done to answer these questions.

⁷¹ *See* II MACNEIL, SPEIDEL & STIPANOWICH, *supra* note 1, § 19.3.3.3. Such a claim was rejected on the facts in *Engalla v. Permanente Medical Group, Inc.*, 43 Cal. Rptr. 2d 621 (Cal. Ct. App. 1994), *review granted*, 905 P.2d 416 (Cal. 1995).

securities arbitration, where the rules and procedures of the SRO have been approved by the SEC.⁷² Thus, where the choice to arbitrate is "take it or leave it," but the content of the contract to arbitrate is mainly AAA rules and the arbitration is administered by the AAA, the unconscionability defense simply will not work. Similarly, where the SEC has power to regulate the activities of the SROs in arbitration and the SROs are working to improve their arbitration processes and procedures, the court is unlikely to deny enforcement of the agreement to arbitrate.

In sum, the adhesion contract to arbitrate, particularly in the securities industry, is enforceable under section 2 of the FAA. According to the courts, the absence of equal bargaining power or the opportunity to bargain does not necessarily signal unfair surprise or oppression to the weaker party or unfair advantage to the stronger party. So long as both parties agree in writing to arbitrate all disputes in an unbiased or impartial arbitration process, the contract is valid and enforceable under the FAA.

B. The Dark Side of Limited Judicial Review

From the perspective of enforceability of the agreement to arbitrate, the judicial rejection of the unconscionability defense in adhesion contracts to arbitrate is defensible. From the perspective of the limited judicial review of arbitral awards, however, the result is more troublesome. The investor cannot bargain to exclude statutory claims from the scope of arbitration and, as a practical matter, may have limited market alternatives. Put differently, an investor who understands what arbitration is and has a choice to leave the proposed adhesion contract may be unable to find a similar investment account without an arbitration clause. If so, the choice to "leave it," no matter how well informed, may be no choice at all. Where there are no realistic alternatives, the adhesion pattern represents a form of mandatory arbitration that insulates the merits

⁷² See *Dillard v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 961 F.2d 1148 (5th Cir. 1992), *cert. denied*, 506 U.S. 1079 (1993); *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282 (9th Cir. 1988).

from judicial review and creates the risk that the adhering party will be bound to other terms, such as a choice of law clause, that is highly favorable to the other party.

One must be careful not to overstate these risks. For example, an attempt in a standard term to require the adhering party to waive or forego certain statutory claims otherwise within the agreement to arbitrate will probably not be successful,⁷³ even though waiver of the right to jury trial through consent to arbitration will be enforced. It is one thing to shift the dispute from a court to an arbitral tribunal and quite another to cut back the rights to which one party would otherwise be entitled in the adhesion contract.

On the other hand, if statutory or other regulatory claims are decided by impartial arbitrators in an effective, neutral arbitration process, the merits of those claims are normally insulated from judicial review. Accepting for argument the Court's assumption that such claims are appropriate for arbitration and that arbitrators are capable of resolving them, the lack of review on the merits under FAA section 10 permits important decisions affecting public policy to be resolved without judicial scrutiny. Unless the parties have agreed to an expanded review or the Court fully endorses the "manifest disregard of law" standard, stronger parties can use the arbitration process to blunt the force of federal and state regulation. Moreover, the Court has preempted efforts by the states to withdraw such claims from broad arbitration clauses or to regulate the arbitration process in a way that discriminates against the federal contract to arbitrate.

In sum, the Supreme Court's purposeful interpretation of the FAA, with its formalistic approach to enforcement, provides no direct controls over the adhesion contract to arbitrate. Even when powerful broker-dealers operate in a regulated industry and there is a common approach by them toward requiring arbitration of all disputes arising under or relating to certain investment accounts, the contract to arbitrate is enforced, and arbitral awards interpreting and applying those statutes are not reviewed on the merits. Whatever the benefits of informed and efficient dispute resolution, burying the out-

⁷³ See, e.g., *Graham Oil v. Arco Prods.*, 43 F.3d 1244, 1247-48 (9th Cir. 1994), *cert. denied*, 116 S. Ct. 275 (1995).

comes of statutory claims against the regulated party in unpublished and unreviewable arbitral decisions is a highly questionable use of the federal contract to arbitrate.

IV. THE RUDER REPORT: WHITHER CONSENT?

How did the NASD Arbitration Task force deal with these issues on the dark side of the consent coin? With one exception, the Ruder Report did not recommend that the scope and quality of private consent be enhanced to improve securities arbitration. A return to the pre-*McMahon* days⁷⁴ was not recommended, and a study of the extent to which an investor who decides to "leave it" can realistically find an alternative investment contract without an arbitration clause was not commissioned.⁷⁵ Rather, the Report endorsed the current "adhesion" method of contracting, concluding that there was "no evidence that SRO sponsored securities arbitration forums were biased against customer participants"⁷⁶ and that "even with its flaws, securities arbitration is clearly preferable to civil litigation."⁷⁷

⁷⁴ Prior to *McMahon*, an investor who opened an investment account could agree to arbitration or not. The broker-dealer, however, had no such choice and was bound by the investor's election. See RUDER REPORT, *supra* note 11, at 6-7.

⁷⁵ The perceived choices were summarized as follows: "[M]ost individual investors who transact in business with broker-dealers, and virtually all individual investors who have margin or option accounts, must resolve claims with member firms in SRO sponsored arbitration." RUDER REPORT, *supra* note 11, at 6.

⁷⁶ RUDER REPORT, *supra* note 11, at 9. The Report relied upon a 1992 Report of the General Accounting Office and the fact that between "1991 and 1995, arbitrators awarded damages to customer claimants in 50 percent of all cases they decided." RUDER REPORT, *supra* note 11, at 18. "Moreover, securities arbitration is conducted by SRO's subject to the direct oversight and regulation of the SEC, not by individual member firms. Further, disputes between customers and member firms are heard either by a single 'public' arbitrator, that is, a person not affiliated with the securities industry, or, in most cases, by two public arbitrators and one arbitrator associated with the securities industry, thus furthering the goal of impartiality." RUDER REPORT, *supra* note 11, at 9.

⁷⁷ "Arbitration offers investors a more efficient, faster, and cheaper process than court litigation." RUDER REPORT, *supra* note 11, at 18. No empirical studies were conducted or cited to support this important but impressionistic conclusion. On the importance of empirical studies in dispute resolution, see Thomas J. Stipanowich, *Beyond Arbitration: Innovation and Evolution in the United States Construction Industry*, 31 WAKE FOREST L. REV. 65 (1996); see also Russell J. Weintraub, *A Survey of Contract Practice and Policy*, 1992 WIS. L. REV. 1, 2-4 (need for empirical data in understanding contract).

Thus, the Ruder Report recommended that the "industry should be permitted to continue to utilize predispute arbitration clauses in customer agreements."⁷⁸

The one exception was enhanced disclosure requirements: "Predispute arbitration agreements should contain certain uniform provisions, including the statement that the FAA governs NASD securities arbitration, and should provide clear notice that the customer is entering into an arbitration agreement and the consequences."⁷⁹ No window, however, was provided for an investor to opt out of NASD arbitration for AAA securities arbitration, and no recommendations were made to expand the scope of judicial review of arbitral awards. The Report attempts to preserve the nature and objectives of private arbitration in an industry regulated by the SEC without enhancing the role of consent or expanding the scope of judicial review.

Beyond expanded disclosure in the contract to arbitrate, the Ruder Report made two recommendations relevant to the contracting process and several recommendations designed to improve the efficiency and fairness of the arbitration process itself. First, it endorsed Rule 21(f)(4) of the NASD Rules of Fair Practice, as approved by the SEC, which provides that "[n]o agreement [between a member and a customer] shall include any condition . . . which limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award."⁸⁰ This long standing rule attempts to neutralize the power and the incentive of broker-dealers to limit substantive claims as part of the arbitration agreement. In short, investors in arbitration are entitled to the applicable state and federal law.

Second, to implement the fair practice rule, the Ruder Report recommended limitations on the content of certain

⁷⁸ RUDER REPORT, *supra* note 11, at 17. Although both parties can agree to forego arbitration or to arbitrate before an institution other than an SRO, the customer cannot unilaterally make that decision.

⁷⁹ RUDER REPORT, *supra* note 11, at 19.

⁸⁰ RUDER REPORT, *supra* note 11, at 17. The SEC, in approving the NASD Rule, stated that the use of arbitration "represents solely a choice of arbitration as a means of dispute resolution" and that agreements "cannot be used to curtail any rights that a party may otherwise have had in a judicial forum." 54 Fed. Reg. 21,144, 21,154 (1989).

terms regularly included by broker-dealers in the contract to arbitrate. For example, to offset the broker-dealers' power to choose the arbitration law of a state that precludes an arbitral award of punitive damages, the Report recommended that "NASD develop a uniform rule relating to the availability of punitive damages in NASD arbitration" and that the rule should "state clearly that punitive damages are available in each state where they are permitted in a judicial forum for the same claims."⁸¹ Moreover, the applicable law is the "state of the investor's domicile where they would be available in court for the same claims."⁸²

Beyond this, the Report relies upon the SROs and the SEC and, perhaps, the active participation of representative organizations such as the Securities Industry Conference on Arbitration ("SICA")⁸³ to further regulate the exercise of contractual power by the broker-dealers and to implement other recommended reforms going to the efficiency and quality of the arbitration process.⁸⁴

Whither consent after the Ruder Report? In essence, the quality of consent is enhanced by better information on whether or not to take securities arbitration at the threshold of contracting. Either choice has its disadvantages. The decision to "leave it" may mean that the investor has, in the relevant competitive market, no access to an investment contract without arbitration from another similarly situated broker. The decision to "take it" means that the investor must depend upon other individuals and organizations to insure that other terms in the contract to arbitrate are balanced and fair, and that the rules and processes administered by the cognizant SRO are de-

⁸¹ This is particularly true in the controversial area of punitive damages. See RUDER REPORT, *supra* note 11, at 40-46.

⁸² RUDER REPORT, *supra* note 11, at 45.

⁸³ See generally Constantine N. Katsoris, *SICA: The First Twenty Years*, 23 FORDHAM URB. L.J. 483, 485-90 (1996).

⁸⁴ Other recommendations include: (1) increased use of mediation and a pilot program on early neutral evaluation of claims, RUDER REPORT, *supra* note 11, at 54-64; (2) simplified procedures for claims not exceeding \$30,000, RUDER REPORT, *supra* note 11, at 71-76; (3) improved information requests and document discovery, RUDER REPORT, *supra* note 11, at 81-87; and (4) a series of proposals on the selection and quality of arbitrators, RUDER REPORT, *supra* note 11, at 88-113. At the time of this writing, the process of implementing the Report's recommendations is well underway.

signed to achieve efficient and responsive outcomes. Either way, validity issues in the investor's choice are not directly regulated by the FAA, and the so-called contract to arbitrate is on the other or the "dark side" of the consent coin.

CONCLUSION: WHITHER THE RUDER REPORT?

What does the decline of consent mean for the future of arbitration in the securities industry? Adhesion or standard form contracts are a fact of commercial and consumer life. In addressing this method of contracting, courts and legislatures are more concerned with preventing unfair surprise through disclosure than assessing the market options if the deal is rejected or regulating the content of the adhesion contract itself. The focus is on the disclosure process rather than the content of the contract.⁸⁵ The Ruder Report, on the other hand, recommends both increased disclosure and some regulation of the content of the contract to arbitrate rather than suggesting methods to improve bargaining between parties or to stimulate market competition between investment accounts with and without arbitration clauses. In short, the Ruder Report seems to endorse a public rather than a private model of dispute resolution: Informed choice coupled with increased regulation of the contract to arbitrate and the arbitration process is the proposed solution.

Assume that this approach to "mandatory" arbitration is the right way to go.⁸⁶ The crucial question is whether the

⁸⁵ See Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 34-51 (1993). Writing from the perspective of an economist, Professor Craswell would support governmental intervention into a contracting process where there was adequate information only when there was a market failure and the government could do a better job than the market in supplying the alternative. As Jean Braucher put it, "Assent is not in fact a useful way to look at the question of when to enforce contingent terms in long forms. It makes more sense to ask whether disclosure promotes sufficient market competition to police against imposition by one party of unwanted terms by the other." Braucher, *supra* note 7, at 63. In securities arbitration, at least, there is reason to believe that "sufficient market competition" is lacking.

⁸⁶ Clearly it is not the only way to go. For example, Dean Seligman has suggested that a "different approach would allow securities brokers to make differential charges to customers, depending on whether the customer wishes to retain the right to litigate or is willing to sign a predispute agreement." He argues that an "internalization approach would respond to long held concerns about customers'

classic model of private arbitration, with its characteristics and objectives, is best suited for a regulated industry where all claims, statutory or otherwise, are required by the regulated party to be arbitrated with the probability that awards on the merits may be insulated from judicial review. The Court, under the FAA, has fostered the view that arbitration is suitable for every dispute regardless of the parties, context or issues. As one commentator put it, the current exalted status of FAA arbitration represents a "window of opportunity created by the interaction of the . . . Court's charitable view of the process, the log jam in the courts, and the concerns of business decision-makers with the costs and other problems associated with traditional litigation."⁸⁷ If that window closes or the opportunity disserves either efficiency or fairness, a reconsideration of the private arbitration model as the appropriate mode for securities dispute resolution should be undertaken.⁸⁸

If doubts about classic arbitration exist, how can a securities dispute resolution system be developed that, although minimizing the importance of consent, is "cost effective, procedurally consistent, and fair, and capable, as a matter of course, of producing outcomes that are accurate and correct?"⁸⁹ Such an alternative system was not proposed by the Ruder Report, and its details are beyond the scope of this Article. Nevertheless, thinking about the new "public" system might take the following considerations into account:

(1) A more persuasive empirical justification for mandatory arbitration, rather than permitting investors and broker-dealers to choose adjudication in courts, is needed. The question is whether the overall system is more efficient than adjudication in courts and capable of reaching decisions that are responsive to the applicable law and facts and fair between the parties. If

lack of negotiating leverage and protect securities brokers from greater cost of litigation." Seligman, *supra* note 11, at 345-46. For objections to this proposal, see Becker, *supra* note 11, at 372; Coffee, *supra* note 11, at 377.

⁸⁷ Hayford & Peeples, *supra* note 4, at 413-14.

⁸⁸ In another article I have expressed doubts about the capacity of classic arbitration in regulated industries to achieve results that are efficient, fair and consistent with relevant public interests. Speidel, *supra* note 4, at 162-67.

⁸⁹ Hayford & Peeples, *supra* note 4, at 414.

not, a system that gives broker-dealers power to decide whether investors must take arbitration or leave it makes no sense at all.

(2) An increased willingness of the SEC through the SROs to regulate the terms of the contract to arbitrate between the investors and the broker-dealers, particularly choice of law clauses, and to develop uniform standards in hotly contested areas such as eligibility to arbitrate and punitive damages is also needed.

(3) A renewed effort should be made to reduce the persistent impression that SRO administered arbitration is biased in favor of broker-dealers. As Dean Joel Seligman suggested, the data in the 1992 GAO study "may now be stale and in any event cry out for amplification."⁹⁰ At a minimum, the representation of private investors' interests in the development of applicable rules and procedures through such groups as SICA should be strengthened and investor choice and the role of "public" arbitrators should be enhanced.⁹¹

(4) Efforts to clarify when and what state law governs the merits of a dispute and to draft, where appropriate, uniform rules for application to securities arbitration should be made. The confusion and controversy over such questions as the eligibility rule and punitive damages are stimulated in part by disagreement over these choice of law questions. Clarity, uniformity and sound results might be enhanced if, for example, a uniform, preemptive statute of limitations were drafted or the grounds for the award of punitive damages were defined.⁹²

(5) Accepting the need to improve the impartiality and quality of the arbitrators selected and to decide exactly what issues they should decide, attention must be paid to the timing and scope of judicial review. After leaving questions of arbitrability to the courts, the Ruder Report recommends that all other issues be resolved by the arbitrators and that judicial review be deferred until after the award.⁹³ Nothing was said,

⁹⁰ Seligman, *supra* note 11, at 367.

⁹¹ See RUDER REPORT, *supra* note 11, at 94-97. A new study on investor satisfaction with NASD arbitration has just been completed. See MGA COMMUNICATIONS, INC., OFFICE OF DISPUTE RESOLUTION, A STUDY OF THE ARBITRATION PROCESS FOR NASD REGULATION (Aug. 20, 1996).

⁹² See RUDER REPORT, *supra* note 11, at 22-46, for the Task Force's recommendations on these issues.

⁹³ RUDER REPORT, *supra* note 11, at 31-33. The recommendations focused on

however, about requiring written opinions with reasons by arbitrators⁹⁴ or altering the usual restrictive review under Section 10 of the FAA.

A new system might require a term in the contract to arbitrate that permits courts to review arbitral awards for errors in applicable law. The review could be limited to decisions on punitive damages or the scope and effect of regulatory legislation. Agreements of this sort are arguably within the scope of *Volt*, although there is some authority to the contrary.⁹⁵ Such a decision would clearly signal the public interest involved in the arbitration process and allay concerns that important decisions that apply regulatory legislation are insulated from judicial review. But it would undercut one essential ingredient of arbitration—finality—and tend to lengthen review proceedings. And, as one commentator has noted, "such review would require written arbitration opinions—not common in the commercial arena—and probably a more complete record and more formal proceedings than are generally maintained. These requirements would add to both the expense and formality of arbitration."⁹⁶

Whither consent in securities arbitration? As much as we may cherish and support "freedom to contract," the conditions generating the question reside on the dark side of the consent coin. Since it is unlikely that informed consent, bargaining and realistic market opportunities can be easily restored, the answer points toward a more overtly public system of dispute resolution in the securities industry. That system, which has yet to be designed, can require informed consent but cannot rely upon consent as a primary method of regulating the feder-

the so-called eligibility rule, but a broader application was intended.

⁹⁴ But see RUDER REPORT, *supra* note 11, at 44, where it is recommended that an award that includes punitive damage "should specify the amount given for compensatory damages and the amount given for punitive damages [and] where requested by the party against whom the award is rendered, should describe the conduct giving rise to the award." This recommendation permits the parties and a reviewing court to determine whether the arbitrators have exceeded their authority by awarding punitive damages in excess of the recommended "cap." RUDER REPORT, *supra* note 11, at 42.

⁹⁵ See *supra* notes 47-48. For an intriguing possibility for limited judicial intervention, see Michael A. Scodro, Comment, *Arbitrating Novel Legal Questions: A Recommendation*, 105 YALE L.J. 1927 (1996).

⁹⁶ See Hugh R. McCombs & Jeffrey W. Sarles, *Arbitration*, NAT'L L.J., Aug. 19, 1996, at B-5.

al contract to arbitrate. Because consent has withered in securities arbitration, the pressing question is, therefore, whether the public interest model of arbitration implicit in the Ruder Report?

