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MIXED ARBITRABLE AND NONARBITRABLE CLAIMS IN SECURITIES LITIGATION:
DEAN WITTER REYNOLDS, INC.
V. BYRD

In 1925, Congress enacted the Federal Arbitration Act (Arbitration Act),\(^1\) overturning a long standing judicial policy against arbitration.\(^2\) The Arbitration Act provides that agreements to submit disputes to arbitration will be as enforceable as any other contractual arrangement.\(^3\) Courts have looked favorably upon arbitration since enactment of the Arbitration Act,\(^4\) liberally construing the Act so that all doubts concerning the scope of arbitrable claims are resolved in favor of arbitration.\(^5\) In addition, arbitration has become an attractive alternative to litigation because it is less expensive and less time consuming for the parties.\(^6\) Moreover, it has proved particularly useful in the area of securities law, where disputes often involve relatively small amounts of money, and the parties therefore wish to resolve disputes quickly and inexpensively.\(^7\)

Following the stock market debacle of 1929, Congress enacted the securities laws to protect the investor and to aid the economy in its climb out of

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2. See infra note 25.
4. See, e.g., Aerojet-General Corp. v. American Arbitration Ass'n, 478 F.2d 248, 251 (9th Cir. 1973) (stating that the use of arbitration had been specifically endorsed by Congress in the Federal Arbitration Act and therefore federal courts should encourage its use); Lundgren v. Freeman, 307 F.2d 104, 110 (9th Cir. 1962) (policy of the Arbitration Act is to construe agreements in favor of arbitration); Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d 978, 985 (2d Cir. 1942) (Congress intended to make agreements to arbitrate as enforceable as any other contract and therefore federal courts must abandon their hostility to arbitration).
5. See infra notes 37-38 and accompanying text.
6. Litigation often involves substantial time lags due to the procedural rights exercised by each party, and consequently, large attorneys' fees are often incurred. See infra text accompanying notes 176, 177, 230.
7. See Jacquin, Arbitration in Action on Wall Street, 1 ARB. J. 261, 261-62 (1946). Arbitration as a method of dispute resolution was established on the New York Stock Exchange in 1817. Id. An Arbitration Committee was thereafter formed and it became one of the earliest forums in the country for compulsory arbitration of business disputes. Id. at 262.
the Depression. One of the benefits these statutes provided for the investor was the right to a federal forum to hear broker-investor disputes. Congress granted this right believing that a federal forum would balance the bargaining positions of the parties. Nevertheless, the securities industry continued to employ arbitration as a method of dispute resolution, including arbitration clauses within broker-investor agreements binding parties to submit disputes to arbitration. Realizing that this practice allowed circumvention of congressional intent in enacting the securities laws, the Supreme Court held arbitration clauses unenforceable as applied to federal securities claims in the seminal case of Wilko v. Swan.

By this determination, the Court declared that federal courts have exclusive jurisdiction of federal securities claims. In effect, the Court determined that when a federal securities claim is brought, the securities acts are preeminent over the Arbitration Act.

The conflict between the securities laws and the Arbitration Act, however,

8. See infra note 40.
9. 15 U.S.C. § 77l(2) (1982). See infra note 47. The Securities Exchange Act of 1934 does not contain a provision similar to § 12(2) of the Securities Act of 1933, but case law has established an implied private cause of action under § 10(b)(5) of the 1934 Act. 15 U.S.C. § 10(b)(5) (1982). See infra note 53. These cases find that a private right of action may be implied from the 1934 Act and that it is in accord with congressional intent. See id.
10. The federal forum provides the investor the procedural guarantees of trial by jury, the federal rules of evidence, full rights of discovery, and the right of judicial review. See Bernstein v. Polygraphic Co., 350 U.S. 198, 203 (1956) (parties in arbitration have no right to trial by jury, arbitrators receive no judicial instruction on the law and need not explain their determinations, and judicial review of arbitral awards is limited); Sobel v. Hertz, Warner & Co., 469 F.2d 1211, 1214-15 (2d Cir. 1972) (arbitrators not required to explain reasons for their award); Neville, The Enforcement of Arbitration Agreements, 34 ARB. J. 5, 10 (1979) (parties do not have full discovery rights in arbitration, awards are rendered without reasons, and judicial review of arbitral award is limited).
11. 346 U.S. 427 (1953). The Court found that arbitration clauses in broker-investor agreements effectively force an investor to waive the protection afforded by the securities acts. Id. at 438. See infra text accompanying notes 67-69.
12. Although the Wilko Court never explicitly stated that federal courts have exclusive jurisdiction of federal securities claims, the effect of its holding and its interpretation of the securities laws (see infra text accompanying notes 63-70) have caused federal courts to refer to their jurisdiction of such claims as "exclusive." See, e.g., Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59, 62 (8th Cir. 1984) (stating that an exception to the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1982), is necessary in an action alleging federal securities violations in order to protect the "exclusive jurisdiction of the federal court over these claims"); Miley v. Oppenheimer & Co., 637 F.2d 318, 335 (5th Cir. 1981) (noting that an exception to the Federal Arbitration Act was formulated to preserve the "exclusive jurisdiction of the federal courts" and that Wilko requires that federal securities claims be adjudicated in federal court).
13. Wilko, 346 U.S. at 438. The Court stated that the policies of the Arbitration Act and the securities laws are "not easily reconcilable," but held that when the two policies conflict, the arbitration agreement must be found invalid in order to enforce Congress' intent to protect the investor in the securities market. Id.
was not resolved by the Court’s decision in *Wilko*.\(^\text{14}\) In recent years, investors have brought numerous suits involving both federal and state law claims. Although *Wilko* holds that the federal claims may not be submitted to arbitration, an issue now under debate is how the federal courts should handle pendent claims, state and common law actions arising out of the same operative facts as the federal securities claim.\(^\text{15}\) The Supreme Court has not addressed this issue, and the circuit courts have split.\(^\text{16}\) Some circuits hold that a federal court should retain jurisdiction of the pendent common law and state claims as well as the federal claims.\(^\text{17}\) Other courts, however, have determined that pendent claims should go to arbitration after judicial resolution of the federal action.\(^\text{18}\) Courts supporting retention of all claims at the federal level uphold the “intertwining” doctrine.\(^\text{19}\) These courts find that federal and pendent claims are sometimes so “intertwined” that the pendent claims cannot be decided without reviewing the facts and

\(^{14}\) 346 U.S. 427 (1953).

\(^{15}\) When a state or common law claim is alleged along with a federal claim, the federal court has the power to assume jurisdiction over the nonfederal claim as well as the federal cause of action. This is known as pendent jurisdiction. See United Mine Workers v. Gibbs, 383 U.S. 715, 724-26 (1966); Fed. R. Civ. P. 2, 18-20, 42. The court will only assume pendent jurisdiction when certain prerequisites are met. First, it must find that the federal claim satisfies the subject matter jurisdiction requirements of the court. *Gibbs*, 383 U.S. at 725. Second, the court must determine that the federal claim and the nonfederal claim constitute a single case and that both claims derive from a common “nucleus of operative fact.” *Id.* at 725, 728. In other words, the same general facts must support both the federal and nonfederal, or pendent, claim. However, even if all of the above prerequisites are met, the court may refuse to assume pendent jurisdiction because its power in this area is discretionary. *Id.* at 726.

\(^{16}\) See On Petition for Writ of Certiorari to the United States Court of Appeals, Memorandum for the Petitioner at 6, Dean Witter Reynolds, Inc. v. Byrd, 726 F.2d 552 (9th Cir.), cert. granted, No. 83-1708 (June 11, 1984).

\(^{17}\) Dean Witter Reynolds, Inc. v. Byrd, 726 F.2d 552 (9th Cir.), cert. granted, No. 83-1708 (June 11, 1984); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu, 675 F.2d 1169 (11th Cir. 1982); Miley v. Oppenheimer & Co., 637 F.2d 318 (5th Cir. 1981); Sibley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977). These courts hold that federal courts should assume jurisdiction over common law and state claims pendent to a federal securities claim so that the federal court may preserve its exclusive jurisdiction of federal securities claims. *See infra* notes 108-27, 149 and accompanying text.

\(^{18}\) Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59 (8th Cir. 1984); Liskey v. Oppenheimer & Co., 717 F.2d 314 (6th Cir. 1983); Dickinson v. Heinold Securities, Inc., 661 F.2d 638 (7th Cir. 1981). These courts maintain that both the Arbitration Act and the securities laws must be enforced, and that the federal courts’ exclusive jurisdiction over federal securities claims can be preserved by staying arbitration of the common law and state claims pending judicial resolution of the federal claim. *See infra* notes 129-48 and accompanying text.

\(^{19}\) See Miley v. Oppenheimer & Co., 637 F.2d 318, 335 (5th Cir. 1981) (explaining that the intertwining doctrine is an exception to the policy favoring arbitration, created to preserve the courts’ exclusive jurisdiction of federal securities claims); Hyman, *Churning in Securities: Full Compensation for the Investor*, 9 U. DAYTON L. REV. 1, 28 (1983) (intertwining doctrine is an exception to the Arbitration Act allowing the courts to refuse to sever arbitrable and nonarbitrable federal claims).
issues relevant to resolution of the federal claim and vice versa. Thus, if issues relevant to the federal claim are decided in arbitration or state court, the federal court may be deprived of its exclusive jurisdiction.

Recently, the Supreme Court agreed to review a decision of the United States Court of Appeals for the Ninth Circuit, *Byrd v. Dean Witter Reynolds, Inc.*, addressing the proper procedure for disposing of both federal and state law claims in a securities case. In *Byrd*, a retired dentist signed a broker-investor contract providing that all disputes arising under the contract be submitted to arbitration. After losing much of the money invested, Byrd brought suit under federal and state law. The issue before the Supreme Court concerns whether all claims should be heard by a federal court, as was decided by the Ninth Circuit, or whether the nonfederal claims should be allowed to proceed to arbitration.

This Note will trace the history of the Federal Arbitration Act and the securities acts and will review the public policy considerations behind these laws. It will examine the *Wilko* decision and its resolution of the tension between the Arbitration Act and the policies underlying the securities laws as well as subsequent Supreme Court decisions enforcing arbitration agreements. The Note will discuss the decisions of those courts of appeals that have adopted either the intertwining doctrine or a bifurcated approach, noting how each court balanced the goals of the two public policies at issue. Recognizing the Securities and Exchange Commission's (SEC or Commission) recent efforts to protect the securities investor, the Note will comment on that agency's role in the creation of improved arbitration procedures and on its promulgation of a rule restricting the use of arbitration clauses. Finally, the Note will analyze the impact of the intertwining doctrine versus a bifurcated approach on the investor, setting the stage for the Supreme Court's treatment of the *Byrd* case.

I. THE LEGAL HISTORY OF ARBITRATION IN THE SECURITIES FIELD

A. The Federal Arbitration Act

During the nineteenth century, American judges were hostile to arbitra-

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20. See *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977) ("when it is impractical if not impossible to separate out non-arbitrable federal securities law claims from arbitrable contract claims, a court should deny arbitration in order to preserve its exclusive jurisdiction over the federal securities act claims"); *Shapiro v. Jaslow*, 320 F. Supp. 598, 600 (S.D.N.Y. 1970).
22. 726 F.2d 552 (9th Cir.), *cert. granted*, No. 83-1708 (June 11, 1984).
23. *Id.* at 553.
24. *Id.*
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tion, an attitude adopted from the English courts. As the country grew, however, the courts became congested and American businessmen began to press for resolution of business disputes through arbitration. Businessmen disliked the expense of litigation and distrusted the results, believing that most disputes could be settled according to practical considerations. American judges also began to realize the illogical nature of a policy against arbitration based on English precedent, especially when their own courts were overflowing with litigation. These judges began to criticize hostility towards arbitration and urged that legislative action be taken to overturn

25. See Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d 978, 982-85 (2d Cir. 1942); H.R. REP. No. 96, 68th Cong., 1st Sess. 2 (1924). The English judiciary's hostility towards arbitration developed in the 1700s. Kulukundis, 126 F.2d at 982. One reason advanced for this hostility was that English judges, whose salaries came largely from fees, wished to avoid loss of income. Id. at 983 n.14 (citing Scott v. Avery, 25 L.J. Ex. 308, 313 (1856)). Others contend, however, it was merely competitive spirit that drove the judges to obtain as much litigation as possible. Baum & Pressman, The Enforcement of Commercial Arbitration Agreements in the Federal Courts, 8 N.Y.U. L.Q. 238, 240 (1931). In any case, the English courts refused to enforce arbitration agreements, stating that parties by contract cannot "oust" the courts of jurisdiction. Kulukundis, 126 F.2d at 983. See Sayre, Development of Commercial Arbitration Law, 37 YALE L.J. 595, 603-05 (1928). The "ouster of jurisdiction" concept became strong precedent and was adopted by American courts during the nineteenth century. Kulukundis, 126 F.2d at 984. See Insurance Co. v. Morse, 87 U.S. (20 Wall.) 445, 451 (1874) ("agreements in advance to oust the courts of the jurisdiction conferred by law are illegal and void"); Mitchell v. Dougherty, 90 F. 639, 644-45 (3d Cir. 1898) (arbitration agreement ousting the courts of jurisdiction held unenforceable); Dickson Mfg. Co. v. American Locomotive Co., 119 F. 488, 490 (M.D. Pa. 1902) (holding that an arbitration clause is revocable because parties may not contract to "oust the courts of their jurisdiction").

26. See Jones, Historical Development of Commercial Arbitration in the United States, 12 MINN. L. REV. 240, 258 (1928). The author cited statistics from the Literary Digest of October 4, 1924, showing that on January 1, 1923, 27,000 cases were awaiting trial "on the supreme court calendars in New York County," and that while 8,000 cases could be disposed of within a year, 13,000 new cases were added to the calendar each year. Id.; see also Cohen & Dayton, The New Federal Arbitration Law, 12 VA. L. REV. 265, 269 (1926) (reviewing the problems that the Federal Arbitration Act was intended to correct, including delays associated with litigation due to congested court calendars).

27. Note, Effect of the United States Arbitration Act, 25 GEO. L.J. 443, 445, & n.20 (1937) (stating that business support was part of a growing movement leading to enactment of the Arbitration Act).

28. Id. at 445. Businessmen believed that court decisions often disregarded "common principles of business." Id. Businessmen preferred practicality and quickness of result to "principles of law." Id.

29. See Kulukundis Shipping Co. v. Amtorg Trading Corp., 126 F.2d 978, 984 (2d Cir. 1942) (noting that lower federal courts felt bound to comply with precedents, although they were critical of hostility towards arbitration); United States Asphalt Refining Co. v. Trinidad Lake Petroleum Co., 222 F. 1006, 1007 (S.D.N.Y. 1915) (criticizing the custom of looking to "the antiquity of the rule" rather than to "its excellence of reason"). See also Jones, supra note 26, at 257-58 (courts' abandonment of hostility to arbitration attributable to the increasing volume of litigation).

30. Kulukundis, 126 F.2d at 984-85. One federal court noted that no reason had ever
the long line of precedent against arbitration. Congress responded in 1925 by enacting the Arbitration Act.

The Federal Arbitration Act (the Act) established a new policy, declaring the validity, irrevocability and enforceability of any contractual agreement submitting future disputes to arbitration. Courts can no longer refuse to enforce valid arbitration agreements between parties. If an action is brought before a court involving an issue referable to arbitration, the court must stay litigation of the action pending arbitration. Thus, the only issues the court need determine are whether there was an arbitration agreement made between the parties and whether the claim before the court is governed by

been given for the statement that arbitration agreements are against public policy, except for the weak "ouster of jurisdiction" principle. United States Asphalt Refining Co., 222 F. 1006, 1008-09. See supra note 25; see also Tatsuuma Kisen Kabushiki Kaisha v. Prescott, 4 F.2d 670, 672-73 (9th Cir. 1925); Atlantic Fruit Co. v. Red Cross Line, 276 F. 319, 322 (S.D.N.Y. 1921) (it is the "duty of courts" to "free themselves from anachronistic rules and precedents that are opposed to principles and standards of modern jurisprudence").

31. H.R. REP. No. 96, 68th Cong., 1st Sess. 2 (1924). See Atlantic Fruit Co. v. Red Cross Line, 5 F.2d 218, 220 (2d Cir. 1924), wherein the court stated that efforts to induce Congress to enact legislation had failed to date, and therefore the courts were being "asked to provide some method of overriding, or explaining away not only its own previous decisions but those of the Supreme Court . . . ." Id. The court concluded its opinion by stating that "the situation is one calling for legislative action . . . ." Id. at 221.


33. 9 U.S.C. § 2 (1982). The Act provides:

A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

Id.

34. 9 U.S.C. § 3 (1982). Section 3 of the Act requires the federal court to stay the trial of any action that is properly subject to arbitration under a written agreement between the parties. The provision states:

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 in which such suit is pending, 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 in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

Id.

35. 9 U.S.C. § 4 (1982). Section 4 requires the court to decide the arbitrability of a claim. It provides in part:

The court shall hear the parties, 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 . . . . If the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to the trial thereof.

Id. See United Steelworkers v. Warrior & Gulf Navigation Co., 363 U.S. 574, 582-83 (1960)
the agreement.\textsuperscript{36} In deciding the latter issue, all doubts concerning the scope of arbitrable claims are resolved in favor of arbitration.\textsuperscript{37} Thus, where an arbitration clause contains ambiguous language, the court should adhere to the meaning giving the broadest scope to arbitration.\textsuperscript{38} The courts liberally construe arbitration clauses to give effect to Congress' intent to expedite and facilitate the settlement of disputes and to ease court congestion.\textsuperscript{39} Congress did not foresee, however, the conflict that would arise when it subsequently enacted the securities laws.

B. \textit{The Federal Securities Acts}

After the stock market crash of 1929, Congress, primarily wishing to protect the investor and to improve the depressed economy,\textsuperscript{40} passed the Securities Act of 1933,\textsuperscript{41} followed by enactment of the Securities Exchange Act of

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  \item \textsuperscript{36} McAllister Bros. v. A & S Transp. Co., 621 F.2d 519, 522 (2d Cir. 1980) (court must make a "threshold inquiry" into whether the arbitration agreement covers the dispute); International Telephone & Telegraph Corp. v. Local 400, 286 F.2d 329, 330-31 (3d Cir. 1961) (courts are limited to determining whether claim is governed by the arbitration agreement).
  \item \textsuperscript{37} Galt v. Libbey-Owens-Ford Glass Co., 376 F.2d 711, 714 (7th Cir. 1967) (doubts regarding the enforceability of arbitration agreements should be resolved in favor of arbitration); Robert Lawrence Co. v. Devonshire Fabrics, Inc., 271 F.2d 402, 410 (2d Cir. 1959), \textit{cert. denied}, 364 U.S. 801 (1960) (doubts regarding the construction of the Arbitration Act should be resolved in keeping with the Act's "liberal policy of promoting arbitration").
  \item \textsuperscript{38} United Steelworkers, 363 U.S. at 582-83 (arbitration should not be refused unless the "arbitration clause is not susceptible of an interpretation that covers the asserted dispute").
  \item \textsuperscript{39} \textit{See} H.R. REP. No. 96, 68th Cong., 1st Sess. 2 (1924). The report states: "It is practically appropriate that the action should be taken at this time when there is so much agitation against the costliness and delays of litigation. These matters can be largely eliminated by agreements for arbitration, if arbitration agreements are made valid and enforceable." \textit{Id.} \textit{See also} Robert Lawrence v. Devonshire Fabrics, Inc., 271 F.2d 402, 410 (2d Cir. 1959), \textit{cert. denied}, 364 U.S. 801 (1960) (doubts regarding the construction of the Arbitration Act should be resolved in keeping with the Act's "liberal policy of promoting arbitration").
  \item \textsuperscript{40} \textit{See United States v. Naftalin, 441 U.S. 768, 775 (1979).} In \textit{Naftalin}, the Court, holding that the Securities Act of 1933 prohibits fraud against brokers as well as investors, stated that while investor protection was not the only purpose of the 1933 Act, Congress' primary intent was to prevent fraud against investors and to improve the economy. \textit{Id. See also} A.C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38, 40 (1941) ("essential purpose" of the 1933 Act is to protect investors); Gilligan, Will & Co. v. SEC, 267 F.2d 461, 463 (2d Cir.), \textit{cert. denied}, 361 U.S. 896 (1959) ("principal and essential purpose of the 1933 Act is to protect investors").
  \item \textsuperscript{41} The Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77mm (1982)).
\end{itemize}
1934. Congress recognized that issuers and purchasers of securities do not occupy relatively equal bargaining positions and sought to rectify this problem by requiring complete disclosure of information to the purchaser of securities. Thus, the 1933 Act requires full disclosure of material information to prospective purchasers of securities through filing of a registration statement with the SEC and issuance of a prospectus to the buyer. The 1933 Act further imposes civil and criminal liabilities for misstatements or failure to disclose required information. Another method Congress employed to balance the relative bargaining positions of the parties was to provide access to a federal forum. Specifically, section 12(2) of the 1933 Act grants the investor a "special right" to recover for misrepresentation and to proceed in federal court against the seller of the security. The right to sue in federal court provides the buyer a broad choice of venue and nationwide

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43. See S. REP. No. 47, 73d Cong., 1st Sess. 1 (1924). The report states that the policy of the 1933 Act is to inform the investor of facts regarding securities offered for sale in interstate commerce. Id. It further states:

The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; . . . to protect . . . against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor . . . ; to bring into productive channels of industry . . . capital which has grown timid to the point of hoarding . . .

Id.; see also Wilko v. Swan, 346 U.S. 427, 435 (1953) ("it is clear that the Securities Act was drafted with an eye to the disadvantages under which buyers labor").

44. See 15 U.S.C. § 77c (1982). This provision prohibits the sale or delivery after sale of unregistered securities and further prohibits the sale or delivery after sale of any security, unless accompanied by a prospectus. Id. See generally 1 L. Loss, SECURITIES REGULATION 130 (2d ed. 1961) (summarizing requirements of the 1933 Act).


46. See Wilko, 346 U.S. at 431 (in order to implement its policy to protect the investor, Congress "created a special right to recover for misrepresentation").

47. 15 U.S.C. § 77l(2) (1982). The statute provides that an investor may bring an action in any court having jurisdiction against a broker who, in selling securities to the investor, misrepresented and/or omitted information regarding the sale of the stock. Specifically, it states that any person who

(2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of 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
service of process. Although the buyer has the burden of proving the misrepresentation or omission, he or she must only prove lack of knowledge of the untruth or omission. The burden then shifts to the seller to prove that he or she did not know, and could not have reasonably known, of the misrepresentation.

The Securities Exchange Act of 1934 is an extension of the 1933 Act, regulating securities transactions conducted upon securities exchanges and over-the-counter markets. The primary purposes of the 1934 Act are to require disclosure of certain information to the securities buyer, to prevent and provide remedies for the manipulation of the securities markets, and to control the amount of the nation's credit that goes into those markets.

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such security from him, who may sue either at law or in equity in any court of competent jurisdiction...  

Id.  

48. 15 U.S.C. § 77v (1982). The provision states that any suit brought under the provisions of the 1933 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." Id. See Wilko, 346 U.S. at 431.

49. See Woodward v. Wright, 266 F.2d 108, 116 (10th Cir. 1959) (buyer need not prove reliance on the false statement to successfully recover under this provision); Murphy v. Cady, 30 F. Supp. 466, 470 (D. Me. 1939), aff'd, 113 F.2d 988 (1st Cir.), cert. denied, 311 U.S. 705 (1940) (plaintiff held to have an action under § 12(2) of the 1933 Act where he had no knowledge of seller's misrepresentations).

50. See Wilko, 346 U.S. at 431 ("seller is made to assume the burden of proving lack of scienter"). The House report accompanying the 1933 Act states: "Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance..." H.R. REP. No. 85, 73d Cong., 1st Sess. 9-10 (1933); see also 3 L. Loss, SECURITIES REGULATION 1704-05 (2d ed. 1961) (§ 12(2) provides seller with a defense if he can prove that he did not know, and could not have reasonably known, of the misrepresentation or omission).


52. 15 U.S.C. § 78(b) (1982). The provision states that regulation is necessary to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:...
Although the 1934 Act does not include a provision similar to section 12(2) of the 1933 Act, providing for a "private" remedy, case law has established an implied cause of action. Therefore, through enactment of the securities laws, Congress established a strong policy of investor protection that has been vigorously enforced in the courts.

Twenty years later, however, Congress' policy protecting the securities investor collided with its policy enforcing arbitration agreements. The clash of these two policies resulted in the Supreme Court decision of Wilko v. Swan.


In 1953, the Supreme Court created an exception to the Arbitration Act when it held in Wilko v. Swan that agreements to submit disputes arising under the Securities Act of 1933 to arbitration are unenforceable. Petitioner, an investor, brought suit in the United States District Court for the Southern District of New York against partners in a securities brokerage firm to recover damages under section 12(2) of the 1933 Act. He alleged that respondents induced him to purchase certain stock, which he subsequently sold at a loss due to the firm's misrepresentation and omission of information regarding trading of his stock. Petitioner's contract with the

53. A private remedy under rule 10b-5, promulgated pursuant to § 10(b)(5) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(b) (1982), has been recognized by most federal courts. See, e.g., Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) ("it is now established that a private right of action is implied under § 10(b)"); Jordan Bldg. Corp. v. Doyle, O'Connor & Co., 401 F.2d 47, 50 (7th Cir. 1968) (agreeing with Seventh Circuit's earlier holdings that a "private right of action exists under § 10(b)"); Janigan v. Taylor, 344 F.2d 781, 783 (1st Cir.), cert. denied, 382 U.S. 879 (1965) (personal action brought for violations of rule 10b-5 arose "by implication of the Act"); Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953) (allowing defrauded buyers and sellers to seek redress in federal courts under § 10(b)(5) is in accord with Congress' intent to make the control of securities transactions "reasonably complete and effective"); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951) (holding that while § 10(b)(5) does not specifically authorize a civil, or private remedy, it does find unlawful the conduct it describes, and therefore, creates a remedy).

54. See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953) (stating Court should focus on offeree's need for the protections afforded by the registration requirements); General Life of Missouri Inv. Co. v. Shamburger, 546 F.2d 774, 780, 783 (8th Cir. 1976) (holding that a corporation's offer and sale of unregistered securities was not exempt from the registration requirement because Congress desired to protect the investor through full disclosure); Associated Sec. Corp. v. SEC, 293 F.2d 738, 740 (10th Cir. 1961) (enforcing the securities laws' policy of investor protection, the court affirmed that petitioners had committed fraud on its customers in the sale of certain stock).


57. 346 U.S. at 429. See supra note 47.

58. 346 U.S. at 429. The broker did not inform Wilko that some or all of the stock he was purchasing was being sold by a director of the subject corporation. Id.
brokerage firm had included an arbitration clause and respondents moved to stay the trial until arbitration. The district court denied the stay, holding that the agreement deprived petitioner of the judicial remedy provided by the Securities Act. A divided United States Court of Appeals for the Second Circuit reversed, concluding that the Securities Act did not prohibit agreements to submit future disputes to arbitration.

The Supreme Court granted certiorari to address the issue regarding whether the Securities Act voids agreements to submit future disputes to arbitration. In reversing the Second Circuit, the Court held that agreements for arbitration of issues arising under the 1933 Act are invalid. Writing for the majority, Justice Reed noted that the public policy behind the Securities Act was to protect the investor—to supplement the age old rule of caveat emptor with the doctrine of "let the seller also beware." This policy was implemented by granting the investor the special right to a federal forum in section 12(2) of the 1933 Act. Although the Court acknowledged the tension between this policy and that of the Arbitration Act, which provides for speedy and economical resolution of disputes, it held that the investor's right to a trial under the Securities Act may not be waived. The majority explained that a federal trial guarantees the investor certain rights that are not available in arbitration, such as greater choice of courts and venue, and judicial review. Justice Reed concluded that the protective provisions of the Securities Act could not be effected if an investor waived the right to trial. Thus, after Wilko, courts and arbitrators deferred to the federal courts' exclusive jurisdiction of federal securities claims.

The majority based its decision on section 14 of the Securities Act, which voids all conditions, stipulations, or provisions that bind securities investors

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59. Id.
60. Id. at 430.
61. Id.
62. Id.
63. Id. at 438.
64. Id. at 430 (quoting Presidential message included within H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933)).
65. See supra note 47 and accompanying text.
66. 346 U.S. at 438. See supra note 39 and accompanying text.
67. 346 U.S. at 435.
68. Id. at 435-37. The Court further noted that arbitrators make their decisions without judicial instruction on the law and that grounds for vacating an award under the Arbitration Act are limited. Id. at 436. See infra notes 219-20 and accompanying text.
69. 346 U.S. at 437.
to waive compliance with any provision of the Securities Act.\footnote{71} Justice Reed explained that an agreement to arbitrate was a “stipulation”\footnote{72} and that the right to select the judicial forum was a “provision” under the Securities Act that could not be waived.\footnote{73} The Court concluded that Congress’ intent in enacting protective securities legislation could best be served by holding the agreement for arbitration of issues arising under the Securities Act invalid.\footnote{74}

Since the Wilko decision, which addressed claims arising under the Securities Act of 1933, uncertainty has surfaced over whether agreements to arbitrate claims arising under the Securities Exchange Act of 1934 are also unenforceable. In Scherk v. Alberto-Culver Co.,\footnote{75} the United States Supreme Court explained that Wilko was brought under the “private remedy” provision of the 1933 Act and that the 1934 Act does not explicitly provide for a private remedy.\footnote{76} Case law, however, has established an implied cause of action.\footnote{77} The Scherk decision further noted that while both acts prohibit “waivers of compliance” with any “provision” of the act, the provisions of the 1933 Act held nonwaivable in Wilko have no counterpart in the 1934 Act.\footnote{78} Generally, however, courts have held that Wilko is equally applicable to both the 1933 and 1934 Acts,\footnote{79} noting the similarity between the an-


\footnote{72} 346 U.S. at 434. See supra note 71.

\footnote{73} 346 U.S. at 435. See supra note 71.

\footnote{74} 346 U.S. at 438.

\footnote{75} 417 U.S. 506 (1974).

\footnote{76} Id. at 513-14. The Court stated that there is no “statutory counterpart” of § 12(2) in the 1934 Act and that while § 10(b) of the 1934 Act provides that the use of manipulative and deceptive devices in connection with the purchase or sale of registered securities is illegal, it does not set forth a private remedy to redress violations of the provision. Id. at 513.

\footnote{77} Id. at 513-14. See supra note 53.

\footnote{78} 417 U.S. at 514. The Court stated that the 1933 Act allows the plaintiff to bring suit in “any court of competent jurisdiction,” 15 U.S.C. § 77v (1982), while the 1934 Act provides that suit may only be brought in federal district courts that have “exclusive jurisdiction,” 15 U.S.C. § 78aa (1982).

\footnote{79} See, e.g., Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59, 61 (8th Cir. 1984) (noting that lower courts have consistently held that Wilko also applies to claims arising under the 1934 Act); Sibley v. Tandy Corp., 543 F.2d 540, 543 n.3 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977) (stating that the similarities between the 1933 and 1934 Acts outweigh any differences and therefore Wilko applies to both the 1933 and 1934 Acts); Colonial Realty Corp. v. Bache & Co., 358 F.2d 178, 183 n.5 (2d Cir. 1964) (§ 14 of the 1933 Act, relied on by the Wilko Court, is almost identical to § 29(a) of the 1934 Act); Macchiavelli v. Shearson, Hammill & Co., 384 F. Supp. 21, 27-28 (E.D. Cal. 1974) (holding that an arbitration agreement may not waive a federal cause of action under the 1934 Act); Starkman v. Seroussi, 377 F. Supp. 518, 522 (S.D.N.Y. 1974) (Wilko is “equally applicable” to the 1934 Act).
Arbitrable and Nonarbitrable Claims

The Court's decision in Scherk is noteworthy, however, because it enforced an arbitration agreement included as part of an international business contract, despite alleged federal securities violations. Under the contract


81. Recently, the Supreme Court has upheld the enforcement of arbitration agreements in nonsecurities cases. In Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1 (1983), the Court held that a district court had improperly stayed a federal action pending resolution of a concurrent state court suit, id. at 4, stating that the Arbitration Act requires "piecemeal resolution when necessary to give effect to an arbitration agreement." Id. at 20. The petitioner, Moses H. Cone Memorial Hospital (Hospital), entered into a contract with defendant Mercury Construction Corporation (Mercury), for construction of additions to the Hospital. Id. at 4. Under the agreement, contract disputes were initially to be referred to the architect and then could be submitted to arbitration. Id. at 4-5. When a dispute arose regarding extended overhead and cost overruns claimed by Mercury, however, the Hospital sought a judgment in state court that there was no right to arbitration and that it was not liable to Mercury. Id. at 7. The Hospital was subsequently granted an injunction forbidding Mercury to proceed towards arbitration, but the stay was dissolled pursuant to Mercury's objection. Id. Mercury then filed in federal court, seeking an order to compel arbitration under § 4 of the Arbitration Act. Id. See supra note 35. The district court stayed the action, pending the resolution of the state court suit, but the court of appeals reversed and entered an order to arbitrate. 460 U.S. at 7-8. The Supreme Court affirmed noting that the Arbitration Act requires any uncertainty regarding the arbitrability of issues to be resolved in favor of arbitration. Id. at 24-25, 29.

The Moses case differs from the securities cases in that there was no federal law or policy that conflicted with the Arbitration Act. The issue in Moses was simply whether the federal suit should be stayed in deference to the parallel state suit. Id. at 13. The Court found that the presence of a federal law issue, arbitrability as required by the Federal Arbitration Act, was "a major consideration weighing against surrender [of federal jurisdiction]." Id. at 26. Thus, resolution of the dispute between the Hospital and Mercury would require two separate suits, one in federal court and one in state court. Id. at 19-20. Although the Court had previously stated that the desirability of avoiding piecemeal litigation is a factor weighing towards dismissal of a federal suit in the face of a concurrent state suit, it now held that a bifurcated resolution was necessary to uphold the policy established by the Arbitration Act. Id. at 20.

In an even more recent case, the Supreme Court held that the Arbitration Act preempts a California franchise statute. In Southland Corp. v. Keating, 104 S. Ct. 852 (1984), franchisees, who had signed a contract containing an arbitration clause, filed suit in state court alleging fraud, misrepresentation, breach of contract and fiduciary duty, and violation of disclosure requirements of the California Franchise Investment Law. Id. at 853. The franchisor's subsequent motion to compel arbitration was granted, except for those claims based on the state's franchise investment law. Id. The state appellate court reversed, holding that the state law did not invalidate arbitration agreements. The state's highest court disagreed, however, interpreting the statute to require judicial consideration of claims arising under it. Id. at 858. The
between Alberto-Culver, an American manufacturer, and Scherk, a German citizen, Scherk granted Alberto-Culver all trademark rights of three foreign enterprises it had purchased, guaranteeing that the trademarks were unencumbered.\(^2\) When Alberto-Culver subsequently discovered that the trademarks were encumbered, it brought suit in federal court alleging that Scherk had violated the Securities Exchange Act of 1934 through his misrepresentations.\(^3\) The contract, however, provided that all disputes would be arbitrated in Paris, France, and that the laws of Illinois would govern the agreement.\(^4\) Scherk moved to stay the action pending arbitration in Paris, but his motion was denied on the basis of the \textit{Wilko} decision. The United States Court of Appeals for the Seventh Circuit affirmed.\(^5\)

The Supreme Court reversed the holding of the Seventh Circuit in a five to four decision,\(^6\) finding that the international character of the contract in dispute distinguished it from the contract in \textit{Wilko}. The Court noted that the parties to the contract were a German citizen and an American company, that negotiations took place in the United States, England, and Germany, that the contract was executed in Austria, and that the business enterprises purchased by Alberto-Culver were organized and located primarily in Europe.\(^7\) In contrast, the parties, the negotiations, and the subject matter of the contract in \textit{Wilko} were all located in one country, the United States.\(^8\) The majority in \textit{Scherk} emphasized that arbitration and forum clauses in international contracts are necessary to avoid the disorder and uncertainty that may accompany a dispute arising under an international

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\(^3\) Id. at 506.
\(^4\) Id. at 509.
\(^5\) Id. at 508.
\(^6\) Id. at 510. The court of appeals' decision was based on its finding that the business transaction involved a "security" within the purview of the Securities Exchange Act of 1934. \textit{Id.}
\(^7\) Id. at 515-16. The Court explained that in \textit{Wilko} it was indisputable, with or without an arbitration provision, that the laws of the United States would govern controversies arising out of the stock-purchase agreement. \textit{Id.} at 515. However, without an arbitration provision in \textit{Scherk}, much uncertainty would exist regarding the law applicable to resolution of disputes arising out of the agreement. \textit{Id.} at 516.
contract governed by the substantive law of each country it touches. Therefore, to avoid this uncertainty and to better enable businessmen to enter into international agreements, the Court held that the parties' agreement to arbitrate disputes arising out of their international contract should be enforced.

The four dissenters in Scherk refused to find the international character of the agreement controlling; rather, they believed that the Wilko doctrine should apply. The dissenters explained that the public policy of the securities acts and the Wilko decision is to protect the investor, and that the international aspects of an agreement should not deprive an investor of that protection.

The minority did concede that the parties in Scherk were sophisticated buyers and sellers who did not necessarily need the protection afforded the small investor in Wilko. Several commentators have suggested that the equal bargaining power of the parties was one reason for the outcome in the Scherk case. One writer espousing this theory argued that the Court bal-

89. Id. at 516. The Court speculated that in the absence of forum and arbitration clauses in international contracts, parties would engage in "jockeying" to secure the most favorable forum for their claim, possibly resulting in the dispute being submitted to a forum "hostile to the interests of one of the parties or unfamiliar with the problem area involved." Id.

90. Id. at 519-20. The Court noted that its holding was reinforced by the United States' legislative adoption of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards in chapter 2 of the Federal Arbitration Act. Id. See 9 U.S.C. §§ 201-208 (1982). The purpose of the Convention is to encourage the enforcement of arbitration provisions in international contracts. Scherk, 417 U.S. at 520 n.15.

91. Id. at 525.

92. Id.

93. Id. at 534. The dissenters conceded that certainty in international contracts is important, but held that when the federal securities laws apply, they take precedence over arbitration clauses. Id. Writing for the dissenters, Justice Douglas stated that section 29 of the 1934 Act, which voids arbitration clauses, "recognizes no exception for fraudulent dealings which incidentally have some international factors." Id.

94. Id. at 525-26. Scherk was a "powerful German operator" and Alberto-Culver was an American manufacturer, aided by lawyers and experts. Id.

95. See Note, International Arbitration—Extraterritorial Application of United States Securities Laws Denied; Arbitration Clause in Investment Contract Enforced, 16 Harv. Int'l L.J. 705, 714-15 (1975) (Wilko and Scherk can be distinguished by the difference in bargaining power of the parties); Note, International Commercial Arbitration and the Federal Securities Laws, 7 N.Y.U. J. Int'l L. & Pol. 383, 392-94 (1974) (judicial protection is appropriate where plaintiff has purchased securities from a brokerage firm, but is hardly necessary between the two sophisticated business parties in Scherk). The Scherk exception to the Wilko doctrine is comparable to the exception carved out for arbitration of disputes between securities exchange member firms, who are also perceived to be on equal bargaining grounds. See, e.g., Axelrod & Co. v. Kordich, Victor & Neufeld, 451 F.2d 838, 842-43 (2d Cir. 1971). In holding that an arbitration agreement between two exchange member firms is exempt from the nonwaiver provisions of the 1934 Act, the Second Circuit stated in Axelrod that the Wilko decision was based on the legislative policy of protecting investors, who may occupy inferior bargaining positions...
anced the two broad policies of the securities laws and the Arbitration Act and that because Scherk involved two savvy business parties, the indispensability of arbitration in international business outweighed the securities acts' policy to protect the investor.96 Thus, in Scherk, the Court found that the policy of the securities laws is not always preeminent.97 Rather, the Court implied that it is necessary in each case to look at the needs and interests of the American investor in the context of the policies of the securities laws and the Arbitration Act.98

II. ARBITRABLE AND NONARBITRABLE CLAIMS IN THE CIRCUIT COURTS: THE INTERTWINING DOCTRINE OR A BIFURCATED RESOLUTION?

After Scherk, the courts faced a new dilemma involving the tension between the securities laws and the Arbitration Act. Investors often bring suits alleging common law and state claims in addition to federal securities claims.99 State claims, based on the contractual and fiduciary relationship between the broker and investor,100 commonly involve breach of contract101 with respect to brokerage firms. Id. The Second Circuit further explained that this policy would not be hampered by enforcement of arbitration agreements between member firms. Id.

96. See Note, supra note 95, at 715.
97. See id. at 720. The author notes that while the Supreme Court has encouraged and supported the policies of the securities laws, it has conceded "[w]e cannot have trade and commerce in world markets . . . exclusively on our terms, governed by our laws, and resolved in our courts." Id. (quoting The Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 9 (1972)).
98. See id. (Scherk makes clear that the "Court intends to focus on how best to protect the interests of the American investor.").
99. See, e.g., Dickinson v. Heinold Sec., Inc., 661 F.2d 638 (7th Cir. 1981) (plaintiff's amended complaint included four counts: one federal securities law count, and three counts alleging various state law tort and contract claims, based upon essentially the same facts relevant to the federal claim); Sibley v. Tandy Corp., 543 F.2d 540 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977) (plaintiff's complaint included four breach of contract counts, one federal and one state securities law count, and one common law fraudulent misrepresentation count, all of which arose out of the same facts); Greitzer v. United States Nat'l Bank, 326 F. Supp. 762, 762 (S.D. Cal. 1971) (alleging common law fraud along with violations of § 10(b) of the 1934 Act and § 17(a) of the 1933 Act).
100. See Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017, 1026 (6th Cir. 1979) (broker-dealer owes customer a high degree of fiduciary care); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 45 (2d Cir.), cert. denied, 439 U.S. 1039 (1978) (broker owed his customer a fiduciary duty); Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978) (broker handling a discretionary account is a "fiduciary of his customer in a broad sense"). Discretionary accounts are those in which the broker determines which purchases and sales to make, whereas, in the case of a nondiscretionary account, the customer determines what transactions will occur. Id. A broker handling a nondiscretionary account, however, still owes a fiduciary duty to the customer—just not as broad a duty as that owed to a discretionary account customer. See id.
101. See, e.g., Mansbach, 598 F.2d at 1021 (plaintiff alleged breach of contract with viola-
and breach of fiduciary duty. Common law actions are often claims of fraud. If there exists a predispute arbitration agreement, that is, an agreement to submit future disputes arising under the agreement to arbitrators for resolution, these common law and state claims may be submitted to arbitration. Under Wilko, however, predispute arbitration agreements are unenforceable as applied to federal securities claims. The question, therefore, becomes whether the common law and state claims are arbitrable if they are joined with a nonarbitrable federal securities claim. When such claims are joined, they are often referred to as mixed arbitrable and nonarbitrable claims.

The first federal appeals court to encounter the issue of mixed arbitrable and nonarbitrable claims in a securities case was the United States Court of Appeals for the Fifth Circuit. In Sibley v. Tandy Corp., the Tandy Corporations of the federal securities laws when broker failed to properly execute plaintiff's order to purchase certain options; Sibley, 543 F.2d at 543 (plaintiff alleged breach of contract in addition to common law fraud and federal and state securities law violations in an action regarding a corporate merger agreement).


103. See, e.g., Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59, 60 (8th Cir. 1984). In Surman, plaintiff sought damages based on common law fraud as well as for violations of the federal and state securities laws in an action alleging loss of funds due to improper management of accounts and misrepresentations regarding the accounts. Id.; see also Haydu, 675 F.2d at 1172 (alleging fraud and misrepresentation in handling of securities account in addition to violations of federal and state securities laws); DeHart v. Moore, 424 F. Supp. 55, 56 (S.D. Fla 1976) (alleging violations of the Securities Exchange Act of 1934 and common law fraud and misrepresentation).

104. Krause, supra note 80, at 709 n.97.


106. See supra notes 56-74 and accompanying text.

107. See, e.g., Surman, 733 F.2d at 62 (noting the argument that bifurcation of "mixed lawsuits" is inefficient); Liskev v. Oppenheimer & Co., 717 F.2d 314, 320 (6th Cir. 1983) (noting one court's holding that the Arbitration Act does not apply to "mixed claims"); Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578, 581 (E.D. Cal. 1982) (intertwining doctrine developed to aid courts confronted with a "mixed claims" issue).

108. 543 F.2d 540 (5th Cir. 1976), cert. denied, 434 U.S. 824 (1977). The Fifth Circuit followed the result reached by a lower court in Shapiro v. Jaslow, 320 F. Supp. 598 (S.D.N.Y. 1970). In Shapiro, plaintiff brought suit against both the brokerage firm and the broker who handled his account. Id. at 599. The defendant brokerage firm, alleging that plaintiff's claims were only common law claims, moved to stay the action and to compel arbitration, as provided
ration and P.J. Parker, Inc. had entered into a merger agreement under which Parker shareholders were to be paid in Tandy stock, two thirds upon surrender of the Parker shares and the remaining third held in an escrow account pending verification of Parker's stated net worth. The parties agreed that all disputes arising under the agreement would be submitted to arbitration. When Tandy's auditors determined that Parker's net worth was substantially less than represented, Tandy ordered the bank to impound the escrowed stock. Sibley, the designated representative of the Parker shareholders, brought suit against Tandy alleging breach of contract and fraudulent misrepresentation as well as violation of the Securities Exchange Act of 1934.

The district court, recognizing that the federal count was not subject to arbitration, refused to sever the other counts and to submit them to arbitration. The court based its decision on the ground that the claims were so "intertwined" that to sever them would violate section 78cc, the antiwaiver provision of the 1934 Act. Section 78cc prohibits stipulations, such as an arbitration agreement, binding a person to waive compliance with a Securities Exchange Act provision, such as the right to select a judicial forum.

On appeal, the Fifth Circuit agreed with the district court that there are instances when it is difficult, if not impossible, to separate nonarbitrable fed-
Arbitrable and Nonarbitrable Claims

eral claims from arbitrable contract claims. The Fifth Circuit determined that in such circumstances, it should preserve its exclusive jurisdiction over federal securities law claims by denying arbitration. In this case, however, the court did not deem the claims before it sufficiently intertwined, noting that the same facts did not underlie each claim.

In *Miley v. Oppenheimer & Co.*, the Fifth Circuit clarified the degree of intertwining required to prevent submission of pendent claims to arbitration. In *Miley*, a case involving mixed arbitrable and nonarbitrable claims, Oppenheimer, the defendant broker, argued that the court should refuse to submit arbitrable claims to arbitration only when the legal issues are inseparable. Although the court agreed that common evidentiary facts underlying the federal and pendent claims alone do not justify refusing to submit the nonfederal claims to arbitration, it did not agree with Oppenheimer's interpretation of the intertwining doctrine. Rather, the court explained that claims are intertwined "sufficiently when the same factual (and legal) conclusions must be drawn from the common evidentiary facts to resolve the federal and pendent state claims." The court concluded that when this degree of intertwining between claims is present, there is a threat to the federal court's exclusive jurisdiction of federal securities claims, and therefore, arbitration must be refused.

The Fifth Circuit refused to order arbitration in *Miley*, holding that there

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117. *Id.*
118. *Id.* at 543-44. The Fifth Circuit distinguished the claims alleged in *Sibley* from the claims held to be intertwined in *Shapiro v. Jaslow*, 320 F. Supp. 598 (S.D.N.Y. 1970). In *Shapiro*, an arbitrator deciding the common law claims would have to deal with the same facts needed to establish the federal claim. In *Sibley*, however, the court found that the federal claim was dependent upon the contract claims. Plaintiff's complaint was essentially a breach of contract claim and the federal securities claim was a fall-back position, predicated upon plaintiff's first two positions being resolved against him. 543 F.2d at 543-44.
119. 637 F.2d 318 (5th Cir. 1981).
120. *Id.* at 335. The defendant contended that Miley's claims were not intertwined legally because they were instituted on three separate causes of action: violation of the federal securities law; breach of fiduciary duty; and violation of the Texas Deceptive Trade Practices-Consumer Protection Act. *Id.* at 325 n.6, 335.
121. *Id.* at 335. The court concluded that pendent state claims almost never would be sent to arbitration if common evidentiary facts were the only requirement of the intertwining doctrine. *Id.*
122. *Id.* at 335-36. In other words, claims are intertwined when a review of the common facts would lead to the same decision for both the federal and pendent claims.
123. *Id.* at 336. In a case where both the federal judge and the arbitrator reach their conclusions from the same facts, the federal judge may be bound through collateral estoppel by the previous findings of the arbitrator, thereby nullifying the exclusive jurisdiction of the federal court. *Id.*
existed a sufficient degree of intertwining between claims. The plaintiff investor had alleged breach of fiduciary duty as well as a violation of the federal securities laws.

To illustrate, Judge Goldberg explained that an arbitrator might find that the investment company did not breach the fiduciary duty owed its client because the account was properly managed in light of the client's objectives. This finding would provide the basis for resolving the federal case, thus obviating the federal court's exclusive jurisdiction.

Other courts, however, believed that arbitration could be ordered while still preserving the federal court's exclusive jurisdiction. These courts found that if arbitration of common law and state claims was stayed pending judicial resolution of the federal securities claim, there would be no threat to the federal court's exclusive jurisdiction. Consequently, several of the appellate courts have rejected the intertwining doctrine, causing a wide split among the federal circuits on this issue.

The United States Court of Appeals for the Seventh Circuit was the first to disagree with the Fifth Circuit's theory. In Dickinson v. Heinold Securities, Inc., plaintiff brought suit against defendant brokerage firm alleging that the broker had violated federal securities laws by making material misrepresentations in soliciting the plaintiff's securities account. Plaintiff further asserted that the defendant had traded his account in a manner that maximized broker commissions, a practice known as "churning".

124. Id. at 336.
125. Id. at 325.
126. Id. at 336.
127. Id. Judge Goldberg stated that in a churning case like Miley, an arbitrator's decision on the breach of fiduciary duty claim, while the federal claim is stayed or heard simultaneously, "could essentially rob the federal court of its exclusive jurisdiction." Id.
128. See infra note 139 and accompanying text.
129. 661 F.2d 638 (7th Cir. 1981).
130. Id. at 640. Plaintiff felt that defendant broker failed to trade his account according to the agreement between the parties that gave defendant limited discretionary power to trade plaintiff's account in conformance with certain preselected investment strategies. Id. at 639-40.
131. Id. at 640. In other words, plaintiff contended that defendant excessively traded the account, receiving a commission for each purchase and sale of stock. See Note, Churning by Securities Dealers, 80 HARV. L. REV. 869 (1967).
132. See Miley, 637 F.2d at 324. Churning occurs when a securities broker induces excessively large and frequent transactions in the account in light of the client's investment objectives and acts in disregard of the client's interest. Id. See Note, supra note 131, at 869. To establish a churning claim, plaintiff must prove that "(1) the trading in his [investor's] account was excessive in light of his investment objectives; (2) the broker in question exercised control over the trading in the account; and (3) the broker acted with the intent to defraud or with willful and reckless disregard for the investors interests . . . ." Miley, 637 F.2d at 324 (citing Mihara v. Dean Witter & Co., 619 F.2d 814, 821 (9th Cir. 1980); Rolf v. Blyth, Eastman
Plaintiff's contract with the broker provided that all disputes arising out of the agreement would be submitted to arbitration. Accordingly, the defendant moved to stay proceedings on the state law tort and contract claims pending judicial resolution of the nonarbitrable federal securities law claim.

The district court decided that the state law claims would proceed to arbitration only if the federal securities claim was resolved against the plaintiff on defendant's pending motion for summary judgment. Defendant's motion was subsequently denied and the court retained all the claims for a judicial resolution.

Defendant appealed the order to the Seventh Circuit, which declined to adopt the intertwining doctrine in this case. The court stated that exclusive jurisdiction of the federal securities claim could be maintained by ordering arbitration stayed pending judicial resolution of the federal claim. Judge Cudahy, writing for the majority, rejected the notion that the intertwining doctrine was more efficient. Instead, he reasoned that duplication of effort would be minimal because of the collateral estoppel effect of the federal court's decision on the subsequent arbitration.

Dillon & Co., 424 F. Supp. 1021, 1039-40 (S.D.N.Y. 1977), aff'd in part and rev'd in part, 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978)). When these elements are proved, the broker may be found in violation of "section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and SEC Rule 10b-5." 637 F.2d at 324. Rule 10b-5 makes unlawful the use of "any device, scheme, or artifice to defraud . . . in connection with the purchase or sale of any security," 17 C.F.R. § 240.10b-5(a) (1984), and churning is described as a "device, scheme or artifice to defraud." Miley, 637 F.2d at 324 n.4; McNeal v. Paine Webber, Jackson & Curtis, Inc., 598 F.2d 888, 890 n.1 (5th Cir. 1979).

Judge Cudahy further...
suggested that many claims may be settled after the federal trial.\footnote{141}

Judge Cudahy also criticized the "common evidentiary facts" test employed by courts to determine if claims are intertwined sufficiently, calling it the "exception that swallowed the rule."\footnote{142} Although the court acknowledged the Fifth Circuit's attempt to refine the rule in \textit{Miley},\footnote{143} it stated that able lawyers could always demonstrate a sufficient intertwining between federal and pendent claims to prevent arbitration of the latter.\footnote{144} Emphasizing the parties' contractual duty to arbitrate and the federal policy favoring enforcement of arbitration agreements,\footnote{145} the Seventh Circuit concluded that the Arbitration Act required a bifurcated resolution: a federal proceeding followed by arbitration of the pendent claims, rather than retention of all claims at the federal level as provided by the intertwining doctrine.\footnote{146}

In the years following \textit{Sibley}, \textit{Miley} and \textit{Dickinson}, other courts of appeals have divided on the issue. The Sixth\footnote{147} and Eighth\footnote{148} Circuits have followed...
the *Dickinson* court's bifurcated approach and the Eleventh Circuit\(^\text{149}\) has adopted the intertwining doctrine.\(^\text{150}\)

III. THE SECURITIES AND EXCHANGE COMMISSION EXAMINES ARBITRATION

An examination of the arbitration process and the use of arbitration clauses by the SEC coincided with the judicial rift on the issue of arbitrability. In 1976, the SEC began exploring the feasibility of a nationwide investor dispute resolution system to be made available through self-regulatory organizations, such as the New York Stock Exchange and the National Association of Securities Dealers.\(^\text{151}\) The SEC discovered that some investors disliked arbitration because they doubted the impartiality of arbitration

that the Arbitration Act does not apply to mixed arbitrable and nonarbitrable claims. *Id.* at 320. Instead, the Sixth Circuit agreed with the *Dickinson* court that a bifurcated approach properly balanced the policies of the Arbitration Act and the Securities Exchange Act of 1934. *Id.*

148. Surman v. Merrill Lynch, Pierce, Fenner & Smith, 733 F.2d 59 (8th Cir. 1984). The Surmans brought suit against defendant brokerage firm, claiming loss of funds due to improper management of their accounts and misrepresentations regarding the risk and profitability of their accounts. *Id.* at 60. They specifically alleged violations of the Securities Exchange Act, state law, and common law. *Id.* The case came before the Eighth Circuit, after the district court refused to order arbitration of the common law and state claims. *Id.* at 60-61. The court of appeals remanded the case to the lower court and ordered that the common law and state claims be referred to arbitration. *Id.* at 63. It agreed with *Dickinson* that the federal court could preserve its exclusive jurisdiction of the federal securities claim by staying arbitration pending judicial resolution of the federal securities law claim. *Id.* at 62. The court conceded that one of the goals of the Arbitration Act, efficiency, might be better served by trying all the related claims together, but it did not believe this a valid reason for holding the arbitration clause unenforceable. *Id.* at 63.

149. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu, 675 F.2d 1169 (11th Cir. 1982). In *Haydu*, plaintiff originally brought suit in state court charging defendant stockbroker with negligence, fraud, and breach of fiduciary duty. *Id.* at 1171. Broker removed the action to federal court and subsequently moved to stay the action and to compel arbitration in accordance with the broker-investor contract. *Id.* Upon plaintiff's motion, the case was remanded to state court. *Id.* Broker then filed in district court, in a separate action, to compel arbitration. *Id.* The court granted the motion, but the court of appeals reversed and remanded. *Id.* On remand, the district court dismissed the action, stating that the state court had disposed of the federal arbitration claim. *Id.* Broker appealed, but the court of appeals affirmed. *Id.* at 1172. The court explained that plaintiff's amended state court complaint, filed during this litigation, included a 1933 Securities Act count. *Id.* Relying on the reasoning in *Miley* and *Sibley*, the court found that an arbitrator deciding plaintiff's state law claims would be forced to review the same facts needed to establish the securities law claim. *Id.* The court, therefore, found the claims intertwined and refused to order arbitration of the pendent state claims. *Id.* at 1173.

150. None of these decisions has added any new arguments to the discussion. *See supra* notes 147-49.

officials associated with these self-regulatory associations. As a result, the SEC recommended that all brokerage firms with public customers be required to establish in-house complaint processing systems. Additionally, the SEC determined that a uniform code of arbitration should be drafted for use by organizations offering arbitration facilities. In response, the self-regulatory groups organized the Securities Industry Conference on Arbitration, which in turn drafted a proposed Uniform Arbitration Code. The Code was subsequently approved by the SEC in 1979.

The Arbitration Code incorporates several provisions not included in former arbitral systems promoting the impartiality of the arbitral forum. For disputes involving amounts over $2,500, the Code provides for the appointment of a panel of no less than three nor more than five arbitrators. A majority of the panel may not be from the securities industry, unless the customer requests otherwise. In addition, the Code requires that the parties be informed of the names and affiliations of the arbitrators at least eight days in advance of the initial hearing date. Finally, it gives the parties two avenues by which they may exclude certain arbitrators. First, each

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152. Id. The Commission further noted that investors may be deterred by the expense of traveling to the site of arbitration. Id.

153. Id.

154. Id.


157. SICA Report, supra note 155, at 3. The Arbitration Code provision states:

(1) Except as otherwise provided in this Code in all arbitration matters involving public customers, and where the matter in controversy does not exceed the amount of $100,000, the Director of Arbitration shall appoint an arbitration panel which shall consist of no less than three (3) nor more than five (5) arbitrators, at least a majority of whom shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

(2) In all arbitration matters involving public customers where the amount in controversy is $100,000 or more, the Director of Arbitration shall appoint an arbitration panel which shall consist of five (5) arbitrators, at least a majority of whom shall not be from the securities industry, unless the public customer requests a panel consisting of at least a majority from the securities industry.

Id. at A-4 to A-5.

158. Id.

159. Id. at 3. Section 9 of the Code provides: “The Director of Arbitration shall inform the parties of the names and business affiliations of the arbitrators at least eight (8) days prior to the date fixed for the initial hearing session.” Id. at A-5.
Arbitrable and Nonarbitrable Claims

party has the right to a peremptory challenge excluding one arbitrator without providing a reason.\textsuperscript{160} Second, each party may exclude an arbitrator for cause.\textsuperscript{161}

Shortly before it approved the Uniform Arbitration Code, the SEC voiced concern about the unrestricted use of arbitration clauses in broker-investor agreements.\textsuperscript{162} The Commission was primarily concerned that most investors were unaware that \textit{Wilko} had secured their right to a judicial forum for claims arising under the federal securities laws.\textsuperscript{163} In fact, the SEC had received inquiries from individual investors regarding the enforceability of arbitration agreements, which broker-dealers often required as a condition of doing business.\textsuperscript{164} Acting on its concern, the SEC issued a warning to broker-dealers, in the form of a notice rather than a binding regulation, that customers must be informed that arbitration agreements do not waive their right to a judicial forum for claims arising under the federal securities laws.\textsuperscript{165} The Commission did not prescribe the form or language by which customers were to be informed of their rights, but placed responsibility on broker-dealers to adequately disclose the meaning and effect of arbitration clauses.\textsuperscript{166} The broker-dealers did not react positively to the Commission’s warning, however, and continued to utilize arbitration clauses without explanatory information regarding the judicial alternative. This course of action on the part of the securities industry provoked the SEC to issue a notice

\textsuperscript{160} \textit{Id.} at 3. Section 10 of the Code provides:

In an arbitration proceeding being heard by a panel consisting of more than one arbitrator, each party shall have the right to one (1) peremptory challenge. A party wishing to exercise a peremptory challenge must do so by notifying the Director of Arbitration in writing within five (5) business days of notification of the identity of the persons named to the panel.

\textit{Id.} at A-5.

\textsuperscript{161} \textit{Id.} at 3.

\textsuperscript{162} Securities Exchange Act Release No. 34-15984 (July 2, 1979), 44 Fed. Reg. 40,462 (1979). Prior to the opening of an account, broker-dealers often request or require customers to sign an agreement, frequently a preprinted form, that includes a clause requiring that any controversy between the broker-dealer and customer be settled by arbitration. \textit{Id.} See infra note 187.


\textsuperscript{164} \textit{Id.}

\textsuperscript{165} \textit{Id.}

\textsuperscript{166} \textit{Id.} The Commission stated

[I]t is incumbent upon those who include arbitration clauses in agreements with customers to provide adequate information about such rights [to a judicial forum] in order to make the clauses not misleading. In addition, customers should not be led to believe, either before or after the occurrence of disputes, that a predispute arbitration agreement constitutes a waiver of the right to a judicial forum, where such waiver would be void under the securities laws.

\textit{Id.}
of proposed rulemaking in May 1983.\textsuperscript{167}

The Commission determined that broker-dealers' use of arbitration clauses without providing information regarding the judicial alternative is an inequitable, unjust trade practice.\textsuperscript{168} The Commission explained that investors are often unaware of their rights, and thus, the investor may submit a dispute to arbitration believing it the only chance for relief, or the investor may simply choose not to pursue resolution of a dispute.\textsuperscript{169} Furthermore, broker-dealers may require that the investor sign an agreement, which includes an arbitration clause, as a prerequisite to doing business.\textsuperscript{170} The Commission also noted that such practices may constitute a violation of the antifraud provisions of the federal securities laws.\textsuperscript{171} Thus, the proposed rule would require broker-dealers to disclose to investors that they do have recourse to the federal courts for claims arising under the federal securities laws, despite arbitration clauses included in the broker-investor agreement.\textsuperscript{172}

The securities industry severely criticized the proposed rule, and charged that despite the Commission's statement to the contrary, it appeared that the Commission no longer supported arbitration as a method of resolving broker-investor disputes.\textsuperscript{173} The industry claimed that the rule would prejudice


A notice of proposed rulemaking is an announcement by a federal agency to the public that it is engaged in the process of formulating, amending, or repealing a rule. With certain exceptions, the Administrative Procedure Act requires publication of notice of rulemaking in the \textit{Federal Register}. Administrative Procedure Act, 5 U.S.C. \textsection{} 553(b) (1982); 1 K. Davis, \textit{Administrative Law Treatise} \textsection{} 6.25 (2d ed. 1978).


\textsuperscript{169}. \textit{Id.}

\textsuperscript{170}. \textit{Id.} \textit{See supra} note 162.

\textsuperscript{171}. Securities Exchange Act Release No. 34-15984 (July 2, 1979), 44 Fed. Reg. 40,462 (1979). The antifraud provisions of the securities acts prohibit any stipulation binding a person buying a security to waive compliance with the securities acts' provisions. \textit{See supra} notes 71, 114. Thus, the Commission found that broker-dealers' practice of requiring their customers to enter into an agreement providing that all disputes arising under the agreement be submitted to arbitration, without alerting such customers to their right to a judicial forum, may be in violation of the antifraud provisions. Securities Exchange Act Release No. 34-15984 (July 2, 1979), 44 Fed. Reg. 40,462 (1979). If no information regarding the judicial alternative is provided to the customer, in effect, the agreement binds the customer to waive rights provided by the securities acts. \textit{See id.}


the investor’s view of arbitration by creating doubts as to the integrity of arbitration panels. The industry feared that as a consequence of the proposed rule there would be an increase in the volume of litigation.

It may be speculated that brokers dislike litigation, and favor arbitration, for several reasons. Primarily, brokers dislike the costs and delays associated with federal litigation. Litigation is often accompanied by a long discovery process, and, because of the possibilities of appeal, lacks the finality of arbitration. When small sums are involved, brokers are especially reluctant to enter into protracted litigation. Further, punitive damages, generally not allowed in arbitration, may be granted in litigation. Moreover, federal jury awards are frequently more liberal than arbitration awards. Although one industry representative denied that brokers fare better in arbitration than in litigation, statistics demonstrate that, at least prior to adoption of the Uniform Arbitration Code, investors did not fare well on their claims submitted to arbitration. In commenting on the proposed rule, however, industry persons suggested that because arbitration procedures have improved significantly, the Commission should ask Congress to repeal the Wilko doctrine, thereby allowing customers to agree to compulsory arbitration.

Despite the industry’s objections, the SEC adopted the rule on November 18, 1983, noting that informal warnings had failed to curtail the securities

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174. Arieff, supra note 173, at 1, col. 4; at 5, col. 2.
175. Poser, supra note 173, at 12.
176. Id.
177. See id.; see also infra note 223 and accompanying text.
179. See infra note 227 and accompanying text.
180. See Hyman, supra note 19, at 36. The author states that brokers include arbitration provisions in contracts, attempting to “avoid liberal federal jury awards in favor of more conservative arbitration awards.” Id.
181. Arieff, supra note 173, at 5, col. 2.
182. See Zepfel, supra note 178, at 130 n.63. During the period 1957-61, 338 cases were initially submitted to the New York Stock Exchange for arbitration, but claimant was granted an award in only 53 cases. Id. During 1982, 473 cases were handled by the New York Stock Exchange’s arbitration division. Arieff, supra note 173, at 5, col. 3. Decisions were reached in 273 cases; customers were successful in 118 cases, noncustomers in 63 cases, and the remaining cases were dismissed. Id.
183. Arieff, supra note 173, at 5, col. 1.
   (a) It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under
industry's use of deceptive arbitration clauses.\textsuperscript{185} Specifically, the rule prohibits broker-dealers from entering into or maintaining agreements with customers purporting to bind them to arbitration of all future disputes, including those arising under the federal securities laws.\textsuperscript{186} It does allow broker-dealers to use remaining supplies of preprinted forms including the standard arbitration clause,\textsuperscript{187} but requires that such agreements be accompanied by a specified written disclosure.\textsuperscript{188}

By promulgating this rule in the face of the securities industry's opposition and continued failure to modify its use of arbitration clauses, the SEC has indicated that the public investor still needs protection in dealing with the securities industry. Thus, the Commission appears to adopt the position that when the policies of the federal securities laws and the Arbitration Act conflict, principles underlying investor protection must override interests in efficient resolution of disputes through arbitration.\textsuperscript{189} The Commission, in the federal securities laws, or to have in effect such an agreement, pursuant to which it affects transactions with or for a customer.

(b) Notwithstanding paragraph (a) of this section, until December 31, 1984 a broker or dealer may use existing supplies of customer agreement forms if all such agreements entered into with public customers after Dec. 28, 1983 are accompanied by the separate written disclosure:

Although you have signed a customer agreement form with FIRM NAME that states that you are required to arbitrate any future dispute or controversy that may arise between us, you are not required to arbitrate any dispute or controversy that arises under the federal securities laws but instead can resolve any such dispute or controversy through litigation in the courts.

\textit{Id.} (codified at 17 C.F.R. § 240.15c2-2 (1984)).

\begin{itemize}
  \item \textsuperscript{185} \textit{Id.} Prior to its 1979 warning, the Commission's staff had advised broker-dealers and security industry organizations of the need to modify arbitration clauses in light of Wilko v. Swan, 346 U.S. 427 (1953), but to the Commission's knowledge, no such changes were made in these agreements nor did broker-dealers provide any additional disclosure to investors regarding their rights. Securities Exchange Act Release No. 34-15984 n.7 (July 2, 1979), 44 Fed. Reg. 40,462 (1979).
  \item \textsuperscript{186} 17 C.F.R. § 240.15c2-2(a) (1984). \textit{See supra} note 184.
  \item \textsuperscript{187} An example of a typical arbitration clause prior to promulgation of this rule is as follows:

\begin{quote}
  Any controversy arising out of or relating to the account of the undersigned, to transactions with you for the undersigned 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 Board of Governors of the New York Stock Exchange or the American Stock Exchange as the undersigned may elect. If the undersigned does not make such election by registered mail addressed to you at your main office within five days after demand by you that the undersigned make such election, then you may make such election. Judgment upon any award rendered by the arbitrators may be entered in any court having jurisdiction thereof.
\end{quote}

  \item \textsuperscript{188} 17 C.F.R. § 240.15c2-2(b) (1984). \textit{See supra} note 184.
  \item \textsuperscript{189} Securities Exchange Act Release No. 34-15984, \textit{supra} note 163.
\end{itemize}
fact, based its actions on *Wilko v. Swan*, which held that Congress had
determined that investors should be entitled to the protection of federal
courts for the resolution of disputes arising under the federal securities
laws. Furthermore, the Commission stated that the Supreme Court's sub-
sequent decision in *Scherk v. Alberto-Culver Co.*, upholding enforcement of
an arbitration agreement, was restricted to the particular facts of that
case. Although the Commission noted that contract and state claims may
be referred to arbitration, and that there are instances where federal securi-
ties claims and contract and state claims are based on the same set of cir-
cumstances, it did not adopt a position on this debate among the circuit
courts.

IV. *BYRD v. DEAN WITTER REYNOLDS, INC.: ACCOMMODATING THE
POLICY UNDERLYING THE FEDERAL SECURITIES LAWS WITH
THE INCREASING USE OF ARBITRATION*

A. Adopting the Intertwining Doctrine Over A Bifurcated Approach

In 1984, the Supreme Court granted certiorari to the United States Court
of Appeals for the Ninth Circuit to review *Byrd v. Dean Witter Reynolds,
Inc.*, a case that may resolve the wide split in the circuits and establish a
uniform rule for mixed arbitrable and nonarbitrable securities claims. In
*Byrd*, a customer sold his dental practice and invested the proceeds with a
brokerage firm, signing a contract containing an agreement to arbitrate dis-
putes arising out of the management of the account. In the course of six
months, the customer's account declined from $160,000 to less than $60,000,
and he brought suit alleging improper handling of the account and misrepre-
sentation by the broker that the account was making a profit. Plaintiff

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34-20397, supra notes 163, 167, 184.
191. 346 U.S. at 438.
193. Id.
194. 726 F.2d 552 (9th Cir.), *cert. granted*, No. 83-1708 (June 11, 1984).
195. Id. at 553.
196. Id. The broker induced plaintiff to invest by representing that he would receive a
monthly income of $4,000 from his investment. On Petition For a Writ of Certiorari to the
United States Court of Appeals for the Ninth Circuit, Respondent's Brief in Opposition at 3,
Dean Witter Reynolds, Inc. v. Byrd, 726 F.2d 552 (9th Cir.), *cert. granted*, No. 83-1708 (June
11, 1984). The broker then altered the client information form so as to misrepresent respon-
dent's investment objectives and his qualifications to invest in speculative investments. *Id.*
Subsequently, he traded options on respondent's account without respondent's prior consent.
*Id.* Further, the broker bought and sold securities excessively, thereby engaging in so-called
"churning" of respondent's account. *Id. See* supra note 132. When respondent received his
monthly statements, indicating the declining balance, he was told to disregard the statements
alleged five separate claims, the first for violation of sections 10(b), 15(c) and 20 of the Securities Exchange Act of 1934, and the remaining four for violations of state law. Pursuant to the arbitration clause, Dean Witter Reynolds, Inc. (Dean Witter) moved for an order severing the federal claim from the pendent state claim and requested staying arbitration of the latter until judicial resolution of the federal securities claim. The district court denied the motion and Dean Witter appealed to the Ninth Circuit.

Noting that district courts in the Ninth Circuit are split on this issue, the Court of Appeals for the Ninth Circuit affirmed the lower court’s adoption of the intertwining doctrine, finding that the pendent and federal claims alleged in Byrd depended upon the same facts. The court noted the approach taken in Liskey and Dickinson, where arbitration of state claims was stayed pending judicial resolution of the federal securities claim, but found this approach lacking because it might frustrate the purpose of the Arbitration Act—efficient resolution of disputes. The Ninth Circuit concluded that the Arbitration Act did not anticipate allegations of arbitrable and nonarbitrable claims arising out of the same circumstances, nor did it anticipate the Supreme Court’s 1953 determination that the federal securities laws’ policy of investor protection is preeminent over the Arbitration Act’s policy of economic dispute resolution.

Thus, Byrd stands for the proposition that courts utilizing a bifurcated approach are not serving the policy of either the federal securities laws or the Arbitration Act. When arbitration is stayed pending resolution of the federal securities claim in a judicial proceeding, the goal of a speedy result

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198. Byrd, 726 F.2d at 553.
199. Id.
201. 726 F.2d at 554.
203. 661 F.2d 638 (7th Cir. 1981). See supra notes 129-46 and accompanying text.
204. 726 F.2d at 554.
205. Id. See supra notes 66-70 and accompanying text.
206. Id.
through arbitration has been frustrated. Likewise, if the federal trial is stayed, pending arbitration of the pendent claims, the investor's right to a federal forum loses its effectiveness because the federal forum will not have exclusive jurisdiction over the federal securities claim.

B. The Impact on the Investor of the Intertwining and Bifurcated Approaches

The Byrd court's analysis raises questions concerning how the two different approaches taken by the circuit courts affect the public investor. The intertwining doctrine places the emphasis on investor protection as provided by the federal securities laws. On the other hand, the bifurcated approach attempts to balance the policies of investor protection along with the goal of quick, economic resolution of disputes. In either case, the approach utilized may have a significant effect on the investor's claim.

One of the major benefits accorded to the investor by the consolidated federal proceeding required by the intertwining doctrine is that this approach preserves the right to a federal forum. Although the Uniform Arbitration Code has improved the investor's procedural rights in arbitration proceedings, the federal forum still provides certain safeguards not available in arbitration. Among these are trial by jury, the federal rules of evidence, and full rights of discovery. Jury awards are generally more liberal than arbitration awards, perhaps because a jury is more sympathetic to an investor than an arbitration panel, which includes members of the securities industry. Also, unlike a jury, arbitrators may not receive judicial instruction on the law, even if they desire such advice. Full discovery rights are important because they enable investors to obtain otherwise unavailable information regarding their accounts that may be helpful in the prosecution of

207. Id.
208. Id. See supra notes 126-27 and accompanying text.
209. See supra notes 108-27, 149 and accompanying text.
210. See supra notes 129-48 and accompanying text.
211. See supra notes 157-61 and accompanying text.
212. See supra note 10.
213. Hyman, supra note 19, at 36.
214. The Uniform Arbitration Code provides only that the majority of the arbitration panel not be from the securities industry. See supra note 157.
215. See Bernhardt v. Polygraphic Co., 350 U.S. 198, 203 (1956) (arbitrators receive no judicial instruction on the law); Wilko v. Swan, 346 U.S. 427, 436 (1953) (arbitrators must make determinations without judicial instruction on the law). The Wilko Court stated that although the provisions of the 1933 Securities Act favor the buyer, the advantage is lessened where arbitrators must make "subjective findings on the purpose and knowledge of an alleged violator of the Act" without judicial instruction on the law. Id. at 435-36.
claims based on the handling of the account.²¹⁶ Brokers usually have more information than investors for the preparation of a case.²¹⁷ More importantly, however, the federal forum entitles the investor to judicial review, whereas arbitration awards are rendered without a statement of reasons, making meaningful judicial review difficult, if not impossible.²¹⁸ Although the Federal Arbitration Act provides certain grounds for vacating an award,²¹⁹ as does case law,²²⁰ it is difficult to prove that any of the grounds exist without a written opinion.²²¹ The securities industry contends that the benefits associated with arbitration—efficiency and economy—are diminished when written opinions are required.²²² The industry maintains that these benefits would also be diminished if full discovery rights were added to the arbitration process.²²³

Another benefit of the consolidated federal proceeding is that it preserves

²¹⁶ See Zepfel, supra note 178, at 131. The author states that although the right of subpoena is generally available to parties in an arbitration proceeding, lack of full discovery rights hinders the investor in gaining information important to the success of his claim. Id. For example, full discovery rights may enable the investor “to learn the volume of commissions generated by his account in relation to other accounts, the nature of recommendations made by the broker’s research department, and possible conflicts of interest.” Id.

²¹⁷ Id.


²¹⁹ 9 U.S.C. § 10 (1982). The statute provides that an arbitral award may be vacated:

(a) Where the award was procured by corruption, fraud, or undue means.

(b) Where there was evident partiality or corruption in the arbitrators, or either of them.

(c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.

(d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

²²⁰ See id. at 436 (cannot examine arbitrators’ application of the law without a written record); Sobel v. Hertz, Warner & Co., 469 F.2d 1211, 1213 (2d Cir. 1972) (plaintiff contended that if arbitrators do not provide reasons, reviewing courts can only speculate on the grounds for an award).

²²¹ See id. at 1215. The Sobel court noted the New York Stock Exchange’s comment that requiring arbitrators to give reasons for their decision might put an end to arbitration altogether. Id. at 1215 n.7.

²²² Neville, supra note 10, at 10-11. The author states that an arbitration process that included full discovery rights and other provisions of the Federal Rules of Civil Procedure would, in effect, create a private court system that would defeat the purpose of arbitration. Id.
the investor's claim for punitive damages. Although punitive damages are not recoverable under the federal securities laws,224 many state laws permit punitive damages.225 In those states, when a state law violation is joined to a federal securities violation, the federal court may grant punitive damages.226 However, if the common law and state claims are submitted to arbitration, the punitive damages claim will likely be lost because arbitration rarely provides for such damages.227 This is the reason that brokers have traditionally advocated arbitration clauses, that is, they reduce the chance of large jury


225. Krause, supra note 80, at 695 n.18. Punitive damages are generally allowed under state law and have been awarded in securities cases for state law violations such as breach of fiduciary duty and fraud. Id. See Hyman, supra note 19, at 24. See, e.g., Miley, 637 F.2d at 329 (punitive damages allowable under Texas law under certain circumstances); Flaks v. Koege1, 504 F.2d 702, 706-07 (2d Cir. 1974) (punitive damages may be recoverable in action alleging federal securities violations and common law fraud and deceit, based on the pendent common law claim); Gann v. Bernzomatic Corp., 262 F. Supp. 301, 304 (S.D.N.Y. 1966) (New York law allows for punitive damages for state claim of fraud and deceit, although punitive damages are not recoverable under the Securities Exchange Act of 1934).

226. See Petrites v. J.C. Bradford & Co., 646 F.2d 1033, 1036 (5th Cir. 1981) (affirming punitive damages award based on common law fraud claim in connection with violation of federal securities laws); Coffee v. Permian Corp., 474 F.2d 1040, 1044 (5th Cir.), cert. denied, 412 U.S. 920 (1973) ("it is well established that exemplary damages may be awarded under state law when a state law violation is joined with the 10b-5 complaint"); Young v. Taylor, 466 F.2d 1329, 1337-38 (10th Cir. 1972) (punitive damages recoverable when federal securities claim joined with pendent common law and state claims).

227. Courts have reached different results on the question of whether arbitrators may grant punitive damages. Some courts have held that under certain circumstances, an arbitrator does have power to award punitive damages. See, e.g., Local 416, Sheetmetal Workers Int'l Assoc. v. Helgastee1 Corp., 335 F. Supp. 812, 815-16 (W.D. Wisc. 1971). In Local 416, the court held that where the labor agreement did not specify remedies, the arbitrator had discretionary authority to award punitive damages, so long as the award was reasonable in light of the arbitration board's findings. Id. at 816. Other courts have held arbitrators only have power to grant punitive damages when they are given such power by the contract authorizing arbitration. See, e.g., Safeway Stores, Inc. v. International Ass'n of Machinists & Aerospace Workers, Automotive Lodge No. 1486, 534 F. Supp. 638, 640-41 (D. Md. 1982) (punitive damages award may not be sustained where not authorized by the collective bargaining agreement); Desert Palace, Inc. v. Local Joint Executive Bd., 486 F. Supp. 675, 684 (D. Nev. 1980) (arbitrator had no authority to award punitive damages where not demanded in claim); International Union of Operating Eng'rs v. Mid-Valley, Inc., 347 F. Supp. 1104, 1109 (S.D. Tex. 1972) (arbitrator's grant of punitive award not enforceable because not authorized by the labor contract). Some courts, however, refuse to allow an arbitrator to grant punitive damages even when the contract does provide for such damages, on the grounds that punitive damages are "a social exemplary 'remedy,' not a private compensatory remedy." Garry v. Lyle Stuart, Inc., 40 N.Y.2d 354, 358, 386 N.Y.S.2d 831, 833, 353 N.E.2d 793, 795 (1976); In re Silverberg, 75 A.D.2d 817, 819, 427 N.Y.S.2d 480, 482-83 (1980) (arbitrator precluded by public policy from awarding punitive damages).
awards.228

The primary advantage accorded to the investor by a bifurcated resolution is economic rather than procedural. Although the intertwining doctrine provides for one proceeding and the bifurcated approach involves two proceedings, the bifurcated approach allows the investor to forego the potentially time-consuming and expensive federal proceeding for a much quicker, less expensive result through arbitration.229 Although investors may elect either a federal proceeding or arbitration, large attorneys' fees and the substantial time lags accompanying federal litigation may persuade investors to choose arbitration.230

Courts that embrace the intertwining doctrine view the investor's choice to arbitrate as a nullification of the purpose of the federal securities laws.231 The securities laws granted federal courts exclusive jurisdiction of federal securities claims so that they could adequately protect the investor.232 By allowing the investor to waive the federal court proceeding in favor of arbitration, however, this purpose is defeated.233 Moreover, even where the investor does not waive the federal proceeding, the court's exclusive jurisdiction may be rendered meaningless when arbitration precedes the federal trial because the court may then be bound to decisions reached in arbitration.234

C. The Future of the Wilko Doctrine

The Byrd case allows the Supreme Court to address the conflicting policies of the Arbitration Act and the federal securities laws. The Court's decision may have the effect of either extending or restricting the Wilko doctrine. In Wilko, the Court clearly held that the purpose of the securities laws must

228. See Hyman, supra note 19, at 26; see also supra text accompanying notes 213-214.
229. Dickinson v. Heinold Sec., Inc., 661 F.2d 638, 644 n.13 (7th Cir. 1981) (bifurcation may prove burdensome, forcing plaintiffs to surrender their right to a judicial resolution in favor of arbitration); Cunningham v. Dean Witter Reynolds, Inc., 550 F. Supp. 578, 584 n.7 (E.D. Cal. 1982) (bifurcation creates "incentive for plaintiffs to drop one set of claims to obtain speedier justice").
230. Id. (plaintiffs may drop federal cause of action to obtain "faster and cheaper results through arbitration"). See supra text accompanying note 177.
232. See supra notes 45-50 and accompanying text.
234. Miley, 637 F.2d at 336. See supra note 231.
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take precedence over the Arbitration Act. 235 Although the Court enforced an arbitration agreement in Scherk, despite alleged federal securities violations, the decision was based primarily on the international character of the agreement. 236 In more recent cases, which did not involve securities or protective legislation, the Court has demonstrated its determination to enforce arbitration agreements. 237 Thus, should the Court follow this previous line of cases, it will uphold the Ninth Circuit’s decision in Byrd, extending the Wilko doctrine to provide that when there are mixed arbitrable and nonarbitrable claims, arbitration of the former must be denied to preserve the federal court’s exclusive jurisdiction of federal securities claims.

Practical and economic considerations, however, may lead the Court to an opposite result. First, bifurcation would reduce the court caseload, a problem of increasing concern. 238 Second, increased regulation of arbitration clauses by the SEC and improved arbitration procedures have lessened the need for the courts to actively protect the public investor. 239

Prior to the recent regulations and procedures approved by the SEC, one commentator suggested that Wilko should be overruled once “clear, unambiguous and fair arbitration provisions are formulated.” 240 Members of the securities industry have also recently requested that Congress repeal the Wilko rule. 241 Whether the new arbitration procedures may be classified as “clear, unambiguous and fair” is debatable, but the SEC does not appear to agree that Wilko should be overruled. To date, the Commission has not responded to the securities industry’s request that it ask Congress to repeal the doctrine. 242 Rather, the Commission based its regulation of arbitration

238. See Dickinson, Exclusive Federal Jurisdiction and the Role of the States in Securities Regulation, 65 IOWA L. REV. 1201, 1201 (1980). The author states that under the helm of Chief Justice Burger, the Supreme Court has endeavored to reduce the federal judiciary’s workload in the area of securities litigation. Id. Bifurcation would reduce the federal courts’ caseload, although only slightly, because federal courts would only hear and resolve federal securities claims, not arbitrable common law and state claims pendent to the federal claim. See supra note 15 and accompanying text.
239. See supra notes 151-93 and accompanying text.
240. Krause, supra note 80, at 721.
242. The Commission’s promulgation of the final rule is its only response to the industry’s criticism of the proposed rule and its request that the Commission petition Congress for repeal of Wilko. See supra note 184 and accompanying text.
clauses on the Wilko decision. Furthermore, its criticism of the securities industry for failing to heed its advice and warning regarding modification of arbitration clauses suggests that the Commission would not approve the overruling of Wilko. Likewise, the Court's prior decisions do not suggest that it is willing to overrule Wilko. In Scherk, the Court was very careful to emphasize that the result was based on the international character of the agreement. Thus, the investor's right to a federal forum for the adjudication of federal securities claims appears safe despite improved arbitration procedures.

V. CONCLUSION

Congress did not foresee a conflict arising between the Federal Arbitration Act and the federal securities laws. When it enacted the former, it intended to provide a ready forum for the speedy, impartial resolution of disputes. In enacting the latter, Congress sought to protect the investor by placing the investor in a bargaining position equal to that of the broker's. In Wilko, the Court was unable to reconcile these two competing policies and held that Congress' desire to protect the investor must prevail.

Byrd presents the Court with the opportunity to end the controversy over the handling of state and common law claims pendent to a federal securities claim. The Court may either determine that investor protection must remain the preeminent public policy by adopting the intertwining doctrine or it may uphold the bifurcated approach, recognizing the increasing importance of arbitration in today's society. Yet, even if the Court approves

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244. See supra note 185 and accompanying text.

245. See supra notes 81-98 and accompanying text.

246. See supra notes 86-90 and accompanying text.

247. On March 4, 1985, after this Note had gone to print, the Supreme Court delivered its decision in Dean Witter Reynolds, Inc. v. Byrd, 53 U.S.L.W. 4222 (U.S. March 5, 1985). The Court held that the Arbitration Act requires that federal district courts compel arbitration of pendent arbitrable claims when a party files a motion to compel. Id. at 4225. Justice Marshall, writing for the unanimous Court, reviewed the legislative history of the Arbitration Act and determined that the primary purpose of the Act was not to promote speedy resolution of claims, but rather to ensure judicial enforcement of privately made arbitration agreements. Id. at 4223. Thus, he rejected the argument that a bifurcated proceeding frustrates the purpose of the Act. See supra text accompanying notes 202-04, 206-07. In support, the Court cited its opinion in Moses H. Cone Memorial Hospital v. Mercury Const. Corp., 460 U.S. 1 (1983), in which it upheld enforcement of an arbitration agreement even though bifurcated proceedings would result. 53 U.S.L.W. at 4224. In Moses, the Court stated that the Arbitration Act "requires piecemeal resolution when necessary to give effect to an arbitration agreement." Id. (quoting Moses, 460 U.S. at 20). See supra note 81.

Justice Marshall also denied that the federal court would necessarily lose its exclusive juris-
bifurcation of securities claims, it will not totally relinquish its role as protector of the public securities investor by overruling Wilko. Not only would such a ruling contradict the intent of Congress, but the SEC's recent regulation of arbitration clauses demonstrates that the public investor still requires
diction of federal securities claims if arbitration preceded the federal trial. 53 U.S.L.W. at 4224. Although the Fifth, Ninth and Eleventh Circuits contend that the federal court will be bound to decisions reached in a prior arbitration proceeding through the principle of collateral estoppel, the Court stated that the preclusive effect of arbitration proceedings is uncertain. Id. It explained that the full faith and credit statute requires federal courts to give the same effect to a State's judicial proceedings as would the courts of that State, but stated that arbitration is not a judicial proceeding. Id. Arbitration proceedings, therefore, may not necessarily have a collateral estoppel effect on subsequent federal court proceedings. The Court refused to address the question of what preclusive effect arbitration proceedings do have, but concluded that a stay of arbitration proceedings until resolution of the federal claim is not required. Id. Justice Marshall stated that federal district courts should neither dictate the order of the bifurcated proceedings nor should they refuse to compel arbitration in order to protect the federal courts' jurisdiction of federal securities claims. Id. at 4224-25. He did not allow, however, that courts shall consider the federal interests in determining the preclusive effects of an earlier arbitration. Id. at 4224. Concouring in the Court's opinion, Justice White added that each of the two proceedings should go forward with neither being delayed until resolution of the other. Id. at 4224.

Justice White also expanded on the Court's refusal to resolve whether Wilko applies to claims under § 10(b) of the Securities Exchange Act of 1934, or under rule 10b-5. Elaborating on Justice Stewart's opinion in Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974), Justice White increased the uncertainty regarding the applicability of the Wilko doctrine to claims brought under the 1934 Act and implied that lower courts are erroneously assuming that Wilko does apply to such claims. 53 U.S.L.W. at 4225. He noted that when Wilko held arbitration agreements unenforceable with respect to claims under § 12(2) of the 1933 Act, it based its decision on the presence of certain language in the 1933 Act not present in the 1934 Act. Id. at 4225. For example, § 12(2) of the 1933 Act creates a special right of recovery for misrepresentation, whereas, the cause of action under § 10(b) of the 1934 Act is implied, rather than express. See supra notes 75-80 and accompanying text.

The Court's decision in Byrd affirmed its determination to enforce the strong federal policy in favor of arbitration, established by passage of the Arbitration Act in 1924. Basing its decision on the plain language of the Act, the Court stated that the Act gives federal courts no discretion to refuse to compel arbitration of arbitrable claims. See id. at 4223. Because Justice Marshall denies that expeditious resolution of claims is the primary purpose of the Arbitration Act, there is no contrary federal interest to outweigh the dictates of the Act. Id. He further asserted that arbitration does not interfere with the federal courts' exclusive jurisdiction of securities claims. Id. at 4224.

The Byrd decision, therefore, clearly answers the question of how federal courts should treat arbitrable pendent claims in securities litigation, but it leaves many questions unanswered. The Court acknowledges that it is not responding to its own question regarding how much preclusive effect arbitration proceedings should have. This question, the Court stated, does not actually present itself until arbitration is complete. Id. Thus, whether an arbitration will bind a federal court, depriving it of its exclusive jurisdiction of federal securities claims, cannot be answered until the question is properly presented. The Court also leaves unanswered the question of applicability of the Wilko doctrine to claims brought under the 1934 Act, leaving federal courts to reexamine the issue in future cases.
the protection of the federal courts to maintain an equal bargaining position with the securities industry.

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