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Gerald A. Madek

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STATE REGULATION OF BROKER-CUSTOMER PRE-DISPUTE ARBITRATION AGREEMENTS

BY
GERALD A. MADEK*

I. INTRODUCTION

In a federation of states, such as the United States, individual states agree to relinquish a degree of control over their own affairs to the federal government for the common good of the republic. However, this pact between the states and the federal government is often an uneasy one. When the terms of the pact dictate that a federal law must invalidate a state law, the state government invariably resents the intrusion into its affairs. A recent example of this tug-of-war is the rash of litigation involving enforcement of pre-dispute arbitration agreements (PDAA's) in brokers' contracts. These agreements are meant to force arbitration as the means of settling disputes between broker and customer over the handling of margin accounts.¹ PDAA's are themselves resonant of another tug-of-war, that between the wish to protect investors' rights and the wish to relieve the pressure on overly crowded courts.² Federal policy requires upholding PDAA's since enactment of the Federal Arbitration Act (FAA) in 1925.³ Nevertheless, since then, over 30 states, distrustful of PDAA's and chafing at their constitutional subordination to the federal government, have attempted to regulate and significantly weaken such agreements through laws at the state level.⁴ The most notable judicial result of this clash to date is the decision in *Securities Industry Ass'n v. Connolly*, where the court struck down a set of Massachusetts regulations seeking to weaken PDAA's.⁵ This paper will examine the history of challenges to the FAA and the current status of the conflict between the FAA and various state laws over PDAA's in the securities industry, with particular attention to the *Connolly* decision.

* Associate Professor of Business Law, Bentley College.

1. Burger, *Isn't There a Better Way*, 68 A.B.A.J. 274, 277 (1982).

2. Allison, *Arbitration Agreements and Antitrust Claims: The Need for Enhanced Accommodations of Conflicting Public Policy*, 64 N.C.L. REV. 219, 224-25 (1986).

3. Federal Arbitration Act, ch. 213, §§ 1-14, 43 Stat. 833-86 (1925) (current revision at 9 U.S.C. §§ 1-14 (1988)).

4. The Boston Globe, Jan. 28, 1990, at 77, col. 4.

5. 883 F.2d 1114 (1st Cir. 1989), *cert. denied*, 110 S. Ct. 2559 (1990).

II. THE FEDERAL ARBITRATION ACT

The nature of the tension between federal and state governments over arbitration agreements is best illuminated by reviewing the purpose of the FAA's support of PDAA's. When Congress enacted the FAA in 1925, it was attempting to solve the problems of overcrowded courts by declaring a national policy favoring arbitration of some disputes rather than resort to judicial forum for resolution of all conflicts.⁶ Thus, section two of the FAA declares that in a maritime transaction or a contract involving commerce "an agreement in writing to submit to arbitration an existing controversy arising out of such a contract . . . shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for revocation of any contract."⁷ This act gives courts the power to compel arbitration in accordance with a written agreement to arbitrate disputes arising from a given contract.

In the securities industry, where the liability exposure is significant, the FAA became the statutory underpinning for an industry-wide policy of incorporating PDAA's into customer agreements as a non-negotiable condition of opening a margin account.⁸ Thus, brokers used the FAA to effectively make arbitration the method of resolving disputes over securities fraud. The securities industry enthusiastically embraced the opportunity to resolve claims through arbitration because arbitration costs less than defending against a customer's claim in court and because arbitral forums, closely linked to the securities industry, give brokers more control over the resolution of claims than does the judicial forum.⁹

What was the congressional intent in handing brokers and other parties to contracts such an effective tool for encouraging arbitration over court suits? In passing the FAA, Congress was forcing abandonment of a long-held suspicion of arbitration by the federal and state courts.¹⁰ Historically, the courts have been loathe to honor arbitration agreements because, at heart, these agreements circumvent the normal checks to abuse present in the judicial system. This judicial distrust of arbitration is best evidenced in the Supreme Court's decision in *Wilko v. Swan*, where the court declined to compel arbitration of a securities fraud case.¹¹ Here, the Court objected to arbitration for the following reasons:

6. Note, *Arbitrarability of Disputes Under the Federal Arbitration Act*, 71 IOWA L. REV. 1137, 1141 (1986).

7. H.R. Rep. No. 96, 68th Cong., 1st Sess. 1-122 (1924).

8. See The Boston Globe, *supra* note 4. See generally Reder, *Securities Law And Arbitration: The Enforceability of Predispute Arbitration Clauses in Broker Customer Agreements*, 1990 COLUM. BUS. L. REV. 91 (1990) (discussing history and changes in securities arbitration made by Congress, courts and regulatory agencies).

9. *Id.*

10. Note, *supra* note 6, at 1137, 1141.

11. 346 U.S. 427 (1953)(overruled by *Rodriguez de Quijas v. Shearson/ American Express, Inc.*, 490 U.S. 477 (1989)).

1. arbitration must make legal determinations without judicial instruction on the law;
2. arbitration awards may be made without explanation and without a complete record of proceedings;
3. the power to vacate an award is limited; and
4. arbitration awards are not subject to judicial review for errors in interpretation.¹²

The fact that the Supreme Court's ruling in *Wilko* was handed down decades after the enactment of the FAA clearly illustrates that this federal statute did not do away with a distrust that arbitration could fairly resolve claims of securities fraud. Rather, this distrust grew, fomented perhaps by the presence of such abuses of customer trust as churning, material misrepresentation of facts, conspiracy, and mail and wire fraud, all of which involve securities industry personnel making decisions about customer accounts on the basis of their own monetary interests rather than those of the customer. Moreover, this distrust surfaced in *Wilko* and in many other individual suits in the form of skirmishing over whether individual PDAA's were actually within the purview of the FAA.

These various skirmishes generally involve the claim that a particular PDAA is invalid, the federal policy supporting arbitration notwithstanding. Under the FAA, there are only two ways to invalidate an existing PDAA. First, if an agreement is entered into in a way which violates common contract law, that is through fraud, mistake, duress, undue influence, or illegality, the PDAA is invalid.¹³ Indeed, some investors have sought release from PDAA's on the grounds that these agreements violate contract law.¹⁴ Second, if the congressional mandate of the FAA is contravened by another congressional mandate which can be proven to govern the PDAA in question, the agreement is invalid even if there was no breach of contract law.¹⁵ In fact, most suits attempting to invalidate PDAA's have claimed that the PDAA in question fell under the purview of another federal statute which prohibited relinquishment of the right to judicial redress.¹⁶ Such suits also claim, in a related argument, that enforcement of arbitration in a particular case would undermine the primary purpose of a contravening federal statute.¹⁷

12. *Id.* at 436-37.

13. H.R. Rep. No. 96, 68th Cong., 1st Sess. 1-122 (1924).

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

15. 346 U.S. at 427.

16. *Id.* at 432-33.

17. *Id.* at 438.

III. THE SECURITIES ACT, THE EXCHANGE ACT AND RICO

As happens, shortly after Congress enacted the FAA, this body enacted two other statutes whose primary purpose was to protect investors from securities fraud, the alleged offense in most investor attempts to avoid enforcement of PDAA's. Not surprisingly, these two statutes, the Securities Act of 1933¹⁸ and the Securities Exchange Act of 1934,¹⁹ became the rationale used by many victims of securities fraud who wished to bring suit in court rather than be bound by PDAA's which they had signed. Such investors claimed that their PDAA's were covered by the federal securities statutes and that these statutes represented congressional commands which contravened the congressional command of the FAA.²⁰ In addition, a more recent federal statute, the Racketeer Influenced and Corrupt Organizations (RICO) section of the Organized Crime Control Act of 1970,²¹ has also been claimed by disgruntled parties to PDAA's as a basis for contravening the FAA's command to uphold the agreements. Although intended by Congress as a weapon against organized crime, RICO has also become a commonly used weapon against securities fraud.²² The basis for claiming that these federal statutes represent congressional commands which counter and supersede the FAA's command to arbitrate is that all three statutes allow allegedly defrauded investors access to the courts for redress of their grievances.²³

Needless to say, there were many attempts to seek judicial redress under the two securities statutes and under RICO. Such attempts focused on the following two facts: arbitration agreements are often buried in the fine print of a customer's contract and customers are often coerced into signing them as a precondition of opening an account with a firm.²⁴ These two facts led to the claim that PDAA's are in violation of Section 14 of the Securities Act, which states that "[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter . . . shall be void."²⁵ Since Section 29(a) of the 1934 Exchange Act is essentially the same as Section 14 of the Securities Act, investors also claimed PDAA's to be in violation of the Exchange Act.²⁶ In the investors' view, two of the provisions of the securities acts which cannot be waived are the right of an investor to

18. 15 U.S.C.A. §§ 77a *et seq.* (West 1981 & Supp. 1988).

19. 15 U.S.C.A. §§ 78a *et seq.* (West 1981 & Supp. 1988).

20. 346 U.S. at 427.

21. 18 U.S.C.A. §§ 1961-1968 (West 1981 & Supp. 1988).

22. Wall St. J., Jan. 11, 1989, at A1, col. 1, & A8, col. 1.

23. 15 U.S.C.A. § 78j(b) (West 1981 & Supp. 1988); 15 U.S.C.A. § 77i(2) (West 1981 & Supp. 1988); 18 U.S.C.A. §§ 1961-1968 (West 1981 & Supp. 1988).

24. See The Boston Globe, *supra* note 4.

25. 15 U.S.C.A. § 77n (West 1981 & Supp. 1988).

26. 15 U.S.C.A. § 78cc(a) (West 1981 & Supp. 1988).

full disclosure of material information and a "special right" to recover for misrepresentations and to proceed against the issuer in federal court.²⁷ Thus, interpreting these two sections in concert, investors argued that Section 14 of the Securities Act and Section 29(a) of the Exchange Act, both congressional mandates, preempted Section 2 of the FAA.²⁸ Thus, plaintiffs claimed that the mandate of the federal securities statutes for protection of investors' rights through clear and honest information contravened the mandate of the FAA for prompt, economical and adequate solution of controversies through arbitration.²⁹

Disgruntled investors who bring suits to invalidate PDAA's under RICO are able to do so because RICO's broad wording lists "securities fraud" as one of a multitude of possible "racketeering" acts. Since this statute does not require that such "racketeering" acts be linked to organized crime to fall within its purview, this apparent misuse is understandable.³⁰ The particular appeal of the RICO statute is that, unlike the two securities statutes, RICO offers investors the possibility of recovering treble damages, allows the use of civil discovery and permits plaintiffs to prove allegations by only a "preponderance of evidence."³¹

IV. ELIMINATING THE CONTRAVENTION ARGUMENT

At present, however, investors can no longer claim the Securities Act, the Exchange Act or RICO as avenues for forcing invalidation of PDAA's. Two cases have settled the law on this point by establishing that the FAA's mandate to uphold PDAA's can be honored without damage to the fabric of these other three statutes. The first of these two cases, *Shearson/American Express, Inc. v. McMahon*,³² dealt with claims under the 1934 Exchange Act and under RICO. The second, *Rodriguez De Quijas v. Shearson/Lehman Brothers*, settled the issue of claims under the 1933 Securities Act.³³

In *McMahon*, the district court and appeals court took opposite sides on the issue of the FAA versus the Exchange Act and RICO. The facts of the case involved losses sustained by Eugene and Julia McMahon in an account they had with Shearson/American Express, which was serviced by one of their registered representatives, Mary Ann McNulty. The McMahons claimed that the losses were caused by McNulty, that her actions constituted fraud and, thus, were a violation both of Section 10(b) of the Exchange Act and of RICO. Even though Julia McMahon had

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

28. *Id.* at 228.

29. 346 U.S. at 438.

30. 18 U.S.C.A. §§ 1961-1968 (West 1981 & Supp. 1988).

31. *Id.*

32. 482 U.S. 220 (1987).

33. 490 U.S. 477 (1989).

signed a pre-dispute agreement to arbitrate any claims relative to this account, the McMahons attempted to litigate their claim in district court. At this point, McNulty and Shearson/American Express moved to compel arbitration in accord with the arbitration agreement signed by McMahon, citing Section 3 of the FAA to support their motion.³⁴

The district court agreed with Shearson that the federal policy, articulated in the FAA, of upholding PDAA's was germane to this case and that claims under 10(b) of the Exchange Act were arbitrable without damage to the intent of the Exchange Act, the protection of investors' rights, but held that the RICO claims were not arbitrable.³⁵ However, when the case was appealed, the court of appeals, while agreeing with the district court on RICO claims, reversed on the Exchange Act and, citing *Wilko's* holding that Securities Act claims were exempt from the FAA, held that in this case the public policy for special protection of investors' rights took precedence over the public policy favoring arbitration.³⁶ Thus, the appeals court held that claims under the Exchange Act were immune from the FAA's mandate to arbitrate.

To resolve these contradicting interpretations of congressional intent evidenced by the lower courts, the Supreme Court heard the *McMahon* case in 1986.³⁷ Agreeing with the district court, the Supreme Court held that nothing in the Exchange Act forbids enforcement of PDAA's.³⁸ The Court addressed the previously discussed *Wilko* argument cited by the appeals court. This argument held that to waive the right to a judicial forum would be to prevent compliance with the terms of the Securities Act, an action expressly forbidden by the statute. In examining this argument in *McMahon*, however, the Court held that the judicial forum provided in Section 27 of the Exchange Act could be waived without violating Section 29(a) which prohibits any practice preventing compliance with its provisions. Thus, the high court did not view resort to judicial redress as a form of substantive compliance with the Exchange Act but rather as a jurisdictional option and so held that claims under Section 10(b) of the Exchange Act are still subject to the command of the FAA to uphold arbitration agreements.³⁹ Likewise, the Court held that nothing in the text or legislative history of RICO suggests that civil claims under this statute cannot be submitted to an arbitral forum.⁴⁰ Clearly, the *McMahon* decision made it impossible for potential litigants

34. 482 U.S. at 222-24.

35. *Id.* at 224.

36. *Id.*

37. *Id.* at 220.

38. *Id.* at 238.

39. *Id.* at 227.

40. *Id.* at 238.

to claim that signed arbitration agreements are unenforceable under either the Exchange Act or RICO.

What, then, remained to completely preclude the possibility of voiding the command of the FAA by citing a contravening federal statute was a formal extension of the Supreme Court's reasoning in *McMahon* to the 1933 Securities Act. This occurred in the second case to be examined here, *Rodriguez De Quijas v. Shearson/Lehman Brothers*.⁴¹ In *Rodriguez*, a group of individual investors claimed that they suffered financial losses at the hands of a Shearson agent who engaged in unauthorized fraudulent transactions in their account. As in *McMahon*, although each appellee had signed a PDAA as part of a customer agreement, the appellees attempted to bring suit against their agent and Shearson in district court. Again, as in *McMahon*, Shearson moved to compel the honoring of the signed arbitration agreements, as mandated by the FAA.⁴²

The litigants in *Rodriguez* made claims under various state laws as well as under the Securities Act, the Exchange Act and RICO. The district court ordered arbitration on all but the federal securities claims.⁴³ When *Rodriguez* was brought to the court of appeals, however, this court reversed the district court, holding that the federal securities claims were also subject to arbitration.⁴⁴ The Supreme Court granted certiorari and upheld the appeals court ruling.⁴⁵ Citing *McMahon*, the Court pointed out that not only were the Exchange Act and RICO claims clearly arbitrable, but that Securities Act claims were arbitrable as well. In so holding, the Supreme Court stated that, because the relevant provisions for judicial redress and prohibition of practices leading to non-compliance were virtually identical in both securities acts, the reasoning of the Supreme Court in *McMahon* had to be extended to the Securities Act as well.⁴⁶ Here, the Court formally overruled *Wilko*'s decision that claims under the Securities Act were immune from the FAA.⁴⁷ The Court further pointed out that, as in *McMahon*, their ruling in *Rodriguez* rested on a belief in the adequacy of arbitration to resolve securities disputes, making clear that the Securities and Exchange Commission's (SEC) oversight authority, considerably broadened since *Wilko*, was clearly adequate for this task.⁴⁸ Thus, both the *McMahon* and the *Rodriguez* courts held that investors' rights would not be compromised in arbitral

41. 490 U.S. 477 (1989).

42. *Id.* at 479.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* at 482.

47. *Id.* at 484.

48. *Id.* at 483.

forums, and, therefore, use of such forums would not undermine the purpose of the Securities Act or of the Exchange Act.

V. AFTER MCMAHON

In view of *McMahon* and *Rodriguez*, it appears that the law is established with regard to upholding PDAA's under both securities acts and under RICO. Interestingly, when faced with an indisputable, unambiguous federal policy for support of arbitration agreements, various federal entities took action to make the arbitration process fairer. These remedial actions gave cognizance to the following common consumer complaints: that investors were often not aware of the existence or consequences of PDAA's in customer agreements, that forcing investors to sign such agreements as a precondition to opening an account was a coercive use of economic power and that arbitration boards were often stacked in the brokers' favor.⁴⁹ Thus, the SEC promulgated a rule that forced brokers to highlight the existence of PDAA's and their implications for investors.⁵⁰ Again, although the SEC did not forbid mandatory PDAA's, it did urge the securities industry to find ways to make such agreements voluntary.⁵¹ Likewise, the Commodities Futures Trading Commission (CFTC), another congressionally created entity, promulgated rules similar to those set forth by the SEC.⁵² In both of these cases, rules limiting PDAA's could be promulgated without fear of running afoul of the FAA because the rules issue from federal entities created by Congress. Further, Representative Markey (D-MA) has announced plans to introduce legislation in Congress to ban mandatory arbitration agreements and make arbitration forums more like court proceedings.⁵³ Were Congress itself to pass such legislation, it would obviously not preempt itself, for, the mandate of the FAA would be contravened by the new statute.

Needless to say, this discomfort with conclusive entrenchment of the federal mandate to substitute arbitration for judicial redress of securities fraud claims was not limited to individual investors and federal entities. As stated earlier, many states were also uncomfortable with the federal mandate for arbitration. However, the power of the states to circumvent the FAA with laws of their own was severely circumscribed by the supremacy clause in the federal constitution which declares that, in the case of a conflict, a federal law always preempts a state law. Thus, although Congress, in the two securities laws discussed earlier, granted

49. The Boston Globe, Jan. 28, 1990, at 80, col. 4.

50. *Id.*

51. The Boston Globe, Jan. 20, 1990 at 59, col. 1 & 2.

52. 7 U.S.C. 7a(11), 12a (Supp. V, 1975).

53. See The Boston Globe, *supra* note 51.

the states concurrent power to regulate their own securities industries,⁵⁴ this power could only be used within the parameters defined by federal statutes.

In fact, all states have securities acts, commonly referred to as "blue sky laws." While varying widely in terms and scope, all of these securities laws offer the same judicial remedies afforded by the federal securities laws. Again, every state has implemented regulations for their securities acts which delineate further state powers over the securities industry. Historically, this vast body of state statutes and regulations, generally based upon the Uniform Securities Act,⁵⁵ echoed the essence of the federal securities laws. The tension between these two sets of laws was activated only when the states wished to contradict or go beyond federal securities policy. Such is the case with the issue of PDAA's. As the federal mandate for arbitration was solidified, dissatisfaction with this policy was growing at the state level, exacerbated by the stock market crash in 1987 and the perceived prevalence of consumer rights violations.⁵⁶ In response to this conflict, many states began to examine the possibility of controlling and limiting the use of PDAA's within their borders. However, given the statutory structure outlined here, these efforts to make PDAA's fairer are less likely to succeed at the state level than were the efforts by the SEC and the CFTC at the federal level.

What would happen then, when a state inevitably challenged this federally weighted balance of power by attempting to use its congressionally granted concurrent power to lessen the impact of the FAA? The best answer to this question, to date, is found in an analysis of *Securities Industry Ass'n v. Connolly*.⁵⁷

VI. THE CONNOLLY DECISION: STATE V. FEDERAL STANDARDS

The *Connolly* case was precipitated when the Massachusetts Secretary of State's office became concerned with what it saw as abuses of Massachusetts investors' rights through mandatory PDAA's.⁵⁸ To remedy this situation, Secretary of State Connolly, using his concurrent powers of regulation, issued regulations meant to curb these abuses. These regulations prohibited brokers from requiring PDAA's as "a nonnegotiable condition precedent to account relationships" and simultaneously enjoined these brokers to fully disclose both the voluntary nature of arbitration agreements and their full legal consequences.⁵⁹ In essence, these

54. 15 U.S.C.A. § 77r, 78bb (West 1981 & Supp. 1988).

55. See UNIFORM SECURITIES ACT § 101-419, 7B U.S.C.A. 509 (1985 & Supp. 1991).

56. See The Boston Globe, *supra* note 51.

57. 883 F.2d 1114 (1st Cir. 1989).

58. The Boston Globe, Jan. 20, 1990, at 57, col. 5.

59. MASS. REGS. CODE tit. 950 § 12.204 (1986).

regulations issued an alarming "caveat emptor" to investors. Once promulgated, the Massachusetts regulations were immediately challenged by a consortium of brokerage firms doing business in Massachusetts. Predictably, these securities dealers contended that Massachusetts regulations were preempted by the FAA.⁶⁰

Upon hearing *Connolly*, the U.S. District Court sided with the brokers, holding that the Massachusetts regulations were indeed preempted by the FAA.⁶¹ Judge Woodlock ruled that the FAA requires that arbitration agreements be treated no differently than contracts in general. Since the Massachusetts regulations "went to the heart of the process of forming contracts to arbitrate," these regulations singled out arbitration contracts for more rigorous regulation than imposed on other contracts in Massachusetts.⁶²

When Massachusetts appealed the district court's decision, the appeals court essentially reached an identical conclusion as did Judge Woodlock, upholding the district court's decision and finding for the brokers.⁶³ Since the Supreme Court has recently refused to hear this case,⁶⁴ a close look at the reasoning of the appeals court should shed significant light on the limits of a state's ability to regulate PDAA's in the manner attempted by Massachusetts.

The Commonwealth of Massachusetts, in presenting its argument to the Court of Appeals, claimed that the power granted it by Congress to concurrently regulate its own securities industry could be used to issue the regulations in questions.⁶⁵ Massachusetts further contended that its regulations did not treat arbitration agreements any differently than other contracts between businesses and consumers. Rather, lawyers for the state argued that the Commonwealth was regulating these arbitration agreements exactly as it regulated all contracts, using the public welfare as indicator of necessary regulation.⁶⁶

The appeals court disagreed with the Commonwealth on both points, finding that the permission granted to the states by Congress to concurrently regulate the securities industry did not exempt states from the preemption effect of the FAA with respect to pre-dispute arbitration agreements.⁶⁷ Again, the court held the Commonwealth's assertion that it was treating PDAA's like all other contracts to be specious. In fact, its finding that Massachusetts was singling out PDAA's for more stringent

60. The Boston Globe, Jan. 28, 1990, at 80, col. 1.

61. 703 F. Supp. 146, 147 (D. Mass. 1988).

62. *Id.*

63. 883 F.2d at 1114.

64. *Id.*; See Wall St. J., May 30, 1990, at B8, col. 1.

65. 883 F.2d at 1114.

66. *Id.* at 1120.

67. *Id.* at 1121-22.

regulation than other contracts formed the heart of the appeals court's holding.⁶⁸

In this context, the court found that the Massachusetts regulations did indeed treat standard-form PDAA's in the securities industry more severely than other standard-form contracts in Massachusetts.⁶⁹ In so doing, the regulations actually conflicted with the national policy favoring arbitration, as it was articulated in the FAA. For, the FAA mandates that arbitration agreements be enforceable except where they are voided by the principles of common contract law.⁷⁰ In issuing these regulations, Massachusetts sought to provide more inclusive grounds for voiding PDAA's than were provided for other contracts in the Commonwealth. While it might be argued that the Massachusetts regulations do generally address the contract law grounds for nullification of contracts, fraud or coercive economic power, they articulate these grounds in a more specific way than is done for other Massachusetts contracts. Further, the specific way in which the regulations set forth the voluntary conditions and disclosure are patently hostile to the policy of arbitration.

Indeed, the appeals court implied that, not only is Massachusetts enjoined from treating arbitration contracts more harshly than it treated other contracts, but the state actually has a duty to treat such contracts more favorably. Thus, the court held that, because the FAA mandates the encouragement of arbitration agreements, no state may simply subject arbitration to individuated regulation in the same way as it might subject some other unprotected contractual device. Here, the court implied that the state actually has less regulatory authority over PDAA's than it has over other contracts, especially if the regulatory authority would be used to discourage rather than encourage the use of PDAA's.⁷¹ In this context, the court pointed out that other courts had previously struck down two state regulations, requiring, respectively, that PDAA's be highlighted in 10-point type and that all PDAA's be signed by an attorney who attests that investors have been fully informed of the effects of the agreement.⁷²

In mandating that state regulations be friendly to arbitration agreements, the court pointed out that the language of the FAA is unambiguous, clearly carving out a broad sphere of influence for its dictates.⁷³ Here, the appeals court followed the Supreme Court's finding in *Southland Corp. v. Keating*, that Congress intended the dictates of the FAA to

68. *Id.* at 1120.

69. *Id.* at 1124.

70. *Id.* at 1120.

71. *Id.*

72. *Webb v. R. Rowland & Co.*, 800 F.2d 803, 806 (8th Cir. 1986); *Collins Radio Co. v. Ex-Cell-O Corp.*, 467 F.2d 995, 997 (8th Cir. 1972).

73. 883 F.2d at 1124.

encompass not just actions in federal courts but also actions in state courts.⁷⁴ *Southland* also holds unequivocally that, in passing the FAA, Congress intended to foreclose state efforts to prevent arbitration.⁷⁵ Again, in *Dean Witter Reynolds, Inc. v. Byrd*, the appeals court reaffirmed the FAA's reach over claims made under state laws, asserting that the FAA requires that, when signed arbitration agreements exist, such claims must be submitted to arbitration, even if a concurrent federal claim is pending.⁷⁶

In light of the clear and sweeping language of the FAA, the *Connolly* court held that congressional intent in passing this law was unquestionably to encourage arbitration.⁷⁷ Thus, in evaluating the legality of any state regulations, the measure must be whether or not they "disturb too much the congressionally declared scheme" of legitimizing the arbitral solution.⁷⁸ If state regulations act as an obstacle to the ends which Congress set out to achieve in the FAA, then the regulations may not stand. In *Connolly*, the court found that the Massachusetts regulations, which obviously emphasized the drawbacks to signing PDAA's, did indeed alter measurably the FAA's scheme by blocking its desired result, a climate favorable to arbitration agreements.⁷⁹

In striking down the Massachusetts regulations considered in *Connolly*, then, the court made clear that it was not voiding all state regulations relating to PDAA's, but only those regulations which were inimical to arbitration. Massachusetts, the court asserted, was free to regulate PDAA's as long as it did so in a manner consistent with its regulation of other contracts under general contract law.⁸⁰ While affirming the circumscribed rights of the states in this area, however, the *Connolly* court also emphasized that the states did not possess the same latitude in issuing regulations which impinged on the purview of the FAA as did the SEC and CFTC in their previously discussed rules.⁸¹

VII. UNACCEPTABLE STATE LEGISLATION

What types of state regulation of PDAA's can be expected to stand the test of judicial scrutiny? Relying on precedent set in the cases discussed earlier, particularly *Southland*, *McMahon* and *Connolly*, some broad conclusions can be drawn. In general, the bench marks to be applied to such a state law are whether the law conflicts with the purposes of the FAA

74. 465 U.S. 1, 12 (1983).

75. *Id.* at 16.

76. 470 U.S. 213 (1985).

77. 883 F.2d at 1119.

78. 883 F.2d at 1118 (quoting *Palmer v. Liggett Group, Inc.*, 825 F.2d 620, 626 (1st Cir. 1987)).

79. *Id.*

80. *Id.* at 1120.

81. *Id.* at 1122.

and whether the law singles out arbitration contracts to be treated more severely than other contracts. In this context, a series of cases have been brought where investors have sought to nullify signed arbitration agreements on the grounds that they are prohibited by a state securities act. Thus, suits have been brought under state securities acts in Kansas,⁸² Pennsylvania,⁸³ Washington,⁸⁴ and Connecticut.⁸⁵ In general, these state securities laws were modeled on the Uniform Securities Act⁸⁶ and contained a non-waiver of substantive rights provision, essentially identical to provisions 14 and 29(a) of the 1933⁸⁷ and 1934⁸⁸ federal securities acts. Predictably, in these cases, the courts struck down the state laws on grounds identical to those spelled out for the federal laws in *McMahon* and *Rodriguez*; namely, that the non-waiver clause referred to substantive rights under these state securities laws rather than jurisdictional rights. Further, the judges noted that even if these non-waiver clauses were construed by the states in question to include jurisdictional rights, as was the case in *Osterneck* concerning the Pennsylvania Securities Act of 1972,⁸⁹ they would be preempted by the FAA on the grounds explicated in *Connolly* where state securities laws impeded actualization of the goal of the FAA and so were preempted.⁹⁰ In *Russolillo*, the court, citing *Kroog*, reiterated that "a naked and irreconcilable conflict between the precise federal mandate to arbitration and a state provision which prevents arbitration" must be resolved through preemption of the state statute by the FAA.⁹¹ Citing *Southland*, the *Reed* court repeated that the FAA had withdrawn the power of the state to require a judicial forum for settlement of securities claims.⁹² The *Osterneck* court, again citing *Southland*, made clear that the likelihood of state securities laws prevailing in the contexts mentioned here was slim. The relevant ruling in *Osterneck* held that, through the FAA, Congress "intended to foreclose state legislative attempts to undercut enforceability of arbitration agreements."⁹³ In summary, the litigation to date makes clear that any state statute expressly or implicitly forbidding arbitration agreements will not stand the test of judicial scrutiny.

82. *Reed v. Bear, Stearns & Co.*, 698 F. Supp. 835 (D. Kan. 1988).

83. *Osterneck v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 841 F.2d 508 (3rd Cir. 1988).

84. *West v. Drexel Burnham Lambert, Inc.*, 623 F. Supp. 26 (W.D. Wash. 1985).

85. *Russolillo v. Thomson McKinnon Sec., Inc.*, 694 F. Supp. 1042 (D. Conn. 1988).

86. See 7A UNIFORM LAWS ANNOTATED 561-708 (1978 & Supp. 1983).

87. 15 U.S.C. §§ 77a-77bbb (West 1981 & Supp. 1988).

88. 15 U.S.C. §§ 78a-78ccc (West 1981 & Supp. 1988).

89. 841 F.2d at 511.

90. *Id.* at 512-13.

91. 694 F. Supp. at 1042.

92. 698 F. Supp. at 839.

93. 841 F.2d at 511 (3rd Cir. 1988)(quoting *Southland*, 465 U.S. at 16).

VIII. ACCEPTABLE STATE LEGISLATION

However, there have been a few cases where state securities statutes were upheld in court. In each of these cases, the statutes survived because they met the two tests for avoiding preemption. That is, these statutes did not impede implementation of the FAA's goals nor did they treat arbitration contracts any differently than other contracts.

As discussed earlier, the Supreme Court ruled in *Volt Information Science, Inc v. Board of Trustees* that arbitration agreements which incorporate state laws hospitable to arbitration are enforceable as written.⁹⁴ Thus, in accordance with the California Franchise Investment Act, the Court in *Volt* held that arbitration could be stayed pending resolution of related litigation involving third parties not bound by the arbitration agreement. Here, the Court upheld the reach of the state statute because it was incorporated into the signed arbitration agreement.⁹⁵ The Court pointed out in *Volt* that the FAA does not confer any absolute right to compel arbitration, but only the right to compel arbitration in accordance with the terms of a signed agreement.⁹⁶ Again, the Court was careful to point out here that the agreement was allowed to stand only because the California law in question did not operate to block the purposes of the FAA.⁹⁷

Again, in *New England Energy, Inc. v. Keystone Shipping Co.*,⁹⁸ (NEEI), the appeals court reversed the Massachusetts district court to uphold the reach of the Massachusetts Uniform Arbitration Act⁹⁹ over an arbitration agreement.¹⁰⁰ The issue here was whether claims could be consolidated for the purposes of arbitration even though the arbitration agreement made no mention of a right to consolidate. The Massachusetts statute in question would allow such consolidation in *NEEI*, since it was factually appropriate to consolidate the claims in question. The court ruled that, since the Massachusetts statute did not speak to the right to choose arbitration over litigation and did not run counter to the federal mandate for favoring arbitration, the statute could appropriately be applied to the arbitration agreement in question.¹⁰¹ The court further pointed out that, in Massachusetts, consent is not required to order consolidation of any contract, so that ordering consolidation without consent in this case would not single out arbitration agreements for

94. 489 U.S. 468 (1989).

95. *Id.* at 468.

96. *Id.*

97. *Id.* at 469.

98. 855 F.2d 1 (1st Cir. 1988).

99. MASS. GEN. LAWS ANN. ch. 251 § 2A (West 1988).

100. 855 F.2d at 2-3.

101. *Id.* at 4-5.

singularly severe treatment.¹⁰² Again, the court's findings here are consistent with the judicial rulings examined earlier.

While the Virginia District Court ruling in *Saturn Distribution Corp. v. Williams*¹⁰³ articulated the same principles for upholding state laws found in *Volt* and *NEEI*,¹⁰⁴ it partially contradicted the finding in *Connolly*.¹⁰⁵ The state statute in question here is the Virginia Motor Vehicle Dealer Licensing Act which precludes mandatory arbitration clauses from incorporation in franchise agreements between automobile manufacturers and dealers.¹⁰⁶ In holding that this preclusion was not preempted by the FAA, the Virginia court, citing *Volt*, found that "arbitration under the Act is a matter of consent, not coercion."¹⁰⁷ Thus, the court reasoned that the Virginia law did not conflict with the FAA because it did not prohibit arbitration agreements summarily but only required that such agreements be voluntary.¹⁰⁸

The district court decision in *Saturn* appears to partially contradict the finding in *Connolly* that the Massachusetts regulations insisting on voluntary and informed consent to PDAA's were preempted by the FAA. Addressing this apparent contradiction, the Virginia court pointed out that, while the Massachusetts regulations were found to single out arbitration agreements for treatment different than that given to other contracts, such was not the case with the Virginia statute. In fact, the *Saturn* court pointed out that arbitration contracts were actually being treated more favorably than were other contracts between supplier and dealer under this statute. These other prescriptive sections of the Virginia statute cannot be violated while preclusion of arbitration agreements can be waived by informed consent.¹⁰⁹ Again, while the court agreed that the state of Virginia should not avoid its duty to enforce section 2 of the arbitration act by banning formation of arbitration agreements, it emphasized that the statute in question regulated arbitration agreements as part of an overall program of regulation of potentially adhesive contracts, rather than in a manner solely prejudicial to arbitration contracts.¹¹⁰

The Virginia court ended its opinion by commenting on what it considered an error in judicial judgment in the *Connolly* decision. In reaching its conclusion that arbitration contracts in *Saturn* were treated similarly to other Virginia contracts, the court relied on a body of law

102. *Id.* at 5-6.

103. 717 F. Supp. 1147 (E.D. Va. 1989), *rev'd*, 905 F.2d 719 (4th Cir. 1990), *cert. denied*, 111 S. Ct. 516 (1990).

104. *Id.* at 1150.

105. *Id.* at 1152.

106. VA. CODE ANN. §§ 46 1-550.5:27 (1989 Supp.).

107. 717 F. Supp. at 1151 (quoting *Volt*, 489 U.S. at 479).

108. *Id.*

109. *Id.* at 1150-51.

110. *Id.*

which included all statutory and common law governing contracts in Virginia. On the other hand, the *Connolly* court determined the Massachusetts regulations singled out arbitration agreements unfairly by surveying only the state's common law, unenhanced by statutory law. The district court in *Saturn* contended that, had the *Connolly* court included statutory law in its analysis, it might have reached the conclusion that the Massachusetts regulations did not treat arbitration agreements differently than other contracts, but rather emphasized informed consent as rule. For, citing the district court finding in *Connolly*, the *Saturn* court pointed out that "Massachusetts law does contain a variety of idiosyncratic statutory provisions which require special treatment of—and disclosure regarding—certain types of contractual provisions."¹¹¹ While the *Connolly* court dismissed these statutory provisions as "the exceptions that prove the rule,"¹¹² the Virginia court believed that consideration of these statutory provisions might indicate that Massachusetts was not really singling out arbitration contracts for treatment different than that given other contracts.¹¹³

When the Saturn Corporation appealed the district court's decision, however, the Fourth Circuit reversed the lower court and essentially echoed the reasoning of the *Connolly* court.¹¹⁴ The appeals court found that to disallow in a contract the inclusion of the provision that arbitration be the mandatory forum for settling disputes arising from that contract is to treat arbitration contracts more harshly than other contracts.¹¹⁵ To buttress this conclusion, the fourth circuit alluded to the fact that general Virginia contract law does not prohibit non-negotiable clauses in contracts, nor does it look disapprovingly on contracts of adhesion.¹¹⁶ In explaining its finding, the circuit court rejected Virginia's defense of its statute's prohibition on non-consensual arbitration clauses, declaring that even limitations on future mandatory agreements would frustrate the federal policy favoring arbitration. Here, the fourth circuit refused to recognize Virginia's attempted distinction between existing agreements and the formation of future agreements and the distinction between banning all arbitration agreements and banning only agreements which are mandated in non-negotiable standardized contracts.¹¹⁷

Interestingly, while the fourth circuit's majority opinion in *Saturn* echoed the *Connolly* decision, the dissent not only echoed the Virginia district court but also voiced all the concerns which led the state of Mas-

111. *Id.* at 1152.

112. *Id.*

113. *Id.*

114. 905 F.2d 719 (4th Cir. 1990).

115. *Id.* at 725.

116. *Id.* at 725-26.

117. *Id.* at 723.

sachusetts to attempt to regulate non-negotiable arbitration agreements. The dissent explicitly disagreed with the *Connolly* court.¹¹⁸ In essence, the fourth circuit's dissenting opinion distills the argument against mandatory PDAA's when it reiterates the *Volt* court's assertion that the VAA contains no express pre-emptive provision nor any indication that Congress intended to occupy the whole field of arbitration.¹¹⁹ The dissent further points out that prohibition of mandatory arbitration agreements is not in direct conflict with the FAA since such prohibition does not preclude consensual arbitration agreements.¹²⁰ Perhaps, the argument advanced here is that the FAA, while attempting to insulate arbitration agreements from entrenched judicial hostility, was not intended to replace judicial hostility toward arbitration with judicial advocacy of arbitration. Indeed, the dissent feels constrained to remind interested parties that the purpose of the judicial system is "to do justice between man and man and citizen and sovereign, not to keep our dockets clear."¹²¹ Here, the dissent questions whether the FAA's goal of reducing congestion in the courts by encouraging arbitration should displace the more fundamental duty of a government to protect the rights of its citizens.

IX. CONCLUSION

Both the *Connolly* court and the *Saturn* court were concerned with the validity of state laws governing the formation of arbitration agreements. As such, they stand differentiated from most of the cases considered here which seek enforcement of existing arbitration agreements rather than preclusion of future ones. Because they speak to the conditions which precede the signing of arbitration agreements, these cases go directly to the issue of consent. Both *Connolly* and *Saturn* involve efforts to insure that parties to an arbitration agreement freely consent to forego judicial redress, rather than being coerced into such consent as a non-negotiable condition of doing business. In so doing, these cases focus on what will probably be the thrust of future parrying between state and federal governments over PDAA's. Clearly, PDAA's do bespeak a degree of coercion if they must be signed before an investor can implement a desired investment strategy. The SEC has acknowledged this fact in urging securities dealers to come up with an acceptable plan for making these agreements voluntary. The CFTC has also acknowledged the element of coercion by issuing regulations forbidding coercion in arbitration agreements relating to futures trading. When Massachusetts attempted to address this issue in its state-level regulations, however, it was preempted,

118. *Id.*

119. *Id.* at 728.

120. *Id.* at 729.

121. *Id.* at 731.

although the intent of the FAA, as explained in *Volt*, was clearly that arbitration agreements be consensual.

With both federal and state governments focusing on the issue of informed consent, more state legislation designed to assert local control over PDAA's can be expected. At present, however, in the wake of *Connolly* coupled with *Saturn*, states have no clear guidelines for constructing statutes to provide for arbitration agreements which are both consensual and legal. Given current case law, states can draw only the general conclusion that their statutes will be upheld if they support the federal policy favoring arbitration and treat arbitration contracts similarly to other contracts. Within these parameters, states are free to exert some control over the details of PDAA's. With the critical issue of how to insure voluntary consent still unsettled, however, they have virtually no control over whether such contracts are permitted. Perhaps, if the Supreme Court had agreed to hear *Connolly*, the states would have received more explicit guidelines for constructing statutes which will satisfy their concern for informed consent without running afoul of the PDAA. Clearly, this is the direction the states need to effectively discharge their concurrent authority to regulate the securities industry within their borders.

If the courts do not articulate clearly the manner in which states can regulate PDAA's to their satisfaction without incurring preemption by the FAA, the skirmishing between state and federal government will continue. Perhaps the most effective way to resolve this apparent conflict of interest is the way suggested by Representative Markey. A state representative should articulate the wishes of the people who elect him in his state by fashioning statutes immune from preemption by the FAA and allowing other elected state representatives to judge this proposed statute. That, after all, is how a democratic federation of states is supposed to operate.