No. 92-747

Supreme Court of the United States

OCTOBER TERM, 1992

Wm. F. McCOLLOUGH et ux., Petitioners,

vs.

A.G. EDWARDS & SONS, Inc., Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Where statutory tort claims are submitted to arbitration under a pre-dispute contract containing an arbitration clause, the arbitrators' award contains neither findings and conclusions nor any reasoned explanation of the decision, and the record strongly suggests that the award was influenced by legal contentions of the prevailing party which are clearly erroneous under applicable statutory law, may the district court, in order to ensure that the dispute is resolved in accordance with statutory law, vacate the award?

2. Where the party defending statutory tort claims in an arbitration proceeding conducted pursuant to a pre-dispute arbitration agreement asserts multiple facially invalid defenses, at least some of which he knows or should know to be invalid under applicable statutory law, and an arbitral award in favor of the defending party is procured through such conduct, may the district court vacate the award?

3. Even if, as the Court of Appeals' opinion puts it, "offering a meritless defense is part and parcel of the business of litigation," when a party defending a statutory tort claim in arbitration both offers and emphasizes a defense which is meritless under applicable statutory law, does the principle that by agreeing to arbitrate a statutory claim a party does not forego the substantive rights afforded by the statute require that an ensuing award in favor of the defending party be subject to vacatur at the award-enforcement stage?

LIST OF PARTIES

The parties to the proceedings below were Petitioners William F. McCollough and Jeanene McCollough and Respondent A.G. Edwards & Sons, Inc., a Delaware corporation.

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CONTENTS OF PETITION FOR WRIT OF CERTIORARI

QUESTIONS PRESENTED	i
LIST OF PARTIES	ii
TABLE OF CONTENTS	iii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	1
STATUTES INVOLVED	2
STATEMENT OF THE CASE	3

REASONS FOR GRANTING THE WRIT

I. In overruling *Wilko v. Swan,* 346 U.S. 427 (1953), this Court has implicitly endorsed the *Wilko* minority's view that in cases of this type "appropriate means of judicial scrutiny must be implied." 7

II. Subjecting the arbitral award to review for error in the application or interpretation of substantive securities law would be consistent with established principles of arbitration law, as well as public policy. 15

III. Since "appropriate means for judicial scrutiny must be implied," where an award is not supported by a reasoned decision and the arbitral record strongly suggests that the award was influenced by legal error, the district court must be free to vacate the award. 21

IV. Broker's extensive reliance on its invalid "note and release" defense justifies the district court's refusal to enforce the arbitration award. 23

APPENDIX (Text Of Opinions) foll. 30

TABLE OF AUTHORITIES

Cases PAGE(S)

Allen v. Interinsurance Exchange of Automobile Club of Southern California, 80 Cal. Rptr. 247 (App. 1969) 16

Bacon v. Dep't of Housing and Urban Development, 757 F. 2d 265 (9th Cir. 1985) 22

Berman v. Riverside Casino Corp., 354 F. 2d 42 (2nd Cir. 1965) 16

Boston Water Power Co. v. Gray, 47 Mass. 131 (1822) 16

Burgess v. Premier Corp., 727 F. 2d 826 (9th Cir. 1984) 20, 26

Childs v. RIC Group, Inc., 331 F. Supp 1078 (N.D. Ga. 1970) 20, 26

Collingswood Hosiery Mills v. American Federation of Labor, 107 A 2d 43 (N.J. App. 1954) 18

Estes v. Mansfield, 88 Mass. 69 (1863) 16

Evans v. Hudson Coal Co., 165 F. 2d 970 (3rd Cir. 1948) 16

Fudickar v. Guardian Mutual Life Ins. Co., 62 N. Y. 392 (1875) 16

Gilbert v. Mason, 222 S.E. 2d 835 (Ga. App. 1975) 8

Greenough v. Rolfe, 4 N.H. 357 (1828) 16

Int'l Longshoremen's Ass'n v. National Mediation Board, 70 F. 2d 733 (D.C. Cir. 1989) 22

Kleine v. Catara, 14 F. Cas. 7,869 (D. Mass. 1814) 16

Leslie v. Leslie, 24 A 319 (N.J. Ch. 1892) 16

Local Union 560 v. Eazor Express, Inc., 230 A 2d 521 (NJ. App. 1967) 18

McMahon *see* Shearson/American Express, Inc. v. McMahon 21

Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614,105 S. Ct. 3346,87 L. Ed. 2d 444 (1985) 8, 12, 21, 22

Newsday v. Long Island Typographical Union, 915 F. 2d 840 (2nd Cir. 1990) 20

Pearlstein v. Scudder & Germain, 429 F. 2d 1136 (2nd Cir. 1970), cert. denied 401 U.S. 1013 (1971) 20, 27

Regional Properties, Inc. v. Financial and Real Estate Consulting Co., 678 F. 2d 552 (5th Cir. 1982) 27

Rodriguez de Quijas v. Shearson/American Express, Inc., 90 U.S. 477,109 S.Ct 1917,104 L.Ed. 2d 526 (1989) 15, 21, 22

Sanborn v. Murphy, 50 N.H. 65 (1870) 16

Cases (Cont'd) PAGE(S)

Shearson/American Express, Inc. v. McMahon, 482 U.S. 230, 107 S.Ct. 2332,96 L.EA 2d 185 (1987) 8,13,21,22

Sobel v. Hertz, Warner & Co., 469 F. 2d 1211 (2nd Cir. 1972) 22

Stroehmann Bakeries v. Local 776, 969 F. 2d 1436 (3rd Cir. 1992) 20

Utah Constr. Co. v. Western Pacific R'y Co., 162 P. 631 (Cal. 1917) 16

W.R. Grace and Co. v. Local Union 759, 461 U.S. 757,103 S.Ct. 2177,76 L.Ed. 2d 298 (1983) 20

Wilko *see* Wilko v. Swan, 346 U.S. 427 8

Wilko v. Swan, 107 F. Supp. 75 (S.D.N.Y. 1952), rev'd 201 F. 2d 439 (2d Cir. 1953) 9

Wilko v. Swan, 201 F. 2d 439 (2d Cir. 1953), rev'd 346 U.S. 427, 74 S.Ct. 182,98 L.Ed. 2d 168 (1953) 10, 18, 28

Wilko v. Swan, 346 U.S. 427,74 S.Ct. 182, 98 L.E4 2d 168 (1953) 8, 9, 11, 13, 15, 18, 28

Young v. Walter, 9 Ves. Jr. 365,32 Eng. Rep. 642 (Ch. 1804) 15,16

Statutes

15 U.S.C. § 77n, Securities Act of 1933, § 14 2

15 U.S.C. § 78cc, Securities Exchange Act of 1934, § 29 2

9 U.S.C. § 10 2, 13, 18

Ariz. Consumer Fraud Act, Ariz. Rev. Stat. §§ 44-1521 et seq. 24

Fed. Arbitration Act of 1925,43 Stat. 883 ff., 9 U.S.C. §§ 1-14 19

Securities Act of 1933,48 Stat. 74 ff., 15 U.S.C. §§ 77a et seq. 19

Securities Act of 1933, § 12 (2), 15 U.S.C. § 771 (2) 8

Securities Act of 1933, § 14,15 U.S.C. § 77n 8

Securities Exchange Act of 1934, 48 Stat. 881 ff., 15 U.S.C. §§ 78a et seq. 19

Securities Exchange Act of 1934, § 10 (b), 15 U.S.C. § 78 j (b) 13

Securities Exchange Act of 1934, § 29 (a), 15 U.S.C. § 78cc (a) 8

Securities Exchange Act of 1934, § 29 (b), 15 U.S.C. § 78cc (b) 27

Treatise

H.S. Bloomenthal, Securities and Federal Corporate Law (1991 Rev.) 26

<u>Encyclopedia</u>

6 CJ.S. Arbitration (1975) 21

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Petitioners William F. McCollough and Jeanene McCollough respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, with respect to which a timely Petition for Rehearing was denied on July 28, 1992.

OPINIONS BELOW

The opinion of the Court of Appeals for the Ninth Circuit is reported at 967 F. 2D 1401, and is reprinted in the appendix hereto, p. Al, *infra.* The opinion of the District Court for the District of Arizona (Rosenblatt, DJ.) is reported at 764 F. SUPP. 1365, and is reprinted in the appendix hereto, p. A8, *infra.*

JURISDICTION

Invoking federal jurisdiction under 28 U.S.C. § 1331 and 9 U.S.C. § 9, Respondent AG. Edwards & Sons, Inc. ("Broker") brought action in the District of Arizona to confirm an arbitrators' award, and Petitioners McCollough ("Investors") crossclaimed seeking vacatur of the award. The District Court vacated the award and ordered re-arbitration before a new panel of arbitrators.

Broker initiated a timely appeal to the Ninth Circuit Court of Appeals, under 9 U.S.C. § 16 (a) (1) (E). The Ninth Circuit, on June 26, 1992, entered a judgment and opinion reversing the district court's judgment and directing that the arbitrators' award be confirmed. Investors filed a timely petition for rehearing, which the Ninth Circuit denied on July 28,1992.

The jurisdiction of this Court to review the judgment of the Ninth Circuit is invoked under 28 U.S.C. § 1254 (1).

STATUTES INVOLVED

15 U.S.C. § 77n, [Securities Act of 1933, § 14]:

Any condition, stipulation or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules or regulations of the Commission shall be void.

15 U.S.C § 78cc, [Securities Exchange Act of 1934, § 29]:

(a) Any condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

9 U.S.C. § 10:

(a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration —

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

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

(3) 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.

(4) 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.

(5) Where an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

STATEMENT OF THE CASE

Petitioners McCollough ("Investors") are a retired couple in their 60s. They first opened an account with Respondent A.G. Edwards, Inc., a securities broker-dealer ("Broker") in 1985. The account out of which the present controversy arises was opened in 1986. Their stated investment objectives, as recorded by Broker in the account records, were, in order of priority, first, safety of principal, second, growth and third, income.

On October 19, 1987, open option positions on Investors' account were closed, to their loss, on that day, of more than $900,000. All of Investors' other assets in Broker's hands were liquidated, and the net result was an account balance owing from Investors to Brokers of almost $260,000. Investors alleged, but Broker denied, that the trades resulting in the loss were unauthorized.

On November 2, 1987, at Broker's offices, an in-house collection attorney representing Broker presented to Investors a note giving them 90 days to pay. The note

contained general release language, pursuant to which Investors purportedly waived all claims of any nature against Broker. Investors signed the note without knowing of any potential claims or causes of action which they might have under the securities laws.

Investor's original customer agreement with Broker, a printed form prepared by Broker, included a provision for arbitration of any claims which might be asserted by Investors. Pursuant to this pre-dispute agreement, Investors submitted an arbitration request to the New York Stock Exchange in October, 1988.

Investors alleged violations of Section 10 (b) of the Securities Exchange Act of 1934 and regulations thereunder, Arizona securities statutes, the Arizona Consumer Fraud Act, Arizona "mini-RICO" law and federal RICO statutes. Broker counterclaimed for the balance due on the November 2, 1987 note. Arbitration hearings before a three-man panel consisting of one practicing attorney, one retired banker and one retired phone company executive were held at Phoenix in the fall of 1990.

In its defense, Broker asserted: that contributory negligence was a defense to Investors' claims, including the Arizona blue sky claims; that Broker's "good faith" was a defense to Investors' claims, including the Arizona blue sky claims; that Investors could have no private right of action under the Arizona Consumer Fraud Act if the alleged misconduct was also violative of Arizona securities statutes; and that even if Broker had been liable to pay damages to Investors under state or federal securities statutes or otherwise, the general release language of the November 2, 1987 "note and release" was a binding and

effectual waiver of any such claim. None of these defenses was ever withdrawn by Broker.

The waiver defense based on the "note and release" was strongly emphasized by Broker throughout the hearing, including closing arguments. However, the uncontroverted evidence was that not only Investors but also Broker's attorney and branch office manager, who represented Broker in connection with the note and release, had no knowledge concerning Investors' potential state and federal securities law claims when the note and release was executed. Broker's distinguished counsel, laying the "note and release" before the banker and the phone company executive, presented common law waiver and release arguments wholly without regard to the special requirements of securities law, in effect contending that a post-transaction waiver which would be binding in the context of an ordinary sale of goods or similar commercial transaction must also be effective in the context of a securities transaction.

Two of the arbitrators concurred in a three-line award whereby Investors took nothing and their liability to Broker on the note was upheld. No findings, conclusions or explanations were given, and no reasons for the award were stated. The third arbitrator (the practicing attorney) dissented and indicated that he would grant Investors' claim, including treble damages under state law, plus expenses.

Broker then commenced a district court action under the Federal Arbitration Act to enforce the award, and Investors contested that action, seeking vacatur of the award. The district court, Hon. Paul G. Rosenblatt, was under the impression that the arbitrators' error in the application or interpretation of securities statutes would

not constitute grounds for vacatur of the award. Although Investors complained of the legal invalidity of the four defenses asserted by Broker and discussed above, Broker made no attempt to establish their validity.

The district court found that certain of these defenses were "facially meritless" and that Broker "knew or should have known" of the invalidity of at least two of them, and concluded that under the circumstances Broker's assertion of "multiple facially meritless defenses constitutes procurement of an award by 'undue means' within the meaning of 9 U.S.C. § 10 (a) [1]." Accordingly, the district court vacated the award and remanded the matter for arbitration before a new arbitral panel. Broker appealed.

On appeal, Investors offered the following alternative argument in support of the district court's judgment. Unlike arbitrators in an ordinary "unrestricted submission" commercial arbitration, arbitrators deciding a statutory tort claim pursuant to a pre-dispute arbitration agreement are bound to decide according to the law. Therefore, if the arbitrators err in the application or interpretation of relevant statutory law and thus do not resolve the dispute in accordance with statutory law, they act beyond their powers and their award is subject to vacatur at the enforcement stage. It remains only to consider by what means error in the application of statutory law must be shown. The extent of the arbitrators' obligation to explain the award is necessarily related to the scope of judicial review of it. Where the arbitrators choose not to render a reasoned decision, error of law *vel non* cannot be shown directly. In such a case, if the defending party relied upon meritless defenses and if the arbitral record discloses a likelihood that the award was influenced thereby, to deprive the district court of the power to vacate such award and compel the court to

enforce it instead would deprive the arbitral process of the minimal integrity which must be maintained. It would also mean that by agreeing to arbitrate a statutory claim a party would not merely be submitting the resolution of his rights to an alternative forum, but also foregoing substantive rights afforded by the statute.

Disregarding Investors' alternative argument entirely, the Court of Appeals held that there was nothing "undue" about Broker's reliance upon defenses which it knew or should have known to be meritless: "Offering a meritless defense... is part and parcel of the business of litigation." Moreover, said the Court of Appeals, where a party to arbitration challenges the award on grounds of "undue means," he must prove that an award in favor of the opposing party would not have been rendered but for the undue means resorted to by that party; that such a showing is almost inherently impossible where no reasons for the award are given is merely another reflection of the "extremely limited scope of judicial review of such awards." Accordingly, the Court of Appeals reversed the district court's judgment and directed entry of an order confirming the arbitration award.

REASONS FOR GRANTING THE WRIT

I. IN OVERRULING *WILKO V. SWAN,* 346 U.S. 427 (1953), THIS COURT HAS IMPLICITLY ENDORSED THE *WILKO* MINORITY'S VIEW THAT IN CASES OF THIS TYPE "APPROPRIATE MEANS OF JUDICIAL SCRUTINY MUST BE IMPLIED."

Where the claim submitted to arbitration under a pre-dispute agreement to arbitrate is a claim arising out of statutory rights and protections belonging to the claimant,

which the claimant could not, by any pre-dispute contract, waive or relinquish, the arbitrators must decide in accordance with the statute even if the agreement has no requirement that the arbitrators follow the law. *Wilko v. Swan,* 346 U.S. 427, 433-34, 436, 74 S.Ct. 182, 186, 98 L.ED. 2D 168 (1953) (point agreed -upon by majority as well as Jackson, J., concurring, 346 U.S. at 439, 74 S.Ct. at 189, and Frankfurter and Minton, JJ., dissenting, 346 US. 439, 440, 74 S.Ct. 189), *overruled on other grounds, Rodriguez de Quijas* v. *Shearson/American Express, Inc.,* 490 U.S. 477, 109 S.Ct. 1917, 104 L.ED. 2D 526 (1989); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.,* 473 U.S. 614, 637-38, 105 S. Cr. 3346, 3359-60, 87 L. ED. 2D 444 (1985); *Shearson/American Express, Inc. v. McMahon,* 482 U.S. 230, 231-32, 107 S.Ct. 2332, 2340, 96 L.ED. 2D 185 (1987); *Rodriguez de Quijas* v. *Shearson/American Express, Inc.,* 490 US. 477, 536, 109 S.Ct. 1917, 1920-21,104 L.ED. 2D 526 (1989).

Wilko involved an investor's claim for damages under § 12 (2) of the Securities Act of 1933. Justice Reed, writing for the Court, remarked (citing in support a series of "unrestricted submission" contract-dispute cases, decided both before and after the enactment of the Federal Arbitration Act) that notwithstanding the arbitrators' duty to follow federal securities law, at the award-enforcement stage "interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error" and held the pre-dispute arbitration agreement unenforceable for that reason, among others.[1] 346 U.S. at 436-37, 74 S.Ct. at 187.

1. Federal securities statutes invalidate contractual provisions which prospectively waive the right to pursue statutory remedies for possible securities violations. Section 14 of the Securities Act of 1933

Justice Jackson wrote a brief concurring opinion simply to state that he

> [found] it unnecessary in this case, where there has not been and could not be any arbitration, to decide that the Arbitration Act precludes any judicial remedy for the arbitrators' error of interpretation of a relevant statute. 346 U.S. at 438-39, 74 S.CT. at 189.

Justices Frankfurter and Minton, in dissent, likewise disputed the majority's restrictive view of enforcement-stage judicial review in such a case:

> [Arbitrators are] "bound to decide in accordance with the provisions of section 12 (2)" [of the Securities Act of 1933]. On this we are all agreed. It is suggested, however, that there is no effective way of assuring obedience by the arbitrators to the governing law. But since their failure to observe this law "would ... constitute grounds for vacating the award pursuant to section 10 of the Federal Arbitration Act," 201 F. 2d 439, 445, appropriate means for judicial scrutiny must be implied, however informal, whereby such compliance will appear, or want of it will upset the award. 346 U.S. at 440,74 S.CT. at 189.

The Second Circuit decision reversed in *Wilko* explicitly addressed the district court's concern (see 107 F. SUPP. 75, 78 (S.D.N.Y. 1952)) that submission of such

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§14, 15 U.S.C. § 77n; Securities Exchange Act of 1934 § 29 (a), 15 U.S.C § 78cc.

Although Arizona's securities statutes lack an explicit anti-waiver provision, under similar state statutory schemes an investor's pre-dispute waiver of blue sky law protections has been held invalid on public policy grounds. *Gilbert v. Mason,* 222 S.E. 2d 835,837-38 (Ga. App. 1975).

disputes to arbitration would deprive investor-claimants of substantive benefits of federal securities law:

> It is urged that arbitration cannot give the same assurance as a trial in court that the arbitrators will apply the proper legal standards, including the provisions of section 12 (2) [of the Securities Act of 1933] as to the shift in the burden of proof and the legal measure of damages, and the requirement of section 14 that the exculpatory provision of the margin agreement [containing investor's purported waiver of securities law claims] be disregarded. The exculpatory provision ... is concededly invalid. Hence no question as to it will be submitted to the arbitrators. With respect to the legal measure of damages and the burden of proof provisions, while it may be true that arbitrators do not ordinarily consider themselves bound to decide strictly according to legal rules, there can be no doubt that they are so bound if the arbitration agreement so provides. Undoubtedly it is true in this country ... when parties have adopted arbitration, ordinarily They must content themselves with looser approximations to the enforcement of their rights than those the law accords them, when they resort to its machinery." But... the agreement in the case at bar is subject to the 1933 Act; consequently, the arbitrators are bound to decide in accordance with the provisions of section 12 (2). Failure to do so would, in our opinion, constitute grounds for vacating the award pursuant to section 10 of the Federal Arbitration Act, 9 U.S.C.A § 10. *Wilko* v. *Swan,* 201 F. 2D 439, 444-45 (2d Cir. 1953), reversed 346 U.S. 427,74 S.CT. 182,98 L.ED. 2D 168 (1953).

Today this Court's opinion in *Wilko* has itself been overruled. This development naturally lends fresh interest

to the dissenting and concurring opinions in *Wilko,* as well as the Circuit Court decision reversed therein. Moreover, the change implies that the Court either: (1.) retains the view that an arbitral award may not be vacated on grounds of erroneous interpretation of law, but is no longer troubled by the implication that the claimant will in such case have waived theoretically non-waivable substantive rights; or (2.) has come around to the more expansive theory of judicial review espoused in *Wilko* by the Second Circuit and the concurring and dissenting Justices.[2] A careful examination of the line of cases leading to the reversal of *Wilko* demonstrates that the latter alternative is correct.

The formerly prevailing view that a party asserting a tort claim arising out of a violation of federal statute could not be compelled to submit that claim to arbitration on the basis of a pre-dispute arbitration agreement was dealt its first serious blow in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.,* 473 U.S. 614, 105 S. CT. 3346, 87

2. The Ninth Circuit asserted that substantive judicial review of securities arbitration awards is precluded by a "strong federal policy encouraging arbitration as a 'prompt, economical and adequate' method of dispute resolution," citing *Rodriguez de Quijas v. Shcarson/American Express, Inc.,* 490 U.S. at 481. That assertion was an exercise in question-begging. *Rodriguez de Quijas* certainly teaches the remedial adequacy of arbitration; but that this Court deems arbitration remedially adequate means either: (1.) that the Court would now disagree with both the *Wilko* majority and the *Wilko* minority, adhering to the majority's restrictive view of enforcement-stage review of awards made in such cases, but deeming the arbitral remedy adequate *despite* the possibility that investors' statutory rights would be disregarded; or (2.) that the Court would now agree with the *Wilko* minority, deeming the arbitral remedy adequate *because* the arbitrators' failure to resolve the dispute in accordance with applicable securities statutes would render the award subject to vacation at the enforcement stage.

L. ED. 2D 444 (1985). In that case, a foreign automobile manufacturer sought to compel arbitration of a dealer's Sherman Act and Clayton Act claims against it, pursuant to an arbitration clause contained in the dealership agreement. Notwithstanding that the Courts of Appeals had "uniformly" held that arbitration could not be compelled in such circumstances, the Court affirmed the district court's decree compelling arbitration of the antitrust claims. The Court rejected the argument that arbitration should not be compelled because the arbitrators might apply what would, in an American court, be considered an erroneous choice-of-law rule, and thus fail to apply American antitrust law. Such rejection, however, reflected a notion that such error, if committed, would be both reviewable and remediable:

Where the parties have agreed that the arbitral body is to decide a defined set of claims which includes, as in these cases, those arising from the application of American antitrust law, the tribunal therefore should be bound to decide that dispute in accord with the national law giving rise to the claim. Cf. *Wilko* v. *Swan,* 346 U.S., at 433-434,74 S. Ct., at 185-186.[FN19]. . .

Having permitted the arbitration to go forward, the national courts of the United States will have the opportunity at the award-enforcement stage to ensure that the legitimate interest in the enforcement of the antitrust laws has been addressed.... While the efficacy of the arbitral process requires that substantive review at the award-enforcement stage remain niinimal, it would not require intrusive inquiry to ascertain that the tribunal took cognizance of the antitrust claims and actually decided them.[FN 20]

FN 19. ... We ... have no occasion to speculate on [the arbitral panel's application of the correct substantive law of restraint of trade] at this stage in the proceedings, when Mitsubishi seeks to enforce the agreement to arbitrate, not to enforce an award. Nor need we consider now the effect of an aribtral tribunal's failure to. take cognizance of the statutory cause of action on the claimant's capacity to reinitiate suit in the federal court. We merely note that in the event the choice-of-forum and choice-of-law clauses operated in tandem as a prospective waiver of a party's right to pursue statutory remedies for antitrust violations, we would have little hesitation in condemning the agreement as against public policy.

FN 20. See n. 19, supra. We note, for example, that the rules of the Japan Commercial Arbitration Association provide for the taking of a "summary record" of each hearing, Rule 28.1; for the stenographic recording of the proceedings where the tribunal so orders or a party requests one, Rule 28.2; and for a statement of the reasons for the award unless the parties agree otherwise, Rule 36.1(4).

473 U.S. at 637-38,105 S. Cr. at 3359-60.

Then, in *Shearson/American Express, Inc. v. McMahon,* 482 U.S. 230, 107 S.Ct. 2332, 96 L.ED. 2D 185 (1987), the Court refused to extend *Wilko* to preclude enforcement of pre-dispute arbitration clauses in the case of an investor's claim for damages under § 10 (b) of the Securities Exchange Act of 1934. However, the viability of *Wilko's* restrictive concept of judicial review under 9 U.S.C. § 10, along with other aspects of the *Wilko* court's attitude toward arbitration, was openly questioned. Moreover, the

question whether, at the award-enforcement stage, judicial review might include inquiry to determine whether issues had been resolved in accordance with statutory law, was expressly said to have been reserved:

> *Wilko* noted that "the power to vacate an award is limited" and that "interpretations of the law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation." *Id.* at 436-437,74 S.Cr., at 187-88.
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> [M]ost of the reasons given in *Wilko* have been rejected subsequently by the Court as a basis for holding claims to be nonarbitrable. ... [W]e have concluded that the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights. *Mitsubishi* at 628, 105 S.Ct. at 3354. Finally, we have indicated that there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute. See id., at 636-637, and n. 19, 105 S.Cr., at 3359, and n. 19 (declining to assume that arbitration will not be resolved in accordance with statutory law, but reserving consideration of "effect of an arbitral tribunal's failure to take cognizance of the statutory cause of action on the claimant's capacity to reinstate suit in federal court.")

482 U.S. at 231-32,107 S.Ct. at 2340.

Finally, in *Rodriguez de Quijas* v. *Shearson/American Express, Inc.,* 490 U.S. 477, 109 S.CT. 1917, 104 L.ED. 2D 526 (1989), the Court expressly overruled *Wilko* in a brief opinion which quoted Justice Frankfurter's *Wilko* dissent with approval, 490 U.S. at 536, 109 S.CT. at 1921, and which heavily stressed a procedural-substantive dichotomy which had been developing since *Mitsubishi:*

By agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial forum. 490 U.S. at 481,109 S.CT. at 1920.

II. SUBJECTING THE ARBITRAL AWARD TO REVIEW FOR ERROR IN THE APPLICATION OR INTERPRETATION OF SUBSTANTIVE SECURITIES LAW WOULD BE CONSISTENT WITH ESTABLISHED PRINCIPLES OF ARBITRATION LAW, AS WELL AS PUBLIC POLICY.

The Second Circuit and the minority Justices in *Wilko,* in asserting that where arbitrators are bound to follow the law their award is subject to review for legal error, were not contending for an innovation in the law of arbitration. Rather, they were reasserting an established rule of law which had almost sunk out of sight, swamped by a 20th-century flood of commercial arbitration cases in which the arbitrators were *not* bound to follow the law.

In resorting to arbitration, disputants may (absent statutory restrictions), but need not, make the arbitrator their law-giver as well as their judge.[3] If the agreement to

3. Where parties agree to accept the result that seems fair and just to the arbitrator, even if the arbitrator is wholly ignorant of, or

arbitrate is silent, it is assumed they want the arbitral process to supply not only the decisional mechanism but also the substantive rules of decision. Arbitration under an agreement which explicitly binds the arbitrators to decide according to law has become a great rarity in modern practice, but it is well established that, in such a case, the award is subject to judicial review for legal error.[4]

intentionally decides contrary to, the controlling substantive law, they have made the arbitrator their Congress and their Supreme Court: If there is a question of law, and the parties choose to refer that to the decision of an arbitrator, instead of the Court, why may not he take all moral considerations into his judgment? If they refer to a person, to decide all matters in difference according to law, and he means to decide according to law, and mistakes, the Court will set that right. But if a distinct question of law ... is referred... and the parties choose to say, they will not take the decision of the Court, but will take whatever an arbitrator shall say is the law between them, why may they not so agree?

... The question is, whether by the reference to arbitration they mean to make the arbitrator *pro hac vice* the Law-giver between them.

Young v. Walter, 9 VES. JR. 365,32 ENG. REP. 642,643 (Ch. 1804) (opinion of Eldon, L. Ch.)

Of course, whatever the parties intend, they cannot prospectively empower an arbitrator to "give" them a securities law which differs from the Securities Act of 1933, the Securities Exchange Act of 1934 and/or applicable blue sky laws.

4. As is already suggested in the passage quoted supra, Note 3: "If [the arbitrator] means to decide according to law, and mistakes, the Court will set that right." *Young v. Walter,* 32 ENG. REP. at 643. There is a long line of authorities distinguishing between (1.) cases wherein the arbitrator is empowered to, and intends to, dispose of the matter in controversy as seems best to him, *ex aequo et bono* and according to his own lights, and (2.) those special cases in which the arbitrator is either constrained by the agreement of reference to decide according to the law or indicates in his award that he is attempting to decide according to the law. In the former circumstance (which obtains in the great majority of commercial arbitration cases), courts will not inquire into the legal correctness of the arbitrators' reasoning because

the inquiry would be irrelevant — such arbitrators "may fashion the law to fit the facts before them." *Berman v. Riverside Casino Corp.,* 354 F. 2D 42,43 (2nd Cir. 1965) Or, to state the point somewhat more fully, an unrestricted submission

> is the commission of the arbitrator. By force of it he... may do what no other judge has a right to do; he may intentionally decide contrary to law, and still have his judgment stand.... [I]f arbitrators mean to decide according to law, but mistake the law in a material respect, and their mistake appears on the face of the award, or they admit it, the award will be set aside because it does not express their real judgment; but in cases where they do not intend to let the law govern their judgment, but to decide according to their own notions of what is just and right, the courts will not interfere, but allow their award to stand. *Leslie v. Leslie,* 24 A. 319,320-31 (NJ. Ch. 1892) (citations omitted).

In the latter situation, however — where the arbitrators were bound to, or expressly attempted to, decide in accordance with a body of applicable substantive law — a court may deny enforcement of an award which is legally erroneous. *Kleine v. Catara,* 14 F. CAS. 7,869 p. 735 (D. Mass. 1814) (opinion of Story, Cir. Justice); *Boston Water Power Co. v. Gray,* 47 MASS. 131,166 (1822); *Greenough v. Rolfe,* 4 N.H. 357, 359 (1828); *Estes v. Mansfield,* 88 MASS. 69 (1863); *Sanborn v. Murphy,* 50 N.H. 65, 67 (1870); *Fudickar v. Guardian Mutual Life Ins. Co.,* 62 N.Y. 392, 399-400 (1875); *Utah Constr. Co. v. Western Pacific R'y Co.,* 162 P. 631, 633 (CaL 1917); Cf. *Evans v. Hudson Coal Co.,* 165 F. 2d 970,974 (3rd Cir. 1948).

Most recent in this line of authorities is a 1969 California case which arose under a statutory scheme which contemplated that certain types of liability insurance disputes be resolved by contractual arbitration, but also required that the arbitrators decide such disputes on the basis of the parties' "legal entitlement" to recovery under applicable tort law. Since the award contained a brief statement of the arbitrator's reasons for the award the court was able to determine that the award was based upon a misunderstanding of California law regarding imputation of negligence.

The insurance company contended that an arbitrator's error of law is no basis for vacating or refusing to enforce his award, and cited many authorities ("unrestricted submission" cases arising out of contract disputes) which appeared to support that contention. However, the appellate court had no difficulty in distinguishing the arbitration under review from an arbitration in which the arbitrator had been under no

It is argued that a rule generally prohibiting such review would foster the speedy and economical resolution of the dispute, which was the parties' presumed objective in agreeing to arbitration. But this argument cannot be used to defend judicial enforcement of an award, rendered under a pre-dispute arbitration agreement, which reflects error in the application or interpretation of the substantive law governing non-waivable statutory rights. If, for example, an investor's effectual waiver of the right to have prospective securities-law claims resolved in accordance with governing securities statues would foster economy, speed, and finality, his outright waiver of prospective securities claims would be still cheaper, faster and more final.

While 9 U.S.C. § 10 (a) (4) "excess of authority" analysis is probably the most logical basis for judicial review of the correctness of the arbitrators' interpretation of the law in cases in which the arbitrators were bound to resolve the dispute in accordance with the law, there is also authority supporting use of "undue means" language identical to that found in 9 U.S.C. § 10 (a) (1) — the same provision relied upon by the district court in this case — for the same purpose. *Local Union 560* v. *Eazor Express, Inc.,* 230 A. 2D 521, 525 (N.J. App. 1967); *Collingswood Hosiery Mills* v. *American Federation of Labor,* 107 A. 2D 43,44 (N.J. App. 1954).

Both the Second Circuit decision reversed in *Wilko* and Justice Frankfurter's *Wilko* dissent reflect the view that 9 U.S.C. § 10 would authorize the district court to inquire into the arbitral tribunal's application and

constraint to decide in conformity with the rules of law. The award was vacated because of the arbitrator's apparent legal error. *Allen v. Interinsurance Exchange of the Automobile Club of Southern California,* 80 CAL. RPTR. 247, 249-50 (App. 1969).

interpretation of substantive securities law, and to vacate the award if the dispute submitted to arbitration had not been resolved in accordance with controlling statutory law, but neither specifies the particular subsection of 9 U.S.C. § 10 which would be relied upon as the statutory basis for such review.

Ultimately, the attempt to identify particular authority in the words of § 10 is probably irrelevant. The Securities Act of 1933 and Securities Exchange Act of 1934 were specific, *later* enactments which not only prescribed substantive standards of conduct but voided contracts purporting to waive compliance with those standards. In working out the implications of this subsequent legislation for contractual arbitration arising out of alleged violation of those standards, and for judicial review of awards arising out of such arbitration, it is the Federal Arbitration Act of 1925 which must give way, to the extent of any conflict.

It must not be forgotten that the suppression of securities fraud and of the use of manipulative or deceptive practices in the sale of securities is a matter of strong public policy. In the Thirties Congress acted to reform common law rules such as *caveat emptor* as applied to the securities field, in pursuit of a strong public policy of ensuring fairness and integrity in the nation's capital markets. In the Sixties and Seventies, Congress acted to impinge upon even such principles as freedom of association and delectation of persons, in pursuit of a strong public policy of ensuring fairness and dignity for workers regardless of race or sex. Surely the policy goals which underlay the reform of securities law are no less "strong" today? Surely "strong public policy" is not a code phrase for the "public policy of the month"?

But if this be granted, how could one explain to Mr. and Mrs. McCollough that they can have no remedy, even though their arbitrators did *not* find that no securities fraud had been practiced upon them and did *not* find that they waived their securities-law claims with actual knowledge of them, while a discharged employee may not be reinstated — despite an award in his favor — unless his arbitrator *does* find that he has not engaged in sexual harassment? See *Stroehmann Bakeries* v. *Local 776,* 969 F. 2D 1436, 1441 (3rd Cir. 1992) and *Newsday v. Long Island Typographical Union,* 915 F. 2D 840, 843-44 (2nd Cir. 1990), both citing *W.R Grace and Co.* v. *Local Union 759,* 461 U.S. 757, 766, 103 S.CT. 2177, 2183, 76 L.Ed. 2d 298 (1983). If the arbitrators in this case did give effect to the "note and release," then clearly the note and release is "a contract [which,] as interpreted by [the arbitrators] violates some explicit public policy" — viz., the policy against unknowing waiver of securities rights, as expounded in *Burgess v. Premier Corp.,* 727 F. 2D 826, 831 (9th Cir. 1984), *Childs v. RIC Group, Inc.,* 331 F. SUPP. 1078, 1083 (N.D. Ga. 1970), *Pearlstein v. Scudder & Germain,* 429 F. 2D 1136, 1142-43 (2nd Cir. 1970), *cert, denied* 401 U.S. 1013 (1971) and numerous other authorities. How, then, consistently with *W.R Grace and Co.* v. *Local Union 759,* supra, can the federal courts enforce the award?

There is a fundamental difference between an arbitration in which the arbitrators are free to make up the substantive rules of decision, and one in which they are bound to resolve the dispute in accordance with applicable statutory law. Investors submit that a clear recognition of this difference, and of its specific implications for judicial review of awards rendered in securities cases submitted to arbitration under *Mitsubishi-McMahon-Rodriguez de*

Quijas, is necessary. There is no reason to believe that the arbitration of securities disputes could not survive as a valuable alternative to litigation if such awards were subject to similar scrutiny, at the enforcement stage, as is currently exercised with respect to labor arbitration awards. To subject securities arbitration awards to the same expectations with regard to reasoned support, and the same requirements vis-a-vis consistency with strong public policies, as are currently applied with respect to labor arbitration awards, would not "doom" or "throttle" securities arbitration.

III. SINCE "APPROPRIATE MEANS FOR JUDICIAL SCRUTINY MUST BE IMPLIED," WHERE AN AWARD IS NOT SUPPORTED BY A REASONED DECISION AND THE ARBITRAL RECORD STRONGLY SUGGESTS THAT THE AWARD WAS INFLUENCED BY LEGAL ERROR, THE DISTRICT COURT MUST BE FREE TO VACATE THE AWARD.

The traditional rule that an award may be vacated where arbitrators intended to follow, but misconstrued, applicable law has been noticed above. In considering cases in which that rule was invoked, the courts have long held that

> where the reasons of the award are not shown, there is no means of knowing whether or not the arbitrators intended to decide according to law. 6 CJ.S. *Arbitration* § 155 (1975).

It is for this reason that various institutions promoting the arbitral resolution of disputes actively discourage arbitrators from stating findings and conclusions or otherwise giving any reasons or explanations for their

awards — arbitrators are frankly advised that stating any reasons for their award may create a basis for a court challenge to the award.

In the context of a proceeding such as the one under review in this case, however, in which, despite the silence of the agreement, the arbitrators were bound to decide according to law (and especially where, as here, they were never explicitly instructed to do so), the implications of such "politic silence" are entirely different. Without a reasoned opinion, there is "no means of knowing whether or not the arbitrators intended to decide according to law," much less whether they did so.

Although it is the general rule that arbitrators need not explain their decision,

> [n]onetheless, the extent of an arbitrator's obligation to explain the award is necessarily related to the scope of judicial review of it. *Sobel* v. *Hertz, Warner & Co.,* 469 F. 2D 1211, 1214 (2nd Cir. 1972).

This principle has not yet been explicitly applied in the newly-opened field of securities arbitration under *Mitsubishi-McMahon-Rodriguez de Quijas.*[5]

5. In *Mitsubishi* the prospect of substantive review of arbitral proceedings at the award-enforcement stage was very obliquely addressed, and then only in the context of a basic choice-of-law determination in an international commercial arbitration. Nonetheless, the Court pointed to the arbitral tribunal's rule requiring a reasoned decision as one of the factors ensuring that effective judicial review would be possible. 473 U.S. at 638,105 S.Ct. at 3360, n. 20.

Perhaps the nearest analog to the enforcement/vacatur proceeding arising out of a *Mitsubishi-McMahon-Rodriguez de Quijas* securities arbitration is the Administrative Procedures Act review case. In each instance, an expert panel utilizing relatively informal procedures and entitled to draw upon its own specialized knowledge has rendered a determination on a particular matter in controversy, and the reviewing

IV. BROKER'S EXTENSIVE RELIANCE ON ITS INVALID "NOTE AND RELEASE" DEFENSE JUSTIFIES THE DISTRICT COURT'S REFUSAL TO ENFORCE THE ARBITRATION AWARD.

In the entire history of this case, no authority has ever been cited which supports the proposition that, *where the arbitrators were bound to decide in accordance with the law,* their award is entitled to judicial enforcement even if it is legally erroneous. Nevertheless, this proposition has clearly been adopted by the Court of Appeals. Therefore, the Court of Appeals never considered in what manner such error must be shown.

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court, while giving due deference to the quasi-judicial panel's findings of fact and its expertise, must determine whether the panel has resolved the disputed matter in accordance with controlling substantive law. In the APA context, as a corollary to the court's duty to review the agency determination for correct interpretation of applicable law, the agency's ruling must include adequate explanation to enable the court to ascertain the legal reasoning supporting the agency decision. *Int'l Longshoremen's Ass'n v. National Mediation Board,* 870 F. 2D 733, 735 (D.C Cir. 1989). "Where an agency undertakes administrative action without stating reasons therefor, a court may set aside such action." *Bacon v. Dep't of Housing and Urban Development,* 757 F. 2D 265,269 (9th Cir. 1985) (dictum).

Similarly, reasoned decisions are the norm in the field of labor arbitration. Because a labor arbitrator's interpretation of the collective bargaining agreement is open to a degree of substantive review at the judicial enforcement stage, it has been recognized that labor contract arbitral tribunals "have a duty to ... give reasons clearly, if briefly, justifying their decisions." Harvill v. Roadway Express, Inc., 640 F. 2d 167, 169-70 (8th Cir. 1981).

In the district court, Investors sought vacatur of the arbitral award on "undue means" grounds, citing four illegal arguments urged upon the panel by Broker's counsel. Specifically, Investors claimed that Broker had misrepresented the law to the arbitrators when it argued: (1.) that contributory negligence would be a defense to Appellee's claims under Arizona securities law; (2.) that under Arizona securities law Broker would have a "good faith" defense to the claims based upon alleged misconduct of Investors' account representative, Broker's employee; (3.) that Investors could have no private right of action under the Arizona Consumer Fraud Act if the alleged misconduct was also violative of Arizona securities statutes; and (4.) that even if Broker had been liable to pay damages to Investors under state or federal securities statutes or otherwise, the "note and release" which Broker procured from Investors was a binding and effectual waiver of any such claim.

The district court found that two of these arguments (to wit, nos. (1) and (3)), asserted in Broker's formal written Answer filed in the arbitration proceeding, were so clearly inconsistent with applicable law that Broker knew or should have known that they were groundless. "Raising multiple facially meritless defenses," the district court concluded, "constitutes procurement of an award by 'undue means' within the meaning of 9 U.S.C. § 10 (a)." [6]

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6. Broker's conduct in this case was especially "undue." First, by asserting defenses which they knew or should have known to be invalid, Broker's counsel breached their duty of candor toward the arbitral tribunal. Rules of the Arizona Supreme Court, R. 42, ER 3.3 (1), provides that an attorney "shall not knowingly make a false statement of law to a tribunal." Second, the impact of Broker's misstatements of Arizona securities law was aggravated by Broker's vigorous and successful objection to Investors' offer of Mr. Matthew Zale, former

On appeal, while maintaining that this conclusion is correct as far as it goes, Investors contended that the district court's review of the award for error in the application or interpretation of securities law: (1.) was not limited to Broker's "facially groundless" defenses; and (2.) was not limited to defenses which Broker "knew or should have known" to be illegal. Since it is clear that legally invalid defenses were invoked by Broker, and since no reasons were given for the arbitrators' decision, whether the award was influenced by Broker's illegal arguments is a question of fact. The record before the district court was more than adequate to support its concern that the award probably reflected, at least in part, the erroneous contentions urged by Broker. Broker never attempted to show that the district court's factual inference was "clearly erroneous."

In its appellate brief, Broker itself confirmed the critical impact of at least one of Broker's misrepresentations of securities law:

> The real issue was the enforceability of the note and release and the viability of the Investors' factual allegations. The panel rejected the Investors' position but adopted A.G. Edwards' position that the note and release were valid. Respondent's Ninth Circuit Opening Brief, p. 22.

At the arbitration hearing, Broker's contention regarding the note was clear and simple: the note which Broker had Investors sign, promising payment of the negative account balance which resulted from their "Black Monday" loss, contained a boilerplate "release of claims," this release language constituted an effectual waiver of Investors'

Director of the Securities Division of the Arizona Corporation Commission, as an expert witness on Arizona securities law.

statutory claims, and because the note was executed after the transactions Investors complain of had been completed, statutory and other restrictions on prospective waiver of such claims are ineffectual to invalidate this waiver. In final arguments at the close of the arbitration hearing, Broker's counsel heavily stressed the purportedly dispositive effect of the release language contained in the note.

The problem with this argument is that waiver is a voluntary and intentional relinquishment of a *known* right, and in the context of alleged violation of securities statutes this has been held to require actual knowledge of the existence of the statutory claim purportedly waived:

> A release is valid for purposes of federal securities claims only if the [plaintiffs] had "actual knowledge" that the claim existed. *Burgess* v. *Premier Corp.,* 727 F. 2D 826,831 (9th Cir. 1984).

> [T]o support a finding of waiver [of private civil remedy for alleged violations of Securities Exchange Act of 1934], it must be found that the particular statutory right was actually known. *Childs* v. *RIC Group, Inc.,* 331 F. SUPP. 1078,1083 (N.D. Ga. 1970).

> [A]s to general releases obtained prior to the initiation of litigation, there is no informed release if the prospective plaintiff is unaware of the violations of federal securities law and/or that he is releasing claims under the federal securities law. 3A H.S. Bloomenthal, SECURITIES AND FEDERAL CORPORATE LAW, § 8.30 [1] (1991 Rev.).

Cf. *Pearlstein* v. *Scudder & Germain,* 429 F. 2D 1136,1142-43 (2nd Cir. 1970), *cert, denied* 401 U.S. 1013 (1971). This point was clearly raised by Investors in response to Broker's "note and release" defense.[7]

Broker never attempted to prove, or even to argue, that Investors had knowledge of a securities violation, or any idea of their rights under the securities statutes, at the time Broker induced them to sign the "note and release." Broker simply asserted repeatedly that the release was valid because it was executed after the allegedly improper transactions had been completed and (obviously) after Investors learned of their loss. Broker never tried to reconcile this defense with case law under the securities statutes.

The note and release defense may not have been "facially invalid" in the sense that it could not have

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7. As Investors also pointed out, Broker's affirmative defense based on the "note and release" would have been invalid as a matter of applicable securities law even disregarding the § 29 (a) anti-waiver provision. Under § 29 (b) of the Securities Exchange Act of 1934:

> Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract... the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void.... 15 U.S.C § 78cc (b).

Assuming, as an affirmative defense must assume, that the debit balance of Investors' account and Investors' consequent debtor relationship to Broker was the result of Broker's conduct in violation of securities law, the note prepared to evidence that indebtedness (and the "release" contained therein) would have been void under this statute. Cf. *Regional Properties, Inc. v. Financial and Real Estate Consulting Co.,* 678 F. 2d 552, 558-60 (5th Cir. 1982); *Pearlstein v. Scudder & Germain, 429 F. 2d 1136 (2d Cir. 1970),* cert. denied 401 U.S. 1013 (1971).

constituted a defense to Investors' claims under any set of facts, but it clearly was invalid in light of the total absence of proof that Investors actually knew of and intended to release statutory securities claims. Since it was heavily stressed by Broker from the beginning to the end of the arbitral proceeding, and since even Broker affirms the crucial importance of this contention in bringing about the arbitral result, it would certainly take a leap of faith to conclude that the arbitrators' unexplained, one-sentence award was not at least in some part based upon this invalid defense.

There can be no question that, if the arbitration hearing had been a jury trial, the submission of the note and release defense to the jury over Investors' objection would have constituted reversible error, in the event of a general verdict in Broker's favor. It is interesting to note that *Wilko* also involved broker-dealer's potential waiver defense, based on boilerplate provisions of the brokerage contract. There, however, by resisting arbitration the investors procured broker-dealer's concession of the invalidity of this defense, leading the Court of Appeals to remark: The exculpatory provision [of the brokerage contract] is concededly invalid. Hence no question as to it will be submitted to the arbitrators." 201F. 2D at 444.

Now this Court has aligned itself with the Second Circuit's approach to *Wilko,* and in this case Broker, which was compelled to make no concessions before entering the arbitration room, not only invoked but emphasized its waiver defense based upon the note and release — even though it now makes no attempt to reconcile that defense with applicable securities law. If, under a rule permitting enforcement of a pre-dispute agreement to arbitrate statutory tort claims, appropriate means for judicial scrutiny must be implied, whereby resolution of the

dispute in accordance with controlling statutory law will appear, or want of it will upset the award, then surely such "appropriate means" must include an intelligent inference that the award was probably influenced by a legally invalid defense which was strongly urged upon the arbitrators by attorneys representing a national securities dealer.

Otherwise, a brokerage contract provision which reads:

> The parties agree that any claim arising out af any alleged violation of any state or federal securities statute shall be submitted to arbitration.

would, in order to provide full disclosure to the lay investor, have to be rewritten as:

> The parties agree that any claim arising out of any alleged violation of any state or federal securities statute shall be submitted to arbitration. The arbitrator may disregard state and federal securities statutes in resolving such claim. By agreeing to this provision, Investor may be waiving substantive rights which he could not waive in any other manner.

RESPECTFULLY SUBMITTED this 26 day of October, 1991

BEGAM LEWIS MARKS WOLFE & DASSE

By: ________________________
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