

RECENT DEVELOPMENTS

THE ENFORCEABILITY OF ARBITRATION AGREEMENTS IN EMPLOYMENT DISPUTES BETWEEN SECURITIES FIRMS AND THEIR EMPLOYEES

Alternative dispute resolution, and especially arbitration, has become an increasingly popular route for litigation-weary (and wary) businesses in recent years. Some courts, however, have not been willing to give up their dominion to what they see as an inferior process with much room for bias and manipulation. This is true even where the industry utilizing arbitration agreements is composed of highly sophisticated employees and employers, and thus the fear of overreaching and like practices should be at its lowest.

This Recent Development details the current conflict in the federal courts regarding the enforceability of securities industry arbitration agreements where an employment dispute is at issue, a conflict precipitated by the Seventh Circuit's decision in *Farrand v. Lutheran Brotherhood*.¹ This Recent Development begins by examining the Federal Arbitration Act² ("FAA") in which Congress espoused its desire to have arbitration agreements enforced according to their terms. This Recent Development then summarizes the Supreme Court's attempt to fashion some general principles regarding the enforceability of arbitration agreements. Next, this Recent Development details arbitration agreements between securities firms and their employees, and how these agreements were treated by courts before the Seventh Circuit's *Farrand* decision. This Recent Development then discusses the *Farrand* decision, the reaction of the securities industry, the largely negative reception the *Farrand* decision has received thus far, and cases in which courts have found ways to avoid the conflict. To complete the story, this Recent Development concludes with a short commentary aimed at unearthing a moral that businesses can take from this conflict.

1. 993 F.2d 1253 (7th Cir. 1993).

2. 9 U.S.C. §§ 1-16 (1994).

I. THE FEDERAL ARBITRATION ACT OF 1925

Congress passed the Federal Arbitration Act³ in 1925, obligating courts to enforce all otherwise enforceable written arbitration agreements involving transactions in interstate commerce,⁴ except for “contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.”⁵

The FAA was not passed in order to establish arbitration as an alternative means of dispute resolution. Rather, the purpose of the bill, evidenced by the language of section 2⁶ and the legislative history,⁷ was to insure that otherwise enforceable agreements to arbitrate “shall be recognized and enforced by the courts of the United States . . . at this time when there is so much agitation against the costliness and delays of litigation.”⁸

Many commentators, and even courts, assailed the FAA. It was deemed the product of “business propagandists” by some.⁹ Others, suggesting that the court system is the only place where “the public . . . can find protection,”¹⁰ criticized the FAA for cutting off access to this sanctuary for those who entered into arbitration agreements. The Georgia Supreme Court warned of

3. Ch. 213, 43 Stat 883 (1925) (codified as amended at 9 U.S.C. §§ 1-16 (1994)).

4. Section 2 provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2 (1994).

The mandate is contained in section 3, which provides:

If any suit or proceeding be brought in any of the courts of the United States upon any issue referable to arbitration under an agreement in writing for such arbitration, the court in which such suit is pending, upon being satisfied that the issue involved in such suit or proceeding is referable to arbitration under such an agreement, shall on application of one of the parties stay the trial of the action until such arbitration has been had in accordance with the terms of the agreement, providing the applicant for the stay is not in default in proceeding with such arbitration.

9 U.S.C. § 3 (1994).

5. 9 U.S.C. § 1 (1994).

6. *See supra* note 4.

7. H.R. REP. NO. 96, 68th Cong., 1st Sess. (1924).

8. *Id.* at 1-2

9. JEROLD S. AUERBACH, JUSTICE WITHOUT LAW? 112 (1983) (quoting Philip G. Phillips, counsel to the National Relations Labor Board during the 1930s).

10. *Id.* at 113 (quoting Philip G. Phillips, *Commercial Arbitration Under the N.R.A.*, 1 U. CHI. L. REV. 424, 429 (1933-34)).

this possibility twenty years before passage of the FAA: “By first making the contract, and then declaring who should construe it, the strong could oppress the weak, and in effect so nullify the law as to secure the enforcement of contracts usurious, illegal, immoral, or contrary to public policy.”¹¹ The constitutionality of the FAA was challenged unsuccessfully as well.¹²

II. THE SECURITIES AND EXCHANGE ACTS OF 1933 AND 1934— SECURITIES FIRMS BEGIN USING ARBITRATION AGREEMENTS

The federal government began its regulation of securities and the securities industry in earnest with the passage of the Securities and Exchange Acts of 1933¹³ and 1934.¹⁴ These acts were in response to the stock market crash of 1929. Due to Congress’s belief that the crash occurred, at least in part, because of a clog in the flow of relevant information,¹⁵ the thrust of the acts was to mandate various forms of disclosure whenever securities were purchased and sold.¹⁶

Although the Acts subject securities transactions to greater federal oversight, the Acts’ provisions most relevant to this discussion call for the federal government to step back, and allow the securities industry to regulate itself, while the federal government acts in merely a supervisory capacity.¹⁷ The vehicles for this self-regulation were aptly named Self-Regulatory Organizations (“SROs”),¹⁸ and the SEC was charged with oversight

11. *Parsons v. Ambos*, 48 S.E. 696, 697 (Ga. 1904).

12. *See, e.g., Marine Transit Corp. v. Dreyfus*, 284 U.S. 263 (1932).

13. Ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

14. Ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78ll (1994)).

15. *See* 15 U.S.C. § 78b (1994) (discussing the necessity for regulation).

16. The required disclosures in the proxy solicitation process are illustrative. *See* 15 *id.* § 78n.

17. *See* 15 U.S.C. § 78s (1994).

18. Section 78s(g) details the duties of SROs:

Every self-regulatory organization shall comply with the provisions of this chapter, the rules and regulations thereunder, and its own rules, and (subject to the provisions of section 78q(d) of this title, paragraph (2) of this subsection, and the rules thereunder) absent reasonable justification or excuse enforce compliance—

(A) in the case of a national securities exchange, with such provisions by its members and persons associated with its members;

(B) in the case of a registered securities association, with such provisions and the provisions of the rules of the Municipal Securities Rulemaking Board by its members and persons associated with its members; and

(C) in the case of a registered clearing agency, with its own rules by its participants.

Id. § 78s(g).

responsibility.¹⁹

SROs became the catalyst for the use of arbitration agreements in the securities industry. The increased use of such agreements led inevitably to litigation over their enforceability. The Supreme Court ultimately resolved the question, and in the process set the stage for today's litigation over the applicability of such agreements to employment disputes.

III. EARLY INTERPRETATION OF ARBITRATION AGREEMENTS: THE SUPREME COURT SETS THE STAGE.

In *Wilko v. Swan*,²⁰ the plaintiff sued under the 1933 Act, claiming that a securities broker's fraudulent misrepresentations induced him to buy securities.²¹ The broker, relying on an arbitration provision contained in the plaintiff's purchase contract, moved for a stay pending arbitration.²²

The Court refused to compel arbitration, finding the agreement void under a provision in the 1933 Act which prohibited any "condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision" of the Act.²³ The Court brought the arbitration agreement within this prohibition by referencing the scienter requirement of the Act and the deference required to be given to arbitrators' decisions on that and other elements, concluding that these two factors combined to amount to a virtual waiver of compliance with the Act by the plaintiff, and thus voided the agreement.²⁴ Although the Court noted the congressional purpose of enforcing arbitration agreements under the FAA, it found this purpose overridden by the protections sought to be afforded investors by the 1933 Act.²⁵

Four years later, in *Textile Workers Union v. Lincoln Mills*,²⁶ the Court dealt with the "contracts of employment" exception to the FAA.²⁷ The Court found that courts could require parties to arbitrate claims arising from collective bargaining agreements, concluding that collective bargaining

19. 15 U.S.C. § 78s (1994).

20. 346 U.S. 427 (1953).

21. *Id.* at 428-29.

22. *Id.* at 429.

23. *Id.* at 430 (quoting 15 U.S.C. § 77n).

24. *Id.* at 431-34.

25. *Id.* at 438.

26. 353 U.S. 448 (1957).

27. *See supra* note 5 and accompanying text.

agreements do not fall within the FAA's "contracts of employment" exception.²⁸

The line of cases known as the "Steelworkers Trilogy"²⁹ marked the Supreme Court's first significant pronouncements regarding its attitude toward the enforceability of arbitration clauses in light of the FAA. All three cases involved suits by unions to compel arbitration of disputes between the union and the employer,³⁰ and in all three, the Supreme Court ordered arbitration.³¹ Most importantly, the Court evidenced its strong intention to construe arbitration clauses in favor of arbitration, relying on the strong public (and, in *Steelworkers I*, statutory) policy in favor of allowing parties to choose alternative methods of dispute resolution.³²

28. See *Textile Workers*, 353 U.S. at 459.

29. *United Steelworkers v. American Mfg. (Steelworkers I)*, 363 U.S. 564 (1960); *United Steelworkers v. Warrior & Gulf Navigation Co. (Steelworkers II)*, 363 U.S. 574 (1960); *United Steelworkers v. Enterprise Wheel & Car Corp. (Steelworkers III)*, 363 U.S. 593 (1960).

30. In *Steelworkers I*, the union filed a grievance to regain employment for a member who had been fired. 363 U.S. at 564. In *Steelworkers II*, the union filed a grievance after the company had contracted out work and subsequently laid off a number of the union's members. 363 U.S. at 577. In *Steelworkers III*, the union filed a grievance after eleven of its members had been fired for protesting the discharge of another union member. 363 U.S. at 595, 599. This dispute actually went to arbitration upon order of a federal district court. *Id.* at 595. The arbitrator found in favor of the union, but the employer refused to comply, bringing the case back to court, and subsequently to the Supreme Court. *Id.*

31. *Steelworkers I*, 363 U.S. at 569; *Steelworkers II*, 363 U.S. at 585; *Steelworkers III*, 363 U.S. at 599.

32. In *Steelworkers I*, the Court stated:

Section 203(d) of the Labor Management Relations Act . . . states, "Final adjustment by a method agreed upon by the parties is hereby declared to be the desirable method for settlement of grievance disputes arising over the application or interpretation of an existing collective-bargaining agreement . . ." That policy can be effectuated only if the means chosen by the parties for settlement of their differences under a collective bargaining agreement is given full play.

363 U.S. at 566 (second omission in original)

In *Steelworkers II*, the Court added:

[T]o be consistent with congressional policy in favor of settlement of disputes by the parties through the machinery of arbitration, the judicial inquiry under § 301 must be strictly confined to the question whether the reluctant party did agree to arbitrate the grievance or did agree to give the arbitrator power to make the award he made. An order to arbitrate the particular grievance should not be denied unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute. *Doubts should be resolved in favor of coverage.*

363 U.S. at 582-83.

The Courts' final word came in *Steelworkers III*:

[T]he question of interpretation of the collective bargaining agreement is a question for the arbitrator. It is the arbitrator's construction which was bargained for, and so far as the arbitrator's decision concerns construction of the contract, the courts have no business overruling him because their interpretation of the contract is different from his.

The Court's affinity for strict application of arbitration clauses continued in *Prima Paint Corp. v. Flood & Conklin Manufacturing*.³³ The plaintiff in *Prima Paint* claimed that he had been fraudulently induced into executing a consulting agreement.³⁴ The agreement, however, contained a broad arbitration clause.³⁵ The issue thus presented to the Court was whether the arbitration clause was effective notwithstanding the fact that the plaintiff claimed that fraudulent inducement voided the entire contract.

The Court answered in the affirmative,³⁶ supporting its conclusion by referencing section 3 of the FAA.³⁷ The Court noted that under that section, a federal court must order arbitration of a dispute contemplated by the arbitration clause "once it is satisfied that 'the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not in issue.'"³⁸ Because the alleged fraudulent inducement did not relate specifically to the arbitration clause, section 3, as well as the "congressional purpose that the arbitration procedure, when selected by the parties to a contract, be speedy and not subject to delay and obstruction in the courts,"³⁹ mandated arbitration of the dispute.⁴⁰ The Court also indicated that the FAA created a substantive law for federal courts to apply, notwithstanding contrary state law.⁴¹

*Alexander v. Gardner-Denver Co.*⁴² represented an abrupt change in the Supreme Court's attitude toward arbitration agreements. In that case, the plaintiff filed a wrongful discharge grievance against his employer.⁴³ The

363 U.S. at 599.

33. 388 U.S. 395 (1967).

34. Plaintiff claimed that the defendant fraudulently represented that it was solvent, when in fact it was insolvent and intended to file for bankruptcy after execution of the agreement. *Id.* at 398.

35. The clause, in pertinent part, provided: "Any controversy or claim arising out of or relating to this Agreement, or the breach thereof, shall be settled by arbitration." *Id.* at 398.

36. *Id.* at 406-07.

37. *See supra* note 4 for text of § 3.

38. *Prima Paint*, 388 U.S. at 403 (quoting 9 U.S.C. § 4) (alterations in original).

39. *Id.* at 404.

40. Justices Black, Douglas, and Stewart dissented. They found it "fantastic" that a court would order arbitration under a contract which itself could ultimately be found void on the basis of fraudulent inducement. *Id.* at 407 (Black, J., dissenting).

41. *Id.* at 405. The indication became a holding in *Southland Corp. v. Keating*, 465 U.S. 1, 16 (1984), where the Court concluded that state law which "undercut[s] the enforceability of arbitration agreements . . . violates the Supremacy Clause." *See also* *Bayma v. Smith Barney, Harris Upham & Co.* 784 F.2d 1023 (9th Cir. 1986); *Johnson Controls, Inc. v. City of Cedar Rapids, Iowa*, 713 F.2d 370 (8th Cir. 1983); *In re Mercury Constr.*, 656 F.2d 933 (4th Cir. 1981), *aff'd*, 460 U.S. 1 (1983).

42. 415 U.S. 36 (1974).

43. *Id.* at 39.

grievance dispute was submitted to arbitration, during which the plaintiff also charged racial discrimination in violation of Title VII.⁴⁴ The arbitrator found in favor of the employer on the wrongful discharge grievance without mentioning the Title VII claim,⁴⁵ and the employee filed suit for the alleged Title VII violation in federal court.⁴⁶ The employer pointed to a provision in its collective bargaining agreement which called for disputes between the employer and any union member to be submitted to arbitration, and moved for summary judgment.⁴⁷ The motion was granted by the district court, which found the arbitrator's findings to be binding on the employee.⁴⁸ The Tenth Circuit affirmed.⁴⁹

The Supreme Court reversed, finding that "final responsibility for enforcement of Title VII is vested with federal courts."⁵⁰ In order to secure to persons the chance to have federal courts exercise this authority, the court found "it clear that there can be no prospective waiver of an employee's rights under Title VII."⁵¹ Of particular importance to the Court were the inherent deficiencies in the arbitration process:

[T]he factfinding process in arbitration usually is not equivalent to judicial factfinding. The record of the arbitration proceedings is not as complete; the usual rules of evidence do not apply; and rights and procedures common to civil trials, such as discovery, compulsory process, cross-examination, and testimony under oath, are often severely limited or unavailable.⁵²

In *McDonald v. City of West Branch, Michigan*,⁵³ the *Alexander* rationale was extended to prevent enforcement of arbitration clauses in actions under 42 U.S.C. § 1983.⁵⁴

44. *Id.* at 42. Title VII of the Civil Rights Act of 1964 is codified at 42 U.S.C. §§ 2000e-2000e-17 (1994).

45. *Alexander*, 415 U.S. at 42.

46. *Id.* at 43. *Alexander* filed suit even though the EEOC found that there was no reasonable cause to believe Title VII was violated. *Id.*

47. *Id.* at 40 n.3, 43.

48. *Id.* at 43 (citing the district court's opinion at 346 F. Supp. 1012 (D. Colo. 1971)).

49. *Id.* (citing the Tenth Circuit's per curiam affirmance at 466 F.2d 1209 (10th. Cir. 1972)).

50. *Id.* at 44.

51. *Id.* at 51.

52. *Id.* at 57-58.

53. 466 U.S. 284 (1984).

54. *See id.* at 292.

*Dean Witter Reynolds Inc. v. Byrd*⁵⁵ signaled another about-face for the Court on the arbitrability issue. The plaintiff, an investor, filed suit against Dean Witter alleging violations of both the Securities Exchange Act of 1934 and state law.⁵⁶ Dean Witter sought to compel arbitration of only the state law claims.⁵⁷ The district court denied Dean Witter's motion,⁵⁸ and the Ninth Circuit affirmed.⁵⁹ The Supreme Court reversed, compelling arbitration of the state law claims, while allowing the 1934 Act claim to be litigated in court.⁶⁰ In doing so, the Court made comments, the likes of which it had not made since *Steelworkers I*⁶¹ and *Prima Paint*,⁶² re-affirming its commitment to enforcing arbitration agreements: "The preeminent concern of Congress in passing the Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is 'piecemeal' litigation."⁶³

Four months later, the about-face signaled by *Byrd* became a sprint toward strict enforcement of arbitration agreements. In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,⁶⁴ the parties had entered into a distributorship agreement, agreeing that "[a]ll disputes, controversies or differences which may arise . . . out of . . . this Agreement . . . shall be finally settled by arbitration in Japan."⁶⁵ The Court found the agreement applicable to Soler's claim that Mitsubishi had violated federal antitrust laws.⁶⁶

The emphatic language used by the Court in *Mitsubishi* was the most profound aspect of the case, especially considering that the Court was rejecting, without even mentioning, the its equally emphatic decisions in *Alexander*⁶⁷ and *McDonald*.⁶⁸ In particular, the Court noted that unless "the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds 'for revocation of any contract,'

55. 470 U.S. 213 (1985).

56. *Id.* at 214.

57. *Id.* at 215.

58. *Id.* at 215-16.

59. *Id.* at 216 (citing the Ninth Circuit's affirmance at 726 F.2d 552 (9th Cir. 1984)).

60. *Id.* at 223-24.

61. *See supra* note 32.

62. *See supra* notes 38-39 and accompanying text.

63. *Dean Witter*, 470 U.S. at 221.

64. 473 U.S. 614 (1985).

65. *Id.* at 617.

66. *Id.* at 640.

67. *See supra* notes 42-52 and accompanying text.

68. *McDonald v. City of West Branch, Michigan*, 466 U.S. 284 (1984); *see supra* notes 53-54.

. . . [t]he Act itself provides no basis for disfavoring agreements to arbitrate statutory claims.”⁶⁹ Also, responding (without citing) to cases which had prohibited a prospective waiver of statutory rights, such as *Alexander*,⁷⁰ the Court made an important distinction:

By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum. . . . Having made the bargain to arbitrate, the party should be held to it unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue.⁷¹

Three years later, in *Shearson/American Express, Inc. v. McMahon*,⁷² the Court reaffirmed the pro-arbitration rationale espoused in *Mitsubishi*.⁷³ In finding that McMahon’s 1934 Act and RICO claims were subject to mandatory arbitration, the Court reinterpreted *Wilko* to mean that while the 1933 and 1934 Acts prohibited waivers of substantive rights, the prohibition did not apply to alternative forum choices.⁷⁴ Echoing *Mitsubishi*, the Court found that the FAA requires enforcement of arbitration agreements, even in relation to statutory claims, unless the court can find congressional intent to preclude a waiver of the right to a judicial forum in the particular statute.⁷⁵

The next expression of the Court’s affinity for arbitration clauses came in *Rodriguez de Quijas v. Shearson/American Express, Inc.*⁷⁶ The Court in *Rodriguez* expressly overruled *Wilko*, holding that in the face of a pre-dispute arbitration agreement, neither claims under the 1933 Act nor the 1934 Act could be litigated.⁷⁷

Perhaps the most pivotal case in this area was *Gilmer v. Interstate/Johnson Lane Corp.*,⁷⁸ where the Court, relying on *Mitsubishi*, held that a securities dealer’s Age Discrimination in Employment Act (“ADEA”) claim was subject to compulsory arbitration under Rule 347 of the New York

69. *Mitsubishi*, 473 U.S. at 627 (quoting 9 U.S.C. § 2, reprinted *supra* note 4) (citations omitted).

70. 415 U.S. 36; see *supra* notes 42-52.

71. *Mitsubishi*, 473 U.S. at 628.

72. 482 U.S. 220 (1987).

73. See *supra* notes 69 & 71 and accompanying text.

74. *McMahon*, 482 U.S. at 228-29.

75. *Id.* at 226-27.

76. 490 U.S. 477 (1989).

77. *Id.* at 485.

78. 500 U.S. 20 (1991).

Stock Exchange (“NYSE”).⁷⁹ The Court reversed the district court, which had relied on *Alexander* and its progeny in finding that the congressionally established mechanism for the adjudication of ADEA claims prevented protected persons from waiving their rights under the statute.⁸⁰

The Court also rejected the plaintiff’s claims regarding the inadequacy of the arbitration process, and in doing so cast doubt on its prior decisions which had expressed animosity toward the arbitration process:

Such generalized attacks on arbitration “res[t] on suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complaints,” and as such, they are “far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes.”⁸¹

The Court also rejected the plaintiff’s attacks on the adhesive and unfair nature of the contract, referencing the FAA: “[A]rbitration agreements are enforceable ‘save upon such grounds as exist at law or in equity for the revocation of any contract.’”⁸² Although warning that “courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds ‘for revocation of any contract,’”⁸³ the Court found no indication of such behavior or such disparity in the facts of *Gilmer*.⁸⁴

IV. INTRODUCTION TO ARBITRATION AGREEMENTS IN THE SECURITIES INDUSTRY

The reasoning of courts in cases following *Gilmer* shifted from a generalized analysis of the arbitration process to a much more particularized analysis of the detailed process by which arbitration agreements come about in the securities industry. For these post-*Gilmer* courts, that process, rather than generalized arguments for and against the arbitration process, became the focal point of the debate. Thus, it is necessary at this point to take a brief detour to explain the process used by SROs to bind employees to arbitration

79. *Id.* at 35. The relevant text of NYSE Rule 347 is reprinted *infra* note 105.

80. 500 U.S. at 24, 35.

81. *Id.* at 30 (quoting *Rodriguez*, 490 U.S. at 481) (alterations in original).

82. *Id.* at 33 (quoting 9 U.S.C. § 2).

83. *Id.* (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 627 (1985) (quoting 9 U.S.C. § 2)).

84. *Id.*

agreements.

Every firm dealing in securities requires its agents to register with an SRO, such as the NYSE or the National Association of Securities Dealers ("NASD"),⁸⁵ and be bound by the rules promulgated for the SRO members. This is accomplished by having applicants sign what is technically called a "Uniform Application for Securities Industry Registration or Transfer," commonly referred to as a "U-4."⁸⁶ The U-4 is the equivalent of an application for employment, with questions about employment history, criminal convictions, and the like.⁸⁷

The interplay of the U-4 and the substantive code of an SRO, especially in the arbitration context, can be tricky, but an understanding of this interplay is essential to an understanding of the case law to be discussed from this point on. Using the NASD as an example,⁸⁸ the agreement to arbitrate is made at the time the applicant signs a U-4. The U-4 contains a clause whereby the applicant-employee "agree[s] to arbitrate any dispute, claim or controversy that may arise between me and my firm . . . *that is required to be arbitrated under the rules . . . of the organizations with which I register.*"⁸⁹ Thus, the U-4 does not itself bind the employee to arbitration. Rather, the U-4 only binds the employee to arbitrate those disputes that are required to be arbitrated by the rules of the SRO to which the employer and employee belong.

The pertinent NASD rule in the arbitration context, the rule referenced by the above clause in the U-4, is the NASD Code of Arbitration Procedure ("NASD Code" or "Code").⁹⁰ Before being amended in 1993, section 1 of the NASD Code,⁹¹ provided in relevant part:

85. 15 U.S.C. § 78c(a)(26) (1994) (specifically includes in its definition of SROs "national securities exchange[s]" (e.g., the NYSE) and "registered securities association[s]" (e.g., the NASD)). Also included are "registered clearing agenc[ies]." *Id.*

86. *See infra* note 89 and accompanying text.

87. *See Alton v. National Ass'n of Sec. Dealers*, No C-94-0618 MHP, 1994 WL 443460, at *4 (N.D. Cal. July 26, 1994) (discussing contents of U-4).

88. The NASD is chosen because the ambiguity of its Code of Arbitration Procedure has engendered the most litigation, and the present conflict. The NYSE Rules, by contrast, are much less susceptible to specific attack, for they have always specifically included employment disputes within the category of disputes subject to compulsory arbitration. *See infra* note 105.

89. Uniform Application for Securities Industry Registration or Transfer (emphasis added), *excerpted in* ANTHONY W. DJINIS & JOSEPH A. POST, *SECURITIES ARBITRATION: PRACTICE AND FORMS* app. 1C (1994).

90. National Ass'n of Sec. Dealers, *Code of Arbitration Procedure*, in NASD Manual (CCH) ¶¶ 3701-46 (1993) [hereinafter NASD, 1993 Code].

91. *See infra* notes 116-20 and accompanying text.

This Code of Arbitration Procedure is prescribed . . . for the arbitration of any dispute, claim or controversy arising out of or in connection with the business of any member of the Association, with the exception of disputes involving the insurance business of any member which is also an insurance company:

- (1) between or among members;
- (2) between or among members and public customers, or other; and
- (3) between or among members, registered clearing agencies with which the Association has entered into an agreement to utilize the Association's arbitration facilities and procedures, and participants, pledgees or other persons using the facilities of a registered clearing agency, as these terms are defined under the rules of such a registered clearing agency.⁹²

Section 8 of the NASD Code expressly mandated that “[a]ny dispute, claim or controversy eligible for submission under Part I of this Code . . . shall be arbitrated.”⁹³ Thus, the arbitration agreement is accomplished by incorporating the rules of the NASD, which require arbitration, into the U-4 application for registration.⁹⁴

92. NASD, *1993 Code*, *supra* note 90, ¶ 3701.

93. *Id.* ¶ 3708.

94. Plaintiffs have challenged this “bind by incorporation” method but have almost universally failed. *See, e.g.*, *Pain, Webber, Jackson & Curtis, Inc. v. Chase Manhattan Bank*, 728 F.2d 577, 580 (2d Cir. 1984) (“[T]he arbitration provisions of the NYSE Constitution and Rules are sufficient in and of themselves to compel arbitration.”); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Hovey*, 726 F.2d 1286 (8th Cir. 1984) (Rule 347 constitutes valid agreement to arbitrate); *Zdeb v. Shearson Lehman Bros.*, 674 F. Supp. 812 (D. Colo. 1987) (plaintiff bound by NYSE Rule 347 even if no separate agreement specifically stating so is signed); *Manes Org. v. Standard Dyeing & Finishing Co.*, 472 F. Supp. 687 (S.D.N.Y. 1979) (arbitration agreement or clause can be effective even if not signed or subscribed to by the parties).

Plaintiffs who brought suit after signing a U-4 but before becoming registered have also tried, unsuccessfully, to avoid the arbitration provisions of the various SRO Codes. *See, e.g.*, *Cherry v. Wethem Schroder & Co.*, 868 F. Supp. 830, 835 (D.S.C. 1994) (Plaintiff must arbitrate pursuant to NASD Code even though she failed to pass the NASD registration exam. “[E]xpress language of the application put Plaintiff on notice that she was agreeing to be subject to the organizations’ rules and regulations by the mere execution of the application form.”); *Foley v. Presbyterian Minister Fund*, Civ. A. No. 90-1053, 1992 WL 63269, (E.D. Pa. Mar. 19, 1992) (plaintiff bound by Code even though suit was brought before registration became effective); *Chisolm v. Kidder, Peabody Asset Mgmt.*, 810 F. Supp. 479 (S.D.N.Y. 1992) (same).

V. THE STATUS OF SECURITIES INDUSTRY ARBITRATION AGREEMENTS AFTER *GILMER*

Most courts took the pro-arbitration statements in *Gilmer* seriously and began rigorously enforcing securities industry arbitration agreements.⁹⁵ Circuit courts soon reversed holdings that had prevented enforcement of arbitration agreements when statutory claims were involved,⁹⁶ and some circuits that did not expressly reverse themselves found that their opinions were no longer considered binding by lower courts.⁹⁷

Still, the fact that some circuits refused to disturb pre-*Gilmer* holdings in refusing to enforce arbitration agreements when statutory claims were at issue⁹⁸ created (albeit through inaction) a conflict, or at least confusion,

95. See, e.g., *Bender v. A.G. Edwards & Sons* 971 F.2d 698 (11th Cir. 1992); *Saari v. Smith Barney, Harris Upham & Co.*, 968 F.2d 877 (9th Cir.) (plaintiff stockbroker's claim under Employee Polygraph Protection Act subject to compulsory arbitration), *cert. denied*, 506 U.S. 986 (1992); *Mago v. Shearson Lehman Hutton, Inc.*, 956 F.2d 932 (9th Cir. 1992) (Title VII claim subject to mandatory arbitration); *Willis v. Dean Witter Reynolds, Inc.*, 948 F.2d 305 (6th Cir. 1991) (Title VII claim subject to mandatory arbitration); *Kaliden v. Shearson Lehman Hutton, Inc.*, 789 F. Supp. 179, 181 (W.D. Pa. 1991) ("Because of the strong federal policy favoring arbitration, and the holding in *Gilmer v. Interstate/Johnson Lane Corporation*, [defendants' motion to compel arbitration of ADEA claim under Rule 347] shall be granted.") (citations omitted); *Boogher v. Stifel, Nicholas & Co.*, 764 F. Supp. 574, 576 (E.D. Mo. 1991) (Plaintiff stock broker's age discrimination claim was subject to mandatory arbitration under Rule 347 of the NYSE because it "falls within the scope of the arbitration agreement.").

96. An excellent example from the Fifth Circuit is *Alford v. Dean Witter Reynolds, Inc.*, 905 F.2d 104 (5th Cir. 1990), *vacated*, 500 U.S. 930 (1991). The district court denied defendants' motion to dismiss plaintiff's Title VII suit and to compel arbitration. *Alford v. Dean Witter Reynolds, Inc.*, 712 F. Supp. 547 (S.D. Tex. 1989). On the first appeal to the Fifth Circuit, the court affirmed, relying on *Alexander*, 905 F.2d at 106-07. Dean Witter appealed to the Supreme Court, which vacated the Fifth Circuit's decision and remanded in light of its holding in *Gilmer*. *Dean Witter Reynolds, Inc. v. Alford*, 500 U.S. 930 (1991). On remand the Fifth Circuit reversed the district court. *Alford v. Dean Witter Reynolds, Inc.*, 939 F.2d 229 (5th Cir. 1991). Noting the similarities between the ADEA (which was the claim the Supreme Court found to be arbitrable in *Gilmer*) and Title VII, the court had "little trouble concluding that Title VII claims can be subjected to compulsory arbitration." *Id.* at 230. The court further noted, "Any broad public policy arguments against such a conclusion were necessarily rejected by *Gilmer*," when the Supreme Court "rejected *Alexander's* 'mistrust of the arbitral process.'" *Id.* (quoting *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 231 (1987)).

The Sixth Circuit also reversed its position. See *Willis*, 948 F.2d 305.

97. See *Kaliden*, 789 F. Supp. at 182 (finding that *Gilmer* "effectively reverses" the Third Circuit's decision in *Nicholson v. CPC Int'l, Inc.*, 877 F.2d 221 (3d Cir. 1989), which held that ADEA claims are not subject to compulsory arbitration). Also, the decision in *Boogher*, 764 F. Supp. 574, ignored the Eighth Circuit's decision in *Swenson v. Management Recruiters Int'l*, 858 F.2d 1304 (8th Cir. 1988), *cert. denied*, 493 U.S. 848 (1989), where the court held that Title VII claims were not subject to mandatory arbitration.

98. See *Uteley v. Goldman Sachs & Co.*, 883 F.2d 184, 186 (1st Cir. 1989), *cert. denied*, 493 U.S. 1045 (1990) (stating that "the Court has done nothing to disturb its prior ruling in *Alexander* that

among the circuits as to the application of arbitration agreements to statutory claims in the wake of *Gilmer*.

VI. THE CIRCUIT SPLIT OVER THE APPLICABILITY OF THE NASD CODE TO EMPLOYMENT DISPUTES

A. *Farrand v. Lutheran Brotherhood—Pre-Amendment NASD Code*

In *Farrand v. Lutheran Brotherhood*,⁹⁹ the Seventh Circuit took the split among the circuits over the applicability of securities industry arbitration agreements to statutory claims one step further by holding that the NASD Code of Arbitration Procedure does not apply to employment disputes of any sort. Farrand, a stockbroker, signed a U-4 agreement with Lutheran Brotherhood, a financial company registered with the NASD, and thus bound himself to the NASD Code.¹⁰⁰ When Farrand sued, alleging violation of the ADEA,¹⁰¹ Lutheran Brotherhood sought to compel arbitration pursuant to the NASD Code.¹⁰² The district court dismissed Farrand's suit, relying on *Gilmer*.¹⁰³ The Seventh Circuit reversed.¹⁰⁴

The Seventh Circuit began by noting the differences between the NYSE Code, which explicitly required arbitration of employment disputes,¹⁰⁵ and the NASD Code, which did not expressly refer to employment disputes.¹⁰⁶ Lutheran Brotherhood argued that the absence was of no moment, as the language of the NASD Code covered "any dispute, claim of controversy arising out of or in connection with the business of any member,"¹⁰⁷ and thus covered employment disputes.¹⁰⁸

arbitration agreements do not preclude an independent right of access to a judicial forum for resolution of Title VII claims"); *Nicholson*, 877 F.2d 221 (although not followed by at least one lower court, see *supra* note 97, the decision has not been expressly overruled); *Swenson*, 858 F.2d 1304 (although the decision has been ignored, see *supra* note 97, it has not been overruled).

99. 993 F.2d 1253 (7th Cir. 1993).

100. *Id.* at 1254.

101. 29 U.S.C. §§ 621-633a (1994).

102. *Farrand*, 993 F.2d at 1254.

103. *Id.*

104. *Id.* at 1255

105. *Id.* at 1254. Rule 347 of the NYSE provides for the arbitration of "[a]ny controversy between a registered representative and any member or member organization arising out of the employment or termination of employment of such registered representative." Rule 347, 2 N.Y. Stock Exchange Guide (CCH) ¶ 2347 (March 1995).

106. See *supra* notes 92-93 and accompanying text.

107. NASD, 1993 Code, *supra* note 90, ¶ 3701 (emphasis added).

108. *Farrand*, 993 F.2d at 1254.

The court disagreed, emphasizing the listing of parties at the end of section 1 of part I of the NASD Code.¹⁰⁹ The court reasoned that the list of parties in that section “establishes which matters are arbitrable.”¹¹⁰ Under this reasoning only disputes which fall within the three categories listed at the end of section 1 would be arbitrable.

Lutheran Brotherhood, tailoring its argument to the court’s reading of the NASD Code, suggested that employees were “others” under section 1(2).¹¹¹ The court rejected this argument, although it admitted that including employees among the “others” “would not exceed the bounds of reason.”¹¹² In the court’s mind, such a huge catch-all would make the explicit list of parties useless,¹¹³ and in the absence of an interpretive “paper trail,” the court could not subscribe to this proposition.¹¹⁴

The court concluded that “§ 1 of the NASD’s Code does not authorize, and § 8 therefore does not require, the arbitration of an employment dispute between a member of the NASD and one of the member’s registered representatives.”¹¹⁵

B. NASD Responds to Contrary Decisions by Amending the NASD Code

In December of 1992, responding to the litigation over the applicability of the NASD Code to employment disputes,¹¹⁶ the NASD proposed to amend its Code to expressly cover such disputes.¹¹⁷ The SEC approved the amendment on August 25, 1993, setting the effective date of the amendment as October 1, 1993.¹¹⁸ The Code, as amended, required the “arbitration of any dispute,

109. *Id.* at 1254-55.

110. *Id.* at 1254.

111. *Id.*

112. *Id.* at 1255.

113. *Id.* The court remarked, “What is the point of writing down a list of parties, only to sweep everything off the table with a comprehensive ‘or others?’” *Id.*

114. *Id.*

115. *Id.*

116. Although the *Farrand* decision was the first *circuit court* decision to hold that the NASD Code does not compel arbitration of any employment disputes, it was not the first *court* to so hold. In fact, the NASD, in its SEC filings accompanying its proposed amendment of the Code, stated that the amendment was precipitated by the decision of a California court in *Higgins v. Superior Court of L.A. County*, 234 Cal. App. 3d 1464 (Oct. 8, 1991), *review denied and decision ordered not officially published*, 1 Cal. Rptr. 2d 57 (1992). 58 Fed. Reg. 45,932, 45,932-33 (1993). The *Farrand* decision, however, being from a federal circuit court, brought increased attention to the issue.

117. 58 Fed. Reg. 39,070 (1993). The amendment sought to make the language of the NASD Code parallel the Code of the NYSE, contained in note 105, *supra*.

118. 58 Fed. Reg. 45,932-33 (1993). Pursuant to 15 U.S.C. § 78s(b)(1) (1994), the SEC must

claim or controversy arising out of or in connection with the business of any member of [the NASD] *or arising out of the employment or termination of employment of associated person(s) with any member.*"¹¹⁹ In an attempt to launch the first volley in the debate that would inevitably ensue, the NASD emphasized that its amendment was made solely for the purpose of clarification, and that no substantive change was being made in the NASD Code.¹²⁰

For employment disputes in which the employee signed his U-4 after October 1, 1993, the applicability of the NASD Code (save ordinary contract and other statutory defenses, discussed more fully below) is virtually unquestioned.¹²¹ However, where employment disputes arise involving

approve all amendments to an SRO's rules and regulations.

119. 58 Fed. Reg. 39,070, *reprinted* in National Ass'n of Sec. Dealers, *Code of Arbitration Procedure*, in NASD Manual (CCH), Rules 10100-10406 (May 1996). While the amendment did clear up the issue of whether the Code, after October 1993, applied to employment disputes, it still must be proven, under both the NASD and NYSE Codes, that the dispute was one "arising out of" employment or termination. If a plaintiff is suing under Title VII, the ADEA, or any other statute prohibiting discrimination in employment or termination, the answer is clear. However, when a plaintiff's claim has a more tangential relationship to his employment, courts have been called upon to interpret the scope of the phrase "arising out of" employment.

The Second Circuit, in the first circuit court case construing the "arising out of employment" clause, opted for a strict temporal test. *Coudert v. Paine Webber Jackson & Curtis*, 705 F.2d 78 (2d Cir. 1983). The court concluded that allegations of employer's tortious conduct which occurred after termination did not relate to employment and were thus not arbitrable. *Id.* at 82.

One year later, the Eighth Circuit adopted a more flexible test, which has become the overwhelming majority rule. In *Morgan v. Smith Barney, Harris Upham & Co.*, 729 F.2d 1163 (8th Cir. 1984), the plaintiff's tort claim arose from statements made after his termination. The court, in concluding that the claim did "arise out of" employment for purposes of NYSE Rule 347, held that claims "arise out of" employment if they "involve significant aspects of the employment relationship." *Id.* at 1167. The *Morgan* rule was subsequently adopted by the Second Circuit in *Fleck v. E.F. Hutton Group, Inc.*, 891 F.2d 1047 (2d Cir. 1989), the Sixth Circuit in *Aspero v. Shearson Am. Express, Inc.*, 768 F.2d 106 (6th Cir.), *cert. denied*, 474 U.S. 1026 (1985), the Ninth Circuit in *Zolezzi v. Dean Witter Reynolds, Inc.*, 789 F.2d 1447 (9th Cir. 1986), and the New York Court of Appeals in *Flanagan v. Prudential-Bache Sec., Inc.*, 495 N.E.2d 345 (N.Y.), *cert. denied*, 479 U.S. 931 (1986). *But see* *Dean Witter Reynolds, Inc. v. Ness*, 677 F. Supp. 866 (D.S.C. 1988) (Plaintiff's claims for false arrest and imprisonment, intentional infliction of emotional distress, negligence, defamation, and abuse of process did not implicate plaintiff's customers, any securities agencies, or any significant issue of plaintiff's performance qua broker, and thus were not arbitrable under either *Morgan* or *Coudert*); *Feinberg v. Oppenheimer & Co.*, 658 F. Supp. 892 (S.D.N.Y. 1987) (using the *Coudert* temporal rule, but in a less strict fashion: "The crucial question in *Coudert* was the relationship of the alleged defamation to the employment agreement between the parties.").

120. 58 Fed. Reg. 45,932 (1993) ("[T]he NASD is proposing to amend Section 1 to clarify that disputes, claims, or controversies arising out of the employment or termination of employment of an associated person are eligible for submission to arbitration." (emphasis added)).

121. There are very few reported cases involving post-amendment signings. The primary reason is probably that the amendment did exactly what the NASD hoped—remove any doubt as to whether the

employees who have not expressly agreed to the amended NASD Code, the question arises: Was the 1993 amendment merely a clarification, as the NASD contends, or was it a substantive change in the type of disputes covered?

Notwithstanding the NASD's attempt to characterize its amendment as merely a clarification, the Seventh Circuit has stood by its holding in *Farrand*. In *Kresock v. Bankers Trust Co.*,¹²² the court found that Kresock was not compelled to arbitrate her Title VII suit.¹²³ The suit was filed in 1992, before the amendments to the Code.¹²⁴ Relying on *Farrand*, the court concluded that the "[pre-amendment] Code did not require arbitration of employment discrimination suits."¹²⁵ Bankers argued that Kresock agreed to be bound by the Code as it may be amended, and the court agreed.¹²⁶ However, the court noted that Kresock's suit was filed before the amendment and, refusing to give retroactive effect to the 1993 amendment, held that the question of arbitrability was to be determined with reference to the Code as it stood in 1992.¹²⁷ Given these facts, the court viewed *Farrand* as controlling.¹²⁸

C. *The Eleventh Circuit Disagrees with Farrand in Kidd v. Equitable Life Assurance Society of the United States*

In *Kidd v. Equitable Life Assurance Society of the United States*,¹²⁹ the

amended Code applies to employment disputes. For an example of a court recognizing this, see *Williams v. Cigna Fin. Advisors, Inc.*, 56 F.3d 656 (5th Cir. 1995). See also *infra* notes 157-59 and accompanying text.

122. 21 F.3d 176 (7th Cir. 1994).

123. Ms. Kresock alleged gender and pregnancy discrimination. *Id.* at 177.

124. *Id.*

125. *Id.* at 178 (citing *Farrand v. Lutheran Bhd.*, 388 U.S. 395 (1967)). In the court's eyes, the amendment to the Code in 1993 was "more than mere clarification[]." *Id.* Rather it reflected a "structural change[] . . . that swe[pt] into the realm of arbitration a whole new class of disputes." *Id.* at 178-79.

126. *Id.* at 179.

127. *Id.*

128. The Seventh Circuit reaffirmed *Farrand* once again in *Turner v. IDS Fin. Servs., Inc.*, No. 94-1263, 37 F.3d 1501, 1994 WL 580186 (7th Cir. Oct. 21, 1994) (unpublished decision, reversal noted). The court rejected the defendant's argument that *Farrand* should be overruled in light of *Gilmer*. "While noting at least one other circuit has disagreed with our position [*Kidd v. Equitable Life Assurance Soc'y*, 32 F.3d 516 (11th Cir. 1994)], this court declines appellee's invitation. The *Farrand* court specifically addressed *Gilmer*, both as to the facts the Supreme Court was presented and the legal rules the Court established." *Id.* at *2.

129. 32 F.3d 516 (11th Cir. 1994).

Eleventh Circuit rejected the *Farrand* court's analysis. In that case, Kidd had signed a U-4 application. Upon his termination, Kidd filed an action claiming race-discrimination, in violation of both Title VII and 42 U.S.C. § 1981.¹³⁰ Equitable moved to stay the proceedings and to compel arbitration, but the district court denied the motion.¹³¹ Equitable appealed, and during the interim the NASD amendment took effect.¹³²

The Eleventh Circuit did not need to rely on the amended Code to compel arbitration. Declining to follow *Farrand*, the court read the list of parties in section one of part I as modifying only the insurance clause.¹³³ Thus, except for the insurance exception, the court read the NASD Code as requiring arbitration of "any dispute connected to an [sic] NASD member's business."¹³⁴

The court noted that its decision comported with the pro-arbitration statements made by the Supreme Court and other circuits.¹³⁵ The court also noted that its reading of pre-amendment section 1 eliminated a conflict created by the *Farrand* court. The court recognized that pre-amendment section 8 requires employees, as "person's associated with members," to arbitrate disputes with their employers. The court noted that interpreting section 1 as not covering employee-employer disputes, as in *Farrand*, renders the mandate in section 8 useless.¹³⁶ By contrast, interpreting section 1 to cover employee-employer disputes maintains the full effect of section 8.¹³⁷

130. *Id.* at 518.

131. *Id.*

132. *Id.*

133. *Id.* at 519.

134. *Id.* The court rejected Kidd's arguments of adhesion, waiver by Equitable, and inadequacy of arbitration process. *Id.* at 518 n.4.

135. *Id.* at 519. The court first quoted from *Moses H. Cone Memorial Hosp. v. Mercury Constr.*, 460 U.S. 1, 24-25 (1983):

[Q]uestions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. . . . The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of a contract [or some other question].

Kidd, 32 F.3d at 519 (alterations in original).

The court then quoted from the Fifth Circuit's decision in *Wick v. Atlantic Marine, Inc.*, 605 F.2d 166, 168 (5th Cir. 1979):

[U]nless it can be said with positive assurance that an arbitration clause is not susceptible of an interpretation which would cover the dispute at issue, then a stay pending arbitration should be granted.

Kidd, 32 F.3d at 519 (alterations in original).

136. *Kidd*, 32 F.2d at 519.

137. *Id.*

Finally, the court criticized *Farrand* for refusing to follow the pro-arbitration dictates of the Supreme Court and others, and adopt a pro-arbitration construction,¹³⁸ which the *Farrand* court itself found to be reasonable.¹³⁹

VII. AFTER THE SPLIT—WHERE ARE WE NOW? WHERE ARE WE GOING?

A. Ninth Circuit Siding with *Farrand*

The Ninth Circuit has, at least in dictum, indicated its approval of the *Farrand* court's holding that the pre-amendment NASD Code did not cover employment disputes. In *Prudential Insurance Co. of America v. Lai*,¹⁴⁰ the Ninth Circuit held that a Title VII plaintiff did not have to arbitrate her claim against her employer.¹⁴¹ The court emphasized that a waiver of the right to pursue a claim in court through an arbitration agreement must have been made voluntarily and knowingly to be enforceable.¹⁴² The court found that Lai did not, and indeed could not, have the requisite knowledge. Noting that there was a dispute as to whether Lai knew the nature of the U-4 agreement, the court concluded that the dispute was immaterial.¹⁴³ Even if Lai was aware that by signing the U-4 she would be bound by the NASD Code, this knowledge would not be sufficient to compel arbitration.¹⁴⁴ Indeed, even if Lai had signed an agreement containing the actual NASD Code language, she would not be forced to arbitrate, because "[t]hat provision did not even refer to employment disputes."¹⁴⁵ Although cautioning that its decision did not rest on the precise language of the U-4 (and, by incorporation, the NASD Code), the court agreed with the Seventh Circuit's holding in *Farrand* that the pre-amendment NASD Code did not, as a matter of law, compel arbitration of employment disputes.¹⁴⁶

138. *Id.* at 519 n.6. For the text of those dictates, see *supra* note 135.

139. See *supra* notes 99-115 and accompanying text.

140. 42 F.3d 1299 (9th Cir. 1994).

141. *Id.* at 1305.

142. *Id.* at 1304-05.

143. *Id.* at 1305.

144. *Id.*

145. *Id.*

146. *Id.*

B. Courts Siding With Kidd

In *O'Donnell v. First Investors Corp.*,¹⁴⁷ the plaintiff had signed his only U-4 before the 1993 amendment.¹⁴⁸ Thus, when the defendant moved to compel arbitration of O'Donnell's breach of employment contract and breach of the duty of good faith claims, the court was squarely presented with deciding "whether the October 1993 amendment to NASD rules was a change or a clarification."¹⁴⁹ The court noted the split among the Seventh and Eleventh Circuits, and also noted that the Second Circuit had not ruled on the issue.¹⁵⁰

The *O'Donnell* court sided with *Kidd*, finding the reading in *Kidd* preferable for two reasons: (1) the reading in *Kidd* "makes more sense given the liberal federal policy towards arbitration," a policy that the *Farrand* decision "glosses over;"¹⁵¹ and (2) the NASD has interpreted its Code to apply to employment disputes as early as 1987.¹⁵²

The court in *F.N. Wolf & Co. v. Bowles*¹⁵³ also sided with the analysis in *Kidd*. The court stated directly that "*Farrand* was incorrectly decided and . . . the [NASD] Code as it existed in 1990 provided for arbitration of this [employment] dispute."¹⁵⁴

A like conclusion was reached in *Strappes Group v. Siedle*,¹⁵⁵ in similarly blunt terms. The court found the reasoning of *Farrand* to be "of highly questionable validity and should not be followed."¹⁵⁶

147. 872 F. Supp. 1274 (S.D.N.Y. 1995).

148. *Id.* at 1275.

149. *Id.* at 1277.

150. *Id.*

151. *Id.* at 1278.

152. *Id.* (citing *F.N. Wolf & Co. v. Bowles*, 610 N.Y.S.2d 757 (N.Y. Sup. Ct. 1994)).

153. 610 N.Y.S.2d 757 (N.Y. Sup. Ct. 1994).

154. *Id.* at 759. The *Bowles* court relied on a NASD statement made in its SEC filings regarding an earlier amendment to the NASD Code. *Id.* This amendment prohibited registered representatives from waiving their rights to arbitration. In its reasons for prohibiting such waivers, the NASD expressed its dissatisfaction with a New Jersey state court which found the arbitration clause in the NASD Code to be optional. The NASD stated that adoption of such reasoning by other courts could have the effect of denying brokers and dealers the opportunity to arbitrate employment disputes, which would be contrary to the NASD Code. *See* 52 Fed. Reg. 9232 (1987).

155. No. CV 93-11385-K, 1993 WL 443926 (D. Mass. Nov. 22, 1993).

156. *Id.* at *4.

The Tenth Circuit decided *Metz v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 39 F.3d 1482 (10th Cir. 1994), a little less than three months after the *Kidd* decision. Although the court did not cite either *Farrand* or *Kidd*, the position taken by the court comports with *Kidd*. In holding that a stockbroker's Title VII claim was subject to arbitration, the court concluded, "Our reading of *Gilmer*,

C. Notable Decisions Avoiding the Conflict

In *Williams v. Cigna Financial Advisors, Inc.*¹⁵⁷ the Fifth Circuit acknowledged the circuit split over the application of the pre-amendment NASD Code to employment disputes,¹⁵⁸ but refused to take sides. Instead, the court relied on the fact that Williams had signed a second U-4 after the NASD Code was amended, and thus explicitly agreed to the arbitration of employment disputes.¹⁵⁹

In *Scher v. Equitable Life Assurance Society*,¹⁶⁰ a New York district court was also able to avoid the issue of whether the pre-amendment NASD Code covered employment disputes by focusing on language in the U-4 which required employers and employees to abide by any amendments made to the Code.

Scher was fired before the 1993 amendment to the NASD Code.¹⁶¹ He brought a Title VII action against Equitable in 1994, after the NASD Code was amended, alleging religious discrimination.¹⁶² Although the table was set for the court to join the *Farrand-Kidd* dispute, it cleverly avoided the issue. The court noted that by signing his U-4, Scher agreed to comply with the

and the inferences that, in light of *Gilmer's* reasoning, can be drawn from the Court's vacating and remanding *Alford*, support the conclusion that Title VII claims are subject to compulsory arbitration." *Id.* at 1487. The case is given only footnote attention here because it failed to expressly pick a side in the *Farrand/Kidd* dispute.

While the Supreme Court has not yet specifically resolved this conflict, the position of Justice Ginsburg is easily predicted. In *Association of Investment Brokers v. SEC*, 676 F.2d 857, 861 (D.C. Cir. 1982), then Judge Ginsburg, in dicta, noted that "NYSE and NASD rules mandate arbitration of employer-employee disputes, and did so, to the same extent as they do now, before the development of a uniform form under SEC auspices."

157. 56 F.3d 656 (5th Cir. 1995).

158. *Id.* at 659 n.2.

159. *Id.* at 659. Williams first signed a U-4 application in 1987, then signed a second U-4 in October of 1993 (the same month the NASD Code amendment took effect). *Id.* at 658-59. The court refused to exempt Williams under section 1 of the FAA, concluding that, whether or not Williams was engaged in interstate commerce, the agreement to arbitrate was contained in his U-4 application, not his contract for employment. *Id.* at 660. The court also rejected the argument that Williams did not knowingly and voluntarily waive his right to a judicial forum, which Williams claimed was required under the ADEA. *Id.* at 659. The court found no indication that Congress intended the ADEA to cover agreements to arbitrate employment disputes and, citing *Mitsubishi*, noted that Williams did not, by signing the arbitration agreement, waive any substantive rights, but rather only waived the right to have his case decided in a judicial forum. *Id.* at 661; see *supra* note 71 and accompanying text.

160. 866 F. Supp. 776 (S.D.N.Y. 1994).

161. *Id.* at 777.

162. *Id.* Scher's complaint began as a class action, but was amended to drop the class action allegations. *Id.* at 777-78.

NASD rules “as they are and may be adopted, changed or amended from time to time.”¹⁶³ Thus, “[t]he arbitrability of the instant matter is not affected by the nature of plaintiff’s claims,” and “[n]or is it relevant that Scher’s employment . . . terminated prior to the 1993 amendment,” because Scher’s signing of the U-4 bound him to “comply with the NASD Code as it existed at the time he commenced this action.”¹⁶⁴

D. The Future and the Moral of the Story

Farrand has never expressly been followed by any other circuit court, and for good reason. Its holding was shockingly broad and, as the *Kidd* court and others have pointed out, rested on a strained reading of the NASD Code.¹⁶⁵ Thankfully, the life-span of *Farrand* has been curtailed by the recent amendments to the NASD Code. Still, the decision hints at a deeper problem: courts can still, in the ambivalence of the Supreme Court’s early decisions on the arbitration issue, find support for ignoring contracts entered into freely.

The problem, however, goes deeper than merely ignoring contract provisions. We must remember who the parties to these contracts are—securities firms and their employees, usually brokers. The employees

163. *Id.* at 778 (quoting the U-4).

164. *Id.* at 778. And, as discussed *supra* notes 116-19, the NASD Code in 1994 expressly provided for the arbitration of employment disputes. The approach of the *Scher* court, enforcing the Code as it exists at the time of suit, has become increasingly popular. *See, e.g.,* *Kurschus v. Paine Webber, Inc.*, No. 95 Civ. 1652 (PKL), 1996 WL 39326 (S.D.N.Y. Feb. 1, 1996) (although U-4 was signed in 1991, court applies amended NASD Code without even mentioning the amendment); *Pitter v. Prudential Life Ins. Co. of Am.*, 906 F. Supp. 130, 134 & n.5 (E.D.N.Y. 1995) (the court noting that because plaintiff’s suit was filed after the NASD amended its Code, and thus “the filing of Pitter’s lawsuit differs from the scenarios presented in both *Kidd* and *Kresock*, this court need not discuss the logical underpinning of their holdings.” However, for the same reason, “it is entirely appropriate to hold Pitter to compliance with non-substantive rules that took effect almost six months before he filed suit.”); *Wojcik v. Aetna Life Ins. & Annuity*, 901 F. Supp. 1282, 1288-89 (N.D. Ill. 1995) (concluding that “[s]ince Wojcik filed his claim after the effective date of the amendment, the amendment is applicable to Wojcik’s case without retroactive application” and noting that “[t]his holding does not contravene *Kresock* since in that case the claim was filed before the amendment”); *Hall v. Metlife Resources*, No. 94 Civ. 0358 (JFK), 1995 WL 258061, at *4 (S.D.N.Y. May 3, 1995) (disagreeing with *Lai*, and noting that “[c]ourts in this Circuit have held that it is the NASD Code in existence at the time an action is commenced that governs . . . [for] innumerable reasons”); *Moore v. Interacciones Global, Inc.*, No. 94 Civ. 4789 (RWS), 1995 WL 33650, at *5-6 (S.D.N.Y. Jan. 27, 1995) (Court distinguished cases in which plaintiffs had “agreed to abide by the Code and not to the Code as ‘amended from time to time.’” The court also rejected plaintiff’s argument that the NASD was attempting to apply its Code retroactively, “[b]ecause this case was filed nine months after the amendments’ effective date and because . . . the amendments did not change the substantive rights of the parties.”).

165. *See supra* note 136 and accompanying text.

involved here are not teenagers, fresh out of school and desperate for jobs. Nor are they blue-collar workers, who, while not fresh out of school, are still not adept at negotiating contract provisions. Quite the contrary, the employees here involved are, for the most part, highly educated and highly trained securities brokers. Several courts have recognized this, and have noted that the basic contract doctrine holding parties to a contract to knowledge of its terms is very well justified when the parties are sophisticated businesspersons.¹⁶⁶

The moral of this story is not particularly esoteric. It is simply that courts are like most everyone else—they have a job to do, and do not like others interfering with the performance of their job. Businesses must realize this, and draft arbitration agreements with the utmost precision, so that even courts that do not wish to relinquish their authority will nonetheless have to.

Drew F. Davis

166. See, e.g., *Gold v. SEC*, 48 F.3d 987, 992 (7th Cir. 1995) (“Registered brokers and associates are presumed as a matter of law to have knowledge of the published rules of the securities exchange.”); *Carter v. SEC*, 726 F.2d 472, 474 (9th Cir. 1983) (same); see also *Sloan v. NYSE*, 489 F.2d 1, 3 (2d Cir. 1973) (“[W]hen appellants became members of the [NYSE] they consented, quite knowingly and intelligently to [its] disciplinary procedures . . .”).

