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Arbitration of International Securities Transactions -- Scherk v. Alberto-Culver Co.

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CASE NOTES

Arbitration of International Securities Transactions—*Scherk v. Alberto-Culver Co.*¹—Alberto-Culver Co., an American corporation, contracted with Fritz Scherk, a German national, to purchase three of his European-based enterprises.² Scherk was contractually obligated to convert his enterprises into stock companies. Consequently, the purchase was executed in the form of a securities transaction.³ An important object of the transaction was the transfer to Alberto-Culver of all rights held by the Scherk enterprises in trademarks of cosmetic goods.⁴ To effectuate this object, the contracts contained warranties whereby Scherk guaranteed the “sole and unencumbered ownership” of the trademarks.⁵ The contracts also contained clauses which provided that, if requested by either party, any controversy arising out of the transaction would be settled exclusively by arbitration before the International Chamber of Commerce in Paris, France.⁶ The laws of the State of Illinois were chosen to govern the interpretation and enforcement of the contracts.⁷

After closing the transaction, Alberto-Culver allegedly discovered that the trademark rights were subject to substantial encumbrances.⁸ Contending that Scherk’s fraudulent representations concerning the status of the trademarks violated section 10(b) of the Securities Exchange Act of 1934 (the 1934 Act),⁹ and Rule 10b-5¹⁰ promulgated thereunder, Alberto-Culver brought an action for damages and other relief in the United States District Court for the Northern District of Illinois.¹¹ Scherk filed a formal request for

¹ 417 U.S. 506 (1974).

² *Id.* at 508.

³ *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 613 (7th Cir. 1973).

⁴ 417 U.S. at 508.

⁵ *Id.*

⁶ *Id.* The arbitration clause relating to the transfer of one of the Scherk enterprises read in its entirety, as follows:

The parties agree that if any controversy or claim shall arise out of this agreement or the breach thereof and either party shall request that the matter shall be settled by arbitration, the matter shall be settled exclusively by arbitration in accordance with the rules then obtaining of the International Chamber of Commerce, Paris, France, by a single arbitrator, if the parties shall agree upon one, or by one arbitrator appointed by each party and a third arbitrator appointed by the other arbitrators. In case of any failure of a party to make an appointment referred to above within four weeks after notice of the controversy, such appointment shall be made by said Chamber. All arbitration proceedings shall be held in Paris, France, and each party agrees to comply in all respects with any award made in any such proceeding and to the entry of a judgment in any jurisdiction upon any award rendered in such proceeding. The laws of the State of Illinois, U.S.A. shall apply to and govern this agreement, its interpretation and performance.

Id. at 508 n.1.

⁷ *Id.* at 508.

⁸ *Id.* at 509.

⁹ 15 U.S.C. § 78j(b) (1970).

¹⁰ 17 C.F.R. § 240.10b-5 (1974).

¹¹ 417 U.S. at 509; 484 F.2d at 614.

arbitration with the International Chamber of Commerce,¹² and then filed a motion with the district court to dismiss for lack of jurisdiction, or alternatively, to stay the action pending an arbitration in accordance with the terms of the contracts.¹³ The district court found it had jurisdiction,¹⁴ denied Scherk's motion,¹⁵ and granted Alberto-Culver a preliminary order enjoining Scherk from proceeding with arbitration.¹⁶

On interlocutory appeal, the United States Court of Appeals for the Seventh Circuit affirmed¹⁷ relying upon the 1953 Supreme Court decision in *Wilko v. Swan*.¹⁸ The holding in *Wilko* was that agreements to arbitrate future controversies are void because such agreements waive the right of a securities purchaser to have his dispute decided in a judicial forum.¹⁹ Reversing the decision of the court of appeals, the Supreme Court found *Wilko* inapplicable to international securities transactions and HELD:²⁰ An agreement to arbitrate controversies arising out of an international securities transaction is to be enforced by the United States federal courts as required by the Arbitration Act.²¹

Scherk provided an opportunity for the Supreme Court to re-examine *Wilko v. Swan*, where it held that an arbitration agreement²² in a contract involving a domestic securities transaction²³ was void under provisions of the Securities Act of 1933 (the 1933 Act).²⁴ In *Wilko*, the Court found that the 1933 Act provides the securities purchaser with the right to have his dispute resolved in a judicial forum²⁵ and invalidates any agreement which operates as a waiver of that right.²⁶ Consequently, an arbitration agreement is void under the Act because it constitutes such a waiver.²⁷ In *Wilko*, however, the Court also implicitly conceded that the Arbitration Act

¹² 417 U.S. at 510 n.2.

¹³ Id. at 509.

¹⁴ 484 F.2d at 612.

¹⁵ 417 U.S. at 510.

¹⁶ Id.

¹⁷ 484 F.2d at 614-15.

¹⁸ 346 U.S. 427 (1953).

¹⁹ Id. at 432-35.

²⁰ 417 U.S. at 519-20.

²¹ 9 U.S.C. §§ 1-14 (1970).

²² The term "arbitration agreement" is used consistently in this note to refer to an agreement to arbitrate controversies that may arise in the future. An agreement to arbitrate a controversy which already exists is denominated a "submission to arbitration" or "submission."

²³ The Supreme Court in *Wilko* did not distinguish between domestic and international transactions. See 484 F.2d at 615.

²⁴ 346 U.S. at 432-35. The provisions which the Court construed were 15 U.S.C. §§ 77n, 77v(a) (1970).

²⁵ 346 U.S. at 431.

²⁶ Id. at 434-35.

²⁷ Id.

of 1925²⁸ mandates the enforcement of arbitration agreements.²⁹ Thus, the Court's analysis posited the existence of a conflict between the Securities Act and the Arbitration Act which could only be resolved by choosing to effectuate the policy of either one statute or the other.³⁰ Essentially the same conflict was present in *Scherk*.³¹

Since the Court, in *Scherk*, assumed the existence of a conflict between the Arbitration Act and the securities statutes and chose to effectuate the policy of the Arbitration Act rather than that of the Securities Exchange Act of 1934,³² it was required to distinguish *Wilko*. The Court has been importuned to regard the *Wilko* holding as resting merely upon a gross disparity of either bargaining power or knowledge between a seller and a purchaser of securities.³³ In *Scherk*, however, the Court explicitly declined to rely upon the disparity in bargaining power rationale in distinguishing *Wilko*.³⁴ Instead, it distinguished *Wilko* on the basis that there, the dispute to be arbitrated arose from a domestic transaction, whereas the dispute in *Scherk* arose from an international transaction.³⁵

In this note, the Court's reasoning in *Scherk v. Alberto-Culver Co.* and *Wilko v. Swan* will be examined to determine the extent to which the distinction between international and domestic transactions provides a sound basis for deciding whether an agreement to arbitrate a controversy arising out of a securities transaction should be invalidated or enforced by a federal court. An alternative criterion for enforcement based on a view of the arbitration clause as a severable, bargained-for agreement will be presented. Finally, the capability of the alternative criterion to overcome the apparent conflict between the Arbitration Act and the securities statutes while promoting both statutory policies will be suggested.

The distinction between international and domestic transactions does not resolve the issue raised by the statutory construction of provisions of the Securities Act of 1933 undertaken by the Court

²⁸ 9 U.S.C. §§ 1-14 (1970).

²⁹ See 346 U.S. at 431, 438.

³⁰ Id. at 438.

³¹ The Court did not explicitly analyze *Scherk* as involving a conflict between the Securities Exchange Act of 1934 and the Arbitration Act. Moreover, it did not seem to regard the securities aspect of the transaction as important. See 417 U.S. at 517-18. However, all the essential factors which constituted the conflict in *Wilko* were present in *Scherk*. The court of appeals held the transaction in *Scherk* to be a securities transaction, 484 F.2d at 615, and this ruling was not assigned as error on appeal to the Supreme Court. 417 U.S. at 514 n.8. The Court also accepted *arguendo* that the language of the Securities Act of 1933 which conflicts with the enforcement of an arbitration agreement is also contained in the Securities Exchange Act of 1934. Id. at 515. Moreover, the Court's attempt to distinguish *Wilko* would appear to be irrelevant if the conflict were not, at least, latently present in *Scherk*.

³² 15 U.S.C. §§ 78a-78jj (1970) [hereinafter referred to as the 1934 Act]. See 417 U.S. at 513. See note 31 *supra*.

³³ 417 U.S. at 512 n.6. See Brief for American Arbitration Ass'n as Amicus Curiae at 11 n.4, 12, *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974); 484 F.2d at 617 (dissenting opinion).

³⁴ 417 U.S. at 512 n.6.

³⁵ Id. at 515.

in *Wilko*. In *Wilko*, the Court held an arbitration agreement invalid under the anti-waiver provision of the 1933 Act,³⁶ because such an agreement waives the rights of the purchaser under the Act's venue provision³⁷ to choose from a wide selection of forums and to have the dispute resolved in a judicial proceeding.³⁸ The venue³⁹ and anti-waiver⁴⁰ provisions of the Securities Exchange Act of 1934, the statute applicable to the *Scherk* case, are so similar to those of the 1933 Act that there appears to be no relevant basis for distinction.⁴¹ Although the *Scherk* Court offered a pair of "colorable" arguments to differentiate the anti-waiver and venue provisions of the 1933 and 1934 Acts,⁴² it accepted *arguendo* the premise "that the operative

³⁶ 15 U.S.C. § 77n (1970), which provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

³⁷ 15 U.S.C. § 77v(a) (1970), which provides in pertinent part:

The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this sub-chapter and under the rules and regulations promulgated by the [Securities and Exchange] Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this sub-chapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein No case arising under this sub-chapter and brought in any state court of competent jurisdiction shall be removed to any court of the United States. . . .

³⁸ 346 U.S. at 434-37. For a critical analysis of the conclusion that an arbitration agreement violates the anti-waiver provisions of the securities statutes, see text at notes 101-03 *infra*.

³⁹ 15 U.S.C. § 78aa (1970), which provides in pertinent part:

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. . . . Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business. . . .

⁴⁰ 15 U.S.C. § 78cc(a) (1970), which provides: "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."

⁴¹ 484 F.2d at 616, 618 (dissenting opinion). Comparison of the anti-waiver provisions of the 1933 and 1934 Acts reveals only one difference: the 1933 Act voids waivers executed by persons acquiring securities while the 1934 Act voids waivers executed by anyone. See notes 36 and 40 *supra*.

⁴² The Court first ascribed significance to the fact that the purchaser's private remedy in *Wilko* was established by § 12(2) of the 1933 Act, 15 U.S.C. § 77l(2) (1970), which has no counterpart in the 1934 Act. 417 U.S. at 513. However, the private remedy invoked by *Alberto-Culver* was inferred from § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1974). See 6 L. Loss, *Securities Regulation* 3869-73 (1969) and cases cited therein. Thus, the distinction seems to be between private remedies explicitly and implicitly created by statute. The Court offered no explanation why arbitration would be a satisfactory method for resolving a dispute the remedy for which was implicitly created by statute while it would be an unsatisfactory method for resolving a dispute the remedy for which was explicitly created by statute. See text at notes 47-62 *infra*.

portions of the language of the 1933 Act relied upon in *Wilko* are contained in the Securities Exchange Act of 1934⁴³ Thus, the enforceability of an agreement to arbitrate disputes arising from a securities transaction does not depend upon which securities statute constitutes the basis of the plaintiff's claim.⁴⁴

There appears to be no provision in the securities statutes which would support the contention that the treatment of transactions subject to the statutes should differ, depending on whether the transactions are international or domestic in character. Specifically, the anti-waiver provisions do not contain language which would restrict the invalidation of waivers of statutory rights to those waivers executed by parties to domestic securities transactions.⁴⁵ Moreover, the cases in which international securities transactions have been the subject of litigation under the securities statutes suggest that once those statutes are found to govern the transaction, they are applied in their full effectiveness, not in a watered-down version.⁴⁶

It is submitted that the distinction between international and domestic transactions is not relevant to the policy considerations which compelled the Court, in *Wilko*, to adopt its construction of the venue and anti-waiver provisions of the 1933 Act. The Court recognized that one of the necessary effects of an arbitration agreement is to foreclose the securities purchaser's opportunity to have the dispute resolved in a judicial proceeding.⁴⁷ Upon examining the arbitration process and implicitly contrasting it with the judicial process in order to determine the impact of the purchaser's waiver of judicial proceedings,⁴⁸ the Court found arbitration to be legally less certain than a law suit.⁴⁹ The potential for misinterpretation and misapplication of legal rules is greater in arbitral than in judicial proceedings, since the arbitration tribunal need not be composed of persons knowledgeable in the applicable law⁵⁰ and since the Arbi-

The Court then suggested that the venue provision of the 1933 Act offers the plaintiff a wider choice of forums than does the venue provision of the 1934 Act. 417 U.S. at 514. This proposition is debatable; a district court has labelled the venue provision of the 1934 Act "broader" than that of the 1933 Act. *Puma v. Marriott*, 294 F. Supp. 1116, 1121 (D. Del. 1969). Compare 15 U.S.C. § 77v(a) (1970), quoted in note 37 supra, with 15 U.S.C. § 78aa (1970), quoted in note 39 supra. Moreover, the comparative breadth of the venue provisions would not seem significant; it should suffice that the venue provision of the 1934 Act provides a wide choice of forums and that the right to exercise that choice is waived by an arbitration agreement.

⁴³ 417 U.S. at 515.

⁴⁴ *Reader v. Hirsch & Co.*, 197 F. Supp. 111 (S.D.N.Y. 1961). Cf. *Moran v. Paine, Webber, Jackson & Curtis*, 389 F.2d 242, 245 (3d Cir. 1968).

⁴⁵ See notes 36 and 40 supra.

⁴⁶ See, e.g., *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1335-37 (2d Cir. 1972); *Schoenbaum v. Firstbrook*, 405 F.2d 215, 219-20 (2d Cir. 1968), cert. denied, 395 U.S. 906 (1969).

⁴⁷ 346 U.S. at 435.

⁴⁸ *Id.* at 435-37.

⁴⁹ *Id.* at 435-36.

⁵⁰ The selection of the arbitrators rests in the hands of the parties to the arbitration

tration Act contains no machinery through which arbitrators may elicit judicial instruction on the law.⁵¹ Moreover, a court is more likely to decide the case solely according to the statutory criteria, while the arbitration tribunal may inject into its decision-making such extra-statutory criteria as the customary practices in the trade.⁵² Thus, the arbitration award may insufficiently reflect and effectuate the purchaser's rights under the securities statutes.⁵³

From both a practical and legal standpoint, judicial review is less likely to be capable of rectifying a legally incorrect arbitral award than a legally incorrect judgment.⁵⁴ Arbitrators are not required to explain their reasons for making an award,⁵⁵ nor are they required to ensure that a complete record of the proceeding is kept.⁵⁶ In addition, arbitrators will not usually be heard in court to impeach their own award.⁵⁷ Thus, reviewing courts face practical difficulties in ascertaining the arbitrators' interpretations of the law. Moreover, the criterion for vacating an arbitral award is not the presence of legal error⁵⁸ but rather a manifest disregard of the law by the arbitrators:⁵⁹ for example, where the arbitrator correctly understood the applicable law but rendered the award in disregard of it.⁶⁰ Thus, even if the reviewing court is able to ascertain the presence and nature of legal error in an award, it may not be empowered to vacate that award.

It would appear that the *Wilko* Court was primarily concerned with the possibility that the agreement to resolve the dispute by arbitration may be tantamount to a waiver of the effective application of the substantive provisions of the Securities Act.⁶¹ Thus, the securities purchaser's venue provision right to have his dispute resolved in a judicial, rather than arbitral, proceeding can be more

agreement; thus, the parties themselves determine whether legally knowledgeable arbitrators are selected. See M. Domke, *The Law and Practice of Commercial Arbitration* § 1.01, at 1 (1968) [hereinafter cited as Domke].

⁵¹ See 346 U.S. at 436.

⁵² One of the frequently cited advantages of commercial arbitration is that persons knowledgeable in the practices and customs of the trade can be chosen to resolve the dispute. E.g., Mentschikoff, *The Significance of Arbitration—A Preliminary Inquiry*, 17 *Law & Contemp. Prob.* 698, 701, 707 (1952). The injection of arbitrators' conceptions of what constitutes fair dealing in the trade into the arbitral decision-making process would appear to be inappropriate where legislation has been enacted for the purpose of altering the patterns of practice in the trade. See *Wilko v. Swan*, 201 F.2d 439, 445 (2d Cir. 1953) (dissenting opinion).

⁵³ 346 U.S. at 435-36.

⁵⁴ *Id.* at 436-37.

⁵⁵ *Id.* at 436.

⁵⁶ *Id.*

⁵⁷ See Domke, *supra* note 50, § 23.02, at 227-28.

⁵⁸ *Amicizia Societa Navegazione v. Chilean Nitrate & Iodine Corp.*, 274 F.2d 805, 808 (2d Cir. 1960), cert. denied, 363 U.S. 843 (1960).

⁵⁹ 274 F.2d at 808. Cf. 346 U.S. at 436.

⁶⁰ *San Martine Compania De Navigacion v. Saguenay Terminals Ltd.*, 293 F.2d 796, 801 (9th Cir. 1961).

⁶¹ 346 U.S. at 438.

realistically characterized as the right to the full benefit of the protections afforded him by the statute rather than merely a right to have his case heard in a specific forum.⁶² Since the potential for insufficient recognition and effectuation of the statutory rights is inherent in the arbitration process, the relevance of the *Wilko* Court's concerns does not depend on whether the dispute to be arbitrated arose from an international or a domestic securities transaction.⁶³

Despite the *Wilko* Court's elaborate critique of the application of law in arbitration proceedings, it did not hold that all disputes arising from securities transactions must not be resolved through arbitration. Rather it held that agreements to arbitrate *future* controversies arising out of securities transactions will not be enforced.⁶⁴ The Court explicitly declined to go so far as to invalidate "submissions" to arbitration⁶⁵—agreements to arbitrate existing controversies.⁶⁶ The decision whether or not to arbitrate involves a trade-off between the advantages of a comparatively quick and inexpensive resolution of the dispute and the disadvantage of a legally less certain resolution.⁶⁷ The Court in *Wilko* seemed to suggest that the purchaser is unlikely to be able to make this trade-off knowledgeably until the presence of a dispute compels him to assess his legal situation; a pre-dispute agreement to arbitrate, therefore, takes unfair advantage of his ignorance.⁶⁸ Also, the arbitration agreement is likely to be an ancillary provision in the seller's standard form contract and if the purchaser is to derive the benefits of the central purposes of the contract, he has little choice but to adhere to the arbitration agreement. After the dispute arises, however, the seller has no leverage to coerce the buyer into agreeing to arbitrate.⁶⁹ Thus, the purchaser's position would appear to be substantially better in negotiating a submission than in negotiating an arbitration agreement. Since the tactic of using a stronger bargain-

⁶² 484 F.2d at 619 (dissenting opinion).

⁶³ In *Scherk* the Court virtually ignored, perhaps purposefully, the waiver of judicial proceedings argument advanced in *Wilko*. See 417 U.S. at 512-13, 515. The Court may have considered that its decision to enforce the arbitration agreement on other grounds disposed of the waiver of judicial proceedings issue. But see text at notes 84-85 infra.

⁶⁴ 346 U.S. at 437-38. See *Moran v. Paine, Webber, Jackson & Curtis*, 389 F.2d 242, 246 (3d Cir. 1968); accord, *Gardner v. Shearson, Hammill & Co.*, 433 F.2d 367, 368 (5th Cir. 1970) (per curiam).

⁶⁵ 346 U.S. at 437, 438. See note 22 supra.

⁶⁶ Obviously, a submission to arbitration is also an agreement which waives the right to have the dispute resolved in a judicial proceeding. See 484 F.2d at 618 n.7 (dissenting opinion).

⁶⁷ See 346 U.S. at 438.

⁶⁸ Id. at 435.

⁶⁹ After the dispute has arisen, the only thing to negotiate is how the dispute is to be resolved. The purchaser may be in a stronger bargaining position than the seller. If the purchaser refuses to agree to submit the dispute to arbitration, he can use the venue provision's wide choice of forum to subject the seller to the expense and inconvenience of litigation in a remote forum. See Note, 62 Yale L.J. 985, 987 (1953).

ing position to gain unfair advantage is neither always absent in international transactions nor always present in domestic transactions, the distinction between domestic and international transactions is irrelevant to the evil which *Wilko* is designed to avoid—the forced or unknowing pre-dispute waiver of the right to have controversies resolved in a judicial forum.

However, the distinction between international and domestic transactions is relevant to the decision whether to enforce an agreement to arbitrate where the focus is confined to the *pre-dispute, forum-selection* aspect of the arbitration agreement. The agreement in both *Wilko* and *Scherk* was to arbitrate future controversies before a specified tribunal.⁷⁰ Thus, as the Court in *Scherk* noted,⁷¹ one of the beneficial functions of the agreement was to select in advance the forum in which any dispute would be resolved.⁷²

The policy considerations which underlie the enforcement of forum-selection clauses in international transactions were first expounded in 1971 in *The Bremen v. Zapata Off-Shore Co.*⁷³ There, the Supreme Court recognized that a forum-selection clause in an international contract provides the essential elements of orderliness and predictability to the transaction.⁷⁴ An international transaction is likely to have sufficient contacts with several countries so that jurisdiction may be legitimately exercised by each.⁷⁵ By selecting a forum in advance, the parties to the transaction can ensure that any disputes which arise will be submitted to a neutral forum familiar with the problem area involved⁷⁶ and relatively convenient to both parties.⁷⁷ By enforcing forum-selection clauses, courts discourage international forum-shopping and the concomitant “mutually destructive jockeying by the parties to secure tactical litigation advantages.”⁷⁸ Enforcement, moreover, enables courts to avoid conflict of laws problems which arise when the courts of several countries have attempted to exercise jurisdiction over the international commercial dispute.⁷⁹ Thus, the Court has concluded that the “parochial con-

⁷⁰ The *Scherk* arbitration agreement designated the International Chamber of Commerce in Paris, France, as the arbitral tribunal. See note 6 supra. The arbitration agreement in *Wilko* designated several arbitral tribunals from which the investor could select. *Wilko v. Swan*, 107 F. Supp. 75, 77 (S.D.N.Y. 1952).

⁷¹ 417 U.S. at 519.

⁷² *Id.*

⁷³ 407 U.S. 1 (1971).

⁷⁴ *Id.* at 13-14. Accord, 417 U.S. at 516.

⁷⁵ 417 U.S. at 516-17.

⁷⁶ 407 U.S. at 12. See 417 U.S. at 516.

⁷⁷ 407 U.S. at 13.

⁷⁸ 417 U.S. at 517.

⁷⁹ *Id.* at 516-17. The Court alluded to this in *Scherk* by suggesting that *Scherk* could have obtained “an order in France or some other country enjoining Alberto-Culver from proceeding with its litigation in the United States.” *Id.* at 517. This example, however, may be inappropriate. Under the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, [1970] 3 U.S.T. 2517, T.I.A.S. No. 6997, implemented in the United States by 9 U.S.C. §§ 201-08 (1970), the courts of the country in which suit is brought may refuse to

cept that all disputes must be resolved under our laws and in our courts . . ."⁸⁰ is counterproductive to stability in international transactions and may adversely affect the "willingness and ability of businessmen to enter into international commercial agreements."⁸¹ Accordingly, in *The Bremen*, it held that forum-selection clauses in international contracts are "prima facie valid and should be enforced unless enforcement is shown by the resisting party to be 'unreasonable' under the circumstances."⁸²

This forum-selection analysis, which was explicitly followed in *Scherk*,⁸³ does not fully justify the *Scherk* Court's failure to cope with the policy considerations which compelled the Court in *Wilko* to invalidate an agreement to arbitrate disputes arising out of a securities transaction.⁸⁴ In *The Bremen*, the Court noted that "[a] contractual choice-of-forum clause should be held unenforceable if enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision."⁸⁵ It would therefore seem to have been incumbent upon the Court in *Scherk* to indicate why the public policy of *Wilko* does not render the arbitration agreement, even viewed solely as a forum-selection clause, unenforceable.

The forgoing analysis of the Court's reasoning in *Wilko* and *Scherk* suggests that the distinction between domestic and international transactions may not provide an adequate basis for the judicial decision whether to enforce an agreement to arbitrate controversies arising out of a securities transaction. However, a contract analysis may provide an adequate basis for that decision.

Viewing the arbitration clause as a severable, bargained-for agreement within the contract provides an alternative analytic framework for deciding whether to enforce or invalidate an agreement to arbitrate any dispute arising from a securities transaction. Section 2 of the Arbitration Act of 1925⁸⁶ provides for application of a contract analysis in determining the enforceability of arbitration agreements: "A written provision in . . . a contract evidencing a

enforce an arbitration agreement that is void under their municipal law. Art. V(2)(b). Moreover, it appears from the Convention that only the courts of the country in which suit is brought are empowered to determine the enforceability of the agreement to arbitrate. Art. V(2). Thus, an injunction by the courts of another signatory nation would be an usurpation of the rights accorded the courts of the United States by the Convention. A more appropriate example would have been the situation in *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1971). There, the courts of England took jurisdiction over the dispute on the grounds that jurisdiction was conferred on them by the forum-selection clause. *Id.* at 4. Had the courts of the United States refused to enforce the forum-selection clause, the courts of both countries would have claimed jurisdiction to resolve that dispute.

⁸⁰ 407 U.S. at 9.

⁸¹ 417 U.S. at 517. See 407 U.S. at 9.

⁸² 407 U.S. at 10.

⁸³ 417 U.S. at 518-19.

⁸⁴ See text at notes 49-63 *supra*.

⁸⁵ 407 U.S. at 15.

⁸⁶ 9 U.S.C. §§ 1-14 (1970).

transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."⁸⁷ Article II of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards⁸⁸ also provides for the application of contract principles. An arbitration agreement subject to the Convention is to be enforced unless it is "null and void, inoperative or incapable of being performed . . ."⁸⁹ or concerns a "subject matter [not] capable of settlement by arbitration."⁹⁰ The Arbitration Act recognizes that arbitration agreements are an "allowable extension of the sphere of contract"⁹¹ and mandates that such agreements be enforced on the same basis as other contracts.

When the enforcement of an arbitration agreement is challenged, the agreement should be severed from the rest of the contract and its validity determined based on its own merits as a contract.⁹² The severability of the arbitration clause is already recognized. For example, where a party seeks to avoid arbitration on the ground of fraudulent inducement, he must show that the arbitration agreement itself, not the contract as a whole, was fraudulently induced.⁹³ This rationale can easily be extended to such contract defenses as duress, illegality, overreaching and void as against public policy.⁹⁴ The arbitration clause should also be severed from the rest of the contract in order to determine whether it has been the

⁸⁷ Id. § 2 (1970).

⁸⁸ [1970] 3 U.S.T. 2517, T.I.A.S. No. 6997, implemented in the United States by 9 U.S.C. §§ 201-08 (1970).

⁸⁹ Art. II(3).

⁹⁰ Art. II(1).

⁹¹ Carlston, *Theory of the Arbitration Process*, 17 *Law & Contemp. Prob.* 631 (1952).

⁹² The procedural provisions of the Arbitration Act, 9 U.S.C. §§ 3, 4, 206 (1970), seem to be designed to focus the court's attention on the arbitration clause. When a party to a proceeding in a federal court moves to stay the proceeding until an arbitration has been completed, the court's inquiry is limited to determining whether: (1) an issue in the proceeding is referable to arbitration under a written arbitration agreement; and (2) the movant is in default in proceeding with arbitration. Id. § 3. When a party seeks an order to compel arbitration, the principal issue before the court is the "making of the arbitration agreement [and] the failure, neglect, or refusal to perform the same . . ." Id. § 4. Thus, severing the arbitration clause from the rest of the contract accurately defines the proper scope of the inquiry under the summary procedures of the Arbitration Act.

⁹³ *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403-04 (1967); *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 410-11 (2d Cir. 1959), cert. granted, 362 U.S. 909, cert. dismissed pursuant to stipulation, 364 U.S. 801 (1960).

⁹⁴ Courts should be somewhat reluctant to hold void, as against public policy, those arbitration agreements which are subject to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. "If the United States is overready to defeat, on public policy grounds, an international arbitration agreement sought to be enforced by a foreign contracting party, it must expect its own nationals to be subject to the same treatment in the courts of foreign enforcing countries." Brief for the American Arbitration Ass'n as *Amicus Curiae* at 16, *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974). See *Parsons & Whittemore Overseas Co. v. Societe Generale de L'Industrie du Papier*, Doc. Nos. 74-1642, 74-1676 (2d Cir. Dec. 23, 1974) at 1046-48.

subject of an actual agreement between the parties; if it has not been the subject of an actual agreement between the parties, it should be held that no contract to arbitrate was formed.⁹⁵

The arbitration clause at issue in *Wilko* was one of seventeen fine print clauses in the brokerage firm's standard form margin contract.⁹⁶ There is no indication that the clause was the subject of an actual agreement between the parties. Also, if the margin contract was offered on a take-it-or-leave-it basis, the arbitration agreement was consummated through the brokerage firm's exercise of grossly superior bargaining power.⁹⁷ Viewed as a severable, bargained-for agreement, the enforcement of the arbitration clause in *Wilko* reasonably could have been denied.

The decision to enforce the *Scherk* arbitration clause was correct under the contract analysis. Since *Wilko* invalidates only agreements to arbitrate future disputes, and does not invalidate submissions to arbitration,⁹⁸ it can be inferred that securities transactions do not involve a subject matter inherently incapable of resolution by arbitration. The arbitration agreement in *Scherk* was apparently the subject of actual bargaining between parties of relatively equal bargaining power.⁹⁹ The prolonged period of negotiation¹⁰⁰ suggests that both parties were afforded the opportunity to assess the relative merits of litigating or arbitrating any dispute that might arise. The contractual analysis would mandate the enforcement of the *Scherk* arbitration agreement.¹⁰¹

⁹⁵ Commercial arbitration is a contractual proceeding and derives its legal validity from the consent of the parties. See Domke, *supra* note 50, § 1.01, at 1; Carlston, *Theory of the Arbitration Process*, 17 *Law & Contemp. Prob.* 631 (1952). One party's agreement to arbitrate is consideration for the other party's agreement to arbitrate. *Hellenic Lines Ltd. v. Louis Dreyfus Corp.*, 249 F. Supp. 526, 530 (S.D.N.Y. 1966), *aff'd*, 372 F.2d 753 (2d Cir. 1967). Or, there must be a "meeting of the minds" on the arbitration agreement itself. See Domke, *supra* note 50, § 5.01 at 31-36, and the cases cited therein. Cf. *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 409-11 (2d Cir. 1959), *cert. granted*, 362 U.S. 909, *cert. dismissed pursuant to stipulation*, 364 U.S. 801 (1960). Thus, the principle of mutual consent as the basis of arbitration is well established. The standard, however, should be *informed* consent. An arbitration agreement should be held to have been fraudulently induced if the party proposing the agreement fails to disclose that an effect of the agreement is to foreclose the opportunity to have disputes resolved in legally more certain judicial proceedings.

⁹⁶ *Wilko v. Swan*, 201 F.2d 439, 442 (2d Cir. 1953).

⁹⁷ But see 346 U.S. at 440 (dissenting opinion).

⁹⁸ See cases cited in note 64 *supra*.

⁹⁹ See Brief for American Arbitration Ass'n as Amicus Curiae at 12-13, *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974).

¹⁰⁰ 417 U.S. at 508-09.

¹⁰¹ Of course, if the *Wilko* Court's statutory construction of the securities statutes' venue and anti-waiver provisions is taken literally, the *Scherk* arbitration agreement would be illegal under a contract analysis. However, *Wilko* may be legitimately viewed as extending the literal coverage of the anti-waiver provisions to deny enforcement of arbitration agreements in certain situations. 484 F.2d at 619 (dissenting opinion); see text at notes 68-69 *supra*. Viewed in isolation, the *Wilko* statutory construction was poorly conceived. The anti-waiver provision of the 1933 Act provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the

In *Wilko*, the Court posited the existence of a conflict between the securities statutes and the Arbitration Act: the Arbitration Act mandates the enforcement of arbitration agreements, but arbitration agreements necessarily waive the plaintiff's right to have disputes resolved in a judicial proceeding—a right which it stated may not be waived under the securities statutes. The anti-waiver provisions seem to be designed to prevent the sellers' use of their stronger bargaining position to contractually deprive buyers of their statutory rights.¹⁰² Thus, insofar as *Wilko* was designed to remedy the situation in which the securities seller uses his greater bargaining power to deprive the purchaser of the opportunity to have the dispute resolved in the legally more certain judicial forum, it executed the congressional intent in enacting the anti-waiver provisions. However, the *Wilko* statutory construction operated, until *Scherk*, as a conclusive ban on the enforcement of agreements to arbitrate disputes arising out of securities transactions. Since there is no ineluctable rule that agreements to arbitrate securities disputes are executed from ignorance and weakness, the *Wilko* invalidation of all such agreements may be considered overly broad. Insofar as the *Wilko* statutory construction invalidates arbitration agreements knowingly executed by parties of comparable bargaining power, it operates contrary to the intent of Congress that such agreements be "valid, irrevocable and enforceable."¹⁰³

In *Scherk*, the Court chose to distinguish *Wilko* on the basis of a distinction between international and domestic transactions. Thus, *Scherk* left intact the *Wilko* ban on the enforcement of agreements to arbitrate securities disputes in domestic transactions, but lifted the ban for international transactions. It would appear, therefore, that *Scherk* also left undisturbed the *Wilko* assumption of the existence of a conflict between the securities statutes and the Arbitration Act. Apparently, the Court merely found that an arbitration agreement, *qua* forum-selection clause, promotes practical policy goals in international transactions which are inapplicable to domestic transactions.¹⁰⁴

rules and regulations of the Commission shall be void." 15 U.S.C. § 77n (1970). However, "[w]hat is waived—if the arbitration agreement is enforced—is plaintiff's right to sue rather than defendant's obligation to comply with the Act. Thus, enforcement of the arbitration agreement is consistent with a literal reading of the text of [the venue and anti-waiver provisions]." 484 F.2d at 618 (dissenting opinion). Stated somewhat differently, the anti-waiver and venue provisions should not be held to provide a non-waivable right to judicial resolution of a dispute. The anti-waiver provisions should be read to prohibit a party from extracting an agreement that he need not comply with the substantive provisions of the securities laws; and the venue provision should be viewed as providing a forum for judicial resolution if the plaintiff is not barred from litigating the dispute.

¹⁰² See 484 F.2d at 616-17 (dissenting opinion).

¹⁰³ 9 U.S.C. § 2(1970).

¹⁰⁴ The Court in *Wilko* also recognized that the arbitration agreement pre-selected the forum in which the dispute was to be resolved; it viewed the forum-selection aspect of the agreement as a waiver of the purchaser's venue provision "right" to choose from among the provision's wide selection of forums. 346 U.S. at 435.

The proposed contract analysis calls for the case-by-case evaluation of the merits of arbitration clauses as severable, bargained-for agreements. Arbitration agreements executed through the exercise of grossly disparate bargaining power and knowledge can be invalidated through the application of contract principles. The case-by-case approach permits such egregious agreements to be invalidated individually. Thus, the overly broad conclusive ban of the *Wilko* statutory construction is unnecessary. The case-by-case contract analysis of agreements to arbitrate securities disputes is capable, therefore, of effectuating the policies of the securities statutes, as declared in *Wilko*, while simultaneously enforcing arbitration agreements to the extent envisioned by the Arbitration Act.

FRANCIS E. GIBERSON

Securities Law—Rule 10b-5—Civil Liability of Tipsters and Tippees: *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*¹—Defendant Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch), and certain of its officers, directors and employees (the individual defendants)² acquired material inside information³ concerning the unfavorable earnings outlook for Douglas Aircraft Company, Inc. through Merrill Lynch's position as prospective managing underwriter for a new issue of Douglas debentures.⁴ The individual defendants conveyed this information to certain Merrill Lynch customers⁵ (the selling defendants) who, after learning of this information, either sold from existing positions or made short sales of more than 165,000 shares of Douglas common on the New York Stock Exchange (NYSE).⁶ These sales were made prior to a public announcement of the inside information by Douglas and without disclosure of the information either to the purchasers of the defendants' stock or to the general investing public.⁷

The plaintiffs alleged that they had purchased Douglas common on the NYSE after the selling defendants had sold and before

¹ 495 F.2d 228 (2d Cir. 1974).

² For the names of the individual defendants and their positions with Merrill Lynch, see *id.* at 232 n.4.

³ This information was essentially that: (1) Douglas would report substantially lower earnings for the entire first six months than it had reported for the first five months of its 1966 fiscal year; (2) Douglas had sharply lowered its estimate of earnings for its full 1966 fiscal year since it now expected to have little or no profit for that year; and (3) Douglas had substantially reduced its projection of earnings for its 1967 fiscal year. *Id.* at 232.

⁴ *Id.*

⁵ For the names of the selling defendants, most of whom were institutional investors, see *id.*

⁶ *Id.* The details of the fact situation are noted in Investors Management Co., Securities Exchange Act Release No. 9267, reprinted in [1970-71 Transfer Binder] CCH Fed. Sec. L. Rep., ¶ 78,163, at 80514, 80516-17 (July 29 1971).

⁷ 495 F.2d at 232.