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REPORT ON THE PROPOSED ARBITRATION FAIRNESS ACT OF 2007 S. 1782 AND H.R. 3010

This Report was prepared by the New York County Lawyers' Association Committee on the Federal Courts. The Committee formed a subcommittee to study and report on the Arbitration Fairness Act of 2007, S. 1782 and H.R. 3010. The results of that study are set forth in this Report and were considered and adopted by the Committee.

This Report reflects the views and opinions of the Committee on the Federal Courts only. It has not been approved by the Board of Directors of the New York County Lawyers' Association and does not necessarily reflect the views of the Association or the Board.

The Report demonstrates that the Act, if enacted in its present form, can be expected to create a permanent and substantial increase in the number of cases handled by the Federal Courts without providing the additional judicial resources necessary to process that increased case load in a timely fashion. The Committee urges proponents of the bill to avoid unintended negative consequences to the overall administration of justice in the Federal Courts by carefully assessing the additional burdens that would be placed upon the courts by this Act if judicial resources were not increased proportionately.

A. Background

In 1925, Congress enacted the Federal Arbitration Act (FAA), which provides that contractual provisions requiring binding arbitration of disputes are "valid, irrevocable, and enforceable," unless legal or equitable grounds exist for revocation of the contract. 9 U.S.C. § 2. The FAA placed arbitration agreements upon the same footing as other contracts and reversed judicial hostility to arbitration agreements. Ware, *Principles of Alternative Dispute Resolution,* § 2.9 (2d ed. 2002). During the intervening 80 years, courts have held that "'[t]here is a strong federal policy favoring arbitration as an alternative means of dispute resolution," *e.g., ACE Capital Re Overseas Ltd.* v. *Cent. United Life Ins. Co.,* 307 F.3d 24, 29 (2d Cir. 2002), and that "doubts as to whether a claim falls within the scope of that agreement should be resolved in favor of arbitrability." *Id. (citing Moses H. Cone Mem'l Hosp.* v. *Mercury Constr. Corp.,* 460 U.S. 1, 24-25 (1983)). Moreover, construing the FAA, courts

have ruled that challenges to the arbitrability of a dispute are to be referred to the arbitrator(s) if the parties have agreed that such challenges are to be submitted to arbitration. *See Preston* v. *Ferrer,* 128 S. Ct. 978, 983-84 (2008); *PaineWebber Inc. v. Bybyk,* 81 F.3d 1193, 1198 (2d Cir. 1996) (*citing First Options v. Kaplan,* 514 U.S. 938 (1995)). In fact, even claims of fraud in the inducement of a contract containing an arbitration clause are held to be encompassed within a broad arbitration clause. *ACE Capital Re Overseas Ltd.* v. *Cent. United Life Ins. Co.,* 307 F.3d 24, 29 (2d Cir. 2002) *[citing Prima Paint Corp.* v. *Flood & Conklin Mfg. Co.,* 388 U.S. 395, 403-04 (1967)].

In the aftermath of this weighty line of case law, arbitration agreements have become pervasive in a number of industries, including securities, franchise, consumer credit, HMOs and insurance. As a result, a broad swath of disputes has been removed from the courts. For example, it has been estimated that at least 20 percent of all employers now use arbitration clauses to remove disputes from the courts.[1]

Despite, or perhaps because of, their pervasiveness, arbitration clauses have come under attack for decades. Until now, these challenges have generally failed. Recently, however, a number of legislators and interest groups have mounted a sweeping challenge to mandatory pre-dispute arbitration clauses. A wide variety of arbitration provisions would become retroactively unenforceable if the Arbitration Fairness Act of 2007 ("Arbitration Fairness Act" or the "Act") becomes law. This bill was introduced July 12, 2007 as S. 1782 and H.R. 3010. S. 1782 was referred to the Senate Judiciary Committee. R. 3010 was referred to the House Judiciary Committee, and then (on August 10, 2007), it was referred to the House Subcommittee on Commercial and Administrative Law, which held hearings on October 25, 2007. A number of consumer and employee groups have backed the legislation.

If enacted, this legislation would invalidate pre-dispute agreements to arbitrate "franchise," "consumer," "civil rights" and "employment" disputes as defined by the statute. Act § 4(4) (amending 9 U.S.C. § 2(b)(1)). In addition, the statute would invalidate any pre-dispute arbitration agreement "arising under any statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power." *Id.* (proposed 9 U.S.C. § 2(b)(1)). The proposed legislation also would invalidate "broad" arbitration clauses that call for arbitrable disputes to be resolved by arbitrators. Instead, such disputes will be decided by a court, and often a federal court:

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[1]U.S. General Accounting Office, Alternate Dispute Resolution: Employers' Experiences with ADR in the Workplace 2 (1997) (19 percent of employers used mandatory arbitration clauses). The number today is likely considerably higher

> ". . . An issue as to whether this chapter applies in an arbitration agreement shall be determined by Federal law. Except as otherwise provided in this chapter, the validity or enforceability of an agreement to arbitrate shall be determined by the court, rather than the arbitrator, irrespective of whether the party resisting arbitration challenges the arbitration agreement specifically or in conjunction with other terms of the contract containing such agreement."

Act § 4(4) (proposed 9 U.S.C. § 2(c)).

"Consumer disputes" are expansively defined. A person may be considered a consumer if he or she "seeks or acquires real or personal property, services, money, or credit . . . ." Organizations do not qualify as a "person," and disputes involving goods and services do not qualify unless the goods and/or services are obtained for personal, family, or household purposes and not for business purposes. "Employment" disputes would be defined as those between employee and employer, as that relationship is defined in the Fair Labor Standards Act. Act § 2(d). The statute would not apply, however, to arbitration provisions in collective bargaining agreements. Act § 4(4) (proposed 9 U.S.C. § 2(d)).

The proposed legislation also makes the following "findings" about arbitration:

> (1) The Federal Arbitration Act (now enacted as chapter 1 of title 9 of the United States Code) was intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power.
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> (2) A series of United States Supreme Court decisions have changed the meaning of the Act so that it now extends to disputes between parties of greatly disparate economic power, such as consumer disputes and employment disputes. As a result, a large and rapidly growing number of corporations are requiring millions of consumers and employees to give up their right to have disputes resolved by a judge or jury, and instead submit their claims to binding arbitration.
>
> (3) Most consumers and employees have little or no meaningful option whether to submit their claims to arbitration. Few people realize, or understand the importance of the deliberately fine print that strips them of rights; and because entire industries are adopting these clauses, people increasingly have no choice but to accept them. They must often give up their rights as a condition of having a job, getting necessary medical care, buying a

car, opening a bank account, getting a credit card, and the like. Often times, they are not even aware that they have given up their rights.

(4) Private arbitration companies are sometimes under great pressure to devise systems that favor the corporate repeat players who decide whether those companies will receive their lucrative business.

(5) Mandatory arbitration undermines the development of public law for civil rights and consumer rights, because there is no meaningful judicial review of arbitrators' decisions. With the knowledge that their rulings will not be seriously examined by a court applying current law, arbitrators enjoy near complete freedom to ignore the law and even their own rules.

(6) Mandatory arbitration is a poor system for protecting civil rights and consumer rights because it is not transparent. While the American civil justice system features publicly accountable decision makers who generally issue written decisions that are widely available to the public, arbitration offers none of these features.

(7) Many corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals, including provisions that strip individuals of substantive statutory rights, ban class actions, and force people to arbitrate their claims hundreds of miles from their homes. While some courts have been protective of individuals, too many courts have upheld even egregiously unfair mandatory arbitration clauses in deference to a supposed Federal policy favoring arbitration over the constitutional rights of individuals.

Act § 2.

B. <u>The Effect of the Arbitration Fairness Act on the Federal Courts</u>

The Committee takes no position on the accuracy of the findings of the Arbitration Fairness Act or on the wisdom of binding pre-dispute arbitration clauses. Reasonable minds can differ as to the policy issues presented by the Arbitration Fairness Act.

However, the Committee has strong concerns that the Arbitration Fairness Act would dramatically increase the workload of the federal courts. Even if it is construed narrowly, the Act would remove many large bodies of cases from arbitrators, resulting in a corresponding

increase in court caseloads. In addition, the Act could deter parties from arbitrating cases and could lead to considerable satellite litigation in federal court over the scope and meaning of the Act itself. In addition, the findings in the Arbitration Fairness Act could have the unintended consequence of undermining all arbitration, not just arbitration in the sectors that fall within the purview of the Act.

Accordingly, the Act would increase the already overburdened caseload of the federal courts. From Fiscal Year 2001 to Fiscal Year 2005, the federal courts' aggregate workload increased 21 percent while on-board court staffing levels declined by a net of 5 percent.[2] The Committee urges that the effect on the federal judiciary be taken into account in assessing the Arbitration Fairness Act.

1. The Scope and Reach of the Act Will Generate Federal Litigation by Removing Cases from Arbitration

a. Arbitration Currently Removes Many Cases from Federal Dockets

If the Arbitration Fairness Act significantly reduces the number of cases committed to arbitration, the Act would have a significant effect on federal dockets. The American Arbitration Association ("AAA") alone resolves close to 200,000 disputes per year.[3] By comparison, approximately 250,000 federal cases are filed each year nationwide.[4] Cornell University's Institute on Conflict Resolution reported that 79 percent of America's 1000 largest corporations had used arbitration in the three years preceding its study.[5] Of these, 33 percent have used arbitration to resolve personal injury disputes and 24 percent have used arbitration in products liability cases. *Id.*

The Act would also have significant effects in a number of specific areas, each of which could create large new sources of cases for the federal courts.

- As set forth below, securities claims likely fall within the coverage of the Act,

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[2] Statement of Hon. Julia S. Gibbons, Chair, Committee on the Budget of the Judicial Conference of the United States Before the Subcommittee on Transportation, Treasury, Housing and Urban Development, the Judiciary, District of Columbia, and Independent Agencies of the Committee on Appropriation of the United States House of Representatives at 3 (April 5, 2006).

[3] Letter dated November 21, 2001 from American Arbitration Association to Kenneth L. Zwick, Director, Office of Management Programs, Civil Division, United States Department of Justice http://www.usdoi.gov/archive/victimcompensation/W000458.html.

[4] Judicial Business of the United States Courts 2006 Annual Report of the Director, James C. Duff http://www.uscourts.gov/iudbususc/iudbus.html.

[5] Comell/Perc Institute on Conflict Resolution, The Use of ADR in U.S. Corporations 3 (1997).

which means that such arbitral regimes as that of the National Association of Securities Dealers, Inc. ("NASD") (now the Financial Industry Regulatory Authority, Inc. ("FINRA")) would be undermined. The FINRA dispute resolution program arbitrates over 6,000 cases per year.[6] Many of these cases would flow to federal courts under the federal securities laws.

- Most notably, the Act would encompass "employment" disputes, effectively overturning *Gilmer* v. *Interstate/Johnson Lane,* 500 U.S. 20 (1991) (upholding mandatory pre-dispute arbitration of employment claims including those involving statutory employment discrimination). This would significantly increase the flow of cases to the courts because, as set forth above, at least 20 percent of all employers use pre-dispute arbitration clauses.

- Civil rights lawsuits continue to be the largest single percentage of cases filed in federal courts. Even with the arbitration regimes that are in place, civil rights claims account for one out of every 11.4 civil cases and one out of every nine federal question lawsuits filed.[7] If arbitration of civil rights claims is not permitted, these figures would increase greatly.

These are just a few of the many large, new bodies of caseload that would burden the federal courts in the event the Arbitration Fairness Act is enacted.

b. <u>The Act Will Deter Parties from Arbitrating Cases</u>

Because the Act contains sweeping and unclear language, if the Act is enacted, it will deter parties from arbitrating cases because of the fear that the Act would invalidate the arbitration.

The legislation covers many broad substantive areas of law. Its findings evince an attempt to cover "consumer" disputes such as franchise, civil rights and employment controversies. However, the "consumer" provision is ambiguous. Although "consumer disputes" are commonly considered to be disputes between buyers and sellers of goods or services, the Act's definition of consumer disputes could encompass securities law cases. The

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[6] ***Gretchen Morgenson,*** *Is This Game Already Over? Critics Say Arbitration Panels Often Have Hidden Conflicts, N. Y. Times,* ***June 18, 2006*** (http://www.nytimes.com/2006/06/18/business/yourmoney/18arb.html?n=Top%2fNews%2fBusiness%2fColumns%2fGretchen%20Morgenson).

[7] Remarks of L. Steven Platt, National Employment Lawyers Association, Meeting of September 8, 2003 (citing Seymour and Aslin, Equal Employment Law Update (BNA 2002) (http://www.eeoc.gov/abouteeoc/meetings/9-8-03/nela.html#N_10_))

definition of "consumer dispute" expansively covers all disputes brought by a buyer against a seller of "personal property," which could encompass securities. Indeed, although the Act makes no specific mention of securities cases, in his statement introducing S. 1782, Senator Russ Feingold specifically referred to "securities broker contracts" as an area that was "unfortunately" (in his view) covered by arbitration agreements.[8]

Although they are not commonly considered "consumer disputes," antitrust claims might also be encompassed within the Act's definition of "consumer disputes" because such claims are often brought by buyers of products alleging anti-competitive overcharges in the sale of products. Similarly, shareholder lawsuits could be classified as "consumer disputes" because they involve claims of "persons" who "seek . . . services." The fulfillment of fiduciary duties could be argued to be "services" sought by shareholder "persons." By similar logic, attorney fee disputes would arguably be encompassed within the Act and hence could not be subject to pre-dispute arbitration.

The Act also contains the broad catch-all clause prohibiting all pre-dispute arbitration clauses for disputes "arising under any statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power." Act § 4(4) (proposed 9 U.S.C. § 2(b)(2)). It is virtually certain that this clause will lead to considerable litigation and unclear and uncertain results.

There are large sectors of federal law not explicitly mentioned in the Arbitration Fairness Act that could be considered to "regulate contracts or transactions between parties of unequal bargaining power." Apart from the areas that are explicitly covered by the statute, the "unequal bargaining power" clause could easily sweep in areas such as securities, antitrust, ERISA, certain bodies of Uniform Commercial Code law, bankruptcy law, certain bodies of admiralty and maritime law, governmental contracts, intellectual property and a host of others. In fact, the "unequal bargaining power" clause could arguably apply to any statutory dispute between the government and any private litigant in the sense that the government can be said to have more bargaining power than any other party.

Accordingly, the uncertainty created by the Act would chill parties from including arbitration clauses in any contract that could even arguably fall within the purview of the "consumer disputes" and "unequal bargaining power" clauses because the Act explicitly provides that questions relating to application of the Act are determined by federal law and that the enforceability of agreements to arbitration are determined by the court rather than the

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[8] Senator Russ Feingold, Statement on Introduced Bills and Joint Resolutions (Senate - July 12, 2007).

arbitrator. The Act would also deter parties from arbitrating cases out of fear that the Act would provide a basis to challenge the arbitration either before or after the fact. At a minimum, the "unequal bargaining power" and "consumer disputes" provisions would impose a layer of threshold litigation that could render arbitration - and arbitration clauses - prohibitively expensive.

2. The Act Would Undermine All Arbitration Clauses

As explained above, the Act would deter parties from including arbitration clauses in the first place because disputes over arbitrability go directly to court.

In addition, the findings in the Arbitration Fairness Act - by describing arbitration as unfair, lacking in transparency and "tilted" against individuals - would have the effect of undermining the rationale and deference accorded to arbitration generally, which would in turn increase the docket of the federal courts. In particular, the findings in the Arbitration Fairness Act would call into question the underpinning of such decisions as *Circuit City Stores, Inc.* v. *Adams*, 532 U.S. 105, 123 (2001), in which the Court stated that "[a]rbitration agreements allow parties to avoid the costs of litigation" and that such a benefit applies with even greater force in the context of smaller cases. Recent data show that federal courts confirm 92.7 percent of arbitrator decisions.[9] This number will surely decline if challengers to arbitration are able to "invoke" legislative findings that call into question the current deference to arbitrators' decisions.

C. Alternatives to the Arbitration Fairness Act

As an alternative to the Arbitration Fairness Act, disclosure and due process safeguards would cause less effect on the docket of the state and federal courts than the sweeping measures contained in the Act. The Committee takes no position as to whether existing arbitration procedures are unfair or whether any additional due process or disclosure requirements are generally necessary or desirable. However, the measures outlined below could address any due process or disclosure issues and burden the federal courts less than would passage of the Arbitration Fairness Act.

1. Voluntary Implementation of Due Process Safeguards

Notably, some of the arbitration services have implemented procedural safeguards to

[9] Michael H. LeRoy, "Misguided Fairness? Regulating Arbitration by Statute: Empirical Evidence of Declining Award Finality at ii (Berkley Electronic Press, Fall 2007)(http://works.bepress.com/michael_leroy/4/).

protect claimants. For employment arbitration, the AAA, which covers arbitrations for companies employing more than three million workers, has implemented a set of due process guidelines, including guidelines on discovery, arbitration hearings, arbitrator competence and impartiality.[10],[11]

2. The Fair Arbitration Act of 2007

On April 17, 2007, Sen. Jeff Sessions of Alabama introduced S. 1135, the Fair Arbitration Act of 2007, which would provide greater due process protections in arbitrations than are currently mandated. The Fair Arbitration Act would require:

- disclosure of an arbitration clause in large, bold print that explicitly states whether arbitration is mandatory or optional;
- identification of a source that a consumer or employee can contact for information regarding the costs and fees of the arbitration and forms and procedures necessary for participation in the program;
- arbitrators to be members in good standing of the bar of the state where the hearing is held and to comply with the Code of Ethics for Arbitrators in Commercial Disputes of the American Bar Association and the American Arbitration Association, as well as any applicable code of ethics of any bar of which the arbitrator is a member;
- arbitrators to be neutral and selected equally by all parties;
- arbitrators to render a decision and award based on the substantive law of the state in which the party who was the non-drafter of the agreement resides;
- availability of representation by an attorney or other agent of the party;
- reasonable pre-hearing discovery;
- arbitrators to conduct a fair hearing on the record within 90 days of the answer, with notice and an opportunity be heard, including the right to cross examination; and
- arbitrators to render a written decision within 30 days after the hearing.

[1010] http://www.ilr.cornell.edu/alliaiice/resources/Guide/guide **employment arbs.html**

[11] The Supreme Court has recently held that the FAA's statutory grounds for judicial review constitutes the exclusive standard for judicial review when the parties take the FAA shortcut to confirm, vacate or modify an award. ***See Hall Street Associates, L.L.C.*** v. ***Mattel, Inc.,*** 128 S. Ct. 1396 (2008).

In the Committee's view, if it is believed that pre-dispute arbitration clauses covering employees and consumers are coercive, the Fair Arbitration Act of 2007 and the voluntary safeguards already adopted by arbitration services, such as AAA, provide a practical mechanism to protect employee and consumer rights, without the burden on the federal courts that would be imposed by the Arbitration Fairness Act.

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