

THE ARBITRATION FAIRNESS ACT:  
UNINTENDED CONSEQUENCES THREATEN U.S. BUSINESS

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*“Don’t throw the baby out with the bathwater”*  
–Thomas Murner, *Die Narrenbeschwörung* (1512)

Various proposed bills to amend the Federal Arbitration Act are gaining support in Congress. The bills’ proponents do not intend the bills to interfere with international arbitration, but the amendments do not distinguish between domestic and international disputes. The bills would have the unintended consequence of severely reducing the efficacy of arbitration as a dispute resolution mechanism for international disputes and inflicting significant damage on U.S. business interests.

I. INTRODUCTION

The most prominent of the bills introduced in the U.S. Congress is the Arbitration Fairness Act of 2007 (the “Arbitration Act” or the “Act”), introduced in the 110th Congress in the House and the Senate and reintroduced at the time of this writing in the House of Representatives.<sup>1</sup> While other bills target specific industry sectors such as long-term care facilities, livestock and poultry growers, and automobile sales, the Arbitration Act focuses on categories of persons whose contracts often contain arbitration clauses. The proposed Act provides that no pre-dispute arbitration agreements shall be valid or enforceable with respect to consumer, employment or franchise disputes. It further provides that pre-dispute arbitration agreements are void if they concern disputes arising under civil rights statutes and statutes intended to regulate contracts between parties of unequal bargaining power.<sup>2</sup>

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<sup>1</sup> This article addresses the Arbitration Fairness Act as introduced in the 110th Congress, H.R. 3010 and S.1782, since similar legislation is likely to be reintroduced in the Senate and certain provisions which were deleted in the House of Representatives current bill may appear in the Senate version or be inserted in the course of the legislative process.

<sup>2</sup> The Arbitration Fairness Act of 2009, H.R. 1020, as introduced in the House in the 111th Congress, deleted the reference to “statutes intended to regulate contracts between

The proposed Act also overrules Supreme Court precedents with respect to the established doctrines of “competence-competence” and “separability,” which concern whether and when the arbitrators themselves or the courts have the authority to make decisions with respect to challenges to the authority of the arbitrators. These principles are fundamental to international arbitration, are incorporated into many international contracts, and are included in the arbitration statutes of major trading nations and the rules of the leading international arbitration institutions.

As drafted, the Arbitration Act would apply equally to domestic and international arbitration. Congressional concerns about the fairness of arbitration to individuals may lead to the abrogation by Congress of contractual terms that reflect international arbitration norms and cause disruption to U.S. business-to-business arrangements. This paper will review the proposed amendments of the Federal Arbitration Act (“FAA”), their impact on international arbitration in the United States and the effect on U.S. companies. Section II will review the U.S. legislation and Supreme Court decisions which form the basic legal predicate for international arbitration in the United States. Section III will report on why arbitration is the preferred method for dispute resolution in international matters. Section IV will describe the U.S. role in international arbitration. Section V will outline and discuss the proposed amendments to the FAA as they relate to consumers, employees and franchises, as well as the vaguely defined statutory claims. Section VI will consider the proposed amendments to the FAA as they relate to competence-competence and separability. Section VII will review the consequences of the Act’s substantive and procedural changes. Section VIII will raise questions as to whether the proposed amendments to the FAA implicate any treaty violations by the United States. Section IX will consider whether the time has come for the enactment of a separate full-fledged federal international arbitration statute and suggest other legislative solutions to minimize unintended consequences.

## II. A BRIEF REVIEW OF THE LEGAL FOUNDATION GOVERNING INTERNATIONAL ARBITRATION IN THE UNITED STATES

Arbitration has been recognized and institutionalized in a series of Congressional enactments in the United States. Following a period of court resistance to arbitration in the United States, the New York Arbitration Statute, which was enacted in 1920, established arbitration as a viable alternative. The New York statute became the model for the FAA, which was enacted in 1925 in order to “enable businessmen to settle their disputes expeditiously and economically.”<sup>3</sup> The FAA placed arbitration agreements upon the same terms as

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parties of unequal bargaining power” but, as noted *supra* in note 1, this article will address the version of the bill in the 110th Congress for the reasons stated.

<sup>3</sup> Hearings on S. 4213 and S. 4214 before the Subcommittee of the Senate Committee on the Judiciary, 67th Cong., 4th Sess., at 14 (1923) (ABA Report). At that time, the Federal Arbitration Act [hereinafter the FAA] consisted of only one chapter, the “domestic” FAA, 9 U.S.C. §§ 1-16, enacted in 1925 and applicable to agreements and

other contracts and reversed years of judicial hostility to arbitration. By its terms the FAA provides for extremely limited judicial review of arbitration awards. Interpreting the FAA, the Supreme Court has repeatedly reiterated that under the FAA there is a strong federal policy favoring arbitration and broadly defined “a transaction involving commerce,” a statutory term for triggering application of the FAA, so that the FAA largely preempts state law provisions relating to arbitration.

International commerce was developing and a need emerged to accommodate the requirements of cross-border commerce. The International Chamber of Commerce (“ICC”) recognized that “in the interest of developing international trade, it [was] important to further means to obtain the enforcement in one country of arbitral awards rendered in another country in settlement of commercial disputes.”<sup>4</sup> From the beginning, the ICC “had recognized that one of the barriers to the development of trade had been the complexity and variety of national legal systems and it had therefore endeavored to aid businessmen in their efforts to find means of settling their disputes quickly, simply and privately.”<sup>5</sup> In this respect, international arbitration provided “modern international trade with the flexibility and the rapidity it needed.”<sup>6</sup>

To meet these needs of the international business community, in 1958 the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards<sup>7</sup> (the “New York Convention” or the “Convention”) was adopted and entered into force in 1959. A corresponding purpose of the Convention was to promote trade, in particular between countries belonging to different economic and social systems. The New York Convention provides for the enforcement of arbitration agreements and arbitral awards subject only to very restricted and defined defenses related to procedural fairness and public policy. Currently, 142 countries are party to the New York Convention.<sup>8</sup>

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awards affecting interstate or foreign commerce. U.S. FAA, Ch. 392, § 1, 62 Stat. 669 (1947) (as codified at 9 U.S.C. §§ 1-16).

<sup>4</sup> U.N. Econ. & Soc. Council [ECOSOC], Committee on the Enforcement of International Arbitration Awards, *Report of the Committee on the Enforcement of International Arbitral Awards*, ¶ 12, U.N. Doc. E/AC42.4/4/Rev.1 (Mar. 28, 1955), available at <http://www.uncitral.org/pdf/english/travaux/arbitration/NY-conv/e-ac/eac424r1-N5508097.pdf>.

<sup>5</sup> Conference on International Commercial Arbitration, May 21, 1958, *Summary Records of the Third Meeting*, at 4, U.N. Doc. E/CONF.26/SR.3 (Sept. 12, 1958), available at <http://www.uncitral.org/pdf/english/travaux/arbitration/NY-conv/e-conf-26-sr/3-N5814342.pdf>.

<sup>6</sup> Conference on International Commercial Arbitration, May 21, 1958, *Summary Records of the Second Meeting*, at 9, U.N. Doc. E/CONF.26/SR2 (Sept. 12, 1958), available at <http://www.uncitral.org/pdf/english/travaux/arbitration/NY-CONV/e-conf-26-sr/s-N5814339.pdf>.

<sup>7</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38.

<sup>8</sup> See [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html).

As the necessities of international commerce became apparent, 12 years after the adoption of the Convention by other nations, in 1970, the United States ratified the New York Convention. Congress adopted implementing legislation as Chapter 2 of the FAA, which applies to awards and agreements falling under the New York Convention.<sup>9</sup> Congress's objective was to facilitate the development of a stable and effective system of international commercial dispute resolution, on which U.S. companies expanding into global markets could rely, in order to promote international trade and investment.<sup>10</sup> Chapter 1 of the FAA applies to both domestic and international arbitrations to the extent not in conflict with Chapter 2 or the New York Convention. Chapter 2 provides, *inter alia*, that foreign arbitral awards are to be confirmed unless the court finds one of the grounds for refusal or deferral of recognition or enforcement specified in the New York Convention. In 1990 the United States ratified the Inter-American Convention on International Commercial Arbitration<sup>11</sup> (the "Panama Convention"), a convention that parallels the New York Convention, which was implemented by Congress through Chapter 3 of the FAA.<sup>12</sup> Currently, 19 countries are members of the Panama Convention.<sup>13</sup>

In 1966, the importance of international arbitration to the conduct of international trade and investment was reaffirmed by the U.S. ratification of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States<sup>14</sup> (the "ICSID Convention"). The ICSID Convention created an innovative and novel mechanism pursuant to which investors can assert direct claims for breach of treaty or contract rights against host states through neutral international arbitration.<sup>15</sup> Under the ICSID Convention, contracting states agree in advance – through investment treaties and investment agreements – to arbitrate disputes brought by an investor of another contracting state concerning alleged violations of investment protections. The mission of ICSID is to foster the rule of law thereby increasing legal security and promoting investment in member countries and stimulating economic growth. To date, the ICSID Convention has been ratified by 143 countries.<sup>16</sup>

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<sup>9</sup> 9 U.S.C. §§ 201-208.

<sup>10</sup> *Foreign Arbitral Awards*, S. Rep. No. 91-702, 91st Cong., 2d Sess. 1-2 (1970).

<sup>11</sup> Text at <http://www.oas.org/juridicio/english/treaties/b-35.html>.

<sup>12</sup> 9 U.S.C. §§ 301-307.

<sup>13</sup> See <http://www.oas.org/juridicio/english/sigs/b-35.html>.

<sup>14</sup> Convention on the Settlement of Disputes between States and Nationals of Other States [hereinafter Convention or ICSID Convention], Mar. 18, 1965, 17 U.S.T. 1270, 575 U.N.T.S. 159.

<sup>15</sup> The International Centre for Settlement of Investment Disputes (ICSID), an institution of the World Bank group, was created by the ICSID Convention as an impartial international forum providing facilities for the resolution of legal disputes between eligible parties, through conciliation or arbitration procedures.

<sup>16</sup> See [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&%20pageName=MemberStates\\_Home](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&%20pageName=MemberStates_Home).

Not only has Congress by these successive legislative acts acknowledged the importance of international arbitration but its importance has been repeatedly recognized by the Supreme Court. In light of the changing face of commerce and the increase in cross-border transactions, the Supreme Court in *Bremen v. Zapata Off-Shore Company*,<sup>17</sup> rejected a U.S.-centered approach:

For at least two decades we have witnessed an expansion of overseas commercial activities by business enterprises based in the United States. The barrier of distance that once tended to confine a business concern to a modest territory no longer does so . . . The expansion of American business and industry will hardly be encouraged if notwithstanding solemn contracts, we insist on a parochial concept that all disputes must be resolved under our laws and in our courts.<sup>18</sup>

The Court noted that “agreeing in advance on a forum acceptable to both parties is an indispensable element in international trade, commerce and contracting.”<sup>19</sup>

Following *Bremen*, and voicing identical concerns, the Supreme Court in *Scherk v. Alberto-Culver Company*,<sup>20</sup> again emphasized the importance of arbitration to international commerce:

A contractual provision specifying in advance the forum in which disputes shall be litigated and the law to be applied is . . . an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction. Furthermore such a provision obviates the danger that a dispute under the agreement might be submitted to a forum hostile to the interests of one of the parties or unfamiliar with the problem area involved.

A parochial refusal by the courts of one country to enforce an arbitration agreement would not only frustrate these purposes, but would invite unseemly and mutually destructive jockeying by the parties to secure tactical advantages. The dicey atmosphere of such a legal no-man’s land would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international commercial agreements.<sup>21</sup>

The court found that “an agreement to arbitrate before a specified tribunal [is] in effect a specialized kind of forum selection clause that posits not only the situs of suit but also the procedure to be used in resolving the dispute.”<sup>22</sup>

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<sup>17</sup> 407 U.S. 1, 8-9 (1972).

<sup>18</sup> *Id.* at 8-9.

<sup>19</sup> *Id.* at 13-14.

<sup>20</sup> 417 U.S. 506 (1974).

<sup>21</sup> *Id.* at 516-517.

<sup>22</sup> *Id.* at 519; *accord* *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth*, 473 U.S. 614, 629, 631 (1985).

### III. ARBITRATION IS THE PREFERRED DISPUTE RESOLUTION MECHANISM FOR INTERNATIONAL COMMERCE

The facilitation of international arbitration through the conventions ratified by the United States, the legislation enacted by Congress and the cases handed down by the Supreme Court has served the needs of cross-border commerce. Access to the neutral forum made available through arbitration is essential in the international context. The ability to enforce awards globally pursuant to the New York Convention is an equally critical attribute of the process.

Conclusions reached in a recent survey on international arbitration released by PricewaterhouseCoopers<sup>23</sup> reflect the marketplace:

- International arbitration remains companies' preferred dispute resolution mechanism for cross-border disputes
- International arbitration is effective in practice
- When international arbitration cases proceed to enforcement, the process usually works effectively.

Corporations involved in business-to-business disputes are the main users of international arbitration. Arbitration is utilized over a wide range of sectors with frequent users including businesses in aviation and transport, banking and financial services, commodities, construction and engineering, insurance and reinsurance, maritime, oil and gas, telecommunications and utilities, all businesses with significant cross-border involvement.<sup>24</sup> Most of the disputes involving corporations arose from commercial transactions (38%), followed by construction disputes (14%), shipping disputes (9%), intellectual property disputes (6%), and insurance disputes (5%).<sup>25</sup> Many high stakes international disputes are handled in international arbitration, with one commentator reporting over 200 arbitrations, each valued at over \$100 million in 2007. Half of these were in the emerging area of investor/state disputes.<sup>26</sup> Eighty-six percent of the corporate counsel participating in the study said they were satisfied with international arbitration.

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<sup>23</sup> PricewaterhouseCoopers, *International Arbitration: Corporate Attitudes and Practices 2008* [hereinafter PWC Survey 2008].

<sup>24</sup> Report of the International Financial Services in London, *International Dispute Resolution in London 2008*, at 6-7, available at <http://www.ifsl.org.uk/output/ReportItem.aspx?NewsID=95>.

<sup>25</sup> PWC Survey 2008, *supra* note 23.

<sup>26</sup> Michael Goldhaber, *Houston We have Arbitration*, and *Arbitration Scorecard 2007*, AMERICAN LAWYER, June 13, 2007 available at <http://www.law.com/jsp/article.jsp?id=900005555704>. The number is undoubtedly considerably higher as arbitrations are generally confidential and can be pursued in multiple fora or in an *ad hoc* proceeding with no administering body. Accordingly, the reporter's ability to ascertain the number of such arbitrations must have been severely limited.

Ninety-five percent of corporations expect to continue using arbitration, and a rise in arbitration cases is projected. In-house counsel appear confident that arbitration law and practice will generate the solutions required to meet future challenges.<sup>27</sup>

It is the many benefits of arbitration in the context of international transactions that has led to the widespread use of the process for dispute resolution. Without international arbitration as an option, parties would find themselves at the mercy of foreign courts, in a setting where the law, procedures and language are unfamiliar, the process may be greatly delayed and, in some cases, before courts that may be biased. Moreover, decisions by courts are not easily enforceable in other countries. International arbitration provides solutions to these problems and offers other benefits:

- *Neutrality*: International arbitration provides a neutral forum for dispute resolution, enables the parties to select decision makers of neutral nationalities detached from the parties or their respective home-state governments and courts in a setting in which bias is avoided and the rule of law is observed.
- *Enforceability*: The existence and effective operation of the New York Convention facilitates the enforceability of international arbitration agreements and awards across borders. In contrast, judgments of national courts are much more difficult to enforce abroad.<sup>28</sup>
- *Flexible Process*: As arbitration is a creature of contract, the parties can design the process so as to harmonize cross-border cultural and legal differences and accommodate the needs of the parties.
- *Expertise*: International arbitration permits the parties to choose adjudicators with the necessary expertise to decide complex transnational issues which often require sensitivity to and familiarity with cultural differences, language skills, knowledge of different legal systems and industry-specific expertise.
- *Finality*: Judicial review of awards is restricted to a few issues primarily related to the fundamental issues of procedural fairness, jurisdiction, and public policy. The finality of awards is important to international business. In many instances, the most important consideration is that a dispute be

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<sup>27</sup> PricewaterhouseCoopers, International Arbitration: Corporate Attitudes and Practices 2006, Survey authored by Loukas Mistelis, *International Arbitration-Corporate Attitudes and Practices – 12 Perceptions Tested: Myths, Data, and Analysis*, 15 AM. REV. INT'L ARB. 525, 548-49 (2004) [hereinafter Mistelis, *Survey* 2006].

<sup>28</sup> The new Hague Convention on Choice of Court Agreements, June, 30, 2005, 44 I.L.M. 1294, which provides for enforcement of court judgments by signatories, may change that, but it is a very young treaty.

decided. Given the time value of money, the cost of capital, and the paralysis that indecision can bring to businesses, having a dispute linger is highly undesirable in many circumstances.

- *Efficiency*: International arbitration can be an efficient means of resolving disputes. In that respect, international arbitration provides for simpler procedural and evidentiary rules than ordinary litigation (e.g., less discovery, limited motion practice, and narrower grounds for appeal) and can be utilized by the parties to craft a streamlined procedure.
- *Confidentiality*: Arbitral hearings, as opposed to court trials, are generally private and confidentiality can be agreed to by the parties, which makes arbitration more appropriate for the resolution of many disputes. This is an important feature for many corporations, particularly when dealing with such issues as intellectual property and trade secrets.
- *Less Adversarial Setting*: Arbitration also enables parties, many of whom have ongoing relationships, to resolve their disputes in a less adversarial setting.<sup>29</sup>

The enduring popularity of international arbitration as a means of dispute resolution is reflected by a steadily increasing caseload at leading arbitral institutions.<sup>30</sup>

#### IV. THE U.S. ROLE IN INTERNATIONAL ARBITRATION

U.S. entities are major participants in international arbitration. The number of U.S. companies involved in international arbitrations administered by the ICC has increased significantly over recent decades.<sup>31</sup> U.S. arbitration institutions and professionals are among the leaders in the international arbitration field and are often engaged by parties from many nations due to their expertise. Reports show that the American Arbitration Association is the institution most frequently used for international arbitration with 3,047 administered international cases.<sup>32</sup> Major international law firms based in the U.S. are also frequently employed to represent parties in international arbitration.

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<sup>29</sup> The top reasons for selecting arbitration reported by survey responders was flexibility of procedure, the enforceability of awards, the privacy afforded by the process and the ability of parties to select the arbitrators. Mistelis, *Survey 2006*, *supra* note 27.

<sup>30</sup> CHRISTOPHER DRAHOZAL & RICHARD NAIMARK, TOWARDS A SCIENCE OF INTERNATIONAL ARBITRATION: COLLECTED EMPIRICAL RESEARCH, App. 1 (2005).

<sup>31</sup> Christopher Drahozal, *New Experiences of International Arbitration in the United States*, 54 AM. J. COMP. L. 233, 243-45 (Fall 2006).

<sup>32</sup> PWC Survey 2008, *supra* note 23.

The United States has been one of the four leading choices for the place or “seat” of arbitration, along with England, France and Switzerland.<sup>33</sup> The selection of the seat of arbitration is of great importance in arbitration. It is the law of the seat of the arbitration that often governs substantive matters if the parties have not specified a choice of law. The law of the seat usually governs procedural matters and may dictate whether and to what extent the courts can be involved in the arbitration. The law of the seat governs the validity of an award once rendered, as enforcement may be denied if the award is set aside by competent authorities of the seat. Finally, a court may deny recognition if the arbitration agreement is void under the law where the award was made or the arbitral procedure was not in accordance with that law.

Parties are well aware of the significance of their choice of the seat of the arbitration. One of the aspects looked at by parties in assessing and selecting the neutrality of the arbitration site is whether the courts “recognize the modern principle of the arbitral panel’s jurisdiction to determine, as an initial matter, its own jurisdiction (*compétence de la compétence*).”<sup>34</sup> Corporations were reported to have recognized the significance of the choice of seat and identified national court intervention as a concern in making that selection both because of its legal consequences and because court intervention increases the time and cost of arbitration. The Mistelis Survey 2006 concluded that legal considerations attaching to the seat of arbitration are the most important reasons for the choice of the arbitration seat.<sup>35</sup>

The proposed legislation would have a marked impact on the acceptability of the United States as an arbitration-friendly jurisdiction. It would not only reverse the trend over the past years towards more frequent selection of the U.S. as a seat for arbitration and potentially reduce the retention of U.S. dispute resolution institutions and arbitration specialists, but would also make U.S. businesses less attractive as trading partners.

#### V. THE PROPOSED AMENDMENTS TO THE FAA: CONSUMERS, EMPLOYEES, FRANCHISES AND STATUTORY CLAIMS

While a series of arbitration acts have been introduced in Congress, this article addresses only the two leading bills.<sup>36</sup> The Arbitration Act<sup>37</sup> which we deal with in

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<sup>33</sup> Mistelis, *Survey 2006*, *supra* note 27.

<sup>34</sup> W. Laurence Craig, *Some Trends and Developments in the Laws and Practice of International Commercial Arbitration*, 30 TEX. INT’L L.J. 1 (Winter 2005).

<sup>35</sup> Mistelis, *Survey 2006*, *supra* note 27, at 568.

<sup>36</sup> Other bills are equally problematic but have not yet gathered as many supporters as the two bills selected for discussion. For example, the Sessions Bill, S. 1135, 110th Cong. (2007), would, *inter alia*, ban *ad hoc* arbitration, require that the arbitrator be a member of the bar of the court in the U.S. where the hearing is conducted and require that depositions be available, all features which conflict directly with international arbitration practice.

<sup>37</sup> H.R. 3010 and S. 1782, introduced in the 110<sup>th</sup> Congress (sometimes referred to as the Feingold bill).

this section, seeks to amend Chapter 1 of the FAA and has garnered several prominent senators and over 100 representatives as co-sponsors in the 110th Congress. Both the House and the Senate versions of the Arbitration Act provide in relevant part the following amendment at § 2:

- (b) No predispute arbitration agreement shall be valid or enforceable if it requires arbitration of
  - (1) an employment, consumer, or franchise dispute; or
  - (2) a dispute arising under any statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power.<sup>38</sup>

This bill, which applies equally to domestic and international arbitrations, would void arbitration agreements in a broad range of business disputes.<sup>39</sup> The vague statutory language of the Arbitration Act does not even permit the scope of the Act's impact to be determined with precision.

The Committee on the Federal Courts of the New York County Lawyers' Association reviewed the sweeping potential impacts of the Act and noted that it significantly reduces the number of cases committed to arbitration and increases the caseload in the courts:<sup>40</sup>

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.

Arbitration currently handles a very significant number of the disputes in this country. For example, the American Arbitration Association, one of several dispute resolution institutions, reported that it handled approximately 65,000 arbitrations in 2008.<sup>41</sup> By comparison approximately 250,000 new cases are filed each year in the federal courts.<sup>42</sup> The Arbitration Act would void pre-dispute arbitration agreements in significant areas and shift these disputes to the courts; this would result in a marked increase in the flow to the courts of a great many

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<sup>38</sup> See *supra* note 2. The discussion here reviews the legislation as introduced in the 110th Congress for the reasons stated.

<sup>39</sup> For a general discussion of the bills proposed and their ramifications, see Mark Kantor, *Legislative Proposals Could Significantly Alter Arbitration in the United States*, 74 ARBITRATION 444-52 (2008).

<sup>40</sup> Committee on the Federal Courts of the New York County Lawyers' Association, *Report on the Proposed Arbitration Fairness Act of 2007* [hereinafter *Federal Courts Report*] at 4 (April 15, 2008), available at <http://www.nycla.org>.

<sup>41</sup> E-mail from the American Arbitration Association, on file with the author.

<sup>42</sup> See <http://www.uscourts.gov/jadbus2007/tables/s07sep07.pdf>.

claims including the very numerous consumer, employment, civil rights and securities claims.<sup>43</sup> Such major changes in the distribution of dispute resolution remedies between the courts and arbitration should not be lightly undertaken.

#### A. *Consumer and Employment*

The outcry over binding pre-dispute arbitration clauses in consumer contracts by those who oppose them created the impetus for the current arbitration activity in Congress. There has been a lengthy and vigorous discussion of the appropriateness of pre-dispute arbitration clauses in consumer transactions in the scholarly literature and in the courts. Some have taken the position that such clauses must be invalidated by legislation because these contracts of adhesion deprive consumers of their right to a day in court and place them in a forum prejudiced against them.<sup>44</sup> Others have suggested that the courts are capably handling the task of screening out unfair contracts as unconscionable<sup>45</sup> and that absent an arbitration option consumers would in fact have considerably less rather than more access to justice.<sup>46</sup> Yet others suggest that if there is a problem, it can be remedied by enacting procedural safeguards for consumers in arbitration.<sup>47</sup> However, many agree that there have been abuses of the arbitration process and that some remedy, whether legislative or judicial, would be appropriate.

As this paper is focused on the international aspects of arbitration, it does not address the relative merits of a legislative versus a judicial remedy, or the wisdom of enacting legislation that voids domestic consumer or employment pre-dispute

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<sup>43</sup> Peter Rutledge, *Who Can Be Against Fairness? The Case Against the Arbitration Fairness Act*, 9 CARDOZO J. CONFL. RESOL. 267, 269 (2008) (noting that securities claims were intended to be covered by the Act). The voiding of arbitration agreements for consumer securities claims could cause the courts to absorb the additional 6,000 cases per year handled by FINRA alone, according to the *Federal Courts Report*, *supra* note 40.

<sup>44</sup> See, e.g., Jean R. Sternlight, *Is the U.S. out on a Limb? Comparing the U.S. Approach to Mandatory Consumer and Employment Arbitration to that of the Rest of the World*, 56 U. MIAMI L. REV. 831 (2002); Mark E. Budnitz, *The High Cost of Mandatory Consumer Arbitration*, 67 LAW & CONTEMP. PROBS. 133 (2004); Paul D. Carrington, *Unconscionable Lawyers*, 19 GA. ST. U. L. REV. 361 (2003).

<sup>45</sup> The courts have in some instances found such clauses to be “unconscionable” and have declined to enforce them on that ground. See, e.g., Laura A. Kaster, *Unconscionability – Should We Revisit This Backdoor Challenge to Arbitration?*, 1(1) N.Y. DISPU. RESOL. LAW. 31 (2008); *Tillman v. Commercial Credit Loans, Inc.*, 655 S.E. 2d 362, 372-73 (N.C. 2008); *Wigginton v. Dell, Inc.*, 2008 WL 2267173 (Ill. App. 2008). See the extensive discussion of unconscionability decisions by the courts in Aaron-Andrew P. Bruhl, *The Unconscionability Game: Strategic Judging and the Evolution of Federal Arbitration Law*, 83 N.Y.U. L. REV. 1420 (2008).

<sup>46</sup> Rutledge, *supra* note 43.

<sup>47</sup> See, e.g., Michael A. Satz, *Mandatory Binding Arbitration: Our Legal History Demands Balanced Reform*, 44 IDAHO L. REV. 19 (2007). The American Arbitration Association and JAMS both have specific due process protocols for consumers. *Id.* at 56 and n. 143.

arbitration agreements, as opposed to legislation that is directed at assuring procedural fairness. This article rather reviews those questions from an international perspective. The Arbitration Act does not distinguish between domestic and international consumer transactions and employee relationships, and as drafted would apply equally to both. Extending any such invalidation of pre-dispute arbitration agreements to international transactions may well be to the detriment rather than the benefit of the consumer of goods and employees in the international marketplace.

There is a growing body of scholarship suggesting that arbitration may be the only practical remedy available for consumers who purchase goods from abroad, especially in light of the growing popularity of online, business-to-consumer transactions, for which online arbitration could be most useful.<sup>48</sup> Such a conclusion appears to be eminently sensible. For example, a U.S. consumer buying a computer product online from a nation in the Far East is simply not going to be able to pursue a claim against the supplier in a court in the Far East; nor would he or she want to do so even if the economics and convenience factors were not prohibitive for fear of an unfamiliar set of procedures, an unfamiliar language and fear that the court in the Far East might favor its own domestic corporation in assessing the claim. Similarly an employee seeking recourse against a foreign employer would likely be better off in arbitration than chasing around the world to a foreign court, even if the economics of that exercise were not prohibitive. It would appear that the better policy position would be not to extend any invalidation of pre-dispute consumer and employee arbitration agreements to international disputes.

Moreover, the Arbitration Act establishes no monetary ceiling for the arbitration agreements it voids. Thus no distinction is made between a claim by a consumer for a \$5,000 or for a \$500,000 purchase. The purchaser of a small jet plane or a high performance car is treated in the same manner as a purchaser of a computer. A well paid executive employed abroad who is party to an extensively negotiated contract is treated in the same fashion as a line employee who signs a form contract for domestic employment. If legislation is enacted with respect to consumers and employees<sup>49</sup> it should not include contracts in excess of a monetary ceiling, or contracts that are individually negotiated, at least in the context of international arrangements, so that parties in an international transaction can be assured of a neutral agreeable forum on a matter of monetary significance.

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<sup>48</sup> See, e.g., Karen Stewart & Joseph Matthews, *Online Arbitration of Cross-Border Business to Consumer Disputes*, 56 U. MIAMI L. REV. 1111 (July 2002); Catherine Rogers, *The Arrival of the Have-Nots in International Arbitration*, 8 NEV. L.J. 341 (Fall 2007). But see Donna Bates, *Consumers' Dream or Pandora's Box: Is Arbitration a Viable Option for Cross-Border Consumer Disputes?*, 27 FORDHAM INT'L L. J. 823 (2004). For statistics on the growth of online commerce, see Drahozal, *supra* note 31, at 250.

<sup>49</sup> The EU Directive implementing statutes' threshold for unfairness is generally claims of less than \$10,000. See Rogers, *supra* note 48, at 366.

The practice in other countries provides precedents for all of these approaches. Provisions affording protections to consumers and employees which impact the availability of arbitration as a remedy have been enacted in various jurisdictions around the world. For example the EU issued a directive requiring member states to provide under national law that unfair terms in consumer transactions not individually negotiated are not binding on the consumer.<sup>50</sup> In its implementing legislation the English Arbitration Act 1996 provides that an arbitration agreement with a consumer “is unfair so far as it relates to a claim for a pecuniary remedy which does not exceed the amount specified by order.” The amount specified by the requisite order is £5,000.<sup>51</sup> In some nations the limitations on consumer arbitration clauses apply across borders, as they do under English law,<sup>52</sup> while in others, as in Hong Kong, the limitations on consumer arbitration clauses are expressly stated not to apply to international disputes.<sup>53</sup>

Thus, if the Congressional policy decision is ultimately to void pre-dispute consumer arbitration clauses, there is ample precedent for limiting such action to domestic disputes and to establishing threshold dollar levels beyond which such clauses would not be void.

#### B. *Franchises*

Franchising agreements are business-to-business arrangements with respect to which extensive statutory protections at the federal and state level are already in place pursuant to the Federal Trade Commission’s Franchise Rules and state franchise laws. Many of these agreements do not reflect any inequality of bargaining power; half of the franchisor members of the International Franchise Association qualify as small businesses under U.S. federal standards.<sup>54</sup> Franchisees range from very small business owners starting a cleaning business

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<sup>50</sup> EU Directive on Unfair Terms in Consumer Contracts, Council Directive, 1993/13/EEC, 1993 O.J. (L 95) 29.

<sup>51</sup> Arbitration Act 1996, § 91; The Unfair Arbitration (specified Amount) Order (SI 1999/2167); For treatment of a consumer arbitration agreement in excess of that amount under English law, see the recent discussion in *Mylcris Builders Ltd v. Mrs. G Buck*, [2008] EWHC 2172 (TCC).

<sup>52</sup> Arbitration awards rendered pursuant to arbitration clauses with consumers may not be enforceable under the New York Convention in some countries pursuant to such countries’ reservations to the Convention limiting enforcement to differences regarded as “commercial” under national laws, as they do not consider consumer disputes to be commercial.

<sup>53</sup> See Section 15 of the Control of Exemption Clauses Ordinance (Laws of Hong Kong, Ch. 71); see also *Meglio v. Societe V2000*, Cass. 1e Civ, May 21, 1997 (in which the French court held that the domestic restrictions on arbitration of consumer claims did not apply in international matters).

<sup>54</sup> Letter from the International Franchise Association to the House of Representatives Subcommittee on Commercial and Administrative Law, Aug. 22, 2007, available at [http://www.franchise.org/uploadedFiles/Franchise\\_Industry/Government\\_Relations/Opposition%20to%20HR%203010%20letter%208.07.pdf](http://www.franchise.org/uploadedFiles/Franchise_Industry/Government_Relations/Opposition%20to%20HR%203010%20letter%208.07.pdf).

with an initial \$3,000 to \$10,000 in start-up costs, to convenience stores or fast-food franchises which would require \$50,000 to \$1 or \$2 million in start-up costs, to a hotel and resort franchise with start-up costs in the tens of millions of dollars.<sup>55</sup> The Arbitration Act does not distinguish among these various and very different franchises.

Limitations on arbitration imposed by the Arbitration Act will impact a vast sector of domestic businesses. There are 1,500 different types of franchise companies operating in the United States.<sup>56</sup> There are believed to be more than 750,000 franchise businesses in the U.S. which employ over 18 million people. In 2004, it is estimated that franchise businesses were responsible for over \$1.5 trillion in economic output. The franchise industry accounts for 40% of all retail sales in the U.S. and approximately one out of every 12 businesses in the U.S. is a franchise business.

Many of the U.S. franchise businesses are multi-national operations with dozens to hundreds of franchisees around the world. Illustrative of global franchise operations are McDonalds, Burger King, Hilton, Intercontinental, Athlete's Foot and UPS Stores.<sup>57</sup> International arbitration is essential to the franchisor's ability to ensure franchisee's performance, maintain the quality and service of the brand and to enable the franchisor to address any necessary corrective action with some measure of urgency. An inability to take such action could cause damage to the brand image and could result over time in significant loss of business to both the franchisor and the franchisee family as a whole as dissatisfied customers in one location shun the franchise's other locations.

If cross-border, pre-dispute arbitration provisions in franchise agreements are voided, the franchisors will be relegated to pursuing remedies against defaulting franchisees in domestic courts all around the world, which may be slow<sup>58</sup> and biased in favor of their own national at the expense of the franchisor, precisely the dangers intended to be avoided by the arbitration agreement. Such a result would not be advantageous for the franchisee or the franchisor. The damage to the brand could diminish the value of the franchisor's franchise and the franchisee's business and the cost of such far-flung and disparate legal proceedings would likely have to be passed on to the franchisees in the form of additional fees.

An invalidation of pre-dispute arbitration agreements in business-to-business franchise agreements does not appear to have a corollary in legal systems outside the United States and should not be grafted onto the extensive protections already afforded to franchisees under U.S. law. At the very least such a restriction should not be enacted with respect to international transactions where the prompt availability of a neutral, mutually agreed forum is of critical importance.

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<sup>55</sup> The franchise figures were taken from 2008 Franchise 500 from Entrepreneur.com, available at <http://www.entrepreneur.com/franchise500/index.html>.

<sup>56</sup> Data taken from <http://www.azfranchises.com/franchisefacts.htm>.

<sup>57</sup> Data taken from <http://www.worldfranchising.com/articles/Industry-Statistics>.

<sup>58</sup> The courts in some countries in which U.S. companies frequently invest and open franchises are known to take ten years or more until resolution of a dispute in court.

C. *Statutes Intended to Protect Civil Rights or to Regulate Contracts or Transactions between Parties of Unequal Bargaining Power*

The Arbitration Act provides no definition of what is intended by the language that voids a pre-dispute arbitration agreement if it “requires arbitration of a dispute arising under a statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power.” First there is no definition of “parties with unequal bargaining power.”<sup>59</sup> In virtually every transaction one party can be argued to have greater power. One party may have access to a needed resource with limited availability in the market. One party may be a bigger company with greater ability to walk away from the deal. One party may have numerous interested customers while the other party desperately needs the goods. One could argue that a negotiated arbitration clause between sophisticated parties such as the government of Russia and Exxon Mobil Corporation may be invalid because the parties are of unequal bargaining power. The scenarios in which bargaining power is unequal are without limit and the enactment of such vague statutory language would lead to endless litigation over the meaning of the amendment and this undefined and imprecise language.

Second, there are a great many statutes that may be argued to fall within the broad language of the Act. The Arbitration Act would seem to encompass both federal law<sup>60</sup> and state law. Indeed, the statutory language would seem to permit the voiding of arbitration agreements if claims are made under foreign law as well. The Federal Courts Committee of the New York County Lawyers Association identified as potentially falling within this rubric “securities, antitrust, ERISA, certain parts of the Uniform Commercial Code, bankruptcy law, certain parts of admiralty and maritime law, governmental contracts, intellectual property and a host of others...[I]t could arguably apply to any statutory dispute between the government and any private litigant.”<sup>61</sup> Voiding arbitration in disputes based on some of these statutes would overrule established Supreme Court precedents which have expressly dealt, *inter alia*, with the availability of arbitration for securities, employment and antitrust claims.

A good example of the Pandora’s box that legislation directed at parties of unequal bargaining power could open are the potential claims that could be brought under the many state consumer protection acts which generally declare to be unlawful deceptive acts or practices in the conduct of any business, trade or commerce or in the furnishing of any service in the state. While numerous court decisions have appropriately limited the application of such statutes to true consumer cases, the phrasing of the law often causes parties to invoke it in commercial contract disputes.<sup>62</sup>

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<sup>59</sup> See *supra* note 2.

<sup>60</sup> The Congressional Research Service Report to Congress, *Federal Civil Rights Statutes: A Primer* (2008) identifies 15 federal statutes alone.

<sup>61</sup> *Federal Courts Report*, *supra* note 40.

<sup>62</sup> See, e.g., *3M Company v. Amtex Security*, 542 F.3d 1193 (8th Cir. 2008) (claim raised under the South Carolina Unfair Trade Practices Act).

Nor are the statutes intended to be covered by the provision for “statutes intended to protect civil rights” specified. This language would appear to include a great many statutes that govern disputes by both individuals and organizations all of whom are within the scope of the protection of such statutes. The 2008 Congressional Research Service Report to Congress, *Federal Civil Rights Statutes: A Primer*, states that there is an “array of civil rights statutes” under both federal and state law. Civil rights have been said to include all rights protected by the U.S. Constitution and the right to obtain other benefits set out by federal or state law. Thus the scope of this provision’s applicability would appear to be essentially without limit. It would also seem to encompass trade and investment treaties entered into by the United States, which generally provide for arbitration as the dispute resolution mechanism and contain anti-discrimination clauses. Indeed, the designation of “statutes intended to protect civil rights” is so broad as to apparently allow foreign statutes to fall within its purview. The constitutions of foreign jurisdictions provide for many rights. For example Chile’s rights include the “right” stated in Chapter III of its Constitution §25 to protection of one’s intellectual property and the “right” in §8 to freedom from environmental contamination; Peru provides for “rights” stated in Chapter I of its Constitution §7 to one’s honor and good name and one’s own voice and image and the “right” in §6 that information services not release information affecting one’s privacy. In addition, the protections accorded under the European Convention on Human Rights and Fundamental Freedoms, which is increasingly being invoked in commercial cases by corporations, may be persuasively argued to fall within the language of the Arbitration Act.

Under the Arbitration Act, merely claiming under any of these provisions could void the arbitration clause, as the case as pleaded would “require arbitration of . . . a dispute arising under a statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power.” Thus, the Arbitration Fairness Act would require the courts to decide legions of cases seeking statutory interpretations as parties claim that the arbitration clause was void because the claim asserted is brought pursuant to such a covered statute. Again, there is no internationally accepted corollary for excluding such cases from binding arbitration agreements.

#### VI. THE PROPOSED AMENDMENTS TO THE FAA: SEPARABILITY AND COMPETENCE-COMPETENCE

To amend § 2 of the FAA, the Arbitration Fairness Act introduced in both the Senate and the House of Representatives provides:

- (c) An issue as to whether this chapter applies to 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.

The Fairness in Nursing Home Arbitration Act of 2008<sup>63</sup> (the “Nursing Home Act”), which was approved by the judiciary committees of both houses in the fall of 2008, contains the following language in both the Senate and the House of Representatives versions of the bill:

(d) A determination as to whether this chapter applies to an arbitration agreement described in subsection (b) shall be determined by Federal law. Except as otherwise provided in this chapter, the validity or enforceability of *such an agreement* to arbitrate shall be determined by the court, rather than the arbitrator, irrespective of whether the party resisting the arbitration challenges the arbitration agreement specifically or in conjunction with other terms of the contract containing such agreement. (emphasis added)

The Nursing Home Act could be considered a subset of the Act banning the enforceability of predispute arbitration clauses in consumer matters as it pertains to individuals engaging the services of nursing homes.

Both of the bills importantly overturn long-standing Supreme Court precedents on “separability” and “competence-competence,” doctrines which “have been called the conceptual cornerstone of international arbitration as an autonomous and effective form of international dispute resolution.”<sup>64</sup>

The Arbitration Act’s language with respect to these doctrines is applicable to *all* arbitrations, not just arbitrations concerning consumers, employees, franchises and claims based on civil rights or unequal bargaining position.

#### A. *The Meaning of Competence-Competence and Separability*

The doctrines of competence-competence and separability operate together to create the framework for the division of authority between the court and the arbitrator.<sup>65</sup> The doctrine of separability means that the agreement to arbitrate is

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<sup>63</sup> H.R. 6126 and S. 2838. The Nursing Home Act of 2009, H.R. 1237 was introduced in the 111th Congress in modified form. The Nursing Home Act may be read to limit its reach to disputes relating only to nursing homes, as it states that it applies to “such an agreement.” However, addressing nursing home issues by amending the FAA may lead to much confusion in the courts as to other kinds of disputes. Further unintended consequences could result if the solutions sought in the Nursing Home Act are enacted as an amendment to Chapter One of the FAA rather than as a separate statute.

<sup>64</sup> Robert Smit, *Separability and Competence-Competence in International Arbitration: Ex Nihilo Nihil fit? Or can Something Indeed Come from Nothing?*, 13 AM. REV. INT’L ARB. 19, 19 (2002) (citations omitted).

<sup>65</sup> For an extensive discussion of these issues, see William W. Park, *Determining an Arbitrator’s Jurisdiction: Timing and Finality in American Law*, 8 NEV. L. J. 135 (2007); Smit, *supra* note 64; Alan Scott Rau, *Separability in the United States Supreme Court*, 1 STOCKHOLM INT’L ARB. REV. 1 (2006).

“separate” or “separable” from the underlying contract, such that a contract is viewed as containing two separate agreements, the agreement to arbitrate and the underlying contract. Utilizing this distinction, the invalidity of the underlying contract does not necessarily invalidate the agreement to arbitrate and does not deprive the arbitrator of authority to decide on the validity of the underlying contract. Thus, arbitrable issues are referred to the arbitrator by the court if it is the underlying contract rather than the agreement to arbitrate that is challenged and the arbitrator has the authority to determine the validity of the underlying contract even if a challenge to that contract is asserted. Pursuant to this doctrine, the arbitrator’s award cannot be vacated for lack of authority on the ground that the arbitrator found that the underlying contract was invalid where no such finding is applicable to the arbitration agreement itself.<sup>66</sup>

Competence-competence is the principle pursuant to which a determination is made as to how the authority to decide challenges to arbitral jurisdiction is allocated between the court and the arbitrator. This allocation determines both the (1) question of timing, which dictates who rules first on the arbitrators’ jurisdiction (*i.e.*, whether the court determines it on a motion to stay or compel arbitration or upon review of the award on a petition to vacate or confirm the award); and (2) what standard of review is to be given to the arbitrators’ ruling on challenges to their jurisdiction. Under established U.S. principles of competence-competence, arbitrators have jurisdiction to decide challenges to their own authority first, and need not halt each time a party raises a question as to the arbitrator’s authority. It has always been accepted that unless and until a court stays the arbitration, the arbitrator may proceed with the arbitration, even in the face of a challenge to his or her authority.<sup>67</sup>

The doctrine of separability was enunciated by the Supreme Court 40 years ago in *Prima Paint v. Flood & Conklin Mfg. Co.*<sup>68</sup> The court held that questions as to the validity of the main contract were for the arbitrator and courts only determine challenges to the arbitration clause itself, which go to the making of the agreement to arbitrate. Such a distinction and allocation of powers was deemed necessary to effectuate the parties’ intention and serve the objectives of the FAA that parties be allowed to proceed in arbitration in accordance with their agreement in a speedy manner “and not subject to delay and obstruction by the courts.”<sup>69</sup>

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<sup>66</sup> In many other countries and under many arbitration institutional rules, as will be discussed below, the arbitrator also has the power to rule on the validity of the arbitration agreement itself, something reserved under U.S. case law to be determined based on the intention of the parties.

<sup>67</sup> William W. Park, *Procedural Evolution in Business Arbitration: Three Studies in Change*, in WILLIAM W. PARK, *ARBITRATION OF INTERNATIONAL BUSINESS DISPUTES, STUDIES IN LAW AND PRACTICE* 3 (2006).

<sup>68</sup> 388 U.S. 395 (1967).

<sup>69</sup> *Id.* at 404.

Amplifying the division of authority between the arbitrator and the court, in *First Options of Chicago v. Kaplan*,<sup>70</sup> the Supreme Court stated that who should decide whether the parties agreed to arbitrate, the court or the arbitrator, depends on the agreement of the parties. That decision can also be made by the arbitrator if the parties so provide.<sup>71</sup> Forty years after *Prima Paint*, in *Buckeye Check Cashing v. Cardegna*,<sup>72</sup> the Supreme Court reaffirmed *Prima Paint*'s holding and held that a challenge to the validity of the whole contract is for the arbitrator to decide, not only where a contract is claimed to be voidable, but also if it is claimed to be void.

Case examples can be useful to illustrate these doctrines. In *Prima Paint*, the plaintiff was the purchaser of a business and was to be provided with advice and consultation services by the defendant seller of the business. Plaintiff sought to rescind the contract claiming that it was fraudulently induced to enter into the purchase based on defendant's representation that it was solvent and would be able to perform its contractual obligations, whereas it was in fact insolvent, unable to perform such services and intended to file for bankruptcy. The court squarely addressed the question of who should decide the question posed on these facts of fraud in the inducement of the entire contract, the arbitrator or the court. The court held that the question was for the arbitrator and that the courts were limited to reviewing challenges to the arbitration agreement itself.

Conversely, in *Engalla v. Permanente*,<sup>73</sup> plaintiff claimed he was fraudulently induced to enter into the arbitration agreement by defendant, which had misrepresented the arbitration process by not disclosing that the defendant itself designed and administered its arbitration program, and had misrepresented the speed of its arbitration program.<sup>74</sup> He further claimed that the defendant had caused him injury by its dilatory conduct in the arbitration, which was contrary to its pre-agreement representations of expedition in the arbitration. The Supreme Court of California, applying California law, which paralleled the jurisprudence under the FAA, reversed the Court of Appeals and remanded the matter for a factual determination, holding that since the challenge was to the arbitration agreement itself, the matter was for the court to decide not the arbitrator.

An effort to crystallize these legal principles can be found in the Revised Uniform Arbitration Act ("RUAA"), which was finalized by the U.S. National Conference of Commissioners on Uniform State Laws ("NCCUSL") in 2000. The RUAA has been adopted as of this date in 12 states<sup>75</sup> and has been introduced in

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<sup>70</sup> 514 U.S. 938 (1995).

<sup>71</sup> See, e.g., *Shaw Group Inc. v. Triplefine Int'l Corp.*, 322 F.3d 115 (2d Cir. 2003) (holding that reference to institutional rules in the contract evidenced the parties' intention to have the arbitrators decide arbitrability).

<sup>72</sup> 546 U.S. 440 (2006).

<sup>73</sup> 938 P.2d 903 (Cal. 1997).

<sup>74</sup> Contrary to the expeditious dates set forth in the agreement for arbitration process milestones, defendant's actual experience in prior years showed that on average it had taken 674 days just for the appointment of the third neutral arbitrator. *Id.* at 913.

<sup>75</sup> Alaska, Colorado, Hawaii, Nevada, New Jersey, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Utah, and Washington have adopted the RUAA.

an additional nine states. The RUAA was intended to remove uncertainty in the use of arbitration and modernize, revise, and explain arbitration law. It is substantially more detailed than the FAA. It provides a comprehensive set of statutory rules for arbitrators and for the courts ruling in arbitration matters, rules that are intended to be consistent with, and complementary to, the more bare-bones precepts of the FAA. With respect to competence-competence and separability, the RUAA provides in Article 6:

(b) The court shall decide whether an agreement to arbitrate exists or a controversy is subject to an agreement to arbitrate; (c) An arbitrator shall decide whether a condition precedent to arbitrability has been fulfilled and whether a contract containing a valid agreement to arbitrate is enforceable.

It is important to keep in mind that these principles do not foreclose all court review for all time. Rather the doctrine makes a choice as to who should suffer the delay. To state it simply, the choice is between the party seeking to arbitrate on the basis of an arbitration clause who would like to move forward with the arbitration or the party challenging the arbitration who would like to delay it and be heard in court. When entering into the arbitration agreement the parties in a commercial transaction have a parallel and mutual interest in using arbitration and gaining its benefits. Once a dispute arises, however, the respondents in the arbitration very frequently have an interest in delay, as defendants in all disputes generally do, causing them to attempt to delay the proceedings by a detour to the courthouse if it is available. In the United States, based on the court's recognition of the arbitration agreement (or of the party's agreement to have the arbitrator decide if there was an agreement to arbitrate), the combined doctrines make a choice in favor of allowing the arbitration to go forward, with the award to be reviewed by the court at the conclusion. Because of the application of the doctrine of separability, an ultimate conclusion by the arbitrator that the underlying contract was invalid does not invalidate the award rendered by the arbitrator.

The separability doctrine is essential to give effect to the parties intent to have all disputes between them determined in arbitration. Competence-competence enables the arbitration to move forward without, as the court said in *Prima Paint*, being "subject to delay and obstruction by the courts."<sup>76</sup> With the application of these doctrines, few arbitrations actually end up in contested proceedings in court. A search on Westlaw for the year 2000 of all cases in all federal and state courts reveals only 479 decisions in which the Federal Arbitration Act is even mentioned. As compared to the approximately 65,000 arbitrations noted above handled by the American Arbitration Association alone in one year, this number is de minimis. Generally, in part because of the application of the doctrines of separability and competence-competence, arbitrations proceed through hearing, award and compliance with the award without any court involvement.

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<sup>76</sup> *Prima Paint*, 388 U.S. at 404.

Counsel for the parties are generally familiar with the law and with the arbitrator's jurisdiction to review his or her own jurisdiction and so know that an approach to court would be unavailing with respect to many of the issues they seek to raise, and perhaps even subject them to sanctions. After participating in the arbitration process and the hearing, parties generally ultimately accept the result in the award without contesting it in court and embroiling the parties in an expensive and prolonged court proceeding. Thus, the result initially intended by the arbitration provision in the contract is achieved with a decision rendered by a neutral forum of choice without court involvement.

B. *The Treatment of Competence-Competence and Separability in Laws of Other Nations and Institutional Rules*

The modern arbitration statutes of many countries codify the principles of competence-competence and separability. For example, arbitration legislation based on the UNCITRAL Model Law on International Commercial Arbitration, which has been adopted in Japan, India, Mexico, Nigeria, Russia, and over 50 other countries,<sup>77</sup> provides in Article 16:

Competence of arbitral tribunal to rule on its jurisdiction

(1) The arbitral tribunal may rule on its own jurisdiction, including any objections with respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract. A decision by the arbitral tribunal that the contract is null and void shall not entail *ipso jure* the invalidity of the arbitration clause.

The arbitration laws of three other countries, England, France and Switzerland, which are frequently selected as seats for arbitration, include similar provisions. The English Arbitration Act 1996 provides in Section 7:

Unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) shall not be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and it shall for that purpose be treated as a distinct agreement.

And in Section 30:

Unless otherwise agreed by the parties, the arbitral tribunal may rule on its own substantive jurisdiction, that is, as to (a) whether there is a valid arbitration

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<sup>77</sup> For a list of countries which have enacted legislation based on the UNCITRAL Model Law on International Commercial Arbitration see [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/1985Model\\_arbitration\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html). Several U.S. states have enacted legislation based on the UNCITRAL Model Law, including California, Connecticut, Illinois, Oregon and Texas.

agreement, (b) whether the tribunal is properly constituted, and (c) what matters have been submitted to arbitration in accordance with the arbitration agreement.<sup>78</sup>

The Swiss Private International Law Act provides in Section 178(3):

The validity of an arbitration agreement may not be contested on the grounds that the principal contract is invalid or that the arbitration agreement concerns a dispute which has not yet arisen.

And in Article 186:

The arbitral tribunal shall rule on its own jurisdiction.

The French *Nouveau Code de Procédure Civile* provides in Article 1458:

When a dispute which has been brought before an arbitral tribunal pursuant to an arbitration agreement is brought before a governmental court, the court must declare itself without jurisdiction. If the dispute has not yet been brought before the arbitral tribunal, the court must also declare itself without jurisdiction unless the arbitration agreement is clearly void.<sup>79</sup>

In parallel provisions, institutional rules for international arbitration provide for the arbitral tribunal to decide on its own jurisdiction and incorporate the principles of separability and competence-competence. Thus, Article 15 of the American Arbitration Association International Arbitration Rules provides:

1. The tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement.
2. The tribunal shall have the power to determine the existence or validity of a contract of which an arbitration clause forms a part. Such an arbitration clause shall be treated as an agreement independent of the other terms of the contract. A decision by the tribunal that the contract is null and void shall not for that reason alone render invalid the arbitration clause.

The International Chamber of Commerce (“ICC”) International Court of Arbitration Rules of Arbitration provides in Article 6(4):

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<sup>78</sup> Sections 67 and 68 of the English Arbitration Act establish the rules for challenges to arbitral awards on the basis of lack of substantive jurisdiction, serious irregularities or exceeding the tribunal’s powers.

<sup>79</sup> The French approach to these doctrines gives the greatest deference to the arbitrator. It is not urged here that the U.S. follow the French model; rather, it is argued that the U.S. should not overturn existing precedents in the fashion proposed by the Arbitration Act, which would put the U.S. at odds with essentially all other nations as it will dispense with the most basic competence of the arbitrator.

Unless otherwise agreed, the Arbitral Tribunal shall not cease to have jurisdiction by reason of any claim that the contract is null and void or allegation that it is non-existent, provided that the Arbitral Tribunal upholds the validity of the arbitration agreement. The Arbitral Tribunal shall continue to have jurisdiction to determine the respective rights of the parties and to adjudicate their claims and pleas even though the contract itself may be non-existent or null and void.

Other institutional rules contain similar provisions.<sup>80</sup>

Significantly, the ICSID Convention, to which the United States itself is a party, provides in Section 3, Article 41:

(1) The Tribunal shall be the judge of its own competence. (2) Any objection by a party to the dispute that that dispute is not within the jurisdiction of the Centre or for other reasons not within the competence of the Tribunal shall be considered by the Tribunal.

## VII. THE CONSEQUENCES OF THE ARBITRATION FAIRNESS ACT

The Arbitration Act will materially alter the legal landscape both as to the substantive nature of the disputes that can be arbitrated and the division of authority between the courts and the arbitrators. These changes will have major ramifications for international arbitration in the U.S and for U.S. businesses in the global marketplace. It “will chill parties from including arbitration clauses in any contract that could even arguably fall within the purview” of the Act and would “deter parties from arbitrating cases for fear that the Act would provide a basis to challenge the arbitration either before or after the fact.”<sup>81</sup>

### A. *Substantive Changes to U.S. Law: Void Arbitration Agreements*

If applied to all claims and disputes that arise after the date of enactment, as the Arbitration Act is now drafted,<sup>82</sup> the legislation would override and displace specific agreements and expectations contained in contracts currently in place both with respect to substantive matters and procedural matters. Such an enactment would be in direct conflict with the purpose served by the passage of

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<sup>80</sup> See, e.g., ARBITRATION RULES OF THE LONDON COURT OF INTERNATIONAL ARBITRATION, Art. 23.1; ARBITRATION RULES OF THE SINGAPORE INTERNATIONAL ARBITRATION CENTRE, Art. 25.1; SWISS RULES OF INTERNATIONAL ARBITRATION, Art. 21; ARBITRATION RULES OF THE DUBAI INTERNATIONAL ARBITRATION CENTRE, Art. 6.1; ARBITRATION RULES OF THE HONG KONG INTERNATIONAL ARBITRATION CENTRE, Art. 20; ARBITRATION RULES OF THE WORLD INTELLECTUAL PROPERTY ORGANIZATION, Art. 36.

<sup>81</sup> *Federal Courts Report*, *supra* note 40.

<sup>82</sup> The Arbitration Act provides for the “amendments to take effect on the date of enactment of the Act and shall apply with respect to any dispute or claim that arises on or after such date.” The Nursing Home Act introduced in the Senate is similarly applicable to all disputes that arise after the date of enactment, while the House version applies to contracts entered into or amended after enactment. Compare H.R. 6126 and S. 2838.

the FAA as described by the Supreme Court: “The central purpose of the FAA is to ensure that private agreements to arbitrate are enforced according to their terms.”<sup>83</sup>

Not only would contractual provisions now in effect that provide for arbitration in consumer, employment, and franchise matters be void and incapable of enforcement, but claims brought under statutes that cannot now be identified under the broad and vague language of the statute would also be void and unenforceable for all contracts governed by the law of any U.S. jurisdiction. Expectations based on existing law, pursuant to which surely many millions of contracts have been executed, would be disrupted. While there are divergent views as to whether the change in the law to be wrought by the Arbitration Act would be of benefit or harm to the classes of people it seeks to protect,<sup>84</sup> there is no question that the voiding of pre-dispute arbitration agreements in these fields would impact broad sectors of the economy.

Not only would litigation over the meaning of the terms of the Arbitration Act proliferate, but the combined application of the proposed Act voiding pre-dispute arbitration agreements in a variety of contexts, coupled with the application of the New York Convention, might leave a party with no remedy at all. To take an example, assume a franchise agreement between a U.S. company and an Indian company for a deluxe hotel franchise in India which provides that Illinois law governs and the seat of the arbitration is Chicago. Knowing that the arbitration clause is now void under the Arbitration Act pursuant to the law applicable to the contract, and that an arbitration would be barred by the court if arbitration were commenced in Chicago, the U.S. company proceeds reluctantly in an Indian court, a famously slow court system, to press its claim against the Indian company. The Indian company will not agree post-dispute to an arbitration, which is permitted

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<sup>83</sup> *Mastrobuono v. Shearson Lehman Hutton*, 514 U.S. 42, 53-54 (1995) (citations omitted).

<sup>84</sup> *Compare* Multi-Industry Letter Opposing the Onslaught of Anti-Arbitration Acts and Provisions That Have Been Introduced in this Congress, May 1, 2008, *available at* [http://www.uschamber.com/issues/letters/2008/080501\\_anti\\_arbitration.htm](http://www.uschamber.com/issues/letters/2008/080501_anti_arbitration.htm) (citing several studies demonstrating that enactment of the anti-arbitration Acts would actually “limit the realistic opportunity for an average consumer, employee and investor to obtain a remedy if a dispute arises” and that the “only real beneficiaries . . . would be class action lawyers who would benefit from the rare blockbuster claim and the possibility of bringing more class action law suits – lawsuits that provide little benefit to class members while ensuring large payouts to class action attorneys”) *with* Public Citizen Letter to Judiciary Committees, July 29, 2008, *available at* <http://www.citizen.org/congress/civjus/arbitration/articles.cfm?ID=17939> (“These arrangements [pre-dispute binding mandatory arbitration], which are increasingly common, set up a severe conflict of interest by enabling businesses to choose the arbitration firms that resolve their disputes with customers or employees . . . This evidence overwhelmingly shows that individuals fare far worse in arbitration than court. The vast majority of available data show individuals winning at lower rates, receiving lower average awards, and receiving lower median awards in arbitration.”).

under the Arbitration Act, recognizing the procedural difficulties now facing the franchisor and preferring to delay and possibly escape liability without ever facing an order from any forum requiring payment. The Indian court to which the matter is brought by the U.S. company might well throw the case out, likely after the passage of several years, holding that it must comply with the requirements of Article II of the New York Convention which requires that Contracting States recognize agreements to arbitrate and send the matter to arbitration.<sup>85</sup> The U.S. company may find itself with no remedy available to collect the millions it is owed. Indeed the U.S. company may find itself stuck with a nonpaying franchisee and no ability to terminate the franchise because there is no forum available for resolution.

B. *Procedural Changes to U.S. Law: Competence-Competence and Separability*

The precise application of competence-competence and separability varies somewhat from jurisdiction to jurisdiction. However, at a minimum, in essentially all jurisdictions, the arbitrator may proceed with the arbitration notwithstanding any jurisdictional challenges. In the words of Professor Park, “modern arbitration regimes show widespread acceptance of the principle . . . whereby arbitrators may decide challenges to their own power (at least as an initial matter) and need not halt proceedings each time a party questions their authority.”<sup>86</sup> This is consistent with current U.S. practice pursuant to which a party can ask the court under the FAA to stay the arbitration, but unless a court issues an order staying the arbitration, the arbitrator has authority to proceed with the matter before him or her and rule on jurisdiction.

Section 2(c) of the Arbitration Act would altogether eliminate this essential and elementary power of the arbitrator by overturning both competence-competence and separability.<sup>87</sup> The Arbitration Act provides that “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.” The most logical reading of this language is that the court is designated as the sole authority to determine the validity of an

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<sup>85</sup> Article II of the Convention provides that arbitration agreements must be enforced by Contracting States if they concern a “subject matter capable of settlement by arbitration.” Query: Which law is to be applied in making that determination, the law of the enforcing jurisdiction or the law governing the contract?

<sup>86</sup> Park, *Procedural Evolution in Business Arbitration: Three Studies in Change*, *supra* note 67. See also, William W. Park, *The Arbitrator’s Jurisdiction to Determine Jurisdiction*, in INTERNATIONAL ARBITRATION 2006: BACK TO BASICS, ICCA Congress Series No. 13 at 59 (Albert Jan van den Berg ed., 2006) (“[M]ost countries accept that a jurisdictional objection does not automatically stop an arbitration”). Accord, Smit, *supra* note 64, at 25 (“At a minimum, competence-competence permits arbitrators to consider challenges to their jurisdiction and to proceed with the arbitration notwithstanding those challenges”).

<sup>87</sup> The Arbitration Fairness Act of 2009, H.R. 1020, retains this language.

arbitration agreement and the arbitrator has no authority to consider his or her own authority in any arbitrations<sup>88</sup> regardless of whether the defect is alleged to be in the arbitration agreement itself or in the underlying contract. Thus the fact that no challenge is made by any party to the making of the arbitration agreement itself would be of no significance and courts would serve as gatekeepers for numerous arbitrations as defending parties sought to delay the proceedings with a side trip to the courts based on claims heretofore reserved for the arbitrator.

For example, assume an arbitration has been commenced and the defendant asserts that he should not be required to arbitrate because he was misled and fraudulently induced to enter into the underlying contract. The arbitrator would be without power to continue the arbitration and the arbitration would have to be halted while a court ruling on the issue is awaited. That ruling might require essentially a full trial on the merits since the challenge to the underlying contract would be placed before the court for review. No progress in the arbitration could be made until the conclusion of the court proceeding. Such a result is contrary to long established principles of arbitration in the U.S., at odds with the practice around the world and places before the court substantive contract issues that the parties had agreed to have decided by the arbitrator.

Dilatory tactics and strategic moves by defendants in arbitration are common just as they are in litigation and claims that a contract was the result of a misrepresentation or suffers from some other defect are now frequently asserted in arbitrations. If such claims could now be brought and litigated in court before the arbitration can proceed, one can be certain that such claims by defendants will increase greatly in number and the arbitral process will be disrupted and delayed in countless cases.

Delays serve strategically to defer payment, to put pressure on the opposing party as additional costs are incurred and recovery is stalled and may even in some cases be used to take steps to render the defendant judgment-proof. The length of the delay occasioned by such claims could be significant, as the arbitrators stop the arbitration and await prosecution of the issue in court (the timing of which may be in the hands of a defendant not interested in a quick resolution). Many years could be added to the resolution of disputes and significant additional sums incurred as the battle in court precedes the process in arbitration.

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<sup>88</sup> David Caron, in his article *Anticipating the 2009 U.S. "Fairness in Arbitration Act,"* 2(3) *WORLD ARB. & MED. REV.* 15 (2008), takes the position that the correct reading of this language limits it to the classes newly protected, but he himself states that "clarity in the bill remains desirable." *Id.* at 21. A contrary reading is found by Thomas Carbonneau, in *"Arbitracide": The Story of Anti-Arbitration Sentiment in Congress,* 18 *AM. REV. INT'L ARB.* 233, 247 (2007) ("It also eliminates, apparently for all arbitration circumstances, the jurisdictional or kompetenz kompetenz powers of the arbitrator"). An informal survey of seasoned arbitration practitioners revealed that of the 30 responders, 20 read § 2(c) to apply to *all* arbitrations, ten found the language to be ambiguous and none thought it was limited to the newly protected classes. Survey results on file with author.

Perhaps even more importantly, the court to which the issue is presented will be a foreign court for at least one of the parties to the arbitration and will carry with it all of the concerns about unfamiliarity, bias, and fear of an excessively slow process – precisely the factors that drove the parties to include an arbitration clause in the first place. In short, the Arbitration Act would enable a party to derail the arbitration before the arbitral process even gets under way and subject the opposing party to a foreign court proceeding, both results which international arbitration is purposefully designed to avoid.

Not only would the proposed Act enable the defending party to easily stall the arbitration but with the retroactive application of the Act to existing contracts, the parties' contractual expectations as to the respective roles of the court and the arbitrator would be dishonored. Contracts which specify a U.S. jurisdiction as the seat of the arbitration based on an expectation that the application of the principles of competence-competence and separability would be in accordance with the law as it now exists would instead be governed by the Arbitration Act provisions.

Parties with contracts that specify the application of the procedural rules of one of the international dispute resolution institutions will find that if the arbitration takes place in the United States and no arbitral seat is designated, a common occurrence, the provisions of the Arbitration Act will govern. The Arbitration Act will simply override the contract between the parties and the institutional rules designated will bow to the law with which they will then be in conflict.<sup>89</sup> When the arbitration hearings are physically held in the United States, even if the designated seat is elsewhere,<sup>90</sup> the courts might find that the arbitration is subject to the proposed Act, if enacted.

All of these results, which would materially alter the parties' expressed contractual intentions as to the dispute resolution mechanism to be employed, would be possible and detrimental to the parties and to international arbitration.

### *C. Existing Transactional Economics Would be Altered*

If the Arbitration Act is applied to all disputes and claims arising after enactment, as it is now drafted, the statutory change would also impact the economics of established transactions. Businesses rely on the dispute resolution mechanism they have specified in their contract and price their transactions accordingly. The economic calculations made during contract negotiation would be thrown into disarray and rendered entirely inaccurate by both the substantive and procedural changes that would be effected by the proposed Act.

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<sup>89</sup> As expressly stated in the American Arbitration Association International Arbitration Rules, Article 1(b): "These rules govern the arbitration, except that, where any such rule is in conflict with any provision of the law applicable to the arbitration from which the parties cannot derogate, that provision shall prevail."

<sup>90</sup> Hearings need not be physically held in the designated "seat" of the arbitration.

The courts have repeatedly acknowledged the economic import of the contractual provisions that deal with dispute resolution. As the court said in *Bremen v. Zapata Off-Shore Company*:<sup>91</sup> “it would be unrealistic to think that the parties did not conduct their negotiations, including fixing the monetary terms, with the consequences of the forum clause figuring prominently in their calculations.”<sup>92</sup>

D. *The U.S. Would No Longer Be an Arbitration-Friendly Forum and U.S. Business Interests Would be Injured*

Whether the Arbitration Act is ultimately enacted and applied to existing contracts or applied prospectively, the consequences for contracts entered into after enactment are equally dire. As the changes in the law become known and influence contract formation, and as other decisions related to arbitration are made, the U.S. will no longer be viewed as a friendly forum for arbitration. Indeed, Emmanuel Gaillard, a well known non-U.S. practitioner of international arbitration has already predicted such a result if the proposed legislation is enacted.<sup>93</sup> Parties may shun the U.S. and it will quickly lose its position as one of the most frequently designated seats in international arbitration. Parties will avoid the U.S. as the place to hold arbitration hearings in order to avoid the possibility of being dragged into court under the procedural rules that would govern under the Arbitration Act.

To preserve their ability to arbitrate disputes effectively, U.S. multi-national corporations will likely be forced to try to negotiate and draft contracts with as few contacts with the U.S. as possible. They will be in the anomalous position of

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<sup>91</sup> *Bremen*, 407 U.S. at 14.

<sup>92</sup> See also *14 Penn Plaza LLC v. Pyett*, 129 S. Ct. 1456, No. 07-581, 2009 WL 838159 at \*7 (April 1, 2009) (in the context of collective bargaining agreements “parties generally favor arbitration precisely because of the economics of dispute resolution . . . As in any contractual arbitration, a union may also agree to the inclusion of an arbitration provision . . . in return for other concessions”); *Carnival Cruise Lines v. Shute*, 499 U.S. 585, 594 (1991) (“it stands to reason that passengers who purchase tickets containing a forum selection clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued”); *Roby v. Corporation Lloyd’s*, 996 F.2d 1353, 1363 (2d Cir. 1993) (the “financial effect of forum selection and choice of law clauses likely will be reflected in the value of the contract as a whole”).

<sup>93</sup> Emmanuel Gaillard, *International Arbitration Law*, N.Y.L.J., April 4, 2008 (The Act poses “a serious threat to the promotion of efficient international dispute resolution and of the United States as a friendly place to arbitrate”). See also Annemarie Ellig & Rebecca Lanctot, *A Decision Looms: How Passage of the United States AFA of 2007 Would Contradict Principles Underlying the New York Convention and Affect the United States’ Role in International Commerce*, 12 VINDOBONA J. INT’L COMM. L. & ARB. 249, 265 (2008) (“Congress’s consideration of the [Arbitration Act] signifies an alarming shift in the U.S.’s traditionally friendly attitude regarding arbitration toward that of hostility, as evidenced by the affect the legislation would have on the doctrine of Competence-Competence”).

not wanting to designate the law of any U.S. jurisdiction as controlling their own contracts for fear that the proposed Act's procedural provisions would be found to be applicable and disable them from using the workable arbitration process that they need to conduct global business affairs, a need that has long been recognized by Congress and the courts.<sup>94</sup> Businesses might feel that they have to raise their prices or otherwise increase the consideration they receive in order to cover the possibility of a dispute that they are not able to resolve in the fashion they had previously factored into their pricing.

U.S. businesses will be at a significant competitive disadvantage as foreign parties look for partners with respect to whom a process consistent with the norm in international commercial matters can be contemplated in the event disputes arise. The litigation process in the U.S. is viewed by many around the world as unduly expensive, burdensome and intrusive of company executive and employee time, as the discovery rules in the U.S. are significantly more generous than those of most other jurisdictions. Fear of becoming embroiled in a U.S. court process (which also raises the specter frightening to non-U.S. parties of U.S.-style punitive damages and class actions), instead of resolving disputes in an arbitration forum of choice, may deter foreign corporations from doing business with U.S. companies. Moreover, U.S. parties will be much less attractive as trading partners since enforcement in the U.S., where the U.S. company's assets are to be found, may not prove to be possible. Indeed it has been suggested that trading partners who wish to do business with a U.S. entity, may require their U.S. counterparties to maintain quantified accessible assets in designated locales abroad to circumvent such a problem.

With today's global economy and the dependence of all nations on international trade, commercial competitiveness in the international arena is critical to the economic success and viability of all nations. The United States is not immune from global forces and faces significant competition. The ability of U.S. businesses to compete should not be hampered by the unintended consequences of arbitration legislation directed at addressing discrete domestic problems relating to concerns about fairness to individuals.

#### VIII. THE PROPOSED LEGISLATION MAY IMPLICATE U.S. TREATY VIOLATIONS

A discussion of the ramifications of the proposed Act would not be complete without some reflection on the question of whether it might lead to violations in the U.S. of the terms or spirit of any U.S. treaties. A thorough analysis of this question is beyond the scope of this paper but one must conclude that further inquiry is necessary as to the interplay among the proposed legislation, the New York Convention, and U.S. bilateral investment treaties.

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<sup>94</sup> Moreover, U.S. corporations will be inconvenienced and forced to incur additional expenses by having to pursue arbitrations outside the country.

### A. *The New York Convention*

The first point of inquiry pursuant to Chapter 2 of the FAA must be whether Chapter 1 of the FAA, as amended by the Arbitration Act, would conflict with Chapter 2 or the New York Convention, as Chapter 1 only applies to the extent it is not in conflict. No simple response to this question presents itself. As discussed above, the goal of the New York Convention was not only to foster the recognition and enforcement of commercial arbitration agreements in international contracts and but also, as noted by the Supreme Court, “to unify the standards by which agreements to arbitrate are observed and arbitral awards enforced in the signatory countries.”<sup>95</sup> Thus, the New York Convention provides for very limited exceptions to enforceability and most scholars would agree that there was no expectation of procedural differences that would have substantive ramifications.

However, many U.S. courts have been hostile to the Supreme Court’s pronouncements favoring arbitration and the language of the Convention might lead some U.S. courts to arrive at results based on the Arbitration Act that could be viewed as contravening the terms, or at least the spirit, of U.S. commitments under the Convention. Both the substantive changes effected by voiding various predispute arbitration agreements and the procedural changes wrought by reversing decades of law on competence-competence and separability would be implicated.

#### 1. *Substantive Changes to U.S. Law*

Article II of the New York Convention provides that courts of contracting states are to refer parties to arbitration:

unless [the court] finds that the . . . agreement is null and void, inoperative or incapable of being performed.

The Convention further provides in relevant part in Article V(1)(a) that recognition and enforcement may be refused if:

The Parties to the agreement . . . were, under the law applicable to them, under some incapacity, or the said agreement is not valid under the law to which the parties have subjected it or failing any indication thereon, under the law of the country where the award was made.

Recognition may also be refused under Article V(2) if the competent authority finds that

- (a) The subject matter of the difference is not capable of settlement by arbitration under the law of that country; or
- (b) The recognition or enforcement of the award would be contrary to the public policy of that country.

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<sup>95</sup> *Scherk*, 417 U.S. at 520.

The Supreme Court, in reviewing the goals of the New York Convention and of the U.S. accession to the treaty, noted that the Convention's "delegates voiced frequent concern that courts of signatory countries . . . should not be permitted to decline enforcement of such agreements on the basis of parochial views of their desirability or in a manner that would diminish the mutually binding nature of the agreements."<sup>96</sup> Recognizing that the benefits of the New York Convention would be undone if national courts allowed national "parochial" views to prevail in enforcement proceedings, the court in *Mitsubishi* stated that "the utility of the Convention in promoting the process of international commercial arbitration depends upon the willingness of national courts to let go of matters they normally would think of as their own."<sup>97</sup>

In deference to the importance of arbitration to international commerce, the *Mitsubishi* court held that an antitrust claim was arbitrable in an international arbitration, stating that "concerns of international comity, respect for the capacities of foreign and transnational tribunals, and sensitivity to the need of the international commercial system for predictability in the resolution of disputes require that we enforce the parties' agreement, *even assuming that a contrary result would be forthcoming in a domestic context*" (emphasis added). Employing similar reasoning, the Supreme Court in *Scherk* found that securities claims in the international context are subject to arbitration pursuant to an arbitration agreement, over the dissent's vigorous objection that the Court had already ruled that securities cases were not arbitrable in domestic cases.

Following the principles established by the Supreme Court, the courts have construed the "null and void" exception narrowly<sup>98</sup> and have found that the "public policy" exception should be limited to denial of enforcement "only where enforcement would violate the forum state's most basic notions of morality and justice."<sup>99</sup> This approach by the courts supports the success of the New York Convention, which depends "not only on common interpretations of the treaty provisions across borders, but also on common methods of implementation."<sup>100</sup>

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<sup>96</sup> *Scherk*, 417 U.S. at 520.

<sup>97</sup> *Mitsubishi*, 473 U.S. at 639.

<sup>98</sup> See, e.g., *Leddee v. Ceramiche Ragno*, 684 F.2d 184 (1st Cir. 1982).

<sup>99</sup> See, e.g., *Parsons & Whittemore Overseas Co. v. Societe Generale De L'Industrie du Papier*, 508 F.2d 969, 973-74 (2d Cir. 1974).

<sup>100</sup> Laura Murray, *Domestic Court Implementation of Coordinative Treaties: Formulating Rules for Determining the Seat of Arbitration Under the Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, 41 VA. J. INT'L L. 859, 860 (Summer 2001) (Arguing that in developing an interpretation of the New York Convention courts should look not only to the language and drafting history of the treaty but also to how it is being actualized in other countries in order to achieve the requisite coordinated approach). See also Leonardo D. Graffi, *Securing Harmonized Effects of Arbitration Agreements Under the New York Convention*, 28 HOUS. J. INT'L L. 663 (2006) (Urging that national courts be educated to apply the Convention uniformly); Jian Zhou, *Judicial Intervention in International Arbitration: A Comparative Study of the Scope of the New York Convention in U.S. and Chinese Courts*, 15 PAC. RIM L. & POL'Y J. 403

It is against this backdrop that the inquiry as to the impact of the proposed legislation must be assessed. Article VI of the Constitution establishes the status of treaties in U.S. law, placing them on an equal footing with federal statutes as “the supreme law of the land.” While not entirely clear, acts of Congress will prevail over treaty obligations if they are later in time or there is an explicit congressional pronouncement. In addressing such conflicts the courts are to favor interpreting statutes so as not to override treaty obligations.<sup>101</sup>

Will the courts be able to reconcile the obligation as enunciated by the Supreme Court to leave “parochial” views behind in applying the New York Convention to international arbitration agreements and awards? Or will they find that since the Arbitration Act would be both later in time and an explicit Congressional pronouncement they must refuse to enforce international awards that concern franchises, or awards based on claims pursuant to civil rights statutes or statutes intended to protect parties with unequal bargaining power where such claims are made pursuant to the law of any jurisdiction? If they do so hold, will that constitute a violation of the Convention which can only operate effectively if there is substantial uniformity among nations in application or would such carve-outs be viewed as permissible under Article V2(a) of the Convention because the “subject matter of the difference is not capable of settlement by arbitration” in the United States?

Will the strong directives of the Supreme Court as to the deference to be accorded to international arbitration be heeded? Will even the express holdings of the Supreme Court as to the arbitrability of antitrust or securities claims<sup>102</sup> survive in international settings or will they be deemed to have been overruled by Congress as the courts find that such claims are subsumed in the new statutory language so that both domestic and international awards based on such claims will not be honored?

Pursuant to the Vienna Convention on the Law of Treaties, enactment of a national statute does not provide an excuse for a treaty violation,<sup>103</sup> so court holdings such as those described might be found to constitute treaty violations under international law if the carve-outs under the Convention are not accepted as legitimate. Scholars have noted that the Convention does not afford unbounded discretion to designate categories as non-arbitrable (or to so define public policy); idiosyncratic designations out of sync with general international consensus are not

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(2006) (Explaining how the implementation of the Convention depends heavily on the domestic legal mechanisms of the contracting states and urging greater consistency).

<sup>101</sup> William W. Park & Alexander A. Yanos, *Treaty Obligations and National Law: Emerging Conflicts in International Arbitration*, 58 HASTINGS L.J. 251, 282 (Dec. 2006). See also Detlev F. Vagts, *The United States and Its Treaties: Observance and Breach*, 95 AM. J. INT'L L. 313 (2001).

<sup>102</sup> In fact Congressional testimony offered on the Fairness in Arbitration Act seeks to void pre-dispute arbitration agreement for securities claims as part of the Congressional enactments.

<sup>103</sup> Vienna Convention on the Law of Treaties, Art. 27, May 23, 1969, 1155 U.N.T.S. 331.

contemplated.<sup>104</sup> It could be persuasively argued that many of the categories carved out of arbitration by the proposed Arbitration Act are out of sync with accepted notions of international public policy. Even if one could persuasively argue that such holdings by the courts would not constitute technical violations of the New York Convention because of the exceptions states are permitted under the Convention, one must conclude that a series of decisions of this sort would be contrary to the spirit of the New York Convention and directly contrary to the wise guidance of the Supreme Court as to the necessity for arbitration based on unified standards in modern international commerce.

## 2. *The Procedural Changes to the U.S. Law*

The New York Convention provides in Article III that arbitral awards shall be recognized and enforced:

in accordance with the rules of procedure of the territory where the award is relied upon. There shall not be imposed substantially more onerous conditions or higher fees or charges on the recognition or enforcement of arbitral awards to which this convention applies than are imposed on the recognition or enforcement of domestic arbitral awards.

It has long been the prevailing view that the only exceptions to enforcement under the Convention are set forth in Article V, which speaks to procedural fairness and substantive public policy and that Article III was never intended to create an avenue for the creation of procedural bars to enforcement.<sup>105</sup> However, a decision by the Second Circuit, *Monegasque De Reassurances S.A.M. v. Nak Naftogaz of Ukraine*,<sup>106</sup> suggests that, by virtue of this clause in the New York Convention, courts might refuse to enforce awards based on procedural considerations. In *Monegasque* the court found that Article III of the New York Convention allowed for procedural differences to be observed as long as they were not applied differently in domestic cases and that accordingly, Article V was not the exclusive basis for refusing to enforce an award. The court held that *forum non conveniens*, a procedural rule, could be applied to deny enforcement, and proceeded to deny enforcement on that ground.<sup>107</sup>

It is entirely conceivable that a court might find that the Arbitration Act would require the court to decide questions of the validity of the arbitration agreement without regard to the doctrine of separability, and that accordingly the court would

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<sup>104</sup> Rogers, *supra* note 48, at 364.

<sup>105</sup> For an extensive discussion of this issue and a review of the drafting history of Article III, see Park & Yanos, *supra* note 101, at 262-65; *see also* Graffi, *supra* note 100.

<sup>106</sup> 311 F. 3d 488 (2d Cir. 2002).

<sup>107</sup> The Second Circuit decision has been criticized. *See, e.g.*, International Commercial Disputes Committee of the Association of the Bar of the City of New York, *Lack of Jurisdiction and Forum Non Conveniens as Defenses to the Enforcement of Foreign Arbitral Awards*, 12 AM REV. INT'L ARB, 407 (2004).

have to conduct an independent, de novo review of the challenge based on the underlying contract. If it were to find on its de novo review that the arbitration clause was not valid because of a defect in the underlying contract, it might well refuse to enforce the award under the New York Convention. If such a line of cases were to develop, the court would be exercising review powers far beyond the limited review regarded traditionally as permissible under the New York Convention and far beyond that of other nations and the desirable unity of standards referred to by the Supreme Court.

### B. *Bilateral Investment Treaties*

Bilateral investment treaties (“BITs”) are legally binding treaties that provide significant legal protections for investors and investments in BIT partner countries. They can serve to increase investor confidence and thereby facilitate foreign investment and enhance economic growth. Approximately 2,600 BITs have been signed by the nations of the world.<sup>108</sup> Generally, BITs grant foreign direct investments made by an investor of one contracting state in the territory of the other a number of guarantees including fair and equitable treatment, the better of national or most favored nation treatment and protection from direct or indirect expropriation. BITs generally also provide for an alternative dispute resolution mechanism, whereby an investor whose rights under the BIT have been violated can have recourse to international arbitration against the host state rather than suing the host state in its own courts, which may be biased or not sufficiently independent from the host state’s government. Many BITs also provide for the free transfer of funds and some protection in the event of war or civil disturbance and often provide an “umbrella” clause, which serve essentially to raise contract obligations to treaty obligations. The United States has BITs in force with approximately 40 countries and continues to work on establishing additional BITs.<sup>109</sup>

Both the 1994 and the 2004 Model U.S. BIT contain a fair and equitable treatment clause and provide for arbitration of disputes. The 1994 United States Model BIT, which was the basis for the U.S. BITs with over 30 nations,<sup>110</sup> contained, *inter alia*, an umbrella clause. Query whether breaches of these U.S. BIT obligations could ultimately result from U.S. courts’ construction of the Arbitration Act if enacted. It has been suggested that failure to comply with treaty obligations could in some circumstances give rise to liability under bilateral

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<sup>108</sup> International Institute for Sustainable Development, *Recent Developments in Regional and Bilateral Investment Treaties* at 2 (2008), available at [http://www.iisd.org/pdf/2008/dci\\_recent\\_dev\\_bits.pdf](http://www.iisd.org/pdf/2008/dci_recent_dev_bits.pdf).

<sup>109</sup> For a list of countries with which the U.S. has a BIT, see Office of the United States Trade Representative, *Summary of U.S. Bilateral Investment Treaties*, available at [http://www.ustr.gov/Trade\\_Agreements/BIT/Section\\_Index.html](http://www.ustr.gov/Trade_Agreements/BIT/Section_Index.html).

<sup>110</sup> Organization for Economic Co-operation and Development, *Interpretation of the Umbrella Clause in Investment Agreements* at 6 (Oct. 2006), available at <http://www.oecd.org/dataoecd/3/20/37579220.pdf>.

investment treaties to which the U.S. is a party. For example, an investor denied the opportunity to enforce a valid award may argue that the decision constituted a denial of justice in violation of the fair and equitable treatment of the bilateral investment treaty.<sup>111</sup>

#### IX. IS IT TIME FOR A SEPARATE NEW INTERNATIONAL ARBITRATION STATUTE AND INTERIM MEASURES?

The question of whether a new and separate international arbitration statute should be enacted in the United States has been the subject of debate in the arbitration community for several years.<sup>112</sup> The constant attempts in Congress in recent years to tinker with arbitration in ways that could negatively impact international arbitration and the increasingly receptive response of U.S. legislators to those attempts suggest that the time has come for the enactment of a separate arbitration statute in the United States for international arbitration.

The efficacy of the dispute resolution mechanism available is an important factor in international commerce and it must be preserved as a viable option for U.S. multi-national companies. Certainly if the new arbitration provisions are enacted as amendments to and carve-outs from Chapter 1 of the FAA, it will be increasingly difficult to draft around the problem of having those changes in the FAA apply to international arbitration as well. Chapter 2 and the New York Convention contain bare bones provisions and, as discussed above, contain several exceptions which can be employed to defeat the purpose of the Convention. Much can be altered in Chapter 1 before a “conflict” can be found with the letter rather than the spirit of those provisions such that the amendments to Chapter 1 would be inapplicable to Chapter 2.

Moreover, the spillover creating a less hospitable environment for international arbitration is inevitable as changes are made to domestic arbitration. For example, the findings which precede and form the basis of the Arbitration Act<sup>113</sup> cannot help but undermine in the eyes of the courts the Supreme Court’s

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<sup>111</sup> Park & Yanos, *supra* note 101, at 282.

<sup>112</sup> Compare William W. Park, *Amending the Federal Arbitration Act*, 13 AM. REV. INT’L ARB. 75 (2002) (advocating for reform of the FAA to provide clarity for international arbitration) with John Townsend, *Leave the Federal Arbitration Act Alone*, ABA BUSINESS LITIGATION COMMITTEE NEWSLETTER (Summer 2007) (advocating for preserving the FAA which has worked well for 80 years and leaving the task of policing unfairness to the courts) and Alan Scott Rau, *Federal Common Law and Arbitral Power*, 8 NEV. L.J. 169, 169-70 (Fall 2007) (advocating for preserving the FAA on various grounds including that the courts are “more likely than legislators to get it right” and “the most plausible outcome would be to let loose all sorts of unanticipated errors and evils”).

<sup>113</sup> The Arbitration Act includes many prefatory findings critical of arbitration: 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 . . . Private arbitration companies are sometimes under great pressure to devise systems that

frequent recitation of the FAA's strong policy in favor of arbitration. These new pronouncements by Congress will color the perception of the courts as to the Congressional intent with respect to the FAA. The deference paid to arbitration agreements and arbitrators' decisions will dissipate.<sup>114</sup> A separate full-fledged international arbitration statute will enable Congress to make specific findings relevant to international arbitration. In order to prevent the detrimental spillover effect from the anti-arbitration findings included in the Act, additional strong findings acknowledging the benefits of international arbitration can be included. It will provide a vehicle to provide guidelines for the courts by creating a legislative history that recognizes the importance of international arbitration, acknowledges how it differs from domestic arbitration and legislates to address those differences.

For example, competence-competence and separability can be specifically codified in the new international statute as it is in the law of so many other nations. At the very least the presumption set forth in *First Options* that the parties intend to litigate rather than arbitrate issues of arbitrability, which may be appropriate in the domestic context, could be reversed in the international context. Quite the converse would be true in an international case where the parties expect the arbitrator to make the initial jurisdictional determination himself or herself, which makes the opposite presumption in favor of sending the question of the validity of the arbitration agreement to the arbitrator the more accurate presumption.<sup>115</sup>

A separate international arbitration statute would allow a reasoned analysis of which sectors should be subject to the voiding of pre-dispute arbitration agreements in the international context. A separate statute would permit the development of such carve-outs, if any, in a manner more consistent with those of other nations of the world and more in keeping with the need to have international arbitration agreements honored and international arbitration awards enforced uniformly across borders.

Many countries have enacted separate statutes to govern international arbitration and many countries have adopted the UNCITRAL Model Law on

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favor the corporate repeat players . . . 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...Mandatory arbitration is a poor system for protecting civil rights and consumer rights because it is not transparent...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.

<sup>114</sup> *Federal Courts Report*, *supra* note 40 ("In addition the findings of the AFA could have the unintentional consequence of undermining all arbitrations, not just arbitrations that fall in the sectors that fall within the purview of the Act").

<sup>115</sup> Smit, *supra* note 64 at 29-30.

International Arbitration. Using the UNCITRAL Model Law as a foundation, a carefully crafted international arbitration statute in the United States would serve to remove uncertainties caused by murky U.S. case law, clarify the rules to be followed in international arbitration cases and prevent the unintended harmful impact on international arbitration of any changes to arbitration legislation now or in the future.

In the event that arbitration legislation is to be enacted before a separate international arbitration statute can be developed, such legislation must be carefully drafted to insulate international arbitration from its impact.<sup>116</sup> The changes in arbitration law contemplated by the Arbitration Act should be drafted as a separate statute rather than as an amendment to the FAA to avoid confusion as to what categories of disputes are subject to the new provisions. Congress has previously approached all such changes by enacting separate legislation outside the FAA. Thus Congress has enacted separate legislation to deal with arbitrations involving poultry growers, motor vehicle franchises and extensions of credit to members of the military.<sup>117</sup> These provisions vary somewhat from one another and are tailored to suit the specific needs of the constituency addressed. Enacting changes for the disputants contemplated in the Arbitration Act in a separate statute would be consistent with prior legislation enacted by Congress and would enable Congress to fine tune the protections required for each category of disputants.

## X. CONCLUSION

U.S. commercial interconnections with countries all over world in today's global economy require that close attention be paid to ensuring that U.S. businesses can compete on an equal footing and not be hampered by any unintended and imprudent impacts of domestic concerns on international arbitration. As President Obama states in his transition page on the web: "Trade with foreign nations should strengthen the American economy and create more American jobs."<sup>118</sup> A separate U.S. international arbitration statute would support the competitiveness of U.S. businesses engaged in international commerce and

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<sup>116</sup> International arbitration could survive defined carve-outs for consumer and employment disputes even in international matters. It could likely survive even legislation limiting arbitration agreements in international franchise relationships, although that would not be consistent with international norms and would eliminate a critical remedy in a substantial segment of international business and cause damage to many U.S. businesses. But U.S. participation in international arbitration cannot survive the overhauling of the doctrines of competence-competence and separability or the application of the broad and vague language with respect to statutes intended to protect undefined civil rights or parties with unequal bargaining power.

<sup>117</sup> See arbitration provisions relating to motor vehicle franchises at 15 U.S.C. § 1226, poultry growers at 7 U.S.C. § 197c and extension to members of the armed services at 10 U.S.C. § 987.

<sup>118</sup> The Obama-Biden Plan on the Economy, *available at* [http://change.gov/agenda/economy\\_agenda](http://change.gov/agenda/economy_agenda).

enable the United States to continue to be viewed as an arbitration friendly forum utilized by U.S. and foreign parties for international arbitration. Absent enactment of a new international arbitration statute, the changes contemplated by the Arbitration Act should be enacted in a separate statute rather than as an amendment to the FAA. They should be carefully tailored to ensure that any changes made do not impact unintended areas of international arbitration.

While this discussion has been focused on international arbitration, the issues and problems raised by the proposed amendments concerning both substantive and procedural changes to the FAA will have precisely the same harmful impact on domestic business-to-business arbitration. The neutrality of the forum, so important in international arbitration, is not a dominant factor in domestic business-to-business arbitration. But the many other reasons that cause businesses to elect to have their disputes settled in arbitration (*e.g.* flexibility, expertise, finality, efficiency and private nature of the proceedings) are of equal validity.

The availability of arbitration as a dispute resolution mechanism unhindered by procedures and rules which would make it an unworkable process should be preserved. Great care must be taken if any changes to the law governing arbitration are enacted by Congress, in order to protect both international arbitration and domestic business-to-business arbitration.

## POSTSCRIPT

On April 29, 2009, as this article was going to press, The Arbitration Fairness Act of 2009 was introduced in the Senate. Hearing the voices of those concerned about the impact of the bill as previously drafted, many of the unintended consequences of the bill described in this article and present in the current House of Representatives version of the bill have been addressed and corrected. Whether the bill is amended in the House and how the bill finally emerges if passed by both houses of Congress remains to be seen, as ultimately the bills must be conferenced and agreement reached on a single version before it can be signed into law.

The principal changes in the Senate bill from last year's Senate version are: (1) the Senate bill is introduced as a new Chapter 4 to the Federal Arbitration Act rather than as an amendment to Chapter 1; (2) the new provisions on competence-competence and separability are applicable only with respect to the classes designated under the new Chapter 4 and not to *all* arbitration; (3) the invalidation of disputes claiming violations of statutes intended to protect parties of "unequal bargaining power" has been deleted from the Senate version as well as the current House version; (4) "civil rights disputes" is defined to mean disputes arising under the constitution of the United States or of a State or a federal or state statute that prohibits discrimination; the protections for these disputes is limited to disputes in which at least one party alleging such a violation is an individual; (5) "franchise disputes" is defined to mean a dispute between a franchisee with a principal place of business in the United States and a franchisor, thus only arbitration agreements with U.S.-based franchisees are invalidated. The Senate bill also appears to overturn the Supreme Court decision issued on April 1, 2009 in *14 Penn Plaza v. Pyett*, 129 S. Ct. 1456 (2009) by providing that even if contained in a collective bargaining agreement "no arbitration provision shall have the effect of waiving the right of an employee to seek judicial enforcement of a right arising under the federal or state constitution or a federal or state statute, or public policy arising therefrom."

The Senate bill continues to invalidate arbitration agreements by foreign franchisors with U.S.-based franchisees, and by all consumers and employees in both domestic and international contexts without exclusion for negotiated executive and other employment contracts. The civil rights disputes definition requires further analysis. However, the Senate version, if adopted, does resolve many of the problems that would be caused by the House bill.

