

# The Unintended Consequences of the Proposed Arbitration Fairness Act

By Edna Sussman

*The principal objective of the Arbitration Fairness Act of 2009 is to protect consumers and employees who are subject to adhesion contracts. However, the bill as drafted would have major impacts on business-to-business arbitration and severely damage the efficacy of arbitration as a dispute resolution mechanism in all arbitrations. The unintended consequences of the bill would void countless existing arbitration agreements and alter the economics of numerous transactions, discourage international commercial parties from engaging in commerce with U.S. companies, add significant costs and delays to many arbitrations, put the United States at risk of breaching the spirit of long-standing treaty obligations, and impose a significant additional burden on the courts. Any legislation enacted must be carefully drafted to protect the classes Congress seeks to protect without inadvertently crippling both domestic and international commercial arbitration.*

*The Law of Unintended Consequences: Undertakings, however well intentioned, are generally accompanied by unforeseen repercussions. These may overshadow the principal endeavor.*

With the relatively recent expansion of arbitration disputes involving consumers as well as employees, the debate on access to justice and fairness of arbitration has raged in academic and advocacy circles. A concern that legislation is necessary to protect consumers and employees has created the impetus for the bills proposed in Congress to amend the Federal Arbitration Act (FAA). Whatever the optimal solution Congress may develop to address issues with respect to arbitration for such parties, the legislation should be carefully reviewed and redrafted to avoid unintended consequences. As now drafted, the bill would undercut more than 80 years of thoughtfully developed arbitration law and reverse fundamental globally accepted principles of arbitration as to the allocation of authority between the court and the arbitrator. The bills that have been proposed would hamper the ability of U.S. business



interests to compete in cross-border commerce, where arbitration is the widely accepted method for dispute resolution, and would have a negative impact on businesses that have freely contracted for domestic arbitration as their mechanism of choice. The bills under consideration are likely to cause significant delays and additional costs, impose a meaningful extra burden on the courts, and alter the economics of commercial transactions.<sup>1</sup>

Congress has not yet enacted the arbitration legislation. It can still be fixed and its unintended consequences avoided. In his seminal work on the law of unintended consequences, Robert K. Merton, a noted sociologist, reported that the principal factor leading to unintended consequences is lack of knowledge and understanding.<sup>2</sup> The fact that lack of adequate information can lead to unintended consequences in national legislation is not surprising since members of Congress must school themselves in a myriad of issues. This article is written to inform readers about the collateral damage that can be inflicted by the bill as now drafted. There is ample time to amend the bills to ensure that only those changes that Congress intends result from any legislation

enacted and to tailor the final bill in a way that will protect each class and will arrive at the optimal solution for each. Both congressional objectives and the avoidance of harmful unintended consequences can be achieved if care is devoted to the drafting changes required.

### The Proposed Legislation

The version of the Arbitration Fairness Act of 2009 (AFA) introduced by the House of Representatives (H.R. 1020) provides in relevant part the following amendment to Chapter 1, Section 2 of the Federal Arbitration Act:

- (b) No pre-dispute 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.
- (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 earlier Senate and House versions of the Arbitration Fairness Act of 2007 (H.R. 3010 and S. 1782) were worded identically, except that they both also invalidated arbitration agreements for disputes arising under statutes intended “to regulate contracts or transactions between parties of unequal bargaining power”—a provision of such broad applicability as to have been likely to apply to essentially every dispute.

This legislation focuses primarily on arbitration agreements involving consumers and employees (not related to collective bargaining) that have raised concerns about imposed contract language and the fairness of arbitration in the context of such disputes. The legal dynamic in this setting is and should be distinct from business-to-business matters. Yet, although business arbitration presents markedly different issues than consumer or employment arbitration does, because both are processes that are currently described as “arbitration” subject to the FAA, tension has arisen and it is spilling over and threatening the integrity of arbitration law in the business context. Responding to a desire to protect consumers and employees, the Arbitration Fairness Act adopts a “one size fits all” approach that voids arbitration agreements in a broad range of disputes, including many agreements in both domestic and international commercial contexts that reflect negotiated terms between sophisticated parties. Moreover, the AFA’s proposed amendments to § 2 (c) of the FAA are not limited to the categories of parties that the bill’s proponents seek to protect; rather, the amendments reverse long-standing Supreme Court precedents on “separability” and “competence-competence” with respect to *all* arbitrations. These arbitration concepts are established throughout the world and are procedures that are essential to the functioning of arbitration.

### The Importance of Arbitration

Arbitration is a dispute resolution process that civilized societies have used to resolve disputes for more than 2,000 years. The growth of arbitration in the United States began with the passage of the FAA in 1925. Surveys and experience have repeatedly demonstrated that arbitration is the preferred mechanism for resolving disputes in many commercial transactions. Because the process benefits from the use of adjudicators with specific, relevant expertise, arbitration typically resolves disputes flexibly, efficiently, privately, and relatively amicably.

In international transactions, arbitration is widely accepted as the standard mechanism for dispute resolution, because it also allows parties to select a neutral forum and to enforce awards across borders much more easily than court judgments. To preserve arbitration and prevent damage to U.S. business interests in global commerce, it is essential to enforce pre-dispute arbitration agreements; permitting post-dispute arbitration agreements is not a viable alternative, because, when faced with an actual dispute, parties that prefer arbitration when entering into a contract would often choose to delay the proceedings and to turn to a court forum that is favorable to them. Arbitration also serves to relieve increasingly overburdened and now increasingly underfunded courts from the task of resolving disputes that the parties prefer to resolve privately through arbitration.

### Unintended Consequences of the Arbitration Fairness Act *Confusion Regarding FAA, Chapter 1*

Since its enactment in 1925, Chapter 1 of the Federal Arbitration Act has provided a stable and consistent legal framework for arbitration in the United States. Chapter 1 has benefited from judicial construction, scholarly analysis, and practical application and sets out the United States’ fundamental policy regarding arbitration. The courts have consistently reaffirmed a strong national policy under Chapter 1 that favors arbitration to resolve business disputes, and this policy should not be diluted by inserting a series of carve-outs in Chapter 1. Altering that chapter of the FAA has the potential to unravel the reliability and predictability of business dispute resolution in this country and to create confusion and unnecessary litigation regarding interpretation of the FAA. Moreover, when presented to a court, the legislative findings that now preface the Arbitration Fairness Act could undermine the rationale and deference accorded to arbitration generally and could be argued in a way that calls into question the underpinning of established judicial precedents for all arbitrations.

The unintended consequences occasioned by drafting the AFA as an amendment to Chapter 1 of the FAA could be largely avoided if Congress located this arbitration legislation elsewhere in the code. Congress has enacted other arbitration legislation outside the FAA and provided for the tailor-made solutions best suited to address the needs of the specific classes that are protected. See, for example, 15 U.S.C. § 1226 (motor vehicle franchises); 7 U.S.C. § 197c (poultry growers); and 10 U.S.C. § 987 (credit for military personnel). Congress should do so again.

## **Overruling of Settled Law Balancing the Authority of the Arbitrator and the Court**

Section 2(c) of the Arbitration Fairness Act would alter settled law that balances the authority of the arbitrator and that of the court in a way that makes arbitration possible. Decades of U.S. Supreme Court precedents, as well as arbitration statutes and institutional rules in use throughout the world, recognize the principles of “separability” and “competence-competence.” These principles mean that, although it is the court’s responsibility to determine if there is a valid agreement to arbitrate, arbitrators generally decide if a contract is otherwise valid or if a specific dispute falls within the scope of the arbitration clause. These principles, viewed as the conceptual cornerstones of arbitration, promote efficiency and reduce costs in the arbitration process by providing arbitrators with the first opportunity to decide jurisdictional challenges that are not based specifically on the arbitration clause itself. See, for example, *Prima Paint v. Flood & Conklin*, 388 U.S. 395, 404 (1967); *First Options of Chicago v. Kaplan*, 514 U.S. 938 (1995); and *Buckeye Check Cashing v. Cardega*, 546 U.S. 440 (2006). Yet the AFA would invest the courts with sole authority to determine the validity of arbitration agreements “irrespective of whether the party resisting arbitration challenges the arbitration agreement specifically or in conjunction with other terms of the contract containing such agreement.”

This development would be a monumental change in arbitration law, and it would seem that it goes far beyond what Congress intends in its effort to protect consumers and employees as it would apply to *all* arbitrations. As a practical matter, it would mean that the arbitrator would have to halt the proceedings if a party merely alleged that a contract involving parties of any description was for any reason invalid or unenforceable, even if that party had no specific objection to the arbitration clause itself and did not dispute that there was an agreement to arbitrate. The Arbitration Fairness Act would thus make the courts the gatekeepers of virtually all arbitrations, because, when faced with an actual dispute, parties that had consented to arbitrate disputes when entering into the contract could choose to delay the proceedings. The AFA would inflict a tremendous additional burden on the courts and frustrate the efficiency for which the parties contracted.<sup>3</sup>

### **Overbroad Invalidation of Arbitration Agreements**

The Arbitration Fairness Act’s proposed amendment to § 2(b)(2) of the Federal Arbitration Act would void any pre-dispute arbitration agreement if it requires arbitration of a “dispute arising under a statute intended to protect civil rights.” “Civil rights” is a broad and vague phrase, and the AFA does not specify which civil rights statutes are intended to be covered. It appears that the act would include a great many statutes and govern disputes that arise among both individuals and organizations—all of whom are within the scope of the protection of such statutes.

A recent report produced by the Congressional Research Service and provided to Congress states that there is an “array of civil rights statutes” under both federal and state law.<sup>4</sup> 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 law—including all rights set out in federal and

state statutes. Thus, the scope of this provision’s applicability appears to be essentially unlimited. The act would also seem to encompass trade and investment treaties signed by the United States, and these generally provide for arbitration as the dispute resolution mechanism and contain antidiscrimination clauses. Indeed, the designation of “statutes intended to protect civil rights” is so broad that it apparently allows foreign statutes to fall within its purview. The constitutions of foreign jurisdictions provide for many rights; for example, Chile’s constitution includes the “right” to protection of one’s intellectual property and the “right” to freedom from environmental contamination, and Peru’s constitution assures the “right” to one’s honor and good name as well as one’s own voice and image, in addition to the “right” to prohibit information services from releasing information affecting one’s privacy. In addition, one could persuasively argue that the protections accorded under the European Convention on Human Rights, which international corporations are increasingly invoking in commercial cases, fall within the language of the Arbitration Fairness Act.

Thus, even though the Arbitration Fairness Act, as introduced in the 111th Congress, deleted the previous reference to “parties of unequal bargaining power,” the continued inclusion of “statutes intended to protect civil rights” without any designation of the statutes intended to be included still presents a serious threat to arbitration of commercial disputes. The AFA may enable creative litigants to assert a claim under a statute argued to fall within this rubric, which, even though it is far removed from any result contemplated by Congress, would enable the party to go to court and delay or even avoid arbitration. Under the Arbitration Fairness Act, a litigant’s mere invocation of such a statute—even if the statutory claim is without merit—would enable the party to derail the arbitration with a side trip to court or perhaps even defeat an otherwise valid arbitration clause.

### **Invalidation of Arbitration Agreements Involving Franchises**

The AFA would invalidate pre-dispute arbitration clauses in disputes involving franchises, which constitute a vast sector of both domestic and international businesses. Many franchising relationships are substantial in size and have sophisticated parties on both sides. Arbitration can be essential to maintain the quality and integrity of the franchise brand for the benefit of both franchisor and franchisee. In the international arena, arbitration is particularly critical to protect U.S. franchisors from being forced into unfamiliar foreign courts that may favor the local party. The Arbitration Fairness Act sweeps all franchises—both domestic and foreign—into one broad provision that prohibits pre-dispute arbitration agreements without any regard to the size of the investment in the franchise or the sophistication of the parties. This prohibition surely will unintentionally invalidate—to the detriment of the parties involved—arbitration agreements with respect to franchises that Congress has no reason to invalidate.

### **Invalidation of Consumer Arbitration Agreements**

The concerns with regard to arbitration that Congress seeks to address have not gone unrecognized. Many con-

sumer and employee plans already contain procedural safeguards. Institutional providers and concerned agencies have adopted protocols such as the Consumer Arbitration Due Process Protocol and the Employer-Employee Arbitration Due Process Protocol. The states and the courts continue to actively address concerns about arbitration fairness.

In crafting legislation for consumers, Congress should move forward slowly and give careful consideration to all potential remedies so that the legislation will arrive at the optimal solution. The testimony before Congress to date has offered many perspectives. Some advocates have taken the position that such clauses must be invalidated by legislation, because these contracts of adhesion deprive consumers of their right to their day in court and place them in a forum that is prejudiced against them. Others have suggested that the courts are capably handling the task of screening out unfair contracts as unconscionable and that, absent an arbitration option, consumers would, in fact, have considerably less, rather than more, access to justice. Yet others suggest that, if there is a problem, it can be remedied by enacting procedural safeguards for consumers involved in arbitration.

Therefore, to assure that it is not setting a policy that will lead to unintended negative consequences for consumers, Congress should carefully review the evidence on access to justice and fairness for consumers in arbitration versus the courts. In addition to the invalidation of pre-dispute arbitration clauses, Congress should consider the following:

- providing for fairness through procedural safeguards, which could include adequate notice, an equal voice in the selection of neutral and impartial arbitrators, responsibility only for limited and reasonable costs of the arbitration, arbitrations that take place at a locale near the consumer, and reasonable discovery;
- providing opt-outs or opt-ins for consumers' contracts;
- establishing a monetary threshold;
- providing for separate rules for international consumer transactions in this Internet age; or
- providing other means to ensure that consumers are protected.

The review should also include an analysis of (1) whether the courts are already adequately dealing with the issue, (2) the ability of the courts to absorb the increased case loads, (3) whether increased funding would be required and available for the courts, and (4) the impact of the legislation on other matters not subject to arbitration that are before the courts. Such a thorough analysis is necessary to understand all the facts and consequences relevant to the important policy decision being made for consumers.

#### ***Invalidation of Employee Arbitration Agreements***

Even though Congress' desire to promulgate legislation intended to protect employees is presumably directed at lower-level employees who must sign form contracts to gain employment, § 2(b)(1) of the AFA, as currently drafted, is so broad as to apply to all employment agreements—an area in which arbitration has historically played a significant and socially useful role. The Arbitration Fairness

Act would invalidate pre-dispute arbitration provisions in employment agreements between sophisticated parties with significant bargaining power who actively negotiate and freely enter into agreements containing arbitration provisions. The act would invalidate employment arbitration agreement in contracts where they are commonplace, such as in mergers and acquisitions, closed family corporations, professional practices, and cross-border employment agreements. Again, to avoid unintended consequences, Congress should conduct the same careful review that is required for consumers to arrive at the optimal solution for appropriate classes of employees.

#### ***Potential Breach of U.S. Treaty Obligations***

The Arbitration Fairness Act would put the United States at risk of breaching the spirit—if not the terms—of the obligations relating to arbitration included in the treaties the government has signed. The goal of the New York Convention,<sup>5</sup> to which the United States and more than 140 other nations are signatories, was not only to foster the recognition and enforcement of commercial arbitration agreements and foreign arbitral awards 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.” *Scherk v. Alberto-Culver, supra*, 417 U.S. 506, 520 (1974). “Parochial” views are discouraged in proceedings that enforce arbitral awards. *Mitsubishi v. Soler Chrysler-Plymouth Inc.*, 473 U.S. 614, 639 (1985).

However, the Arbitration Fairness Act could well produce results that contravene if not the terms, at least the spirit, of U.S. commitments under the New York Convention. For example, courts may refuse to refer a matter to arbitration, finding that it falls within the “null and void exception” of Article II of the New York Convention. Courts may deny enforcement of an arbitral award, finding that the agreement “was not valid” under Article V § 1(a) or that “the subject matter of the difference is not capable of settlement by arbitration under the law of that country” or is against “public policy” under Article V § 2 of the New York Convention. Courts might apply the new procedural rules on separability and competence-competence to international awards under Section III of the New York Convention and refuse to enforce an award granted by a foreign court. Thus, the AFA would implicate potential violations of the spirit of the New York Convention under various approaches, encouraging parties to avoid U.S. law and U.S. courts.

#### ***Risk of Making the United States an Unattractive Partner in International Commerce***

There is also a significant risk that if the Arbitration Fairness Act as drafted becomes law, the United States will no longer be viewed as a friendly forum for international arbitration, as prominent foreign arbitration practitioners have already noted.<sup>6</sup> Many parties engaged in international commerce, particularly those located in civil law countries that do not allow jury trials or pretrial discovery, have traditionally relied on the enforceability of arbitration clauses and the accepted alloca-

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Supp. 349, 353–356 (N.D. Ind. 1994) (same).

<sup>2</sup>*Incorporated Village of Lynchburg, Ohio v. Douglas N. Higgins Inc.*, 822 F.2d 1088 (6th Cir. 1987).

<sup>3</sup>See *National Broadcasting v. Bear Stearns & Co. Inc.*, 165 F.3d 184, 190–191 (2nd Cir. 1999); *Burton v. Bush*, 614 F.2d 389, 390–391 (4th Cir. 1980); *Yasuda Fire & Marine Ins. Co. v. Continental Casualty Co.*, 840 F. Supp. 578, 579 n.4 (N.D. Ill. 1993); *Commercial Solvents Corp. v. Louisiana Liquid Fertilizer Co.*, 20 F.R.D. 359, 361 (S.D.N.Y. 1957).

<sup>4</sup>*Integrity Ins. Co. v. American Centennial Co.*, 885 F. Supp. 69, 73 (S.D.N.Y. 1995).

<sup>5</sup>*Security Life Ins. Co. of Am.*, 228 F.3d 865, 870–871 (8th Cir. 2000) (a nonparty must produce documents prior to the hearing). See also *Stanton v. Paine Webber Jackson & Curtis Inc.*, 685 F. Supp. 1241, 1242–1243 (S.D. Fla. 1988) (arbitrators may order nonparties to produce documents prior to the hearing: “arbitrators may order discovery as they find necessary”); *Meadow Indemnity Co. v. Nutmeg Ins. Co.*, 157 F.R.D. 42, 45 (M.D. Tenn. 1994) (arbitrator has the power to compel a nonparty to produce documents prior to the hearing: “power of the panel to [order documents to be produced at hearing] ... implicitly authorizes the lesser power to compel [same] ... prior to a hearing”); *Burton*, 614 F.2d at 391.

<sup>6</sup>See, for example, *Amgen Inc. v. Kidney Center of Delaware County Ltd.*, 879 F. Supp. 878, 880 (N.D. Ill. 1995).

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tion of authority between the courts and the arbitrators when doing business with U.S. entities to avoid the risk of lengthy and invasive discovery, jury trials, and/or punitive damages awards—all of which are not accepted in the domestic law of the countries in which these parties reside. U.S. parties engaged in international commerce may find themselves at a competitive disadvantage and increasingly forced to accept foreign law in contracts and non-U.S. court forums to resolve disputes as the United States becomes known to be hostile to arbitration. It is impossible to predict the full impact on commerce if Congress creates unprecedented uncertainty as to the ability of a business to rely on domestic and international arbitration remedies. Such a chilling effect is not necessary to achieve congressional objectives.

### The Need to Avoid Unintended Consequences

Although the Arbitration Fairness Act aims to protect domestic consumers, employees, and franchisees, as drafted the legislation threatens to do far-reaching and significant damage to U.S. interests. Legislation can be crafted in a way that not only preserves commercial domestic and international arbitration but also affords protection to the designated classes. It is in the hands of all interested parties to work together to develop legislation outside § 1 of the Federal Arbitration Act and pay particular attention to avoiding the unintended consequences of any changes. **TFL**

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<sup>7</sup>In *Comsat Corp.*, the appellate court suggested that a party may ask a court to order pre-hearing discovery upon a showing “of special need or hardship.” *Id.* at 276. The U.S. District Court for the Eastern District of Pennsylvania observed that, if the Fourth Circuit were correct, then an arbitrator also has the power to order discovery in those situations when the arbitrator believes discovery is “appropriate.” *Hay Group Inc. v. E.B.S. Acquisition Corp.*, 2003 U.S. Dist. LEXIS 4909 (E.D. Pa. Mar. 4, 2003).

<sup>8</sup>*Commercial Solvents Corp.*, 20 F.R.D. at 363 (court could not compel a Louisiana resident to comply with a subpoena issued in New York).

<sup>9</sup>As to grounds for an appeal, in *Hall Street Associates, L.L.C. v. Mattel Inc.*, 128 S. Ct. 1396 (2008), the U.S. Supreme Court ruled that parties may not expand the limited grounds set forth in the FAA (§§ 10 and 11) for vacating an award.

<sup>10</sup>FAA, § 16(b)(1); *Lloyd v. Hovensa, LLC*, 369 F.3d 263, 268–270 (3d Cir. 2004).

<sup>11</sup>FAA, § 16(a)(1)(A); *Lloyd*, 369 F.3d at 268–270.

<sup>12</sup>FAA, §§ 16(b)(2), 16(a)(1)(B); § 16(a)(3); *Lloyd*, 369 F.3d at 268–270.

<sup>13</sup>See also *Cozza v. Network Associates Inc.*, 362 F.3d 12, 15 n.1 (1st Cir. 2003) (court again notes it expressed sympathy for the foreclosure of the appeal because of a belated appeal of nonfavorable arbitration orders).

ed at esussman@sussmanADR.com. The author thanks Mark Friedman and Floriane Lavaud for their review and comments. © 2009 Edna Sussman. All rights reserved.

### Author's Update

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, most of the unintended consequences of the bill described in this article and which are found in the current House of Representatives version of the bill have been addressed and corrected.

### Endnotes

<sup>1</sup>See Edna Sussman, *The Proposed U.S. Arbitration Fairness Act: A Threat to U.S. Business*, 18 AM. REV. OF INT'L. ARB. 455 (2009); Mark Kantor, *Legislative Proposals Could Significantly Alter Arbitration in the United States*, 74 ARB. 444–452 (2008).

<sup>2</sup>Robert K. Merton, *The Unanticipated Consequences of Purposive Social Action*, 1 AM. SOC. REV. 894–904 (1936).

<sup>3</sup>*Report of the Committee on the Federal Courts of the New York County Lawyers Association on the AFA of 2007* (April 15, 2008), available at [www.nycla.org](http://www.nycla.org).

<sup>4</sup>Congressional Research Service, Report to Congress, *Federal Civil Rights Statutes: A Primer* (October 2008).

<sup>5</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. 38r.

<sup>6</sup>See, for example, Emmanuel Gaillard, *International Arbitration Law*, N.Y.L.J. (April 4, 2008).