Fairness Act Could Move Arbitration Overseas

Greater consumer protection may be needed, but Congress should beware a raft of unintended consequences

By Urs Martin Laeuchli

Perceived abuses in the arbitration process have attracted attention in Congress and, as a result, new legislation has been proposed to regulate it. The Arbitration Fairness Act is aimed at protecting consumers, employees and franchisees. It has been introduced several times over the last three years and this time it may become law, according to some observers. If so, the legislation would create an altered landscape for litigants, as well as for those who represent them and arbitrate their disputes.

With similar bills introduced in the House and the Senate, the legislation is designed to invalidate mandatory pre-dispute arbitration clauses found in thousands of contracts. Consumers, employees, franchisees and civil rights litigants could arguably then back out of an arbitration proceeding at any time and switch to a court proceeding. Or they could do nothing, leaving the opposition with the option of resubmitting the dispute to the court. This would represent a considerable power shift away from businesses.

If passed, the Arbitration Fairness Act will affect where people go with their disputes, lead to new business challenges, change litigation and transactional strategies and alter the thinking of key decision makers in the arbitration process, including trial and appellate judges and arbitrators. One result will be that litigants will spend much more time in court on the increasing number of cases where there are no post-dispute agreements on arbitration. They will also spend more time in court on cases in which one side disputes the case's suitability for arbitration.

Under the bill, federal judges will not only determine whether an arbitration clause survives a potentially unenforceable agreement but also whether a case can even be subject to arbitration. This abrogates well-settled principles in American and international arbitration law, such as the competence-competence principle (*First Options of Chicago v. Kaplan*, 514 U.S. 938, 1995; see also *Buckeye Check Cashing v. Cardegna*, 546 U.S. 440, 2006), and the principle of separability (*Prima Paint v. Flood & Conklin*, 388 U.S. 395, 404 1967). These principles ensure that the arbitration tribunal rather than federal judges determine the arbitrability of cases.

The competence-competence principle can occur when one adjudicator such as a judge makes no ruling so as not to interfere with the other adjudicator such as the arbitrator. Or, the adjudicator can make an affirmative decision whether the arbitration tribunal shall handle the case. Under the separability principle, arbitration clauses are treated separately from the rest of a contract and do not necessarily share the

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contract's fate. For example, even if a contract is deemed void, its arbitration clause may still survive.

This aspect of the legislation may thus amplify the flood of court cases, as federal judges must then determine issues such as the arbitrability of a case, the validity of a contract containing an arbitration clause, the scope of the clause, and whether a party qualifies as protected under the act.

Many observers have said that there are no remarkable differences between the way judges or arbitrators handle their cases. Switzerland, France and England are some of the most frequently designated arbitration jurisdictions. Together with the United Nations, these countries have all codified the competence-competence and the separability principles in their arbitration statutes.

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If the Arbitration Fairness Act does pass, the U.S. may lose its competitive edge in international arbitration if it is perceived as hostile to arbitration. The resulting higher risk of litigation will discourage international parties from choosing the American system to arbitrate their cases, whether the venue is here or elsewhere. Hence U.S. businesses may face the unappealing prospect of being forced into dispute resolution abroad, namely in foreign courts.

For instance, a litigant may allege that a binding pre-dispute arbitration clause was in contravention of the "*ordre public*" or international public policy in the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards (known as the New York Convention, ratified by the U.S. in 1970). They may resist enforcement of an otherwise valid international arbitration award, arguing there is a public policy in the U.S. against mandatory pre-dispute arbitration clauses. While the New York Convention basically facilitates the smooth enforcement of an arbitration award world-wide in its 144 member states, contravention of public policy is one of the few defenses against such enforcement.

However, this argument is flawed because, among other reasons, an international notion of "*ordre public*" should be applied rather than a national or U.S. one.

While the House bill would outlaw pre-dispute arbitration clauses in all franchise agreements, the Senate bill invalidates those clauses in franchise contracts involving a domestic franchisee. In my opinion, doing so is not advisable because the franchise agreements used in over 70 industries are often between sophisticated parties on both sides who are substantial in size. Regulatory intervention may be justified to protect weak parties. However, this is not the case in most franchises, where typically wealthy and sophisticated business partners enter transactions.

Interestingly enough, this national legislation comes at the same time as various efforts to make California a more arbitration-friendly place. For example, the California State Bar is involved in an initiative to prevent the termination of the "*Birbrower* rule" under the California Code of Civil Procedure §1282.4. That effort tries to lessen the hostility against non-California attorneys appearing in arbitration in California. Given that the Golden State has a significantly larger economy than the other international arbitration heavyweights, such as New York and all but seven countries in the world, it is dismaying that California hosts less than half as many international arbitrations as New York. However, if the federal legislation goes through as drafted, California and New York will be chosen far less as the site of arbitrations.

On top of that, the legislation is poorly crafted. Instead of locating the protective legislation elsewhere in the U.S. Code as customary, the House tampers with the well-established 80-year-old Federal Arbitration Act. Chapter 1 of the existing Federal Arbitration Act is consistent and predictable arbitration law based on a balanced public policy, and it is enriched with judicial and scholarly analysis. The re-ordering of the act seems problematic, confusing and unnecessary.

When two sections of the Bar Association of San Francisco recently conducted a debate on the Arbitration Fairness Act, the focus was mainly on the calamities of consumer arbitration. One camp of opponents of the legislation does not want a bill at all and thinks regulation should be left to market forces. This principled policy standpoint might be overly optimistic given the impact of some players like the National Arbitration Forum on the consumer arbitration market. The forum lost its credibility as a neutral provider organization in consumer arbitrations following widespread allegations that it had become too close to the debt collection and banking industry.

Another camp of opponents to the Arbitration Fairness Act aims at measures to bring consumer and employment arbitration back to normalcy and fairness. For example, the arbitration provider should observe Consumer and Employment Arbitration Due Process Protocols. Arbitration venues should be at or near the consumer's place of residence or work. Arbitrations should be free of charge for the consumer up to a certain threshold of the amounts in dispute. And, there should be opt-in or opt-out clauses in the underlying contracts that are clearly presented to the parties, with a period of possible rescission after entering those contracts. That opt-out mechanism is necessary so that consumers are not forced against their will into arbitration.

Various organizations have asked to at least revise the presently drafted bill. They include the American Arbitration Association, the American Bar Association, the New York State Bar Association's Dispute Resolution Section, the California Dispute Resolution Council, and the Arbitration Committee of the Bar Association of San Francisco.

There remain serious concerns about the unintended consequences of the Arbitration Fairness Act. The preferred option is to improve and reform the arbitration market and make it more consumer friendly while also preserving the strengths of commercial arbitration developed under the Federal Arbitration Act, as opposed to leaving it alone or eliminating it altogether. ■