

JULY 9, 2013

## Congress Again Considers The Arbitration Fairness Act

### A. Introduction

**The Arbitration Fairness Act, which was still pending at the end of the 112th Congress, has been reintroduced by its sponsors, Senator Al Franken (D-MN) and Representative Henry C. “Hank” Johnson, Jr. (D-GA).** Like the 2011 legislation, the Arbitration Fairness Act of 2013 would invalidate and bar enforcement of pre-dispute arbitration agreements requiring arbitration of *inter alia* customer disputes against securities broker-dealers. Any challenge to the validity and enforceability of an agreement to arbitrate such a dispute would be determined under federal law, and by a court rather than an arbitrator.

The Arbitration Fairness Act of 2013 is premised on the same legally dubious “findings” that formed the basis for the 2011 legislation. Such findings do not provide legal support for the legislation’s invalidation of pre-dispute arbitration provisions in securities brokerage agreements. Moreover, the proposed legislation ignores the empirical evidence concerning consumer arbitrations which was presented to Congress at a hearing on the 2011 legislation. It also ignores the empirical evidence concerning securities arbitrations conducted before FINRA Dispute Resolution. As explained below, this empirical evidence “does not support the view that arbitration is necessarily unfair to consumers” and instead suggests that “broad-ranging restrictions on arbitration may well be counter-productive.” Testimony of Christopher R. Drahozal, John M. Rounds Professor of Law,

University of Kansas School of Law, Hearing on S. 987, Senate Judiciary Committee (October 13, 2011) (hereinafter “Drahozal Testimony”) at 10.

### B. The Proposed Arbitration Fairness Act of 2013

On May 7, 2013, the Arbitration Fairness Act was reintroduced in the Senate and House of Representatives. The bills (S. 878 and H.R. 1844, respectively) are virtually identical to the bills which were introduced in 2011. The Arbitration Fairness Act of 2013 would invalidate and bar enforcement of any pre-dispute arbitration agreement that requires arbitration of an employment, consumer, anti-trust or civil rights dispute. Like the 2011 legislation, the 2013 legislation would amend the Federal Arbitration Act (“FAA”), 9 U.S.C. § 1, *et seq.* (2013) by adding Section 402(a), providing:

(a) IN GENERAL -- Notwithstanding any other provision of this title, no predispute arbitration agreement shall be valid or enforceable if it requires arbitration of an employment dispute, consumer dispute, antitrust dispute or civil rights dispute.

2013 S. 878 and 2013 H.R. 1844, 113th Cong., 1st Sess. (2013). Apart from the fact that S. 878 and H.R. 1844 add anti-trust claims to the types of disputes which are encompassed by the Arbitration Fairness Act, Section 402(a) is identical to its 2011 counterpart.

Like the 2011 legislation, Section 401(3) of the Arbitration Fairness Act defines the term “consumer dispute” as “a dispute between an

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individual who seeks or acquires real or personal property, services (*including services relating to securities and other investments*), money, or credit for personal, family, or household purposes and the seller or provider of such property.” 2013 S. 878 and 2013 H.R. 1844, 113th Cong., 1st Sess. (2013) (emphasis added). The Arbitration Fairness Act thus expressly encompasses claims brought against securities broker-dealers by customers arising out of transactions in their securities brokerage accounts.

The Arbitration Fairness Act of 2013, like its 2011 counterpart, would require that any issue concerning the applicability of the FAA to an arbitration agreement and the enforceability of that agreement be determined under federal law in a judicial forum. Section 402(b) of the proposed legislation provides:

(b)(1) IN GENERAL -- An issue as to whether this chapter applies to an arbitration agreement shall be determined under Federal law. The applicability of this chapter to an agreement to arbitrate and the validity and enforceability of an agreement to which this chapter applies shall be determined by a court, rather than an 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.

2013 S. 878 and 2013 H.R. 1844, 113th Cong., 1st Sess. (2013).

The findings upon which the Arbitration Fairness Act of 2013 are predicated are essentially the same as the findings that were contained in the 2011 legislation:

(1) The Federal Arbitration Act (now enacted as chapter 1 of title 9 of the United States Code) was intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power.

(2) A series of decisions by the Supreme Court of the United States have interpreted the Act so that it now extends to consumer disputes and employment disputes, contrary to the intent of Congress.

(3) Most consumers and employees have little or no meaningful choice whether to submit their claims to arbitration. Often, consumers and employees are not even aware that they have given up their rights.

(4) Mandatory arbitration undermines the development of public law because there is inadequate transparency and inadequate judicial review of arbitrators' decisions.

(5) Arbitration can be an acceptable alternative when consent to the arbitration is truly voluntary, and occurs after the dispute arises.

2013 S. 878 and 2013 H.R. 1844, 113th Cong., 1st Sess. (2013).

S. 878 was referred to the Senate Committee on the Judiciary on May 7, 2013. H.R. 1844 was referred to the House Committee on the Judiciary on May 7, 2013 and then to the Subcommittee on Regulatory Reform, Commercial and Anti-Trust Law on June 14, 2013. No hearings have been scheduled to date on either bill.

## C. Analysis

The Arbitration Fairness Act of 2013 is as flawed as its 2011 counterpart. It is predicated on findings that are legally unsound, particularly insofar as securities arbitrations are concerned. The 2013 legislation also ignores the empirical evidence concerning consumer arbitrations which Professor Christopher Drahozal discussed in his testimony at the hearing on the 2011 legislation that was held before the Senate Judiciary Committee as well as the empirical evidence concerning securities arbitrations conducted before FINRA Dispute Resolution. As set forth below, this evidence does not support the premise of the Arbitration Fairness Act that compulsory arbitration of consumer disputes (including customer claims against securities broker-dealers) is unfair.

First, the legislative history of the FAA does not support the finding that the statute was “intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power.” Rather, the FAA’s primary purpose was to ensure enforcement of arbitration agreements:

The purpose of this bill is to make valid and enforceable agreement for arbitration containing in contracts involving interstate commerce or within the jurisdiction of admiralty, or which may be the subject of litigation in the Federal courts.

H.R. Rep. No. 96, 68th Cong., 1st Sess. 1 (1924). The FAA sought to “overcome the rule of equity, that equity will not specifically enforce any arbitration agreement.” Hearing on S. 4214 before a Subcommittee of the Senate Committee on the Judiciary, 67th Cong., 4th Sess. 6 (1923) (remarks of Senator Walsh). The House Report accompanying the bill further provided:

The need for the law arises from an anachronism of our American law. Some centuries ago, because of the jealousy of the English courts for their own jurisdiction, they refused to enforce specific agreements to arbitrate upon the ground that the courts were thereby ousted from their jurisdiction. This jealousy survived for so long a period that the principle became firmly imbedded in the English common law and was adopted with it by the American courts. The courts have felt that the precedent was too strongly fixed to be overturned without legislative enactment, although they have frequently criticized the rule and recognized the illogical nature and the injustice which results from it. This bill simply declares that such agreements for arbitrations shall be enforced, and provides a procedure in the Federal courts for their enforcement.

H.R. Rep. No. 96, 68th Cong., 1st Sess. 1-2 (1924). The secondary purpose of the FAA, as the legislative history demonstrates, was to promote the expedited resolution of disputes:

It is practically appropriate that the action should be taken at this time when there is so much agitation against the costliness and delays of litigation. These matters can be largely eliminated by agreements for arbitration, if arbitration agreements are made valid and enforceable.

*Id.* at 2. There is nothing in the FAA’s legislative history reflecting that the statute was only intended to apply to disputes between “commercial entities of generally similar sophistication and bargaining power.” *See also, Southland Corp. v. Keating*, 465 U.S. 1, 12-14, 104 S. Ct. 852 (1984); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 219-21, 105 S. Ct. 1238 (1985).

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**First, the legislative history of the FAA does not support the findings that the statute was "intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power"**

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**Second, the Arbitration Fairness Act's premise that "arbitration is necessarily unfair to consumer" is not supported by the empirical evidence.**

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The finding that “[a] series of decisions by the Supreme Court of the United States having interpreted the [FAA] so that it now extends to consumer disputes and employment disputes....” is likewise without legal merit. Section 2 of the FAA makes enforceable any “written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction....” 9 U.S.C. § 2 (2013). The statute does not distinguish between “consumer disputes” such as claims by customers against securities broker-dealers and disputes between “commercial entities of generally similarly sophistication and bargaining power.” To the contrary, provided that the interstate commerce requirement is met, Section 2 of the FAA makes enforceable pre-dispute agreements to arbitrate all such disputes. Judicial enforcement of agreements requiring the arbitration of customer disputes against broker-dealers merely shows that the courts interpret the FAA precisely as Congress intended.

Further, the criticism that “mandatory arbitration undermines the development of public law because there is inadequate transparency and inadequate judicial review of arbitrators’ decisions” is, as Professor Peter Rutledge has previously pointed out, not unique to arbitration. As he testified at the hearing on the original version of the Arbitration Fairness Act introduced in 2007, settlement is another mechanism which is not transparent, nor does it facilitate the development of public law, yet there are clear benefits associated with settlement, such as “reduced stress on the judicial system, speedier relief for plaintiffs and lower legal fees for both sides.” *See* Testimony of Peter B. Rutledge, Associate Professor of Law, Columbus School of Law, Catholic University of America, Hearing on H.R. 3010, House Judiciary Committee (October 25, 2007) at 9. As Professor Rutledge concluded, “the same logic supporting

settlements -- notwithstanding their retarding effect on the development of public law -- also support arbitration.” *Id.*

Moreover, the alleged lack of meaningful judicial review of arbitration awards must be weighed against the cost factor in litigating a matter in court, which undoubtedly is substantially more expensive than prosecuting a claim in an arbitration forum such as FINRA Dispute Resolution. In other words, the high cost of judicial review can end up leaving the prospective claimant without an effective means of vindicating his rights.

Second, the Arbitration Fairness Act’s premise that “arbitration is necessarily unfair to consumers” is not supported by the empirical evidence. Such evidence includes a study conducted by the Searle Civil Justice Institute of consumer arbitrations held before the American Arbitration Association (“AAA”) which Professor Drahozal cited in his testimony at the hearing on the 2011 legislation (the “Searle study”). While the Searle study did not examine securities arbitrations held before FINRA Dispute Resolution, its findings are nonetheless instructive with respect to such arbitrations because the criticisms which the Searle study refutes are similar to the criticisms that have been expressed over the years regarding securities arbitrations.

Among other things, Professor Drahozal responded to the argument advanced by critics of consumer arbitration that “excessively high win rates for businesses [is] evidence that arbitration is unfair to consumers,” testifying that “the conclusions critics draw from [the] data are incorrect.” Drahozal Testimony at 5. Relying on the Searle study, Professor Drahozal concluded that “the data provide no support for the view that consumers fare worse in arbitration than they do in comparable cases in court” and that “the data

show definitively that high business win rates in arbitration do not in and of themselves prove that arbitration is unfair to consumers.” *Id.* at 6. As Professor Drahozal observed, “the Searle study found that consumer claimants won some relief in 53.3 percent of the AAA consumer arbitrations studied, and that, in those cases, consumers were awarded 52.1 percent of the amount they sought.” Drahozal Testimony at 5.

Addressing the claim that arbitrator providers are biased in favor of businesses, Professor Drahozal responded that this assertion seems “belied by the adoption and enforcement of ‘due process protocols’ by the two leading providers of arbitration services in the United States (the AAA and JAMS).” Drahozal Testimony at 7. Examining the AAA’s enforcement of the consumer due process protocol, the Searle study found that “the arbitration clauses in 98.2% of the AAA cases studied either complied with the Due Process Protocol or that the AAA properly identified and responded to any non-compliance.” *Id.* In light of this evidence, Professor Drahozal concluded, “[i]t is hard to square the AAA’s enforcement of the consumer due process protocol with the suggestion that arbitration providers are systematically biased in favor of businesses.” *Id.* at 8.

Professor Drahozal also pointed out a number of unintended consequences that might result from the adoption of restrictions on the use of pre-dispute arbitration clauses in consumer contracts. Among other things, Professor Drahozal observed that “restrictions on the enforceability of arbitration agreements may reduce rather than enhance the ability of some consumers and employees to have their claims heard,” explaining that “[t]he available empirical evidence suggests that for relatively low-dollar claims, arbitration may be a more accessible forum than court.” Drahozal Testimony at 9-10. Professor Drahozal also pointed out that “some

consumers will be less able to have their cases actually heard if the availability of arbitration is restricted.” *Id.* Observing that “very few court cases actually make it to trial,” the Searle study found by contrast that “over 50 percent of consumer claims in AAA arbitrations made it to a hearing before an arbitrator, and over 30 percent were resolved by the issuance of an award after a hearing.” *Id.* Professor Drahozal concluded that “[t]o the extent there is value in consumers actually being able to present their claim to a neutral decision maker, restricting the availability of arbitration will deprive consumers of that value.” *Id.*

The empirical evidence concerning the arbitration of customer disputes against securities broker-dealers before FINRA Dispute Resolution also refutes the Arbitration Fairness Act’s premise that “arbitration is necessarily unfair to consumers.” Over the years, FINRA Dispute Resolution has adopted numerous changes to the Code of Arbitration Procedure designed to make the process of arbitrating customer claims fairer to customers. Among the rules that FINRA Dispute Resolution has adopted in order to make the arbitration process fairer to customers are the following: (i) Rule 12403(b), which allows the customer claimant to opt for an all public arbitrator panel; (ii) Rule 12504(a), which discourages the filing of motions to dismiss prior to the conclusion of a party’s case in chief; (iii) Rule 12904(g), which provides parties with the option of an explained decision in the arbitration award; and (iv) Rule 12100(p), which precludes individuals who have a substantial relationship with the securities industry from serving as public arbitrators. Moreover, the most recent statistics on the disposition of customer claims that are litigated to an award are comparable to the statistics contained in the Searle study that Professor Drahozal cited. During the period from 2008 through May 2013, customers were

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awarded damages in nearly half the cases that were litigated to an award. The breakdown is as follows: (i) in 2008, customers were awarded damages in 199 cases out of 474 cases, or 42%; (ii) in 2009, customers were awarded damages in 304 cases out of 669 cases, or 45%; (iii) in 2010, customers were awarded damages in 415 cases out of 882 cases, or 47%; (iv) in 2011, customers were awarded damages in 297 cases out of 670 cases, or 44%; (v) in 2012, customers were awarded damages in 255 cases out of 570 cases, or 45%; and (vi) from January through May 2013, customers were awarded damages in 76 cases out of 194 cases, or 39%. Cases which have been tried by all public panels have yielded similar results. The breakdown of the awards that have been issued since the implementation of the all public panel program in February 2011 is as follows: (iv) in 2011, customers were awarded damages in 7 cases out of 13 cases tried by all public panels, or 54%; (v) in 2012, customers were awarded damages in 49 cases out of 99 cases tried by all public panels, or 49%; and (vi) from January through May 2013, customers were awarded damages in 22 cases out of 47 cases tried by all public panels, or 47%. Additionally, in 2012 customer claimants obtained a monetary or non-monetary recovery in approximately 78% of the cases, whether through settlements or awards. *See* FINRA Dispute Resolution Statistics, <http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/index.htm>.

## Conclusion

The legislative process for the Arbitration Fairness Act of 2013 is at a very early stage. Insofar as securities arbitrations are concerned, the current legislation suffers from the same fundamental legal flaws that permeated the 2011 legislation. It also disregards the empirical evidence that largely refutes the Arbitration Fairness Act's premise that "arbitration is necessarily unfair to consumers." Consequently, the Arbitration Fairness Act of 2013 does not provide any legal or evidentiary justification for invalidating pre-dispute arbitration provisions in securities brokerage agreements. ■

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