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Fixing the Mandatory Arbitration Problem: We Need the Arbitration Fairness Act of 2009

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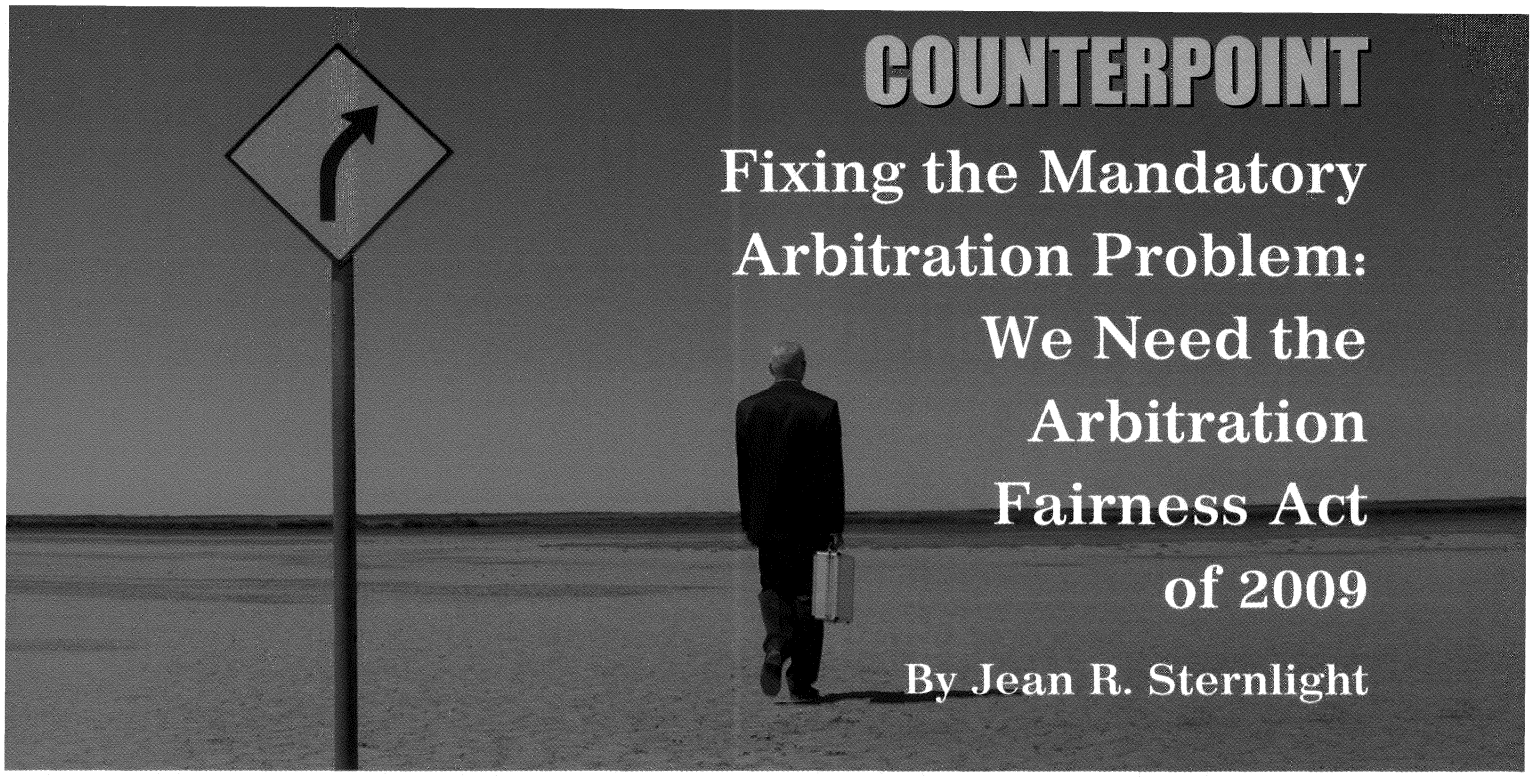


COUNTERPOINT

Fixing the Mandatory Arbitration Problem: We Need the Arbitration Fairness Act of 2009

By Jean R. Sternlight

U.S. companies are increasingly requiring their consumers and employees, whom I refer to here as "little guys," to arbitrate rather than litigate disputes with the company. With envelope stuffers, computerized click-through agreements, or just small print, companies can eliminate "little guys' " opportunity to litigate, even if the "little guys" did not knowingly or intelligently agree, and even if they never signed the provision.

The U.S. Supreme Court has held that the 1925 Federal Arbitration Act requires that courts enforce such "agreements," called "mandatory" binding arbitration by their critics. Although such clauses usually affect potential plaintiffs, sometimes they also affect "little guys" as defendants. Credit card companies are increasingly using mandatory arbitration clauses to bring collection actions against their customers in arbitration rather than in court.

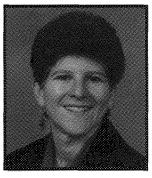
Pointing to the often inaccessible litigation system, some argue that consumers are better off in mandatory arbitration than in litigation. Defenders assert that most arbitrators are fair, that the purportedly cheaper process will keep wages higher and prices lower, and that empirical studies prove mandatory arbitration is better than litigation. Some even contend that mandatory arbitration is necessary to protect companies from "predatory" litigation by consumers or employees.[1]

But empirical studies don't resolve this dispute. Few have been done, as arbitration providers are unwilling to provide open access to their files. Moreover, to the extent studies look only at who prevails in an arbitration hearing, they miss most of the empirical picture. Much of mandatory arbitration's impact is that it deters people from bringing claims at all and causes them to settle on unfavorable terms.

Defenders of mandatory arbitration play a rhetorical game when they suggest critics should have the burden of proving the practice is unfair, instead of requiring defenders to prove the practice is fair. Yet, without definitive proof either way, we know that companies have an incentive to eke out every advantage in battles against consumers and employees. Companies want to prevent "little guys" from bringing claims against the company and then want to maximize companies' opportunities to prevail if claims are brought. When courts enforce "agreements" that studies show few will read or understand, companies have every opportunity to skew the clauses to their own advantage. Even the rare consumer or employee who reads and understands the clauses usually can't avoid them because all the other industry companies are imposing similar clauses.

Sometimes, companies try to use arbitration to gain blatant advantage over consumers and employees—such as by eliminating claims for punitive or compensatory damages, shortening statutes of limitations, or imposing biased arbitrators. The Minnesota attorney general recently brought a claim alleging that one provider, the National Arbitration Forum, was actually owned in part by a company that also owned the very debt collection companies that regularly sued consumers in NAF arbitration. In settlement of this claim, NAF has now ceased handling consumer arbitrations. Sometimes, the skewing is less blatant but equally detrimental—like preventing "little guys" from bringing class actions when that would be the only economically feasible means of presenting a small claim affecting numerous consumers.

In addition to adversely impacting individuals, mandatory arbitration clauses may have a detrimental impact



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on the public. Such clauses ensure that disputes will be resolved behind closed doors, rather than through public precedent.

Theoretically, a company could set up an even-handed mandatory binding arbitration program. Some companies and many arbitrators do their best to give consumers and employees justice, and sometimes they succeed. But human nature and the profit motive ensure that many companies will take advantage of the opportunity to use mandatory arbitration to treat the "little guys" unfairly.

State legislators and regulators have no ability to rein in abusive arbitration practices.

If unfairness or potential unfairness is the problem, what is the solution? Some say courts already have the power to knock out unfair clauses using standard contract doctrines such as unconscionability. Yet, although courts have voided some of the most blatantly unfair clauses, these case-by-case reviews are insufficient to ensure justice. First, many "little guys" will never attempt to challenge unfair clauses. Many won't even realize a challenge could be possible. Second, it is time-consuming and expensive for challengers to meet their burden to prove unconscionability. Successful challenges often take years, and more than $100,000 may be needed to pay for discovery and experts. Third, many unfair clauses have survived court challenge because the law targets only the most blatantly unfair provisions.

State legislators and regulators have no ability to rein in abusive arbitration practices. Numerous Supreme Court decisions have held that state attempts at regulation are preempted by the FAA.[2]

Unless the Supreme Court chooses to reverse 20 years of arbitration precedents, a highly unlikely short-term prospect, federal legislation is needed to protect ordinary Americans from mandatory arbitration. Note that other countries, including members of the European Union, have ensured that companies cannot use mandatory binding arbitration to secure unfair advantage over consumers and employees. We in the United States ought to protect ourselves as well.

Congress could protect Americans by enacting either of two types of legislation: prohibitive or regulatory. Prohibitive legislation, of which the proposed 2009 Arbitration Fairness Act (AFA) is an example, would prohibit mandatory predispute arbitration altogether with respect to consumers, employees, and civil rights claimants.[3] Regulatory legislation, on the other hand, would eliminate only the most egregious forms of mandatory arbitration, allowing companies to continue to mandate arbitration for consumers and employees so long as it meets minimal fairness requirements. For example, companies might be barred from using biased arbitrators or using arbitration to eliminate remedies available in court.

Upon reflection, there are two significant problems with the seemingly reasonable regulatory approach. First, how will unfair/impermissible arbitration practices be defined? In the past, with providers' voluntary due process protocols, the definition of unfair practices has proven to be a moving target. Just as one unfair practice is restricted, companies creatively devise another unfair arbitration provision, such as prohibiting all class actions so as to insulate the company from smaller claims. As long as companies have the incentive and ability to define arbitration in a way that is beneficial to them, attempts to regulate such practices may resemble that famous Dutch boy trying to put his fingers in the holes in the dike. No sooner is one hole blocked than another springs up.

Second, a regulatory approach is only as effective as the regulator. How vigorously would a statute prohibiting unfair arbitration practices be enforced? If the statute requires individual "little guys" to prove particular arbitration clauses are unfair under the new federal law, they will suffer the same high burdens of proof and expense that they already face as they try to prove particular arbitration clauses are unconscionable. Alternatively, a new federal agency (such as the Consumer Financial Protection Agency recently proposed by President Obama) could be empowered to police all arbitration clauses. But, as we have seen with other federal regulatory efforts in this country, inadequate funding will likely cause enforcement to fall short of the aspiration.

The proposed AFA is a far preferable means to protect consumers, employees, and civil rights claimants. Its direct prohibition on the imposition of mandatory predispute arbitration in these settings would be simple to enforce. The prohibition would protect persons who, realistically, will not read or understand the meaning of an arbitration provision prior to when a dispute has even arisen. Yet, the statute would allow members of those groups to voluntarily opt for binding arbitration on a postdispute basis, thereby permitting disputants to select arbitration over litigation once they can meaningfully compare the costs and benefits of the two processes.

Some have criticized the AFA as overly broad in that it would outlaw even predispute agreements that are entered knowingly, voluntarily, and intelligently. It is true that a broad prohibition no doubt catches up at least a small number of persons who could capably draft a predispute arbitration agreement. However, it is better that this statute be a bit overly broad than significantly overly narrow. It simply is not possible to draft a statute that would perfectly distinguish between knowing consensual and nonconsensual predispute arbitration agreements without imposing impossibly high regulatory costs. To the extent parties are precluded from entering enforceable predispute arbitration agreements, they always have the option to agree to arbitration postdispute. Although defenders of mandatory arbitration typically assert postdispute agreements are infeasible, both sides would have every incentive

to agree to a process that was truly better and more efficient for all.

In the end, the most practical way to ensure that arbitration is fair is to make it voluntary on a postdispute basis. Once a dispute has arisen, consumers, employees, and other "little guys" will be able to make knowledgeable determinations as to whether the proposed arbitration is efficient and fair for all concerned. The proposed Arbitration Fairness Act in this sense would use the free market to ensure that arbitration is fair and just. ◆

Endnotes

1. Alan S. Kaplinsky & Mark J. Levin, *Excuse Me, But Who's the Predator? Banks Can Use Arbitration Clauses as a Defense*, BUS. L. TODAY (May–June 1998) at 24.
2. *E.g.*, Doctors Associates Inc v. Casarotto, 517 U.S. 681 (1996) (holding that the FAA preempted Montana law specifying that an arbitration clause be printed at page one of a contract and be provided in capital letters and underlined).
3. The currently pending bills, S. 931 and H.R. 1020, would also prohibit franchisors from imposing mandatory arbitration on franchisees, on the theory that many franchisees require protection from the more powerful franchisors.

Point

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lawyers generally will demand high recoveries and a high prospect of success before they are willing to undertake a case. By contrast, the lower costs of arbitration and the procedural flexibility enable an individual to obtain judgment at a lower cost.

Apart from access to counsel, arbitration improves access to justice in another respect. Individuals achieve results faster. Every major empirical study on arbitration has found that it produces results faster than litigation. For individuals who seek recovery, the speed to resolution may be a valuable advantage of this system of alternative dispute resolution. By eliminating predispute arbitration, Congress may worsen access to justice and end up hurting the very classes of people whom it purports to protect.

For society as a whole, the costs of resolving disputes without arbitration would rise. Consider the thousands of disputes currently resolved by arbitration. If those disputes no longer were arbitrable, where would they go? "To the courts" is the obvious answer. But any self-respecting lawyer or judge would tell us that the court dockets are already overburdened. Shuttling these cases out of arbitration simply lengthens the line at the courthouse for everyone.

Some defenders of the Arbitration Fairness Act try to turn these arguments on their head by arguing that arbitration deprives plaintiffs of the ability to bring class actions and thereby deprives those plaintiffs "access to justice." There is some surface appeal to this argument, but it ultimately does not support adoption of the Arbitration Fairness Act. For one thing, the argument assumes the widespread adoption of class action waivers, and although some evidence suggests its use in certain industries (such as the cellular telephone industry), I am unaware of any systemwide evidence on this point. For another thing, even assuming the problem is widespread, the argument further assumes that a large number of cases exist that would satisfy Federal Rule of Civil Procedure 23's exacting standards—again, I am unaware of any empirical evidence on this point. Finally, even assuming that these two preceding hurdles can be overcome, the argument does not support the wholesale invalidation of arbitration clauses—a more calibrated solution would simply invalidate class action waivers but not the arbitration clauses themselves. Organizations such as the American Arbitration Association have begun to develop extensive experience administering class arbitrations, and there is no principled reason why the purported benefits of a class action cannot also be realized through the mechanism of an arbitration. Thus, at bottom, the class action argument is a bit of a ruse—at best it is an argument for the invalidation of class action waivers; at worst, it is self-interested politicking by class action plaintiffs' lawyers masquerading as policy making in the public interest.

Third, defenders of the Arbitration Fairness Act often argue that postdispute arbitration mitigates these and other risks of eliminating enforceable agreements. Yet postdispute arbitration is not a viable alternative to predispute arbitration agreements. One problem is psychological—parties are simply far more willing to agree on matters before a dispute has arisen; once a dispute arises, the opportunities for cooperation dwindle. The second problem is structural: the parties' incentives in the postdispute context fundamentally differ from the predispute context. Postdispute parties have more information, which enables them to make more calculated decisions regarding which form of dispute resolution better promotes their interests or effectively hinders the individual's interests. Conversely, in the predispute context, parties have an incentive to enter into arbitration. An individual's incentive is that arbitration is an affordable forum with superior chances for a favorable result. A company's incentive is that arbitration can lower the company's litigation costs.

At bottom, the Arbitration Fairness Act applies a meat cleaver to an issue that requires a scalpel. The solution is not for Congress to prohibit predispute arbitration agreements in employment, consumer, and franchise contracts. Instead, Congress should encourage and await additional empirical research. Research may show minor additions to the regulatory repertoire are necessary. However, wholesale, retroactive elimination of predispute arbitration agreements would effectively make worse off the individuals whom Congress, through this legislation, seeks to protect. ◆

Endnotes

1. *See generally* Peter B. Rutledge, *Whither Arbitration?* 6 GEORGETOWN J. L & PUB. POL'Y 549 (2008).
2. *See* Alexander J.S. Colvin, *Empirical Research on Employment Arbitration: Clarity Amidst the Sound and Fury?* 11 EMPL. RTS. & EMPLOY. POL'Y J. 405 (2007).