

ARBITRATION'S DARK SHADOW

Benjamin P. Edwards*

Arbitration has expanded broadly, removing disputes involving entire industries from judicial review. The absence of judicial review plunges these disputes and industries into the shadow. This shadow causes the public to lose sight of vital information about industry practices and arbitrators to gradually lose sight of the law. Federal intervention may be necessary to restore consumer protections, including customer choice, to bring these disputes out of the shadows.

INTRODUCTION

As arbitration grew and supplanted vast amounts of litigation, it changed—leaving both its opponents and its enthusiasts dissatisfied.¹ Concerns about arbitration's fairness caused some arbitral forums to adopt procedures closely resembling traditional litigation.² While these reforms mollified some concerns, they also altered arbitration—reducing its benefits and increasing its cost. Despite the increased costs and complexity, however, arbitration continues to grow.³

Today, arbitration casts a long, dark shadow that obscures information that would otherwise be available. It now cloaks countless conflicts. Unlike disputes resolved through public courts that allow the public to access information, disputes resolved through arbitration deprive the public of significant information.⁴ This absence of information alters behavior and undercuts reputation's

* Associate Professor, University of Nevada, Las Vegas, William S. Boyd School of Law; J.D., Columbia Law School. For helpful comments and conversations, special thanks to Rebecca L. Scharf.

¹ Deborah Hensler and Damira Khatam capture this dissatisfaction in their piece explaining the need to reconsider arbitration's domestic and international scope. Deborah R. Hensler & Damira Khatam, *Re-Inventing Arbitration: How Expanding the Scope of Arbitration Is Reshaping Its Form and Blurring the Line Between Private and Public Adjudication*, 18 NEV. L.J. 387 (2018).

² See, e.g., Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1105–06 (1993) (explaining that “the self-regulatory organizations, at the urging of the SEC, have introduced certain protections comparable to those routinely provided in civil litigation in the federal courts.”).

³ See Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631, 1633 (2005) (describing arbitration's growth).

⁴ See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 52 (2008) (explaining how arbitration often “blocks public access to information revealed in the arbitration, and eliminates the procedural rights that would have been available in the court system.”).

critical role in a free economy.⁵ Defendants face substantially lower reputational risks for abusive practices when allegations may be resolved through private, secretive arbitration.

Yet arbitration's shadow stretches further and now plunges parties and courts into darkness as well. This short essay describes mandatory arbitration's stunning growth and explores some of that growth's implications. Part I briefly reviews the rise of pre-dispute arbitration agreements before describing arbitration's broad reach today. Part II explores some implications of arbitration's vast expansion and explains how its success undercuts its legitimacy by causing the public to lose sight of disputes and arbitrators to lose sight of the law.

I. ARBITRATION'S EXPANSION

In the past, arbitration served as a tool for parties to voluntarily agree about how to resolve future disputes without going to court.⁶ Parties would negotiate and select arbitration forums and procedures that offered a superior alternative to judicial resolution.⁷ Congress enacted the Federal Arbitration Act (FAA) to protect these contracts from skeptical courts.⁸

A. Pre-Dispute Arbitration Agreements

Since that time, arbitration has mutated and migrated from the "consensual business-to-business" context and into the consumer realm.⁹ In this context, consumers and employees do not negotiate the arbitration procedures and often cannot even shop around between service providers to avoid signing arbitration agreements.¹⁰ Instead, consumers and employees often find that they are required to sign pre-dispute arbitration agreements (PDAAs) either as a condition of employment or in order to access goods and services.¹¹ PDAAs obligate consumers to resolve any claims which may arise in arbitration forums selected by the more powerful party.¹²

⁵ See Roy Shapira, *Reputation Through Litigation: How the Legal System Shapes Behavior by Producing Information*, 91 WASH. L. REV. 1193, 1241 (2016) ("All else being equal, the informational value of the law represents another previously overlooked argument against confidential litigation.").

⁶ See Jean R. Sternlight, *Hurrah for the Consumer Financial Protection Bureau: Consumer Arbitration as a Poster Child for Regulation*, 48 ST. MARY'S L.J. 343, 346 (2016) [hereinafter Sternlight, *Poster Child*] ("Once upon a time, arbitration was a dispute resolution process that was adopted knowingly and voluntarily by two or more businesses that preferred to resolve disputes outside of court.").

⁷ *Id.*

⁸ Originally passed as the United States Arbitration Act, Pub. L. No. 68-401, 43 Stat. 883 (1925) (codified at 9 U.S.C. §§ 1-14 (2012)).

⁹ See Sternlight, *Poster Child*, *supra* note 6, at 346-47.

¹⁰ See Judith Resnik, *Diffusing Disputes: The Public in the Private of Arbitration, the Private in Courts, and the Erasure of Rights*, 124 YALE L.J. 2804, 2839-40 (2015).

¹¹ See *Id.* at 2871-72.

¹² See Sternlight, *Poster Child*, *supra* note 6, at 346-49.

As arbitration expanded, the Supreme Court repeatedly blessed the use of arbitration provisions to insulate disputes from public litigation.¹³ It first expanded arbitration's reach to include federal securities claims before expanding arbitration's reach further to include antitrust claims.¹⁴ In 1991, the Supreme Court blessed the arbitration of federal employment law claims.¹⁵

The Supreme Court's support for arbitration provisions now even encompasses class-action waivers.¹⁶ These class-action waivers effectively bar any recovery for many negative-value claims.¹⁷ An individual claim has a negative value when the costs of litigating or arbitrating to recover exceed the claim's value.¹⁸ Class actions solve this problem by allowing plaintiffs to aggregate their claims—transforming negative-value claims into a positive-value class action. By removing this procedural mechanism, PDAs with class-action waivers effectively insulate many consumer businesses from challenge or judicial review.

B. Arbitration's Broad Coverage

Arbitration agreements now blanket vast swaths of law and business. In 2015, the Consumer Financial Protection Bureau (CFPB) released an empirical study detailing arbitration's broad reach.¹⁹ It found that arbitration agreements were incredibly common in consumer financial contracts.²⁰ As of 2015, arbitration agreements covered the majority of the market in: (i) credit card contracts (53 percent); (ii) prepaid cards (82.9 percent); (iii) storefront payday loans (98.5 percent); and (iv) mobile wireless services (99.9 percent).²¹ Studies find

¹³ For a detailed discussion of the evolving case law, see Christopher R. Leslie, *The Arbitration Bootstrap*, 94 TEX. L. REV. 265, 273–74 (2015) (reviewing the Supreme Court's arbitration jurisprudence).

¹⁴ *Id.* at 271–73 (chronicling the changing jurisprudence).

¹⁵ *Id.* at 273.

¹⁶ *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 352 (2011) (finding that arbitration agreements may require plaintiffs to bring any claims in arbitration—and not in a class action).

¹⁷ David H. Webber, *Shareholder Litigation Without Class Actions*, 57 ARIZ. L. REV. 201, 210 (2015) (“The primary purpose of arbitration provisions in this context is not to shift shareholder claims from judges to arbitrators, but to eliminate the claims entirely by undermining their economic viability.”).

¹⁸ Benjamin P. Edwards, *Disaggregated Classes*, 9 VA. L. & BUS. REV. 305, 342 (2015) (explaining negative-value claims).

¹⁹ *See generally* CONSUMER FIN. PROTECTION BUREAU, ARBITRATION STUDY: REP. TO CONGRESS, PURSUANT TO DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT § 1028(a) (2015). [hereinafter CONSUMER FIN. PROTECTION BUREAU, REP. TO CONGRESS].

²⁰ *Id.* § 2.3.

²¹ *Id.*

that consumers rarely understand these contracts and incorrectly believe that they retain the ability to go to court.²²

While not included in the CFPB's report, arbitration agreements also cover nearly all brokerage industry contracts.²³ These contracts require investors to arbitrate claims against the brokerage industry in an arbitration forum overseen by the Financial Industry Regulatory Authority, a trade association of broker-dealer firms.²⁴ One industry-funded study found that investors had a more negative perception of arbitration than any other participants in the arbitration process and believed that arbitrators were biased against investor claims.²⁵

II. ARBITRATION'S DARK SHADOW

Industry-wide adoption of pre-dispute arbitration agreements now plunges entire fields of law into shadow.²⁶ As arbitrators resolve these disputes in the shadow of the law, the public loses sight of critical information and arbitrators gradually lose sight of the law. Consider how rarely public courts will consider payday lending practices on the merits. Payday lenders now impose arbitration in about 98.5 percent of their transactions.²⁷ Isolated from public courts, arbitration's shadow now envelopes nearly all payday lending disputes.

²² Jeff Sovern et al., "Whimsy Little Contracts" with Unexpected Consequences: An Empirical Analysis of Consumer Understanding of Arbitration Agreements, 75 MD. L. REV. 1, 63 (2015) ("It is not an exaggeration to say that consumers have no idea what they are agreeing to when they enter into contracts containing arbitration clauses."); Victor D. Quintanilla & Alexander B. Avtgis, *The Public Believes Predispute Binding Arbitration Clauses Are Unjust: Ethical Implications for Dispute-System Design in the Time of Vanishing Trials*, 85 FORDHAM L. REV. 2119, 2122 (2017) ("Prior studies underscore that the public fails to grasp what these terms in adhesion contracts mean when seeking goods, services, credit, or employment.").

²³ See Jill Gross, *The Historical Basis of Securities Arbitration as an Investor Protection Mechanism*, 2016 J. DISP. RESOL. 171, 171-72 (2016) ("Today, in fact, most disputes between customers of broker-dealer firms and the firms and their associated persons must be arbitrated through FINRA Dispute Resolution. . . .").

²⁴ For a review of FINRA's investor protection history, see Benjamin P. Edwards, *The Dark Side of Self-Regulation*, 85 U. CIN. L. REV. 573, 584-85 (forthcoming 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2829592 [https://perma.cc/36SZ-9R8P].

²⁵ Jill I. Gross & Barbara Black, *When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration*, 2008 J. DISP. RESOL. 349, 350 (2008). Since 2008, FINRA has instituted changes to its process to address some investor concerns. See Teresa J. Verges, *Evolution of the Arbitration Forum as a Response to Mandatory Arbitration*, 18 NEV. L.J. 437, 439 (2018).

²⁶ Cf. Deborah R. Hensler, *Alternative Courts? Litigation-Induced Claims Resolution Facilities*, 57 STAN. L. REV. 1429, 1429 (2005) ("[T]he bulk of civil litigation is vanishing from public view.").

²⁷ CONSUMER FIN. PROTECTION BUREAU, REP. TO CONGRESS, *supra* note 19, § 2.3.

A. *The Public Benefits of Public Courts*

The federal courts have long recognized that public proceedings offer significant benefits.²⁸ Transparency creates public confidence in the judicial system and also ensures that the system operates fairly.²⁹ As these courts operate, they create public goods, including doctrinal precedent and social norms.³⁰ In contrast, industry-wide arbitration replaces a court's public benefit with secrecy.³¹ Because the public lacks meaningful oversight over arbitration, it cannot be assured that the process operates fairly. Importantly, arbitration also often removes the frequency, type, and result of disputes from the public eye, undercutting reputation's ability to police market behavior.

Also, reputation plays a critical, understudied role in market transactions.³² Public legal disputes provide important reputational information that allows the public to make more informed assessments about market participants.³³ When a company faces the threat of litigation, it must consider whether its public statements will later be proved false in litigation—causing it to speak more truthfully and alter its behavior.

Widespread arbitration undercuts litigation's ability to influence reputation. Arbitration and private dispute resolution remove a discovery and broadcast channel for reputational information, making it less likely that non-legal market forces will deter misbehavior.³⁴

²⁸ See, e.g., *Littlejohn v. BIC Corp.*, 851 F.2d 673, 678 (3d Cir. 1988) (“[T]he bright light cast upon the judicial process by public observation diminishes possibilities for injustice, incompetence, perjury, and fraud.”).

²⁹ See Laurie Kratky Doré, *Public Courts Versus Private Justice: It's Time to Let Some Sun Shine in on Alternative Dispute Resolution*, 81 CHI.-KENT L. REV. 463, 469 (2006) (“Access to civil cases facilitates public monitoring. . . .”); Benjamin P. Edwards, *When Fear Rules in Law's Place: Pseudonymous Litigation as a Response to Systematic Intimidation*, 20 VA. J. SOC. POL'Y & L. 437, 443 (2013) (discussing the public's interest in open courts).

³⁰ Scott Dodson, *Party Subordination in Federal Litigation*, 83 GEO. WASH. L. REV. 1, 13 (2014) (explaining that courts create public goods).

³¹ See, e.g., *Union Oil Co. of Cal. v. Leavell*, 220 F.3d 562, 568 (7th Cir. 2000) (“People who want secrecy should opt for arbitration. When they call on the courts, they must accept the openness that goes with subsidized dispute resolution by public (and publicly accountable) officials.”).

³² See Kathryn Judge, *Fee Effects*, 98 IOWA L. REV. 1517, 1547 (2013) (explaining that “[r]eputation is a powerful internal constraint on” market behavior); Shapira, *supra* note 5, at 1197 (“Scholars have largely neglected the question of how reputation matters not because they find reputational incentives to be unimportant, but rather because scholars find them to be messy.”).

³³ See Shapira, *supra* note 5, at 1213–21 (describing how legal disputes shape reputation and affect behavior).

³⁴ *Id.* at 1241 (“[O]penness could also make non-legal sanctions more accurate, such as by drawing attention to unnoticed misconduct or helping market players get better information on noticed misconduct. All else being equal, the informational value of the law represents another previously overlooked argument against confidential litigation.”).

B. Arbitrators Lose Sight of the Law

Arbitrators and judges adjudicate disputes in different ways. Precedent-creating judges owe a duty to the public to correctly state the law because court judgments are public acts by public officials.³⁵ This means that judges will not simply regurgitate incorrect statements of law provided by the parties. Judges owe an independent duty to the public to correctly state the law.³⁶

In contrast, arbitrators do not owe these duties to the public. Some arbitration forums even prohibit arbitrators from conducting any independent research.³⁷ Instead, they obligate them to rely on the parties to define the cases and precedent that an arbitrator may consider.³⁸ For example, the Financial Industry Regulatory Authority (FINRA) Arbitrator's guide instructs that:

Arbitrators should not make independent factual investigations of a case. When arbitrators are in doubt about an issue, legal or otherwise, they should request briefs from the parties. If cases are cited in a party's motion or brief, and the arbitrators wish to read the full court opinions, the arbitrators should ask the parties to supply copies. Arbitrators generally should review only those materials presented by the parties.³⁹

Industry-wide arbitration now causes arbitration to grow increasingly lawless over time. This process begins when the overwhelming majority of industry members impose PDAAs on consumers. In the securities context, case law began to grow increasingly stale after the Supreme Court decided *Shearson/Am. Express, Inc. v. McMahon* and upheld the arbitration of securities disputes arising under the Securities Exchange Act of 1934.⁴⁰

Since that time, nearly all investor disputes with stockbrokers have been resolved within an industry-controlled arbitration forum.⁴¹ Because courts no longer consider these cases, parties in these disputes regularly rely on outdated case law. For example, one of the leading cases explaining the duties a broker

³⁵ Cf. *In re Mem'l Hosp. of Iowa City, Inc.*, 862 F.2d 1299, 1302 (7th Cir. 1988) ("The precedent, a public act of a public official, is not the parties' property. We would not approve a settlement that required us to publish (or depublish) one of our own opinions, or to strike a portion of its reasoning.").

³⁶ Cf. *Marbury v. Madison*, 5 U.S. (1 Cranch) 137, 177 (1803) ("It is emphatically the province and duty of the judicial department to say what the law is.").

³⁷ FIN. INDUS. REG. AUTH., FINRA OFFICE OF DISPUTE RESOLUTION ARBITRATOR'S GUIDE 60, 70 (2017), <https://www.finra.org/sites/default/files/arbitrators-ref-guide.pdf> [<https://perma.cc/9HS4-AHUM>].

³⁸ *Id.*

³⁹ *Id.* at 60.

⁴⁰ *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987).

⁴¹ See Myriam Gilles, *The Day Doctrine Died: Private Arbitration and the End of Law*, 2016 U. ILL. L. REV. 371, 422 (2016) ("Today, the law reporters are nearly devoid of any mention of these subjects, as the 'law' of broker-dealer duties has disappeared into the vortex of FINRA arbitrations.").

owes to a customer comes from the 1970s.⁴² The case law remains unchanged despite a changing business, statutory, and regulatory environment—growing increasingly stale and irrelevant with each passing year.

Even though the law has frozen, reality has continued to change. Stockbrokers play different roles today than they did in the past.⁴³ Their primary role has evolved from providing order execution to serving as trusted financial advisers.⁴⁴ Despite the changing role and business model of brokerage firms, public courts have had few opportunities to update doctrine to conform to this ever-changing reality.⁴⁵

Industry-wide arbitration may also allow exploitative financial innovation to continue unchecked by courts.⁴⁶ Consider the emergence of non-traded real estate investment trusts (non-traded REITs).⁴⁷ Even though non-traded REITs raised billions in capital, few court decisions even mention the products. Because arbitration agreements govern the relationships between brokers and their clients, courts may never hear cases about a broker's obligation to a client when recommending these products.

If allowed to consider these disputes today, courts might craft different doctrine. For example, because brokers now regularly portray themselves as trustworthy financial advisers,⁴⁸ courts might craft doctrine to hold brokers accountable for breaches of that trust. Similarly, courts might police modern product offerings, particularly ones seemingly created to exploit retail investor misperceptions about reality.⁴⁹

⁴² See *Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 461 F. Supp. 951, 952 (E.D. Mich. 1978), *aff'd*, 647 F.2d 165 (6th Cir. 1981); Benjamin P. Edwards, *Fiduciary Duty and Investment Advice: Will a Uniform Fiduciary Duty Make a Material Difference?*, 14 J. BUS. & SEC. L. 105, 115 (2014) (explaining that *Leib* is “an often-cited case”).

⁴³ See Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 714 (2012) (explaining that “broker-dealers, which historically sold securities and profited when a sale was made, have assumed a role that causes investors to believe that brokers provide impartial advice.”).

⁴⁴ *Id.* at 730 (“Although brokers did provide advice to customers before the mid-twentieth century, execution was the main task.”).

⁴⁵ See Gilles, *supra* note 41, at 421–22.

⁴⁶ See Benjamin P. Edwards, *Conflicts & Capital Allocation*, 78 OHIO ST. L.J. 181, 194 (2017) (describing misdirected financial innovation).

⁴⁷ *Id.* at 188 (explaining that the products “appear cynically designed to make it possible for financial intermediaries to advance their own interests at the expense of their clients”).

⁴⁸ Joseph C. Peiffer & Christine Lazaro, *Major Investor Losses Due to Conflicted Advice: Brokerage Industry Advertising Creates the Illusion of a Fiduciary Duty, Misleading Ads Fuel Confusion, Underscore Need for Fiduciary Standard*, 22 PUB. INV. ARB. B. ASS'N B.J. 1 (2015) (explaining that brokers now “advertise in a fashion that is designed to lull investors into the belief that they are being offered the services of a fiduciary.”).

⁴⁹ Brian J. Henderson & Neil D. Pearson, *The Dark Side of Financial Innovation: A Case Study of the Pricing of a Retail Financial Product*, 100 J. FIN. ECON. 227, 228 (2011) (concluding that retail investors pay, on average, an 8 percent premium over fair market value for certain complex financial products).

To be sure, increased judicial involvement would not guarantee that the law would do more to protect investors. Courts might bless previously untested, controversial business practices, making it more difficult for consumers to recover in arbitration or otherwise. At the least these outcomes would be public—allowing legislative bodies to observe outcomes and craft appropriately responsive legislation.

In the dark shadow of industry-wide arbitration, new questions continually arise and go unanswered. Arbitrators cannot “answer” these questions in any meaningful way because their decisions do not create precedent. As the same questions arise again and again, and are continually re-litigated and decided in different ways by different arbitration panels, arbitration outcomes grow increasingly arbitrary. Arbitrators increasingly lose sight of the law because the available precedent bears little resemblance to current circumstances.

Arbitration’s dark shadow arises when an overwhelming majority of cases involving an industry flow through arbitration. If a significant percentage of cases were resolved by courts, these cases could allow courts to set standards for the arbitration of other cases. Courts could decide issues presented by class actions or by a subset of individual actions. One possible solution would be to allow consumers to choose whether to go to arbitration or court after a dispute arises.⁵⁰

Some state regulators support federal legislation giving investors a choice about whether to proceed in court or in arbitration. The North American Securities Administrators Association (NASAA) has argued that giving investors the right to choose their dispute resolution forum would increase market confidence and participation.⁵¹ With increased confidence in their ability to seek a recovery for wrongdoing, investors may grow more willing to invest.

Federal regulators also have the power to restrict mandatory arbitration. Section 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) granted the SEC the authority to regulate the use of PDAs.⁵² For reasons that remain unclear, the Securities and Exchange Commission has not yet sought to use its authority to regulate arbitration agreements.

⁵⁰ The Investor Choice Act of 2017 would do this for securities arbitration. Investor Choice Act of 2017, H.R. 585, 115th Cong. §§ 1–2 (2017).

⁵¹ Letter from Mike Rothman, President, N. Am. Sec. Adm’rs Ass’n, Inc., Minn. Comm’r Commerce, to The Honorable Keith Ellison, Member of Cong. (Jan. 30, 2017), <http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-letter-to-Rep.-Keith-Ellison-Re-Investor-Choice-Act-of-2017.pdf> [<https://perma.cc/6L4U-NSMJ>].

⁵² 15 U.S.C. § 780(o) (2017) (“The Commission . . . may prohibit, or impose conditions or limitations on the use of, agreements that require customers . . . to arbitrate any future dispute . . . if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.”).

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CONCLUSION

For alternative dispute resolution to remain fair, it must be fairly characterized as an alternative. When entire industries impose arbitration on consumers and investors through PDAAs, it removes cases from public courts and public processes, casting entire fields of law into shadow.

Lifting this shadow may require federal intervention to lessen industries' ability to impose arbitration on nearly all consumers. While the CFPB's rule prohibiting class-action waivers offers a partial solution, much more may be required to effectively lift arbitration's dark shadow.⁵³

⁵³ Cf. Sternlight, *Poster Child*, *supra* note 6, at 375 ("Congress and the CFPB have taken a great first step in this area by recognizing the need for regulation when individual consumers are not in a position to protect their own interests.").

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