Anticipating The 2009 U.S. “Fairness in Arbitration Act”

David D. Caron
Seth Schreiber
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In the 110th Congress, legislation entitled the “Fairness in Arbitration Act of 2007” was introduced in both the Senate (S. 1782) and the House of Representatives (H.R. 3010) and closely considered.¹ Several provisions of the bill raise substantial concerns for some regarding the legislation’s possible unintended effects for international commercial arbitration in the United States. Simultaneously, it can be argued that the risk of unintended consequences is overstated. Although the bill was not adopted, it is thought – particularly given the outcome of the recent elections in the United States – that the bill will be introduced early in the 111th Session of Congress which commences in January 2009.

The good news for international commercial arbitration is that it is not the intent of the sponsors of the legislation to change the federal laws regarding international commercial arbitration in the United States. In addition, the legislation offered in 2007 may be amended so that unintended effects for international commercial arbitration are minimized. Such modifications will not happen of their own accord, however. This brief editorial lays out the two views of the possible unintended effects of the bill and how the language of the bill may be modified to avoid such potential consequences.

I.

S. 1782 is brief. The bill opens with seven “findings” that set forth the drafter’s assessment of the problem to be addressed by the legislation. These findings include, among other things, the following:

¹ On July 12, 2007, Senator R. Feingold (Democrat from Wisconsin) with five co-sponsors introduced Senate Bill 1782 (“S. 1782”), while Representative Hank Johnson (Democrat of Georgia) with 100 co-sponsors introduced House of Representatives 3010 (“H.R. 3010”) in the House of Representatives. S. 1782 was referred to the Committee on the Judiciary. The House Subcommittee on Commercial and Administrative Law held hearings on H.R. 3010 in October of 2007 and voted to report H.R. 3010 favorably to the full Judiciary Committee on July 15, 2008; transcripts from testimonies of that hearing may be found at http://judiciary.house.gov/hearings/hear_102507.html. The Senate Subcommittee on the Constitution of the Judiciary Committee held hearings on December 12, 2007. The written testimony of members and witnesses, as well as an audio recording, may be found at http://judiciary.senate.gov/hearings/testimony.cfm?id=3055&wit_id=6825.
(1) The Federal Arbitration Act . . . was intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power.

(2) A series of United States Supreme Court decisions have changed the meaning of the Act so that it now extends to disputes between parties of greatly disparate economic power, such as consumer disputes and employment disputes ....

(3) Most consumers and employees have little or no meaningful option whether to submit their claims to arbitration ....

(4) Private arbitration companies are sometimes under great pressure to devise systems that favor the corporate repeat players who decide whether those companies will receive their lucrative business.

(5) Mandatory arbitration undermines the development of public law for civil rights and consumer rights, because there is no meaningful judicial review of arbitrators’ decisions ....

(6) Mandatory arbitration is a poor system for protecting civil rights and consumer rights because it is not transparent ....

(7) Many corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals .... While some courts have been protective of individuals, too many courts have upheld even egregiously unfair mandatory arbitration clauses in deference to a supposed Federal policy favoring arbitration over the constitutional rights of individuals.

To address the issues described, S. 1782 proposes essentially three amendments to Section 2 of Chapter 1 of the Federal Arbitration Act Section 2 which would be relabeled as Section 2(a). Each of the three amendments adds an additional paragraph to Section 2.

First, S. 1782 would make certain categories of disputes non-arbitrable by declaring an arbitration agreement concerning such disputes agreed to before they arise to be invalid and unenforceable. Thus a proposed section 2(b) would read:

(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 or to regulate contracts or transactions between parties of unequal bargaining power.

This provision reflects a policy choice to make certain disputes not subject to arbitration, at least where the agreement was made before the dispute arose. Although the details can vary significantly, a number of countries already exclude employment, consumer or franchise disputes from arbitration and the fairness arguments present in the findings of S. 1782 are echoed in these choices of other nations. Two arguments of those who favor the continued arbitrability of such disputes in the United States is that these other countries do not have court systems nearly as costly as those of the United States.

Second, S. 1782 proposes to further limit the possibility that an individual is unwittingly drawn into arbitration by placing the question of enforceability and validity of arbitration agreements in the hands of the courts rather than the arbitral tribunal. The proposed Section 2(c) reads:

(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.

Third and last, S. 1782 proposes to limit the application of Sections 2(b) and 2(c) by excluding one type of arbitration agreement from the reach of these two sections. A new Section 2(d) would read:

(d) Nothing in this chapter shall apply to any arbitration provision in a collective bargaining agreement.

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II.

The Federal Arbitration Act has three Chapters. Chapter 1 is the general Chapter regulating arbitration in the United States. Chapter 2 addresses the enforceability of arbitration agreements and of arbitral awards for those arbitration proceedings that fall within the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, while Chapter Three addresses arbitrations that fall within the 1975 Inter-American Convention on International Commercial Arbitration. If the enforceability of an agreement to arbitrate is not governed by Chapters 2 or 3, then it is governed by Chapter 1.

S. 1782 modifies Chapter 1. Thus, a fair question asks: How is it that S. 1782 might affect international commercial arbitrations which one ordinarily thinks of as falling under Chapter 2, and occasionally under Chapter 3? The answer has at least two aspects. First, but tangential to the issue at hand, Chapter 1 exclusively sets forth the procedures for the set aside of awards rendered in the United States. Second, both Chapters 2 and 3 end with the following provision: “Chapter 1 applies to actions and proceedings brought under this chapter to the extent that chapter is not in conflict with this chapter ....”\(^3\) Thus, it is possible under these closing provisions for an aspect of Chapter 1 to migrate to the other Chapters.

The members of the international arbitration community who are expressing substantial concerns regarding the proposed legislation tend to focus on proposed Section 2(c). The concerns voiced are twofold. First, it is argued that Section 2(c) in essence overturns the doctrine of severability recognized by the U.S. Supreme Court in *Prima Paint v. Flood & Conklin Manufacturing*\(^4\). The severability doctrine provides that challenges as to the validity and enforceability of the contract, as distinct from challenges to the agreement to arbitrate, should be decided upon by the arbitration tribunal.\(^5\) It is argued that such a change would be unique and unprecedented among other major economic powers and common seats of

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\(^5\) See, e.g., UNICITRAL Model Law on International Commercial Arbitration, art. 16(1).
international arbitration that also have clearly delineated between concerns for consumers and international arbitration along the lines of Section 2(b). Second, it is argued that Section 2(c) also undercuts the proposition that a tribunal possesses the jurisdiction to decide upon its own jurisdiction. Given that neither the New York Convention nor the Inter-American Convention specifically call for the “severability doctrine,” the provisions of Chapter 1, it is argued, could migrate to matters decided under Chapters 2 and 3. Although Section 2(b) might have only limited effects for international commercial arbitration inasmuch as the categories of disputes listed in that section are perhaps not as common in international commercial arbitration, Section 2(c) potentially raises questions possibly present in virtually all arbitrations.

It can be argued, however, that the danger of spillover is overstated. Arguably, a careful reading of the language of Section 2(c) indicates that it does not involve a challenge to the doctrine of severability. The crucial sentence of Section 2(c) would read as follows:

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.

First, the clause by its own terms, really addresses the allocation of adjudicatory functions, not the substantive doctrine of whether invalidity of the surrounding contract necessarily entails invalidity of the arbitration clause. It is noteworthy that the proposed amendment leaves untouched the existing language in Section 4 of Chapter 1 which the Court in Prima Paint said was the key language through which Congress made clear its purpose that attacks specific to the arbitration clause go to the courts, while attacks not specific to the arbitration clause go to the arbitrators.6

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6 *Prima Paint*, 388 U.S. at 403, holding:

Under § 4, with respect to a matter within the jurisdiction of the federal courts save for the existence of an arbitration clause, the federal court is instructed to order arbitration to proceed once it is satisfied that “the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not in issue.” Accordingly, if the claim is fraud in the inducement of the
Second, the language quoted above is, arguably, carefully crafted for the specific purpose of making sure that federal courts will get to review whether an arbitration clause is invalidated by the new grounds of invalidity proposed to be added in by Section 2(b). The new grounds for invalidating pre-dispute arbitration agreements are noteworthy in that sometimes the invalidity of the agreement will be clear simply by examining the arbitration clause itself (e.g., the clause may describe its scope as encompassing rights of consumer protection) and sometimes the invalidity of the agreement will require an examination of the surrounding contract (e.g., the arbitration clause is embedded in a franchise agreement). But even in the latter situation, the inquiry of the court arguably is not one into the invalidity of the contract (i.e., of the franchise agreement) with that invalidity nullifying the arbitration clause; rather, it is an inquiry limited to an arbitration agreement where it is the fact that the arbitration clause is contained in a franchise agreement that makes it invalid.

The second part of the quoted language is consistent with this interpretation. Under the proposed Section 2(c), the question of “the validity and enforceability of an agreement to arbitrate” is reserved to the courts “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 sentence does not say “irrespective of whether the party resisting arbitration challenges the arbitration agreement specifically or because of the invalidity of the contract,” which would much more directly implicate the doctrine of severability. Rather, the presence of the phrase “specifically or in conjunction with other terms of the contract” suggests that the section is intended to cover the kinds of hybrid grounds of invalidity outlined above – hybrid in the sense that the court must examine both the contract and the arbitration clause to see whether a ground for invalidity, such as the arbitration of a franchise dispute, is implicated by a given arbitration clause.

arbitration clause itself – an issue which goes to the “making” of the agreement to arbitrate – the federal court may proceed to adjudicate it. But the statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally. Section 4 does not expressly relate to situations like the present in which a stay is sought of a federal action in order that arbitration may proceed.
Simultaneously, it must be admitted that a reading of Section 2(c) asserting that it is focused solely on the new grounds set forth in Section 2(b) would be more persuasive if the language of Section 2(c) were a part of Section 2(b) rather than a separate section.

III.

Even if one concludes that the risks posed by the proposed legislation are quite limited, it is clear that clarity in the bill remains desirable. Fortunately, a fix to the text is readily available. For example, if the 2007 proposed legislation is reintroduced, there need only be added a brief Section 2(e):

(e) Sections 2(b) and 2(c) do not apply to arbitration agreements that are addressed by Chapters 2 and 3 of this Act.

Such a provision makes clear that Congress does not intend that the proposed amendments to Chapter 1 migrate to Chapters 2 and 3.

If a change such as that just described is not adopted, it appears quite clear that such legislation at a minimum would create uncertainty regarding the law of the United States for at least some sophisticated international negotiating parties, and such uncertainty may be enough to engender negative implication. Thus, despite its aim of reforming domestic arbitration, a 2009 Fairness in Arbitration Act could discourage the growth and use of the United States as a seat of international commercial arbitration and diminish the competitive advantages of American firms transacting abroad. In ways difficult to predict, such legislation might also affect enforcement proceedings or produce an uptick in parallel litigation proceedings undertaken despite agreements selecting arbitration abroad. Richard Naimark, Senior Vice President of the American Arbitration Association (AAA), in his testimony before the Senate Judiciary Committee stated:

What is more, the shaping of the FAA has been consistent with international standards of practice in arbitration, making the U.S. a jurisdiction successfully aligned with the predominant cross border system of justice – International arbitration. To modify the FAA would upset over 80 years of judicial wisdom and guidance for a process that works quite well in tens of thousands of business arbitrations annually. Modification would unnecessarily send a message
of ambiguity and policy hostility to arbitration to the international community.\textsuperscript{7}

In this way, sophisticated international negotiating parties, all other things being equal, may choose not to name the United States as the place for their arbitration. Ironically, the clamor that would arise in such a turn of events may mean that the adoption of an S. 1782-like piece of legislation without changes will precipitate the adoption by the United States of its own version of the UNCITRAL Model Law for International Commercial Arbitration.

David D. Caron
\textit{Co-Editor in Chief}

Seth Schreiberg
\textit{J.D. Candidate, University of California at Berkeley}

\textsuperscript{7} Testimony of Richard Naimark (Dec. 12, 2007), \textit{available at} http://judiciary.senate.gov/testimony.cfm?id=3055&wit_id=6825.