

SECURITIES LAW ALERT

OCTOBER 2011

Congress Considers The Proposed Arbitration Fairness Act of 2011

Legislation has been introduced in both the United States Senate and the House of Representatives that would invalidate and bar enforcement of predispute arbitration agreements requiring (among other things) arbitration of customer disputes against securities broker-dealers. This legislation, known as the Arbitration Fairness Act of 2011, is very similar to the identically-titled Arbitration Fairness Act of 2007, introduced in Congress several years earlier. In disputes arising out of securities brokerage accounts, the key difference between the two Acts is that the Arbitration Fairness Act of 2011 appears to expressly encompass predispute arbitration provisions in agreements between securities broker-dealers and their customers, in contrast to the 2007 version of the legislation, which was less specific on the terms for the coverage of such agreements. Under the proposed legislation, customers would no longer be required to submit to arbitration claims against broker-dealers and their registered representatives but instead would have the right to sue in a judicial forum. 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.

Just like the preceding legislation, the Arbitration Fairness Act of 2011 is premised on a number of “findings” that are without legal foundation. As set forth below, these findings provide no basis for the drastic measure of invalidating

predispute arbitration provisions in securities brokerage agreements that this legislation would mandate.

The Proposed Arbitration Fairness Act of 2011

On May 12, 2011, Senator Al Franken (D-MN) and Representative Henry C. “Hank” Johnson, Jr. (D-GA) introduced identical bills in the Senate and House of Representatives (2011 S. 987 and 2011 H.R. 1873, respectively) that would invalidate and bar enforcement of any predispute arbitration agreement that requires arbitration of an employment, consumer, or civil rights dispute. Entitled the Arbitration Fairness Act of 2011, the proposed legislation would amend the Federal Arbitration Act (“FAA”), 9 U.S.C. § 1, *et seq.* (2011), by adding, *inter alia*, new Section 402(a), which provides:

(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, or civil rights dispute. 2011 S. 987 and 2011 H.R. 1873, 112th Cong., 1st Sess. § 3 (2011).

Section 401(2) of the Arbitration Fairness Act defines the term “consumer dispute” as “a dispute between an individual who seeks or acquires real or personal property, **services (including services relating to securities and other investments)**, money, or credit for

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... Section 402(b) of the Arbitration Fairness Act 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 and in a judicial forum.

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personal, family or household purposes and the seller or provider of such property, services, money or credit.” 2011 S. 987 and 2011 H.R. 1873, 112th Cong., 1st Sess. § 3 (emphasis added). By contrast, the definition of “consumer dispute” set forth in the 2007 legislation did not have the parenthetical reference to securities- and investment-related services. *See* 2007 S. 1782 and 2007 H.R. 3010, 110th Cong., 1st Sess. at § 3. The drafters of the current legislation appear to have sought to eliminate any doubt that the Arbitration Fairness Act would encompass claims brought by persons with securities brokerage accounts against securities broker-dealers arising out of transactions in these accounts. As a result, as drafted, a plaintiff is likely to succeed in persuading a court that the proposed legislation invalidates and bars enforcement of arbitration provisions in contracts between broker-dealers and customers and therefore entitles that plaintiff to bring such a claim in court rather than in FINRA Dispute Resolution or other arbitral forum.

Moreover, Section 402(b) of the Arbitration Fairness Act 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 and in a judicial forum:

(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.

2011 S. 987 and 2011 H.R. 1873, 112th Cong., 1st Sess. §3 (2011).

Similar to the earlier legislation, the proposed legislation recites the following findings that purportedly justify the Arbitration Fairness Act of 2011:

(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 changed the meaning of the act so that it now extends to consumer disputes and employment disputes.

(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.

2011 S. 987 and 2011 H.R. 1873, 112th Cong., 1st Sess. §2 (2011).

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2011 S. 987 was referred to the Senate Committee on the Judiciary on May 12, 2011. That committee held a hearing on the bill on October 13, 2011. 2011 H.R. 1873 was referred to the House Subcommittee on Courts, Commercial and Administrative Law on May 12, 2011; no hearings have been scheduled to date on the House bill.

Analysis

Although the findings cited as the basis for the proposed Arbitration Fairness Act of 2011 are not nearly as one-sided as the findings cited in the 2007 version of the legislation, in a number of critical respects those findings are just as legally flawed as the 2007 findings, particularly as to securities arbitrations. *First*, the finding that the FAA was “intended to apply to disputes between commercial entities of generally similar sophistication and bargaining power” is not supported by the legislative history of the FAA. To the contrary, that legislative history demonstrates that the primary purpose of the FAA was to insure enforcement of arbitration agreements. As set forth in the House Report on the FAA:

The purpose of this bill is to make valid and enforceable agreements for arbitration contained in contracts involving interstate commerce or within the jurisdiction or 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 Subcomm. of the S. Comm. on the

Judiciary, 67th Cong., 4th Sess. 6 (1923) (remarks of Sen. 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 embedded 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 its illogical nature and the injustice which results from it. This bill declares simply that such agreements for arbitration 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 stated secondary purpose of the FAA was to promote the expedited resolution of disputes. As the House Report observed:

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 indicating that the statute was only intended to apply to disputes between “commercial entities

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of generally similar sophistication and bargaining power.” See also *Southland Corp. v. Keating*, 465 U.S. 1, 12-14, 104 S. Ct. 852, 79 L. Ed. 2d 1 (1984); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 219-21, 105 S. Ct. 1238, 84 L. Ed. 2d 158 (1985).

Second, given the stated purpose of the FAA, the finding that a “series of United States Supreme Court decisions have changed the meaning of the [FAA] so that it now extends to consumer disputes and employment disputes” is incorrect. Since the FAA’s purpose was, and has always been, to insure enforcement of arbitration agreements, the statute’s scope has always included “consumer disputes” such as claims by customers against securities broker-dealers as well as disputes between “commercial entities of generally similar sophistication and bargaining power.” That the courts are enforcing agreements requiring the arbitration of customer disputes against broker-dealers merely shows that the courts are interpreting the FAA exactly as Congress intended.

Third, the bills’ criticisms of arbitration based on the lack of judicial review of arbitrators’ decisions and the absence of transparency are, as Professor Peter Rutledge of Catholic University of America, Columbus School of Law, has previously pointed out, not at all unique to arbitration. As he testified at the hearing on the 2007 version of the Arbitration Fairness Act, 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, Assoc. Professor of Law, Columbus School of Law, Catholic Univ. of Am., Hearing on H.R. 3010, House Judiciary Comm., on Commercial and Admin. Law (Oct. 25, 2007) at 9. As Professor Rutledge concluded, “the same logic supporting settlements -- notwithstanding their retarding effect on the development of public law -- also supports arbitration.” *Id.*

Thus, the proposed findings upon which the Arbitration Fairness Act of 2011 is premised are at best of dubious legal validity, particularly as to the arbitration of securities claims.

Conclusion

The legislative process of the Arbitration Fairness Act of 2011 is still at a relatively early stage. Where securities arbitrations are concerned, the current legislation suffers from many of the same fundamental legal flaws that permeated the 2007 legislation. Consequently, this legislation provides no legal justification at all for invalidating arbitration provisions in securities brokerage agreements.

For more information about any of the topics covered in this issue of the Securities Law Alert, please contact:

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