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Determining if Mandatory Arbitration is "Fair": Asymmetrically Held Information and the Role of Mandatory Arbitration in Modulating Uninsurable Contract Risks

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I. INTRODUCTION

Pre-dispute mandatory arbitration provisions are a favorite whipping post for consumer advocates. Recent academic literature is filled with articles condemning the process. Opponents see mandatory arbitration clauses as unconscionable and designed principally to deny the consumer a day in court. Almost daily, calls are made for legislation and/or regulations *banning* mandatory pre-dispute arbitration provisions. At the time of this writing, bills are pending in the United States House of Representatives and the Senate that would effectively void any pre-dispute mandatory arbitration provision in contracts involving consumer transactions, franchise agreements, employment agreements, and any dispute arising under any statute intended to protect civil rights.[1] (I will refer these agreements as the "targeted group.")

Of course, not everyone agrees that mandatory arbitration is unfair and/or unconscionable. Its proponents point to a long list of practical reasons they claim should be considered in favor of arbitration.[2] In this article, I argue that because mandatory arbitration clauses serve to overcome destabilizing and toxic effects of asymmetrical information, this function should be added to the proponent's list of practical reasons favoring mandatory arbitration.

Asymmetrically held information is about "situations where one economic agent knows something that another economic agent doesn't."[3] In the rough and tumble of the marketplace, parties doing business require information about one another in order to build a foundation of trust. The more fluid the exchange and the more perfect the information, the more likely there will be a high level of trust. Asymmetrically held information, by definition, undermines achieving trust. It's a powerful negative force—one that can tilt the playing field in favor of the party in possession of the information and away from party who is in the dark. Why? Because asymmetric information:

- Can, without warning, dramatically magnify the scope of an assumed risk, rendering that risk uninsurable;[4]

1. H.R. 1020, 111th Cong. (2009). This bill is similar to two bills that were before the 110th Congress but that never made it to a vote in either the House or the Senate. *See Recent Proposed Legislation: Arbitration – Congress Considers Bill to Invalidate Pre-Dispute Arbitration Clauses for Consumers, Employees and Franchisees. - Arbitration Act of 2007, S. 1782, 110th Cong. (2007)*, 121 Harv. L. Rev. 2262 (2008). Also pending in the Senate is S. 931, 111th Cong. (2009). In substance, this bill seeks to achieve the same goals as H.R. 1020 except that S. 931 creates a new chapter within the Federal Arbitration Act dealing exclusively with the enforceability of predispute arbitration provisions in employment, consumer, franchise, and civil rights disputes. *Id.*

2. *See* list *infra* text accompanying note 13 and Part IV.A..

3. Hal R. Varian, Microeconomics Analysis, 440 (3d ed. 1992).

4. For purposes of this article, uninsurable risks include risks for which there is simply no insurance product available, as well as risks for which there is insurance but it is nominal compared to the entire risk. For instance, liability insurance exists that covers employment discrimination claims. However, these policies are quite expensive and include very large deductibles and very low coverage limits.

- Can create new risks that are so ethereal as to be uninsurable by third parties; and
- Can stimulate the need to develop new techniques and tools to overcome uncertainty.

As we shall see, with each type of agreement in the targeted group, the effects of asymmetrically held information yield a unique type of risk. For example, for consumer credit, it is credit risk; for franchising, it is reputation risk; and for employment, it is morale and business interruption risk. These risks are real, come about because of an imbalance, undermine commerce, and for the most part cannot be mitigated with the purchase of insurance.

In this article, I posit that if asymmetrically held information creates an uncertainty that can't be insured against, mandatory arbitration is a reasonable measure for the restoration of the equilibrium; it affords a flexible, efficient, timely, and cost effective method for dispute resolution and assists businesses competing in uncertain markets.[5] Because of these benefits, mandatory arbitration compensates in the sense that it transfers some of the risk created by asymmetrically held information back to the party creating that risk. This in turn: (1) levels the playing field, and (2) acts at the very least as a partial substitute for insurance purchased from a third party. This "transfer effect" occurs with all the agreements in the targeted group. Public policy should not be fashioned to deny this valuable benefit to anyone wishing to give it serious consideration. And this is true even when mandatory arbitration is operative because of an adhesion agreement.[6]

I also propose that before legislation is enacted to regulate the use of pre-dispute arbitration clauses, the following four (4) conditions need to be established with empirical evidence:

1. Mandatory arbitration serves no practical purpose other than unfairly benefiting the party insisting on such a clause;

5. Arbitration as a tool for the management of risk is a relatively new concept. *See generally* Scott Baker, *A Risk Based Approach to Mandatory Arbitration*, 83 Or. L. Rev. 861, 862–63 (2004).

6. Adhesion agreements with pre-dispute arbitration clauses are not per se unconscionable. DeLuca v. Bear Stearns & Co., 175 F. Supp. 2d. 102, 115 (D. Mass. 2001); Bolter v. Superior Court of Orange County, 104 Cal. Rptr. 2d 888, 894 (Cal. Ct. App. 2001); Walther v. Sovereign Bank, 872 A.2d 735, 746 (Md. 2005). *See* Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 33 (1991); Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, 170 F.3d 1, 17 (1st Cir. 1999); Gold v. Deutsche Aktiengesellschaft, 365 F.3d 144, 150 (2d Cir. 2004); Nagrampa v. Mailcoups, Inc., 469 F.3d 1257, 1281 (9th Cir. 2006); Chase Commercial Corp. v. Owen, 588 N.E.2d 705, 708-09 (Mass. App. Ct. 1992). The adhesion agreement argument against mandatory arbitration presupposes that consumers, franchisees and employees are unsophisticated and vulnerable to opportunistic behavior on behalf of large corporations. *See* Opening Statement of U.S. Senator Russ Feingold, Senate Judiciary Subcommittee on the Constitution: Hearing on "The Arbitration Fairness Act of 2007," 110th Cong. (2007), *available at* http://Feingold.senate.gov/statements/07/12/20071212.htm; William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, 28 Franchise L. J. 23–4 (2008).

2. The practical purposes served by mandatory arbitration are without economic justification;

3. The practical purposes are at the least substantively unconscionable; and

4. There is resulting direct harm to the party against whom mandatory arbitration is imposed.

In Part II of this article, I explore details about the role that asymmetrically held information plays in the decision to rely on arbitration as the preferred method for dispute resolution. The discussion in Part II is framed in the context of three types of contracts that are the subject of ongoing congressional efforts to ban pre-dispute mandatory arbitration: consumer agreements (limited in this article to credit cards[7]), franchise agreements, and arrangements for employment.[8]

In Part III, I will first review the arguments, pro and con, concerning the fairness of arbitration and match these positions with the recent flood of empirical studies evaluating the efficacy and fairness of the arbitration process. In Part IV, I examine issues surrounding the public policy debate and the wisdom of any solution that bans the enforcement of pre-dispute mandatory arbitration clauses.

I conclude that asymmetrically held information can have a pernicious impact in the commercial arena, one that is appropriately offset in large measure by mandatory arbitration. The empirical evidence examining the issue of fairness is trending toward a presupposition of fairness, and there is no need at this time to reform arbitration as we know it to either regulate or ban the use of mandatory arbitration clauses.

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7. The concerns about arbitration differ substantially when larger loans are involved. *See* Keith N. Hylton, *Agreements to Waive or Arbitrate Legal Claims: An Economic Analysis*, 8 S. Ct. Econ. Rev. 209, 231–32 (2000). This dichotomy is not unique to banking. It is found in franchising as well.

> [P]arties may avoid arbitration of what might be called "bet-the-company" cases – high stakes cases in which an erroneous outcome could jeopardize the continued existence of the company. At least some parties may perceive arbitration as too risky for such cases because of the limited court review of arbitration awards. In more routine cases, "knucklehead awards" or "'roll-the-dice' or 'Russian roulette' arbitration" awards would be just another cost of the dispute resolution process. But in high stakes cases, an aberrational award could have a devastating effect on the company, and may lead parties to avoid arbitration altogether for contracts that may give rise to such disputes.

Christopher R. Drahozal & Quentin R. Wittrock, *Is There a Flight From Arbitration?*, 37 Hofstra L. Rev. 71, 80 (2008).

8. These are the three specified types of agreements that are targeted by the Arbitration Fairness Act of 2007. Arbitration Fairness Act of 2007, S. 1782, 100th Cong. § 2 (2007); *see supra* note 1. The Arbitration Fairness Act of 2007 made unenforceable contracts or transactions between parties of "unequal bargaining power." *Id.* § 4. This language was so vague that it was dropped from the revised version submitted in 2009. *See* Arbitration Fairness Act of 2009 S. 931, 111th Cong. (2009).

II. EFFECT OF ASYMMETRICALLY HELD INFORMATION: MANDATORY ARBITRATION AND THE NEED FOR SELF-HELP MEASURES

This section examines the potentially harmful effects associated with asymmetrically held information. The discussion is framed by the terms of a bill pending in Congress: the Arbitration Fairness Act of 2009, which would render unenforceable pre-dispute mandatory arbitration clauses in the targeted group.[9] There is a debate that runs parallel; it is about whether it is appropriate to employ mandatory arbitration to resolve statutory claims. That debate is beyond the scope of this article.[10] The purpose of Part II is to establish the need for the public policy

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9. The Arbitration Fairness Act of 2009 provides in part:

> No predispute arbitration agreement shall be valid or enforceable if it requires arbitration of—
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> (1) an employment, consumer, or franchise dispute; or
>
> (2) a dispute arising under any statute intended to protect civil rights.
>
> An issue as to whether this . . . applies to an arbitration agreement shall be determined by Federal law. Except as otherwise provided . . . , 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. . . . Nothing in this chapter shall apply to any arbitration provision in a collective bargaining agreement.

H.R. 1020, 111th Cong. § 2(b) (2009). The version of the bill introduced in the Senate defines in detail what is meant by employment, consumer, franchise, and civil rights dispute. *See* S.931, 111th Cong. § 401 (2009). A civil rights dispute is:

> [A] dispute arising under the Constitution of the United States or the constitution of a State; or a Federal or State statute that prohibits discrimination on the basis of race, sex, disability, religion, national origin, or any invidious basis in education, employment, credit, housing, public accommodations and facilities, voting, or program funded or conducted by the Federal Government or State government, including any statute enforced by the Civil Rights Division of the Department of Justice and any statute enumerated in section 62(e) of the Internal Revenue Code of 1986 (relating to unlawful discrimination); and in which at least 1 party alleging a violation of the Constitution of the United States, a State constitution, or a statute prohibiting discrimination is an individual.

Id. (formatting notations omitted). A consumer dispute is "a dispute between a person other than an organization 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, services, money, or credit." *Id.* The term employment dispute "means a dispute between an employer and employee arising out of the relationship of employer and employee as defined in section 3 of the Fair Labor Standards Act of 1938 (29 U.S.C. 203)." *Id.* A franchise dispute is:

> [A] dispute between a franchisee with a principal place of business in the United States and a franchisor arising out of or relating to contract or agreement by which a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor.

Id.

10. For a discussion of the issues involved in that debate, see Margaret L. Moses, *Arbitration Law: Who's in Charge?*, (Loyola Univ. Chicago Sch. of Law Pub. Law & Legal Theory Research Paper Series No.

debate to take into account the practical necessities of arbitrations as a solution to realistic threats to players in the marketplace. These threats arise from a number of circumstances, including asymmetrically held information. It is my view that if Congress adopts any scheme to reform arbitration under the Federal Arbitration Act ("FAA"),[11] Congress must consider these concerns.[12]

Not everyone sees mandatory arbitration as being an attack on the consumer, employee, or franchisee. Professor Ware notes that there are many practical and appropriate reasons why a business might prefer arbitration over the traditional litigation format:

- Elimination of juries and the potential for high damage awards;
- Emphasis on confidentiality serves to shield participants from publicity;
- Assurance that disputes are resolved using a nationally uniform set of procedures;
- Savings on the cost of appeals;
- Elimination of class action litigation;
- Deterrence of litigation by imposing obligations to pay fees on claimants; and
- Reduction of discovery costs.[13]

In addition, two more "business" related reasons have been suggested: (1) it affords a hands-on opportunity to decide who will resolve a dispute, and (2) dispositive decisions are made using commercial norms.[14]

In this article, my task is to persuade the reader that when asymmetrically held information gives rise to risks that are uninsurable, mandatory arbitration is a "fair" measure of self-help.

2009-001, 2009), Seton Hall L. Rev. (forthcoming), *available at* http://ssrn.com/abstract=1287303. *See also* Jean R. Sternlight, *A Creeping Mandatory Arbitration: Is it Just?*, 57 Sta. L. Rev. 1631, 1643–75 (2005).

11. 9 U.S.C. §§ 1–16 (2009).

12. Also before Congress is H.R. 991, 111th Cong. § 1003(a) (2009). The scope of this bill is limited to consumer transactions. The bill would not only render a pre-dispute arbitration clause unenforceable in consumer transactions, but in addition, the inclusion of such a provision would be "treated as an unfair and deceptive trade act or practice under Federal or State law." *Id.*

13. Stephen J. Ware, *Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. Disp. Resol. 89, 90–91. *See also* Drahozal, *supra* note 7, at 71, 77–78.

14. Linda Demaine and Deborah Hensler, *"Volunteering" to Arbitrate Through Predispute Arbitration Clauses: The Average Consumer's Experience*, 67 Law & Contemp. Probs. 55 (2004).

A. *The Problem of Asymmetrically Held Information: Why it Belongs on the List of Valid Business Reasons Supporting the Need for Mandatory Arbitration*

Donald Rumsfeld, referring to the *Johari Window,* famously observed:

> There are known knowns. There are things we know that we know. There are known unknowns. That is to say, there are things we that know we don't know. But there are also unknown unknowns. There are things we don't know we don't know.[15]

Asymmetrically held information is about knowing that we don't know something and how to react accordingly.

Information once disclosed is only perfect while it remains current and accurate and therefore useful for measuring a particular risk. When change happens, information may become imperfect, which is to say outdated and inaccurate. When information becomes imperfect, the risks that were assumed based on perfect information must be reevaluated. The injunctions of the commercial market environment require participants to assume that information will morph and become imperfect over time. Participants must then develop strategies to reallocate assumed risk. The key for survival is recognizing the need to implement appropriate strategies.

For our purposes, in a commercial setting, asymmetrically held information can be thought of as:

- Information that has morphed from perfect to imperfect;
- Thereby having the potential to handicap the ability of any party to reallocate and/or reapportion risk;
- With this condition known to just one party to a commercial relationship.

So we can say that under certain circumstances, asymmetrically held information can operate to magnify an existing risk. In addition, the mere possibility that asymmetrically held information may exist creates uncertainty that renders the original risk, much less any subsequent transformation, uninsurable because insurers are not likely to insure something that can't be evaluated and priced on an ongoing basis.

Of the three contracts making up the target group, consumer and franchise agreements involve risks arising from the conduct of a party who is either in default or has failed to perform in accordance with contractual standards. In other words, these risks are *respondent,* as opposed to *claimant* driven, and the asymmetrically held information concerns *respondent* behavior. Employment presents a somewhat different picture. In this arena, the employer, the proponent of mandatory arbitration, is most

15. Donald Rumsfeld, U.S. Sec'y of Defense, Defense Dept. Briefing (February 12, 2002) (transcript *available at* http://www.defenselink.mil/transcripts/transcript.aspx?transcriptid=2636). *See also* Jospeh Luft, *A Graphic Model of Awareness in Interpersonal Relationships*, NTL Reading Book for Human Relations Training, 1982, http://www.library.wisc.edu/EDVRC/docs/public/pdfs/SEEDReadings/JohariWindow.pdf.

likely the respondent based on claims said to arise from the employer's behavior. While the asymmetrically held information (the employee's attitude) is a by-product of the employer's alleged behavior, the genesis for the risk is the inability of the employer to learn of and address employee dissatisfaction until it's too late.

In the context of employment, Professor Scott Baker equates functional characteristics of mandatory arbitration to insurance. He notes that there are three (3) attributes common to both insurance and mandatory arbitration:

1. Transfer of a given risk.
2. The probability of the risk actually materializing depends on the actions or latent characteristics of the party making the transfer.
3. Asymmetrically-held information about the potential for the actuality of the risk is controlled by the party making the transfer which in turn makes the cost expensive.[16]

Baker concludes that an employer has two choices when considering the cost of a claim for discrimination. The employer can pay for an expensive insurance policy from a third party and lay off the cost of litigation and verdicts. Or, the employer can insist on mandatory arbitration, a process likely to mean an abbreviated litigation process, smaller awards, and the possible elimination of class action claims.[17] In other words, Baker argues that mandatory arbitration is actually operating as a direct

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16. Baker, *supra* note 5, at 874–75. As Baker describes:

> The [insurance] model is used to highlight problems of asymmetric[ally-held] information. These problems arise under three conditions: (1) one party agrees to bear a risk, (2) the probability that the risk will materialize depends on another party's actions or latent characteristics, and (3) information asymmetries make it hard to contract on these actions or latent characteristics. With insurance, for example, the insured pays a premium and transfers the risk of the insured-against event to the insurer. The insured's actions and latent characteristics influence the chance that the insured-against event will take place. And, finally, it is sometimes hard to write a contract whose payment is contingent on the insured's actions and latent characteristics. . . .
>
> In the case of mandatory arbitration, a similar transaction takes place. Through mandatory arbitration, the employer transfers to the employee some of the risk of discriminatory conduct in the workplace. The employer's actions and characteristics influence whether or not there is discrimination in the workplace. That is, the employer's monitoring, training, and selecting its workforce impacts whether an employee suffers discrimination or perceives she has suffered discrimination.

Id.

17. *Id.* at 879–80. Baker describes:

> These structural differences between arbitration and litigation clarify the risk-management benefits of arbitration. Arbitration reduces the employer's payout if the employee suffers discrimination and files suit. By eliminating the chance of a large jury verdict or class-action lawsuit, mandatory arbitration insulates the employer from some of the risk that flows from the filing of discrimination claims.

Id. (internal references omitted).

substitute for insurance.[18] I argue that in the case of employment disputes, mandatory arbitration does more: If used in conjunction with other dispute resolution techniques such as mediation, it also serves to mitigate the risk created by asymmetrically held information.

Like financial institutions extending commercial credit, and franchisors, (collectively referred to as "providers"), employers almost never have perfect information about anyone with whom they do business. They almost always learn about adversities only after conditions have already impacted the risk profile of "the other guy." With this often unwelcome new information, providers by necessity look for tools to restore the balance that existed when the original risk was accepted. High on the list of tools available is mandatory arbitration. For the financing institution and the franchisor, arbitration proactively serves to help contain the adverse effects of behavior likely to increase lender risk or reputational risk. In employment agreements, arbitration serves not only to transfer risk of, and reduce exposure to, excessive verdicts and other costs, it also serves to affirmatively support the workplace environment and assist in resolving disputes quietly; thereby minimizing business interruption and the decline of workplace morale.

Given these advantages, it seems understandable that each of the providers would want assurances that the tool of arbitration is available at the outset of the relationship.[19] Waiting until after a dispute arises isn't a realistic option because by then the disputant will most likely resist realizing that the provider is at a distinct disadvantage if consent is withheld.[20]

Let's now apply these observations to some real world situations.

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18. *Id.* at 896–97.

> Mandatory arbitration may function as a substitute for, or a complement to, liability insurance. Employers might choose to use mandatory arbitration as a substitute for three reasons. First, although widely available, liability insurance is expensive. Second, when a discrimination claim arises, the parties often contest whether the claim falls within the coverage limits of the liability insurance policy. Similar coverage disputes do not arise with mandatory arbitration, because the risk-management benefits of mandatory arbitration accrue no matter what kind of claim is asserted against the employer. Third, liability insurance policies usually cap the amount of payment on the policy and exclude coverage for punitive damages. There are no similar restrictions with mandatory arbitration.

Id.

19. Thomas J. Stipanowich, *Arbitration: The "New Litigation,"* Pepperdine Univ. Sch. of Law Legal Studies Research Paper Series Paper No. 2009/15 (Feb. 12, 2009), *available at* http://works.bepress.com/thomas_stipanowich/1/. "Choice regarding arbitration is too important to be left until the eleventh hour of negotiation; process options should be considered and developed ahead of time." *Id.* at 58.

20. *See* Christopher R. Drahozal, *"Unfair" Arbitration Clauses*, 2001 U. Ill. L. Rev. 695, 747. Professor Drahozal notes:

> [O]nce a dispute arises, the costs of agreeing to arbitrate combined with a transfer payment may be greater than simply settling the case altogether. If both parties benefit from arbitration, they can agree to arbitrate without having to put a dollar value on those benefits. If the arbitration clause is one-sided, however, so that the corporation

B. The Lender's Risk: Credit Card Issuers Confront the Reality of Asymmetrically held Information[21]

Any business entity that extends credit must accommodate "lender's risk," defined for our purposes as the risk of non-payment. Lender's risk is amplified when the debtor's obligation to repay is unsecured. If a lender becomes aware of opportunistic consumer behavior, such as deferment of repayment or simply a default altogether, that lender has no choice but to move as quickly as possible to protect itself. Obviously, information about opportunistic behavior is critical, and until uncovered by the lender, it is knowledge in the sole possession of the borrower.

How the consequences of this can play out is illustrated by the credit card industry. This industry has been the subject of a lot of criticism, most of which is based on the assumption that the consumer is victimized by predatory measures, including mandatory arbitration imposed by issuers (consumer banks for our purposes) in search of unconscionable profits.[22] This simplistic assumption fails to give recognition to the harsh realities of the marketplace. In this market, mere card use obligates the issuer to advance cash without any form of security. Each use creates for the issuer a new and separate risk. Until any given advance is repaid, the issuer bears

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> gains and the individual loses from arbitration, the corporation will have to make a transfer payment to induce the individual to agree to arbitrate. For the individual to determine how much to demand, the individual will have to value his or her losses, including the possibility of a reduced recovery in arbitration. Once the individual makes that determination, however, it is only marginally more costly to settle the claim altogether, and avoid the further uncertainty of going to arbitration. In other words, submission agreements combined with transfer payments may well face much higher transactions costs, at least as compared with simply settling the claim.

Id. See also Peter Rutledge, *Whither Arbitration?*, 6 Geo. J. L & Pub Pol'y 549, 587 (2009). Professor Rutledge notes:

> Moving from the theoretical discussion to an empirical one, the case against postdispute arbitration becomes clearer. At bottom, it just does not work. A variety of empirical measures suggest this to be the case. A recent survey of lawyers indicated that an overwhelming majority of them would advise their clients not to agree to postdispute arbitration. Utilization rates tell a similar story, a recent study of AAA employment arbitrations by Lewis Maltby found that only 6% were post dispute in 2001 and a mere 2.6% were postdispute in 2002.

Id.

21. *See* Paul Bennet Marrow, *Non-Negotiable Mandatory Arbitration Clauses: From the Perspective of the Drafting Party,* 24 Alternatives to the High Cost of Litigation 164, Issue 10, 164–67 (Nov. 6, 2006).

22. *See generally* Samuel Issacharoff & Erin F. Delaney, *Homo Economicus, Homo Myopicus, and the Law and Economics of Consumer Choice: Credit Card Accountability*, 73 U. Chi. L. Rev. 157 (2006); Carolyn Carter, Elizabeth Renuart, Margot Saunders & Chi Chi Wu, *The Credit Card Market and Regulation: In Need of Repair,* 10 N.C. Banking Inst. 23 (2006); Public Citizen, *The Arbitration Trap: How Credit Card Companies Ensnare Consumers* (2007), *available at* http://www.citizen.org/documents/ArbitrationTrap.pdf; Discover Bank v. Superior Court, 30 Cal. Rptr. 3d 76 (2005). On May 22, 2009, President Obama signed into law the Credit Card Act of 2009. Pub. L. No. 111–24, H.R. Res. 627, 111th Cong. (2009) (enacted). The stated purpose of this law was to reform numerous practices in the credit card industry. The legislation does not address the use of pre-dispute arbitration clauses. *See id.*

the entire risk. At the same time, while the debt remains unsatisfied, the user has complete control over the quality of the risk, and the user and only the user has perfect knowledge about his or her ability and willingness to repay the loan.

Card issuers want to do business with "good users," i.e., users who care about their credit profile. It is in the issuer's best interests to take reasonable steps to accommodate the good user whenever possible, so long as doing so does not undermine the ability to recover any amounts advanced. The good user is likely aware of the need to preserve good-user status. The good user knows the value of a good credit rating. The good user, like the issuer, is a repeat player who is concerned about his or her credit reputation.

Good users can, and do, encounter circumstances that put their credit worthiness in jeopardy. If the good user is silent, the effects of asymmetrically held information come into play. But if there is disclosure, the effects of asymmetrically held information, for the most part, evaporate. If there is disclosure, the issuer can evaluate the risk of non-payment based on current information. Wishing to preserve a positive business relationship with a good user, the issuer has every reason to assist the user. From the issuer's perspective, the good user need not be penalized just because of a change in circumstances. This explains why issuers provide users the option to ask for help through a toll-free phone number shown on all credit cards. Employees responding to these calls are often given a certain amount of discretion to say yes or no. Discretion is a win-win situation. The issuer wins favor for being reasonable and the user is able to get help when needed.[23]

An issuer's survival is in large measure predicated upon an ability to find meaningful ways to screen out the "bad guys." Information is the key ingredient for success. Still, even the most conscientious issuer has only partial information about credit worthiness. Services such as those provided by Equifax Credit Information Services, Inc. (www.Equifax.com); Experian Information Solutions, Inc. (www.Experian.com); and Transunion LLC (www.Transunion.com) are a start, but they also are far from perfect because the information provided is always about past performance.

To restate the obvious, things change: The user loses a job or incurs an unexpected debt for something like medical bills not covered by insurance, etc. So over time, even the "good" user can morph into the opportunistic customer with the issuer having no forewarning whatsoever.

There are users who are simply opportunists, and sometimes identifying them at the outset is hard to do. This reality is known to every issuer. Opportunistic users have little regard for their own reputation and are prepared to run up large outstanding balances with little intention of meeting the obligation to repay. They are even

23. *See* Lucian A. Bebchuk & Richard A. Posner, *Boilerplate in Consumer Contract: One-Sided Contracts in Competitive Consumer Contracts,* 104 Mich. L. Rev. 827, 831–33 (2006). *See also* Jason Scott Johnston, *Boiler Plate in Consumer Contract: The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation Between Businesses and Consumers*, 104 Mich. L. Rev. 857, 858–59; Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 Mich. L. Rev. 1724 (2001).

disposed to frustrating collection in the hope that the issuer will compromise a claim. The problem is that the issuer may not be able to identify this type of user until it is too late.

When issuers look at the market, this is some of what they see:

- The environment is competitive. There are many issuers. Users aren't loyal and can easily establish and terminate relationships with multiple issuers.
- Even though there are many potential users to choose from, issuers can't always accurately determine who is and who isn't a good potential user.
- Issuers know that all potential users have the potential to become opportunistic.
- Issuers require a mechanism with which they can signal their intentions to counter opportunism in a forceful, expeditious, and prompt manner.
- Issuers know that the judicial system is subject to delays and not user friendly. In the courthouse, summary judgment is rarely available.[24]
- Issuers know that the risk involved can't be hedged through insurance because insurance companies will not assume a risk that can't be quantified and that is likely to become magnified without warning.

Obviously, the user holds all the cards until it is time to pay back an outstanding balance. So the issuer must always be prepared to move quickly if the user becomes opportunistic. The courthouse may not be an attractive option because of formalities and delays inherent to the system. And in the courthouse lurks a defendant's ability to cause delay with frivolous counterclaims, excessive demands for disclosure, and class action claims. In sum, the issuer sees the court system as being about unpredictability, delay, and expense.

Credit card disputes are uniquely suited to the arbitration process because of the limited factual circumstances likely to arise: (1) the card issuer does not advance money at the user's instruction, (2) the user has a Fair Credit Billing Act[25] claim

24. Summary judgment is almost never available because of the ability of the user to raise questions of fact concerning the accuracy of the size of the claim or even the possibility that there was never a contract between the parties because of fraud and identity theft.

25. *See generally* Fair Credit Billing Act of 1974, 15 U.S.C. § 1601 *et. seq.* The Fair Credit Billing Act is an amendment to the Truth in Lending Act of 1968, 15 U.S.C. § 1666(e) (2006). The Truth in Lending Act provides that if an issuer fails to cooperate and correct a billing error, that issuer "forfeits any right to collect from the obligor the amount" that is the subject of an alleged error, as well as any associated

pending, or (3) the user fails to repay the issuer. That's pretty much it, except for the extremely rare claim that the issuer engaged in a fraud.

Issuer-drafted, pre-dispute mandatory clauses are attacked as being procedurally unconscionable on the grounds that the cards are made too widely available to individuals who have less than sterling credit. It is the "Devil made me do it!" argument. But agreeing to advance money for a user with questionable credit doesn't entitle the beneficiary to a free ride. Being willing to assume such a risk doesn't mean that the issuer should be precluded from using any and all lawful means to collect.

While mandatory arbitration is no panacea, it gives the issuer a greater measure of control over timeliness of resolution and the removal or reduction of asymmetrical information related risk. The arbitration clause can be tailored to the practical needs of the issuer. The rules of the CPR Institute, ("CPR") the American Arbitration Association ("AAA"), and JAMS all provide for fast-tracked, expedited, or streamlined proceedings. The National Arbitration Forum ("NAF") permits a document hearing on claims of less than $75,000. Service providers and arbitrators handling the case encourage prompt resolution. Although not available as a right, discovery is tolerated under the arbitrator's careful watch. In the end, arbitration can produce an award in far less time than a comparable courthouse proceeding.[26]

The opportunistic user is most likely going to be aware of the benefits of arbitration to the issuer. It shouldn't be a surprise that an opportunistic user would attempt to frustrate collection by refusing to agree to arbitration after a default. That is why issuers frequently condition use of a credit card on agreements imposing mandatory arbitration.

Obvious as it may seem, it's worth stating that the lender/borrower relationship involves nothing more than the obligation to advance money upon demand and an obligation to repay the advance on the terms agreed to at the outset. It is simple nonsense to claim that repayment of money advanced is unfair or unjust because mandatory arbitration as a means to resolve disputes amounts to unjust enrichment.

While this discussion has been framed by credit card issuers, the argument has broad application to any provider of consumer credit. Many nationwide retail operations offer consumer credit on terms that include pre-dispute mandatory arbitration clauses. Mandatory arbitration provisions are almost universal in contracts between the various telephone companies and their subscribers, vendors for cable and satellite television and their subscribers, and contracts involving retail where consumer credit is the lifeblood. All of these providers of credit are confronted by the reality of asymmetrically held information. If denied the use of tools such as mandatory arbitration, the practical effect would be the tightening of standards concerning the availability of credit and a contraction in economic activity.

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finance charges. "[T]he amount required to be forfeited . . . may not exceed $50.00." *Id.* Truth in Lending Act § 1640(a) also gives a cardholder a cause of action for actual damages, statutory damages of no more than $1,000 and legal fees. The Federal Reserve regulation administering the Truth in Lending Act provisions, known as Regulation Z, is at 12 C.F.R. § 226.1.

26. Mark Fellows, *The Same Result as in Court, More Efficiently: Comparing Arbitration and Court Litigation Outcomes*, Metropolitan Corp. Couns., July 2006, at 32, 32.

C. *Franchises—Asymmetrically held Information and Risks to Reputation*

The franchise business model by definition creates a number of risks for the franchisor. The one that is paramount is the risk associated with the reputation of the franchisor and other parties associated with a brand. The franchise model is structured to create an impression in the mind of the public that the level of service and the quality of the goods sold by the franchisee comports to strict standards set by the franchisor. In the eyes of the public, the franchisee and the franchisor are one in the same. The franchisee is allowed the use of a trademark, confidential and proprietary information, and a business structure. The franchisor provides ongoing support information about the uniform basket of products or services offered to the public. In addition, the franchisor usually provides training and (sometimes) access to a line of products manufactured by the franchisor to be sold by the franchisee. The franchisor insists on the right to impose standards for the operation of the business and to set the bar for the quality of the goods and/or services offered to customers. In some cases franchisors even insist on standardized building plans, color schemes, and the design and content for signage containing the name and/or trademark of the franchisor. Finally, the franchisor grants exclusivity of location for the franchise by agreeing not to grant other franchises within a defined geographical area.[27]

Key to the relationship is the requirement that the franchisee perform as required under the terms of the agreement. Because the arrangement assumes that the franchisor will be engaging with others under identical terms, uniformity and compliance are essential. A franchisee who fails to comply threatens the reputation of not only the franchisor, but all other franchisees in the franchise network.[28]

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27. Christopher R. Drahozal and Keith N. Hylton, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, 32 J. Legal Stud. 549, 555–56 (2003); James A. Brickley et al., *Contract Duration: Evidence from Franchise Contracts* 5–6 (Univ. of Rochester William E. Simon Graduate Sch. of Bus. Admin., The Bradley Policy Research Ctr., Fin. Research and Policy, Working Paper No. FR 03-08, 2003), *available at* http://ssrn.com/abstract=383700.

28. *See* Drahozal, *supra* note 20, at 556.

> There is a fundamental incentive divergence under franchising that results in the franchisee investing too little effort in maintenance of brand capital. In the presence of a population of mobile consumers who patronize other units in the franchise network, an individual franchisee will not capture the full benefits from increasing his level of effort. The benefits of such efforts are shared with the franchisor and with other franchisees in the network. As a result, the franchisee will tend to exert too little effort from the franchisor's perspective (Rubin 1978; Brickley and Dark 1987; Brickley 1999). Moreover, the franchisee has an incentive to free ride on the brand's capital, since he captures the full savings from reducing his effort level, while the devaluation of brand capital is shared by other units in the network (Rubin 1978).
>
> There are several factors that constrain the franchisee's incentive to shirk or free ride. First, the franchisor will attempt to control the franchisee's incentives through various structural and contractual incentive alignment devices. One structural device is the ownership of a large percentage of outlets in the network. Since company-owned outlets are less likely to free ride, their presence in the network reduces the overall level of shirking. This enables the franchisor to allocate his monitoring effort toward franchised units. It may also enhance franchisee incentives by providing a form of "yardstick

The franchisor may have other concerns. Some franchises require the franchisee to devote specified amounts of time, effort, and resources. The franchisee may be required to evidence an ongoing commitment to the franchise, to invest in a physical plant, or to contribute to common costs of the franchise network, like advertising. Failure of the franchisee to meet any of these obligations creates a risk to the franchise network and may oblige the franchisor to consider whether to cover for the short fall, or to terminate the arrangement with the recalcitrant franchisee. For the franchisor, just having the ability to quickly terminate the franchise can provide the leverage needed to correct objectionable behavior.[29] If the franchisor elects to terminate, speed becomes essential for minimizing the potential impact of the recalcitrant franchisee on the franchise itself.

When franchisors look at the market, this is some of what they see:

- Even though there are often many potential franchisees to choose from, there is a risk that the selected franchisee will default. Information about a given potential franchisee is limited to past behavior.
- Even a good franchisee can encounter conditions that necessitate behaviors that are inconsistent with the commitments made by the franchisee.
- All franchisees have the latent potential to become opportunistic by seeking a free ride on a brand's capital.
- Mechanisms are required to counter opportunism in a forceful, efficacious, and prompt manner.
- The judicial system is subject to delays and not user-friendly.
- The risk involved cannot be hedged through insurance because insurance companies do not offer products to insure against the failure of a franchisee to comply with the requirements of a franchise.

While franchises may be available to anyone, not everyone is awarded a franchise. Judgments about qualifications and credit worthiness are based on information provided by an applicant. But as noted throughout this article, information received is usually about past behavior and is always subject to unexpected change. To assure that at the very least this information remains somewhat current, the franchisor requires the franchisee to agree to some form of monitoring. Still, the franchisor may

competition" with franchised outlets. Company-owned outlets serve as a benchmark for comparison to franchised units.

Id.

29. *Id.* at 745–48 (discussing the value of deterrence as a factor for accepting a pre-dispute arbitration agreement between sophisticated parties). *Id.* at 558.

face a significant lag time between the actual change and discovery by the franchisor since the franchisee is the first to know when change will occur and is responsible for communicating about the event. During this lag period, there is a heightened potential for damage to the reputation of the franchisor and the franchisee.

The franchisor depends on the franchisee to generate income for the franchisor from the operation of the franchise. It is therefore not in the franchisor's interest to terminate a franchise unless there is no other choice. The franchisor has an incentive to work with the franchisee and address problems as they arise, provided that the franchisor is aware that the franchisee is experiencing some form of difficulty. But sometimes termination is the best or only option. Most franchise agreements provide for early termination by the franchisor for franchisees' failure to meet specified conditions and obligations. Of course having the right to terminate is not the same thing as actual termination. Absent consent by the franchisee, actual termination still requires the sanction of a court or an arbitrator. Between court and arbitration, only arbitration is likely to provide the speed and efficiency required to terminate the contract, award damages, or both.[30]

Arbitration can provide additional advantages to a franchisor. The process provides the franchisor with the opportunity to select a third party who understands the complexities and nuances of the business environment to hear and evaluate the case. This is particularly important when the grounds for termination involve performance issues. A knowledgeable arbitrator is more likely to see through the possible smoke screens advanced by the franchisee to mask inadequate performance. With this need in mind, both the CPR and JAMS offer panels of arbitrators who specialize in franchise disputes. Specialization can lead to cost savings since the specialized arbitrator does not need to be educated on the fine points of the franchise business. In contrast, a jury or judge often has little to no specific knowledge of the franchise business, and educating them can be an arduous and costly task. Moreover, the jury may neither understand nor have the patience to try and understand the nature of the franchise business.

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30. *Id.* at 559–60. Consider the following example of a dispute over the amount of effort a franchisee gives to his business:

> Franchisors sometimes include provisions in the franchise contract specifying the number of hours per week or the specific times the franchisee must spend working at his franchised unit (Brickley 1999). These provisions are designed to increase the franchisee's effort level by restricting his outside activities, thereby lowering the opportunity cost to the franchisee of exerting effort at his unit (Brickley 1999). In the absence of such a provision, it would be difficult to demonstrate to a jury that the franchisee violated implicit contractual terms regarding his level of effort. Even with such a provision, there are innumerable ways in which a franchisee could comply with the hours requirement and yet fail to exert an acceptable level of effort. For example, a franchisee required by contract to spend 40 hours per week at his unit could come in at off-peak hours or pursue other personal projects while at the unit. Given the difficulties in specifying and evaluating effort levels, an arbitration forum could provide substantial deterrence benefits to the parties by increasing the accuracy of contractual compliance assessments involving the franchisee's level of effort.

Id.

D. Employment

The employment arena presents a number of challenges and concerns not found in consumer credit and franchising. Most notably, contracts for employment may be negotiated in a variety of circumstances, including:

- Negotiated one on one between an employer and a single individual. Typically these agreements are negotiated with highly-paid executives.
- Negotiated by a union and presented to all employees who are members of the union as a condition for employment.
- Not negotiated, but imposed by the employer as a condition of employment. These agreements are typically drafted by the employer and presented to the employee on a take it or leave it basis. This sub-group of agreements sometimes includes terms and conditions set forth in a human resource policy manual.

Arbitration clauses are found in all of the different types of employment agreements. For purposes of this article, the discussion excludes clauses and claims arising from union contracts.

In disputes involving consumer credit and franchising, the party drafting the agreement is typically the plaintiff/claimant. In contrast, in employment litigation, the employer—who drafts the terms of the agreement—is usually the defendant/respondent. And in employment disputes there can be more than one theory for a case, i.e., breach of contract and/or a statutory claim, usually for discrimination arising outside the terms of the contract. Employment disputes also differ from consumer credit and franchising disputes in that some employment claims are insurable. These products, designed to address and indemnify the employee for the behaviors of the employer, are quite expensive, have large deductibles, and very low total coverage limits.

An employee's attitude toward the employer is often concealed until an actual claim is asserted. The practical effect is to deny the employer an opportunity to address employee dissatisfaction as a pre-condition for the assertion of a claim. In general, the combination of alternate dispute techniques—particularly arbitration—with a human resources initiative provides powerful tools to overcome such risks. The combination serves to flush out asymmetrically held information in a constructive manner making remediation more likely and reserving arbitration for only the most difficult matters. Additional benefits resulting from arbitration are confidentiality, a vital aspect of any human resources driven process,[31] and speed.[32]

Those opposed to mandatory arbitration maintain that it is "unfair" to an employee because it can be misused to limit damages, alter the applicable statute of

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31. David Sherwyn, J. Bruce Tracey & Zev J. Eigen, *In Defense of Mandatory Arbitration of Employment Disputes: Saving the Baby, Tossing out the Bath Water, and Constructing a New Sink in the Process,* 2 U. Pa. J. Lab. & Emp. L. 73, 98 (1999). As Sherwyn et al. explain:

> The public aspect of litigation is potentially detrimental to employees and employers alike. Employer-defendants tear voraciously at the character and integrity of employee-plaintiffs during long, arduous trials. Litigation leaves ample public record not only of the employee's accusations but also of the employer's. Following the trial, employees may be blacklisted, disrespected, and distrusted when they attempt to return to work. Employers face the possibility of baseless accusations shattering their reputations that may have taken years to develop.

Id.

32. Alexander J.S. Colvin, *Empirical Research and Employment Arbitration: Clarity Amidst the Sound and Fury?,* 11 Empl. Rts & Employ. Pol'y J. 405, 425–6 (2007). Colvin elaborates on the comparative speed of arbitration:

> An advantage of arbitration compared to litigation that has been widely acknowledged is the relatively speedy time to hearing and a final decision in arbitration cases. The empirical research confirms the relative efficiency of employment arbitration in this regard. Eisenberg and Hill found that the mean time to final disposition for 172 non-civil-rights-based AAA employment arbitration cases in 1999–2000 was 250 days, whereas the mean time to final disposition for 170 non civil rights based state court cases from 1996 was 723 days. Similarly, whereas the mean time to final disposition for forty-two civil rights based AAA employment arbitration cases in 1999–2000 was 276 days, the mean time to final disposition was 709 days for 1,430 federal court employment discrimination cases from 1999–2000 and 818 days for 163 state court employment discrimination cases from 1996.
>
> In their study of securities industry arbitration, Delikat and Kleiner also find a speed advantage to arbitration over litigation, though the difference is of smaller magnitude than in Eisenberg and Hill's study. Whereas the median time from filing to judgment in securities industry employment arbitration cases was 16.5 months, with a mean time of 20.5 months, in employment discrimination cases in the Southern District of New York the median time from filing to judgment was twenty-five months and the mean time was 28.5 months.
>
> The results from the AAA C-filings data also suggest shorter time periods to obtain a hearing in arbitration than is typical in litigation. Among 849 cases that involved an award, the mean time to a decision was 332.2 days. It is noteworthy that whereas in other respects the California-AAA filings suggest a different set of characteristics to the emerging system of employment arbitration than the earlier studies, they confirm the relative speed of employment arbitration for obtaining a hearing compared to the litigation system.

Id. An examination of over 300 commercial arbitrations conducted under the auspices of the AAA and found that the "average time from filing to final award for the consumer arbitrations studied was 6.9 months. Cases with business claimants were resolved on average in 6.6 months and cases with consumer claimants were resolved on average in 7.0 months." Christopher R. Drahozal & Samantha Zyontz*, An Empirical Study of AAA Consumer Arbitrations* 2–3 (Searle Civil Justice Institute and University of Kansas School of Law, 2009), *available at* http://ssrn.com/abstract=1365435.

limitations, alter the burden of proof, and limit discovery. Moreover, opponents of mandatory arbitration argue that it is:

- Lawless because arbitrators aren't required to follow the law;
- Conducted in secrecy and without written opinions, raising issues of bias and prejudice; and
- Foisted on employees by contracts of adhesion and unequal bargaining power.

If these contentions are accurate, one would expect to find that all employers would rush to implement an arbitration system and, yet, this simply is not the case.[33] Why?

One explanation may be that many employers are not sophisticated and are not aware of an arbitration option. Another reason is that some employers consistently obtain better results in court. These employers are "low risk" employers, i.e., they have a profile that shows a history of few claims, which is to say they aren't repeat players. Claims against these employers tend to lack merit and are more likely disposed of by summary judgment.[34] This group of employers is: (1) engaged in activities less likely to generate complaints about employer behavior;[35] (2) less likely to be blind-sided by asymmetrically held information; or (3) located in parts of the United States where there are low levels of employee litigation.[36] For example, an employer with only a few employees is more likely to learn of employee dissatisfaction sooner than a large employer with many employees simply because the lines of communication in the smaller organization are more direct and information about dissatisfaction is less likely to be asymmetric. These are players who also benefit from features of the litigation process that aren't found in arbitration. While empirical studies indicate that employees tend to win larger verdicts in court as compared to arbitration, the litigation process extends to appeals. The appellate feature not only provides the opportunity to lower or even eliminate an award, but it also gives the employer the chance to negotiate a lower amount in damages with the employee.[37]

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33. Colvin, *supra* note 32, at 411. Colvin estimates that the number of employers who have adopted arbitration for employment disputes is someplace between 15 and 25%. *Id.*

34. Baker, *supra* note 5, at 864, 880–82. One study found that 60% of all employment cases brought in federal courts are resolved on summary judgment. Lewis L. Maltby, *Employment Arbitration and Workplace Justice,* 38 U.S.F.L. Rev. 105, 112–13 (2003). When employers make the summary judgment motion, they prevail 98% of the time. *Id.* In state courts, employers making such motions prevail only 15% of the time. *Id.*

35. Michael Z. Green, *Debunking the Myth of Employer Advantages From Using Mandatory Arbitration for Discrimination Claims,* 31 Rutgers L. J. 399, 418–467 (2000); *see* Baker, *supra* note 5, at 864, 880–82.

36. Colvin, *supra* note 32, at 412.

37. Colvin, *supra* note 32, at 423. Colvin elaborates:

> The data on litigation outcomes reflect the conventional wisdom that there are a small number of large verdicts, with the result that the studies find much higher mean than median award amounts. However, in litigation there also exists the ability to appeal the

As for the remaining employers, there is ample evidence that their motives for insisting on arbitration have little to do with being "unfair" to their employees. When these employers look at an available labor pool, this is some of what they see:

- Accurate reference information about job applicants is often difficult to obtain because sophisticated employers are aware they can be sued for sharing negative information about a former employee. Many employers by policy will provide only confirmation of dates of tenure.
- The vetting process, no matter how complete and sophisticated, only tells the employer about past behavior.
- How a potential employee will adjust to and perform within the environment provided by the employer is not knowable until an individual is actually performing within that environment.
- Determining employees' attitudes toward the employer, toward their fellow employees, and toward the environment created by the employer can be difficult and expensive.
- The reluctance of an employee to divulge information about his/her attitudes and perceptions about the workplace can frustrate the employer's ability to address concerns and complaints.
- Factors resulting in low employee morale, unless known and addressed by an employer, can interfere with the efficient operation of a business, undermine the ability of the employer to compete in the marketplace, and in extreme situations, result in an interruption of the business.

Against this backdrop, an employer's offer for employment always carries a number of risks arising from unknowns about the employee's inclination to bring a claim. The employer lacks knowledge as to an employee's (1) perceptions about what is and what isn't inappropriate employer behavior, (2) willingness to voluntarily submit to a form of alternate dispute resolution, (3) ability to understand and enforce his or her rights, and (4) ability to hire a lawyer.[38]

Once an employee is hired, there are still a number of unknowns. As the employee begins to interact with other employees while unmonitored by the employer, his or

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> verdict and many larger damage awards are reduced on appeal. Even in the absence of an appellate hearing, the employer may be able to get the employee to accept a lower amount than the damages award in settlement to avoid the possibility of appeal. Lewis Maltby has estimated that this may reduce the amount ultimately received by employees from jury awards by half.

Id.

38. *See* Baker, *supra* note 5, at 873.

her attitude can be affected both positively and negatively. The employee, and the employee alone, is aware of his or her tolerances and prejudices, which may become known to the employer only after a complaint has been made.[39]

Lipsky et al. have found that in the employment arena, avoidance of litigation is the key driver for the implementation of a dispute resolution system.[40] This seems reasonable considering that employers are, first and foremost, committed to running their business. In extreme circumstances, poor employee morale can lead to the diminished ability to compete, and to business interruptions—strikes being a case in point. Most employers compete in a commercial environment that is intolerant of business interruptions; if an interruption occurs, customers simply go some place else. Monitoring for behaviors among employees that suggest dissatisfaction is challenging, rarely effective, and is almost always very expensive. Litigation in any form is more than a distraction; it's very costly in time and resources. Many employers have concluded that this risk is best addressed by the implementation of a dispute resolution system designed to flush out asymmetrically held information, provide for an opportunity to correct problems, foster settlement, and relegate only the most stubborn claims to evaluation by a third party.

Clearly, employers have an incentive to resolve issues involving employee dissatisfaction as soon and efficiently as possible. As a matter of policy, many human resource departments require that employees with a complaint take steps in attempt to resolve the problems at hand as a precondition to seeking the intervention of a court or an arbitrator. Employees are typically required to (1) work with their management to resolve the dispute, (2) if the issues are not resolved, allow intervention

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39. *Id.*, at 873–74. Professor Baker makes the following point about the value of mandatory arbitration for managing risk:

> In the conventional debate, commentators on both sides miss the chief benefit of mandatory arbitration—managing risk. Commentators have a simple discrimination story in mind—the employer discriminates and the employee sues. This story neglects the randomness of most discrimination claims and, hence, the interaction of risk and mandatory arbitration. Two factors contribute to the uncertainty of discrimination claims.
>
> First, before hiring, the employer cannot assess the applicant's proclivity to file suit. The applicant's decision to file turns on a host of factors, many of which the employer is unable to predict. These factors—which vary from applicant to applicant—include: (1) the applicant's perceptions about what constitutes discrimination; (2) the applicant's willingness to subject herself to dispute resolution; (3) the applicant's ability to read, understand, and enforce her rights; and (4) the applicant's ability to retain an attorney.
>
> Second, after hiring, the employer does not have complete control over the activities of its employees. The divergence between the interests and preferences of many of the employees and the interests of the employer, combined with imperfect monitoring, means that employers cannot eliminate the chance of actual discrimination or the perception of discrimination in the workplace.

Id.

40. David B. Lipsky, Ronald L. Seeber & Richard D. Fincher, Emerging Systems for Managing Workplace Conflict: Lessons from American Corporations for Managers and Dispute Resolution Professionals 58–61, 75–76 (Jossey-Bass 2003).

by human resource professionals, and (3) if these steps don't work, submit the matter to mediation.

Consider also the possibility of the "appellate effect" suggested by Professor Hill. When arbitration is linked to other dispute resolution measures, usually by larger employers who are "repeat players," those procedures serve to filter out and resolve meritorious cases leaving only the less-meritorious matters for "appeal" to an arbitrator for final resolution.[41] Arbitration, especially when combined with mediation, provides an opportunity for an employee to air the complaint in a timely fashion, obtain a hearing,[42] and if need be, a determination from an arbitrator.[43] The reality of the

41. *See* Elizabeth Hill, *Due Process at Low Cost: An Empirical Study of Employment Arbitration Under the Auspices of the American Arbitration Association,* 18 Ohio St. J. on Disp. Resol. 777, 817–18 (2003). Hill looked at thirty-four cases involving a repeat player employer:

> Eighty-eight percent of these repeat players were employers with nationally known names, which are likely to process a relatively large number of cases. The employers in 74% of those cases (25 cases) maintained an in-house dispute resolution program (DRP) culminating in AAA arbitration. The win-loss ratio for this 74% of cases was 3.2, a full 190% higher than the 1.3 win-loss ratio for employers over-all. On the other hand, the remaining 26% of repeat employer cases (9 cases) involved employers who did not maintain in-house DRPs. Their win-loss ratio was only 1.25, just slightly below the 1.3 win-loss ratio for employers over-all. In short, the "repeat player effect" does not exist where the repeat player does not maintain an in-house DRP. Thus, the "Appellate Effect" appears to be the result of the selection processes of large employers' in-house DRPs, not merely the by-product of large employers' repeat appearances at arbitration.
>
> The "appellate effect theory" is further confirmed by a reading of the 25 individual cases which do manifest the "repeat player effect." They are indeed, of little or [no] merit. A reading of these awards reveals that over half, 56%, were without any merit. An additional 20% had some merit, but were properly denied. Thus, a total of 76% of the claims fall into the category of no merit or little merit, supporting the theory that the DRPs of repeat player employers push cases of questionable merit to the final step of external appellate review under the auspices of AAA, producing a higher than average rate of dismissal.

Id.

42. Maltby, *supra* note 34, at 113. Professor Maltby found that in the AAA employment arbitrations he sampled, all employees wishing a hearing were provided the opportunity. *Id.*

43. Colvin, *supra* note 32, at 438. Colvin elaborates on several studies showing that arbitration can be a viable substitute for litigation:

> These studies reflect the reality that employment arbitration was developed as and serves the function of an alternative to the litigation system for resolving employment law claims. Yet employment arbitration is also frequently adopted by organizations as part of their internal dispute resolution procedures used to resolve the conflicts that inevitably arise in work and employment relations. In addition to serving as the mechanism for resolving potential employment law claims, in this role employment arbitration serves as the final appeal stage for complaints or grievances brought by employees through the earlier stages in the internal procedures. For this reason, employment arbitration can also be viewed as part of what have been described as Organizational Dispute Resolution (ODR) systems, including various other dispute resolution procedures the organization may have adopted, such as peer review panels, internal or external mediation, management appeal boards, or ombudspersons. Where employment arbitration is introduced as the final step in an ODR system for nonunion employees, it is fulfilling a structural role more akin to that of labor arbitration in the grievances of union procedures. Although we should not jump to the conclusion that

appellate effect is confirmed by studies showing lower *win* rates for employees seeking arbitration based on personnel manuals than employees with claims arising from individually negotiated employment agreements.[44] And the presence of asymmetrically held information in circumstances confronting the employer serves to extinguish the value of the appellate effect.

But there is a price to be paid by all parties. For the employer, it is the possibility that the employee *win* rate will go up in arbitration, and the potential for the employee to receive a more favorable consideration as to the merits of the claim than might be the case in a court. The price paid by the employee for the ability to resolve disputes through remediation and settlement, and with freedom from the appeals process, is a system in which they are more likely to receive a lesser award than might be the case in court. This argument is supported by the empirical data reported on elsewhere in this article.[45]

In sum, asymmetrically held information can, and often does, unfairly tilt the playing field, and efforts to reform arbitration under the FAA must recognize this concern. A wholesale *ban* on the enforcement of pre-dispute mandatory arbitration clauses would serve to permanently reset the playing field in a manner that would discourage commercial intercourse and impair growth in the economy. In the following discussion, we will look in greater detail at the tone and content of the calls for reform.

III. USING EMPIRICAL RESEARCH TO EVALUATE FAIRNESS: FILTERING MUDDY WATERS

As I noted in the introduction to this article, there is a tension between those who see arbitration in any form as a procedurally inferior and biased process for dispute resolution and those who see it as a practical and efficient technique that facilitates their ability to do business in sometimes unpredictably treacherous circumstances. That tension is best understood within the framework of what the antagonists perceive to be "fair" and "unfair."

It's hard to argue that determinations about "fairness" are not subjective. What is and isn't fair might have a lot to do with whose ox is being gored. Of course, just because an ox is being poked at doesn't mean that doing so is actually unfair. Circumstances may exist requiring it and an absolute assumption that the poor creature's owner will *always* be resistant might be without any foundation. So it follows that within the context of the debate about the propriety of predispute

> employment arbitration does, or perhaps even should, function similarly to labor arbitration, this shift in perspective poses different questions about how we evaluate the operation and impact of employment arbitration. While the research in this area is more limited, some studies have begun to address these issues.

Id. (internal references omitted).

44. Mark C. Weidemaier, *From Court-Surrogate to Regulatory Tool: Re-Framing the Empirical Study of Employment Arbitration*, 41 U. Mich. J. L. Reform 843, 856 (2008).

45. *See infra* note 124 and accompanying text.

mandatory arbitration in commercial settings, assuming for all purposes *per se* unfairness is without merit. It's better to rely on empirical evidence of actual attitudes and circumstances.[46] In this section, I present evidence developed from a series of empirical studies designed to test for actual attitudes and to contain subjectivity. It should become clear that even though the evidence isn't conclusive and isn't complete, the weight is tipping toward the conclusion that mandatory arbitration is an appropriate means to dispute resolution.

A. Basic Arguments

The emphasis here is on the word "fair." At least on the surface, to those who oppose the process, mandatory arbitration is first and foremost patently unfair. They insist that at the core, mandatory arbitration is imposed (1) as an impenetrable barrier to class action litigation discouraging anyone with a minor grievance from seeking redress, and (2) as a fail safe mechanism to insure that any consumer, with the fortitude to nevertheless persist, will find himself/herself before a forum that is anti-consumer, anti-franchisee, and anti-employee. These opponents assume that with these givens about mandatory arbitration, anyone upon whom the process is imposed will always find it to be "unfair." These groups literally have no use whatsoever for mandatory arbitration in particular, and arbitration in general.[47] They propose that legislation *banning* the enforcement of pre-dispute mandatory arbitration clauses is the optimal solution.

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46. Not everyone agrees with this conclusion. Professor David Schwartz argues that reliance on an empirical approach for the determination of fairness is flawed and is a "clever rhetorical strategy" designed to frustrate efforts to reform the F.A.A. David Schwartz, *Mandatory Arbitration and Fairness*, 84 Notre Dame L. Rev. 1247 (2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401469. "Interposing the empirical question as a hurdle to legislative reform would be a strategic victory for mandatory arbitration supporters, because there is a good likelihood that a definitive answer is years away and perhaps unattainable." *Id.* "Behavioral evidence" is not defined any place in the article. *See Id.* Professor Schwartz basis his arguments on the conclusion that the empirical studies reported to date reveal little of value:

> Ten years of empirical research into the fairness of mandatory arbitration have produced only a handful of empirical studies, and these have told us very little. The studies, which compare win rates and average monetary awards in arbitration hearings and trials, are fraught with problems and objections: small data sets, an overreliance on data from AAA arbitrations, and skewed samples. Also, they deal almost exclusively with employment and not consumer cases, which may be significantly different. Finally, it is far from clear that any researcher will be able to design a study that will overcome the fundamental problem in comparing arbitrated and litigated "outcomes" in this way: cases that wind up going to trial and to arbitration may systematically differ from each other and even from the overall mix of claims filed and resolved through their respective (litigation and arbitration) systems.

Id. at 1283.

47. *See* Richard A. Alderman, *Why We Really Need the Arbitration Fairness Act: It's All About Separation of Powers*, 12 J. Consumer & Com. L. 151, 154 (2009) (arguing that "[a]rbitration is not about relocating or simplifying consumer dispute resolution; it is about eliminating consumer disputes and controlling resolution.").

On the other hand, those who champion the process argue that arbitration is more efficient, faster, and more economical than the judicial system.[48] They also argue that because the providers of arbitration services[49] have adopted rules and procedures designed to insure fairness and due process (the so-called "Protocols"), and because courts routinely screen agreements for procedural and substantive unconscionability, mandatory arbitration is as fair as, or perhaps even superior to, traditional litigation.[50] They believe that absent conclusive evidence that the

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48. *See* Lee Goldman, *Contractually Expanded Review of Arbitration Awards*, 8 Harv. Negotiation L. Rev. 171 (2003). Consider the argument that the dispute is resolved faster by arbitration:

> Arbitration, a contract-based form of dispute resolution, is increasingly popular because it allows the parties to avoid court litigation and structure dispute resolution in a manner that best suits each party's needs. Parties can choose the decision-maker, define her powers, select the procedures to be used, and decide whether a written opinion is required. As such, arbitration can be faster, cheaper and more private than litigation.

Id.; *see also* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985). The court recognized that:

> By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum. It trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and *expedition of arbitration*.

Id. (emphasis added). In arbitration, claims are resolved in months, rather than years, which is usually the time needed in the judicial system. Fischer and Haydock explain:

> The arbitration process is typically measured in months instead of the years it can take to resolve disputes in the litigation system. Because of the flexibility and adaptability of arbitration, it is generally quicker and more efficient than litigation. Trials are dictated by detailed rules and proceedings that have evolved to accommodate an extremely broad array of disputes in society. Arbitration procedures have developed as a streamlined alternative to provide fast, fair and final resolutions.

Robert Donald Fischer and Roger S. Haydock, *International Commercial Disputes Drafting an Enforceable Arbitration Agreement,* 21 Wm. Mitchell L. Rev. 941, 954 (1996). This is because the rules of the arbitration facilitators usually don't provide an absolute right to discovery and motion practice because these mechanisms are likely to cause delay. Instead, the arbitrator must grant permission for the parties to proceed with discovery and motion practice. By contrast, in state and federal judicial systems, where parties have the right to seek discovery and make motions, the judge will intervene only to control abuse. For an advocate who needs a quick result, arbitration is a practical means to an end. *See id.*

49. This article is limited to the following facilitators: American Arbitration Association ("AAA"), International Institute for Conflict Prevention and Resolution ("CPR"), JAMS, Financial Industry Regulatory Authority ("FINRA"), and National Arbitration Forum ("NAF").

50. Rutledge, *supra* note 20, at 563–64. The employment protocol sets forth a variety of rights including:

- [T]he employee's right to be represented by a person of her own choosing;
- the employer is encouraged to pay at least a share of the employee's fees; employees should have access to all information reasonably relevant to their claims; before selecting an arbitrator, parties should have sufficient information to contact parties who previously have appeared before her;
- arbitrators should have sufficient skill and knowledge;
- arbitrators should be drawn form a diverse background;
- arbitrators should be free of any relationships that would create an actual or apparent conflict of interest;

advantages they perceive don't actually exist, it is "unfair" to bar them from using arbitration to do business in a manner that is reasonable and appropriate given the risks that they must contend with. The proponents suggest that there is no need for *any* legislation, much less legislation *banning* the use of pre-dispute mandatory arbitration clauses.

Beneath the surface there is a darker side that is rarely talked about. For both sides in the debate, the bedrock issue is overreaching. Many engaged in providing consumer credit, franchising, and employment (collectively "advocates") are concerned that those with whom they do business will become opportunistic and overreach so as to create risks that are unforeseen, unpredictable, and worse yet, uninsurable. For the advocates, arbitration is looked to as a tool to level the playing field—as a vehicle for modulating the impact of the unanticipated risks. For their part, many consumers of credit, franchisees, and employees (collectively "opponents") fear that arbitration will be used as a weapon to extract unwarranted financial gain in an arena where the opponent has no chance to prevail.

B. Digging Deeper

So, is mandatory arbitration a fair process? Resolving this question is potentially impossible if one takes into account nothing other than hyperbole, speculation, unsubstantiated assumptions, and anecdotal evidence. In recent years, efforts have been made by the academic community to settle the matter by relying on empirical evidence culled from carefully designed studies. While the results are inconclusive, the cumulative weight of these studies points toward the conclusion that arbitration is perceived as a fair process.[51] Unfortunately, while further empirical examination may be needed to shed more light on the matter, criticism based on hyperbole, speculation, unsubstantiated assumptions, and anecdotal evidence continues to overshadow the debate.

1. Hyperbole, Speculation and Anecdotal Evidence

Those who oppose arbitration don't appear to have much to say when it comes to trying to use empirical evidence to undermine the arguments of the proponents.

- the employee's entitlement to the same array of remedies in arbitration as she would be entitled to in a judicial proceeding.

Id. Rutledge further explains:

> Subsequent protocols governing consumer disputes and health care disputes differ in some of the specifics but contain the same basic protections. Many of the major arbitration associations have committed to administering arbitrations in the consumer and employment areas only if the parties agreed to be bound by the protocols.

Id.

51. *See* Amy Schmitz, *Curing Consumer Warranty Woes Through Regulated Arbitration*, 23 Ohio St. J. on Disp. Resol. 627 (2008). "Moreover, the limited empirical studies of arbitration outcomes available indicate that individuals may not benefit from a ban on arbitration agreements because arbitration is faster and cheaper than litigation, and may provide individuals with higher recovery rates than they would obtain in court." *Id.* at 629–30.

Instead, they simply argue that (1) by its very nature, mandatory arbitration is unfair and denies due process;[52] and (2) there is no substance in the arguments raised by those favoring the process. [53] The opponents claim that the process doesn't actually yield the benefits suggested by those who support it, and that the empirical evidence is unclear as to whether all of these benefits universally exist. Further, the opponents argue that if these benefits don't really exist, and they maintain that they don't, then the real motivation for insisting on arbitration is that it is a stacked deck, one that is stacked against the consumer, the franchisee, and the employee. Countering this argument, the proponents note that what is uncontested is their *belief* that mandatory arbitration provides them with these benefits in most of the disputes they have with those they do business with. Therefore, they maintain that absent conclusive empirical proof, these benefits are real and that it would be unfair to deny them the right to do business as they see fit.[54]

The claim by the opponents that empirical evidence is inconclusive might be a double-edged sword. Empirical evidence supporting the validity of the opponents' concerns is noticeably very thin,[55] forcing them to rely on hyperbole,[56] assumptions,

52. *See*, *e.g.*, Mark E. Budnitz, *The High Cost of Mandatory Arbitration,* 67 Law & Contemp. Probs. 133 (2004); Drahozal, *supra* note 20; Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 Mich. L. Rev. 373 (2005); Ware, *supra* note 13.

53. Rutledge, *supra* note 20, at 570. Professor Rutledge summarizes the argument nicely:

> According to the argument, arbitration clauses coupled with class action waivers effectively deny claimants any opportunity for meaningful relief. The arbitration clause takes them out of court, depriving them of the procedural advantages (such as discovery and a jury); the class action waiver eliminates the opportunity to aggregate small claims, thereby eliminating the incentive for any private party (much less any attorney) to prosecute the case.

Id.

54. Professor Schwartz maintains that this "burden" shifting argument is just wrong:

> The logic of this argument is where there's no smoke, there's no fire. To be sure, if a well-conceived and diligent search turns up no evidence of a condition, then that can support an inference that the condition does not exist. But the search must be thorough enough for that inference to cross the threshold from "I didn't find it in this spot" to "we're probably not going to find it anywhere."
>
> . . . .
>
> The "no evidence" claim also reflects an additional rhetorical move. Its clear implication is that the existing evidence is insufficient to shift from a regime of enforcement to one of nonenforcement of predispute arbitration agreements. Thus, the claim *sub silentio* imposes a burden of proof on the critics of mandatory arbitration. What justification is there to place the burden of proof on critics?

Schwartz, *supra* note 46, at 1259–60.

55. Lisa B. Bingham, *Why Suppose? Let's Find Out: A Public Policy Research Program on Dispute Resolution*, 2002 J. Disp. Resol. 101 (2002); Drahozol, *supra* note 20, at 720–21.

56. For an example of how far afield these arguments can go, consider what one author had to say about the inability of arbitrators who happen to be situated outside "large urban" areas to adequately grasp federal and state laws applicable to consumer transactions:

and conclusions drawn mostly from anecdotal evidence of abuse, which they posit as proof that arbitration is unfair.[57] And the rhetoric can become quite shrill.

For example, one noted author warns that "[t]he Supreme Court has created a monster"[58] and describes the process as "'despotic decision making' in the sense that the governing law makes arbitrator's decisions virtually unreviewable while accepting procedural and substantive results that would be considered unfair in a judicial setting."[59] He also suggests that pre-dispute mandatory arbitration clauses "are, in substance, immaterial to the core of the transaction, which would typically center on price or, in an employment contract, wages."[60] The motivation for the imposition of such draconian methods is said to be the selfish desire to reduce transaction costs, to transfer risk to the party upon whom arbitration is imposed, and to secure a forum where the deck is stacked in favor of the party imposing the process. [61]

> In addition to the problems posed by limited discovery, it may be difficult to find qualified persons to sit as arbitrators of claims based on these statutes, especially outside large urban areas. These are very difficult cases. First, the subject matter is complex. A simple loan transaction may involve principal, interest charges, points or various other front-end charges, and fees of many types including recording fees, appraisal fees, and late fees. In a typical case involving claims of usury as well as Truth in Lending Act violations, the arbitrator will have to know state usury law, which may vary depending upon whether the loan is covered by the state's retail installment act, motor vehicle retail installment act, or small loan act. The Truth in Lending Act has its own concepts in which the finance charge is altogether different from the interest rate. In addition, the statutes themselves often are only the starting point. State credit laws frequently are supplemented by state banking regulations. The federal statutes are supplemented by regulations and official commentary, both of which change periodically.

Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection,* 10 Ohio St. J. on Disp. Resol. 267, 314–15 (1995).

57. *See* Samuel Issacharoff & Erin Delaney, *Credit Card Accountability,* 73 U. Chi. L. Rev. 157, 172–73 (2006) (reporting the individual story of Joseph Bellavia); *see also* David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 Wis. L. Rev. 33, 40–53 (1997).

58. Schwartz, *supra* note 46, at 36.

59. *Id*. at 38. The author refers to Justice Steven's dissent in Mitsubishi Motors Corp. v. Soler Chrystler-Plymouth, Inc., 473 U.S. 614, 657 (1985).

60. Schwartz, *supra* note 46, at 56–57.

61. Professors Issacharoff and Delaney summarize nicely:

> Given the motivation for profit maximization, it seems inevitable that, absent regulation, companies will seek to take advantage of consumers' irrational behavior by manipulating arbitration clauses together with other aspects of consumer contracts.
>
> Every indication is that the imposed arbitration clauses are nothing but a shield against legal accountability by the credit card companies.

Issacharoff, *supra* note 22, at 173. The lack of empirical evidence doesn't mean that there is no basis for concern. Perceptions of unfairness are a powerful force that can't be dismissed out of hand. *See generally* Barbara Black and Jill Gross, *Perceptions of Fairness of Securities Arbitration: An Empirical Study, Report to the Securities Industry Conference on Arbitration* 1 (Univ. of Cincinnati C. of Law, Pub. Law & Theory Research Paper Series No. 08-01 Feb. 6, 2008), *available at* http://www.ssrn.com/abstract=1090969.

Courts have even gotten into the act. Consider the following statement offered by a bankruptcy judge: "The reality that the average consumer frequently loses his/her constitutional rights and right of access to the court when he/she buys a car, household appliance, insurance policy, receives medical attention or gets a job rises as a putrid odor which is overwhelming to the body politic."[62]

A recent study issued by Public Citizen focusing on perceived abuses in the credit card industry proclaimed that binding arbitration is "big business" with credit card companies paying large sums to facilitators such as the AAA and NAF. These payments are said to be used to compensate compliant arbitrators willing to issue rubberstamp rulings against any and all card users. "The method is to isolate and conquer, as the cloak of secrecy makes it impossible to see the full picture of corporate wrongdoing or to use the public courts to stop it."[63]

Statements such as these are unquestionably inflammatory. Reliance on emotional triggers to defeat mandatory arbitration is unfortunate, less than intellectually honest, distracting, and capable of interfering with sound judicial reasoning.[64]

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62. Knepp v. Credit Acceptance Corp., 229 B.R. 821, 827 (Bankr. N.D. Ala. 1999).

63. Public Citizen, *supra* note 22, at 4. The Public Citizen report elaborated:

> Binding mandatory arbitration is wholly distinct from post-dispute arbitration, nonbinding arbitration and mediation or other forms of alternative dispute resolution, particularly because agreements to use them are made after a dispute arises, not before and as a condition of receiving the good or service.
>
> Binding mandatory arbitration is big business. Binding mandatory arbitration clauses are found in most boilerplate contracts for everyday needs, including auto insurance, as well as nursing homes or other services like cable television. To receive a good or service, the consumer must sign the contract. According to a legal brief filed by the Chamber of Commerce of the United States in a 2006 Supreme Court case, BMA clauses are in millions of consumer contracts across the United States.
>
> Many consumers would be shocked to learn that a binding mandatory arbitration clause buried in the fine print strips them of their constitutional right to a trial by jury and an impartial judge.
>
> How is the system rigged? First, credit card and other companies drive millions of dollars in business to arbitration firms, which in turn hire arbitrators to rubberstamp rulings that favor business and then pass many of the costs onto the consumer. The evidence proves that BMA stacks the deck to favor corporate interests over consumers.
>
> . . . .
>
> Safeguards built into the justice system are not found in binding mandatory arbitration.

Id. (internal citations omitted). Public Citizen is a respected non-profit organization that advocates on behalf of consumers. About Public Citizen, http://www.citizen.org/about/ (last visited Oct. 4, 2009).

64. *See* Omri Ben-Shahar, *Symposium: Empirical Studies of Mandatory Arbitration: Introduction: How Bad are Mandatory Arbitration Terms?*, 41 U. Mich. J.L. Reform 777 (2008). For proof of "the paucity of empirical knowledge," Professor Ben-Shahar points to some comments made by the judiciary in the often cited opinions of Armendaris v. Foundation Health Psychare, 24 Cal 4th 83 (Cal. 2000) and Oblix, Inc. v. Winiecki, 374 F. 3d 488 (7th Cir. 2004). Ben-Shahar notes that in *Armendaris*, the California Supreme Court concluded that arbitration is an unfavorable forum for employees based on win rates, citing as support for that generalization just two published studies. Ben-Shahar notes that in

Hyperbole aside, empirical studies have looked at a number of markers thought to measure fairness. These include studies comparing performance before courts and arbitrators as evidenced by win rates,[65] rates of usage and time, and cost comparisons, to name but a few. Parties on both sides of the issue have generated empirical studies.

As I have already noted,[66] not everyone is sanguine about reliance on empirical evidence to answer the question: Is mandatory arbitration a fair process? For example, Professor Sternlight maintains that there are at least three (3) core problems with the ability of researchers to properly evaluate empirical evidence:

> 1. Researches can't obtain access to the data they need for a good study;
>
> 2. Even if available, the data can't be properly compared with courthouse results; and
>
> 3. The approach of looking at and comparing win rates and the size of awards/judgments doesn't tell the whole story because no consideration is given to other factors that might influence the decision to go to court or arbitration, thus obscuring the differences between the two possibilities. [67]

The studies discussed in the subsections that follow should put to rest these concerns.

Oblix, Inc., the 7th Circuit reached the opposite conclusion based on just one empirical study. Ben-Shahar observes:

> Surely, one's view about the empirical reality of arbitration—on how well claimants fare relative to litigation—is not the only relevant factor in evaluating the legality of arbitration clauses. For example, one might think that arbitration is bad but that arbitration clauses cannot be vacated under state contract law or the Federal Arbitration Act. But it is striking that many of the attempts to justify the competing views on legality are based on alleged empirical underpinnings. Unfortunately, these underpinnings have not been fully developed to provide the desired foundations. We simply do not know enough facts to pass a judgment on arbitration as a mandatory procedure.

Id. at 778–79.

65. Raw win-rate studies generally have shown that claimants do quite well. *See* Maltby, *supra* note 34, at 110 (according to data aggregated from a variety of studies, employees prevailed 62% of the time in proceedings before the AAA); California Dispute Resolution Institute, Consumer and Employment Arbitration in California: A Review of Website Data Posted Pursuant to Section 1281.96 of the Code of Civil Procedure (August 2004), *available at* http://www.mediate.com/cdri/cdri_print_Aug_6.pdf. Comparative win rate studies, which compare win rates in arbitration to win rates in litigation, show a similar trend. *See*, *e.g.*, Samuel Estreicher, *Saturns for Richshaws: The Stakes in the Debate Over Predispute Employment Arbitration Agreements*, 16 Ohio St. J. Disp. Resol. 559, 564–65 (2001); David Sherwyn, Samuel Estreicher & Michael Heise, *Assessing the Case for Employment Arbitration: A New Path for Empirical Research,* 57 Stan. L. Rev. 1557, 1569 (2005).

66. Schwartz, *supra* note 46, at 1259–60.

67. Sternlight, *supra* note 10, at 1658.

2. *Empirical Studies: The "Rate" Wars*

The anti-arbitration forces often point to *win*-rate data to support their conclusions.[68] For example, the Public Citizen study, mentioned above, relies on an analysis that Public Citizen conducted using raw numbers provided by the National Arbitration Forum for its activities in California during the period from January 1, 2003 to March 31, 2007 (34,000 cases are claimed to have been reported by NAF and "crunched" by Public Citizen).[69] Public Citizen concluded:

> All but 118 of the cases were card/finance companies or firms that purchase their debts. In other words, consumers chose to bring only 118 cases before NAF while corporations chose this business friendly forum nearly 34,000 times—99.6 percent of the total cases.
>
> In the more than 19,000 cases in which an NAF-appointed arbitrator was involved, 94 percent of decisions were for business. . . .
>
> In sum, we found that the privatization of our justice system through pre-dispute BMA (binding mandatory arbitration) is being pushed by business interests well aware of its perils for consumers. *BMA is, in fact, a deliberate strategy to substitute a secret, pro-business kangaroo court for an open trial on the merits of a claim. The courts provide little protection from this increasing threat.* [70] (Emphasis and definition added).

"Rate" data comes in a variety of forms, many of which are used to undermine the belief that arbitration is fair because it is fast, efficient, and economical. Consider a recent study by Eisenberg et al. comparing arbitration *usage* rates.[71] The authors collected consumer agreements with mandatory arbitration clauses drafted and frequently used by a group of "large" corporations. They then searched the files of the Securities and Exchange Commission ("SEC") for the *same* corporations and

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68. *See*, *e.g.* Public Citizen, *supra* note 22, at 1. Professor Rutledge also describes the problem with win rate data:

> Raw win rates are, however, a relatively poor method by which to answer the "better off" question. For one thing, standing alone, they offer relatively little insight into how the claimant would have fared in litigation. Furthermore, anyone interpreting these results must closely consider how the researchers define a "win." An arbitration might award a claimant $ 100 (thereby qualifying as a "win" according to some reports), yet, if the claimant were seeking $ 100,000, such a paltry sum could hardly be considered a good outcome if the claimant had a meritorious claim.

Rutledge, *supra* note 21, at 557.

69. Public Citizen, *supra* note 22, at 1.

70. Public Citizen, *supra* note 22, at 1–3.

71. Theodore Eisenberg, Geoffrey P. Miller & Emily Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. Mich. J.L. Reform 871 (2008).

reviewed numerous negotiated agreements[72] deemed by the SEC to be material to operations. Next they compared the consumer contracts with the negotiated contracts to see if the arbitration clause usage rate in negotiated agreements was anywhere near the number found in the consumer contracts.[73] The data revealed that over 75% of the consumer agreements reviewed contained mandatory arbitration clauses and over 90% of the employment agreements reviewed contained such a clause. In contrast, less than 10% of the negotiated contracts contained an arbitration clause,[74] leading to the conclusion that the companies involved were disingenuous about their open embrace of arbitration.[75] From this the authors conclude: "Our data support the inference that the companies . . . do not view consumer arbitration as offering a superior combination of cost savings, expeditious decision-making, consistency, and justice. Rather, they view consumer arbitration as a way to save money, by avoiding aggregate dispute resolution"[76]

The Public Citizen and Eisenberg studies are indicative of the many that have appeared recently in the literature.[77] The general tone and import is the same: "large" companies rely on arbitration to defeat consumers with small claims by imposing

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72. *Id.* at 881. The authors further explained their methodology:

> Contracts filed by the companies we studied included stock purchase agreements; credit and security agreements; loan pooling and service agreements; employment agreements; and various agreements relating to benefits and incentives for key employees. Given the economic significance of these contracts—implied by their inclusion in Forms 8-K and 10-K—we assume that they were negotiated with care.

Id.

73. *Id.* at 878. The authors explained their core hypothesis as follows:

> [T]he companies we studied, or organizations to which they belong, have publicly endorsed the virtues of arbitration, particularly in the context of challenges to pre-dispute arbitration clauses and related class action waivers in consumer agreements. Arbitration . . . "takes less time and costs less than litigation;" it is "fair and effective;" and it offers "a quick, cheap, and easy dispute resolution mechanism" that is "more efficient" than resolving disputes through litigation. Based on these assertions, we would expect that companies would consistently contract for dispute resolution through arbitration.

Id. (internal footnotes omitted).

74. *Id.* at 883.

75. *Id.* at 895 ("[C]orporations' selective use of arbitration clauses against consumers, but not against each other, suggests that their use of mandatory arbitration clauses may be based more on strategic advantage than on a belief that corporations are better serving their customers.").

76. *Id.* at 894–95.

77. For a good sampling of this literature, see Eisenberg, *supra* note 71, at 872 n.1. While Public Citizen advocates on behalf of consumers, there are a number of studies that have been paid for by associations that support the business community. *See*, *e.g.*, U.S. Chamber Institute of Legal Reform, Arbitration: Simpler, Faster, Cheaper than Litigation (April 2005), *available at* http://www.instituteforlegalreform.org/get_ilr_doc.php?docId=489; Ernst & Young LLP, Outcomes of Arbitration: An Empirical Study of Consumer Lending Cases (2004), *available at* www.ard-forum.com/rcontrol/documents/ResearchStudiesndStatistics/2005ErnstAndYoung.pdf.

unfavorable terms that limit consumer flexibility, while at the same time creating cost efficiencies that are rarely passed along to the consumer.[78]

Digging deeper, it turns out that these studies don't necessarily provide a complete picture because they don't provide context. For example, the Public Citizen observations rely on the so called *win-rate* argument; the higher the win rate for any party who is a repeat player over parties that are one-time players, the more unfair the process is presumed to be.[79] Win-rate statistics in and of themselves aren't a complete picture unless the data set is controlled[80] for factors such as settlements,[81] conditions leading to settlements, participation of counsel representing a respondent,[82] internal filters that resolve meritorious cases while referring all others to arbitration,[83] and training of the arbitrator.[84] In other words, the 94% win rate in favor of credit card issuers reveals only that 94% of the time the credit card issuer prevailed—it looks no deeper to any empirical evidence as to the factors and circumstances surrounding each such victory.

The Public Citizen study, showing that NAF-appointed arbitrators ruled in favor of the credit card issuer 94% of the time,[85] neglects to point out a crucial fact: These rulings involved situations in which the consumer not only defaulted in repaying the debt, but also failed to contest the merits of the claim being asserted by the credit card issuer. In other words, the Public Citizen study overlooked the nature of the

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78. With respect to the claim that cost efficiencies are rarely passed along to the consumer, Professor Rutledge notes:

> Recall that the theoretical model suggested that the savings generated from arbitration would be passed onto consumers, employees, and investors depending on the elasticity of demand for products, labor, and capital. As with the literature on cost savings, there appears to be no systematic study on the distributive effect of commercial arbitration.

Rutledge, *supra* note 20, at 579.

79. *See* Hill, *supra* note 41, at 816–18. Evidence that there is a *per se* repeater effect in employment matters is scant to non-existent. *Id.* This appears to be the case as well in commercial arbitration under the auspices of the AAA. *See* Drahozal & Zyontz, *supra* note 32, at 3.

80. *See* Colvin, *supra* note 32, at 412–19.

81. *See* David Sherwyn, Samuel Estreicher & Michael Heise, *Assessing the Case for Employment Arbitration: A New Path for Empirical Research,* 57 Stan. L. Rev. 1557, 1567–68 (2005).

82. Hill, *supra* note 41, at 819–20.

83. Weidemaier, *supra* note 44, at 848–54; Sherwyn et al., *supra* note 81, at 1566–67.

84. Stephen J. Choi, Jill E. Fisch & Adam C. Pritchard, *Attorneys as Arbitrators* 8, (Univ. of Mich. Law Sch. Law & Econ., Olin Working Paper No. 09-001, 2009 N.Y.U. Law Sch. Law & Econ., Research Paper No. 08-18, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1086372.

85. The 94% win rate is in keeping with win rates in cases processed through the court systems. *See* David Caplovitz, Consumers in Trouble: A Study of Debtors in Default 221 (1974); John A. Goerdt, Small Claims and Traffic Courts: Case Management, Procedures, Case Characteristics, and Outcomes in 12 Urban Jurisdictions 53 (1992); Hillard M. Sterling & Philip G. Schrag, *Default Judgments Against Consumers: Has the System Failed?,* 67 Denv. U. L. Rev. 357, 384–85 (1990).

evidence before the arbitrator[86] that showed, that as a practical matter, there was no alternative to awards favoring the credit card issuer.[87]

Arbitrators can easily be put into a position where they have no choice but to rule against a credit card user, even if there has been appearance by the respondent. For example, in the case of NAF, claims for less than $75,000 (a category into which most credit card claims fall)[88] are often resolved at document hearings, i.e., hearings in which the parties submit only written statements and other documentary evidence.[89] Mere denials of liability, unsupported by evidence of credit card theft, fraudulent use, identity theft, or improper accounting and bookkeeping, are insufficient to overcome a documented claim that the credit card was properly used and that a debt was actually incurred. Thus, the mere appearance of the respondent, without valid grounds for the denial of liability, leaves the arbitrator with no reasonable choice but to issue an award favoring the claimant (credit card issuer). This should not be a surprise. Moreover, it is unlikely, if not impossible, to imagine that the outcome of these cases might differ if considered by a court. The only difference is that the arbitration process is faster and more efficient.

Consider the details of the *usage* rate study comparing consumer and non-consumer contracts conducted by Eisenberg et al. described above. [90] That study failed to take into account the unique nature of each agreement that did not have an

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86. Nat'l Arbitration Forum, Code of Procedure, Rule 36, at 31–2 (2008), *available at* http://www.adrforum.com/ main.aspx?itemID=330&hideBar=False&navID=357&news=3 (arbitrators are permitted to enter an award in a case where the respondent defaults, but Rule 36 (B) requires that the award must still be based on a review by the arbitrator of the merits of the claim). *Compare* Am. Arbitration Ass'n., Commercial Arbitration Rules and Mediation Procedures, Rule 29, at 14 (2009), *available at* http://www.adr.org/sp.asp?id=22440&printable=true (requiring the party who is present to submit such evidence as the arbitrator may require for making an award), *with* JAMS Comprehensive Arbitration Rules and Procedures, Rule 22(j) (2009), *available at* http://www.jamsadr.com/rules-comprehensive-arbitration/ (setting forth that the arbitrator may not render awards solely on the basis of the default of the party. The arbitrator shall require any party seeking relief to submit evidence that the arbitrator may require).

87. *See* Sarah R. Cole & Theodore H. Frank, *The Current State of Consumer Arbitration,* 15 Disp. Resol. Mag. 30, 31 (2008).

> In a collections case, the consumer is the defendant. Typically, there is no question that the consumer owes the debt to the credit card issuer. . . . In arbitration . . . the debtor will lose, because he owes the debt. In such situations, all an arbitrator can do is enter an award against the debtor. Thus, the win-loss record for consumers in these cases is not cause for concern.

Id; see also Yvonne W. Rosmarin, *Consumers-R-Us: A Reality in the U.C.C. Article 2 Revision Process*, 35 Wm. & Mary L. Rev. 1593, 1625–26 (1994); Budnitz, *supra* note 56, at 309–10; Dwight Golann, *Developments in Consumer Financial Services Litigation*, 43 Bus. Law 1081, 1092 (1988).

88. *See* Ware, *supra* note 13, at 97–98.

89. Any party may demand a participatory hearing in which case a document hearing is heard as part of the participatory hearing. Nat'l Arbitration Forum, Code of Procedure, Rules 15 (D), 25, 28, at 15, 23, 26 (2007), *available at* http://www.adrforum.com/users/naf/resources/20070801CodeOfProcedure.pdf.

90. Eisenberg, et al., *supra* note 71.

arbitration clause.[91] It turns out that these were stock purchase agreements, credit and security agreements, and loan pooling and service agreements that came about through negotiations in which there was a free flow of information between the parties. These arrangements were negotiated with the advice of attorneys—and perhaps more importantly, independent accountants—and performance was subject to review by accountants.[92] Asymmetrically held information played no role, and thus there was no need for a mechanism to modulate against its drawbacks. Interestingly, in situations involving negotiated employment agreements, arbitration clauses appeared with regularity. [93]

91. Compare this study with Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publically Held Companies*, 56 DePaul L. Rev. 335 (2007).

92. The authors provide no information as to the circumstances of the parties to these agreements. *See* Eisenberg et al., *supra* note 71. Those that are publically listed on the various stock exchanges are subject to ongoing disclosure obligations with their information being freely and readily available.

93. The findings are consistent with those reported by Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 Wash. & Lee L. Rev. 231 (2006). They observe:

> Both parties to a CEO employment contract frequently view arbitration clauses as desirable. Companies universally want to arbitrate disputes to keep matters private, and thereby avoid adverse publicity over a messy termination and possible public litigation. Normally, employees would want to preserve their right to a jury trial (but for the greater expense) because they calculate that a jury of their peers would be more sympathetic to their situation than to the company firing them. However, CEOs may have good reason to believe that juries will not identify with their compensation demands because the amounts involved may seem excessive to most members of the public. This may lead executives to favor arbitration generally, although they will still carefully negotiate such things as the selection process for the arbitrators and their right to appeal from an adverse decision.

Id. at 238. Theodore Eisenberg and Geoffrey Miller conclude:

> Table 2 reports the number and percentage of contracts that contain arbitration clauses. The overwhelming majority, about 89%, do not mandate arbitration. Whatever arbitration's supposed efficiencies, sophisticated actors are not flocking to it in a broad range of important contracts. Some contract types—pooling and servicing agreements and trust agreements—never provided for arbitration. Others—bond indentures, underwriting agreements, and security agreements—almost never did. But material variation exists across contract types. For example, 37% of employment contracts and 33% of licensing agreements provided for arbitration. Clearly, the nature of the contract is associated with whether the parties agree ex ante to arbitrate.
>
> The results support the view, expressed by corporate lawyers, that the decision to include an arbitration provision in a commercial contract is complex and cannot be determined across the board. The infrequency of arbitration clauses across the entire range of categories also suggests that sophisticated contracting parties may not, in fact, believe in the purported benefits of arbitration over litigation.

Eisenberg & Miller, *supra* note 92, at 350 (internal footnotes omitted).

3. The sampling of attitudes

Other empirical academic studies suggest that evidence is accumulating pointing to the conclusion that arbitration is fair.[94]

Sherwyn et al., in 2005, looked at the full history of a claim from initial filing to resolution. The data the researchers reviewed gave them confidence in the fairness of employment arbitration.[95] The study concluded "that plaintiffs do not fare significantly better in litigation, that arbitration provides a quicker resolution than litigation, and that available data do not indicate whether damages are fairer under either system."[96]

Similarly, Elizabeth Hill, in a study of 200 employee dispute awards handed down by AAA arbitrators in 1999 and 2000, concluded that objections to arbitration were without empirical foundation.[97] Hill's study focused on claims by middle and lower income groups. She found that employment arbitration "is the primary venue" for claims by middle- and lower-income employees in large measure because of the

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94. *See* Sherwyn et al., *supra* note 81, at 1568–69, 1572–73, 1575, 1578; Hill, *supra* note 41, at 784, 807–08, 818–24. For a detailed discussion of analysis based on win-loss rates, repeat player bias, disposition time and damages, *see* Sherwyn et al., *supra* note 81, at 1567–78.

95. Sherwyn et al., *supra* note 81, at 1578.

> As with much empirical work, it is possible to critique and discount prior research. Still, despite the flaws, there are some conclusions about which we can be confident regarding the "fairness" of arbitration. First, there is no evidence that plaintiffs fare significantly better in litigation. In fact, the opposite may be true. Second, arbitration is faster. Because employment dispute resolution can be both heart wrenching and financially crippling, a quicker resolution is a positive. Third, the question of damages is too difficult to determine based on available data. While the strongest consensus exists with respect to disposition time, further research is warranted on all three factors, especially on the questions of win/loss records and damages. Of course, even more and better data are unlikely to provide definitive answers to all empirical questions. Moreover, data will not answer the critical nonempirical questions that greatly influence the debate

Id.

96. *Id.* at 1564. *See also* Maltby, *supra* note 34, at 117–18 ("The data currently available shows that the results of quality employment arbitration compare well to the results of employment litigation. . . . The only negative for employees who arbitrate their employment disputes may be that extremely large awards are less common in arbitration.").

97. Hill, *supra* note 41, at 824.

> Opposition to employer-sponsored employment arbitration is widespread, strong, and based on the belief that it robs employees of the right to trial and supplants it with a "kangaroo court" dominated by employers' interests. In contrast, research shows that middle- and lower-income employees and employees who arbitrated pursuant to promulgated agreements had no real, practical right to trial. This study indicates that AAA employment arbitration offers affordable, substantial, measurable due process to employees arbitrating pursuant to mandatory arbitration agreements and to middle- and lower-income employees.

Id.

inability of these claimants to obtain legal assistance on a contingent fee basis.[98] Hill concluded that there was no support for claims that:

- Employment arbitration cannot competently resolve statutory employment discrimination claims;
- Employer-sponsored arbitration is biased in favor of highly-compensated employees;
- Employer-sponsored arbitration is biased in favor of employers; and
- The "repeat player effect" is a failure of due process.[99]

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98. Hill, *supra* note 41, at 784. Others have reached the same conclusion. *See* John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 Stan. L. Rev. 983 (1991); William M. Howard, *Arbitrating Claims of Employment Discrimination: What Really Does Happen?* Disp. Resol. J., Oct.–Dec. 1995, at 40; Lewis L. Maltby, *Out of the Frying Pan, into the Fire: The Feasibility of Post-Dispute Employment Arbitration Agreements,* 30 Wm. Mitchell L. Rev. 313 (2003). *See also* Weidemaier, *supra* note 44, at 855–56 (2008); Sherwyn et al., *supra* note 81, at 99–100.

99. Hill, *supra* note 41, at 784.

> [T]his study evaluates, and tends to refute, the beliefs that: (1) employment arbitration cannot competently resolve statutory employment discrimination claims; (2) employer-sponsored arbitration is biased in favor of highly-compensated employees; and (3) employer- sponsored arbitration is biased in favor of employers.
>
> Indeed, the data here do not even support the theory that the "repeat player effect" is a failure of due process. The "repeat player effect" is the only empirically proven theory of alleged failure of due process in employment arbitration. The empirically proven fact upon which the theory is based is that employers who arbitrate frequently win arbitrations more often tha[n] those that arbitrate only once.

Id. (internal footnotes omitted). Professor Rutledge adds:

> One oft-stated concern about arbitration is that it systematically favors repeat players. According to the argument, many arbitrations such as in the fields currently under consideration by Congress involve participation by one party who regularly arbitrates—the employer, the company, the franchisor—and one who rarely does so—the employee, the consumer, the franchisee. Because the former party in each case is a repeat player, critics argue that this will skew the results in favor of that party's advantage.
>
> Why might repeat players do well in arbitration? One reason might be that the repeat player may have superior knowledge about the arbitral process and, therefore, may be able to exploit that informational asymmetry to its advantage. The validity of that proposition, however, is not unique to arbitration. Rather, it would be equally valid in any other dispute-resolution forum, including litigation. The employer, the corporation, or the franchisor would appear in the forum more frequently and, therefore, could have superior knowledge about the forum's operations. Thus, to the extent informational asymmetries explain the repeat player's success in arbitration, eliminating arbitration does not correct the asymmetries.
>
> Another reason for the repeat player's success might be the financial incentives of arbitrators. The argument would go that arbitrators, unlike judges, depend on repeat business to generate a stream of income and, therefore, have an incentive to render awards favoring the party more likely to appoint them in the future. Unlike the informational-asymmetry explanation, this reason is indeed unique to arbitration.

Rutledge, *supra* note 20, at 565 (internal footnotes omitted).

While these studies indicate that arbitration as an alternative to litigation is fair, other studies indicate that at least some people are not convinced that mandatory arbitration is all that desirable. Richey et al.[100] studied a sample of potential job applicants and found that while non-binding arbitration was not seen as an impediment to applying for work, mandatory arbitration was viewed less favorably and was considered as a negative factor in the decision to apply for a job.[101] Similarly, Mahony et al. found that employees favored employers who offered *voluntary* arbitration as a method for resolving employment-related disputes. [102] Together these studies imply that at least among potential employees, control over the choice to arbitrate or go to court hinges on the question of ultimate control. This is a finding that is consistent with the findings of Black and Gross, discussed in the next section.

There may be some empirical evidence to support this skepticism. A series of studies suggest a significantly lower success rate for employment cases arbitrated by the Financial Industry Regulating Authority (FINRA).[103] The combined results of these studies showed an employee success rate of only 43%. While there is much speculation about why these rates differ from those reported in cases administered by the AAA, the best explanation appears to be that the types of cases involved were simply not comparable. The FINRA cases were exclusively statutory civil rights cases, whereas the AAA cases were exclusively contract cases.[104]

What about the preferences of employees who earn large sums? The Arbitration Fairness Act of 2009 would render a pre-dispute mandatory arbitration agreement between a sophisticated CEO and his/her corporation unenforceable, an outcome that would be unquestionably unfair if there is empirical evidence that CEOs have a preference for mandatory arbitration. Stewart J. Schwab and Randall S. Thomas conducted a *usage*-rate study of 375 employment contracts for chief executive officers of some of the largest U.S. publicly held corporations. The study found that 41.6% of the time (156 contracts), arbitration was the preferred vehicle for dispute resolution.[105] This finding casts doubt on the assertion that mandatory arbitration clauses come about because a coercive employer seeks to take advantage of an employee with little

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100. Brenda Richey, H. John Bernardin, Catherine L. Tyler & Nancy McKinney, *The Effect of Arbitration Program Characteristics on Applicants' Intentions Toward Potential Employers*, 86 J. Applied Psychol. 1006, 1009 (2001).

101. *Id*. at 1009.

102. Douglas M. Mahony, Brian S. Klaas, John A. McClendon & Arup Varma, *The Effects of Mandatory Employment Arbitration Systems on Applicants' Attraction to Organizations,* 44 Hum. Resource Mgmt. 449, 458–59 (2004).

103. In one study, the sample consisted of 62 cases with employees winning only 36% (twenty-two cases) of the time. Stuart H. Bompey & Andrea H. Stempel, *Four Years Later: A Look at Compulsory Arbitration of Employment Discrimination Claims after* Gilmer v. Interstate/Johnson Lane Corp., 21 Emp. Rel. L.J. 21, 37–43 (1995). In another, the sample was 572 cases and the win rate was 44%. Michael Delikat & Morris M. Kleiner, *Comparing Litigation and Arbitration of Employment Disputes: Do Plaintiffs Better Vindicate Their Rights in Litigation?*, 6 A.B.A. Sec. Conf. Mgmt. 1 (2003).

104. *See* Maltby, *supra* note 34, at 100–11. *See also* Weidemaier, *supra* note 44, at 847–56.

105. Schwab & Thomas, *supra* note 93, at 257.

bargaining power.[106] The authors note that the reason for this attraction to arbitration may result from a concern that, to juries, a CEO's compensation demand might have a decidedly hollow ring. [107]

4. *Studies About Third Party Rules Mandating Arbitration*

A series of recent studies looking at arbitration within the context of securities cases focused not only on *win* rates, but also on the perceptions of participants in mandatory arbitration proceedings. These studies involved disputes between customers/investors and brokers. The forum administering these proceedings was FINRA, a self-regulating industry organization.[108] The panels hearing cases are composed of three individuals, one of whom must be affiliated with the securities industry.

Beginning with the issue of *win* rates, these studies show that since 1998, customer *win* rates have been steadily declining, especially if the respondent was a larger brokerage firm. In addition, awards as a percentage of the amounts being claimed have also declined.[109] Against this backdrop, Barbara Black and Jill Gross

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106. *Id.* at 238.

> Both parties to a CEO employment contract frequently view arbitration clauses as desirable. Companies universally want to arbitrate disputes to keep matters private, and thereby avoid adverse publicity over a messy termination and possible public litigation. Normally, employees would want to preserve their right to a jury trial (but for the greater expense) because they calculate that a jury of their peers would be more sympathetic to their situation than to the company firing them. However, CEOs may have good reason to believe that juries will not identify with their compensation demands because the amounts involved may seem excessive to most members of the public. This may lead executives to favor arbitration generally, although they will still carefully negotiate such things as the selection process for the arbitrators and their right to appeal from an adverse decision.

Id.

107. *Id.*

108. FINRA was organized in the summer of 2007. It is composed, on a consolidated basis, of what was previously the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") arbitration forums. For purposes of this article, all references to FINRA include references to the NASD and the NYSE. About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/index.htm (last visited Oct. 4, 2009).

109. Edward S. O'Neal & Daniel R. Solin, Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fair (2007) *available at* http://smartestinvestmentbook.com/pdf/061307%20Securities%20Arbitration%20Outcome%20Report%20FINAL.pdf.

> There may well be innocent explanations for fact that the chances of an investor recovering significant damages from a major brokerage firm are statistically small in mandatory arbitration. However, our data clearly indicates a decline in both the overall "win" rate and the expected recovery percentage against major brokerage firms, at a time when the misconduct of these firms reached its apex with the analyst fraud scandal.
>
> This data gives credence to Commissioner Galvin's testimony about the system really being a "... damage containment and control program masquerading as a juridical proceeding", intended to protect the major brokerage firms from significant damages.

undertook a study of the perceptions of fairness for participants in the securities arbitration system.[110] Their study picks up where a prior study, called the Perino Report,[111] left off. The Perino Report found that "there is little if any indication that undisclosed conflicts represent a significant problem in [self regulatory organization ("SRO")]-sponsored arbitrations. Available empirical evidence suggests that SRO arbitrations are fair and that investors perceive them to be fair."[112]

In comparison, Black and Gross found that while participants believed they were given a procedurally appropriate hearing, attitudes were mixed when it came to the performance of the panel in reaching an impartial award.[113] These findings appear to

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> Whether for good reason or otherwise, the mandatory arbitration system is achieving this result.

Id. at 17.

110. *See* Black & Gross, *supra* note 61.

111. Michael Perino, *Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations* 1 (2002), http://www.sec.gov/pdf/arbconflict.pdf.

112. *Id.* at 48. The Perino report followed a report by Gary Tidwell, Kevin Foster & Michael Hummel, Party Evaluation of Arbitrators: An Analysis of Data Collected from NASD Regulation Arbitrations 3 (1999), http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@neutrl/documents/arbmed/p009528.pdf.

113. Black & Gross, *supra* note 61, at 3. According to their survey:

> [P]articipants [had] divided views about the fairness of securities arbitration, based on their most recent experience with the process. In general, when asked to focus on their most recent dispute filed for arbitration, participants overwhelmingly agreed that the arbitration panel listened to the parties, their representatives and the witnesses and gave the parties enough time to present their evidence and argue the merits of their cases. Participants also perceived that the arbitrators appeared competent to handle the dispute, to resolve pre-hearing issues, and to understand the issues and legal arguments in the case. They also believed that the discovery process allowed them to obtain the necessary information for a hearing.
>
> In contrast, participants' perceptions as to other aspects of the panel's performance in their most recent dispute were more mixed; in particular, whether the panel was open-minded and impartial and whether the panel applied the law. Views were also divided on whether the hearings took too long and whether the arbitration process was too expensive. Survey participants were divided about whether they would recommend that others use arbitration to resolve their securities disputes; whether they had a favorable view of securities arbitration; and whether the outcome was very different from their initial expectations.
>
> Furthermore, overall, participants were not satisfied with the outcome of their most recent dispute and would be more satisfied if they had an explanation of the award. Many survey participants with recent comparable experience in a civil court case perceived arbitration as unfair by comparison.
>
> Finally, when asked about their overall perception of securities arbitration (as opposed to their perceptions derived from their most recent experience), survey participants were more negative. Although participants agreed that arbitration is conducted in a simple way, they were split as to whether the process is economical, and they disagreed with the statements that it is conducted without bias and conducted in a way that is fair to all parties.

be at odds with the long-held belief among some scholars that perceptions of procedural fairness impact perceptions of substantive fairness, and account for a greater willingness to accept the outcome, even if it isn't favorable.[114] However, perceptions of procedural fairness are rooted in concerns about an ability to control the dispute resolution process,[115] with an emphasis on the advancement of self-interests.[116] Black and Gross found that 79.3% of the respondents believed that their customer agreement contained a pre-dispute arbitration clause[117] and that 56.2% of participants believed they had no choice but to have their dispute resolved in arbitration.[118] Moreover, they also found that nearly 40% of the respondents were concerned that the process would not be fair going in.[119] Taken together, these findings seem to suggest that the respondents did not believe strongly that they were able to control the dispute resolution process. This conclusion is confirmed by a further finding that 55.48% of the customers sampled and 43.79% of all others sampled said they would have been more satisfied if they had been provided with an explanation of the final award.[120]

> For almost every question in the survey, statistical analysis reveals that customers have a more negative perception of the process than non-customers.

Id.

114. *Id.* at 6–7.

> Dispute resolution scholars recently have focused on procedural justice as a more reliable predictor than substantive justice with respect to parties' assessment of the overall fairness of a process. These scholars have found that perceptions of procedural fairness strongly impact perceptions of substantive fairness, which results in a greater willingness to comply with the outcome and greater trust in and respect for the decision-maker. Summarizing prior research by social psychologists, a leading scholar of procedural justice writes that "people who believe that they have been treated in a procedurally fair manner are more likely to conclude that the resulting outcome is substantively fair, even if that outcome is unfavorable." She posits that four key elements "reliably lead people to conclude that a dispute resolution process is procedurally fair:" (1) the process provides an opportunity for disputants to voice their concerns to a third party; (2) the disputants perceive that the third party actually considered these concerns; (3) the disputants perceive that the third party treated them in an "even-handed" way; and (4) the disputants feel that they were treated in a dignified and respectful manner.

Id. (internal footnotes omitted). *See also* Nancy A. Welsh, *Making Deals in Court-Connected Mediation: What's Justice Got to With It*?, 79 Wash. U. L. Q. 787, 817–830 (2001). *See generally* Tom R. Tyler, Why People Obey the Law (2006); Donna Shestowsky, *Procedural Preferences in Alternate Dispute Resolution: A Closer, Modern Look at an Old Idea*, 10 Psychol. Pub. Pol'y & L. 211 (2004).

115. *See* Shestowsky, *supra* note 114, at 225–27.

116. Donna Shestowsky, *Misjudging: Implications for Dispute Resolution*, 7 Nev. L.J. 487 (2007).

117. Black & Gross, *supra* note 61, at 19.

118. *Id.* at 20 n.49.

119. *Id.* at 21.

120. *Id.* at 39.

Studies comparing actual *win* rates in litigation to actual *win* rates in arbitration, sometimes called "macro justice" studies,[121] suggest a bias in favor of arbitration. Delikat and Kleiner looked at 125 employment discrimination cases tried in the Southern District of New York[122] and compared the results to 186 such cases resolved by arbitrators in proceedings facilitated by NASD/NYSE. The study suggests that while the *win* rates in arbitration exceed those realized in the courthouse, the amounts (on average) awarded by arbitrators were significantly lower than the amounts awarded in court.

This study and others like it are not without flaws. Cases resolved through arbitration and litigation often aren't comparable because of the screening techniques used in the selection and assignment process and because of settlement.[123]

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121. *See* Lisa B. Bingham, Tina Nabatchi, Jeffrey M. Sanger & Michael S. Jackman, *Dispute Resolution and the Vanishing Trial: Comparing Federal Government Litigation and ADR Outcomes* 32 (3rd Annual Converence on Empirical Legal Studies Papers, 2008), *available at* www.ssrn.com/abstract=1127878. "Macrojustice involves issues about the 'fairness' of dispute resolution processes, and specifically about whether a particular dispute resolution process favors one side or the other." *Id.*

122. Michael Delikat & Morris M. Kleiner, *An Empirical Study of Dispute Resolution Mechanisms: Where Do Plaintiffs Better Vindicate Their Rights?*, 58 J. Disp. Resol. 56, 56–58 (2003). Comparing to the Southern District of New York, the findings were:

	SDNY	ARBITRATION
Plaintiffs prevail	33.6%	46.2%
Media judgment/award	$95,554	$100,000
Average judgment/award	$377,030	$236,292
Media attorney fee judgment award	$69,338	$76,684
Average attorney fee judgment/award	$149,756	$36,282
Media time to resolution	25 months	16.5 months

Id.

123. *See* Sherwyn, *supra* note 81, at 1564–65. Sherwyn et al. note:

> To answer the question of whether arbitration is fair to employees, researchers typically compare the results of cases adjudicated in arbitration against those adjudicated in litigation. Specifically, win/loss rates and monetary awards are compared across the two systems. There is, of course, a problem with this type of analysis: the stream of litigated and arbitrated cases differs. Consequently, one can never be sure if the reason for a disparity in outcomes, if any, involves the adjudication system or some other factor, such as the strength of the case, or perhaps a selection factor determining which cases go to court and which cases end up in arbitration.

Id. See also Bingham et al., *supra* note 121, at 35.

> Macrojustice debates about ADR and litigation have addressed issues of both monetary relief requested and monetary relief granted. Some have speculated that plaintiffs do better in ADR than in litigation, because plaintiffs who settle a case sidestep the possibility of having a judge dismiss the lawsuit entirely (dismissal occurs in a significant number of litigated cases). On the other hand, some believe that plaintiffs may do worse in ADR than in litigation, because they may settle for less than their case is worth out of fear that they will recover nothing if a jury finds in favor of the defendant. Thus, determining whether there are differences between ADR and litigation cases in the amount of relief granted is an important macrojustice issue, especially when viewed from a public policy perspective.

5. *Other studies*

If mandatory arbitration is "unfair," one would expect to find a decrease in the use of arbitration clauses. But Professors Drahazol and Wittlock have found that at least in the case of franchise agreements, this is apparently not the case. They compared *usage* rates for a group of franchisors in 1999 to 2007. They found: (1) there was little change in the use of arbitration clauses by franchisors, (2) there was little to indicate that franchisees were attempting to avoid arbitration clauses, and (3) few if any of the clauses reviewed were modified in response to the possibility of a risk that courts would invalidate the clauses based on unconscionability.[124]

And finally, while not necessarily the most objective participants in the process, an American Bar Association survey found that 78% who were surveyed believed the arbitration process itself to be as effective, if not more so, than traditional litigation.[125]

To sum up, it is a mistake to dismiss the claims about the practical benefits in arbitration. Empirical evidence suggests that general and mandatory arbitration

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Id.

124. Drahozal & Wittrock, *supra* note 7, at 5–6.

> We find that, in the aggregate, there has been little change in the use of arbitration clauses in the franchise agreements studied. The proportion of franchise agreements with arbitration clauses is essentially the same in 2007 (43.7%) as it was in 1999 (45.1%). Viewed individually, there has been some reshuffling among franchisors as to their chosen means of dispute resolution. Four franchisors (out of 32, or 12.5%) replaced arbitration clauses in their franchise agreements with exclusive forum selection clauses, which was largely offset by three franchisors adding arbitration clauses to their franchise agreements (which previously had contained no dispute resolution clause at all). This reshuffling of franchisors may provide at least a partial explanation for the anecdotal reports of flight.
>
> We also find little indication that franchisees are fleeing arbitration by avoiding franchisors that include arbitration clauses in their arbitration agreements. The number of franchised locations for franchisors in the sample that use arbitration clauses increased from 57,397 in 2000 to 75,874 in 2006. The share of those franchised locations as a percentage of the total likewise increased, from 43.7% in 2000 to 46.3% in 2006. These numbers provide no evidence that franchisees avoid franchisors that use arbitration.
>
> Finally, most changes to the terms of arbitration clauses studied were relatively minor, although some are worth noting. The use of class arbitration waivers increased substantially (from 50 percent to over 80 percent of the clauses). Notably, three (of 28, or 10.7%) of those class arbitration waivers included "non–severability" provisions under which, if a court holds the 6 class arbitration waiver invalid, the entire arbitration clause is invalidated. Given that a number of jurisdictions have held class arbitration waivers to be unconscionable or otherwise unenforceable, these non–severability provisions result in what might be characterized as a partial but small flight from arbitration. The use of common carve-outs (i.e., exceptions to arbitration) also increased slightly, again indicating a partial flight from arbitration, albeit only for those types of disputes or remedies excluded from the obligation to arbitrate.

Id.

125. *See* Lawrence R. Mills, *You Can Get What You Need in Arbitration*, 2008 A.B.A. Sec. on Lit. Conf. Mgmt. 10.

within the context of agreements made by the targeted group are fair. As we have seen, even when assessed using one or more of many variables, arbitration remains a practical and useful solution for the disposition of disputes arising in the commercial arena. Further, there is no empirical evidence that suggests that mandatory arbitration is an unfair or inappropriate solution to the pernicious effect of asymmetrically held information.

From here, the debate moves to public policy and the alleged need to reform our system for using arbitration. What follows in the next part is a look at that debate and the consequences of efforts to regulate or ban the enforcement of pre-dispute mandatory arbitration.

IV. PUBLIC POLICY: THE DEADLOCK

As we have seen, the current effort by those who oppose mandatory arbitration is aimed at federal legislation *banning* the enforcement of *any* pre-dispute arbitration found in contracts for (1) consumer transactions, (2) franchise agreements, (3) employment agreements, and (4) disputes arising under any statute intended to protect civil rights.[126] If passed, such legislation would apply to all targeted agreements, no matter *when* made.[127] Professor Rutledge characterizes this as a "jackhammer approach to arbitration reform."[128] Blunderbuss is another way to describe the effort. The proposed statutory scheme makes no effort to regulate or control the use of particular terms and conditions in arbitration clauses claimed to be offensive, such as terms restricting application of law, class action waivers, damages, discovery, and jury trials. Supporters of *banning* arbitration maintain that regulation is impractical and unrealistic because no matter how sophisticated the regulatory scheme, those favoring arbitration will always find a way to circumvent regulation.[129] The proposed legislation is absolute; pre-dispute arbitration clauses would be simply outlawed. The consequences of this legislation would be stark, as it would kill off most arbitration between individuals and corporations, partnerships, and all governmental agencies. In some instances, employment being an example, even two sophisticated parties—i.e., a C.E.O. and his/her employer—would be denied the ability to agree on a predispute arbitration clause because the Arbitration Fairness Act of 2009, as written,

126. The Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. § 4 (2009).

127. Peter Rutledge, *Who Can Be Against Fairness? The Case Against the Arbitration Fairness Act,* 9 Cardozo J. Conflict Resol. 267, 268–69 (2008) (discussing the version of the Arbitration Fairness Act that was considered by the 110th Congress, S. 1782, H.R. 3010, (2007)). The only substantive difference between the 2007 and 2009 legislation is that the prior proposes "transactions between parties of unequal bargaining power" in the target group. Arbitration Fairness Act, S. 1782, H.R. 3010, 110th Congress § 4 (2007)

128. Rutledge, *supra* note 127, at 269.

129. *See* Jean R. Sternlight, *Dispute Resolution and the Quest for Justice,* 14 Disp. Resol. Mag.12 (2008) ("Regulation is not sufficient because no legislature can ever think creatively or broadly enough to proscribe every practice that a company might impose, and litigation challenges are too costly and time-consuming to offer adequate protection from unfair arbitration provisions.").

applies to all employment agreements.[130] It would also foist on civil courts millions, if not tens of millions, of new cases that would further clog an already overburdened and underfunded system.

Those favoring the arbitration process believe that they shouldn't be summarily and absolutely denied the basic benefits that arbitration offers, i.e., efficiency and speed. They urge that their opponents' concerns about access to justice have already been addressed since many providers of arbitration services have adopted protocols designed to insure fairness and due process. Supporters of arbitration also dismiss as unworkable and unrealistic the suggestion that those that they do business with will readily agree to arbitration after a dispute arises.[131] They note that, with few exceptions, pre-dispute mandatory arbitration clauses are rarely found by courts to be unconscionable.[132] The proponents of arbitration conclude that it is unfair to deny them access to a system that they believe best serves their needs.

The result is what appears to be a classic deadlock between antagonists completely unwilling to accommodate one another. Does this deadlock need to be broken? I

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130. *See supra* note 9.

131. *Developments in the Law: Access to Courts,* 122 Harv. L. Rev. 1151, 1177 (2009).

> Achieving cost efficiencies requires that parties already be bound to arbitrate before a conflict arises, and this is precisely the type of arbitration agreement that the AFA would void. The necessity of requiring arbitration pre-dispute arises for three reasons. First, assuming that arbitration is a cheaper way of enforcing legal rights, rational defendants might not want to enter into it post-dispute if they know they are likely to lose. Such a defendant might hope that, faced with the significantly greater costs of pursuing litigation, the corporate plaintiff would simply drop the claim. Second, the use of a loser-pays rule in some arbitrations can further amplify the disincentive for a defendant to accede to arbitration. Third, even if it were economically rational for the consumer to enter into a post-conflict arbitration agreement (perhaps if her legal fees were paid), the transaction cost of bargaining might itself be overly expensive, and given the high stakes for the individual consumer, she might be too hostile to agree to anything that her creditor is requesting of her. Contrariwise, if arbitration were in fact a cheaper and more efficient way of enforcing legal rights, a consumer entering into an initial contract with a creditor would have an interest in consenting to mandatory binding arbitration in the event of a dispute, since at least some of the benefits would likely be passed on to the consumer in the form of lower costs. These reasons all argue for allowing consumers to make a binding choice pre-dispute rather than forcing arbitration choices to be made after a conflict has arisen.

Id. (internal footnotes omitted).

132. *See* cases, *supra* note 6. *See also* Salley v. Option One Mortg. Corp., 246 Fed. Appx. 87 (3d Cir. 2007) (applying Pennsylvania law); Desiderio v. NASD, 191 F.3d 198 (2d Cir. 1999); Deaton v. Overstock. Com, No. 07-643, 2007 U.S. Dist. LEXIS 94436 (S.D. Ill. Dec. 27, 2007); Nichols v. Wash. Mut. Bank, No. 07-3216, 2007 U.S. Dist. LEXIS 85936 (E.D.N.Y. Nov. 27, 2007); Lyman v. Mor Furniture for Less, No. 06-0666, 2007 U.S. Dist. LEXIS 58187 (D. Nev. Aug. 7, 2007); Sherr v. Dell, Inc., No. 05-10097, 2006 U.S. Dist. LEXIS 51864 (S.D.N.Y. July 28, 2006) (applying Texas law); Cunningham v. Citicorp., No. 05-3476, 2005 U.S. Dist. LEXIS 33805 (D.N.J. Dec. 16, 2005). *But see* Ferguson v. Countrywide Credit Indus., 298 F.3d 778 (9th Cir. 2002); Luafau v. Affiliated Computer Servs., No. 06-0347, 2006 U.S. Dist LEXIS 33048 (N.D. Cal. May 15, 2006); *In re* Poly-America, L.P., 262 S.W.3d 337 (Tex. 2008); Olson v. Bon Inc., 183 P.3d 359 (Wash. Ct. App. 2008); Armendariz v. Foundation Health Psychcare Servs., Inc., 6 P.3d 669 (Cal. 2000).

submit that the apparent deadlock is an illusion; legislation is not called for because the current marketplace environment is sufficiently flexible to accommodate the concerns of all the players.

Keeping in mind the reality that regulation can stifle constructive economic activity, a number of pre-conditions should be met in order for legislation banning arbitration to be necessary. These pre-conditions include empirically based findings that confirm the following:

- Mandatory arbitration serves no practical purpose and unfairly benefits the party insisting on such a clause;

- The practical purposes served by mandatory arbitration are without economic justification;

- The practical purposes are at the least substantively unconscionable; and

- There is resulting direct harm to the party against whom mandatory arbitration is imposed.

As we have seen, there is no empirical evidence to conclusively establish any one of these pre-conditions. Mandatory arbitration clauses are appropriately used by commercial players doing business in very competitive commercial market environments. Adequate safeguards in the form of "protocols" are already in place to protect against overreaching and other forms of abuse. In addition, the courts are steadfast in assuring that any term thought to operate in an unconscionable manner will be reviewed and if appropriate, struck as invalid. For the providers included in the targeted group, survival is contingent on how they position themselves relative to those against whom they must compete. All participants in our commercial system have and should continue to enjoy the freedom to accommodate completive forces by promoting terms they believe are reasonable with the understanding that no consumer, franchisee, or employee is under any obligation to do business with them on their terms. In short, the existing commercial system sufficiently addresses the concerns of all who participate. There is no justification for legislative intervention at this time.

Notice that up to now I have interchangeably used "pre-dispute mandatory arbitration" and "arbitration." This is not an accident. The debate about arbitration is always framed in the context of the appropriateness of pre-dispute mandatory arbitration clauses imposed unilaterally either by contract, or in certain cases, disputes governed by the rules of the New York Stock Exchange, NASD, and FINRA. Doing so equates and debases any form of "arbitration" with the feelings of mistrust, apprehension, and helplessness that are associated with the imposition of "mandatory arbitration." This approach creates the impression that their overall concerns about arbitration will be put to rest if pre-dispute clauses are banned. But if this is the case, they need to explain why it is that at the same time they favor "banning" legislation that lumps franchise contracts together with consumer and employment agreements. The alleged justification is that the common denominator is an unequal bargaining power that serves to undermine the requirement of mutual acceptance. That argument may have limited validity when considering consumer contracts and certain classes of employment agreements, but it rings hollow with respect to franchise agreements. Franchise arrangements are usually entered into by relatively sophisticated business people who are typically represented by counsel. Moreover, state laws regulate franchise offerings requiring extensive disclosures and regulatory approval of anyone offering prospectuses or circulars. The states also grant authority to the state attorney general to monitor franchise activities and to seek civil and criminal sanctions when appropriate. Given the current levels of disclosure and regulation, there simply is no inherent issue of unequal bargaining. Therefore, it must be the arbitration process itself that is the real target, and by including franchise agreements, the end game is to chip away at arbitration in any kind of commercial agreement, even those where the unequal bargaining defect doesn't actually exist.

A. The Effect of Legislation Banning Enforcement of Pre-dispute Mandatory Arbitration Clauses

But suppose that Congress does pass legislation banning pre-dispute arbitration clauses in agreements used by the targeted group. What might be the consequences? The most obvious consequence would be the end of arbitration's benefits. It's worth restating those benefits. Arbitration promotes efficiency and speed because it:

- Does away with juries and the potential for high damage awards;
- Provides confidentiality and serves to shield participants from publicity;
- Insures that disputes are resolved using a nationally uniform set of procedures;
- Saves on the cost of appeals;
- Eliminates class action litigation;
- Acts as a deterrent by imposing obligations to pay fees on claimants;
- Reduces the costs of discovery;
- Affords a hands on opportunity to participate in the decision about who will resolve a dispute;
- Insures dispositive decisions using commercial norms;

- Acts as a substitute for insurance against asymmetrically held information; and
- Assures that the consumer of credit, the franchisee, and the employee will have access to a forum for the airing of grievances because it reduces the cost of attorney fees.

Without these benefits, providers will be forced to build into their pricing the increase in costs that will result from the uncertainties associated with traditional litigation. That cost will have to be passed along directly in some form or another to the consumer of credit, the franchisee, and indirectly to the customers of the employer who previously relied on mandatory arbitration.

Cost aside, given the unique risks for each of the agreements in the targeted group, providers are more likely to insist on new devices to contain the harmful effects that the loss of these benefits will have on the manner in which they do business. In the case of a consumer of credit, the likely result will be an overall reduction and restriction in the lending of credit to only those with a proven track record. This would cause a negative impact on the entirety of our commercial system and impairment on growth. In the end, when the implications of banning pre-dispute arbitration in the consumer credit arena are fully realized, it is likely that pressure will be brought to bear on Congress to reintroduce arbitration.

Without mandatory pre-dispute arbitration, the franchisor will be forced to devise new methods to protect the reputation of the franchise and the franchisor from the ill effects of the non-cooperating franchisee. As with consumer credit, the most likely course will be restrictions on the awarding of new franchises to only those with a proven track record and those who are willing and able to fund up front the financial means for development, improvements, and shared universal costs, such as advertising. And it is likely that these restrictions will undermine franchising as a business model, particularly in areas such as restaurant and hotel development and automobile sales. And in the end, as with consumer credit, the reduction in franchise availability will likely create pressure on Congress to engineer to reintroduce arbitration.

For employers, the potential consequences of banning mandatory pre-dispute arbitration will likely be the greatest. Without the ability to use arbitration as a part of an overall human resources strategy designed to remediate, employers are more likely to experience workplace strife and business interruptions. Employees are likely to realize that given the reality of increased employer costs associated with litigation and the risk of excessive jury awards, awards for punitive damages, and/or class action claims, it may not be in their best interest to delay the filing of a claim by accommodating employer preferences for an opportunity to have a human resource specialist try to address employee dissatisfaction. With this in mind, employers are likely to insist, as a condition of employment, on an employee agreeing to waive any potential claim for punitive damages, class action status, and to agree to some form of liquidated damages in the event of a claim for wrongful termination or any form of discrimination.

There will also be consequences for the judicial system. Claims that would otherwise be handled in arbitration will be foisted upon the courts. Although the banning of pre-dispute arbitration is likely to be set at the federal level, the dollars and cents impact will be felt at the state and local level for it will be the task of the state and local courts to absorb the influx of the millions of new cases resulting from the federal mandate. With state and local budgets already insufficient to handle the current caseload, the influx of new cases will likely result in the collapse of the existing system, and with that, a greater disrespect for law than already exists.

B. *Effect of Legislation Regulating the Use of Pre-dispute Mandatory Arbitration Clauses*

If legislation regulating pre-dispute mandatory arbitration is to be considered, what should the goals be? What form would the scheme take? And how would it be implemented? Because the consequences of regulation are hard to anticipate and fully evaluate without the benefit of experience, I urge caution and restraint.

We have seen that pre-dispute mandatory arbitration clauses can appear in a variety of agreements. This suggests that any scheme, presumably designed to regulate without making a distinction for the arena in which the clause appears, is likely to prove difficult to implement to assure fair, just, and consistent results. Indeed, any regulatory format that lacks flexibility might do more harm than good.

Consider the different types of agreements in the targeted group: a mandatory arbitration clause provides different benefits in the unique context of each agreement. For instance, the benefit of confidentiality doesn't have universal application. In matters involving credit, public disclosure of the details of the debt is of little concern and does no harm. However, disclosure of details about a dispute involving human resources can have a chilling and potentially devastating effect. The same can be seen with any rule that would deny the benefit of having disputes resolved using a nationally uniform set of procedures and decisions based on commercial norms. These concerns are unlikely to be significant in a collection matter where debtor defaults are common, but it might be otherwise in disputes involving franchise contracts. The franchise structure assumes the possibility of franchisees located in multiple locations, perhaps even across state lines. Reliance on a uniform standard for the processing and resolution of a claim assures that all franchisees will be treated the same, no matter where located—a benefit that favors both the franchisor and the franchisee. The "jackhammer" approach advocated by some would undermine attempts to treat all parties in a franchise enterprise in an even-handed, fair, and uniform manner.

A regulatory scheme implies a need for some mechanism to control unacceptable behavior. What agency should be responsible for this function? Is there room for regulation at both the federal and state levels of government? Would the scheme replace existing schemes such as FINRA? What impact would such a scheme have on the current trend favoring federal preemption in many matters involving arbitration?[133]

Two differing approaches have been suggested for the regulation of arbitration agreements. The first is a self-executing ban on the enforcement of most pre-dispute mandatory arbitration clauses accompanied by a lengthy list of sanctioned exceptions. The second proposal addresses the applicability of arbitration to disputes involving rights created by specific statutes and that are monitored by a governmental agency.

Paul Carrington proposes a self-executing system that would ban enforcement of any contract provision designed to preclude the application of federal or state laws enacted to protect an employee, "local" franchisee, or consumer.[134] Also unenforceable would be provisions drafted to deny an employee, local franchisee, or consumer access to state courts otherwise available to enforce state or federal laws enacted to protect the affected party. However, an exception would be provided that such a provision would still be enforceable if it allows for:

> (a) Application of an otherwise valid choice of law, forum selection, or arbitration clause to proceedings brought to enforce rights created by the contract in which the clause appears;
>
> (b) Enforcement of an arbitration agreement between an investor and an investment broker pursuant to regulation by a Self-Regulating Organization as authorized by Section 78(s) of Title 15;
>
> (c) Enforcement of an arbitration agreement made with respect to a dispute existing between the parties at the time the agreement is made;
>
> (d) Enforcement of an otherwise valid arbitration agreement if:
>
> (i) The place of arbitration is located in the state;
>
> (ii) The employee, local franchisee, or consumer is required to pay no fees in excess of those required by courts in the state;
>
> (iii) The arbitral tribunal is required by contract to enforce statutory rights; and

133. *See*, *e.g.*, Preston v. Ferrer, 128 S. Ct. 978, 981 (2008) ("We hold today that, when parties agree to arbitrate all questions arising under a contract, state laws lodging primary jurisdiction in another forum, whether judicial or administrative, are superseded by the FAA.").

134. Paul D. Carrington, *Regulating Dispute Resolution Provisions in Adhesion Contracts*, 35 Harv. J. on Legis. 225 (1998). A local franchisee is defined as "a person engaged in retailing goods or services at not more than three locations in a single county or parish of a state who is authorized by contract to use the trade name or trademark of a franchisor engaged in commerce." *Id.* at 231.

(iv) The arbitral award is subject to judicial review by courts in the state to assure that there are no errors of law or clear errors of fact resulting in non-enforcement of state or federal laws enacted to protect employees, franchisees, or consumers.[135]

A second approach, proposed by Amy Schmitz, would provide for agency regulation within the rubric of an enacted federal program.[136] Schmitz proposes such a program in the context of arbitration agreements addressing consumer warranty claims arising out of the Magnuson-Moss Warranty Federal Trade Commission Improvements Act.[137] The Magnuson-Moss Act was passed to enhance notice and disclosure of consumer warranties and to improve consumer access to remedies for breach of warranty claims. The Act grants authority to the Federal Trade Commission to monitor and prescribe "minimum requirements for any informal dispute settlement procedure which is incorporated into the terms of a written warranty" covered by the Act.[138] Schmitz would build on existing FTC rules and regulations to include new rules to insure that arbitration clauses appropriately provide for:

- Notice;
- Neutrality;
- Reasonable costs;
- Adequate discovery and the presentation of claims;
- Fair use of telephonic or online dispute resolution with retained right to in-person hearings at reasonable locations;
- Preservation of remedies;
- Class relief, consolidation, or joinder;
- Timely decisions and compliance with awards;
- Public disclosure of awards; and
- Access to small claims court.

The Carrington approach suffers from inflexibility. Once a list of sanctioned exceptions is written into a statute for political reasons, it becomes very difficult, if not impossible, to amend the list to include new items or to remove old ones. This, in

135. *Id*. at 232.

136. *See* Amy J. Schmitz, *Curing Consumer Warranty Woes Through Regulated Arbitration,* 23 Ohio St. J. on Disp. Resol. 627 (2008), *available at* www.ssrn.com/abstract=1270827.

137. *Id.;* 15 U.S.C. §§ 2301–12 (2006).

138. 15 U.S.C. § 2310(a)(2) (2006).

turn, is an invitation for litigation trying to discern congressional intentions concerning the specific inclusion or exclusion of any items not included on the list. The Schmitz approach makes better sense because it is possible to create regulations that contain flexibility, and there would be fewer obstacles to overcome to implement changes or modifications.

Still open is the following question: Is this the time for Congress to reform arbitration? Let's revisit and evaluate the four pre-conditions I argue need *supra* to be met before Congress adopts any legislation that would amend the FAA and change the face of arbitration as we know it.

Given the depth of the empirical studies to date, I maintain that none of the four pre-conditions have been met and that there is no need for reform:

- Mandatory arbitration clearly serves a number of practical purposes. For example, as discussed in Part II supra, arbitration plays a significant role in the containment of the pernicious effects of asymmetrically-held information;

- Mandatory arbitration has a practical economic justification, i.e. it levels the playing field where one party engaged in a commercial relationship unexpectedly turns predatory;

- There is nothing per se unconscionable (or unreasonable for that matter) about a commercial player's insistence that there is one or more specific practical reasons for reliance on mandatory arbitration as a technique for dispute resolution;

- If mandatory arbitration is justified by the practical realities of the market place and not per se unconscionable (or unreasonable for that matter). There is no direct harm to any party upon whom it is imposed because:

    - Arbitration is a recognized technique sanctioned by Congress and the courts;[139]

    - All parties to an arbitration proceeding are protected by the vacatur provisions of the FAA;[140]

    - The major providers of arbitration services have adopted protocols designed to insure procedural fairness and due process in disputes that these providers administer.

139. *See* Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp., 460 U.S. 1, 24–25 (1983); cases cited *supra* note 6.

140. 9 U.S.C. §§ 10–11 (2006).

Given the realities of the existing system, it would thus appear that there is no need at this time for the system of arbitration as we know it to be reformed—a conclusion that is consistent with the empirical evidence reported to date.

V. CONCLUSION

Arbitration as we know it has become an accepted feature of commerce. While not a complete, and by no means perfect system, it serves many practical and useful purposes. The flaws complained of by those in opposition are a function of attempts at application in environments for which arbitration wasn't designed. For example, arbitration was originally seen as a tool for the resolution of only factual issues. Today it is used in disputes involving issues of fact and law, and yet the commercial rules of the AAA allow an arbitrator to "grant any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties."[141] In other words, while the uses have evolved over time, the rules of the process have in many instances remained static. This suggests that it may well be time to revisit federal and state enabling statutes with a view toward determining whether regulating the most offensive aspects of arbitration is in order. But an outright ban on the use of mandatory pre-dispute arbitration clauses, or arbitration in general, is unquestionably inappropriate. Even regulation may not be justified absent clear and convincing empirical proof that arbitration as we know it today is "unfair" as an alternate dispute mechanism. In the final analysis, it may well turn out that arbitration in all forms is justified and acceptable if for no other reason than the alternative—costly and unpredictable litigation—is far worse.

141. Commercial Arbitration R. & Mediation P. 43(a); *See also* CPR R. For Non-Administered Arbitration 10.3 ("The Tribunal shall apply the substantive law(s) or rules of law designated by the parties as applicable to the dispute. Failing such a designation by the parties, the Tribunal shall apply such law(s) or rules of law at it determines to be appropriate."); JAMS Comprehensive Arbitration R. & P. 24(c); NAF Code of P. 20(D).