S. HRG. 106–1066

OVERVIEW OF CONTRACTUAL MANDATORY BINDING ARBITRATION

HEARING

BEFORE THE

SUBCOMMITTEE ON ADMINISTRATIVE OVERSIGHT AND THE COURTS

OF THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

ONE HUNDRED SIXTH CONGRESS

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OVERVIEW OF CONTRACTUAL MANDATORY BINDING ARBITRATION

WEDNESDAY, MARCH 1, 2000

U.S. SENATE,
SUBCOMMITTEE ON ADMINISTRATIVE OVERSIGHT
AND THE COURTS,
COMMITTEE ON THE JUDICIARY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:57 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Charles E. Grassley, (chairman of the subcommittee) presiding.

Also present: Senators Sessions and Feingold.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. I am going to start early, and let me explain why. Before my colleagues get here, I will take care of some administrative stuff.

First of all, there will be three votes on the floor starting at 2 p.m., and you know how votes are. They ought to only take a half-hour, but they end up taking longer than that. So I expect that we are going to be bothered by votes between now and 3 p.m. But because we have had such a hard time working this hearing into the hearing schedule of the Judiciary Committee and I promised so many people I was going to have this meeting, we are going to try to conduct the meeting this way while the votes are going on. I will have colleagues coming, I think, who have consented to chair the hearing while I vote, and then I will run over and vote and come back. And then they will go vote, and that we expect to hopefully get through this without any interruption.

We will probably only have one round of questioning per member per panel, and it also would help us then—each of you probably have already been informed of the 5-minute limit on testimony—if you make sure that you stay within that limit, and if you haven't done that, maybe you can take some action between now and your turn to testify to do that to that extent.

Then for my members who may be here and not be able to ask all the questions they want to ask or for people who are on the subcommittee who can't come at all, we are going to keep the record open until close of business Friday for questions that we want to ask of either panel on any of the bills that are before the subcommittee to have those answers submitted to the panelists for answer in writing.

So, with those less than very ideal conditions, we hope to, between now and when the last word is said, get this meeting done in as orderly of a fashion as we can.

If per chance we would have to adjourn, I would hope that nobody will go very far. I shouldn't say adjourn, just recess until somebody gets back, that none of the panels will go very far so we don't lose any time.

I am going to start out by—everything that has been said until now, for all those that just got in here, was strictly administrative, but we are going to try to keep this meeting going while we have these votes starting at 2 o'clock.

I welcome all of you and, of course, say good afternoon and hope that when we are done we can still say it was a good afternoon. We are having an overview of mandatory binding arbitration. That includes S. 1020, the Motor Vehicle Franchise Contract Arbitration Fairness Act of 2000, and it also includes S. 121, a bill that has been introduced by Senator Feingold of Wisconsin.

Some of you probably know that over the years I have been kind of in the forefront of promoting alternative dispute resolution, various mechanisms to encourage alternatives to litigation when disputes arise. Such legislation that I have gotten passed, I suppose, in the last decade and a half have included permanent use of ADR by Federal agencies and court-annexed arbitration. These statutes are based on the premise that arbitration should be voluntary rather than mandatory. Legislation before us today in this hearing does not limit the use of arbitration. S. 1020 only stipulates that the utilization of binding arbitration be based upon voluntary agreement of both parties.

The intent of S. 1020 is to prevent automobile manufacturers from forcing an automobile dealer to accept mandatory arbitration as the sole remedy for settling all disputes between a dealer and the manufacturer by including a provision in the franchise contract, with little or no negotiation.

In an effort to balance what appears to be a disparity in bargaining power between automobile dealers and manufacturers, many States have enacted statutes. A number of these statutes prohibit a manufacturer from terminating a dealer without just cause and protecting the rights of spouses and children to continue ownership after a dealer's death. They also prevent a manufacturer from using its controls to coerce or intimidate a dealer.

However, the courts have often invalidated these State laws, stating that they are preempted by the Federal Arbitration Act, which declares arbitration agreements are valid, irrevocable, enforceable, and provide procedures for the enforcement of such agreements in the Federal courts.

In 1925, when the Federal Arbitration Act was enacted to make arbitration agreements enforceable in the Federal courts, it did not expressly provide for the preemption of State law, nor is there any legislative history to indicate that Congress intended the act to occupy the entire field of arbitration.

Congress certainly never intended that the Arbitration Act be a tool that the stronger party use to contract and have the effect of forcing the weaker party into binding arbitration. With mandatory binding arbitration agreements becoming prevalent in various contract agreements, now is the time to address the preemption issue, and in doing so, we need to do what we can in the process of protecting States' rights.

Parenthetically, I am kind of an advocate, and I don't know whether a sweeping advocate or not, but I think that Congress ought to be more intent with every statute we pass the extent to which we want preemption or not have preemption and not leave it to the courts to make that determination. That would be true of any committee of the Congress. I would like to see that be the case—not meaning that preemption wouldn't be used as much as it has already been used, but, specifically state that is congressional intent or not congressional intent, and not let the courts assume or be in a quandary about it.

Now, in addition to the auto industry, there are a number of other areas in which there is an increased trend of the stronger party to contract forcing the weaker to accept mandatory binding arbitration as the sole means of addressing his or her grievances. That is where my colleague, Senator Feingold, comes in, and he has introduced S. 121, the Civil Rights Procedure Protection Act, which begins a discussion in these areas.

It is my understanding that Senator Feingold's legislation seeks to amend certain civil rights statutes to prevent the involuntary application of arbitration to claims that arise from unlawful employment discrimination and sexual harassment.

In addition, as we have seen in the Washington Post today, the relatively new problems arising out of forced consumer credit arbitration happen to be issues that need to be addressed to make sure that consumers are protected.

The Motor Vehicle Franchise Contract Arbitration Fairness Act of 2000 begins the process of addressing these kinds of issues. I thank the witnesses for their participation, and I look forward to their testimony.

I am now going to introduce the panel, and I would like to have all of the first panel come while I am going through the process of introduction.

First of all, we welcome you. We have five witnesses, and this is to discuss S. 1020.

Our first witness, Richard Holcomb, is commissioner of the Department of Motor Vehicles for the Commonwealth of Virginia. In this capacity, he oversees the State of Virginia motor vehicle franchise arbitration process.

Next we have Gene Fondren, president of the Texas Automobile Dealers Association, and I happen to know you and welcome you back.

Mr. FONDREN. Thanks, Senator.

Senator GRASSLEY. Our next witness, William Shack, is an automobile dealer from Henderson, NV, and if that is too short of an introduction, I will let you fill in details, which is perfectly appropriate because we need to know all about you that we can.

Our next witness is Jill Lajdziak. Ms. Lajdziak is president of Saturn Distribution Corporation and vice president of sales, service and marketing for Saturn Corporation.

And rounding out our panel is Jill MacDonald. Ms. MacDonald is currently a consultant to the Alliance of Automobile Manufacturers on franchise and related legislation.

I am going to start with Mr. Holcomb. Now, here is the way it might work. I assume that by 2:20 p.m. somebody on the panel will be over here to take over while I go vote. But if they don't, then I am going to have to shut down about 2:18 p.m. because it takes me about 2½ minutes to get over there.

Mr. Holcomb, would you please start out?

A PANEL CONSISTING OF RICHARD D. HOLCOMB, COMMISSIONER, DEPARTMENT OF MOTOR VEHICLES, COMMONWEALTH OF VIRGINIA, RICHMOND, VA; GENE FONDREN, PRESIDENT, TEXAS AUTOMOBILE DEALERS ASSOCIATION, AUSTIN, TX, ON BEHALF OF AUTOMOTIVE TRADE ASSOCIATION EXECUTIVES; WILLIAM SHACK, AUTOMOBILE DEALER, HENDERSON, NV; JILL LAJDZIAK, PRESIDENT, SATURN DISTRIBUTION CORPORATION, AND VICE PRESIDENT, SALES, SERVICE AND MARKETING, SATURN CORPORATION, TROY, MI; AND JILL N. MacDONALD, ALLIANCE OF AUTOMOBILE MANUFACTURERS, WASHINGTON, DC

STATEMENT OF RICHARD D. HOLCOMB

Mr. HOLCOMB. Thank you, Mr. Chairman. I appreciate the opportunity to appear today in support of Senate bill 1020.

This is a bit of a homecoming for me because from October of 1983 to January of 1987, I served as general counsel to Senator Jeremiah Denton's Subcommittee on Security and Terrorism. I think studying the issues of security and terrorism have probably qualified me to deal with relationships between dealers and manufacturers. [Laughter.]

Senator GRASSLEY. Let me note that not everybody is laughing.

Mr. HOLCOMB. I am sure you noted that for the record. Thank you, Mr. Chairman.

Mr. Chairman, one of the inherent rights of the Commonwealth of Virginia is to protect its citizens. In that vein, we developed a dispute resolution process which we codified into our statute which levels the playing field for dealers and manufacturers. That procedure, that State procedure, has been challenged, was challenged in the late 1980s by Saturn. And what happened was a franchise agreement was filed which required the dealers only to go through binding arbitration if there was a dispute.

My predecessor refused to approve that because our statute allows for the freedom of choice for the dealers. But my predecessor did say that they would approve that franchise agreement if Saturn would agree to give the dealers an option to either go to binding arbitration or the State system. Saturn refused, filed a lawsuit. While we prevailed at the district level, we lost on the Fourth Circuit by a vote of 2–1 with a very strong dissent.

Mr. Chairman, I am not opposed to arbitration. I, like Judge Wilder, who wrote the dissent in the opinion, as the sponsor and cosponsor of this legislation, I just believe the dealer should have freedom of choice.

Just very briefly, to compare arbitration to the Virginia system, let me say the following: Under the Virginia system, at my request, the executive secretary of the Virginia Supreme Court appoints an active attorney to chair the hearing. That attorney is bound by the rules of discovery and collects evidence using those rules of discover. That is not the case with an arbiter.

Also, that hearing officer is bound by the laws of evidence. That is not the case when it comes to an arbiter.

Also, that hearing officer must render a written decision which is based on suggested findings of facts and conclusions of law by the parties. I then review that decision and decide either to accept it, to modify it, or to remand it back to the hearing officer for additional evidence.

I should also state that that decision becomes precedent. I should also say that that decision has to be based on precedent previously determined.

As an aside, I will say that since we started publishing a synopsis of the decision, I think we are seeing less disputes even being brought to my attention because once the manufacturers and the dealers know the rulings that we have had, I think that has an impact on future litigation.

Finally, those decisions by a hearing officer which I incorporate are subject to judicial review. An aggrieved party has an absolute right of appeal into the Virginia circuit court. So those are just a comparison.

Certainly the article in the Washington Post this morning said one of the benefits of arbitration is it would unclog the courts. But let me give you just a snapshot of Virginia.

Over the last 4 years, I have had 46 requests for hearings. Out of those 46, 35 have gone away; that is, once the dealer exercised their right to a hearing, all of a sudden the manufacturer came to the table, bargaining in good faith, and resolved those issues to everyone's satisfactions.

Out of the remaining 11, I did grant a hearing in eight but refused a hearing in three because they just did not quality. Out of that eight, three were appealed into the circuit court. One appeal was withdrawn prior to the time the circuit court sat. Only two took up time of the circuit court. Both of those decisions affirmed the decisions that we had made. So out of 46 decisions, only two clogged up the courts.

Mr. Chairman, in conclusion, I am not here talking as a lawyer. I am not here talking about congressional intent. That is up for the committee to determine what was meant by the FAA. All I am asking you is to give the citizens of Virginia the freedom of choice which our general assembly enacted.

I am more than happy to answer any questions of the Chair.

[The prepared statement of Mr. Holcomb follows:]

PREPARED STATEMENT OF RICHARD D. HOLCOMB

EXECUTIVE SUMMARY

Currently, automobile and truck dealers have no choice but to accept mandatory binding arbitration provisions in franchise agreements provided by motor vehicle manufacturers. These "take it or leave it" contracts leave dealers with no alternative methods to resolve disputes. This practice clearly violates the dealers' fundamental due process rights and runs counter to basic principles of fairness.

Senate Bill 1020 proposes to make arbitration of dealer-manufacturer disputes totally voluntary. The proposed legislation does not prohibit arbitration; rather, it seeks to offer arbitration as one of several avenues to problem resolution.

The majority of states have created their own alternative disputes resolution mechanisms with access to auto industry expertise that provide inexpensive, efficient and non-judicial resolution of disputes. For example, Virginia Code, §46.2–1573 (a copy of which is attached) establishes a standard hearing process and designates specific time frames for each step in the process.

Clearly, the Virginia system quickly and efficiently resolves manufacturer/dealer disputes while preserving all the remedies to which dealers, and any small business owner, should have recourse. In short, this bill will ensure that the decision to arbitrate is truly voluntary and that the rights and remedies provided for by our judicial and administrative system re not waived under coercion.

The Motor Vehicle Franchise Contract Arbitration Fairness Act of 2000 would allow each party to an auto or truck franchise contract to choose the method of dispute resolution. This bill does not prohibit arbitration. On the contrary, the bill makes it one of several fair choices that both parties may willingly and knowingly select. In conclusion, this bill will ensure that the decision to arbitrate is truly voluntary and that both parties have equal bargaining power concerning the method of dispute resolution.

INTRODUCTION

I personally wish to thank the Subcommittee on Administrative Oversight and the Courts for giving me the opportunity to testify on S.B. 1020. Since March 1994, I have served as the Commissioner of the Virginia Department of Motor Vehicles. DMV administers the dispute process between motor vehicle dealers and manufacturers, as well as franchise laws. In 1995, the Motor Vehicle Dealer Board, which I serve on as chairman, was created to license automobile and truck dealers in Virginia. Today, I wish to speak in favor of S.B. 1020. The bill will allow the creation of a level playing field for both motor vehicle dealers and manufacturers to choose mutually acceptable forms of dispute resolution.

PROBLEM

Motor vehicle manufacturers are forcing small business auto and truck dealers into mandatory binding arbitration clauses by including the clauses in non-negotiated dealer agreements. Legitimate state protections, however, are unavailable for dealers with arbitration contracts because of overly broad federal policy favoring arbitration. In a landmark case, *Southland Corporation* v. *Keating*, 107 S.Ct. 852 (1884), the U.S. Supreme Court held that state laws that prohibit mandatory binding arbitration in adhesion contracts or prohibit waiver of judicial or administrative remedies as a contract are preempted. Unfortunately, preemption prevents states from enforcing protective laws that limit or regulate unfair arbitration practices in contacts, despite the fact that enforceability of private contracts is ordinarily a question of state law. These arbitration clauses substantially deteriorate dealers' rights and remedies as provided under protective state franchise laws.

PROPOSED REMEDY

Senate Bill 1020 proposes to make arbitration of dealer-manufacturer disputes totally voluntary. This proposed legislation does not prohibit arbitration but does seek to offer arbitration as one of several possible avenues to problem resolution. It ensures that arbitration is used only when both parties to a sales and service contract voluntarily agree, thereby preventing manufacturers from forcing dealers to prospectively waive protective state rights, remedies and procedures otherwise available. In cases where the two parties voluntarily elect arbitration to settle a dispute, the proposed legislation provides for written explanation of the factual and legal basis for the award.

BACKGROUND

Under current law, dealers have no choice but to accept a mandatory binding arbitration provision in a franchise agreement. Automobile and truck manufacturers present dealers with traditional adhesion contracts. Since dealers cannot delete the mandatory binding arbitration provision, the manufacturer is coercing the dealer into binding arbitration as the only method of resolving disputes.

This practice forces dealers to submit their disputes with manufacturers to arbitration. As a result, dealers are forced to waive access to judicial or administrative forums, substantive contract rights and statutorily provided protection. This practice clearly violates the dealers' fundamental due process rights and runs counter to basic principles of fairness.

Arbitration lacks several of the important safeguards and due process offered by administrative procedures and the judicial system. Arbitration lacks the formal court-supervised discovery process often necessary to learn facts and gain documents. An arbitrator does not need to follow the rules of evidence. Arbitrators generally have no obligation to provide factual or legal discussion of the decision in a written opinion. And, arbitration often does not allow for judicial review. Thus, a dealer seeking to overturn an arbitration decision may be unable to appeal the decision. Further, an arbitrator's misinterpretation or misapplication of the law is not subject to court review.

Dealers have clear and enforceable rights under state franchise laws that protect small business dealers from a host of documented manufacturer abuses. Generally, however, arbitrators are not bound by state law in their decisions. As a result, arbitration allows manufacturers to circumvent state laws and the protections they provide to dealers.

ALTERNATIVE DISPUTE RESOLUTION MECHANISMS USED BY STATES

The majority of states have created their own alternative dispute resolution mechanisms with access to auto industry expertise that provide inexpensive, efficient and non-judicial resolution of disputes. For example, Virginia Code, § 46.2–1573 (a copy of which is attached) establishes a standard hearing process and designates specific time frames for each step in the process.

1. Upon receipt of the request for a hearing, DMV contacts the executive secretary of the Virginia Supreme Court for the appointment of a hearing officer. The hearing process commences within 90 days of the dealer request. Certain types of hearings require the appointment of a three-member dealer board panel by the DMV Commissioner. The hearing officer may hold a pre-hearing conference to establish procedural dates, notify foreign attorneys of participation, prepare exhibits and identify witnesses, identify issues and stipulations, determine the order of presentation, make requests for admissions, depositions and subpoenas.
2. The hearing officer must provide recommendations to the DMV Commissioner within 90 days of the conclusion of the hearing.
3. The DMV Commissioner must render a decision within 60 days from receipt of the hearing officer's recommendation. Under these statutory provisions, a hearing should be completed within 240 days or eight months.
4. Additionally, the Commissioner's decision may be appealed to an appropriate Virginia Circuit Court within 33 days of the decision date.

Unlike arbitration, the hearing process provides written documentation of the findings and decision. This documentation establishes precedents for subsequent cases. Further, the Virginia Motor Vehicle Dealer Board publishes the results of hearings in a newsletter to Virginia's motor vehicle dealers.

EFFICACY OF THE VIRGINIA HEARING SYSTEM

The efficacy of Virginia's hearing system for equitably resolving disputes between manufacturers and dealers can be demonstrated through a review of the state's caseload between 1996 and 2000.

During that period, the Department of Motor Vehicles (DMV) received 46 requests for hearings. However, 35 of those requests were resolved prior to a hearing. That is, the requests for a hearing were withdrawn because both sides, working together, were able to negotiate a mutually acceptable solution. In other words, when manufacturers realized that they were facing an objective, standardized hearing process, they decided to take the dealer's issue seriously and to negotiate a mutually acceptable agreement.

Of the remaining requests, the Commissioner rendered a decision eight times and three requests were denied. Since 1996, the Commissioner's decision has been appealed five times. Of those, one was withdrawn by the manufacturer, two were won by DMV and two appeals are pending. Currently, seven hearing requests are in process.

Clearly, the Virginia system quickly and efficiently resolves manufacturer/dealer disputes while preserving all the remedies to which dealers, and any small business owner, should have recourse.

VIRGINIA BACKGROUND

All states except Alaska have enacted substantive law to balance the enormous bargaining power enjoyed by manufacturers over dealers and to safeguard small business dealers from unfair automobile and truck manufacturer practices. Many states, recognizing that mandatory binding arbitration provisions in contracts nullify their state statutes and procedures, have enacted laws to prohibit inclusion of mandatory binding clauses in certain agreements. As previously noted, the courts have held that these state laws are preempted by the *Federal Arbitration Act (FAA).* Courts have interpreted preemption in the FAA provisions that declare arbitration agreements "valid, irrevocable and enforceable."

Virginia has first-hand experience with the preemption issue. In 1989, Saturn Corporation, a General Motors subsidiary, challenged a Virginia law prohibiting mandatory binding arbitration. Saturn filed suit against the State of Virginia when Virginia refused to approve Saturn's franchise agreement. The Saturn agreement was rejected because it mandated binding arbitration and denied dealers access to the procedures, forums and remedies provided in state law.

The federal district court ruled in favor of the State of Virginia, *Saturn Distribution Corp.* v. *Williams,* 717 F. Supp. 1147 (E.D. VA. 1989). However, the Fourth Circuit reversed the district court, holding that the Virginia dealer law prohibiting mandatory binding arbitration conflicts with the FAA and is preempted by the Supremacy Clause of the U.S. Constitution, *Saturn Distribution Corp.* v. *Williams,* 905 F.2d 719 (4th Cir. 1990). The Appellate Court relied on two Supreme Court decisions, *Southland Corporation* v. *Keating,* 104 S.CT. 852 (1984) and *Perry* v. *Thomas,* 107 S.CT. 2520 (1987).

When Congress enacted the FAA in 1925, the narrow intent of Congress was to make arbitration awards enforceable in federal courts. The purpose of the Act was to overrule the long-standing hostility to arbitration and the failure of courts to enforce arbitration decisions in arms-length transactions.

Legal commentators have argued that congress never intended the FAA to apply arbitration agreements that would allow a stronger party to a contract to force a weaker party to relinquish rights to a judicial forum and other dispute resolution forums as a condition of entering into a contract.

The FAA does not expressly provide for preemption of state law, nor is there an explicit Congressional intent to occupy the entire field of arbitration. However, in recent years, the Supreme Court has clearly interpreted the FAA to preempt state law (refer to *Southland*). This decision has had the effect of preempting state laws that protect the weaker party from being forced to accept arbitration.

The *Saturn* decision further supported the Supreme Court's interpretation and also frustrates Congressional intent as expressed by the Dealer's Day in Court Act, 15 U.S.C. §§ 1221–1225. Through this legislation, Congress granted automobile dealers access to the federal courts to seek relief against manufacturers. Recognizing the disparity in bargaining power between manufacturers and dealers, Congress sought to level the playing field by providing protection for dealers.

CONCLUSION

The Motor Vehicle Franchise Contract Arbitration Fairness Act of 2000 provides that each party to an auto or truck franchise contract will have the choice to select arbitration. This bill does not prohibit arbitration. On the contrary, the bill encourages arbitration by making it a fair choice that both parties to a franchise contract may willingly and knowingly select. In short, this bill will ensure that the decision to arbitrate is truly voluntary and that the rights and remedies provided for by our judicial and administrative system are not waived under coercion.

ACTION ITEM

I would therefore urge this subcommittee to favorably report S.B. 1020 to the Judiciary Committee for consideration. Again, thank you for the opportunity to testify today. I will be glad to answer any of your questions.

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§ 46.2–1573—HEARINGS AND OTHER REMEDIES

A. In every case of a hearing before the Commissioner authorized under this article, the Commissioner shall give reasonable notice of each hearing to all interested parties, and the Commissioner's decision shall be binding on the parties, subject to the rights of judicial review and appeal as provided in Chapter 1.1:1 (§ 9–6.14:1 et seq.) of Title 9.

B. Hearings before the Commissioner under this article shall commence within ninety days of the request for a hearing and the Commissioner's decision shall be rendered within sixty days from the receipt of the hearing officer's recommendation. Hearings authorized under this article shall be presided over by a hearing officer selected from a list prepared by the Executive Secretary of the Supreme Court of

Virginia. On request of the Commissioner, the Executive Secretary will name a hearing officer from the list, selected on a rotation system administered by the Executive Secretary. The hearing officer shall provide recommendations to the Commissioner within ninety days of the conclusion of the hearing.

C. Notwithstanding any contrary provision of this article, the Commissioner shall initiate investigations, conduct hearings, and determine the rights of parties under this article whenever he is provided information by the Motor Vehicle Dealer Board or any other person indicating a possible violation of any provision of this article.

D. For purposes of any matter brought to the Commissioner under subdivisions 3, 4, 5, 6 and 7b of § 46.2–1569 with respect to which the Commissioner is to determine whether there is good cause for a proposed action or whether it would be unreasonable under the circumstances, the Commissioner shall consider:

1. The Volume of the affected dealer's business in the relevant market area;
2. The nature and extent of the dealer's investment in its business;
3. The adequacy of the dealer's service facilities, equipment, parts, supplies, and personnel;
4. The effect of the proposed action on the community;
5. The extent and quality of the dealer's service under motor vehicle warranties;
6. The dealer's performance under the terms of its franchise;
7. Other economic and geographical factors reasonably associated with the proposed action; and
8. The recommendations, if any, from a three-member panel composed of members of the Board who are franchised dealers not of the same line-make involved in the hearing and who are appointed to the panel by the Commissioner.

With respect to subdivision 6 of this subsection, any performance standard or program for measuring dealership performance that may have a material effect on a dealer, and the application of any such standard or program by a manufacturer or distributor, shall be fair, reasonable, and equitable and, if based upon a survey, shall be based upon a statistically valid sample. Upon the request of any dealer, a manufacturer or distributor shall disclose in writing to the dealer a description of how a performance standard or program is designed and all relevant information used in the application of the performance standard or program to that dealer.

Senator GRASSLEY. We are going to wait until we hear from all five panelists before we have questions.

Mr. Fondren, please.

STATEMENT OF GENE FONDREN

Mr. FONDREN. Thank you, Mr. Chairman. I am delighted to be here today. I am the president of the Texas Automobile Dealers Association representing approximately 1,400 franchised new car and truck dealers, and I also speak on behalf of colleagues in the Automotive Trade Association Executives group who represent Metro and State associations throughout the entire United States. There are about 110 of us all told. We are here in support today of S. 1020 and are very proud and very pleased to do so.

Briefly, the Congress passed the Federal Arbitration Act in 1925, and in evaluating the history and the hearing record on the Federal Arbitration Act, it appears to me that the sole purpose of the passage of the Act at that time was to ensure that the courts were willing to enforce, that the courts would enforce arbitration in cases where the parties included it in arm's-length contracts, arm's-length transactions, and that it was not to apply to contracts of adhesion, which are the type of contracts that motor vehicle manufacturers impose on automobile dealers.

As a matter of fact, in response to questions by Senator Walsh, supporters of the FAA in 1925 assured the Congress that the bill was not intended to cover take-it-or-leave-it contracts. However, over the years, the courts have greatly, in my opinion, at least, expanded the original intent of the Federal Arbitration Act. And, finally, in the *Southland* case and again in the *Mitsubishi* case, the

Supreme Court of the United States held that the Act created substantive rules that were applicable to State as well as Federal courts and that Congress intended to foreclose State legislation, attempting to undercut arbitration. So the courts have reached the outer limits of the scope and the effect of the Federal Arbitration Act.

If I might spend a moment or two about the history of the dealer-manufacturer relationship, which is the subject of S. 1020. Professor Stewart Macauley stated in 1966, "Franchised automobile dealers have been trying to get help from the legal system to give them enforceable rights," because the franchise crafted by the manufacturers was to minimize dealers' rights. The manufacturer-dealer contract is indeed a contract of adhesion. It is not a negotiated contract.

The Congress recognized this first back in 1956 when it passed the Dealer Day in Court Act, and then subsequent to the Dealer Day in Court Act, which was well intended but turned out to be insufficient to grant the kind of rights that dealers needed in order to have a level playing field, legislatures in 49 of our States have adopted substantial codes and substantial laws to govern and regulate the manufacturer-dealer relationship.

Those laws granted by 49 States have been upheld in the United States Supreme Court in the seminal case of *New Motor Vehicle Board of California* v. *Orrin W. Fox.* This was in 1978, 22 years ago.

The Court, in upholding the California Franchise Act, which is quite similar to laws in Virginia and laws in the State of Texas, quoted the 1956 congressional committee findings on disparity of bargaining power between manufacturers and dealers, and this is what that congressional report says: "This vast disparity in economic power and bargaining strength has enabled the factory to determine * * * the rules by which the parties conduct their business affairs * * * When the dealer has invested, he becomes the economic captive of [the] manufacturer." From the standpoint of the manufacturer, any single dealer is expendable. True in 1956, true in 1978, true today.

That is why Texas and Wisconsin and Iowa and New Jersey and Pennsylvania and Utah and many other States have enacted substantial bodies of law and administrative dispute resolution procedures to regulate the dealer, manufacturer, and consumer law.

There is an issue that has been raised in the testimony filed with your committee, Mr. Chairman, as to the number of bodies buried or to be buried by mandatory binding arbitration. Opponents suggest that 1,891 dealers are covered by mandatory binding arbitration and that, of those, 1,572 are either under optional agreements, as is the case with some Chrysler dealers, or under voluntary negotiated agreements which they claim is the case in the Saturn arbitration provision.

I would respectfully suggest to the committee, Mr. Chairman, based on the best evidence that is available to us—and, obviously, we do not have in hand the dealer-manufacturer agreements. But based on the best evidence available to us, it appears to me that the number, the true number of dealers today under some form of mandatory binding arbitration and manufacturer agreements is between 5,700 and 5,800, a long way from 1,871. There are side agreements, there are ancillary agreements, there are credit-armed agreements, and there are franchise agreements that include mandatory binding arbitration.

Senator GRASSLEY. Mr. Fondren, I am going to go vote now. There are only 2 minutes left. So will you wait until either I come back or Mr. Feingold comes before we start with the rest of the panel?

Mr. FONDREN. I would be pleased to wait, Mr. Chairman.

[Recess 2:18 p.m. to 2:21 p.m.]

Senator FEINGOLD [presiding]. Let me continue the hearing. Chairman Grassley has asked that at this point I give my statement that I wanted to give at the beginning, and when he gets back, he will continue. I believe Mr. Fondren was testifying, and we will go on from there. I, of course, apologize for the votes that we have at this point.

Mr. FONDREN. Thanks, Senator.

STATEMENT OF HON. RUSSELL D. FEINGOLD, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator FEINGOLD. But that is one of the things we do here.

Let me give my statement about these issues because I am delighted that we are having these hearings. I want to thank the chairman for holding the hearings. I want to commend him for his commitment to working in a bipartisan way to address the issues raised by the growing prevalence of pre-dispute contractual agreements to substitute mandatory binding arbitration for the right to take a claim to court.

As you know, these mandatory binding arbitration provisions have shown up in many contractual settings, including auto dealership franchise contracts, credit card and other consumer loan agreements, and employment agreements. And I am honored to work with the chairman on S. 1020, the Motor Vehicle Franchise Contract Arbitration Fairness Act, and I want to especially thank the chairman for agreeing to expand this hearing to address the broad problem of contractual mandatory arbitration in other areas where these provisions are becoming more and more common.

One of the most important pillars of our justice system is the right to take a dispute to court. Indeed, all Americans have the constitutional right in both criminal and civil cases to a trial by jury. The right to a jury trial in criminal cases is contained in the Sixth Amendment to the Constitution. The right to a jury trial in civil cases is contained in the Seventh Amendment.

Of course, constitutional rights can be waived, and crowded court dockets and the expense of litigation lead many litigants in civil cases to, appropriately, seek alternative ways to resolve their disputes. And I do believe we should encourage arbitration and mediation in cases where they can be helpful.

At the same time we need to remember the constitutional foundation of our civil justice system, and we need to remember the important statutory and even constitutional rights and policies that the courts are sometimes best suited to enforce.

I believe that arbitration can be a credible and legitimate means of dispute resolution only when all parties know and understand the full ramifications of agreeing to arbitration and waive their right to go to court voluntarily. That is why mandatory binding arbitration contracts are so troubling to me in a whole variety of contexts. Parties with little bargaining power are being forced, in effect, to waive their right to go to court. That is not right. When people are essentially forced to give up their constitutional rights in order to have a job, conduct a business, or take out a loan, that is not right and we have to do something about it.

So far, I have had a chance to pursue this issue in three separate areas where I think there is a demonstrated need for Federal legislation.

First, I have joined with the chairman, as I indicated, to introduce the Motor Vehicle Franchise Contract Arbitration Fairness Act of 1999. This bill will ensure that auto dealers are not forced into arbitration to resolve their disputes with auto manufacturers. Our bill enjoys wide bipartisan support, including that of the Chair and the ranking member of the full committee, Senators Hatch and Leahy.

I am looking forward to hearing from the first panel today about this bill, and I hope we can move it through the full committee promptly.

Also, similarly to the auto dealer franchise contract situation, there is a growing and menacing trend of credit card companies and consumer credit lenders slamming the courthouse doors shut on consumers. Companies like First USA Bank, the largest issuer of Visa cards with 58 million customers, American Express, and Greentree Discount Company insert mandatory binding arbitration clauses in their agreements with consumers often without the consumer's knowledge or consent.

The most common way credit card companies have made these contractual changes is through the use of bill stuffers. Bill stuffers are the advertisements and other materials that the credit card companies include with the customer's monthly billing statements. The bill stuffers say that if the consumer continues to use the card, it is bound by those contractual provisions. And the effect of these provisions, which are often set out in complex legal language and fine print, is that the card holder cannot take a dispute with the credit card company to court, not even to small claims court. The card holder must use arbitration, and the arbitration decision is final. In the case of American Express and First USA, the arbitration is conducted by an organization selected by the company, the National Arbitration Forum.

And, Mr. Chairman, the problem extends beyond creditors. It is also a growing practice in the consumer loan industry. Consumer credit lenders like Greentree Discount Company are including mandatory binding arbitration clauses in their loan agreements. Obviously, consumers seeking a loan for such a company are not in a position to bargain to have the clause removed. Some consumer borrowers may not fully understand exactly what mandatory binding arbitration is, and they certainly are not represented by counsel.

So yesterday I introduced a bill, the Consumer Credit Fair Dispute Resolution Act, to prohibit mandatory arbitration provisions in consumer credit agreements. This bill is identical to the bill I offered but did not seek a vote on during our consideration on the floor of the Senate of the bankruptcy bill. And I am pleased to have Senator Leahy, the ranking member of the full committee, as a cosponsor of the bill, and I hope that other members from both sides of the aisle will join us.

Finally, for many years—in fact, this is the issue of this group that I first got interested in—I have been concerned about the imposition of mandatory binding arbitration in the employment context. There is a growing trend among employers to require employees to agree to resolve employment discrimination or sexual harassment claims through mandatory binding arbitration before they can be hired or promoted. These agreements effectively coerce individuals into relinquishing fundamental legal protections that exist to address discrimination in the workplace. Plain and simple, mandatory arbitration provisions thwart the will of Congress by forcing employees to waive their right to take their grievances to court.

I have introduced legislation in the last three Congresses to address this trend. Senate bill 121, the Civil Rights Procedures Protection Act, amends a number of Federal civil rights statutes to specify that the statutory procedures for enforcement of those laws can be superseded only by a voluntary agreement to engage in arbitration after a claim arises.

On our committee, Senators Torricelli, Kennedy, and Leahy have joined me as cosponsors of this important initiative. A broad coalition of civil rights organizations as well as the Department of Justice support this bill, and I would ask that a copy of the letters in support of the bill from the Leadership Conference on Civil Rights and the Department of Justice be included in the record of this hearing. There is no objection.

[The letters follow:]

LEADERSHIP CONFERENCE
ON CIVIL RIGHTS,
Washington, DC, August 4, 1999.

DEAR SENATOR: On behalf of the Leadership Conference of Civil Rights' (LCCR) Employment Task Force, we write to urge your support for the Civil Rights Procedures Protection Act (H.R. 872/S. 121). This important civil rights legislation would prevent employers from forcing workers to give up their right to go to court—and accompanying legal protections—when they have job discrimination claims.

In a disturbing trend, more and more employers require workers to agree—as a condition of hiring or promotion—that any and all future employment disputes will be settled through mandatory, binding arbitration. Mandatory arbitration undermines fundamental principles established by the hard-fought civil rights battles of the last 30 years. It allows defendants to escape one of the key tenets of federal civil rights law: the right of job discrimination victims to have their claims heard in court by judges sworn to apply and uphold the law. Instead, through a mandatory arbitration program, employers can bypass some of the most important civil rights protections first established in the Civil Rights Act of 1964 and later expanded by the Civil Rights Act of 1991, such as access to jury trials and fuller remedies for discrimination victims.

Mandatory arbitration seeks to replace our public system of justice with a private system that has little accountability and few controls. While courts have played a critical role in vindicating the civil rights of bias victims—including, for example, developing the legal standards against sexual harassment and publicly highlighting employers' responsibility to maintain a discrimination-free workplace—mandatory arbitration often allows employers to limit dramatically the remedies and procedural protections available to discrimination victims.

For example, some mandatory arbitration programs limit or deny compensatory and punitive damages, denying the very remedies that the Civil Rights Act of 1991 extended to victims of harassment and other forms of discrimination. Moreover, the

Federal Rules of Evidence, which can be so important in protecting against intrusive inquiries into harassment victims' private sexual histories, do not apply in arbitration proceedings. Arbitrators also lack the authority to issue the injunctive relief that is routinely available in the courts to end discriminatory practices and prevent their recurrence. Arbitrators are not even required to have a background in basic employment law, including knowledge of legal protections against job discrimination.

While we believe that alternative dispute resolution, when fully voluntary and properly designed, can in many cases helpfully resolve employment disputes, mandatory arbitration forces workers to abandon their access to the courts and accompanying legal safeguards. H.R. 872/S. 121 would prevent such unfairness and restore the protections of our civil rights laws. Please support the Civil Rights Procedures Protection Act.

Sincerely,

AARP
American Civil Liberties Union
American Federation of Government Employees
Communications Workers of America/Coalition of Labor Union Women
Lawyers Committee for Civil Rights Under Law
Mexican American Legal Defense and Educational Fund
NAACP Legal Defense and Educational Fund, Inc.
National Asian Pacific American Legal Consortium
National Council of La Raza
National Employment Lawyers Association
National Partnership for Women & Families
National Women's Law Center
Women Employed

The Leadership Conference on Civil Rights is the nation's oldest, largest and most diverse coalition of organizations committed to the protection of civil and human rights in the United States. It is comprised of more than 180 national organizations representing people of color, women, children, labor unions, persons with disabilities, older Americans, major religious groups, gays and lesbians and civil liberties and human rights groups.

DEPARTMENT OF JUSTICE,
OFFICE OF LEGISLATIVE AFFAIRS,
Washington, DC, January 18, 2000.

Hon. RUSSELL D. FEINGOLD,
U.S. Senate,
Washington, DC.

DEAR SENATOR FEINGOLD: This letter responds to your letter of September 30, 1999, requesting the views of the Department of Justice on S. 121, the Civil Rights Procedures Protection Act of 1999. S. 121 would amend several Federal statutes to prohibit pre-dispute agreements that mandate, as a condition of employment, binding arbitration of any future job discrimination claims. The Department of Justice strongly supports the goals of this proposal as furthering effective civil rights enforcement.

The Department of Justice is firmly committed to the voluntary use of alternative dispute resolution ("ADR") methods, such as mediation and arbitration, as extremely helpful tools in resolving employment and other disputes. However, we share your concern that important civil rights protections are undermined when employers require workers to agree—as a condition of hiring or promotion—to give up their right to pursue discrimination claims in court and instead submit such claims to binding arbitration. We agree with the view of the Equal Employment Opportunity Commission that such mandatory arbitration agreements are "contrary to the fundamental principles" of Federal antidiscrimination law.

The private right of access to a judicial forum is central to our Federal statutory enforcement scheme in job discrimination cases. Indeed, mandatory arbitration of employment discrimination claims undermines one of the primary legacies of the Civil Rights Act of 1964, which first provided job discrimination victims with the right to have their claims heard in court by Article III judges, who have lifetime tenure and are sworn to apply and uphold the law. It also evades some of the key protections of the Civil Rights Act of 1991, which provided for the right to a jury trial when damages are at issue.

Furthermore, mandating that job discrimination claims be submitted to a private arbitrator circumvents the development of a clear and uniform civil rights jurisprudence through the decisions of an independent judiciary. For example, Federal courts first established the principle that sexual harassment is unlawful sex discrimination in *Meritor Savings Bank* v. *Vinson,* 477 U.S. 57 (1986), and outlined the structure for evaluating cases involving circumstantial evidence of intentional discrimination in *McDonnell Douglas Corp.* v. *Green,* 411 U.S. 792 (1972). Such civil rights precedent gives valuable public guidance regarding employers' and workers' rights and responsibilities under Federal civil rights law, enhancing voluntary compliance. The private nature of mandatory arbitration does not permit the realization of these benefits.

Moreover, parties in discrimination cases often depend on judicial enforcement of a range of protections that arbitrators may not be required or empowered to respect. For example, the judicial power to order injunctive relief where appropriate to redress injury and to prevent future discrimination is central to meaningful civil rights enforcement. Arbitrators' ability to fashion and enforce such relief is often limited. Similarly, arbitrators are not bound by Federal rules of evidence that generally prohibit the use of evidence of a victim's private sexual behavior in harassment cases, discovery rules that allow a party to develop and evaluate the strength of his or her case, and fee-shifting provisions that recognize the public interest in asserting equal employment opportunity by awarding attorney's fees to prevailing plaintiffs. In short, prohibiting mandatory arbitration protects the rights of individual claimants as well as the public interest in effective civil rights enforcement.

Furthermore, as you know, the circumstances under which mandatory arbitration agreements are permissible under current law have been the subject of considerable litigation since the Supreme Court's decision in *Gilmer* v. *Interstate/Johnson Lane Corp.,* 500 U.S. 20 (1991). Prohibiting mandatory arbitration would end any uncertainty about its lawfulness in a manner consistent with effective civil rights enforcement.

We look forward to working with you to accomplish the goal of prohibiting mandatory arbitration, while allowing for the continued use of more helpful means for addressing complaints of discrimination, such as other alternative dispute resolution processes. Feel free to call on us to assist you in evaluating the effect of your legislation and in refining statutory language. We also encourage you to consult other affected agencies such as the Equal Employment Opportunity Commission and the Department of Labor, which also enforce civil rights statutes that would be amended by this proposal.

Thank you for this opportunity to present our views. Please do not hesitate to call upon us if we may be of further assistance. The Office of Management and Budget has advised us that from the perspective of the Administration's program, there is no objection to submission of this letter.

Sincerely,

ROBERT RABEN,
Assistant Attorney General.

Senator FEINGOLD. Mr. Chairman, again, I thank you for holding this hearing and for giving it such a wide scope. I think the Senate and the public will benefit from the light we are shining on this problem today.

At this point I would—has the second vote started? Well, since the second vote hasn't even started, I think we should proceed. Mr. Fondren, I understand you were making your remarks?

Mr. FONDREN. That is correct, Senator Feingold.

Senator FEINGOLD. Please continue.

Mr. FONDREN. Yes, I will. I think I am under the red light, so I am going to coalesce my testimony as best I can.

We had reached the point in my discussion with respect to the substantial number of automobile dealers who are under mandatory binding arbitration provisions of one kind or another from contracts from manufacturers. These include Chrysler and Saturn, and I must say here, if I may, parenthetically, that I disagree with the opponents who claim that the Saturn arbitration agreement was negotiated with Saturn dealers. At the time it was negotiated with a group of some 15 dealers who are described in the testimony as retailers, there were no Saturn dealers. And I will be glad to discuss that with the committee at some length if the committee wishes me to do so.

Opponents also claim that the National Automobile Dealers Association did not oppose the Saturn arbitration provision, and we strongly disagree with that position because they did oppose it in resolution and statements by Mr. McCarthy, their president, and they oppose it still today.

I also would mention to you that when Sterling or DaimlerChrysler through Freightliner bought out Ford Motor Company Truck Division and created the Sterling Division, they imposed mandatory binding arbitration on all of those existing Ford dealers.

Ford and General Motors both have mandatory binding arbitration in minority contracts that they offer to dealers who are in what we commonly call "dealer development."

Nissan in a notice dated November 30, 1999, effective December 1, 1999, the next day, said please note we have made some revisions and included mandatory binding arbitration in the contract having to do with factory and dealer incentives.

Volkswagen Credit on October 11, 1999, effective November 1, 1999, applied the mandatory binding arbitration to prior agreements with 825 dealers.

Action in State district court is pending now, one in California and the other in Ohio. The Ohio court enjoined a Texas dealer from attempting to or pursuing his rights under Texas law in the State of Texas, and the district court in California enjoined the State of Texas from proceeding on a dealer complaint under Texas law.

On the issue of disparate bargaining power, opponents suggest that it is no longer necessary because of the existence of publicly held dealerships, and there are some of these. There are a few.

In my written testimony, I outline the size and the location of dealers throughout the State of Texas and respectfully suggest that in other jurisdictions who have less population, those figures are cogent and pertinent. Over half the dealers in Texas reside in towns of less than 50,000, and they are sole proprietorships and family-owned dealerships. They are not mega-dealers and they are not publicly held corporations. I suggest that in Wisconsin and Ohio and other States the same will be true.

Finally, I would like to say, Mr. Chairman, if I might, and Senator Feingold that S. 1020 addresses the significant motor vehicle contract problem, serious problem, in a very simple and a very straightforward way. It simply allows both parties to agree or not agree to binding arbitration after the dispute arises. S. 1020 simply makes arbitration voluntary. And the U.S. Senate, the U.S. Congress, have indicated a strong desire, a strong intent that arbitration should be voluntary.

S. 1020 solves the problem that it addresses, and it is a good bill.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Fondren follows:]

PREPARED STATEMENT OF GENE FONDREN

SUMMARY

S. 1020, introduced by Senator Grassley and Senator Feingold, and co-sponsored by twenty-six members of the Senate, amends the Federal Arbitration Act, but in no way does violence to the public policy interest favoring arbitration as an alternative dispute resolution mechanism.

Pertinent elements of the testimony supporting S. 1020 include:

(1) under federal court decisions an arbitration clause is enforceable on its face, regardless of state or federal law or regulation to the contrary.

(2) the franchise agreement between a motor vehicle manufacturer and franchised dealers is a contract of adhesion.

(3) agreements presented by motor vehicle manufacturers to franchised dealers are inherently unfair and inequitable.

(4) provisions imposed by manufacturers are onerous, unreasonable and oppressive. Examples are illustrated.

(5) every state except one has a regulatory scheme in place to bring equity to this motor vehicle manufacturer-dealer relationship.

(6) an arbiter is not required to understand and enforce state or federal law, he has no ability to enter injunctive relief, and there is no appeal if state or federal law is misapplied or ignored.

(7) in a "take it or leave it" contract the stronger party may impose mandatory binding arbitration and circumvent state and federal law.

This is the problem. S. 1020 addresses the problem in a straightforward and simple way. Under the term of S. 1020, an arbitration clause may properly be included in a Motor Vehicle Franchise Contract. However, the potential for abuse of such a clause in a non-negotiable contract has been eliminated by Subsection (b) of the new Section 17 that S. 1020 would add to the Federal Arbitration Act. That provision expressly provides that, "Whenever a motor vehicle franchise contract provides for the use of arbitration to resolve a controversy arising out of or relating to the contract, each party to the contract shall have the option, after the controversy arises and before both parties commence an arbitration proceeding, to reject arbitration as the means of settling the controversy. Any such rejection shall be in writing."

Thus, S. 1020 will remove the potential of these contracts to deprive persons of statutory rights and remedies without doing violence to the public policy interest served in encouraging arbitration as a means of dispute resolution. S. 1020 simply makes arbitration voluntary. It solves the problems it addresses.

INTRODUCTION

Mr. Chairman and members of the committee. My name is Gene Fondren. I am the President of the Texas Automobile Dealers Association, a trade association composed of approximately 1400 franchised new automobile and truck dealers. I have held this position for almost 28 years. Prior to that, I practiced law in Taylor, Texas, served in the Texas House of Representatives and, immediately prior to assuming my current position, represented the Texas Association of Railroads and the Missouri Pacific Railroad here in Washington. I also speak for Automotive Trade Association Executives who represent metro and state dealer associations across the country.

I appear before you in support of S. 1020, introduced by Senator Grassley and Senator Feingold and co-sponsored by twenty-six other Senators. S. 1020 amends the Federal Arbitration Act, but in no way does violence to the principle or the spirit of the doctrine favoring arbitration. We support alternative dispute mechanisms, including arbitration.

It is neither the intent nor the effect of the legislation to restrict or interfere with the use of voluntary arbitration as an alternative dispute resolution option.

HISTORICAL BACKGROUND: FEDERAL ARBITRATION ACT

In response to judicial hostility to the enforcement of arbitration agreements, the Congress in 1925 enacted the Federal Arbitration Act (FAA). In 1947, the Act was reenacted and codified as Title 9, U.S.C.[1] The stated purpose of the FAA is to ensure court enforcement of a contractual provision specifying arbitration as the means of settling a dispute. Since the issue presented by S. 1020 involves the applicability of the FAA to contracts of *adhesion*, it may be important to briefly examine congressional intent regarding such contracts. In the *Florida Law Review,* Professor Atwood, discussing the intent of the Congress in enacting the FAA said: "* * * courts feared that arbitration agreements could be coerced of unequal bargaining power with the stronger party forcing the weaker party to relinquish the right to a judicial forum." (Atwood, *Issues in Federal-State Relations Under the Federal Arbitration Act,* 37 Fla. L. Rev. 61, 74)

[1] 9 U.S.C. S1 et seq.

In the same article, Professor Atwood also made the following cogent observation: "The federal Act's opponents believed courts should not compel arbitration of disputes unknown to parties at the time of agreements since an individual might unwittingly sign away the right to a judicial forum for an important claim. The federal Act's legislative history does not reveal whether Congress was aware of such controversy. Nevertheless, testimony suggests some members of Congress were concerned about the related problem of the Act's applicability to adhesion contracts. When Senator Walsh of Montana voiced that during the 1923 hearing on the proposed legislation, the bill's supporters assured Congress the bill was not intended to cover insurance contracts or other "take it or leave it" arrangements. The proposed legislation, its supporters argued, simply would empower courts to enforce arbitration clauses in arms-length transactions * * *" (37 Fla. L. Rev. at 75, citing the record hearings on the bill that enacted the Federal Arbitration Act.)

Congress, in its more recent enactments affecting arbitration, has shown a similar concern regarding the importance of voluntary consent and agreement in the use of arbitration. The "Administrative Dispute Resolution Act" enacted in 1990 amended Section 10 of the Act relating to the grounds for vacating an arbitration award. It is interesting to note that in § 582 of the 1990 amendment, the Congress provided that "[A]n agency may use a dispute resolution proceeding for resolving an issue if the parties agree to that proceeding. (5 U.S.C. § 582)[2] Congress articulated the same view in adopting the Judicial Improvements and Access to Justice Act.[3]

The concern expressed by Senator Walsh and the concerns implicit in recent Congressional emphasis on voluntary arbitration are, based on the interpretation given the FAA by the Supreme Court of the United States, fully justified. Judicial interpretations of the Federal Arbitration Act hold that, rather than being merely a benign tool for the management of judicial dockets, mandatory binding arbitration may be used as a hammer by which one party to a contract takes unconscionable advantage of the other. At the same time, in the case of the motor vehicle franchise agreements, arbitration can circumvent an entire body of state substantive law enacted precisely to bring equity to that specific relationship.

The principle that the Act is preemptive of state law emanates from the Supreme Court's opinion in *Southland Corporation* v. *Keating.*[4] The issue in the case was the enforceability of a California statute, upheld by the California Supreme Court, regulating the relationship between franchisers and franchisees—this statute had the effect of preempting contractual arbitration clauses in favor of the regulatory structure created by the California Legislature to resolve disputes arising from a franchise relationship.

In the *Southland* case, the Chief Justice said: "[I]n creating a substantive rule applicable in state as well as federal courts, Congress intended to foreclose state legislative attempts to *undercut* the enforceability of arbitration agreements." (at 861, emphasis added) It would seem that, with the quoted language, the court lays to rest the supremacy issue and the issue of whether or not the FAA's enforcement requirements are limited to actions brought in federal court (an issue made the subject of a stinging dissent).

In 1985, the Supreme Court revisited the issue in the case of *Mitsubishi Motors Corporation* v. *Soler Chrysler-Plymouth,*[5] a case in which a motor vehicle dealer attempted to avoid the enforcement of a mandatory arbitration provision in its distribution agreement on the grounds that the enforcement of the arbitration clause would deprive the dealer of the ability to invoke its statutory right to bring an antitrust action under the Sherman Act. The Supreme Court was unimpressed by the argument that the vindication of substantive statutory rights should not be left to mandatory binding arbitration, even when the issues presented are complex and carry as many public policy implications as a Sherman Act claim.[6] For the court,

[2] P.L. 101–522

[3] Although it is not amendatory of the Federal Arbitration Act, a 1988 Act of Congress (The Judicial Improvements and Access to Justice Act," 28 U.S.C. SS 651 et seq.) also provides insight into a more recent Congressional approach to the issue of arbitration. In that law, which allows a U.S. District Court to authority the use of arbitration in a civil action under certain circumstances, the Congress expressly provided that arbitration could not be ordered "without the parties' consent. The law further provides that such consent must be "freely and knowingly obtained."

[4] 104 S. Ct. 852 (1984).

[5] 105 S.Ct. 3346 (1985).

[6] Prior to this opinion the law on this precise issue had been established by the Court of Appeals for the Second Circuit in 1968, where the court held that, regardless of the terms of a contract, a Sherman Act claim is not subject to arbitration. *American Safety Corporation* v. *J.P. Maguire & Co.* 391 F.2d. 821 (1968). In a well-reasoned opinion the court there provided four reasons not to compel arbitration in a Sherman Act action: the importance of private [judicial]

Justice Black simply stated that "[B]y agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by a statute; it only submits to their resolution in an arbitral rather than a judicial forum. * * *"

Thus, the court indicates that an arbitral forum is the same as a judicial forum for the adjudication of statutory rights. Yet there is at least one major distinction: the existence of an appellate procedure to guarantee adherence to the principles of due process and other important constitutional and statutory rights. It is difficult to imagine the adjudication of substantive rights without the right to appeal but the FAA offers no effective appeal from the award of an arbitration panel. It is certainly worthy of note that, in his dissent, Justice Stevens distinguishes between simple contract claims and those arising as a result of a statutory right, stating that "[N]othing in the text of the 1925 Act, nor its legislative history, suggests that Congress intended to authorize the arbitration of any statutory claims." (Id. at 3364.) Had Justice Stevens' position been that of the court, S. 1020 would not be necessary.

To summarize, the situation is this: the FAA, created to facilitate the enforcement of arbitration agreements, has been interpreted uniformly. It seems clear that:

(1) the FAA has been construed to be preemptive of state law;

(2) the FAA may be applied to require arbitration of a claim arising under a statutory right;

(3) the courts are expected to enforce an arbitration clause without regard to:

(A) the complexity of the issues presented;

(B) the public policy issues presented;

(C) the existence of a comprehensive body of state statute law established for the sole purpose of adjudicating disputes arising under the contract;

(D) the fact that an arbitration panel has no authority to invoke injunctive relief; or

(E) the fact that the contract is a contract of adhesion.

With that background, let me turn to the history of the particular contractual relationship that exists between the manufacturer of a motor vehicle and its franchised dealer.

HISTORY OF CONTRACTUAL RELATIONSHIP BETWEEN MOTOR VEHICLE DEALER AND MANUFACTURER

In the preface to his book *Law and the Balance of Power* (Stewart Macauley, Russell Sage Foundation, New York, 1966) Professor Macauley has the following to say: "For over forty years [franchised automobile dealers] have been trying to get help from the legal system to give them enforceable rights against the manufacturers which would influence the daily operation of their relationships with them. One can guess why. The 'franchise' which governed the arrangement was drafted by the manufacturer to minimize the dealer's rights, and the dealers lacked the bargaining power to gain a better contract."

It is our position that a franchise contract between the manufacturer of a motor vehicle and its franchised dealers is not a proper one to be interpreted or enforced by arbitrators, unless the arbitration route has been chosen voluntarily by both parties after the controversy arises. This is so, because this contract is a classic example of a contract of adhesion. It is not negotiated. It is handed to a dealer who is expected to make, or already has made, a very substantial investment, on a "take it or leave it" basis. It is unilaterally renewed, modified or amended in the same way * * * on a "take it or leave it" basis.[7] One need impute neither malice nor avaricious intent to any party to such an agreement to note that a Chevrolet dealer in a small town does not—and can never—enjoy equal bargaining power with the largest corporation in the world.

It was this very inequity that the Congress cited in 1956 as the basis for the "Automobile Dealers' Day in Court Act."[8] In its 1956 report, the Congressional Committee made the following significant and still relevant observations:

"* * * This vast disparity in economic power and bargaining strength has enabled the factory to determine arbitrarily the rules by which the two parties conduct their

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enforcement; the possibility that a contract that results in a Sherman Act claim might be adhesive; antitrust issues are too complicated to be resolved by arbitration; and antitrust issues involve business disputes that ought not be decided by an arbitration panel of business people. As convincing as these arguments may be, however, the court in *Mitsubishi* refuted them expressly, one by one.

[7] Obviously, the contractual inequity is particularly onerous in a franchise renewal or modification where the dealer already has millions of dollars invested in the dealership. At that point the dealer truly has no choice but to renew or simply accept the agreement regardless of its provisions.

[8] 439 U.S.C. 96 (1978)

business affairs. These rules are incorporated in the sales agreement or franchise which the manufacturer has prepared for the dealer's signature.

"Dealers are with few exceptions completely dependent on the manufacturer for their supply of cars. When the dealer has invested to the extent required to secure a franchise, he becomes in a real sense the economic captive of his manufacturer. The substantial investment of his own personal funds by the dealer in the business, the inability to convert easily the facilities to other uses, the dependence upon a single manufacturer for supply of automobiles, and the difficulty of obtaining a franchise from another manufacturer all contribute toward making the dealer an easy prey for domination by the factory. On the other hand, from the standpoint of the automobile manufacturer, any single dealer is expendable. The faults of the factory-dealer system are directly attributable to the superior market position of the manufacturer." S. Rep. No. 2073, 84th Congress, 2nd Sess., 2 (1956).

Although the Automobile Dealers Day in Court Act was well-intended, it has proved to be insufficient to level the playing field. The Act provides no equitable relief; it requires that a dealer prove coercion; and it fails to address the real problem inherent in this contractual relationship: the coerciveness and "one sidedness" of the franchise agreement itself.

Thus it has fallen on the various state legislatures to provide the kind of equitable statutory redress necessary to protect the public and the dealer/citizens of the states and, since 1937, state legislatures have been doing just that. Typically that regulations has taken the form of a comprehensive body of statute law that regulates the relationship between dealers and manufacturers and provides specific remedies available only to the parties to these agreements. Today, all states, except Alaska, have some sort of statutory plan in place to regulate this contractual relationship. While manufacturers may allege that these statutes are too protective of dealers, in truth and in fact, they are merely reactive to the onerous, oppressive and unfair burdens imposed by the manufacturers in the franchise agreement.

In this context, I think it is helpful to hear what the Supreme Court of the United States has to say about such regulatory enactments. In its seminal opinion in the case of *New Motor Vehicle Board of California* v. *Orrin W. Fox Co.*[9] the court said: "In particular, the California Legislature was empowered to subordinate the franchise rights of automobile manufacturers to the conflicting rights of their franchisees where necessary to prevent unfair or oppressive trade practices. '[S]tates have power to legislate against what are found to be injurious practices in their internal commercial and business affairs, so long as their laws do not run afoul of some specific federal constitutional prohibition, or of some valid federal law * * * [T]he due process clause is [not] to be so broadly construed that the Congress and state legislatures are put in a strait jacket when they attempt to suppress business and industrial conditions which they regard as offensive to the public welfare," 9439 U.S. 409, 411, citing and quoting from *Lincoln Union* v. *Northwestern Co.* 335 U.S. 525, 536–537.)

The court went on to hold that: "Further, the California Legislature had the authority to protect the conflicting rights of the motor vehicle franchises through customary and reasonable procedural safeguards, i.e., by providing existing dealers with notice and an opportunity to be heard by an impartial tribunal—the New Motor Vehicle Board—before their franchiser is permitted to inflict upon them grievous loss. Such procedural safeguards cannot be said to deprive the franchisor of due process. States may, as California has done here, require businesses to secure regulatory approval *before* engaging in specified practices." (439 U.S. 409, 411. Emphasis in original)

In my own state, in response to these problems, the legislature in 1971 enacted the Texas Motor Vehicle Commission Code[10] which created the Texas Motor Vehicle Commission and, with it, valuable property rights and other protections for the dealer/citizens of Texas. That body of law provides a comprehensive structure whose only purpose is to regulate the relations between and among consumers, dealers and motor vehicle manufacturers. Section 1.02 of the Code provides the following.

"Section 1.02 POLICY AND PURPOSE. The distribution and sale of new motor vehicles in this State vitally affects the general economy of the State and the public interest and welfare of its citizens. It is the policy of this State and the purpose of this Act to exercise the State's police power to insure a sound system of distributing and selling new motor vehicles through licensing and regulating manufacturers, distributors, converters, and dealers of those vehicles, and enforcing this Act as to other persons, in order to provide for compliance with manufacturer's warranties

[9] 15 U.S.C. § 1221–1225
[10] 439 U.S. 96 (1978)

and to prevent frauds, unfair practices, discriminations, impositions, and other abuses of our citizens."

As with other such state laws that have proven successful in serving the interests of the public generally, consumers and the regulated industry, the key to the Texas law is that it expressly preempts specific terms of the franchise agreement if the terms are in conflict with the law. Thus, the Texas Legislature has, as it has in a substantial number of other areas of contract law, determined that public policy favoring comprehensive regulation of the industry is more important than upholding specific provisions of a franchise agreement. I submit that that kind of regulation is a sound and proper exercise of the power of the state legislature and should not be over-ridden by the power of a party to impose mandatory binding arbitration. Indeed, the courts have agreed. Our state law has withstood all challenges, constitutional or otherwise.

As is the case in most state jurisdictions, this law is designed to regulate:

(1) termination of a franchise;

(2) contractual provisions prohibiting or limiting the right of a dealer to dispose of his/her interest in the dealership on his/her death;

(3) contractual provisions limiting the right of *inter vivos* transfer;

(4) placing of unreasonable performance requirements on a dealer;

(5) the unreasonable use of a manufacturer-related finance arm to bring financial pressure on a dealer;

(6) the obligations of the dealer and manufacturer in providing warranty and product performance standards for consumers.

Each of these issues, along with others, is addressed very specifically and very thoroughly in the law. A state agency, created in 1971, is in place to administer and enforce the law. It is an agency bound by law to follow precedent and to adhere scrupulously to principles of due process. It is an agency whose official acts are subject to judicial review. And let me emphasize that the law *works.* It works because its provisions exist to regulate unreasonable, oppressive and unfair terms of the franchise agreement and unreasonable, oppressive and unfair practices. Manufacturers prevail as often, perhaps more often, than dealers. For these reasons, the law works and works well.

If parties are required to resolve their disputes outside these long-standing regulatory frameworks; if they are forced into a forum that must interpret a franchise agreement within the four corners of the agreement, without regard to the unreasonableness or unfairness of its provisions and without appeal, if they are forced to go to a forum that lacks the specific expertise that can only come after years of experience and precedent, there is no reason to think that provisions of the law will be observed at all. It is inconceivable to me that any arbitrator or arbitration panel could develop the kind of expertise that this agency has developed over nearly three decades of regulating this contractual relationship. In effect, we have (and have had for these nearly three decades) a very effective alternative dispute resolution system, a system specifically created, and uniquely suited, to enforce these important substantive statutory rights.

Yet the effect of the FAA, as interpreted by the Supreme Court, is to allow a party to a franchise agreement, through the imposition of a pre-dispute mandatory binding arbitration provision, to circumvent these substantive statutory rights as if they do not exist.

USE OF MANDATORY BINDING ARBITRATION BY MOTOR VEHICLE MANUFACTURERS AND DISTRIBUTORS

Although opponents to S. 1020 claim that mandatory binding arbitration is little used, the facts indicate otherwise. According to a document produced by representatives of manufacturers in November, 1999, approximately 1875 dealers are covered by mandatory binding arbitration. The document is designated on its face as a "work in progress"—as indeed it must be. None of the nation's heavy duty truck dealers are listed and there is evidence that approximately 1,000 are covered by mandatory binding arbitration.

In addition to the manufacturer's list and the truck dealers, there are others. Both Ford and General Motors impose mandatory binding arbitration in some of their dealer agreements. On November 30, 1999 Nissan notified its dealers, 1,230 in number, that mandatory binding arbitration is now the exclusive remedy for dealer manufacturer disputes involving incentives. On October 11, 1999, Volkswagen Credit, Audi Financial Services and Bentley Financial Services notified dealers that all disputes, including tort, would be resolved by binding arbitration and that the laws of the state of Michigan would govern. There are 567 Volkswagen and 258 Audi dealers.

The first major imposition of mandatory binding arbitration by a member of the "big three" occurred when Chrysler Motors Corporation acquired American Motors. Although Chrysler subsequently offered an "opt out" addendum on arbitration, the following is reflective of classic examples of terms and conditions unilaterally imposed on existing dealers along with mandatory binding arbitration. At least 1,321 Daimler-Chrysler dealers are still covered by these provisions.

Following its acquisition of American Motors (AMC) in 1987, Chrysler Motors Corporation (CMC) submitted a "new Franchise Agreement (also referred to as a sales and service agreement) to existing dealers, both AMC dealers and CMC dealers. Its directive to AMC dealers stated "* * * you will be visited by a Zone Sales Representative who will present you with a new form of Agreement for your signature * * *."

The Chrysler Franchise (sales and service) Agreement was submitted to the dealers in two parts. The first was a basic signatory document describing the parties, products, etc. This was followed by a separate "Sales and Service" Agreement document containing "Additional Terms and Provisions"—thirty four in number—plus a Motor Vehicle Addendum.

The basic document has a global Mandatory Binding Arbitration provision which contains the following: "*Any and all disputes * * * including but not limited to * * * disputes under rights granted pursuant to the statutes of the state in which dealer is licensed shall be finally and completely resolved by arbitration pursuant to the arbitration laws of the United States of America as codified in Title 9 of the United States Code * * *"* (Emphasis added)

The "Additional Terms and Provisions," "Sales and Service" Agreement document, containing operative provisions covered by the mandatory binding arbitration clause, included among its more onerous provisions the following impositions:

A requirement that the dealer maintain a rating "equal to or greater than the average of Customer Satisfaction Index * * * for the Sales Level Group in which dealer is included." Failure to do so would subject dealer to termination.

Automatic termination without notice on the death of dealer in a sole proprietorship.

Automatic termination when the manufacturer offers a new Sales and Service Agreement to all dealers of the same line make.

A prohibition against a surviving spouse retaining a financial interest in a successor dealership unless (a) prior to death, dealer had delivered notice in writing naming surviving spouse as person to hold a financial interest and (b) the surviving spouse, within 60 days after death, agreed in writing not to participate in any way in the management of the dealership.

A provision that venue and jurisdiction lay in Michigan.

All of the above-cited terms and conditions are contrary to the laws of many states, and the arbitration provision clearly was included with the intent to circumvent such state statutes. Through the utilization of an arbitration mechanism in a "take it or leave it" contract offered to existing, invested dealers, the manufacturer intended to deprive its dealers of statutory rights and remedies under state laws.

NON-NEGOTIABLE AGREEMENTS

Some opponents to S. 1020 may argue that contracts between manufacturers and dealers are negotiated. The overwhelming evidence proves the contrary. It is also sometimes argued that an arbitration provision has been *negotiated* with dealers. This is the claim made by factory representatives when discussing the Saturn arbitration provision.

During the formative stages of Saturn, discussions were held with a few selected General Motors dealers * * * I believe there was an initial group of five and then a second group of ten. However, these were only prospective Saturn dealers: General Motors dealers who may have been hoping to obtain a Saturn franchise. I am told that only two of the original five actually became Saturn dealers. Securing an understanding or agreement with a prospect who represents no one but himself is not a "negotiation" with an existing or invested automobile or truck dealer.

Within the past two years, Saturn dealers in different jurisdictions attempted to enter into agreements with a third party. Saturn refused to approve the transactions, and insisted on mandatory binding arbitration. After attempting to exercise their rights and remedies under state laws and administration procedures which would have likely allowed them to proceed with plans, and after a very considerable amount of time and expense, the dealers finally capitulated and sold their dealerships to Saturn.

You may well ask why these dealers did not take their chances with Saturn arbitration. A look at the Saturn arbitration scheme provides an answer. The Saturn arbitration plan has a panel of four arbiters—two employees of Saturn and two Saturn dealers chosen from a pre-selected list. Sounds reasonably fair except—Saturn picks all four and all four must reach a unanimous decision to achieve an outcome. If a unanimous decision is not reached, the parties must rearbitrate their dispute before a different Saturn arbitration panel. Although it seems obvious that this creates opportunity for inherent "bias," a court has rejected any such notion.

Again, on the issue of negotiation and on the point of convenience and expense of arbitration, the Sterling Truck saga offers telling insight. Freightliner, a subsidiary of Daimler-Chrysler, purchased HN–80 and cargo product lines from Ford Motor Company. In its notice to existing Ford dealers and its offer of a franchise agreement, HN–80 Corporation (now Sterling) included mandatory binding arbitration of all disputes and added a requirement that the dealer personally guarantee payment for all purchases, including vehicles, from the manufacturer.

Because there was a substantial number of dealers involved (rather than the typical case where there is a manufacturer vs. one dealer) a proposal that the manufacturer perceived to be a compromise was offered. In lieu of the personal guarantee, "it was agreed that invoicing and payment terms for new trucks will be the day trucks are ready for delivery to the transporter (Day 1)." Apparently, instead of guaranteeing payment, the dealers pay in advance of delivery.

On the issue of mandatory binding arbitration the manufacturers provided: "Binding arbitration will be required of all qualified current Ford HN–80 dealers * * * for three years. Any HN–80 dealer signed with this provision will be offered an "Opt Out" after the three year period, *providing that the dealership is meeting all HN–80 requirements and is not on termination notice.*" (Emphasis added) All other/subsequent HN–80 dealers signed will be bound by Binding Arbitration and will not be offered an "Opt Out." As anyone with any experience in the industry knows it is virtually impossible for a dealer to meet "all requirements" of the factory. So there is a serious question as to whether there will really be an "Opt Out" for any Sterling dealers. The manufacturer clearly controls that final decision.

Recently an issue has risen between Sterling and a number of its dealers regarding a medium duty truck called the *Acterra*. Sterling insists that it is a new line-make and is attempting to require dealers to sign a separate agreement and meet certain other criteria. Dealers maintain that it is merely a new model covered by the existing franchise agreement.

Knowing that their agreements require mandatory binding arbitration, approximately forty Sterling dealers filed for consolidated arbitration in Cleveland, Ohio, the situs of Sterling's home office. Sterling objects and argues: "Because the arbitration agreements between the claimants do not contain a provision for consolidating arbitration, Sterling cannot be forced to proceed with the consolidated arbitration * * *" Counsel for the dealers responds: "Having once touted binding arbitration as 'the most expeditious and least costly method of resolving disputes,' Sterling now seeks to undermine the essential advantage of arbitration, as advertised *by it* and compel the resolution of more than forty virtually identical claims in at least twenty different venues." Sterling, in its pleadings, also complains that the dealers "paid only a single filing fee" for arbitration. Although the American Arbitration Association (AAA) is apparently satisfied, Sterling insists on a separate fee from each dealer.

The extent to which manufacturers will overreach the dealer on this issue is illustrated in both Ford Motor Company's *Stock Redemption Plan/Dealer Development Agreement* and in General Motor's *Motors Holding Investment Plan.* These are the agreements Ford and General Motors offer in dealer development programs, principally with minority dealers.

In the Ford *Dealer Development Agreement* we find the following: "If appeal to the Policy Board fails to resolve any dispute covered by this Article 10 within 180 days after it was submitted to the Policy Board, the dispute shall be finally settled by arbitration in accordance with the rules of the CPR Institute for Dispute Resolution (the 'CPR') for Non-Administered Arbitration for Business Disputes, by a sole arbitrator, but no arbitration proceeding may consider a matter designated by this Agreement to be within the sole discretion of one party (including without limitation, a decision by such party to make an additional investment in or loan or contribution to the Dealer), and the arbitration proceeding may not revoke or revise any provisions of this Agreement. Arbitration shall be the sole and exclusive remedy between the parties with respect to any dispute, protest, controversy or claim arising out of or relating to this Agreement."

In the General Motors *Investment Plan* the dealer, referred to as the Operator, is required to agree to the following provision: "The Operator will not be allowed to bring a lawsuit against General Motors for claims arising before and during the time Motors Holding is an investor in the Dealer Company. Instead, the Operator, General Motors and the Dealer Company agree to submit any and all unresolved claims, including those pertaining to any dealer sales & service agreement, to mandatory and binding arbitration. The results of the arbitration will be binding on the Operator, the Dealer Company and General Motors."

Nissan, in its recent *Revised Incentive Program Rules,* provides for mandatory Binding Arbitration and attempts to foreclose any remedies otherwise available to dealer under state or federal law. "By receiving incentive payments, Dealer agrees to resolve disputes involving incentives payments by this Dispute Resolution Process. Furthermore, Dealer acknowledges that at the state and federal level, various courts and agencies would, in the absence of the agreement, be available to them to resolve claims or controversies which might arise between NNA and Dealer (NNA and Dealer collective referred to as 'Parties'). The Parties agree that it is inconsistent with their relationship for either to use courts or governmental agencies to resolve such claims or controversies."

In its October 11, 1999 notice to its dealers, Volkswagen Credit imposes Mandatory Binding Arbitration with the following language:

"The parties will attempt first to resolve each and every dispute or claim, whether based in contract, tort, statute, fraud, misrepresentation or any other legal theory, whether pre-existing, present or future arising out of or relating to this Agreement ('Dispute') through good faith negotiations. Any Dispute that is not resolved within 180 days, or any other period of time that the parties may agree in writing, will be settled by final and binding arbitration by either party making a demand to the other for arbitration of the Dispute. Such demand must be made pursuant to the filing procedures of the American Arbitration Association ('AAA') for the arbitration of commercial disputes."

DISPARATE BARGAINING POWER

It has been suggested by opponents that S. 1020 is unnecessary because there is no longer disparate bargaining power between manufacturers and dealers—and cite for you the existence of large publicly-held dealer companies, mega-dealers etc. There are, of course, a few of these. But it is the vast majority of independent dealers who need the relief granted by the passage of S. 1020.

Texas is a fairly populous state with approximately eighteen million people. Many other jurisdiction represented here today are far less populous, but I believe that the Texas numbers will be helpful in revealing the relative size and resources of the dealer body. In Texas, we have a count of about 1500 franchised dealers. Of these, 184 are in towns of fewer than 5,000; 238 in towns of 5,000 to 15,000; 246 in towns of 15,000 to 50,000; 294 in towns of 50,000 to 250,000; and 352 in cities of 250,000 plus. The vast majority of dealers reside and do business in the small and medium size towns. These are not mega-dealers, but rather are small, sole proprietor or family-owned businesses.

Are these dealers in these small and medium sized cities important? They're important to their employees and the communities they serve—and they should be important to the manufacturers. In 1996, 23% of the vehicles sold by General Motors in Texas were sold in towns of not more than 15,000 population. If you add the towns of not more than 50,000 population, it's 41%.

These dealers, many of whom have received "stay-with-you" letters from their manufacturers, represent the vast majority of the dealers across the nation affected by S. 1020. The so-called "stay-with-you" letters told the dealer that he or she could continue to operate the dealership, but that in the event of the dealer's death or attempt to sell the dealership, it (the dealership) would be declared non-viable.

SUMMARY

From the foregoing, the following may be concluded:

(1) The franchise agreement that exists between a motor vehicle manufacturer, importer, or distributor and its franchise dealers is not a negotiated agreement; it is a classic contract of adhesion, presented to the dealer on a "take it or leave it" basis;

(2) historically and currently, the agreement offered by a manufacturer, importer, or distributor of motor vehicles to its franchised dealers is inherently unfair and inequitable;

(3) every state except one has a regulatory scheme in place to bring equity to this inherently inequitable relationship;

(4) an arbitration clause in a contract is enforceable on its face, regardless of the existence of state law or regulation to the contrary;

(5) although an arbitration panel may attempt to understand and enforce the terms of a state regulatory scheme, nothing requires it to do so, it has no ability to enter injunctive relief, and there is no appeal if the panel misapplies or ignores state or federal law; and

(6) by placing an arbitration clause in this "take it or leave it" contract, the stronger party may impose mandatory binding arbitration on an unwitting or unwilling dealer and circumvent state and federal law designed specifically to regulate the relationship that is the subject of the agreement.

Thus is the problem S. 1020 addresses the problem in a straightforward and simple way. Under the terms of S. 1020, an arbitration clause may properly be included in a Motor Vehicle Franchise Contract. However, the potential for abuse of such a clause in a non-negotiated contract has been eliminated by Subsection (b) of the new Section 17 that S. 1020 would add to the Federal Arbitration Act. That provision expressly provides that, "Whenever a motor vehicle franchise contract provides for the use of arbitration to resolve a controversy arising out of or relating to the contract, each party to the contract shall have the option, after the controversy arises and before both parties commence an arbitration proceeding, to reject arbitration as the means of settling the controversy. Any such rejection shall be in writing."

Thus, S. 1020 will remove the potential of these contracts to deprive persons of statutory rights and remedies without doing violence to the public policy interest served in encouraging arbitration as a means of dispute resolution. S. 1020 simply makes a arbitration voluntary. It solves the problems it addresses.

Senator FEINGOLD. Thank you for that, Mr. Fondren.

It is my understanding we have already heard from Mr. Holcomb. Then we look forward to the comments of Mr. Shack. Go ahead.

STATEMENT OF WILLIAM SHACK

Mr. SHACK. Senator Feingold and members of the subcommittee, my name is William Shack, and I commend you for holding this hearing and appreciate the opportunity to explain why Congress should pass S. 1020 as soon as possible.

I speak to you from a different perspective because I was a Saturn retailer, and we feel that we are victims at this point. I am currently a Honda dealer in Las Vegas and Henderson, Nevada. I am a member and founder of the National Association of Minority Auto Dealers, representing over 600 minority dealers. I have been a franchise automobile dealer since 1977, and over the years I have owned several different automobile dealerships with many different manufacturers.

In many ways, I have lived the American dream because through hard work and determination I built a successful business. We have traveled here today, however, to discuss events that occurred between 1989 and 1995 when my partner, Timothy Woods, and I were seeking a Saturn dealership. After much time and substantial financial investment, Saturn unilaterally terminated our agreement, contrary to our wishes. Our dispute was resolved by mandatory binding arbitration. We attempted remedy through the State's Motor Vehicle Board and through State court, but we were rejected because of the Arbitration Act.

There is one important limitation to my testimony today. As part of our settlement from the arbitration case, my partner and I had to agree not to publicize certain aspects of the dispute and negotiation.

Senator FEINGOLD. I am sorry. I am going to have to interrupt you in the middle. I have to go vote now, and I have two votes in a row, but they are 10-minute votes. So it will be quicker, and when the chairman gets back, we will continue with your comments.

I apologize. We will go in recess.

[Recess 2:34 p.m. to 2:39 p.m.]

Senator GRASSLEY [presiding]. We will continue where Mr. Shack left off.

Mr. SHACK. We have traveled here today, however, to discuss events that occurred between 1989 and 1995, when my partner, Timothy Woods, and I were seeking a Saturn dealership. After much time and substantial financial investment, Saturn unilaterally terminated our agreement. Contrary to our wishes, our dispute was resolved by mandatory binding arbitration. We attempted remedy through the Motor Vehicle Board and through State courts, but we were rejected because of the Arbitration Act.

There is one important limitation to my testimony today. As part of our settlement from the arbitration case, my partner and I had to agree not to publicize certain aspects of the dispute and negotiations. I am confident that my written testimony and oral testimony are consistent with our obligation under that confidentiality agreement.

But the very fact that we cannot tell our complete story highlights one of the oppressive aspects of this type of case. If we had been permitted to exercise our rights under State law, there would have been a public record of the proceedings.

The terms of the dealer agreement severely restrict the opportunity to present our case under California law. The forum for addressing this type of dispute is the California Motor Vehicle Board and governing laws would be California law. We could not rely on that law.

With the arbitration panel's characterization of their decision as a victory for us, we were awarded only $66,000, plus reimbursements of a franchise fee in an amount not to exceed $25,000.

This amount was grossly unfair. Our total investment at that time exceeded $400,000. We suffered other financial losses because of Saturn's termination. We could not use a $1.2 million sales tax subsidy which would have helped offset the cost of our property. Also, if our Saturn dealership had become operational, we believe that the franchise itself, not including the real property, would have been worth at least $3 million. As you can see, Saturn's termination cost us several million dollars.

We had no opportunity to negotiate any material terms of the dealer agreement. As potential franchisees, we had no opportunity at all. We reject categorically—again, we reject categorically the idea that we voluntarily agreed to submit to mandatory binding arbitration or that Saturn dealers somehow have agreed to this procedure on our behalf.

The truth is simple. Every franchise application or renewal is a "take it or leave it" transaction.

The fact that the manufacturers are fighting so hard to retain their ability to compel dealers to relinquish their rights under State law is within itself very telling. It is understandable that they would like to be able to take a dealer's franchise—his livelihood—without adequate or fair compensation and that they have also found a method of doing so through forced arbitration.

This problem is a ticking time bomb. Every car or truck dealer that has signed a franchise agreement with mandatory binding arbitration clauses could be subjected to the same treatment that we received. Since manufacturers can unilaterally amend a franchise agreement by merely mailing to the dealer an addendum to the agreement, a manufacturer can insert these clauses in existing franchises at any time. Nothing prevents the manufacturer from circumventing State law through these types of clauses. That is why the enactment of S. 1020 is so critical. The bill is necessary to restore fundamental fairness.

Again, there is nothing fair about the process. We are not able to really tell the true story. We also risk the wrath of General Motors and Saturn in doing so. We welcome that because finally maybe we will get an opportunity to deal with this in an open forum.

Thank you for your time, and we look forward to your questions. Thank you.

[The prepared statement of Mr. Shack follows:]

PREPARED STATEMENT OF WILLIAM SHACK

EXECUTIVE SUMMARY

My name is William Shack, and I have been a franchised automobile dealer since 1977 and am a member of the National Association of Minority Automobile Dealers. Between 1989 and 1995, my partner and I sought a Saturn dealership. After a substantial financial investment, Saturn unilaterally terminated our dealer agreement and forced us into mandatory binding arbitration. The arbitration panel's award was grossly unfair and inadequate when considering our total acquisition-related expenses, all incurred to comply with Saturn's terms and conditions.

As a result of the mandatory and binding arbitration clause unilaterally inserted in the franchise contract by the manufacturer, we never received a fair hearing on the merits, even though we appealed our case all the way to the U.S. Supreme Court. It is my understanding that only Congress can provide dealers relief from the system that we had to deal with. Federal legislation, like S. 1020, which gives parties to motor vehicle franchise contract a choice to accept arbitration after a dispute arises, is the only remedy available to protect auto and truck dealers from the imposition of mandatory binding arbitration, a process which denies dealers of important state procedural and substantive protections.

As potential franchisees, we had no opportunity to negotiate any material terms in the Dealer Agreement. We reject categorically the idea that we "voluntarily" agreed to submit to mandatory binding arbitration or that Saturn dealers somehow have agreed to this procedure on our behalf. The truth is simple—every franchise application or renewal is a "take it or leave it" transaction.

The administration of Saturn's mandatory binding arbitration process is fundamentally unfair. All of the decision makers in the process have economic ties to Saturn. Under the mandatory binding arbitration that I was subjected to, I had no state remedies, no right to a hearing on the record, no right to an unbiased decision maker, and no real right to an appeal. I was forced to forfeit these fundamental protections—all available under state law—when I signed an agreement drafted by the manufacturer containing a mandatory binding arbitration clause.

With the overwhelming leverage that the manufacturers enjoy, mandatory binding arbitration serves only one purpose—to strengthen the manufacturer and weaken the dealer. Every car or truck dealer that has entered into a franchise agreement with a mandatory binding arbitration clause could be subjected to the same treatment that I received. Also, nothing under current law prevents a manufacturer from unilaterally inserting these clauses in existing franchise agreements at any time. As a result, the manufacturers have the complete freedom to circumvent the law of every state in the country. That is why Congress should enact S. 1020. Balance and fairness must be restored.

Chairman Grassley and Members of the Subcommitte, my name is William Shack. I commend you for holding this hearing and appreciate the opportunity to explain why Congress should pass S. 1020 as soon as possible. At the conclusion of this hearing, I hope that you will agree that the use of mandatory arbitration clauses in automobile sales and service agreements is inherently unfair.

I am currently a Honda Dealer in Las Vegas, Nevada and a member of the National Association of Minority Automobile Dealers. I have been a franchised automobile dealer since 1977, and over the years I have owned several different dealerships. In many ways I have lived the American Dream, because through hard work and determination I have built a successful business.

I have traveled here today, however, to discuss events that occurred between 1989 and 1995, when my partner, Mr. Timothy L. Woods, and I were seeking a Saturn dealership. After much time and substantial financial investment, our effort to finalize plans for a Saturn dealership ended with a dispute that, contrary to our wishes, was resolved by mandatory binding arbitration. That dispute drove home to us in a drastic fashion just how one-sided the mandatory binding arbitration process can be for dealers. We were surprised to learn that, despite the great system of justice that we have in this country, we could be deprived of the basic right to an impartial decision on the merits of our case. That is a grave injustice.

There is one important limitation to my testimony today. As part of our settlement from the arbitration case, my partner and I had to agree not to publicize certain aspects of the dispute and negotiations. I am confident that my written statement and oral testimony are consistent with our obligations under that confidentiality agreement, but the very fact that we cannot tell our complete story highlights one of the oppressive aspects of this type of case. If we had been permitted to exercise our rights under state law, there would have been a public record of the proceeding.

A few comments about Saturn are necessary to put our case in the proper context. General Motors established Saturn purportedly to create a new way of doing business. As part of that effort, the Saturn franchise agreement included a mandatory binding arbitration clause. While Saturn likes to characterize the clause as "supported by the dealers," the clause was a non-negotiable condition to becoming a franchised Saturn dealer.

Now, I would like to turn to our specific case. On September 9, 1989 my partner Mr. Woods signed a Dealer Agreement with Saturn, which originally called for a dealership in Montclair, California. This contract set forth what we needed to do to obtain a dealership. If Saturn had not terminated this agreement, this contract would also have controlled how we operated the dealership.

To comply with the terms and conditions of the agreement, we took the steps necessary to acquire the land and develop the site for use as an automobile dealership. After completing a six-month study (that we paid for), Saturn agreed that two dealerships were warranted—one in Ontario and one in Pomona. Next, we identified property in Ontario and started the acquisition process, but Saturn decided that the first dealership should be in Pomona. Although the city of Pomona had offered us five acres of land free of charge, we identified several problems with the location and resisted the decision that Pomona be the site of the dealership. After we requested mediation on the location decision, Saturn agreed with our assessment, and it was decided that the location of the first dealership should be in Chino. Although the Chino site cost approximately $4 million, we simply wanted the best location for the Saturn franchise. We then finalized negotiations with the City of Chino to obtain a sales tax subsidy of $1.2 million.

During the negotiations for the property in Chino, Saturn became very impatient and imposed new cut off dates. By 1993, we had secured the land, received economic development support, finalized the physical plans and were arranging financing. We sought a loan from General Motors Acceptance Corporation, which is a wholly-owned subsidiary of GM. The loan package was complete, pending an appraisal. An appraiser, recommended by GMAC, delayed sending the final report. Even so, the appraised amount was higher than expected and the loan was eventually approved. However, because of the delay in the appraisal, the loan documentation was not completed within Saturn's deadline.

Saturn's final deadline was August 2, 1993, and we were supposed to have financing and break ground on the Chino facility by that date. Saturn refused to recognize the financing approval that we had in hand, because of the late appraisal. Therefore, on August 11, 1993, Saturn terminated the Dealer Agreement. On September 15, 1993, Saturn rescinded the termination for the Chino location, but restated its termination of the Ontario location. On September 21, 1993 we offered an alternative that would have allowed us to maintain the Ontario location based on very strict guidelines. Saturn rejected that proposal on September 29 and terminated our agreement for both locations.

To protect our investment we challenged Saturn's termination. The terms of the Dealer Agreement, however, severely restricted the opportunity to present our case.

Under California law, the forum for addressing this type of dispute is the California Motor Vehicle Board and the governing law would be California law. We could not rely on state law, however, because Saturn's contract mandated that the Federal Arbitration Act (FAA) would govern disputes arising under the franchise agreement. The dispute resolution process as set forth in our "take it or leave it" contract consisted first of mediation and then mandatory binding arbitration. The mediation ended with the panel recommending that Saturn agree to an equitable settlement with us. Saturn rejected that idea, and arbitration was scheduled.

We challenged the arbitration procedure in state court in California on April 5, 1994. We alleged breach of contract and asked for an injunction to prevent the arbitration from proceeding. Saturn removed the case to Federal court the next day, and we agreed to delay the Federal case pending the outcome of the arbitration. We conducted the arbitration on April 7 and 8, and the panel issued a decision on April 9, 1994. While the arbitration panel characterized their decision as a victory for us, we were awarded only $66,754, plus a reimbursement of franchise fees in an amount not to exceed $25,000.

This amount was grossly unfair. Our out-of-pocket expenses alone were far in excess of the arbitrator's award. Our total investment in acquisition related expenses, all incurred to comply with Saturn's terms and conditions, exceeded $400,000. We suffered other financial losses because of Saturn's termination. We could not use the $1.2 million sales tax subsidy that would have helped offset the cost of the property. Also, if our Saturn dealership had become operational, we believe that the franchise itself, not including the real property, would have been worth $3 million. As you can see, Saturn's termination cost us several million dollars.

One of the beauties of mandatory binding arbitration from the manufacturer's perspective is the very limited right that a dealer has to appeal the decision. We challenged the arbitrator's decision in Federal court, and all the way to the United States Supreme Court. The legal fees associated with this challenge were substantial. We undertook this fight to address the abuses that occurred as the result of having been forced to relinquish both procedural and substantive rights under state law. We are here today because only Congress can provide dealers relief from the system that we had to deal with. Federal legislation, like S. 1020, is the only remedy available to auto and truck dealers faced with mandatory binding arbitration.

We had no opportunity to negotiate any material terms in the Dealer Agreement. Our discussions could not be called negotiations. This was a "take it or leave it" transaction. If there had been an attempt to delete the mandatory binding arbitration clause from our contract, we have no doubt that Saturn would have terminated all discussions immediately. There were actually only two options: sign the agreement that forces you to give up your statutory rights; or walk away from the deal.

Moreover, we want to reject the argument that Saturn dealers somehow have agreed to this procedure through a negotiation. This procedure originated during discussions with approximately 16 individuals, all hand picked by GM to discuss the formation of Saturn. There were no Saturn dealers at the time. Based on the limited input from these individuals, Saturn inserted the mandatory binding arbitration clause as a standard provision in the franchise agreement.

Aside from the fundamental unfairness of forced arbitration, the administration of Saturn's mandatory binding arbitration is clearly not a model of fairness. All of the people involved in the actual decision making or the administration of the mandatory binding arbitration procedure owe their economic well being to Saturn. Saturn's process involves a panel of two Saturn dealers and two Saturn employees. These four individuals are selected by Saturn from a pool which includes 10 Saturn employees and 10 Saturn dealers. The process also includes an administrative officer, who is under contract to Saturn. The administrative officer rules on discovery motions and "for cause" challenges to panel membership and advises the panel on questions of law.

The imposition of mandatory binding arbitration will almost always be to the detriment of the dealer. It forces the dealer to forfeit important protections under state law for the uncertain outcome of arbitration. This is truly a one-way street. All arbitration awards are binding and awards may not be appealed absent fraud and collusion. We suffered extreme hardship and are absolutely convinced that we lost hundreds of thousands of dollars as a result of being forced into arbitration. We are passionately opposed to this procedure because it was, and continues to be, so inherently biased against the dealer.

This is not to say that I am totally opposed to arbitration. In fact, under the right circumstances, and if I thought the process would be fair, I would agree to this form of dispute resolution. First, it would depend on the nature of the dispute. Also, I would never choose mandatory binding arbitration when there is any hint of the bias so evident in Saturn's process. And certainly, I would never choose arbitration in a situation where the manufacturer is trying to terminate my very right to continue operating my business and the arbiters are hand picked by the manufacturers.

The fact that the manufacturers are fighting so hard to retain their ability to compel dealers to relinquish their rights under state law is in itself very telling. It is understandable that they would like to be able to take a dealer's franchise—his livelihood—without adequate and fair compensation, and they have found a method of doing this through forced arbitration.

I understand that the manufacturers are able to engage in this unfairness because of the Federal Arbitration Act which the courts have held prevents states from stopping this type of abuse. I believe that a number of states have enacted laws which prohibit this practice and other states even have constitutional provisions that protect a citizen's right to go to court. Unfortunately, this Federal law makes such state laws unenforceable. The reason we are here is to try and correct the inequity that allows manufacturers to circumvent protections of state law. I am sure Congress never intended this result in the first place.

This problem is a ticking time bomb. Every car or truck dealer that has signed a franchise agreement with a mandatory binding arbitration clause could be subjected to the same treatment that we received. Since a manufacturer can unilaterally amend a franchise agreement by merely mailing to the dealer an addendum to the agreement, a manufacturer can insert these clauses in existing franchises at any time. Nothing prevents the manufacturers from circumventing state law through these types of clauses. That is why the enactment of S. 1020 is so critical. The bill is necessary to restore fundamental fairness.

Thank you for your time and I look forward to your questions.

Senator GRASSLEY. Thank you very much, and before you go ahead, all of your testimony will be printed in the record as written. I didn't make that clear, but I wanted to say that. Regardless of how short your testimony might be, your entire statement will be in the record.

Ms. Lajdziaka.

STATEMENT OF JILL LAJDZIAK

Ms. LAJDZIAK. Thank you. Good afternoon, Chairman Grassley. My name is Jill Lajdziak, and I am president of Saturn Distribution Corporation and vice president of Sales, Service and Marketing for Saturn Corporation. I want to thank you for the opportunity to testify today on the importance of mandatory binding arbitration clauses in franchise agreements between Saturn and its 227 Saturn retailers. And I also want to state right up front that Saturn opposes S. 1020, the Motor Vehicle Franchise Contract Arbitration Fairness Act.

I want to spend a minute and talk a little bit about Saturn and what we tried to create when we entered the industry in the mid-1980's. From the very beginning, we recognized that there was a different way to do business, and that was in collaboration with retailers and involved retailers in decisions that affect them. We wanted to have joint decisionmaking. Even before we knew what kind of car we were going to produce, we pulled 15 retailers together. They have been referred to in my document and in my testimony, my written testimony, at the MPT. They represented over 50 different franchises. Many of them have sat on State associations and boards.

Now, contrary to how they have been portrayed, they have been and were and still are highly successful business people. Some are Saturn retailers. Some chose not to become Saturn retailers. We sought their input on how we could make change in the industry, and they gave willingly of their time to think through how we should do business in the future. And I might add that two of them were lawyers.

The House Judiciary Committee recently had a meeting with dealers. Hank Faulkner was one retailer that testified in that session just a few short weeks ago. He is also a lawyer by profession. And his comment, to remind everybody, was that he really wanted fellow Saturn retailers to make judgment on issues; and, secondly, because we were going to have joint decisionmaking within the Saturn family on items that affect the network that arbitration—mandatory arbitration was the right thing to do, that we should solve problems within the family.

The development of Saturn's franchise agreement by the MPT is probably the best example of Saturn's collaborative approach with its retailers. The team wrote the agreement, draft by draft, word by word. They took red pens and rewrote it. The result is a document that focuses on working together towards common goals.

The agreement developed by this team has three key pillars: joint decisionmaking, joint business planning, and joint dispute resolution.

To ensure that Saturn continues to work in partnership with retailers and receive meaningful input, mechanisms were put in place to ensure that the network would continue to be guided by retailers, and that governing body of the network is known at the FOT. It exists today, and they look at the agreement as necessary, and it is rewritten every 5 years.

The franchise operations team is the main decisionmaking body for Saturn and the retail partnership. It is combined of eight Saturn retailers and eight Saturn leaders. With the FOT, Saturn retailers are represented in all major decisions that affect their business. The primary focus is on anything that touches the retail network.

The MPT felt that it was absolutely critical to take a collaborative approach in resolving any disputes between Saturn and the retailers. It was the consensus opinion of that group—and it has been further endorsed by the FOT over the past few years—that it was in the mutual best interest to solve our problems jointly rather than resort to litigation that could jeopardize a long-term relationship. Our relationship is based on the covenantal agreement.

The group also concluded that it was essential for the entire retail body to operate under the same agreement so that there was consistency. Consistency ultimately leads to doing what is right for the consumer in the marketplace.

It was with this background that the team developed Saturn's mediation and arbitration process. Further, it was the very strong belief that disputes should be solved within the family. It was so strongly felt that retailers and Saturn brought this position to NADA to explain why mandatory arbitration we believed was a right thing for the Saturn retailer agreement. And because of our joint decisionmaking and because of the retailers' positioning it, as this is what they wanted to do and it was the recommendation of the retailers, NADA at the time did not oppose the provision.

Now I would like to briefly describe how the process works. The process being with either Saturn or a dealer filing a request for mediation. The dispute is then forwarded to the mediation panel, which is required to recommend a consensus decisionmaking, like all decisions are made within Saturn. If either party rejects the mediated solution or if both parties choose to waive mediation, they may proceed to binding arbitration. The arbitration process provides for document discovery and a hearing. And the hearing is designed to fully air the dispute so that the arbitration panel can make a very informed and fair decision. The decision of the arbitration panel is final and unappealable, except as otherwise provided by the Federal Arbitration Act.

The mediation and the arbitration panels are comprised of two dealers and two Saturn representatives. These panelists are selected by a consensus decision of the retailers who sit on the FOT from a pool of dealers who have expressed interest and of company representatives. The panelists are trained by Endisputes, which moderates the process as well. The dispute resolution process provides for the removal of prospective panel members peremptorily or for cause. These safeguards were designed to eliminate not just the existence but also the appearance of partiality.

In the nearly 10 years since our inception, the process has been invoked only five times. Two matters were solved at mediation, one was solved after mediation, and the fourth was heard initially at the arbitration step and upheld by the Federal district court, and the final matter was withdrawn after mediation.

In conclusion, our dispute resolution process was born of the unique relationship between those that created the company—retailers and Saturn—and their desire to have problems solved within the family. The dispute resolution process falls in the oversight of the FOT, which includes, as I mentioned, retailers, and to date, that body has not asked for that provision to be changed.

Under these circumstances, the Saturn management and the retail body, as represented by the Franchise Operations Team, do not understand why Congress would take a step contemplated in this bill—to effectively eliminate an important tool in the approach that Saturn retailers have agreed to in managing disputes.

We have achieved many things since we have entered the marketplace in the mid-1980's. We set out as a company to do business a different way, and that was in cooperation with our retailers in a relationship where we would have joint decisionmaking.

I believe it is a single reason why we are successful today as a company, and that is the relationship that we have with our retailers and the decisionmaking that they have with us in anything that affects the retailer network. This bill has the potential to destroy what has been created.

Thank you.

Senator GRASSLEY. Thank you, Ms. Lajdziak.

Ms. MacDonald.

STATEMENT OF JILL N. MacDONALD

Ms. MACDONALD. Thank you, Mr. Chairman and Senator Feingold. My name is Jill MacDonald. I am here today representing the Alliance of Auto Manufacturers. Our members include BMW, Daimler-Chrysler, Fiat, Ford, General Motors, Isuzu, Mazda, Nissan, Toyota, VW, and Volvo.

Prior to my association with the alliance, I was an attorney at Ford Motor Company for 18 years, the past 14 as counsel to the sales operations.

I appreciate the opportunity to share the alliance members' views on the utility of alternative dispute resolution as well as to explain our opposition to Senate bill 1020.

Manufacturers do not view mandatory binding arbitration as an opportunity to take advantage of their dealers. Their very success depends on having a strong, profitable dealer network. It is counterintuitive for the manufacturers to want to harm and take actions to harm their dealers.

Currently, the manufacturers win the vast majority of cases in which they litigate with their dealers. We are not seeking to tip the scales in the manufacturers' favor through arbitration, but we need prompt resolution of disputes. The cost of delay in the court process often exceeds the cost of the litigation to the manufacturers.

Almost all manufacturers offer some form of dispute resolution to their dealers through their sales and service agreements. Less than 7 percent have mandatory binding arbitration, and these are not imposed. Daimler-Chrysler offers their dealers at the inception of the relationship the opportunity to either adopt mandatory binding arbitration or not. As the witness that preceded me indicated, Saturn's dispute resolution process, which dealers agree to at the inception of their relationship, is part of their philosophy of doing business, of shared decisionmaking as well as shared dispute resolution.

These are fair processes. Arbitration programs are required to satisfy due process concerns. Arbitration rules are specifically designed to protect all parties, provide for necessary discovery, and are fair to both sides.

Mandatory binding arbitration has become the preferred way of resolving commercial disputes, and there are good reasons for that. It promotes and expedites resolution of disputes. It promotes harmonious resolution of disputes, preserving relationships, and this is perhaps a key reason why it is an important thing. It ends up with a fair decision, not necessarily a winner and a loser.

It also provides certainty of forum in which you are going to resolve disputes. It is more cost-efficient, eliminates bias, and provides finality.

Resort to courts or State agencies do not result in prompt resolution of disputes. The Texas Motor Vehicle Commission can take a year to issue a decision after the hearing is completed, and that is before you have process of appeals. In Virginia, while the administrative decision may be issued in less than a year, appeals can stretch the time for final decision out for many years.

Arbitration by manufacturers is not being pursued to avoid State law. In fact, Iowa, Arizona, New York, South Carolina, and Texas, to name a few, require the application of their State law in arbitration proceedings. Nor is mandatory arbitration being imposed on dealers with existing agreements. In fact, it simply could not be imposed without the dealer's voluntary agreement, or it would be unenforceable in the courts.

Moreover, modification of existing sales and service agreements can be challenged in most States. In Wisconsin, for example, a manufacturer may not modify an existing agreement which substantially and adversely affects the dealership's rights, obligations, investment, return on investment, without notice to the dealer and opportunity to protect and a showing of good cause by the manufacturer for the modification.

Dealers themselves are using mandatory binding arbitration in their relationships with their customers. In Alabama, the dealers there use binding arbitration in their contracts with their customers in a way to help preserve their dealerships from an avaricious trial bar in that State. Legislation is pending there, which the Dealer Association opposes, that would prohibit mandatory binding arbitration in certain contracts. If passed, is this the next group that will come before Congress seeking a similar exception that the automobile and truck dealers are currently seeking through Senate bill 1020?

We firmly believe there is simply no justification for departing from longstanding policy to encourage arbitration for commercial disputes, relieving courts of congestion and saving precious State resources with a proscriptive ban on the use of mandatory binding arbitration in the automobile industry.

I will be happy to answer questions that the committee may have for me.

[The prepared statement of Ms. MacDonald follows:]

PREPARED STATEMENT OF JILL N. MACDONALD

INTRODUCTION

Good Afternoon Chairman Grassley and Members of the Subcommittee. I'm Jill MacDonald, representing the Alliance of Automobile Manufacturers ("Alliance").[1] The members of the Alliance include BMW Group, DaimlerChrysler Corporation, Fiat Auto S.p.A., Ford Motor Company, General Motors Corporation, Isuzu Motors America, Inc., Mazda North American Operations, Nissan North America, Inc., Toyota Motor North America, Inc., Volkswagen of America, Inc., and Volvo Cars of North America, Inc. I am pleased to have the opportunity to appear before you today to testify on behalf of the Alliance regarding S. 1020, the "Motor Vehicle Franchise Contract Arbitration Fairness Act of 1999."

Federal Arbitration Act

The Federal Arbitration Act (FAA) was passed in 1947 to promote alternatives to the delays, complexities and costs of litigation. Time and again, courts and Congress have affirmed the validity and wisdom of that legislation, which has effectively and efficiently resolved disputes between business entities, lessening the strain on our courts.

Mandatory binding arbitration has become the preferred way of resolving commercial disputes for the following reasons:

It expedites settlement of disputes;
It promotes harmonious resolution of disputes preserving relationships;
It provides certainty of forum for resolving disputes;
It is more cost efficient;
It eliminates biased results; and
It provides finality.

Automobile manufacturers want a good working relationship with their dealers and resolving disputes without litigation certainly strengthens that relationship. In this very competitive industry, it is also important to resolve any disputes in a timely and cost efficient way. Therefore, many manufacturers have a procedure for resolving disputes and a few companies use mandatory binding arbitration.

The Alliance fully supports maintaining the FAA as currently written. The rationale for passing the Act in 1947 has not changed. In fact with the demands on our

[1] Alliance members are 11 car and light truck manufacturers representing more than 90% of U.S. vehicle sales. Alliance member companies have approximately 600,000 employees in the United States, with more than 250 facilities in 35 states.

courts today, it is even more important to preserve alternative dispute resolution, including mandatory binding arbitration. Dealers and manufacturers who participate in alternative dispute resolution mechanisms have been satisfied with the process. Therefore, the Alliance sees no basis for Congress to single out the automobile industry with a proscriptive ban on the use of mandatory binding arbitration.

S. 1020: A solution in search of a problem

Motor vehicle franchise agreements are, in general, national agreements, with standard terms and conditions, which have been negotiated between each manufacturer and representatives of their dealers. They define the working relationship between the dealers and the manufacturer and enhance product distribution. While mandatory arbitration clauses are not extensively included in manufacturer/dealer contracts, they provide a useful approach to resolving disputes.

There is no evidence at all to suggest that these clauses are unfair or have have been abused, and there is no reasonable justification to prevent their use in motor vehicle dealer agreements. When these provisions are used, they are generally included after there is agreement to include them by both—the dealer and manufacturer. In fact, in one instance the clause was included at the specific request of the dealers. They encourage the parties to talk and attempt to resolve issues in advance. They were designed to encourage a better working relationship between the parties, rather than encouraging litigation.

Attachment 1 is a current chart showing the limited number of franchise agreements with mandatory binding arbitration clauses (MBACs). The chart shows that of the 27,274 dealers only 1,891 have MBAC in their franchise agreements. Of the 1,891 dealers that have MBAC, 1,572 of the dealers (DaimlerChrysler and Saturn dealers) either opted to have MBAC in their franchise agreement or supported the inclusion of MBAC during the founding of the company.

S. 1020 would ban the enforcement of MBACs in dealer franchise agreements if either party objects. This legislation for some reason solely applies to motor vehicle manufacturers and dealers. This is particularly ironic given the fact that a growing number of businesses including auto dealers are using MBACs with their customers. If arbitration is an appropriate forum for automobile dealers (many of which are multimillion/billion dollar corporations) to resolve disputes with ordinary citizens and other small businesses, then it is equally appropriate as a means of resolving disputes with their manufacturers. There is simply no reason for Congress to carve out an exemption for a specified class and as a result to interfere with existing agreements and potentially prohibit parties from pursuing or being protected by their established rights under the terms of these contracts.

Proponents of S. 1020 argue that MBAC allows manufacturers to circumvent laws specifically enacted to safeguard small business dealers from unfair automobile manufacturer practices. This is simply not the case. Arbitration is a fair process for resolving disputes and maintaining business relationships. Moreover, state law is just as likely to be applied by arbitrator as it is by the state and federal courts. Some states including Wisconsin and Texas, specifically require that state law be applied in arbitration.

Constantly changing competitive industry

The automobile industry has changed dramatically in last few years. Manufacturers are very competitive and constantly looking for market-based, cost-effective solutions. Most dealers are sophisticated businesses which now include large public companies openly traded on the stock exchanges. The future of the industry will undoubtedly involve further dramatic changes.

Legislation like S. 1020 would have serious implications for the future use of arbitration as well as on the judicial system. It would weaken arbitration as an effective means of resolving disputes between motor vehicle manufacturers and dealers. And it will not make those disputes between motor vehicle manufacturers and dealers. And it will not make those disputes disappear; instead, they will be pushed into courts and state agencies. And, passage of this bill would also encourage other special interest groups to seek special treatment at a time when court dockets are becoming more congested and judges are overworked.

In light of federal preference for arbitration, and in the absence of any indication of abuse, precluding mandatory binding arbitration clauses in business-to-business contracts is unwarranted. The FAA has worked effectively for 40 years and this remedy for dispute resolution should continue to be a viable tool for the future.

Attachment 1

NUMBER OF FRANCHISE AGGREEMENTS WITH *MANDATORY BINDING ARBITRATION CLAUSE (MBAC)**

MANUFACTURER**	APPROX. # OF DEALERS	DEALERS WITH MBAC	NOTE
DaimlerChrysler	4435	Approximately 1336	Dealer option at time of agreement except in Alabama.
Ford	4958	5	
General Motors	7753	0	
Saturn	236	236	
Honda and Acura	1254	4	
Suzuki	285	285	
BMW	337	0	
Ferrari	29	29	
Hyundai	483	0	
Isuzu	567	0	
Kia	441	0	
Land Rover	118	0	
Mazda	763	0	
Mercedes-Benz	316	0	
Mitsubishi	495	0	
Nissan/Infiniti	1230	0	
Porsche	194	0	
Rolls-Royce	36	0	
Subaru	603	0	
Toyota Lexus	1195 174	0 0	
Volkswagen Audi	567 258	0 0	
Volvo	332	0	
Saab	215	0	

* Excludes agreements with public companies

** Manufacturers listed include members of the Alliance of Automobile Manufacturers and the Association of International Automobile Manufacturers, Inc.

Senator GRASSLEY. Thank you.

Senator Feingold, I think we will go with 5-minute rounds, and I will start. I think I will start with Ms. MacDonald and Ms. Lajdziak. And, Mr. Fondren, you might want to listen to their answers because I might want you to respond.

Auto manufacturers argue that S. 1020 is unnecessary because most dealer franchise agreements do not contain mandatory arbitration and binding clauses. If that is the case, this legislation should have limited impact and, contrary to what some may argue, "interfere with few existing agreements." If most dealer franchise agreements don't contain these clauses, how would prohibiting their inclusion in these franchise agreements have any significant impact on existing agreements beyond those few that currently contain the clauses?

Ms. MACDONALD. Well, if I may, with respect to Saturn, it is 100 percent of their dealers; therefore, it is going to have a significant impact in the way that they currently do business and have chosen to do business, the same thing with respect to nearly half the Daimler-Chrysler dealers in the United States. So there are going to be significant impacts on those existing agreements.

We also don't think that down the road there should be an absolute foreclosure of the use of mandatory binding arbitration. Voluntary arbitration at the time the dispute arises is not likely to end up in the use of arbitration very often. So I think long term there is a concern, even though today you are correct, 93 percent of the agreements don't have it. But it is of significant importance. And, Jill, you may want to——

Ms. LAJDZIAK. Chairman Grassley, if I may make a comment, we really believe that it would change the relationship that we have with our retailers. When you know that you are going to solve problems within your family, you continue to work through to find win/win resolutions. And we believe such a change in our agreement changes the relationship with our retailers.

Senator GRASSLEY. The purpose of my question was that this was a statement that was made by manufacturers as we were doing preliminary work for this hearing. Mr. Fondren?

Mr. FONDREN. Mr. Chairman, I agree with the premise that if they are correct and there are not many covered and there is no intent to do so, certainly it would not have an impact on those that have not. It certainly would in the future—as you know from my testimony, sir, I think substantially more dealers are covered than as indicated by representatives of the manufacturers.

Consistently over the last several years, more and more manufacturers have invoked mandatory binding arbitration. Ms. MacDonald in her testimony pointed out that Wisconsin and Texas, for example, have laws that require the application of State law. Manufacturers in many instances have agreed to those laws, and yet are willing and able to avoid their circumstances and to circumvent those laws by mandatory binding arbitration.

The trend has been steadily on the part of manufacturers to add those to the agreements to deny the rights granted by States like Texas, Wisconsin, and other States throughout the country.

Senator GRASSLEY. Mr. Holcomb, do you believe that States should be allowed to fashion their own mechanisms of addressing alternative dispute resolution without a Federal mandate? And then, secondly—so I don't interrupt you—how well has the Virginia alternative dispute resolution process worked, especially in relationship to the Saturn dealerships?

Mr. HOLCOMB. Mr. Chairman, one thing that I learned when I was staff for the committee up here under Senator Thurmond, a strong believer in States' rights. Yes, sir, I believe that the States should be allowed to protect their citizens through promulgating of regulations and laws.

As I stated in my testimony, I think our system has worked tremendously well.

Senator GRASSLEY. You say that for Saturn, too, Saturn dealerships? Or don't you have a focus just on that segment?

Mr. HOLCOMB. Well, Mr. Chairman, we have no—we can't testify on the Saturn dealers because, since they have binding arbitration, their dealers cannot exercise the statutory rights given to other dealers in Virginia.

As I stated in my testimony, 46 dealers filed a complaint with us; only two of those—or eight of those led to hearings, and two of them led to circuit court. So the testimony that appeals can go on for years and years and years, I would state that the witness may want to check her facts a little bit better, because we have only had two appeals in 4 years.

Senator GRASSLEY. Back to Ms. Lajdziak and Ms. MacDonald, I hope that we can all kind of agree as a common-sense approach that arbitration is a very cost-effective way to resolve disputes. Why would providing a mechanism that allows each party to choose this clearly more efficient method after a dispute arises weaken arbitration? And if the advantages of arbitrating disputes between auto dealers and manufacturers over litigation are obvious and numerous, shouldn't these advantages be just as obvious after the dispute arises as before the dispute? And then, lastly, with the advantages of arbitration over litigation, why are auto manufacturers opposed to allowing a dealer to make a post-dispute choice between whether to arbitrate that dispute?

Then, Mr. Shack, you may want to listen and comment.

Ms. MACDONALD. If I can put this in the context, I think the concern with respect to permitting the choice of going to arbitration or using some other mechanism or go to court at the time the dispute arises sets up two things. First of all, there is never any clear understanding precisely what form you are going to resolve your disputes in or how you are going to do it.

Secondly, there may be a perception—and I think there frequently is a perception—that the State forum may be a friendlier place, in other words, may be more predisposed to the dealer's position than to the manufacturer's position. The reason why we have diversity laws, permit diversity in things to be moved to Federal court.

I can say from my experience at Ford Motor Company that with voluntary binding arbitration for termination cases in the Ford sales and service agreement that has existed since 1972, and over the last 28 years it has been selected by the dealers three times, I can categorically say we have had—Ford had more issues with dealers than three, and they ended up in State courts and before State agencies.

I think the fact of the matter is, if it is at the time that there may not be an understanding among a broad group of dealers that arbitration really does work in everybody's favor, and that it just would not be selected. I think that is a strong issue. And if it is not going to be utilized, then we are back to the same issue of crowded court dockets and delays, and that is particularly important because the State laws enjoin the manufacturer without any of the safeguards that you normally see when a mandatory injunction is issued until after the processes have been completed so that you may not be able to terminate a dealer who was engaged in some kind of consumer fraud for years and have to continue to do business with them.

But I would like to give Ms. Lajdziak an opportunity just to respond with respect to Saturn.

Ms. LAJDZIAK. With respect to Saturn, Chairman Grassley, it was the desire of Saturn and the retailers to have the bounds of our agreement applied consistently for all retailers. And mediation and binding arbitration consistently applied, it was the right thing to do, again, to solve problems within the family when all of the decisions were jointly made to begin with in the bounds of our agreement.

We also believe that it would jeopardize, if we went down another path, the long-term relationship that we have, and we want to stay focused on bringing quick resolve to our issues, to work very hard to bring resolve to them—if we can't, we would proceed to mediation and arbitration—but to bring resolve to issues because, at the end of the day what we want to do is continue to take care of the consumer in the best possible way in the marketplace. That is our end game, not being tied up in a court system.

Senator GRASSLEY. Mr. Shack, would you like to comment?

Mr. SHACK. I would like to comment on two of the—fortunately, I have been on both sides of it. I was a Ford dealer, Ms. MacDonald, for 22 years, and I have had the opportunity to be involved in the process. The difference is with the court system with Ford, there was a choice for me, and whenever I had a dispute, I was able to settle it.

With Saturn, there is no choice. You are forced into the binding arbitration. It is a "take it or leave it" deal, and once you are in, there is no further remedy.

What I am most concerned about with the Saturn agreement is that all of the people that are involved in the decisionmaking process have economic ties to Saturn. There are two Saturn employees. Well, their impartiality should be very obvious. Then there are two Saturn retailers that are hand-picked by them in a pool. If I am picking a pool, I am certainly not going to pick anyone that is going to be contrary to my wishes as a manufacturer.

And this family relationship thing that Ms. Lajdziak describes simply isn't so. Either you want to be a profitable Saturn dealer, you sign the agreement, or you don't. It is as simple as that. And most of the people that sign the agreement chose to do so on that basis. And, again, there were no retailers when these agreements were put together. That was a select group of people put together to put an agreement together that really did not understand the effects of it. And Mr. Woods and I are the people that challenged it all the way through the system, so we know full well the inequities involved in the way that it is done.

Senator GRASSLEY. Thank you.

Senator Feingold.

Senator FEINGOLD. Thank you, Mr. Chairman.

Senator GRASSLEY. Did you get a chance to make your opening statement?

Senator FEINGOLD. I did, and I thanked you many times during that statement for holding this hearing. I sincerely believe that this is a great step forward on this issue, and I am grateful for your leadership on it. And this proves that we are not the same person because we are in the room at the same time at this point.

[Laughter.]

Let me first also thank all the witnesses. I think this is an ideal way to talk about this, to have the different sides here. And I would like to just make one quick comment on something Ms. MacDonald said. The fact that only three times since 1972 did the dealers voluntarily opt for arbitration is an awful strong testament to just what a big thing it is to give up that option. So I think that is something that could be interpreted either way.

But I would like to follow up on what both Ms. MacDonald and Ms. Lajdziak said about the problems of having a voluntary arbitration system. You mentioned issues of consistency, of being sure what the forum of procedure would be, I believe, and the time frame. Why couldn't all those issues be set forth in a voluntary arbitration mechanism in your agreements where all that is laid out, if you seek the arbitration approach, these are the rules, if you don't, you go to court? It seems to me that perhaps all of those concerns could be addressed in the context of voluntary arbitration.

Ms. LAJDZIAK. Again, Senator, if I may make a comment, we really believe that you are not going to work as hard to resolve your problems and it will ultimately change your relationship in your partnership, and that is why we have chosen—when you are creating the business together, when anything that affects the retail network is jointly made with Saturn retailers, then we think that you can solve the problems together, and you will work very hard to bring resolution to problems.

Senator FEINGOLD. Ms. MacDonald.

Ms. MACDONALD. Maybe I can answer that question best by talking about a process that we put together in the State of Wisconsin with working with the Wisconsin Auto Dealers Association, and that is, we came together a number of years ago and agreed on legislation that included a special Wisconsin arbitration plan, and we worked very hard at putting that together. And the ideal was to have dealers and the State manufacturer representatives be the arbiters and be trained to, in fact, pursue the arbitration.

Unfortunately, there has not been—it has not, even though it was decided by both parties, proved to be popular at the time that disputes arise. And as a consequence, there was a great deal of effort put forward, and it just has not been utilized. And I can't indicate to you any way, shape, or form why or why not, but I think that if these are all left to be voluntary, it is a situation in which they probably in the context of auto manufacturer relationships will not be used.

SENATOR FEINGOLD. Maybe Mr. Fondren would like to respond to these concerns.

MR. FONDREN. Senator, I think that one of the most significant problems underlying the attitudes that have been expressed is the fact that the agreements themselves are so one-sided, so skewed in favor of the manufacturer and against the dealer, provisions like automatic termination without notice at time of death, inability to sell or buy a dealership either to or by a qualified person, the right to unilaterally modify or change the agreement.

Certainly there is a law in Wisconsin and there is a law in Texas that prohibits that, but under mandatory binding arbitration, looking at the four corners of the agreement itself, which is what an arbitrator typically does, and if he is ordered by law to follow the law of Wisconsin or Texas, fine. But if he doesn't, there is no appeal.

Senator FEINGOLD. Fair enough. Let me switch gears and ask Mr. Fondren or Mr. Shack a question about some other aspects of this question. Today you have expressed your concerns about the mandatory arbitration clauses that are included in dealer franchise agreements. Do you include such clauses in your sales agreements with customers?

Mr. FONDREN. In Texas we do not. We very strongly encourage and urge our dealers not to do so.

Senator FEINGOLD. So would you agree that some of the same concerns that you express about these clauses would apply on the other side of the transaction, in car sales by dealers to consumers, and that sales contracts with consumers should not contain mandatory binding arbitration clauses?

Mr. FONDREN. I personally agree with that, sir. The National Automobile Dealers Association has adopted a resolution—not having all of the facts about all of the legislation we are talking about, but already in advance agreeing that they would not oppose legislation in other pre-dispute adhesion contracts. It is just wrong.

Senator FEINGOLD. Do you know how prevalent this practice is with regard to customers and dealers?

Mr. FONDREN. So far as I know, sir, it is limited. It does happen in some jurisdictions. I think the primary reason that it has developed in some areas is because of the fear and the immediacy of class action lawsuits over small claims, and I think that that has been the driving factor.

I know that in some employment contracts it is also included, but as a general rule throughout the United States, it is not a major factor. That doesn't mean it shouldn't be dealt with, but it is not a major factor in my opinion.

Senator FEINGOLD. Mr. Shack, any comments on that?

Mr. SHACK. Yes; in my dealership contracts, the answer is no. As it relates to my opinion of the relationship between the dealer and the customer, I think there should be choice in that matter where they are not forced into the same situation. So I would not seek a different remedy for my customers as I do for myself.

Senator FEINGOLD. I appreciate that answer very much from both of you because I think one of the themes of this entire hearing is that, generally speaking, mandatory arbitration agreements between parties with unequal economic power is just something we ought to get away from. And with that I see my time has expired.

Senator GRASSLEY. OK; Senator Session? And then if it is all right with my colleagues, I am going to go on to the second panel after Senator Sessions is done.

Senator SESSIONS. Mr. Chairman, I think Senator Feingold is raising a very important point. I think there is a place for arbitration clauses, and I think maybe the Federal law needs to be looked at some more to see whether it is appropriate—as a matter of fact, I have some serious reservations about the present state of Federal law, and I think it can be improved. It certainly is question—it is most questionable when you have uneven bargaining positions such as perhaps an illiterate car buyer and a car dealer. But most of these automobile dealerships now, some if not all, most, many are multi-million-dollar organizations that have high-paid attorneys when you entered into those contracts, and they want you and you want them, or you wouldn't make the deal, presumably. And I find it difficult to justify a special exemption for dealers.

Now, I know you can have some adverse bargaining position there. My father made the mistake, when I was in junior high school, of selling his country store and buying an International Harvester dealership in a small town. I was the parts man and worked in the shop and that kind of thing, every hour I had a chance to do that. But International Harvester decided to close all these small dealerships, and it was a bad time. It was not good. He did not have an economic equal footing. But I don't think he ever thought about suing anybody. If they didn't want him, then that was the way life was, I guess. And we took it and went on with our business.

But I would just say that I am real troubled about this, Mr. Chairman. I think we have got to go very carefully before we would do this rapidly. As a matter of fact, a number of automobile dealers in my State talked to me about it, and I said, Well, you are the same people that are asking me to protect you from plaintiff lawyers and that kind of thing, and now you want to sue the manufacturers.

And I have a letter here from Mr. Jerry Beasley, Alabama's most well-known trial lawyer, former lieutenant governor, one of the Nation's—ranked by Forbes as one of the top-earning lawyers in America. And he wrote in his newsletter recently that he calls the National Automobile Dealers special alert that encourages all dealers to support 1020 “mind-boggling.” He goes on to say that it is shocking that NADA opposes arbitration in Congress but has pushed binding arbitration down the throats of customers of these very dealers throughout the country.

Now, whether he is biased or not—and maybe that is not a totally accurate summation of it, but I do think we are in a situation in which I believe there is a place for arbitration. I find it less defensible when you are talking about an automobile dealer dealing with a manufacturer.

Does anybody want to comment on my comments?

Mr. FONDREN. I would first say, Senator, that Mr. Beasley is in error on two counts. The notion that the National Automobile Dealers Association—and they certainly can speak for themselves, but the notion they have crammed or even supported the inclusion of mandatory binding arbitration in consumer contracts is just an error. He is wrong.

Senator SESSIONS. Well, it is being done in a lot of States, don't you agree?

Mr. FONDREN. It is being done in Alabama, as I understand it. It is not done in many jurisdictions, in my opinion.

Senator SESSIONS. Are you saying—I think, wouldn't you agree that there are a number of States where automobile dealers—maybe not all—that use the arbitration clauses in their contracts?

Mr. FONDREN. Well, speaking from the only jurisdiction of which I have intimate knowledge, we do not use it in Texas. There may be a few dealers, but it is discouraged strongly by the dealer body and by the association in the State of Texas. That is the one, of course, that I am familiar with.

Senator SESSIONS. Well, I would just say, Mr. Chairman, I understand your concerns. I have talked with automobile dealers who are concerned about the big manufacturers and their leveraged position. But I think the issue is a big one. My concern is dealing with it one issue at a time. We probably ought to deal with it in an overall piece of legislation.

But I won't belabor the point. I am sorry to be late, Mr. Chairman.

Senator GRASSLEY. Thank you very much, Senator Sessions.

Thanks each of you on the first panel for participating. We appreciate it very much, and you may expect some questions. I had a couple that I wasn't able to ask that I may submit for answer in writing. Thank you all very much.

Ms. MACDONALD. Thank you, Mr. Chairman.

Ms. LAJDZIAK. Thank you, Mr. Chairman.

Mr. HOLCOMB. Thank you, Mr. Chairman.

Mr. FONDREN. Thank you, Mr. Chairman, Senator Feingold, Senator Sessions.

Senator GRASSLEY. Thank you.

I would now ask our second panel and last panel to come to the table. The first two witnesses that we are going to hear from will be discussing mandatory binding arbitration and consumer credit. Our final two witnesses will be discussing S. 121, which deals with arbitration in cases of employment discrimination.

Our first witness is Patricia Sturdevant. Ms. Sturdevant is executive director and general counsel of the National Association of Consumer Advocates.

Next we will hear from Eric Mogilnicki. Mr. Mogilnicki is testifying on behalf of the American Bankers Association, Consumer Bankers Association, the American Financial Services Association, and the National Retail Federation.

Our next witness is Lawrence Lorber. Mr. Lorber represents the U.S. Chamber of Commerce, and he is also a partner in the Sonnenschein, Nath and Rosenthal firm.

And our last panelist, Lewis Maltby, is president of the National Workrights Institute, Inc., and the director of the American Civil Liberties Union National Task Force on Civil Liberties in the Workplace.

We will start with Ms. Sturdevant.

PANEL CONSISTING OF PATRICIA STURDEVANT, EXECUTIVE DIRECTOR AND GENERAL COUNSEL, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES, WASHINGTON, DC; ERIC MOGILNICKI, WILMER, CUTLER, AND PICKERING, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION, CONSUMER BANKERS ASSOCIATION, AMERICAN FINANCIAL SERVICES ASSOCIATION, AND THE NATIONAL RETAIL FEDERATION, WASHINGTON, DC; LAWRENCE Z. LORBER, U.S. CHAMBER OF COMMERCE, WASHINGTON, DC; AND LEWIS L. MALTBY, PRESIDENT, NATIONAL WORKRIGHTS INSTITUTE, PRINCETON, NJ

STATEMENT OF PATRICIA STURDEVANT

Ms. STURDEVANT. Thank you, Senator Grassley.

From our perspective, consumer protection in this country is in jeopardy, particularly in the important areas of credit and finance. Consumers' ability to enforce the rights which are afforded them under Federal and State consumer protection laws is seriously threatened by the proliferation of arbitration clauses in contracts of adhesion. All across the country, financial institutions are unilaterally drafting and inserting in their form contracts standardized clauses which provide that consumers agree to resolve any disputes by arbitration and to waive their rights to trial by judge or jury and their right to participate in a class action.

The purpose of these clauses very simply is to insulate unlawful, unfair, or deceptive practices from any meaningful review by eliminating the remedies that deter wrongful conduct. Arbitration does not merely substitute an alternative forum, but it limits the availability of substantive rights and statutory remedies. By requiring arbitration, the financial institutions would make it impossible for consumers to challenge lucrative, unlawful business conduct and relegate them to a forum where they cannot obtain discovery, they cannot secure injunctive relief against unlawful practices, they cannot receive awards of punitive damages, and they cannot proceed on behalf of a class.

These clauses are being used as a license to gouge consumers and exclude lucrative practices from oversight and review. Two recent examples are illustrative. First, American Express recently notified its card holders by a statement stuffer of numerous changes in their account agreement which would increase the charges imposed on consumers. First, they increased the annual percentage rate on any payment which is past due to 23.99 percent. That is about triple the prevailing rate for home mortgage. They also increased the fees for stop-payment orders and returned checks to $25 each. They increased the cash transaction fee to 3 percent of the amount advanced with the $3 minimum and no maximum so that getting an advance of $500 would cost the card hold $15. Finally, they imposed a 2 percent charge above the prevailing exchange rate for any transactions made in foreign currencies.

At the same time that it imposed all these additional charges on card holders, American Express imposed an arbitration requirement. This deprives consumers of any access to the courts. The arbitration clause is retroactive, and it purports to cover claims arising even from prior agreements. In addition, it applies to claims of every kind, including those based on fraud or on deception in the solicitation and the advertising of accounts. It also covers conduct by third parties, like credit insurance providers or debt collectors, insulating the conduct of those parties from any meaningful review. The clause further provides that there will be no discovery and no class actions are allowed. Plainly put, the clause allows American Express and related companies to lie to and cheat their customers and violate consumer protection laws with impunity.

Saks Fifth Avenue also recently notified its customers by a statement stuffer of changes to their accounts. Saks imposed similar additional charges, increasing the finance charge, increasing the late charge, shortening the grace period before a charge is imposed, and increasing the returned-check fee to $25. Again, the Saks clause provides that there will be no discovery, so the consumers have no ability to obtain the facts necessary to prove their claim and no right to participate as a representative or a member of the class. Use of the card after receiving the statement stuffer is said to indicate the consumer's consent to these new terms, including the arbitration clause. Yet the evidence in the only case that I have tried involving in an arbitration clause sent out by statement stuffer is that the bank—in that case, the Bank of America—knew that no more than 4 percent of the card holders would read these statement stuffers, let alone understand the provisions.

Consumer advocates are very concerned about the potential for injustice in the arbitral forum which can be very unfair to consumers and is deficient in a number of very significant ways.

First, discovery is discretionary, not a matter of right, so consumers may not be able to obtain the documents they need to prove their claim that a company has violated the law.

Second, arbitrators do not need to explain the basis for their decisions, and they don't need to follow the law, so consumer protection statutes and case law can be simply ignored.

Third, the proceedings are secret, not public, so challenged practices won't be brought to the attention of the public generally or to regulatory authorities, which allows wrongful conduct to continue unchecked.

Additionally, an arbitrator does not have the power to order injunctive relief, so that a consumer who is victimized by a widespread business practice will not be able to obtain an order that the company cease engaging in its wrongful conduct.

Finally, an arbitrator's decision is immune from judicial review, except on very narrow grounds, such as fraud by the arbitrator, and decisions are final and binding even if they are wrongly decided on the facts or incorrect as a matter of law and they result in manifest injustice.

The simple fact is that arbitration is being used to give financial institutions an unfair advantage, and that is a powerful argument why they should not be allowed in pre-dispute contracts between parties of unequal bargaining power. While it may be true that arbitration is speedier on some occasions, we in this country do not need a system that results in speedy injustice.

Thank you.

[The prepared statement of Ms. Sturdevant follows:]

PREPARED STATEMENT OF PATRICIA STURDEVANT

MANDATORY ARBITRATION: A THREAT TO ACCESS TO JUSTICE

Consumer protection in this country is in jeopardy, particularly in the extremely important areas of credit and finance. Consumers' ability to enforce the rights afforded them under federal and state consumer protection laws is seriously threatened by the proliferation of arbitration clauses in contracts of adhesion. All across the country, financial institutions are unilaterally drafting and inserting in their form contracts standardized mandatory, binding arbitration clauses which provide that consumers agree to resolve any disputes by arbitration, and to waive their rights to trial by judge or jury, and their right to participate in a class case. Arbitration clauses have been adopted by a number of financing entities, including credit card issuers such as American Express, First USA, and the Discover Card; retail stores such as Saks Fifth Avenue and Sears; finance companies such as ITT, Beneficial, Thorpe, and Greentree; and by sellers and financers of manufactured homes and automobiles.

The purpose and intent of such clauses is to insulate unlawful, unfair, or deceptive practices from any meaningful review by eliminating the remedies that deter wrongful conduct. As these financial institutions well know, arbitration does not merely substitute a different or alternative forum for a court, judge, and jury, but limits the availability of substantive rights and statutory remedies. By requiring arbitration, the financial institutions intend to make it impossible for consumers to challenge lucrative business misconduct by relegating consumers to a forum where they cannot obtain discovery, secure injunctive relief against unlawful practices, receive awards of punitive damages, or proceed on behalf of a class.

These clauses are being used as a license to gouge consumers and exclude lucrative business practices from regulation, oversight, or effective review. Two recent examples illustrate the point.

I. American Express notified its cardholders of a number of costly changes to their agreements by statement stuffers, effective June 1, 1999. American Express:

Increased the annual percentage rate of interest on accounts where any amount is past due to 23.99%, about triple the prevailing rate for home mortgages.

Increasd the fee for stop payment orders to $25.00.

Increased the fee for returned Optima checks to $25.00.

Increased the cash transaction fee to 3% of the amount of each transaction, with a minimum of $3.00, and no maximum, so that a cash advance of $250 would cost $7.50, and a $500 advance, $15.00.

Imposed a 2% charge above the prevailing exchange rate on transactions made in foreign currencies.

At the same time, in an attempt to ensure that no effective challenge could be made to the legality of these increased charges, American Express imposed an arbitration requirement for consumer disputes that deprives consumers of access to the courts. Its arbitration clause is retroactive and purports to cover claims arising from prior agreements. Moreover, it applies to claims of every kind, including those based on deception or fraud in advertising or describing the account and those based on intentional torts, statutes, common law, or equity. The clause also covers the conduct of third parties providing products or services on the account, such as credit insurance companies and debt collectors, thereby preventing the legality of their conduct from being effectively challenged. Plainly put, the clause allows American Express and the companies who sell credit insurance to lie to and cheat their customers and violate consumer protection laws with impunity.

The clause further provides that all claims will be decided by the National Arbitration Forum, the there will be no discovery, and that no class actions will be allowed. As further insurance that the clause will be used as it is intended, to protect only American Express, it provides that an artibrator's award will be final and binding, with the exception that if an award exceeds $100,000, any party can appeal to a panel of three arbitrators. So if a consumer does prevail, the company gets a second bite at the apple.

II. Saks Fifth Avenue, a major national retail chain, notified its customers of changes to their accounts, effective July 1, 1999. Saks, like American Express, also took the opportunity to increase its charges, in the following ways:

Increased the finance charge to 21.6%, again nearly three times the current prevailing rate for home mortgages.

Increased the late fee to $15.00. Because this fee is imposed in addition to finance charges at 21.6% until the payment is received, it is a double charge and pure profit.

Reduced the grace period to avoid a late charge to five days.

Increased the returned check fee to $25.00, even though it continues to receive finance charges until the check is made good. The bank will impose its own charges for a check drawn on insufficient funds.

Increased the minimum finance charge to $0.50, even when it is actually less than that.

The Saks clause specifies that either party may elect arbitration, and that there will be "no discovery (i.e., the pre-trial fact finding process) for the dispute," no class actions, and no right to participate as a representative or member of a class. The provision goes on to state that the clause requires arbitration at Saks' election, that it intends to request arbitration for all disputes, and when it does so that the dispute will be arbitrated even if the customer does not want arbitration. Use of the card after this stuffer is sent to said to indicate the customer's consent to these new terms, including the arbitration clause.

Consumer advocates are concerned about the potential for injustice in the arbitral forum, which can be very unfair to consumers and is deficient in a number of ways:

Discovery is discretionary, not a matter of right, so consumers may not be able to obtain the documents they need in order to challenge a company's misconduct.

Arbitrators need not explain the basis for their decisions or follow the law, so consumer protection statutes and case law can be ignored.

The proceedings are secret, rather than public, so challenged practices will not be brought to the attention of the public generally or to regulatory authorities, making it more difficult for abusive practices to be uncovered or eliminated.

An arbitrator does not have the power to order injunctive relief, so that a consumer victimized by a widespread business practice will not be able to obtain an order requiring that the wrongful practice cease.

An arbitrator's decision is immune from judicial review, except on very narrow grounds, such as fraud by the arbitrator, and decisions are final and binding even if they are wrong on the facts, incorrect as a matter of law, and result in manifest injustice.

Another troubling aspect of arbitration is its undue expense. Unlike the court system, arbitration requires that the parties pay high filing fees, which escalate based on the amount of recovery sought, as well as daily fees to the arbitrator(s), and fees for hearings, processing, and administration. The costs of arbitrating may exceed the costs of litigation, and in consumer cases are often in excess of the amount in dispute. The arbitration clauses described above do not allow consumers to sue even in small claims court and significantly increase the expense of proceeding to challenge a charge or practice they correctly believe is illegal and unfair.

The simple but unpleasant fact is that arbitration is being used to give financial institutions an advantage over consumers. It is marketed as a way to avoid the costs and risks of the jury system, meaning that class action lawsuits and punitive damage awards can be avoided. Indeed, some providers of arbitration services offer an unlevel playing field as an inducement to financial institutions to utilize their services. The National Arbitration Forum, which was established as a mechanism for resolving ITT Consumer Financial Services' claims against its consumer borrowers across the country by default judgments in Minnesota, has widely distributed a Legal Memorandum which concludes that arbitrations under its Forum rules may not be consolidated into class actions unless all parties consent.

These mandatory arbitration clauses are imposed on unsuspecting consumers, without their knowledge, negotiation, or consent. This use of arbitration clauses infringes consumers' constitutionally protected rights. Recently, a California appellate court held in *Badie* v. *Bank of America* (1998) 67 Cal. App. 45th 779,806, rev den (Feb. 1999) that, because the right to a jury trail is a substantial fundamental right, it cannot lightly be deemed waived, and waiver requires a "clear and unmistakable" or an "unambiguous and unequivocal waiver" of that right. A statement stuffer purporting to change contract terms was found inconsistent with that requirement and therefore unenforceable. Applying fictional concepts of consent to adhesionary contracts between financial institutions and consumers, like Saks is attempting to do, distorts the law of contract and the arbitration mechanism beyond recognition.

Arbitration is supposedly favored as a method of resolving disputes. But that preference is derived from a series of Supreme Court cases between commercial entities that had bargained for the speed and efficiency of arbitration, so the court was merely enforcing their contractual agreement. Arbitration as a method of resolving disputes is a creature of contract premised on the ability of parties of equal bargaining power to choose what method of resolving disputes will best serve their mutual needs. Free choice, meaning actual agreement, is the foundation of arbitration, and the reason such clauses are enforceable is because they reflect the bargain between the parties. There simply is no public policy favoring arbitration as a mechanism of dispute resolution but only a policy favoring the enforcement of the parties' freely negotiated agreements. Unilateral imposition of mandatory, binding arbitration in adhesionary contracts has none of the indicia of choice, consent, or bargaining. Moreover, unilaterally imposing arbitration raises troublesome issues for consumer advocates because of the potential for abuse by institutional interests and the consequent denial to consumers to access to the courts and to justice.

All of these factors are powerful arguments against the use of mandatory, predispute arbitration clauses in contracts between financial institutions and consumers, to which the National Association of Consumer Advocates is adamantly opposed for the reasons set out in the Position Paper, which is attached. Although arbitration may, in some instances, be faster than litigation, there is no public policy served by a process that results in speedy injustice.

FYI3 4/99

F.Y.I.

A Summary of Changes to Agreements and Benefits

For Optima® Gold Cardmembers
of American Express

Cards

F.Y.I. (For Your Information) is an update that notifies you of changes to your Cardmember Agreements and provides you with other important notices. Please take a moment to look over this document carefully before you file it away in a safe place. You should also share this information with the Additional Cardmembers on your Account, as it applies to them as well. ***All changes go into effect June 1, 1999, except where otherwise noted.***

Arbitration Provision

We are changing the Cardmember Agreement to include an Arbitration Provision. This Provision may affect your right to go to court or to have a jury trial. It is important that you carefully read the Provision in its entirety.

Other Important Changes to Cardmember Agreements

We are also making other changes to your Cardmember Agreements. Please review these changes carefully. Some of you may have been previously notified of these changes.

Additional Free Benefits and Services

Several benefits and services will be added to your Optima Card Account at no additional cost. You will be able to take advantage of these valuable free Card features as of April 4, 1999: Best Value Guarantee, Express Cash, Global Assist® Hotline, Return Protection, and Year End Summary. For additional information, please refer to your existing Cardmember Agreement. You will also receive coverage under the Car Rental Loss and Damage Insurance Plan. For further information on eligibility and coverage, please call 1-800-338-1670 or refer to the Plan's Description of Coverage.

Important Changes to Insurance Plans

Important changes are being made to the following Insurance Plans:

- **Purchase Protection℠ Plan**
  For changes made to your Purchase Protection Plan, please see the Purchase Protection Plan Benefit Summary and Description of Coverage rider located within *F.Y.I.*
- **Buyer's Assurance℠ Plan**
  For changes made to your Buyer's Assurance Plan, please see the Buyer's Assurance Plan Benefit Summary and Description of Coverage rider located within *F.Y.I.*
- **Car Rental Loss and Damage Insurance Plan**
  For your convenience and clarification, the Car Rental Loss and Damage Insurance Plan has been reprinted within *F.Y.I.*
- **Credit Protection Plan**
  If you are currently enrolled, your Credit Protection coverage automatically terminates when your Card statement is overdue. The change will now extend coverage until you elect to cancel your coverage or until your Card Account isdeemed uncollectable.

Please note that not all Card products offer these benefits. You can call Customer Service to verify if you are eligible.

Arbitration Provision

Implementation of Arbitration Program

We are changing the Cardmember Agreement (the "Agreement") to include an Arbitration Provision. By using the Card after receipt of this notice, you accept and agree to this Provision, which becomes effective upon such use. It is important that you read the entire Provision carefully. This new Provision reads as follows:

ARBITRATION PROVISION: This Arbitration Provision sets forth the circumstances and procedures under which Claims (as defined below) may be arbitrated instead of litigated in court.

As used in this Arbitration Provision, the term "Claim" means any claim, dispute or controversy between you and us arising from or relating to the Agreement, any related or prior agreement that you may have had with us or the relationships resulting from the Agreement or any prior agreement, including the validity, enforceability or scope of this Arbitration Provision, the Agreement or any prior agreement. "Claim" includes claims of every kind and nature, including but not limited to initial claims, counterclaims, cross-claims and third-party claims and claims based upon contract, tort, fraud and other intentional torts, statutes, regulations, common law and equity. The term "Claim" is to be given the broadest possible meaning and includes, by way of example and without limitation, any claim, dispute or controversy that arises from or relates to (a) the account(s) ("Account") created by the Agreement or any related or prior agreement, or any balances on the Account, (b) advertisements, promotions or oral or written statements related to the Account, goods or services financed under the Account or the terms of financing, (c) the benefits and services related to Cardmembership (including free benefit programs, enrollment services and rewards programs), and (d) your application for the Account.

This Arbitration Provision will not apply to Claims previously asserted in lawsuits filed before this Arbitration Provision becomes effective as provided above. However, this Arbitration Provision will apply to all other Claims, even if the facts and circumstances giving rise to the Claims existed before the effective date of this Arbitration Provision.

Any Claim shall be resolved, upon the election of you or us, by arbitration pursuant to this Arbitration Provision and the Code of Procedure ("Code") of the National Arbitration Forum ("NAF") in effect at the time the Claim is filed. (If for any reason the NAF is unable or unwilling or ceases to serve as arbitration administrator, another nationally recognized arbitration organization utilizing a similar code of procedure will be substituted by us.) For any Claims covered by this Arbitration Provision, a party who has asserted a Claim in a lawsuit in court may elect arbitration with respect to any Claim(s) subsequently asserted in that lawsuit by any other party or parties. The Code, rules and forms of the NAF may be obtained by calling 1-800-474-2371 or by visiting NAF's website at www.arbforum.org. All Claims shall be filed at any NAF office or at Post Office Box 50191, Minneapolis, Minnesota 55405.

IF ARBITRATION IS CHOSEN BY ANY PARTY WITH RESPECT TO A CLAIM, NEITHER YOU NOR WE WILL HAVE THE RIGHT TO LITIGATE THAT CLAIM IN COURT OR HAVE A JURY TRIAL ON THAT CLAIM, OR TO ENGAGE IN PRE-ARBITRATION DISCOVERY EXCEPT AS PROVIDED FOR IN THE NAF CODE. FURTHER, YOU WILL NOT HAVE THE RIGHT TO PARTICIPATE IN A REPRESENTATIVE CAPACITY OR AS A MEMBER OF ANY CLASS OF CLAIMANTS PERTAINING TO ANY CLAIM SUBJECT TO ARBITRATION. EXCEPT AS SET FORTH BELOW, THE ARBITRATOR'S DECISION WILL BE FINAL AND BINDING. NOTE THAT OTHER RIGHTS THAT YOU WOULD HAVE IF YOU WENT TO COURT MAY ALSO NOT BE AVAILABLE IN ARBITRATION.

There shall be no right or authority for any Claims to be arbitrated on a class action basis or on bases involving Claims brought in a purported representative capacity on behalf of the general public, other Cardmembers or other persons similarly situated; provided however, that the claimant's individual Claim would be subject to this Arbitration Provision. Furthermore, Claims brought by or against a Cardmember(s) of one Account may not be joined or consolidated in the arbitration with Claims brought by or against any other Cardmember(s) of any other Account, unless otherwise agreed to in writing by all parties. Any arbitration hearing that you attend shall take place in the federal judicial district of your residence. At your written request, we will consider in good faith making a temporary advance of all or part of the filing, administrative and/or hearing fees for any Claim you initiate as to which you or we seek arbitration. At the conclusion of the arbitration, the arbitrator will decide who will ultimately be responsible for paying the filing, administrative and/or hearing fees in connection with the arbitration.

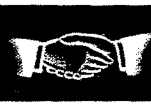
This Arbitration Provision is made pursuant to a transaction involving interstate commerce, and shall be governed by the Federal Arbitration Act, 9 U.S.C. Sections 1-16, as it may be amended (the "FAA"). The arbitrator shall apply applicable substantive law consistent with the FAA and applicable statutes of limitations and shall honor claims of privilege recognized at law and, at the timely request of either party, shall provide a brief written explanation of the basis for the award. In conducting the arbitration proceeding, the arbitrator shall not apply the Federal or any state rules of civil procedure or rules of evidence. In addition to the parties' rights to exchange information pursuant to the Code, either party may submit a request to the arbitrator with a copy of the request provided to the other party to expand the scope of discovery allowable under the Code. The objecting party may submit objections to the arbitrator with a copy of the objections provided to the requesting party, within fifteen (15) days of the requesting party's notice. The granting or denial of either party's request will be in the sole discretion of the arbitrator who shall notify the parties of his/her decision within twenty (20) days of the objecting party's submission. Judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction. The arbitrator's decision will be final and binding, except for any right of appeal provided by the FAA and/or if the amount of the award exceeds $100,000, any party can appeal that award to a three-arbitrator panel administered by the NAF which shall reconsider *de novo* any aspect of the initial award requested by the appealing party. The appealing party shall have thirty (30) days from the date of entry of the written arbitration award to notify the NAF that it is exercising the right of appeal. The appeal shall be filed with the NAF in the form of a dated writing. The NAF will then notify the other party that the award has been appealed. The NAF will appoint a three-arbitrator panel who will conduct an arbitration pursuant to the NAF Code and issue its decision within one hundred and twenty (120) days of the date of the appellant's written notice. The decision of the panel shall be by majority vote and shall be final and binding. The costs of such an appeal will be borne by the appealing party regardless of the outcome of the appeal.

As used in the Arbitration Provision, the terms "we" and "us" shall for all purposes mean American Express Travel Related Services Company, Inc., American Express Centurion Bank, as applicable, all of their parents, wholly or majority owned subsidiaries, affiliates, licensees, predecessors, successors, assigns, and any purchaser of your Account; and all of their agents, employees, directors and representatives. In addition, "we" or "us" shall mean any third party providing any product, service or benefit in connection with the Account (including, but not limited to credit bureaus, merchants who honor the Card issued for the Account, third parties who provide or participate in free benefit programs, enrollment services and rewards programs, credit insurance companies, debt collectors and all of their agents, employees, directors and representatives) if, and only if, such third party is named as a co-defendant with us in a Claim asserted by you. As solely used in this Arbitration Provision, the terms "you" or "yours" shall mean all persons or entities approved by us to use the Account, including but not limited to all persons or entities contractually obligated under the Agreement or any prior agreement you may have had with us and all authorized users of the Account.

This Arbitration Provision shall survive termination of your Account as well as voluntary payment of the debt in full by you, any legal proceeding by us to collect a debt owed by you, any bankruptcy by you and any sale by us of your Account. If any portion of this Arbitration Provision is deemed invalid or unenforceable under any law or statute, consistent with the FAA, it shall not invalidate the remaining portions of this Arbitration Provision, the Agreement or any prior agreement you may have had with us, each of which shall be enforceable regardless of such invalidity. In the event of a conflict or inconsistency between the NAF Code and this Arbitration Provision, this Arbitration Provision shall govern.

Note to California residents: This Arbitration Provision shall not apply to you unless and until you use the Card after we notify you in writing that it is applicable in California.

Other Changes to Cardmember Agreements



Other Important Account Changes

Certain other important changes and clarifications are being made to the American Express® Card Account, the Optima® Account, and the American Express® Credit Card Account ("Account"), and to the agreement governing electronic fund transfers under the Express Cash Program. This notice formally amends each of the respective Agreements, as applicable, governing those Accounts, and any contrary or conflicting language previously in such Agreements is fully superseded. Please retain this copy for your files.

Electronic Fund Transfer Transaction Error Resolution
Effective April 1, 1999, in case of errors or questions about electronic fund transfers under the Express Cash Program, we will tell you the results of our investigation within 10 business days* after we hear from you and we will correct any error promptly. If we need more time, however, we may take up to 45 calendar days to investigate your complaint or question. If we decide to do this, we will ensure that your bank credits your account within 10 business days* for the amount you think is in error. If we ask you to put your complaint or question in writing and we do not receive it within 10 business days following your oral notification, we may not recredit your account. For transactions initiated outside the U.S. (and in the event there are transfers resulting from any point-of-sale debit card transactions), we have 90 calendar days instead of 45 calendar days to complete the investigation. If notification of an error on your Account is received within 30 calendar days after your Account is opened, we will have 20 business days instead of 10 business days to provide you with the results of our investigation and correct any error and 90 days to complete the investigation.

* For Massachusetts residents: 10 calendar days instead of 10 business days.

Renewal of Cards and Cancellation

Effective immediately, any reference to the Card being our property in the section of the Cardmember Agreement entitled "Renewal of Cards and Cancellation" or elsewhere (including on the Card itself) is hereby deleted.

Cash Transaction Fee
Effective July 1, 1999, we are increasing the fee we may charge for cash transactions to 3% (minimum of $3.00 with no maximum) of the amount of each transaction.

Transactions Made in Foreign Currencies
Effective June 15, 1999, if you initiate a transaction in a foreign currency, it will be converted into U.S. dollars on the date it is processed by us or our agents at a rate set by us based on an interbank, tourist, or (where required by law) official rate, increased in each instance by up to 2%.

Privacy — Use of the Card at Federal Agencies
Effective immediately, the following paragraph is being added to the section of the Cardmember Agreement entitled "Privacy":

American Express has entered into contracts which enable the American Express® Card to be accepted for payments to certain Federal Government agencies and departments ("Agencies"). As with Card transactions at commercial establishments, when you choose to use the Card for payments to an Agency certain Charge information is necessarily collected by American Express. Charge information from Card transactions for payments to Agencies may be used for processing Charges and payments, billing and collections activities and, in some instances, information that is aggregated (so as not to be identifiable with any individual) may be used for reporting, analysis, and marketing activities. Additional "routine uses" of Charge information by Agencies are published periodically in the Federal Register.

Use of the Card — Recurring Billing
Effective immediately, the following paragraph is being added to the end of the section of the Cardmember Agreement entitled "Using the Card":

If you provide authorization to a merchant to bill Charges on a recurring basis to your Card Account ("Recurring Charge(s)"), and if a replacement Card has been issued to you (because, for example, your Card has been lost, stolen, canceled, upgraded, or renewed), then we may provide such merchant with your current Card Account status, account number, and/or expiration date in order to permit the merchant to continue to bill the Recurring Charge to your current Card Account until you notify us and the merchant that you have withdrawn your authorization.

Use of the Card for Motor Vehicle Purchases
Effective immediately, you may use your Account to purchase and make down payments on motor vehicles.

For Optima Accounts and American Express Credit Card Accounts only:

Annual Percentage Rates
Effective with billing periods ending in July, 1999, the Annual Percentage Rates for certain formulas are being increased by .09%. Those Annual Percentage Rates which are determined using a formula of the Prime Rate plus a margin of X.9% will thereafter use a formula of the Prime Rate plus a margin of X.99%.

Annual Percentage Rate for Accounts Not In Good Standing
If you have received prior notification of the following, it will become effective with billing periods ending in April, 1999. If you have not received prior notification, the following will become effective with billing periods ending in May, 1999. The **Annual Percentage Rate** for any Account not in good standing will be a fixed rate of 23.99%, with a Daily Periodic Rate of .0657%. An Account not in good standing includes any Account a) with respect to which any portion of any minimum payment on such Account is included within an unpaid previous balance on billing statements on multiple occasions, or b) is either considered in default for any reason or canceled (previously "in default ... and canceled").

Finance Charges on Express Cash Fees
Effective with billing periods ending in July, 1999, Express Cash Fees will no longer be excluded from the calculation of the Average Daily Balance for Purchases or the assessment of Finance Charges.

Stop Payment Orders
Effective July 1, 1999, we are increasing the fee we may charge your Account if you request us to stop payment on a check drawn on your Account to $25, subject to applicable law.

Fee for Declined Optima Check
Effective July 1, 1999, if a check drawn on your Account is not honored by American Express, we may charge your Account a fee of $25, subject to applicable law.

For Delta SkyMiles® Credit Cardmembers, Hilton Credit Cardmembers, Sheraton Starpoints℠ Credit Cardmembers, American Express® Golf Cardmembers, New York Knicks Cardmembers, New York Rangers Cardmembers, and National Multiple Sclerosis Society Cardmembers only:

Effectively immediately, any reference to Optima in your Cardmember Agreement and/or elsewhere is hereby replaced with American Express® Credit Card.

Important Notice
Saks Fifth Avenue
Credit Card Accounts

Please Read This Notice Carefully

3/99

Dear Saks Fifth Avenue Credit Card Holder:

This Notice is about changes that are being made to the terms of your Saks Fifth Avenue credit card account agreement. All Saks Fifth Avenue credit card accounts are now owned, and all credit is now extended, by National Bank of the Great Lakes, 140 Industrial Drive, Elmhurst, Illinois 60126. Whenever in this Notice we use the words "you charge a purchase to your account," "purchases charged to your account," or similar words, we mean a charge to your account by you or by any person you authorize to charge a purchase to your account. The new Saks Fifth Avenue Revolving Credit Agreement/Retail Installment Credit Agreement appearing at the end of this Notice (the "***New Agreement***") will govern your account on and after July 1, 1999 (the "***Effective Date***") except as noted below in this Notice.

Please read this Notice carefully for an explanation of these changes, how these changes will apply to your account, including whether these changes will apply to any existing balance in your account on the Effective Date, and how these changes can be avoided if you do not wish to agree to them. Also, please read the New Agreement carefully and retain this document for your records. The New Agreement states that it is subject to Illinois law and applicable federal law. The New Agreement is different from your existing Saks Fifth Avenue Retail Installment Credit Agreement (the "***Current Agreement***") in several important ways. Several capitalized terms used in this Notice are defined in the New Agreement.

Paragraph 10 of your Current Agreement provides that any term of that Agreement, including the rate of Finance Charge, may be changed by furnishing you notice of the change to the extent required by law. Paragraph 10 of your Current Agreement also provides that, if permitted by applicable law, any new term may at our option be applied to any balance existing in the account at the time of the change, as well as to any subsequent transactions.

Summary of Important New Terms

1. Arbitration of Disputes. We are adding a provision to the New Agreement at paragraph 18 in which both we and you agree to resolve all disputes involving your account (but only as to the part of your account balance attributable to purchases charged to your account **on or after the Effective Date)** by arbitration rather than by litigation in court, if you **OR** we request arbitration on or for a particular dispute. This means that if only one of us requests arbitration for a dispute involving your account, (1) the dispute will be arbitrated in accordance with paragraph 18 (even if the other does not want to arbitrate the dispute), (2) there will be **no jury trial** for the dispute, (3) generally, there will be no prearbitration discovery (i.e., the pre-trial fact-finding process) for the dispute, and (4) the dispute will not be arbitrated on a class-action basis, and neither you nor we will have the right to participate as a representative or member of any class of claimants pertaining to any dispute involving your account. If neither you nor we requests arbitration, the dispute will not be resolved by arbitration and instead will be litigated in court. However, absent unusual circumstances, we currently intend to request arbitration for all disputes that are claims by you against us, and when we request arbitration the disputes will be arbitrated in accordance with paragraph 18 even if you do not want the disputes to be arbitrated.

Please carefully read paragraph 18 of the New Agreement. If you do not wish to agree to this new arbitration provision, do not charge a purchase to your account on or after the Effective Date. In that case, the arbitration provision will not apply to your account, and the current terms of your account will continue to apply until your account balance is paid in full. However, **if you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new arbitration provision** in which you agree to resolve all disputes between you and us by arbitration in accordance with paragraph 18 of the New Agreement, **but arbitration will not apply to disputes involving any part of your account balance attributable to purchases charged to your account before the Effective Date.**

2. Increase in Finance Charge Rate. Under the New Agreement, in all jurisdictions if we do not receive the full amount due (the *"New Balance"* shown on your monthly statement) within twenty-five days after the Closing Date shown on your monthly statement, we will compute a Finance Charge on the Average Daily Balance by applying a monthly periodic rate of 1.8% **(ANNUAL PERCENTAGE RATE 21.6%).** The Current Agreement's rate of Finance Charge for your account is shown on the front of the monthly statement that accompanies this Notice in the "ANNUAL PERCENTAGE RATE" box. If that current rate is 21.6%, the rate of Finance Charge for your account will not change. However, if that current rate is less than 21.6%, the rate of Finance Charge for your account will increase to an **ANNUAL PERCENTAGE RATE of 21.6%** beginning as of the first day of the first billing period beginning on or after the Effective Date in the circumstances described in the following paragraphs.

Residents of All Jurisdictions Except CA, IL, ME, MT, ND, OK, PR, SC, SD, TX, and WY: if you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the increased rate of Finance Charge, and the increased rate of Finance Charge will apply both to any account balance existing in your account before the Effective Date and all future account balances. If you do not charge a purchase to your account on or after the Effective Date, the current rate of Finance Charge will continue to apply to your account until the balance in the account has been paid in full.

Residents of CA, IL, ME, MT, OK, and WY: if you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the increased rate of Finance Charge, but that increased rate of Finance Charge will apply only to the balance attributable to purchases charged to your account on and after the Effective Date. Whether or not you make such a purchase, the current rate of Finance Charge will continue to apply to the balance attributable to purchases charged to your account before the Effective Date until that balance is paid in full.

Residents of ND, PR, SC, SD, TX: the increased rate of Finance Charge will apply both to the balance attributable to purchases charged to your account on and after the Effective Date and to any balance attributable to purchases charged to your account before the Effective Date, unless you write to us at Saks Fifth Avenue, P.O. Box 219044, Dallas, TX 75221 within twenty-five days of the Effective Date stating that you do not accept the new rate of Finance Charge. However, if you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new rate of Finance Charge, which will apply both to the balance attributable to purchases charged to your account prior to the Effective Date and to purchases charged to your account on and after the Effective Date.

Residents of ND and SD: see the Additional Notice to North Dakota and South Dakota Residents at the end of this Notice (before New Agreement).

Residents of SC: see the Additional Notice to South Carolina Residents at the end of this Notice (before New Agreement).

Residents of TX: see the Additional Notice to Texas Residents at the end of this Notice (before New Agreement).

3. Change in Minimum Finance Charge. Under the New Agreement, in all jurisdictions we will impose a minimum **FINANCE CHARGE** of $.50 in any month in which the Finance Charge that would result from the application of the monthly periodic rate is less than $.50. This change affects you if you reside in AR, DC, HI, MD, NE, NC, OR, and PR, where we do not impose any minimum Finance Charge. Under the Current Agreement, we impose the $.50 minimum FINANCE CHARGE in all jurisdictions except those mentioned above.

The change in minimum Finance Charge described above will become effective on the first day of the first billing period that begins on or after the Effective Date, but only if you charge a purchase to your account on or after the Effective Date.

4. Change in Balance Computation Method for Figuring the Finance Charge. Under the New Agreement, in all jurisdictions we will figure the Finance Charge on your account by applying the monthly periodic rate to the "Average Daily Balance" of your account (*including current transactions*). To get the "Average Daily Balance" we will take the beginning balance of your account each day, add *all new purchases, all billed and unpaid Finance Charges, all late fees, and all returned check fees*, and subtract all payments and credits. This will give us the daily balance. Then we will add up all the daily balances for the billing period and divide the total by the number of days in the billing period. This will give us the "Average Daily Balance." This new balance-computation method will be a change for you if you reside in AL, AR, AZ, CA, CO, DE, HI, IA, IN, LA, MA, MN, MS, MT, NE, NM, PA, PR, WA and WI. This new balance-computation method is the same as the Current Agreement's balance-computation method and will not be a change for you if you reside in AK, CT, DC, FL, GA, ID, IL, KS, KY, ME, MD, MI, MO, NV, NH, NJ, NY, NC, ND, OH, OK, OR, RI, SC, SD, TN, TX, UT, VT, VA, WV, WY, or outside the USA.

Under the Current Agreement, we figure the Finance Charge on your account by applying the monthly periodic rate to the "Average Daily Balance" of your account (including current transactions, except in MN, MT, and NM). To get the "Average Daily Balance" we take the beginning balance of your account each day, including any unpaid Finance Charge (except we do not include any unpaid Finance Charge in AL, AR, AZ, CA, DE, HI, IA, LA, MS, NE, PA, PR, and WA), add any new purchases (except we do not add in new purchases in MN, MT, and NM), and subtract any payments and credits and any late fee in CO, IN, MA, and WI. This gives us the daily balance. Then we add up all the daily balances for the billing period and divide the total by the number of days in the billing period. This gives us the "Average Daily Balance."

The new balance computation method for figuring the Finance Charge will apply to your account only if you charge a purchase to your account on or after the Effective Date. If you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new balance computation method on your account, and the new balance computation method (i) will become effective on the first day of the first billing period that begins on or after the Effective Date and (ii) will apply to your account balance existing before the Effective Date and all future account balances. If you do not charge a purchase to your account on or after the Effective Date, the current balance computation method will continue to apply to your account until the balance in the account has been paid in full.

5. Increase in Late Fee; Reduced Period to Avoid Late Fee. Under the New Agreement, in all jurisdictions if your minimum monthly payment is not received by us within *5 days* after the Payment Due Date shown on your monthly statement, we may impose a *late fee of $15.00*.

In all jurisdictions except AK, MD, NV, NY, ND, OH, OR, VA, WA, WI, and outside the USA, there will be an increase in the amount of the late fee, a reduction in the period for avoiding the late fee, or both. Under the Current Agreement, if your minimum monthly payment is not received by us within 5 days after the Payment Due Date (10 days in AL, AZ, CA, CO, DC, FL, GA, HI, IL, IN, KS, KY, LA, MI, MN, MS, MO, MT, NE, NJ, OK, SC, UT, WA, WV, and WY, 15 days in ID, ME, MA, and RI; 21 days in TX; 29 days in PA; 30 days in IA and NC), we may impose a late fee of $15.00, subject to the following exceptions: in AL, CA, FL, GA, ID, IL, KS, KY, MS, MO, MT, NJ, TX, and WY, $10.00 ($5.00 if amount past due is $25.00 or less in KS and MO); in AR, CT, NH, SD, TN, and WV, the lesser of 5% of the amount past due or $5.00 ($1.00 minimum); in AZ, the lesser of 5% of the amount past due or $10.00; in HI and LA, the lesser of 5% of the amount past due or $15.00; in IN, $14.00 (the amount of the late fee is subject to change as provided in Indiana Code Section 24-4.5-1-106); in MA, the lesser of $10.00 or 10% of the outstanding balance; in NE, $5.00; in NC, $5.00 ($10.00 if the New Balance is over $100.00); in PA and RI, $12.00; in SC, 5% of the amount past due ($4.00 minimum, $12.80 maximum); and in WI, none if minimum Finance Charge is imposed in the same billing period. No late fee is imposed in DE, NM, PR, and VT. Under the Current Agreement, a late fee lower than the current late fee described above in this paragraph may be imposed if your account has been inactive.

The increase in late fee/reduction of period for avoiding the late fee on your account described above will become effective on the Effective Date, and the increase in late fee/reduction of period for avoiding the late fee will apply to your account balance existing at the Effective Date and to all future account balances. However, please read the following exception paragraphs if you reside in DC, IA, ME, SC, SD, or WY.

Residents of DC: the new period for avoiding the late fee will apply to your account only if you charge a purchase to your account on or after the Effective Date. If you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new period for avoiding the late fee. If you do not charge a purchase to your account on or after the Effective Date, the current period for avoiding the late fee will continue to apply to your account until the balance in the account has been paid in full.

Residents of IA: the new late fee/period for avoiding the late fee will apply to your account only if you charge a purchase to your account on or after the Effective Date. If you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new late fee/period for avoiding the late fee. If you do not charge a purchase to your account on or after the Effective Date, the current late fee/period for avoiding the late fee will continue to apply to your account until the balance in the account has been paid in full.

Residents of ME: the new period for avoiding the late fee will apply to your account only if you charge a purchase to your account on or after the Effective Date. If you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new period for avoiding the late fee, but the new period for avoiding the late fee will apply only to your account balance attributable to purchases charged to your account on and after the Effective Date. If you do not charge a purchase to your account on or after the Effective Date, the current period for avoiding the late fee will continue to apply to your account until the balance in the account has been paid in full.

Residents of SC: see the Additional Notice to South Carolina Residents at the end of this Notice.

Residents of SD: see the Additional Notice to North Dakota and South Dakota Residents at the end of this Notice.

Residents of WY: the new late fee/period for avoiding the late fee will apply to your account only if you charge a purchase to your account on or after the Effective Date. If you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new late fee/period for avoiding the late fee, but the new late fee/period for avoiding the late fee will apply only to your account balance attributable to purchases charged to your account on and after the Effective Date. If you do not charge a purchase to your account on or after the Effective Date, the current late fee/period for avoiding the late fee will continue to apply to your account until the balance in the account has been paid in full.

6. Change in Returned Check Fee. Under the New Agreement, in all jurisdictions if any check sent to us in payment on your account is returned to us unpaid by the bank, we may charge you a *returned check fee of $25.00* to cover our collection costs.

Under the Current Agreement, in all jurisdictions except AL, AK, AZ, FL, IL, MT, NV, NH, NC, OH, OR, VA, WA, and outside the USA, there will be an increase in the returned check fee. Under the Current Agreement the returned check fee ranges between $5.00 - $25.00, depending upon your place of residence, except currently we do not impose any returned check fee on residents of DE, ME, MA, NE, PA, or WY.

In all jurisdictions except MD, the change in returned check fee on your account described above will become effective on the Effective Date.

Residents of MD: the new returned check fee will apply to your account only if a purchase is charged to your account on or after the Effective Date. If you charge a purchase to your account on or after the Effective Date, that purchase will be your agreement to the new returned check fee. If you do not charge a purchase to your account on or after the Effective Date, the current returned check fee will continue to apply to your account until the balance in the account has been paid in full.

Residents of ND: See the Additional Notice to North Dakota and South Dakota Residents at the end of this Notice.

7. **New Provisions**. We are adding the following paragraphs to the New Agreement (these paragraphs either do not appear in the Current Agreement or they appear in a different form):

Changes and Additions: We may (a) change any term of this Agreement, including without limitation the rate of Finance Charge, and (b) add new terms to this Agreement, including without limitation new terms that do not pertain to subject matters addressed in this Agreement, by furnishing you notice of the change or the addition to the extent required by applicable law. If permitted by applicable law, all changed terms and all new terms may at our option be applied to the balance existing in your Account at the time of the change or the addition as well as to any future balance.

Disputed Accuracy of Credit Report: If you believe we have reported inaccurate information about you to a consumer reporting agency, please contact us at Saks Fifth Avenue, P.O. Box 219044, Dallas, TX 75221. When you notify us, identify the inaccurate information and tell us why you believe it is inaccurate. If you have the credit report that includes the inaccurate information, include a copy.

No Waiver By Us: You agree we have the right without notice to you to delay or refrain from enforcing our rights under this Agreement without losing them. For example and without limitation, you agree we may extend the time to make payments without extending the time to make other payments, accept late or partial payments without waiving our right to have future payments made when they are due, and waive any late fee in case of a late payment without losing our right to impose a late fee for other late payments.

Use of Account Information; Information Sharing: (a) From time to time we make information, such as your name and address, available to others (that are not our affiliates) who may in turn solicit you for quality products and services. You may tell us you do not want us to make information about you available to these non-affiliates. To do so call us at 1-800-221-8340 and we will honor your request. **(b) We may share among our affiliates information as to experiences and transactions between you and one or more of our affiliates. Also, we may share among our affiliates other information about you (such as information you provided on your Application) ("Other Information"). You may prohibit that sharing of Other Information by writing us at P.O. Box 219044, Dallas, TX 75221 and we will honor your request.**

Governing Law: You agree this Agreement is not valid until we accept it in Illinois and all credit we extend to you is extended from Illinois. You also agree this Agreement is governed only by applicable federal law and Illinois law, including without limitation the Illinois Financial Services Development Act, even if you do not reside in Illinois or use your credit card for your account or otherwise make a purchase in Illinois.

The new provisions described above in this paragraph 7 will become effective on the Effective Date, and the new provisions will apply to your account balance existing before the Effective Date and to all future account balances.

Notice to DC Residents: You have two options with regard to the new minimum Finance Charge and the change in the grace period for avoiding the late fee: (1) you can use the account on or after the Effective Date and in so doing you will be agreeing to these changes; or (2) you can refrain from using the account on and after the Effective Date, in which case these new terms will not apply to the account.

Notice to Maryland Residents: We elect to make these changes under Section 12-912(D) of the Maryland Commercial Law Article and therefore the change in the minimum Finance Charge and returned check fee will become effective only if you use the account on or after the Effective Date.

Additional Notice to South Carolina Residents: If you do not want to continue the revolving account under the increased late fee, we will terminate the account, and permit you to pay the existing balance under the late fee in effect before the change in terms, if you request us to do so by writing to us at P.O. Box 219044, Dallas, TX 75221. You may apply for a new account on the new terms.

Additional Notice to North Dakota and South Dakota Residents: If you notify us in writing at P.O. Box 219044, Dallas, TX 75221 within 25 days after the Effective Date that you do not accept the new returned check fee (North Dakota residents) or the new late fee (South Dakota residents), the current terms will continue to be applied. However, any use of your Saks Fifth Avenue credit card after the Effective Date will constitute your agreement to the new terms.

Additional Notice to Texas Residents: YOU MAY TERMINATE THE SAKS FIFTH AVENUE REVOLVING CREDIT AGREEMENT/RETAIL INSTALLMENT CREDIT AGREEMENT IF YOU DO NOT WISH TO PAY THE INCREASED FINANCE CHARGE RATE, THE INCREASED LATE PAYMENT FEE, OR THE INCREASED RETURNED CHECK FEE. To reject these changes and terminate the Agreement as to your account, a) do not use the account on or after the Effective Date, and b) notify us in writing within 21 days after the date this Notice was mailed to you that you do not wish to continue the account under these new terms. You can mail notice to us at: P.O. Box 219044, Dallas, TX 75221. If you use the enclosed postcard, there will be no postage expense to you. Rejection of these new terms will not cause any amount to become due any sooner that it would have under the payment terms to which you previously agreed. You have the right to pay off the balance attributable to purchases charged to your account before the Effective Date under the current Finance Charge rate, current late payment fee, and current returned check fee if you do not use your account and if you notify us as explained above.

NATIONAL ASSOCIATION OF CONSUMER ADVOCATES

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POSITION PAPER: REASONS TO OPPOSE PRE-DISPUTE ARBITRATION CLAUSES IN CONSUMER CONTRACTS

I. Overview.

Recent years have witnessed an assault on the rights of consumers to access to the courts, and to trial by judge and jury. Banks, credit card companies and other financial institutions are jeopardizing consumers' rights to the protections afforded them by statutory and case law through the use of mandatory, binding arbitration clauses. These clauses are drafted by the financial institutions and unilaterally inserted in adhesionary contracts with consumers, without negotiation or consent. Arbitration as a method of resolving disputes is a creature of contract premised on the ability of parties of equal bargaining power to choose what method of resolving disputes will best serve their mutual needs. Free choice is the foundation of all alternative dispute mechanisms, including arbitration, and the reason such clauses are enforceable is because they reflect the bargain between the parties. Unilateral imposition of binding arbitration raises troublesome issues for consumer advocates because of the potential for abuse by institutional interests and the consequent denial to consumers of access to the courts and to justice.

II. Specific Problems With Pre-Dispute Arbitration Clauses.

A. The purpose and intent of such clauses is to insulate unlawful, unfair, or deceptive practices from any meaningful review by making it difficult to obtain discovery, impairing consumers' ability to proceed on behalf of a class, and to reduce compensatory and punitive damage awards.

B. By placing arbitration clauses into contracts before a dispute arises, the consumer is deprived of any way to intelligently decide if she really wants arbitration or if it will be an appropriate way to resolve that particular dispute.

C. Discovery is not available as a matter of right, but is within the discretion of the arbitrator. This can make the proceedings very unfair to consumers if they need to obtain documents from the defendant to demonstrate the nature and scope of challenged business practices.

D. Arbitration, unlike the court system, requires that the parties pay a high filing fee as well as a daily fee to the arbitrator(s), and may impose other fees for hearings, processing, and administration. The costs of arbitrating may exceed the costs of litigating, and are often in excess of the amount in dispute.

E. The arbitrator need not follow precedent or explain the reasons for his or her decision, so consumer protection statutes and case law can be ignored.

F. The proceedings are secret, so challenged practices will not be brought to the attention of the public generally or to the regulatory authorities such as the Federal Trade Commission, making it more difficult for abusive practices to be uncovered.

G. An arbitrator does not have the power to order injunctive relief. A consumer victimized by a widespread business practice may obtain individual recovery, but may not be granted an order that the wrongful practice cease.

H. The arbitrator's decision is immune from judicial review, except on very narrow grounds, such as fraud by the arbitrator, and a decision is final and binding even if it is wrongly decided as a matter of fact or incorrect as a matter of law.

I. The company chooses the forum, which can lead to proceedings which are conducted in an inconvenient forum and are inordinately expensive.

J. The supposed preference for arbitration as a means of resolving disputes is derived from a series of Supreme Court cases between commercial entities which had bargained for the speed and efficiency of arbitration, so the court was merely enforcing a freely negotiated contractual agreement between parties of equal bargaining power. That rationale is inapplicable to cases involving consumers who did not know about, negotiate, or accept the clause.

K. Defendants argue that arbitration may not proceed on a class wide basis, requiring consumers to pursue each case individually and depriving them of a very important procedural tool for stopping wrongful conduct and obtaining meaningful relief.

L. Future consumers are deprived of the clarification and development of consumer law through the courts. Statutes and regulations are full of ambiguity and uncertainty which case law could rectify and which the drafters of new and revised laws need for informed decisionmaking.

Senator GRASSLEY. Thank you, Ms. Sturdevant.

Now, Mr. Mogilnicki.

STATEMENT OF ERIC MOGILNICKI

Mr. MOGILNICKI. Good afternoon, Mr. Chairman and members of the subcommittee. My name is Eric Mogilnicki, and I am a partner at the law firm of Wilmer, Cutler and Pickering. I appear today on behalf of the American Bankers Association, the Consumer Bankers Association, the American Financial Services Association, and the National Retail Federation. Each of these groups deeply appreciates this opportunity to provide the subcommittee with information regarding the enormous benefits of using arbitration to resolve consumer disputes.

For over 75 years, there has been a strong Federal policy in favor of arbitration. That policy was embodied in the Federal Arbitration Act because it was clear, even in 1924, that litigation was consuming too much of the time, effort, and money of businesses and individuals alike. The Senate Judiciary Committee report that was prepared in connection with the Arbitration Act noted that, "[t]he desire to avoid the delay and expense of litigation persists. The desire grows with time and as delays and expenses increase. The settlement of disputes by absolutely appeals to * * * business * * * as well as to individuals."

That report went on to document the fact that arbitration took weeks, where litigation took years; that the costs of arbitration were "trifling" compared to the expense of litigation, and that the participants in arbitration—"winners and losers alike"—were satisfied with the arbitration process.

All of those conclusions are even more valid today. The delays and expenses of litigation are enormous. Indeed, this Congress recently noted in the Y2K Act that there are individuals who already find the legal system inaccessible because of its complexity and its expense.

Arbitration is still faster and less expensive than litigation. Today, arbitration takes less than half the time of litigation. Arbitration also allows individuals to pursue their claims without having to pay a lawyer to shepherd them through the complexities of our court system.

And arbitration still satisfies the individuals whose claims are resolved. One recent study of securities arbitration indicated that well over 90 percent of the participants in arbitration believed their case was handled fairly.

For all of these reasons, the Supreme Court has consistently upheld the use of arbitration clauses in consumer contracts. In 1989, the Court explained that "suspicion of arbitration * * * has fallen far out of step with our current strong endorsement of the federal statutes favoring this method of resolving disputes."

There are other substantial benefits to arbitration in the consumer credit context.

First, arbitration agreements give consumers a valuable right: the right to take financial institutions to arbitration, and so to have their dispute resolved quickly and inexpensively. Consumers do not have that right without an arbitration agreement. For its part, a bank or business that has agreed to arbitration has forfeited its right to litigate the consumer's claim. Instead, the financial institution must accept arbitration and abide by the arbitrator's decision.

Second, consumers who do not want arbitration can avoid it simply by choosing to do business with one of the many financial service providers that does not offer an arbitration clause in their contracts. Dispute resolution is one of the many areas in which different financial service providers offer different products and compete for business. A ban on arbitration agreements would limit the choices available to consumers.

This issue of choice is a significant difference between consumer credit contracts and arbitration agreements with auto dealers and employees who cannot easily avoid the agreement that is offered to them.

Third, certain disputes will never be heard unless they are arbitrated. To be sure, some claims are large enough to justify the costs of litigation. But the vast majority of claims are not large enough for litigation—even though they involve disputes that are important to consumers. For such individual cases, only arbitration offers a cost-effective way of having the dispute resolved by a neutral third party.

Finally, the Federal Arbitration Act already prevents abuses of arbitration. If an individual arbitrator proves biased or improperly excludes evidence, the Federal Arbitration Act provides for judicial review. The Federal Arbitration Act similarly permits courts to review and reallocate fees that are excessive, as is appropriate, and the courts have reallocated costs when the costs have been deemed to be excessive.

For all of these reasons, and others, the American Bankers Association, the Consumer Bankers Association, the American Financial Services Association, and the National Retail Federation believe that arbitration offers an important way by which their members can resolve customer disputes fairly and expeditiously. Each of these organizations welcomes the opportunity to be heard on this important issue and would welcome the opportunity to work with the subcommittee and its staff as its consideration of arbitration continues. We also ask at this time for an opportunity to supply additional materials for the record.

Senator GRASSLEY. Is that material available?

Mr. MOGILNICKI. No, not presently. No.

Senator GRASSLEY. OK; can you get it to us in just a few days?

Mr. MOGILNICKI. Yes, I will.

Senator GRASSLEY. OK.

And, by the way, the same as for the first panel, your entire statement beyond your 5-minute summary will be included in the record, if you submit it.

Mr. Lorber.

STATEMENT OF LAWRENCE LORBER

Mr. LORBER. Thank you, Mr. Chairman. I am Lawrence Lorber. I am partner in Sonnenschein, Nath and Rosenthal, and I appear today on behalf of the U.S. Chamber of Commerce, and we greatly appreciate the opportunity to address this committee and specifically to address S. 121.

Let me begin by stating a simple proposition: The U.S. Chamber of Commerce vigorously opposes S. 121. In our view, S. 121 provides a remedy to a now non-existing problem.

In the year 2000, after 9 years of experience with the Supreme Court's decision in the *Gilmer* case, we have learned several things: first, that the courts are almost unanimously in favor of arbitration and have almost unanimously upheld mandatory pre-employment arbitration agreements. They have done so for sound legal and policy reasons, understanding, as they do, that arbitration, at least in the employment context, is not foreign but is typical, indeed has existed in employment for over 40 years.

Second, I think it is important to understand what the employment context is. As the Congress now knows after the Congressional Accountability Act was passed, employers are faced with a multitude of legal proscriptions. It is very difficult both for employers and employees to understand their rights. These tend to be overlapping and sometimes confusing, both with statutory and regulatory impositions upon the system.

However, the employment relationship is an ancient one, and it consists of an agreement between an employee and an employer to join together to provide work and to provide a product or a service. Why should mandatory arbitration be applied to this system?

First of all, I think it is important to go back to the Supreme Court's *Gilmer* decision to understand certain precepts which the Court stated then and which, as I said, except in one instance, every court has adopted. The Supreme Court in *Gilmer* stated that it is now clear that statutory claims may be the subject of an arbitration agreement, and we are talking about both statutory and contractual agreements between employees and employers.

Secondly, the Supreme Court in *Gilmer* reiterated the Supreme Court's prior holding in *Mitsubishi* and stated that by agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute. It only submits to their resolution in an arbitral rather than a judicial forum. That is what the law of arbitration stands for today in the employment context.

Furthermore, the Congress recognized the *Gilmer* decision because after *Gilmer* was issued in March of 1991, the Congress in October of 1991 enacted the Civil Rights Act of 1991, and within that Act was Section 118 in which the Congress stated that, where appropriate and to the extent authorized by law, the use of alternative means of dispute resolution, including arbitration, is encouraged to resolve disputes.

Again, every court which has addressed Section 118 has found that mandatory preemployment arbitration agreements are consistent with law.

Let me address, however, perhaps the issue of arbitration and raise questions, at least in the employment context, as to why arbitration has apparently in some instances been viewed as a negative and detrimental to the employer's rights.

Well, the notion that employees always lose in arbitration is simply not so. Data produced by the Securities Industry Association showed that, for example, from the period 1992 through 1998 in arbitrations conducted under the stock exchange rules, employees prevailed 41 percent of the time. In arbitrations conducted under the NASD rules, employees prevailed 26 percent of the time. In cases that were tried to the jury in the Southern District of New York, employees prevailed only 19 percent of the time.

So the notion that this is a system stacked against employees is simply not true. But more to the point, I think it has been stated today—and, Mr. Chairman, you have stated it—that arbitration is, in fact, an expeditious and economical way of dispute resolution.

Data that we have submitted with our testimony showed that at least in 1998 there were some 24,000 new filings in Federal courts involving employment matters, and that doesn't count State courts. The same data that I cited earlier showed that resolution from filing to conclusion in the arbitrable forums took approximately 15 months. A case from start to finish in the Southern District of New York took approximately 29 months.

Furthermore, let me address the issue, as has been stated, the employee's right to a day in court. As we all know, in judicial proceedings employers often and the courts recognize such things as motions to dismiss and summary judgment. Many cases, a vast preponderance of the cases that are brought under those systems, are resolved prior to the employee, in fact, getting his or her day in court. That system does not pertain in an arbitration. Employees do get their right to adjudicate their grievance and have their grievance resolved.

Furthermore, I think it is fair to say that in most instances, certainly in the employment context, employees don't wish to spend months and years and thousands and tens of thousands of dollars waiting for their grievance to be resolved. They want to get on with their career, and employers, too, have the same interest in resolving the grievance so that it can conduct its workplace in an efficient and productive manner.

For all of these reasons, arbitration is a preferred means of dispute resolution. It is a means that is growing in importance, and I think that legislation such as S. 121 would serve to dramatically stop that growth and place into the court system some 24,000 new cases a year, which I don't believe the court system can handle.

Thank you.

[The prepared statement of Mr. Lorber follows:]

PREPARED STATEMENT OF LAWRENCE Z. LORBER

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 71 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of the number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 10,000 members. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 83 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. Currently, some 1,800 business people participate in this process.

Summary of Testimony

Legislation prohibiting mandatory arbitration of employment disputes is rooted in a flawed understanding of the arbitration process, a mistaken assumption that "the grass is always greener" on the litigation side of the fence, and the erroneous belief that employees would be better off resolving employment issues through expensive, time-consuming litigation, rather than having their claims resolved expeditiously through fair and impartial arbitration. The courts have addressed this issue and have overwhelmingly decided that for sound judicial, statutory, and policy reasons, mandatory employment arbitration agreements are preferred. It is for this reason that the U.S. Chamber of Commerce strenuously opposes S. 121, or other efforts to preclude the use of fair alternative dispute resolution mechanisms to resolve employment disputes. S. 121 seems likely to result in harmful consequences for all – employees, employers, and society in general, because litigation is more costly, more time-consuming, and will overburden our already over-burdened court system. Finally, regardless of whether or not one believes employees would be better off litigating rather than arbitrating employment claims, the point is essentially moot inasmuch as our judicial system simply cannot handle the increase in case load that would result if employment claims could not be arbitrated.

TESTIMONY BEFORE

THE SUBCOMMITTEE ON ADMINISTRATIVE OVERSIGHT AND THE COURTS

OF THE

COMMITTEE ON THE JUDICIARY

OF THE UNITED STATES SENATE

BY LAWRENCE Z. LORBER

MARCH 1, 20000

I. Introduction

Chairman Grassley and Members of the Committee, I am pleased and honored to be here today to testify on behalf of the U.S. Chamber of Commerce. The U.S. Chamber of Commerce is a business federation representing more than three million businesses and organizations of every size, sector and region. Thank you for your kind invitation.

By way of introduction, I am currently a partner in the Labor and Employment group in the law firm of Sonnenschein Nath & Rosenthal. I have been practicing labor and employment law for almost thirty years both in the government and in private practice. I was an attorney in the Office of Solicitor, U.S. Department of Labor in the division of Labor Relations and Civil Rights. I concluded my federal career as Deputy Assistant Secretary of Labor and Director – Office of Federal Contract Compliance Programs ("OFCCP"). The OFCCP is the agency within the Labor Department that administers the government's affirmative action and non-discrimination requirements for federal contractors. I have been in private practice since 1977 and primarily represent employers. In addition to my private practice, I have frequently been asked to testify before Congress in various oversight and legislative hearings involving employment issues. In 1985 I was made an Honorary Life Member of the Society for Human

Resources Management and in 1997 I was elected as a Fellow of the College of Labor and Employment Lawyers. In 1995 I was honored to be appointed as one of the original five members of the Board of Directors of the Office of Compliance, the Congressional Agency established by the Congressional Accountability Act to administer eleven employment statutes with respect to the Congress and congressional instrumentalities. In 1991, I was counsel to The Business Roundtable with respect to the 1991 Civil Rights Act. I am a member of the Labor Relations Committee of the U.S. Chamber of Commerce.

My testimony today will set forth the reasons that Congress should not prohibit mandatory arbitration of claims under the various employment law statutes. Legislation prohibiting mandatory arbitration of employment disputes is rooted in a flawed understanding of the arbitration process itself, a mistaken assumption that "the grass is always greener" on the litigation side of the fence, and that employees would be better off resolving their workplace disputes through laborious court litigation, rather than have their claims resolved through arbitration. Yet, "the grass is not always greener" on the litigation side of the fence, and legislation that is based on the most well meaning of intentions can have unintended and quite harmful consequences for all of us – employees, employers, and society in general because litigation is more costly, more time-consuming, and will overburden our already overburdened court system.

II. <u>Argument</u>

A. Legal Background

In considering prohibiting mandatory arbitration agreements in the employment context, Congress should recognize that it is not acting in a vacuum. Courts have addressed the issue, and have consistently upheld arbitration agreements provided the arbitration procedure contained certain procedural protections and safeguards.

In Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991), the Supreme Court held that the Federal Arbitration Act required the enforcement of the pre-dispute mandatory arbitration clause then required of applicants for securities industry trading licenses. The Court's decision provided "that statutory claims may be the subject of an arbitration agreement, enforceable pursuant to the FAA." Id. at 26. The Court's opinion cited to several other statutes in which resolution of issues by arbitration was permissible. Perhaps most importantly, the Gilmer decision cited to a previous holding of the Court in the case of Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, 473 U.S. 614 (1985), which held "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." Id. at 628.

Subsequent to the Gilmer decision, the Congress passed and the President signed into law the Civil Rights Act of 1991. Apart from the introduction of a damages regime and jury trials into Title VII and the ADA, Section 118 of that Act provided that : "[w]here appropriate, and to the extent authorized by law, the use of alternative means of dispute resolution, including ... arbitration, is encouraged to resolve disputes arising under the Acts or provisions of Federal law amended by this title." It is the interplay between Gilmer and §118 on the one hand, and the explosion of employment or employment related litigation on the other hand, which serves as the basis for these hearings.

Subsequent to the events of 1991, the federal courts have had occasion in many instances to review the interaction between pre-employment mandatory arbitration provisions and the various workplace statutes. Since the purpose of this hearing is not to reargue settled case law, I would direct the attention of this Committee to the recent First Circuit Court of Appeals case of Rosenberg v Merrill Lynch, 170 F.3d 1(1st Cir. 1999) in which the court examined with length and care the Gilmer decision, §118 of the 1991 Act, and its application to Title VII and the reported cases in the Circuits which addressed various aspects of this issue. With the exception of the Ninth Circuit Court of Appeals,[1] the various Circuit and District courts which have examined this issue have concluded that neither the 1991 amendments (with respect to Title VII and the ADA), ADEA or the Older Workers Benefit Protection Act, or the other employment laws prohibit pre-employment mandatory arbitration clauses. Indeed, the state courts which have reviewed this issue also appear to follow the overwhelming majority of the federal circuit courts upholding arbitration agreements. Armendariz v. Foundation Health, 68 Cal. App. 4th 374 (Cal. App. 1st Dist. 1998).

Further, the Supreme Court has touched on this issue since Gilmer. In the case of Wright v. Universal Maritime Service, 119 S. Ct. 391 (1998), the Supreme Court addressed the question as to whether a general arbitration clause in a collective bargaining agreement would preclude an ADA case from being brought in federal court. A unanimous Court held that such a general clause would not require such an action to be referred to arbitration, but based its decision on the fact that a general arbitration clause does not provide sufficient notice to constitute a knowing waiver. However, language in the Wright decision, while probably dicta, strongly suggests the Supreme Court's views regarding private employment agreements. In reconciling the superficially conflicting holdings in Gilmer and Alexander v. Gardner-Denver, 415 U.S. 36 (1974), the Wright Court stated:

> Petitioner and the United States as *amicus* would have us reconcile the lines of authority by maintaining that federal forum rights cannot be waived in union-negotiated CBAs even if they can be waived in individually executed contracts – a distinction that assuredly finds support in the text of Gilmer. . .

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[1] See Duffield v. Robertson Stephens & Co, 144 F. 3d 1182 (9th Cir. 1998). But see In Nghiem v. NEC Electronic, Inc., 25 F.3d 1437 (9th Cir. 1994).

Wright, 119 S. Ct. at 395 (emphasis added). Thus, with the exception of the Ninth Circuit, whose views have found no support in other jurisdictions, the legitimacy of employment mandatory arbitration contracts is settled.

Notably, notwithstanding judicial policy to defer to agency interpretations, the Equal Employment Opportunity Commission ("EEOC")'s Guidelines opposing pre-employment mandatory arbitration clauses have received no judicial support – a fact that is some indication that courts continue to believe that the Gilmer line of cases has been correctly decided on legal, as well as policy grounds. See EEOC v. Kidder Peabody & Co., 156 F.3d 298 (2d Cir. 1998).

B. Arbitration Should Be Encouraged, Not Discouraged, Because "Justice Delayed Is Justice Denied"

It is common knowledge that the litigation process is much more time-consuming than arbitration, which is the indisputable advantage that arbitration has over litigation. To say that prohibiting arbitration of employment claims will be fairer or more just ignores the amount of time a party must wait to have the claim resolved. From the perspective of employees and employers, time is critical. No employee or employer thinks it a good result that it takes years in the litigation process to obtain resolution of the issue. No employee or employer relishes the prospect of waiting years for the case to end, and expending extended periods of time engaging in protracted and increasingly acrimonious legal jousting in order to resolve an individual employee's employment grievance. In the interim the employee's career is effectively put on hold, and the employer incurs substantial legal costs and misuse of management time answering repeated demands for discovery, attendance at deposition, or voluminous production of documents designed as much to attempt to expand the action, or perhaps to convert it to a class action rather than resolve the immediate issue. In fact, as the current system operates the object is to bury the other side under a volume of paper work and legal skirmishing. Nor is this an apocryphal parade of horrors. Rather, in most courts this represents the norm in employment litigation.

The old adage that "justice delayed is justice denied" is not disputed, and indeed, is at the core of our legal tradition. The concept dates all the way back to the Magna Carta, which provided that justice be to none denied or delayed). Strachan v. Colon, 941 F.2d 128 (2d Cir. 1991) (citing 1 W.S. Holdsworth, A History of English Law, 57-58 (3rd ed. 1922)).

Recognition that justice delayed is justice denied is reflected in the Civil Rights Act of 1991, which expressly provides in Section 118 that: "[w]here appropriate, and to the extent authorized by law, the use of alternative means of dispute resolution, including . . . arbitration, is encouraged to resolve disputes arising under the Acts or provisions of Federal law amended by this title." It is also reflected in the Alternative Dispute Resolution Act of 1998, 28 U.S.C. §651 et. seq., which authorized a formal program of alternative dispute resolution at the federal trial court level out of Congress' recognition that arbitration should be encouraged because of the advantage it enjoys over litigation in more prompt resolution of disputes. While that specific Act does not offer the degree of final resolution or expedition private arbitration offers, it is instructive to revisit Congress' findings and policy determination. In Section 2 of the Act, "Findings and Declaration of Policy," Congress found in pertinent part:

> (1) alternative dispute resolution, when supported by the bench and bar, and utilizing properly trained neutrals in a program adequately administered by the court, has the potential to provide a variety of benefits, including greater satisfaction of the parties, innovative methods of resolving disputes, and greater efficiency in achieving settlements.
>
> (2) certain forms of alternative dispute resolution, including mediation, early neutral evaluation, minitrials, and voluntary arbitration, may have potential to reduce the large backlog of cases now pending in some Federal courts throughout the United States, thereby allowing the courts to process their remaining cases more efficiently;

Alternative Dispute Resolution Act of 1998, 28 U.S.C. § 651.

C. Preventing the Freedom of Parties to Contract for Mandatory Arbitration of Employment Disputes Will Have Harmful Unintended Consequences

1. The Costs of Prohibiting Mandatory Arbitration Outweigh the Benefits

Since the various employment statutes were enacted, there has been an explosion in the number of claims. The modern workplace is the subject of a multiplicity of new protective statutes. The employee is led to believe that any negative employment result "violates the law." The employer often believes that it acted appropriately and consistent with the law as it understands it. The system of overlapping and often contradictory statutes adds to the confusion and to the burden that employers bear. Added to this, of course, is the regulatory process in which the agencies often attempt to redefine a statute by regulation or interpretation in a manner designed to expand upon congressional action rather than provide more specific guidance.

The introduction of a damages regime into the workplace laws has encouraged the increasing contentious and litigious nature of workplace relations. The system encourages trial lawyers to promote confrontation rather than resolution. The attorneys fees provisions reward extraordinary litigation efforts, including extended discovery and motion practice because the lawyers, on both sides, will get paid. These developments have served in many instances to transform employment law into a legal lottery. We all read about the rare case where a plaintiff, and his or her counsel, is awarded a breathtaking jury verdict. What we don't see are the hundreds or thousands of cases in which the plaintiff is unsuccessful or in which the plaintiff is awarded a minimal judgment while his or her attorney is handsomely rewarded. In fact, I just filed an amicus brief before the Second Circuit Court of Appeals in a case in which the plaintiff received an approximately $5,000 Equal Pay Act adjustment while her attorney was awarded over $90,000 in attorneys fees.

Further, the system in fact falls more heavily on the small or medium sized employer who faces immediate legal costs in answering administrative charges and answering complaints. The practice of the EEOC and plaintiffs' attorneys is to remind employers of the legal costs they face as the incentive to settle cases, even those which may not have merit. Indeed, this system makes the "cost of doing business" so prohibitive that it builds in a real disincentive to hire permanent employees.

2. Mandating That Previously Arbitrable Claims Be Litigated in the Courts Is Not An Option When Courts Are Not Able to Handle the Increased Case Load

Regardless of whether or not one believes employees would be better off litigating instead of arbitrating employment claims, the point is essentially moot inasmuch as our judicial system simply cannot handle the increase in case load that would result if employment claims could not be arbitrated. In the past decade, what is most striking is the explosion of employment related lawsuits. Data derived from the annual reports published by the Administrative Office of the United States Courts[2] shows that federal court filings of employment cases jumped from approximately 3.9% of all such filings in 1991 to 8.6% of all filings in 1998. Similarly, civil rights filings jumped from 9.2% in 1991 to 15.4% in 1998. And because of the general litigation explosion during the past decade, the raw numbers are even more startling. In 1991, there were 8,102 federal employment cases filed. In 1998, that number jumped to 24,111. Civil Rights filings jumped from 19,100 in 1991 to 43,187 in 1998. This explosion in employment and employment related litigation places an ever increasing burden on the federal courts, which are facing a concomitant increase in other litigation, civil as well as criminal. And of course, the data does not account for State court filings, which even exceed the federal volume.

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[2] See Exhibit "A," attached.

3. Further Overburdening of the Courts Will Adversely Affect The Prompt and Just Resolution of All Other Claims, Including Claims Which Involve Issues of Equal or Greater Social Importance Than Individual Rights Under Employment Statutes

It is one thing to say that every employee deserves his or her "day (or years) in court." It is quite another to take the necessary steps to "put one's money where one's mouth is." If the courts are overburdened, and cannot accommodate the resulting increase in the courts' dockets, are we really prepared to hire many more federal judges, build more courthouses, and/or create a circuit to hear employment claims exclusively--which is what would be required were we to mandate that plaintiffs be entitled to litigate their employment claims in federal court, or to otherwise reallocate judicial resources away from matters of perhaps greater societal import. If the answer is not clearly "yes," I submit that prohibiting arbitration agreements in the employment context will have adverse and far-ranging consequences not only for the already overburdened court system, but for all parties in the civil and criminal context, as well as for society as a whole. When employment disputes take longer to resolve and are more costly to resolve, and when other claims of social import are not accorded the judicial attention that they deserve, whatever perceived "benefit" that litigation represents to employees over arbitration will be far outweighed by the costs. At the end of the day, given the inevitability of increased delay in the court system, and the frustration and cynicism for the law that will no doubt be engendered, it is unclear whether anyone will be "better off" litigating, instead of arbitrating claims, except, perhaps, the lawyers.

III. <u>Conclusion</u>

For the foregoing reasons, the U.S. Chamber of Commerce strongly opposes S.121 or any other legislation that will compel workplace issues to be resolved by litigation. The courts have almost universally upheld mandatory arbitration of employment disputes, which affords procedural protections and ensures that substantive statutory rights are protected.

ATTACHMENT A

Civil Rights and Employment Case Filings in the Federal Courts

Year	Civil Rights	Employment	Civil Rights as % of Total	Employment as % of Total
1975	9,108	3,966	9.4%	4.1%
1976	9,607	4,423	10.0%	4.6%
1977	12,822	5,773	9.9%	4.5%
1978	12,817	5,457	9.4%	4.0%
1979	13,549	5,835	9.0%	3.9%
1980	12,437	4,782	7.5%	2.9%
1981	14,741	5,802	8.4%	3.3%
1982	16,796	7,526	8.5%	3.8%
1983	18,880	8,529	8.1%	3.7%
1984	21,196	9,959	8.2%	3.8%
1985	19,846	8,315	7.4%	3.1%
1986	19,870	8,892	7.5%	3.4%
1987	19,962	9,017	8.3%	3.7%
1988	19,439	8,641	8.2%	3.7%
1989	19,210	8,971	8.1%	3.8%
1990	18,920	8,527	8.5%	3.8%
1991	19,100	8,102	9.2%	3.9%
1992	22,486	9,672	10.0%	4.3%
1993	25,598	11,725	11.2%	5.1%
1994	30,222	14,351	13.0%	6.2%
1995	34,701	17,528	14.6%	7.4%
1996	38,729	20,943	14.6%	7.9%
1997	42,893	23,547	16.4%	9.0%
1998	43,187	24,111	15.4%	8.6%

Administrative Office of the U.S. Courts, Annual Report, various years.

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Senator GRASSLEY. Thank you, Mr. Lorber.

Now, Mr. Maltby.

STATEMENT OF LEWIS L. MALTBY

Mr. MALTBY. Good afternoon, Mr. Chairman. Thank you for inviting me to be here.

I have to admit, uncharacteristic as it may be, that Mr. Lorber makes a very good point. Arbitration of statutory employment disputes is not necessarily a bad thing. It is not necessarily unfair, and it is something that we probably need.

The simple fact of the matter is that most employees cannot afford to go to court when they have an employment dispute with their employer. It costs at least $50,000 today to take an employment case to court, and most employees just don't have that kind of money even when they have a job, much less when they just lost their job and are struggling to put the roof over the head of their children.

But for arbitration to be as useful as it could be, it has to be fair. I think we could all agree on that. At least, I hope we can.

Now, sometimes it is said that fairness is like beauty. It is in the eye of the beholder. But that is not really the case here. We know what arbitral fairness means. The American Bar Association has published a point-by-point protocol of due process standards for employment arbitration. It has been blessed and reviewed by everyone from manufacturers and employers' groups to the National Employment Lawyers Association and the ACLU. There isn't anybody who disagrees that the protocol is a fair and workable due process standard.

We also know that that standard is generally not being met. The United States General Accounting Office reviewed existing employer arbitration systems relatively recently, and what they found is the majority—the majority—of employers' arbitration systems did not meet the standards called for by the ABA. And in some cases, the abuses that creates are absolutely staggering. Let me just give you one example, not necessarily a typical one but to show you how bad it can be.

Helen Walters was a legal secretary in a brokerage firm in California. Her boss called her—and I am sorry for the profanity, but I have to quote the record. He called her a "bitch," he called her a "streetwalker," he called her a "hooker." He brandished a riding crop in her face in front of her coworkers. When he wanted to talk to her, he would call across the crowded trading floor in front of hundreds of people, "Hey, bitch, drag your ass over here." And he threw condoms on her desk, knowing as a conservative religious woman that she would be deeply offended by this. I can't imagine a more blatant case of sexual harassment. But when she took her case to the New York Stock Exchange arbitration system, those arbitrators found that nothing that those employers had done to her was sexual harassment. They totally exonerated the employer of any responsibility or liability under those circumstances.

That is simply not the way it has to be.

And what is at stake here is more than just injustice done to a large number of individuals, although that is extremely important. What is at stake here is nothing less than the survival and long-term viability of our employment discrimination laws. This Congress and the rest of the country have worked for 40 years to create a workplace free of discrimination. We passed laws to prevent racial discrimination. We passed laws to prevent gender discrimination and sexual harassment, and also disability discrimination and age discrimination.

But all of that depends upon a workable enforcement mechanism to mean anything. If those laws can only be enforced in arbitration systems where the due process rules are not being applied or the forums are stacked against the employee, then it is highly questionable whether Title VII and the ADA and ADEA mean much of anything anymore. We have all invested far too much in creating a just, discrimination-free workplace to have it jeopardized by taking away an efficient enforcement mechanism.

The answer to this dilemma is actually quite simple. All we have to do is make arbitration voluntary. It is easy to see why employers so frequently don't make the system fair. They have no incentive to make the system fair. If the employer stacks the deck, it can reap substantial financial advantages, and if it stacks the deck, there is no downside. The employees can't walk away from the system. You almost have to be crazy not to stack the deck as an employer under today's law.

But if it were voluntary, everything changes. The only way the employer can get the employees into the program as it wants and needs to do is to make it fair enough that the employees will choose it voluntarily.

Voluntariness is not some sort of ivory-tower impractical idea. The American Arbitration Association, the oldest and largest organization of arbitration providing in this country and in the world, recommends that arbitration be voluntary, not a condition of employment. At least 12 major American corporations have voluntarily chosen voluntary arbitration agreements. Every one of those 12 programs is a success, and by that I mean a success in the eyes of the management that set it up.

And voluntariness is also the right thing to do. Obviously, most conditions of employment can and should be negotiated between the employer and the employee. But there are some things that are just too important to leave up to that kind of process. It is simply wrong—and we all know it is wrong—to say that your boss could require you to sleep with him or her to get a job. Your boss can't make you change your religion or tell you how to vote to get your job. And the right to go to court is just too important to leave to unequal negotiations. It has to be beyond the realm like the other important values I have talked about.

Employment arbitration is here to stay. It is real. It is the wave of the future. And it could be extremely beneficial. But it is only going to be beneficial if it is fair, and it is only going to be fair if it is voluntary.

Thank you.

[The prepared statement of Mr. Maltby follows:]

PREPARED STATEMENT OF LEWIS L. MALTBY

Americans need better access to justice. It is no secret that our courts have become so complex and expensive that it is difficult for the average citizen to achieve justice through litigation. Alternative dispute resolution, including arbitration, holds the potential to make justice more affordable and more available.

This is especially true of workplace disputes, which frequently involve complex factual and statutory issues. The cost of bringing a statutory employment dispute to court is at least $50,000. This is far beyond the financial resources of most people, even when they are employed. To raise such a sum when one has just been fired and has no income is virtually impossible. A few people circumvent this economic hurdle by obtaining counsel on a contingency fee basis. But an attorney can only afford to accept a case on contingency if the probability of success is very high and the amount of damages is large enough for the attorney's share of the final award (generally 35–40%) to compensate for the substantial number of hours he or she will have to work. Paul Tobias, founder and past president of the National Employment Lawyer's Association, testified before the Dunlop Commission that the private bar rejects at least 95% of those who come to it seeking help. Nor can federal agencies meet the need for representation. The EEOC, for example, is able to litigate only 1 out every 200 complaints it receives. Under these circumstances, the need for additional avenues to justice in employment disputes is clear.

But it is equally clear that these new methods of access to justice must be fair. Systematic access to injustice cannot be the goal or the result of our efforts.

It has been said that fairness, like beauty, lies in the eye of the beholder. But, fortunately, we now have an objective standard for due process in employment arbitration. In 1994, the American Bar Association assembled a national blue ribbon panel to discuss due process in arbitration and attempt to find common ground. This panel included representatives of all concerned groups, including management, labor, the dispute resolution community, and civil rights groups. I was privileged to serve on this panel representing the American Civil Liberties Union. In 1995, this group unanimously endorsed a set of due process principles, known collectively as the ADR Protocol.

The Protocol includes the following requirements:

1. A neutral and unbiased arbitrator
2. Right of the employee to an equal role in selecting the arbitrator
3. Right to counsel
4. Reasonable discovery
5. Identical remedies to those available in court
6. A written opinion.

These requirements are not difficult to meet. The American Arbitration Association, the world's largest provider of arbitration services, modified its rules to make these six points part of its mandatory operating procedures in 1996. After 4 years of experience, AAA has reported no difficulties with complying with these rules.

But many employers' ADR systems do not meet these requirements. When the U.S. General Accounting Office examined existing employment arbitration systems, they found that the majority did not provide the due process called for in the Protocol. A more recent survey published in the *Dispute Resolution Journal* reached the same conclusion. For example, 50% of the plans studied did not authorize the arbitrator to award the full range of legally authorized remedies.

There seems to be no limit to the injustice that is produced when due process standards are absent. Helen Walters was a trading room secretary at a California brokerage firm. Her boss called her a "bitch", a "hooker", and a "streetwalker", and a "f---ing idiot". When he wanted to talk to her, he told her to "drag your ass" over to him. He brandished a riding crop at her and threw condoms on her desk. It would be hard to imagine a more blatant case of sexual harassment. Yet when Walters took her case to arbitration, the arbitrators ruled in favor of her employer.

But the harm to individual employees, as bad as it is, does not reveal the true extent of the damage we face if the problem remains unaddressed. Our entire national effort toward a workplace free of discrimination is at risk. As every lawmaker knows, in order for a statute to be effective it must have a clear statement of the rules it establishes and an effective enforcement mechanism. Without a method of enforcement, a statute is merely an empty admonition which people are free to disregard.

This is the situation we face regarding our carefully constructed and vitally important civil rights laws, including Title VII, ADEA, and the ADA. If employees are required to surrender their right to take violations of civil rights laws to court and the arbitration systems to which they must turn do not provide due process, our nation's four decade struggle to create a workplace free of discrimination will be severely compromised.

This risk is especially great in light of the number of employers turning to arbitration. Private arbitration was virtually unknown outside the realm of collective bargaining until the 1980's. By 1995, the U.S. General Accounting Office found that

8.4% of all employers had established an arbitration system, and that 10% more were actively considering it. Only 2years later, the GAO found that the use of arbitration had more than doubled; 19% of all employers were now using it. All the available evidence indicates that employment arbitration has continued its spectacular growth. At this rate of increase, the majority of employers have either already adopted arbitration programs or soon will have. Employment arbitration is well on its way to replacing the courts as the primary method of resolving statutory employment disputes. If arbitration does not provide justice to those who have been victims of racial discrimination or sexual harassment, our civil rights laws are in great danger.

The issue we face is how to encourage the growth of this potentially valuable new source of access to justice while ensuring that it is fair. The answer is to make arbitration voluntary. The courts should enforce agreements to arbitrate only when they represent the voluntary choice of both parties.

This is not the law today. Following the Supreme Court's decision in *Gilmer* v. *Interstate/Johnson Lane Corp.,* federal courts have consistently held that employers may require all employees to sign an agreement to arbitrate as a condition of employment. While a few highly marketable employees may be able to accept another offer if they object to this provision, for most people this is no choice at all. They have rent to pay and children to feed and must accept whatever terms a prospective employer offers. Even employees who are in high demand lose their ability to exercise meaningful choice as arbitration becomes standard industry practice.

The reason so many arbitration systems fail to provide due process is because employers have little incentive to make them fair. In fact, it is in an employer's best financial interest to make the system unfair. By failing to provide an impartial arbitrator, or eliminating discovery, an employer can win many cases in which it broke the law and would have lost in court. By restricting the damages an arbitrator can award an employer often reduces the size of the award it must pay in the cases it loses. These financial incentives are substantial.

There are no offsetting financial incentives encouraging employers to be fair. The employer's objective in setting up an ADR program is to get as many as possible of its employees to enroll. When employees have no choice about enrolling, the employer can reap the financial rewards of stacking the deck with no loss in enrollment.

But if the agreement to arbitrate had to be a voluntary choice on the employee's part, the entire system of incentives would change. An employer who chose to cut corners on due process would pay the price of having employees opt out of the arbitration system entirely. The only manner in which employers could achieve the widespread participation they desire in order to avoid the costs of litigation would be to make the arbitration system fair.

Making the decision to arbitrate voluntary is also the right thing to do. The right to take legal disputes to court is a fundamental part of our democratic society. It is enshrined in our Constitution. Without an independent court system (and the ability of citizens to use it), the rule of law itself is undermined. Employers have every right to establish the terms on which they offer employment. But some rights are too fundamental to allow employers to tamper with. Employers may not require prospective employees to have sex with them as a condition of employment. Employers may not require employees to change their religion or tell them how to vote. Employers should also be prohibited from requiring employees to give up their right to go to court.

Making employment arbitration voluntary is not only right in principle, but feasible in practice. The American Arbitration Association, the world's oldest and largest provider of arbitration services, recommends that employment arbitration be voluntary. At least 12 major corporations have heeded AAA's advice and established voluntary arbitration programs. Every one of these programs has been successful.

The question facing us is not whether employment disputes will be arbitrated, but under what conditions this will take place. Under the present system, employers have the ability to establish arbitration systems that deny due process and force employees to use them. Employers have substantial financial incentives to take this low road, and many do. Surely this is intolerable. The solution is to make arbitration voluntary. This is right in principle and would ensure that arbitration provides the fairness and justice that all Americans deserve.

The Civil Rights Procedures Protection Act (S. 121) would accomplish this crucial goal. I urge the members of this subcommittee to support it.

Senator GRASSLEY. This is how we are going to handle the questioning. I am going to take 5 minutes now, and then Senator Sessions will take 5 minutes, and then we have to go to meetings at

4 p.m. or a little after 4 p.m., and Senator Feingold has consented to finish up the questioning and to adjourn the meeting.

So before I ask questions, I want to, as Chairman of the subcommittee, thank my members for being here and giving attention to these important issues of these three bills, as well as the second panel, I thank you for your participation. I want to thank you in advance.

Ms. Sturdevant, I would like to ask you the first question. You argue that each party should have the option of choosing to arbitrate after the dispute arises in order to ensure that the decision to arbitrate is based on consent and not coercion.

Couldn't this proposal be somewhat a double-edged sword because businesses and creditors could force consumers to resolve grievances through costly litigation rather than arbitration? Do you advocate that both businesses and consumers should have the option to choose to resolve disputes through the courts rather than arbitration?

Ms. STURDEVANT. I thank that both parties should have the right to choose, and I do not see it as a problem for consumers if there is no predispute agreement because, for one thing, a consumer with a small claim against the bank, under the present system, can go to small claims court, which costs just a few dollars and have a judge resolve that issue speedily and fairly following the law and applying consumer protection statutes.

Secondly, I do not fear that consumers will be prevented from going to their favored arbitral forum, absent companies' agreement because I have seen too many companies adopt arbitration requirements thinking that that will give them an unfair advantage, and it is not an advantage to a consumer who is challenging an unlawful business practice of a major national corporation to go to arbitration with no discovery, high costs, no rules of law and no adequate remedy. So I do not see the harm, and I see the benefits of requiring consent after the dispute has been arisen.

Senator GRASSLEY. How would you keep businesses then and consumers then from threatening consumers with—maybe I said that wrong—business and creditors from threatening consumers with costly and time-consuming litigation?

Ms. STURDEVANT. Well, the consumer can elect to file in municipal court, can file in superior court, if that is appropriate, and can seek the advice and the involvement of the trial judge in minimizing that danger. So I see that there is a problem potentially of abuse in the system that you posed, but I have seen the actuality of abuse in mandatory binding arbitration. It is intended to be unfair, it is intended to preserve banks' financial well-being. It is intended to prevent runaway jury verdicts, punitive damages, injunctive relief and class litigation. It is intended to be unfair, and that is how it is operating.

Senator GRASSLEY. Now, I am going to go to Mr. Mogilnicki. There was some reference, allusion to this in the Post article that I have referred to. One of the most problematic aspects of many arbitration services is the degree to which they appear to be dependent upon a few large clients for virtually all of their income. There seems to be a distinct conflict of interest when many arbitration services actively solicit business from a party that might come before it with strong hints that the solicited party would get favorable treatment in its forum.

Could you comment on how an arbitration service that has a vested interest in ensuring one of the parties coming before it is satisfied, and moreover, whether the services who relies on that party's continued business for its financial solvency can function as a nonbiased mediator?

Mr. MOGILNICKI. Thank you, Mr. Chairman. That is obviously an important issue and one that financial institutions wrestle with as they determine which arbitration forum to use.

There are at least two ways of guaranteeing that the process that an individual encounters in arbitration forum is fair, and they both exist presently. The first is to rely upon the fairness of the individual arbitrator or the panel of arbitrators that is hearing the case. Now, in the case of the arbitration forum that is featured in the Washington Post article, there are detailed rules that require the arbitrator to disclose to the consumer his or her background and qualifications as an arbitrator and allows the individual to strike that arbitrator for cause or to employ a preemptory challenge to the arbitrator because even though there is not cause, the consumer does not feel comfortable with that particular arbitrator.

So there are detailed rules at the arbitration forum. Similarly, the same forum has recusal rules for arbitrators, and those recusal rules look just like the rules for recusal in Federal court. So, again, another safeguard within the rules of the arbitration forum, to make certain that the arbitrator is fair.

The second protection that I just want to touch upon briefly is that there is, in fact, judicial review of arbitration awards, where there appears to have been partiality or bias in the arbitration forum so that there is always the safety net of judicial review should the internal processes of the arbitration forum not succeed in weeding out any potential for bias.

Senator GRASSLEY. Ms. Sturdevant, you argue that if businesses require arbitration by contract, they should also allow a consumer, dissatisfied with the results, to also have the option of litigation. Should businesses, dissatisfied with the result of arbitration, also be accorded the same option of litigation? And if you would disagree with that, why not?

Ms. STURDEVANT. Well, Senator Grassley, that is the way the system works now in judicially supervised arbitration. I think arbitration and mediation can be very useful as ways of resolving disputes and of clearing court calendars, but the harm is that if it is coerced on one party and there is no safety net so that an unfair or wrong result remains. I think if the company agrees to be bound to arbitration and the consumer is brought into it, the only possible way to make it fair, if the consumer does not consent, is to have the safety valve that the consumer can appeal to the court. I would not make it both ways. My preference would be not to require or impose arbitration, but make it voluntary on both parties.

Senator GRASSLEY. Mr. Lorber and Mr. Maltby, I am going to have to submit my questions to you for answer in writing. I have several.

[The prepared questions of Senator Grassley are located in the appendix.]

Senator GRASSLEY. Senator Sessions.

Senator SESSIONS. Thank you very much.

Well, this is a big, big deal in America. We believe in due process. We believe in people having rights. But what we are learning, as Mr. Maltby said, we are talking about $50,000 a lawsuit. That is a big deal, and the system figures ways to reduce those lawsuits and contain them, and it is harder to get an expeditious and fair day in court. So I tend to believe that arbitration is something to be encouraged, and I tend to believe that in some circumstances, it can be required as a condition of doing business with somebody.

However, if we do that, particularly I would say to the business community, we have got to be sure that it is perceived over a period of time as working fairly, and justly and expeditiously getting their claims. I do note, Ms. Sturdevant, that the American Bar Association, which is a lawyer group, found that consumers prevailed in 80 percent of their claims in arbitration, compared to 71 percent in court that they did, and that nonunion employment arbitration, employees win between 63 and 74 percent of their claims in arbitration, compared to 15 to 17 percent in court. There is a Law Week article on that. I do not know, Mr. Maltby, how good those numbers are. But I would not be surprised that arbitrators tend to be a little more "split the baby," so to speak, and split the difference and not attempt to all or nothing, some particular phrase of law or clause or you get nothing because you did not quite qualify. So I think it has something good to be said for it.

Fifty-nine percent, according to a Roper survey recently, said that Americans would choose arbitration over a lawsuit to resolve claims for money. And the American Bar Association calculates 100 million Americans are locked out of court by high legal fees. They cannot afford justice. An American Bar Journal reports that most lawyers will not begin a lawsuit worth less than $20,000. So I do not know. And Mr. Lorber, I am sure the automobile dealers are members of your Chamber of Commerce, are they not?

Mr. LORBER. I suppose they are.

Senator SESSIONS. Many good members, I assume. Is it not a fact that you are troubled by the position they are taking on this deal with the manufacturers?

Mr. LORBER. Well, I do not know what the Chamber's position on that is. As I said, it is in our view that employment simply stands in its own stead. There is mandatory arbitration now in employment. Any employee who goes to work for a company which is organized by a union has mandatory arbitration without any choice. So that, at least insofar as the employment posture is concerned, the Chamber simply does not believe that impeding, which we believe S. 121 will do to the arbitration system, is going to help anybody. It certainly is not going to help the employees, and we think it is going to put significant costs and disruption into the business process.

Senator SESSIONS. Well, I have a letter of February 28th this year, a few days ago, in which Mr. Josten, Bruce Josten, you know him——

Mr. LORBER. Uh-huh.

Senator SESSIONS. Your president, wrote that, "I am writing on behalf of the Chamber of Commerce, representing businesses of every size, sector and region, to express our opposition to S. 1020."

Do you oppose S. 1020?

Mr. LORBER. Well, if Mr. Josten does, then the Chamber does. Any bills which will interfere in the arbitration system, I mean, 121 prohibits mandatory arbitration; the other bill does as well.

Senator SESSIONS. We cannot have it both ways. I am just telling you. I think there is a conflict there between my friends, the automobile dealers, and these big corporations that I do not know anything about. We did have a lawsuit. I can understand the manufacturers' problems. *Spro* v. *Ford Motor Company* in Alabama, in which a dealer was given a dealership under a minority recruitment program, an African-American minority dealership, and they wanted to encourage minority dealerships. It subsequently failed, and he sued alleging that he was not told that more minority dealerships failed than nonminority dealerships and won $10 million against Ford, who apparently had an affirmative action program that they were working on to try to do that.

So, Ms. Sturdevant, I think the thing that concerns business is that an error or disagreement over a certain matter in a contract can all of a sudden get before a jury and turn into $10 million. And if they made a mistake, most of the time they are willing to pay it, I think, and I think that is a legitimate concern. So how we can protect people against fraud, clear manipulation of innocent consumers beyond arbitration, I am open to that. But I think most disputes would be better off settled through arbitration.

My time is expired. Would any of you want to comment on the present state of Federal arbitration law briefly? And does it need any changes or improvements?

Mr. MALTBY. Senator Sessions, I would like to make two comments about the state of the Federal law. The first is that Mr. Lorber and other witnesses are correct, the Supreme Court and the Federal judiciary have almost uniformly held that it is legal for an employer to insist upon an arbitration agreement as a condition of employment. However, that does not mean what certain people seem to think it means. It does not mean that the Supreme Court thinks it is the right way to go, it does not even think that the Supreme Court thinks that it is a good way to do business or that it is fair. All it means is that the Supreme Court has interpreted the extremely difficult to understand Federal Arbitration Act, which was drawn up long before anyone contemplated the issues we face today, to require it to allow situations like the case in *Gilmer.* The law is on Mr. Lorber's side in this case. But the Supreme Court has not said that these contracts of adhesion are a good thing. All it said is that they are allowable by the Federal Arbitration Act.

Senator SESSIONS. But you do not disagree that in union contracts, there is arbitration and that other nonunion employees win far more often in arbitration than in litigation?

Mr. MALTBY. Senator, you are absolutely correct.

Senator SESSIONS. And at less expense, obviously.

Mr. MALTBY. You are absolutely correct, Senator, that that is the way things work in every union shop in America.

Senator SESSIONS. It sounds like the kind of thing we ought to do more of.

Mr. MALTBY. But there is a critical difference. In the union shop, the employees collectively get to look at the arbitration system and the arbitrators that get used, and if they do not think the system is fair or the arbitrators are fair, they can walk. That is not the situation when a lone employee walks into General Motors. They have got no ability to walk away from the system if it is not fair, no ability to influence it if it is unfair. That is a very big difference.

Senator SESSIONS. Mr. Lorber.

Mr. LORBER. That is simply not true. Let me just very briefly, you do not need a debate among lawyers here. I know time is short, but I would just point out, for example, the Rosenberg case, the First Circuit case I cite, which talked at length about analyzing how the courts have accepted mandatory arbitration, in that case that First Circuit said on its own, it was not litigated at the District Court, that because it believed there was not proper notice to Ms. Rosenberg, it did not enforce the arbitration agreement. There are lots of cases now, as I said, since *Gilmer,* since *Gilmer,* the Federal law of employment arbitration, I think the Courts of Appeals have established a fairly well-understood body of law as to what is fairness. This is not 1991. It is 2000.

And the question, Senator Sessions, what is the law today? Today, the law is there has to be notice, it has to be fair. One Circuit said the employer has to pay the cost of the arbitration. The fourth circuit said arbitration must be binding on both sides. The employer cannot opt out of arbitration. So that there are now I think a very substantial body of law, which has established the fairness that Mr. Maltby suggests. I do not quite understand him saying, on one hand, arbitration is a good way to go; on the other hand, in one case, somebody lost. I mean, I know a case where an arbitrator held that reinstated individual who threatened the life of somebody else, the arbitrator felt that that individual was protected by the Americans with Disabilities Act. I mean, one could differ with that result, but that was binding.

So all I would simply submit again is now we have not the Federal Arbitration Act, but we have a body of law since *Gilmer,* and that body of law I think has established very well understood predicates for fairness.

Senator SESSIONS. I just think we need to be careful before we dump a whole host of cases that are being arbitrated today back onto the court system. They are already overworked and too expensive.

Mr. MALTBY. If I could make one very brief comment, Senator. I knew Mr. Lorber and I would find something to totally disagree about, and we finally found it. We do not have the time or the right forum for a long legal debate here, but I would welcome the opportunity to submit written materials to this subcommittee talking about how totally lacking and almost nonexistent the Federal appellate review standards on due process are concerned.

Senator Feingold.

Senator FEINGOLD [presiding]. This has been an excellent hearing, and when a hearing allows a long-suffering member of the minority party to chair the hearing, it gets even better. [Laughter.]

So I appreciate this opportunity.

Senator SESSIONS. You are very able.

Senator FEINGOLD. Thank you. And actually as Senator Sessions is leaving, I just want to indicate that I am pleased that he asked the question on the motor vehicle contracts about whether or not dealers and consumers had a practice of requiring these agreements. And I just want to note for the record, again, what our witnesses said; is that if it exists, it is a limited practice and that they are prepared to say that it should not be the practice. That is the kind of consistency that I am looking for in having these different issues brought together. And all I can say to my friend from Alabama who has left, but I am sure his staff will convey it to him, there is no reason why we cannot expand our legislation to include banning mandatory binding arbitration in those contexts as well.

He said it well. He said you cannot have it both ways—Senator Sessions did. And that is why it was so important to me, that when the auto dealer representatives answered that question, they were not trying to have it both ways. I think that is very important when we are looking at mandatory binding arbitration.

Before I begin my questions, I just want to ask that a couple of statements be entered into the record; a statement by the Consumers Union, a statement by the National Partnership for Women and Families and written testimony by a Public Citizen. Each of these statements address the problems that arise from predispute contractual agreements to enter mandatory arbitration.

[The statements follow:]

CONSUMERS UNION, PUBLISHER OF CONSUMER REPORTS,
Washington, DC, February 29, 2000.

Subject: Hearing on arbitration clauses.

Hon. RUSS FEINGOLD,
U.S. Senate,
Washington, DC.

DEAR SENATOR FEINGOLD: Thank you for your leadership in raising the alarm about the increasing creep of mandatory and binding arbitration clauses into consumer contracts. Often times consumers are unaware that they are agreeing to be bound by arbitration at the time they sign the contract. In some cases, credit card and charge card companies unilaterally changed the terms of the agreement by adding a new provision requiring the consumer resolve any disputes solely through mandatory and binding arbitration. Unilateral changes in contract terms often without the consumers prior knowledge or ability to consent docs little to assure that consumers will benefit from a fair process when trying to resolve a dispute. Likewise, an arbitration provision should not be required as part of the contract unless both parties agree and are fully informed. Although arbitration can be useful to consumers, it is not always preferable to litigation, especially if the arbitration process is costly to consumers or where the consumer is faced with a decision-maker who depends on the business involved in the arbitration for a large share of business.

Consumers Union is concerned that these mandatory and binding arbitration clauses prevent consumers from having their claims heard in court. Such a backstop is necessary to ensure that the process is fair for all parties and may be necessary to rectify any unfairness in the arbitration process. Fair procedures in the implementation of dispute resolution clauses are vital to ensure a just result for both the consumer and business. Additionally, any form of arbitration must not be costly to the consumer seeking redress and avoid potential conflicts of interest between the parties and the entity serving as the arbitrator.

Attached please find a copy of Consumers Union's Policy on Arbitration. Should you have any questions or comments, please let us know.

FRANK TORRES,
Legislative Counsel.

Attachment.

CONSUMERS UNION POLICY ON ARBITRATION AND OTHER ADR CLAUSES IN STANDARD FORM CONSUMER CONTRACTS

Standard form contracts offered to consumers by commercial parties are increasingly likely to contain clauses requiring the consumer to participate in arbitration or another form of alternative dispute resolution (ADR). These clauses have the potential to prevent consumers from having their claims heard in court. Consumers Union's policy on mandatory arbitration and ADR clauses is designed to promote standards for when these clauses should be permitted to be placed in consumer form contracts, or enforced if found in such contracts, and to promote fair procedures in the implementation of ADR clauses.

A. ADR, including arbitration, should not be required in consumer form contracts unless the consumer has the option either to decline to engage in the ADR process after the dispute arises or to reject the results of the ADR process. In other words, ADR clauses should be permitted and enforceable in consumer contracts only if the ADR process is: (1) contractually mandated with non-binding results, (2) optional with binding results, or (3) optional with non-binding results.

B. The ADR process must be fair. The overall fairness of a contractually imposed ADR process should be judged by compliance with the following criteria.

a. ADR clauses imposed in a consumer form contract must not select an ADR provider if the location of that provider would impose unreasonable travel costs upon the consumer in order to fully participate in the hearing of the claim.

b. Any consumer contract requiring the consumer to submit to ADR should contain a clear, conspicuous, and understandable disclosure describing the degree to which the consumer gives up any rights he or she otherwise possesses to go to court. Whenever the parties or their agents engage in face-to-face discussions leading to formation of the contract, there should also be a clear oral disclosure.

c. ADR clauses should not apply to cases where a consumer is seeking injunctive relief unless, after the dispute arises, the consumer agrees to the ADR process and the ADR decisions maker has the power to order injunctive relief.

d. In order for any ADR provider to be preselected in a consumer form contract, that provider must maintain an index of actions which is open to the public. The index must identify the parties to the disputes it has pending and has resolved in the past five years. The results of its ADR procedures involving individual consumers should also be available, unless the ADR decision maker has found that there is a special need to seal the results of the ADR proceeding.

e. Whenever the result of ADR will be binding or subject only to limited review, all parties should have access to civil discovery to the degree necessary to the claims and defenses presented. In particular, consumers should always have access to the complete file, if any exists, about their claim or dispute, and to evidence indicating that any problem they allege is part of a larger pattern or practice of the business.

f. Standard form consumer contract ADR clauses should be invalid if the preselected ADR provider does not require that the officer who presides at the ADR proceeding must swear all the witnesses to tell the truth.

g. Standard form contract ADR clauses in consumer contracts should be disallowed unless they provide that the consumer may appeal for review of alleged errors.

h. ADR providers selected in consumer form contracts must provide for waiver of fees and costs for indigent individuals.

i. ADR clauses in consumer form contracts should be invalid if they select an ADR provider which does not have an effective method of internal review to reduce the risk of selection bias. This is of critical importance. State licensing of ADR providers may also be necessary.

j. ADR providers selected in consumer form contracts must provide a written statement of the basis for any decision which is binding when issued.

k. Conflict of interest disclosures should be made by all proposed single ADR decision makers and all who are proposed to serve as a so-called "neutral third." At least the following should be disclosed:

Names of prior or pending cases involving any party to the ADR agreement or any attorney for any of the parties in which that person is serving or has served as an arbitrator, party or attorney.

The results of each concluded case involving any of the parties or attorneys for the current case, including the identity of the prevailing party and the date and amount of any award.

After disclosure, the consumer should have the right to reject the proposed decision maker.

l. ADR should never be used to eliminate or delay a consumer's access to a small claims court action, licensing or other administrative proceeding, or a consumer class action.

NATIONAL PARTNERSHIP
FOR WOMEN & FAMILIES,
Washington, DC, March 1, 2000.

Hon. CHARLES GRASSLEY,
Chairman, Administrative Oversight and the Courts Subcommittee, U.S. Senate, Washington, DC.

DEAR SENATOR GRASSLEY: As the Senate Subcommittee on Administrative Oversight and the Courts considers S. 121, the Civil Rights Procedures Protection Act of 1999, we write to urge that the Senate pass this important civil rights legislation. S. 121 would prevent employers from forcing workers to give up their right to go to court—and accompanying legal protections—when they have employment discrimination claims.

In a troubling trend, an increasing number of employers require workers to agree—as a condition of hiring or promotion—to settle any and all future employment disputes through mandatory, binding arbitration. Such mandatory arbitration undermines fundamental principles established by the hard-fought civil rights battles of the last 30 years. It enables defendants to circumvent a key federal civil protection: the right of job discrimination victims to present their claims in court to judges who have sworn to apply and uphold the law. Instead, a mandatory arbitration program allows employers to bypass some of the most important civil rights protections first established in the Civil Rights Act of 1964 and later expanded by the Civil Rights Act of 1991, such as access to jury trials and fuller remedies for discrimination victims.

In place of this public system of justice, mandatory arbitration offers a private system with little accountability and few controls. Courts have played a critical role in vindicating the civil rights of bias victims—including, for example, developing the legal standards prohibiting sexual harassment and emphasizing employers' responsibility to maintain a workplace free of discrimination. In contrast, mandatory arbitration often allows employers to curtail dramatically the remedies and procedural protections available to discrimination victims. For instance, some mandatory arbitration programs limit or deny compensatory and punitive damages—thus denying workers the very remedies that the Civil Rights Act of 1991 gave to victims of harassment and other forms of discrimination. Arbitrators also lack the authority to issue the injunctive relief that is routinely available in the courts to end discriminatory practices and prevent their recurrence. Arbitrators are not even required to have a background in basic employment law, including knowledge of legal protections against job discrimination. Finally, the Federal Rules of Evidence, which can be so important in protecting against intrusive inquiries into harassment victims' private sexual histories, do not apply in arbitration proceedings.

Although we believe that alternative dispute resolution, when fully voluntary and properly designed, can in many cases helpfully resolve employment disputes, mandatory arbitration forces workers to abandon their access to the courts and accompanying legal safeguards. S. 121 would prevent such unfairness and preserve the protections of our civil rights laws. Please support the Civil Rights Procedures Protection Act.

Sincerely,

DONNA R. LENHOFF,
General Counsel.
JOCELYN C. FRYE,
Director of Legal and Public Policy.
SANDHYA L. SUBRAMANIAN,
Policy Counsel.

PREPARED STATEMENT OF JOAN CLAYBROOK

Chairman Grassley and Members of the Subcommittee Committee: We commend you for holding today's hearing. We believe this may be the first congressional hearing to examine the growing problem of mandatory pre-dispute arbitration. Your foresight and leadership on this issue is greatly appreciated.

Public Citizen is a nonprofit, national consumer advocacy organization with approximately 150,000 members nationwide. One of our primary goals is to assure that injured consumers and workers have the ability to hold responsible and receive fair compensation from the wrongdoers that injured them.

On behalf of consumers and small businesses, Public Citizen's Litigation Group has argued two cases in the U.S. Supreme Court on arbitration issues and many more in lower courts. In *Barrentine* v. *Arkansas-Best Freight System,* 450 U.S. 728 (1981), the Supreme Court upheld Public Citizen's contention that a union contract arbitration clause did not preempt the drivers' right to sue with regard to a statutory claim under the Fair Labor Standards Act. In *Doctor's Associates* v. *Casarotto,* 517 U.S. 681 (1996), Public Citizen argued before the Supreme Court that states had an inherent interest in ensuring the fairness of arbitration agreements in all contracts. Unfortunately, the Court ruled that the Federal Arbitration Act preempted state protections, helping create the problem this hearing is exploring: the injustices that occur when the weaker parties to a contract are forced involuntarily into arbitration proceedings stacked against them.

PART I—CONGRESS SHOULD REVIEW THE INJUSTICE OF PRE-DISPUTE, MANDATORY ARBITRATION AND RESTORE THE CONSTITUTIONAL RIGHT TO FAIR DISPUTE RESOLUTION

Today's hearing focuses on three specific bills that address specific situations in which mandatory pre-dispute arbitration has proved to be unfair to the less powerful party to a contract. The hearing is particularly revealing in its demonstration of the abuses of mandatory, pre-dispute arbitration by the more powerful party in a contract. For instance, the auto dealers are seeking to be relieved from mandatory, pre-dispute arbitration contractually imposed upon them by the much more powerful auto companies. The dealers feel they have little ability to stand up to the auto manufacturers and distributors who use their power to impose these unfair clauses in the contracts vital to the dealers continued existence.

At least the dealers have some leverage as the auto companies need them to sell their cars. Imagine the fate of individual consumers or employees in such unbalanced situations.

Ironically, many of these same auto dealers are at the forefront of a trend to impose mandatory pre-dispute requirements on the consumers who purchase their cars. Auto purchase and repair consumers suffer from the same or greater disparity in bargaining power with the dealers as the dealers do with the manufacturers. Perhaps the subcommittee can provide protection for all those without the power to actually negotiate contract provisions and thereby restore all their rights to just dispute resolution.

Public Citizen supports both S. 121, the Civil Rights Procedures Protection Act of 1999, and S. 2117, the Consumer Credit Fair Dispute Resolution Act. Both bills are excellent steps forward in addressing the serious inequities caused by mandatory, pre-disputes arbitration clauses. We especially appreciate the leadership of Senator Feingold in this effort on behalf of workers and consumers. However, Public Citizen believes that Congress must go beyond these bills and address the issue of unfair arbitration more broadly.

Public Citizen is not opposed to arbitration *per se.* There is social benefit in voluntary arbitration as a fair and expeditious alternative to litigation. However, an arbitration agreement must be entered into voluntarily after the dispute arises and the consumer, employee—or even the small business owner such as an auto dealer—knows which rights she is waiving, who will arbitrate the dispute, who will bear the costs of arbitration, whether discovery will be allowed, what law will be applied, what information will be public, and whether she will have recourse following the award. Without a fully-informed voluntary consent, arbitration loses all credibility as a just alternative to litigation.

In the real world, most contracts are not made by equally powerful and knowledgeable parties. While this is certainly true of employment and consumer credit contracts, it is equally true for virtually all consumer contracts, as well as business-to-business contracts between disparately-sized companies. As Part II of this testimony reviews in detail, mandatory, pre-dispute arbitration clauses can never be fair, when the parties do not have: Equal bargaining power, equal experience in arbitration, equal ability to understand the consequences of contract language, particularly the ramifications of the rights being waived, and an equal ability to insist on clauses being included or excluded in the contract.

Without this balance of power, there can be no effective voluntary consent to mandatory, pre-dispute arbitration clauses.

Public Citizen believes that the escalating use of mandatory, pre-dispute arbitration clauses in contracts between unequal parties is impinging on individuals' basic rights as guaranteed by the Constitution's Bill of Rights. The Seventh Amendment to the U.S. Constitution states, "In suits at common law, where the value in controversy shall exceed $20, the right of trial by jury shall be preserved * * *" When the Bill of Rights was passed, the right to a jury trial was the only Amendment of the 10 proposed that was approved by all 13 states. The right to a civil trial was included in the Constitution because that right was a critical issue in the decision of the colonies to revolt against the arbitrary decision of King George III. More than giving individuals a right to a particular procedure, the Bill of Rights guarantees public legal proceedings where the lowly and the mighty are equal and have the same ability to receive justice.

The escalating use of mandatory, pre-dispute arbitration clauses threatens that fundamental freedom. These clauses are designed to give businesses significant advantages in their disputes with consumers, employees, and small businesses. They threaten the very basis of our justice system—equal justice under the law.

The profundity of this rising tide of mandatory, pre-dispute arbitration agreements and its effect on the right to trial by jury has not yet full been felt. But the reality is that too many of America's businesses are trying to opt out the American judicial system—by exempting themselves from the rules of conduct and responsibility to which the rest of us are held. By insisting that consumers and employees waive their right to their day in court as a precondition to doing business, corporate America is trying to insulate itself from the consequences of doing business negligently, recklessly and in violation of the law.

The result will be the creation of a massive system of arbitrators parallel to, but untouchable by, the courts. Consumer and employee rights, public safety and public policy will be weighed by arbitrators neither elected nor appointed under any legal system. We may be witnessing the birth of a private judicial system—created by corporations seeking to avoid legal responsibility for their actions. As Judge Harry Edwards put it, an arbitrator "serves simply as a private judge * * * yet unlike a judge, an arbitrator is neither publicly chosen nor publicly accountable." *Cole* v. *Burns International Sec. Servs.,* 105 F.3d 1465, 1476 (D.C. Cir. 1997).

We now have 75 years of experience under the Federal Arbitration Act. In its present form, the Act is fostering arbitration procedures that severely weight the scales of justice toward large businesses and away from consumers, employees and small businesses.

Public Citizen believes that this threat to fundamental concepts of American justice is so significant that the U.S. Congress and the states' legislatures should work together to adopt policies that restore citizens' fundamental rights to impartial, unbiased and public adjudication of disputes. Without such a system of fair redress in a civil society, citizens will start to take the settlement of disputes into their own hands with potentially disastrous results. We propose a comprehensive federal-state legislative initiative to achieve that goal:

First, both State and Federal legislators should pass legislation to ensure that parties with weaker bargaining positions are not forced into unfair arbitration. This legislation should take the form of an absolute ban on mandatory, pre-dispute arbitration clauses. Alternatively, legislation could make all such clauses in contracts between unequally powerful parties unenforceable. At a minimum, mandatory, pre-dispute arbitration clauses should be unenforceable in all consumer and employee contracts. This would expand the approach used in the bills that are the subject of today's hearing.

Eliminating the ability of the more powerful party to force the weaker party into unfair arbitration would go far toward eradicating the problems detailed in Part II of this testimony. Consumers and employees would make a choice whether to go to arbitration only after the controversy arose. At that time they would have the proper incentive to carefully assess the pro and cons of the proposed arbitration and determine whether it would be a fair dispute resolution mechanism. Essentially this would institute a market-oriented system where parties who believe arbitration is the best forum would have to design arbitration systems that are attractive—fair—to the other party.

Secondly, Congress and the States could promote fair arbitration by passing an Arbitration Bill of Rights. The Bill of Rights would be designed to make arbitration an attractive alternative that a fully-informed consumer would voluntarily choose to resolve a pending dispute by ensuring fair selection of arbitrators, fair distribution of arbitration costs, full and fair discovery and appealability of awards. An Arbitration Bill of Rights should include:

A mutuality requirement—parties should have identical opportunities to access the courts. One-away "agreements" favoring corporations should be prohibited.

Proof that both parties are actually aware of any arbitration provision in a contract.

Full disclosure about the arbitration process, including specific information about what kind of claims and rights are being waived and about the costs of pursuing arbitration.

True choice—the ability to reject the arbitration clause without jeopardizing the employment opportunity or consumer transaction.

Judicial review of awards on the merits.

Availability of all judicial remedies, such as injunctions and punitive damages.

A fair system of cost allocation that does not deter or preclude valid claims from being made.

A choice of venue that is convenient to the party less able to bear the costs of travel.

Discovery to ensure the ability to pursue and prove the claim.

A requirement for a written opinion by the arbitrator explaining bases of findings of fact and applications of law.

Public records of arbitration awards so that consumers as well as corporations can learn about the arbitrators' past decisions and any previous awards on similar disputes.

Lastly, states should have the ability to regulate arbitration procedures if they desire to better protect consumers and employees or to deal with specific local problems. To accomplish this, Congress should amend the FAA to remove the judicially-imposed federal preemption of state regulation of arbitration agreements. While federal legislation should establish basic minimum standards to guarantee arbitration fairness, states should be able to give consumers additional protections such as deciding whether arbitration is appropriate in a given situation or whether notice provisions or arbitration procedures are necessary to protect their citizens. Federal law should provide a foundation upon which the states could build greater consumer protection.

PART II: MANDATORY ARBITRATION ABUSES

The scope of the problem

Over the past several years, more and more consumer creditors have inserted mandatory pre-dispute arbitration clauses in the fine print of their consumer credit contracts. You may not know it, but if you have a credit card, mortgage or other credit account with BancOne, First USA, GE Capital, Discover, American Express, Household Financial or Beneficial Financial Services; if you belong to an HMO or investment group; if you recently bought a personal computer, cell phone, mobile home, or product over an Internet site such as eBay, or if you bought a new home from a fly-by-night contractor, you have probably waived your rights to take those corporations to court if they harm you by breaching their contract or even by defrauding you.

You might be blissfully unaware that you have forfeited your right to a day in court, because the mandatory arbitration agreement was lurking in the fine print of your car lease or tucked in with the offers of personalized check printing from your credit card company, or perhaps in your teenager's employment contract with the local burger joint. By accepting the car lease, using your credit card or taking the job, you and your family forfeited one of the most treasured American rights—the right to a day in court and a jury of your peers to judge whether you have been wronged.

If you don't know whether you have waived your rights to access the judicial system, you are not alone. You likely didn't read through the entire cell phone contract, or didn't notice the arbitration clause in your car lease. Like most Americans, you might not have have understood that the clause meant you were forfeiting your constitutional rights as a consumer, rights that protect your health and safety and protect you from fraud.

If you did see the arbitration clause in your credit card contract, you might have thought that it might not be such a bad thing. Before any dispute has arisen between you and your creditor or service provider, the prospect of such a dispute is distant and theoretical. Arbitration might even sound better than litigation should the unthinkable happen and you and the company you are doing business with have a falling out. But the average consumer (and even the more sophisticated consumer) does not consider the breadth of rights waived by agreeing to the clause.

You should also be troubled that you had no choice but to agree to the mandatory arbitration if you wanted to make the transaction. It was not a term you could negotiate out of the contract—most mandatory arbitration clauses are in standard form, take-it-or-leave-it contracts. And you could hardly "leave it" and go to another creditor or retailer because more and more of them insist you give up your rights. In these situations, it is manifestly unfair to allow these contracts of adhesion (one-sided contracts that are not negotiated by the parties and are embodied in a standardized form prepared by the dominant party) to take away consumers' constitutional rights of access to the courts to protect their rights. The power imbalance at the moment of contract is tremendous and without any real remedy for consumers, abuses will soar to new heights.

In the employment context, the power imbalance is even more obvious and insidious. There is no true voluntary assent to mandatory arbitration clauses when employees are told to either assent or lose their jobs and applicants who refuse simply are not hired. Very few job seekers are in a position to refuse proffered employment, which would provide the means to support their family, in order to preserve a comparatively intangible right should an unforseen problem develop years later.

Some courts have recognized the extreme power imbalance and lack of true bargaining power in employee contracts, particulary when the employee seeks to invoke state or federal antidiscrimination policy. Those courts have refused to enforce a mandatory, pre-dispute arbitration clauses. Unfortunately, other circuits have held such clauses are enforceable.

The Federal Arbitration Act and its preemption of consumer protection and anti-discrimination law

The Federal Arbitration Act (FAA) of 1925 grew out of international maritime dispute resolution systems. In that commercial context, companies have essentially equal bargaining power and can negotiate over the suitability of adopting alternative dispute resolution systems such as arbitration.

However, in consumer credit and employment contracts, as well as in other transactions between individual consumers and businesses, the parties have extremely unequal bargaining power. In consumer credit contracts, consumers often don't even see the full language of the contract until the credit application or the consumer purchase has been completed. Job seekers focus on pay and benefit packages and are seldom in an economic position to insist on rights they never expect to use.

Many state legislatures have recognized these problems and have been particularly concerned about individuals in these types of adhesion contracts, where they are faced with signing take-it-or-leave-it contracts for employment or credit without the option to strike the arbitration clause or negotiate the terms. Some states have passed laws to protect consumers in those situations. Some have required arbitration clauses to be particularly visible to ensure that consumers know what they are agreeing to. Other states have disallowed pre-dispute arbitration agreements in particular subject areas of law, such as employment discrimination disputes, because they deemed arbitration to be unsuitable to enforce their state's public policy in those critical areas.

However, the Supreme Court has interpreted the Federal Arbitration Act as preempting those consumer and employee protection efforts by individual states. Despite the extreme power imbalance in formulating these contracts, the Supreme Court has in a series of decisions ruled that Congress' intent to promote arbitration preempts sate regulation. The Court has enforced pre-dispute arbitration agreements even in consumer credit and employment contracts.

In particular, the Court has invalidated all state laws that single out as unenforceable arbitration provisions in contracts that are otherwise enforceable. Under the Court's rulings, the only way a state court may avoid enforcing a pre-dispute arbitration agreement is by voiding the contract under traditional, general contract rules regarding consent, fraud, unconscionability and revocation. State legislatures cannot pass a bill that just regulates arbitration abuses; they can only legislate general contract law changes. But mandatory arbitration clauses are different. They should not be treated the same as any other contract term (such as price, quantity, dates of service, etc.) because: The constitutionally protect right to a day in court is too important; Consumers do not fully understand the importance of the rights they are waiving until a dispute actually arises; and the enforceability of the entire contract depends on the fairness of the arbitration provision because the consumer can have them enforced nowhere else.

In other decisions, including *Gilmer* v. *Interstate/Johnson Lane Corp.,* 500 U.S. 20 (1991), the Supreme Court ruled that absent proof that Congress intended civil rights legislation to preclude arbitration, contractual mandatory pre-dispute arbitration can be enforced. The Court cited the FAA's provisions that manifest a "liberal federal policy favoring arbitration agreements."

Because the Supreme Court's decisions interpreted the U.S. Congress' intent in adopting the FAA, Congress has the responsibility to revise the law to level the playing field for the consumer and employees and restore their fundamental legal rights.

Mandatory pre-dispute arbitration clauses are discriminatory and unfair

In addition to the denial of consumers' and employees' rights to seek remedies in court, arbitration between two parties with unequal bargaining power is too often a discriminatory and one-sided process, benefitting the corporations mandating it. The following are problems faced by consumers and employees who are forced into arbitration by contracts written solely by the corporation:

Substantial up-front costs.—For most consumer transactions and many employment disputes, the fees imposed by mandatory arbitration may make it economically impossible for consumers or employees to vindicate their rights. Many arbitrators require hundreds of dollars in filing fees and hundreds or thousands more in hearing fees. Some consumers, particularly those who have just suffered a financial loss, will be unable to pay these fees and will therefore be precluded from any remedy. Similarly, high fees may preclude employees whose financial future may already be endangered because of their employment dispute from pursuing their anti-discrimination claims. In other consumer claims, the small amount in dispute may actually be less than the arbitration fees, making any arbitration a losing proposition economically. In contrast, most jurisdictions provide consumer access to small claims courts with minimal fees and costs.

Prohibition of class actions.—Certain harms inflicted on consumers may be small yet widespread so that they would be impractical to pursue unless brought as a class action. Companies are using mandatory arbitration clauses to avoid class actions, making it impossible for plaintiffs with small claims to pursue their cases or afford any legal advice. The prohibition on class actions thereby provides legal immunity for corporations who may have gained a substantial benefit through small injuries to a large number of persons.

Choice of venue.—Arbitration clauses often include a venue selection that favors the corporation, such as requiring arbitration in a location inconvenient to the consumer. Thus, consumers may find themselves having to bear the cost of long-distance travel to make their claims heard. For example, the Internet auction site eBay requires its consumers to travel to its home turf of San Jose, California, to arbitrate any dispute. This requirement is obviously an impediment to justice for modest disputes of a couple of thousand dollars or less.

One-way agreements.—Many arbitration clauses require only one side (the consumers or employees) to resort to arbitration on a particular claim, while allowing the other side (the corporation) to sue in court on the same claim. In addition, sometimes only one side (the consumers or employees) is bound by the outcome of the arbitration while the other (the corporation) is not. Arbitration clauses also may provide certain remedies for one side but not the other—for example, allowing the imposing corporation to be awarded attorney fees, but not the consumer on whom arbitration has been imposed.

Choice of arbitrator.—Many arbitration clauses give the company the right to pick the arbitrator, formulate the list of possible arbitrators from which the consumer or employee must select, or select the arbitration organization. When companies establish relationships with arbitration organizations to handle their continuing business, arbitrators have a self-interest in favoring the company in their decisions in order to attract repeat business. Moreover, neither arbitrators, nor those that impose arbitration, are required to keep a public archive of decisions. Therefore, consumers and employees suffer from the disadvantage of not being able to check for biases in prospective arbitrators, even when they have some role in choosing them.

Lack of a public record.—Because in many cases no written decisions are made available and most arbitration clauses require that all facts relating to a dispute are confidential, public discussion on the validity the fairness of a given arbitration finding is discouraged, no legal precedents or rules for future conduct are set and individuals cannot cite previous decisions for precedential effect. Imagine if we had never learned about tobacco company misbehavior from the Minnesota litigation.

Since businesses that impose arbitration are likely to keep an archive of decisions, they enjoy the advantage of being able to choose those arbitrators that have ruled for them. And with no public record, the companies can present to the arbitrator favorable cases from their own files while not disclosing cases favoring the employee or consumer.

Lack of discovery requirements.—Many arbitration schemes greatly restrict discovery, the process by which parties obtain information from one another, even though in-court claims cannot be litigated effectively without it. The lack of discovery and adherence to rules of evidence and procedure in arbitration amounts to the wholesale denial of one of the most basic rights in our civil justice system. Lack of discovery may make creditors' and employers' discriminatory behavior impossible to prove. Consumers and employees are prevented from discovering patterns of abuse that would reveal the corporation's culpability; this immunizes companies from sanctions, including injunctions, sufficient to deter continued wrongdoing.

Limited Judicial Review.—Under the FAA, parties are allowed only limited judicial review of an arbitration award and virtually no review of the substantive merits of the award. The court can review for bias in the process, partiality by the arbitrators, and whether the arbitrators exceeded their powers. But to overturn a decision on substantive legal grounds, the appellant must show "manifest disregard of the law," an extraordinarily difficult standard to prove. The true scope of review is even more limited because often there is no requirement for any written opinion and no requirement that any voluntarily prepared written opinion include a statement of what law the arbitrators applied or what facts were deemed proven. Any consumer wishing to show bias or partiality or error in applying law or finding fact has an extraordinary burden to meet, particularly where no records of the company's dealings with the arbitrator are made public and no discovery rules provide for their disclosure.

Arbitration is ill-suited to decide causes of action based on statutes involving preferred public policies such as civil rights protections.—Statutory rights and remedies are not fully vindicated in the arbitration process. The use of unilaterally imposed pre-dispute mandatory arbitration clauses in employment contracts as a condition of employment harms both the individual employee and the public interest in eradicating civil rights violations. Those who the laws seeks to regulate should not be allowed to exempt themselves from the enforcement of civil rights laws. Nor should they be allowed to deprive the civil rights claimants the ability to vindicate their rights in a court of law by a jury of peers.

Likewise, consumer protection statutes designed to ensure the public's safety embody important public policies. Corporations should not be allowed to avoid those policies, by forcing individuals into arbitrations where their rights are not protected.

Limited Remedies.—Mandatory pre-dispute arbitration clauses may eliminate some remedies, such as injunctive relief and punitive damages, or shorten the time within which a claim must be brought. These provisions circumvent carefully considered and crafted laws governing the creditor/consumer and employer/employee relationships. Many claims are not worth bringing without the prospect of full legal remedies. By inserting these clauses into their contracts, creditors and employers intend to prevent legitimate claimants from ever receiving justice.

Examples of how current arbitration law is fundamentally unfair to consumers and employees

Unfortunately, examples of how mandatory arbitration has unfairly twisted the resolution of disputes are quickly accumulating day by day. The Washington Post (3/1/00, pp. E1/E10) revealed that for just one large company, First USA, mandatory, pre-dispute arbitration had resulted in 19,705 arbitration awards over the last two years. Only 87 were decided in favor of the customers; First USA won 99.6% of the cases.

The following real life examples demonstrate how consumers and employees are severely disadvantaged by the mandatory arbitration process. As other consumers and employees have similar experiences, most injured persons will choose not to pursue their legitimate claims because the likelihood of fair hearing and decision is so small.

Contractor/finance company fraud

Harris v. Green Tree Financial Corporation (183 F.3d 173; Third Circuit, 1999) illustrates how the courts have interpreted the Federal Arbitration Act in a way that is fundamentally unfair to consumers.

The Harrises were approached by home improvement contractors marketing themselves as Federal Housing Authority and U.S. Department of Housing and Urban Development-approved dealers promising affordable work with no payment required until the customer was satisfied with the construction.

In fact the contractors themselves had been solicited by Green Tree Financial Corporation to encourage consumers to use high-interest rate secondary mortgage contracts to finance home improvements.

The Harrises allege that they receive little of value from the contractors, but were saddled by sizeable debt secured by mortgages on their homes. When they attempted to sue Green Tree and the contractors alleging fraud and breach of contract, Green Tree moved to compel arbitration.

The work orders for home improvements that the Harrises originally signed when agreeing to have the work done did not mention arbitration. However, the secondary mortgage contract (described to them as standardized contracts that needed to be signed before construction could begin) included an arbitration clause in small print on the back page near the end of the contract.

The arbitration clause was not only boilerplate language about which the Harrises had no opportunity to bargain, but the clause bound only the Harrises, not the contractors or Green Tree. The companies who allegedly defrauded the Harrises retained their right to go to court to enforce the mortgage or to foreclose on the real property secured by the loan.

Despite the lack of effective notice, the unequal bargaining power of the parties, the use of a boilerplate contract of adhesion, and an arbitration clause that only bound one party to the contract, the Third Circuit upheld the arbitration clause. It found that the District court had erred in holding that the clause was not enforceable because of lack of mutuality or procedural or substantive unconscionability. The court then used the FAA's "liberal policy favoring arbitration clauses" to bar the courtroom door to these defrauded consumers, forcing them into arbitration where all the advantages lie with the repeat user of arbitration, not the one-time consumer complainant.

Automobile consumer credit fraud

On January 31, 1999, Ann Brown of Sandusky, Ohio borrowed $5,500 at 25% interest from a J.D. Byrider Franchise car lot to finance her purchase of a car from Byrider's used car lot. The car turned out to be a "junker" and a safety hazard. The entire wheel and axle fell off when Ms. Brown's teenage daughter was driving down the road. In her lawsuit in Ohio court, Ms. Brown alleged that she was forced to pay an artificially inflated price in violation of the Truth in Lending Act. Ms. Brown also alleged that Byrider violated the Truth in Lending Act by requiring her to accept an $895 warranty fee that was also to be financed by J.D. Byrider at 25% interest. In addition, Ms. Brown alleged violations of the Ohio Sales Practices Act and fraud.

But Ms. Brown was denied her day in court by the district court in Ohio, which ruled that the arbitration agreement contained in Ms. Brown's contract had to be enforced because of the FAA's policy favoring arbitration. Under that arbitration clause, Ms. Brown lost all her claims under state and federal lending and consumer protection laws although Byrider retained the right to sue her. She also waived her right to punitive damages, no matter how reckless or malicious Byrider's conduct. Instead, she must proceed under Byrider's choice of arbitration, for which she must pay half the costs and attorney fees. The costs of arbitration, which begin with $300–$500 filing fees and approximately $1,500 per day arbitrator's fee, exceed the value of her claim. It is simply not worth it to take the case to arbitration. In sum, Byrider is using this arbitration clause to insulate itself from the consequences of violating the Truth in Lending Act, Ohio Sales Practices Act and flat-out fraud.

Ms. Brown did not understand that she was waiving her right to go to court when she signed an arbitration agreement with Byrider. This is hardly surprising because the Byrider financing officer himself had no idea what arbitration is or what the rules of arbitration are, so he was unable to tell Ms. Brown what rights she was waiving. Nor was she given an option—the credit contract was presented in a standard form, take-it-or-leave-it format and she was not allowed to challenge any of its provisions. The mandatory arbitration provision only applied to Ms. Brown. Had she defaulted on her loan, Byrider would have been able to file a lawsuit against her.

When Ms. Brown first filed her lawsuit, Byrider stopped using the mandatory arbitration clauses in their contracts. But once the courts refused to vindicate Ms. Brown's rights in court in favor of arbitration, Byrider began using the clauses again. Ms. Brown's attorneys have received inquiries from over 40 consumers similarly defrauded by Byrider. Unfortunately, no matter how many of J.D. Byrider's former customers are defrauded, they cannot file as a class action because the mandatory arbitration clauses in their contracts waive their right to maintain class actions.

Sexual harassment

In a San Francisco, California case a woman named Sherry claimed that her employer, a prominent physician, physically and verbally sexually harassed her. Whether her claim was legitimate or not we will never know, but there was a great deal of evidence supporting her allegations, including: corroborating testimony from another employee, an admission that the defendant had been "squeezing titties," a calendar owned by the defendant showing his female employees nude, and expert testimony from a psychologist. Sherry filed suit in 1994 for violations of her civil rights.

The defendant employer had included a mandatory arbitration clause in the plaintiff's employment contract, although Sherry did not see the arbitration material until she had been working a week. At that time, the document was given to her while she was working and she was told that it was necessary for her to sign it to keep working; she was given no time to read the document. In addition, Sherry did not understand the mandatory arbitration clause or its significance. Despite this clear evidence that Sherry had not agreed to waive her rights, the court ruled that Sherry was bound by the clause and could not sue here employer in court.

Sberry took her cause to arbitration under the American Arbitration Association (AAA). After three years and eight days of hearings, the arbitrator found in favor of the defendant. The result in the cause perplexes civil rights attorneys—and with good cause. The arbitration proceedings were conducted behind closed doors and the legal and factual bases for the arbitrator's decision are not publically available.

Most shocking in Sherry's case is that the arbitrator also found Sherry liable for over $207,000 in attorney fees to pay the defendant's attorneys. Under civil rights litigation in the federal and state courts, such attorney fees are only awarded for frivolous or bad faith suits, because public policy favors the bringing of such suits. In addition, the cost of the arbitrator and the AAA's fees totaled $16,000, compared to the $200 filing fee for a court case.

Sherry's ability to vindicate her civil rights was hampered in part by here inability under the arbitration rules to conduct discovery and develop a full factual record. Future employees who are discriminated against will not be able to use Sherry's experience to assist in building their cases. Under the arbitration procedure, both Sherry and her attorney are effectively gagged and cannot discuss the case without risking a lawsuit, which, ironically enough, the employer would be able to pursue in court.

The outcome in Sherry's case will act as a deterrent to others wishing to bring suit for sexual harassment when there is a mandatory pre-dispute arbitration agreement in their employment contracts. And more ominously, it will encourage employers to use pre-dispute arbitration clauses to insulate themselves from civil rights laws.

CONCLUSION: S. 121 AND S. 2117 ARE IMPORTANT CONSUMER AND EMPLOYEE PROTECTIONS INITIATIVES

As noted in Part I of this testimony, Public Citizen believes that the current state of arbitration law has resulted in a corruption of citizens' fundamental rights to equal justice under the law. We have suggested a comprehensive legislative initiative to resolve the problem.

Pending consideration of that comprehensive solution, we urge your support for S. 121, the Civil Rights Procedures Protection Act of 1999 and S. 2117, the Consumer Credit Fair Dispute Resolution Act of 2000. These pre-consumer, pro-worker bills would address two areas of law where arbitration is exceptionally inequitable.

Employers should not be allowed to force employees charging their employers with illegal discrimination into an unfair dispute resolution scheme of the companies' own device. S. 121 would expressly prohibit the use of arbitration or other alternative dispute resolution procedures in federal civil rights discrimination claims unless after the claim arises, the claimant voluntarily agrees to arbitration.

Mandatory arbitration schemes in consumer credit adhesion contracts deny consumers their right of access to the courts and the protection of state consumer laws. S. 2117 would make mandatory arbitration clauses in consumer credit contracts invalid and unenforceable, unless the consumer voluntarily agrees to arbitration after the controversy has arisen.

Both S. 121 and S. 2117 would not eliminate arbitration in these situations, but would harness market forces to reduce current abuses. After a dispute has arisen, if both sides believe it is in their interest to proceed to a specified arbitration forum, they may agree to do so. After the dispute, both parties have inducements to pay attention to the equities of the arbitration procedure. If a consumer or employee is only offered a biased or procedurally unfair arbitration, then she will not choose arbitration. Therefore, the legislation provides the proper incentive to make these voluntary arbitrations demonstrably fair.

Public Citizen urges the Subcommittee to explore the broader issue of unfair arbitration. As a first step we support the enactment of S. 121 and S. 2117 into law. Consumers and employees need the bills' protections now.

Senator FEINGOLD. I also ask that the Washington Post article, dated today, already referred to, entitled, "Win Some, Lose Rarely: Arbitration Forums' Rulings Called One-Sided," be entered in the record of this hearing.

[The article follows:]

[From the Washington Post, Mar. 1, 2000]

WIN SOME, LOSE RARELY?—ARBITRATION FORUM'S RULINGS CALLED ONE-SIDED

(By Caroline E. Mayer)

Like many banks, car dealers and retailers, First USA N.A., the nation's second-largest issuer of credit cards, no longer permits its customers to sue it in court. Instead, any disputes must be resolved through arbitration by a firm chosen by First USA.

Businesses such as First USA say that for everyone involved, arbitration is faster, more efficient and cheaper than litigation. But arbitration may also mean that the company wins most of the time—at least according to data recently submitted in a lawsuit in an Alabama state court.

The data, disclosed last month by First USA in a class-action lawsuit challenging mandatory arbitration, show that not only has the company sought arbitration far more often than consumers, it has also won in 99.6 percent of the cases that went all the way to an arbitrator.

First USA's experience in the two years since it imposed its arbitration requirement is likely to become a focal point in the debate over the arbitration rules contained in many consumer contracts. Arbitration has for years been a means to resolve disputes between businesses, but increasingly companies are including arbitration clauses in consumer agreements and employment contracts. In First USA's case, consumers were notified by a fine-print insert in their monthly bills that by using their cards, they agreed to take disputes to arbitration.

Dozens of lawsuits around the country are contesting the arbitration rules, with mixed results. At least three of these suits also question the impartiality of the arbitration firm selected by First USA and many other credit-card firms and retailers, such as American Express and Best Buy.

These suits contend that the firm, the National Arbitration Forum, is so financially dependent on the banking industry that it can seldom afford to rule against companies. Furthermore, they say the forum's own marketing materials, promising a "positive impact on the bottom line," suggest that the organization is inherently biased against consumers.

A spokesman for Bank One, which owns First USA, declined to discuss the suits, saying the company doesn't comment on pending litigation.

Edward Anderson, managing director of the forum, dismissed the allegations in the lawsuits, saying, "We are impartial, and more importantly our arbitrators—former judges, lawyers and law professors—are impartial." Anderson said the lawsuits "are merely an attempt by trial lawyers to find a way to avoid arbitration" so they can continue to collect high fees in big class-action court cases. In arbitration, high lawyer fees are unlikely because almost all involve individual claims for relatively small amounts.

The controversy over arbitration will get attention today in Congress. The Senate Judiciary subcommittee on administrative oversight and the courts will hold a hearing on the growing number of contracts that require employees, businesses and consumers to agree, in advance of any disputes, to give up their rights to sue and submit all future disputes to arbitration.

Subcommittee Chairman Charles E. Grassley (R–Iowa) said he is a proponent of arbitration as a means of unclogging the courts. But he said he wants to "make sure consumer interests are protected in the process and that the arbitration is being conducted in a fair way."

Rep. Luis V. Gutierrez (D–Ill) introduced a bill in the House last year that would bar mandatory-arbitration provisions in consumer contracts, and Sen. Russell Feingold (D–Wis.) plans to introduce similar legislation. He tried to attach such a provision to the bankruptcy legislation recently passed by the Senate, but he dropped the attempt in exchange for the subcommittee hearing.

Since First USA implemented its arbitration clause in early 1998, it has filed 51,622 claims against consumers with the forum. In the cases that First USA filed, the forum has made 19,705 awards. First USA prevailed in 19,618, card members in 87. (Of the remaining cases, First USA said more than 28,000 had "expired" because the customers had not been notified in a timely fashion as is required by the forum's rules. More than 3,600 cases are still pending.)

Meanwhile, only four consumers have filed cases against First USA with the forum. In two of these four cases, the arbitrators made awards against first USA; one case was settled, and another is still pending.

The fact that the company sends cases to arbitration far more often than consumers is a function of economics, say consumers' lawyers. It costs $49 to file a complaint with the forum, an amount that may be reasonable to big businesses trying to collect large unpaid debts. But for a consumer challenging late fees of about $29 or high interest rates, the filing fee may not be worthwhile. In the past, these consumers might have joined a class-action suit to fight the companies. Costs for such suits are minimal because most lawyers take them on a contingency basis.

While Bank One spokesman Thomas Kelly declined to talk about the lawsuits, he said "the overwhelming majority" of cases that First USA filed at the forum "are claims against customers who are more than six months delinquent" in paying their bills.

To the forum's Anderson, the figures are meaningless because First USA would probably have had a similar success rate had it pursued the same cases in court. Anderson said creditors win about 98 percent of collection actions brought against debtors in federal courts. While declining to discuss the specific numbers provided by First USA, saying they ere confidential, Anderson said "expired" cases should be counted as victories for consumers.

As companies have adopted these clauses, business has grown for the forum, a private firm where 20,000 cases were filed last year, up from 16,000 the year before, according to Anderson. It is the second-largest arbitration firm in the country, behind the nonprofit American Arbitration Association, which handled more than 140,000 cases last year. Officials at the American Arbitration Association said almost all of those were commercial cases that didn't involve consumers. In contrast, arbitration industry experts say, the forum's business involves more corporate-consumer disputes, in large part because of the company's aggressive marketing.

The forum's marketing letters are an issue in at least three lawsuits that question its impartiality. In one letter, Anderson wrote: "There is no reason for your clients to be exposed to the costs and risks of the jury system."

Another letter urged lawyers to contact the forum to see "how arbitration will make a positive impact on the bottom line."

A coalition of public interest groups that includes the Trial Lawyers for Public Justice, AARP, the National Association of Consumer Advocates and the Association of Trail Lawyers argues that these letters suggest that the forum will take the companies' side.

"If a court were to solicit business from a party that might come before it with strong hints that the solicited party would get a good deal in her on his courtroom, there is no doubt that this would be improper and sanctionable behavior," the group said in a fried-of-the-court brief filed in a case challenging First USA's arbitration clauses.

Anderson said the letters simply state the law and economics of arbitration. "The letters say you save money through arbitration, and that's true—all parties save money. * * * There's nothing secret about the way we market. We market to everybody—to attorney's general, consumer protection administrators, anybody who will listen," he said.

Britton D. Monts, a Dallas lawyer who has filed a class-action suite against First USA in a federal court in Texas alleging improper late fees, said evidence collected in his lawsuit shows that "virtually all" of the forum's income comes from First USA collection fees, making its business vital to the future of the company.

Anderson said that is a "complete fabrication" and "there's no evidence that it's true." He declined to disclose specific financial data, saying the forum was a privately held company. The company did submit is financial records to the federal court in Dallas, after a court order, but on the condition that they be kept confidential.

Firtst USA papers filed in the Dallas case show that the company paid the forum $5.3 million between January 1998 and November 1999. "Without question, loss of First USA's business would result in a major financial blow to [the forum] and is the kind of loss [the forum] would necessarily have to avoid," Monts said, "The idea of a private court being financially dependent on a litigant appearing before it is an insult to the integrity of our justice system."

Alan Kaplinsky, a Philadelphia lawyer who represents several financial institutions and is a strong advocate of mandatory-arbitration clauses, said such charges are unfair. "The forum has put together an extensive list of experienced, highly reputable arbitrators," he said. "To suggest that the forum would basically become partial because of the First USA fees impugns the integrity of their arbitrators."

WHEN THE CUSTOMER IS RARELY RIGHT

Tha National Arbitration Forum has ruled in favor of First USA in more than 99 percent of the cases that went to an arbitrator.

Victories by: First USA: 19,618; Customers: 87.

Note: More than 28,000 cases have expired; more than 3,600 are pending.

Senator FEINGOLD. One other quick comment. What I am going to do as I work on this issue, I hope with other committee members, is really sort of watch and almost fly-speck this tendency to talk about mandatory arbitration's merits and then quickly shift to just reading quotations and comments that refer only to arbitration. This is sort of a bait and switch, where you are taking a concept of arbitration, which as Mr. Maltby suggests, everyone supports, thinks is an excellent part of our system, and then to somehow attribute general characteristics of arbitration to mandatory binding arbitration. I think they are very different things.

And I think the conversation, the discussion led by Mr. Lorber, about what the courts have said is a fair point. But the purpose of these hearings is not to suggest that there is a constitutional problem with mandatory arbitration or to suggest that they are not at least technically legal, it is whether it is good policy and whether it is fair, and that is our job here.

So what we are about here is considering passing Federal legislation that will say—even though it may be something you can do, I will leave that to the courts whether or not there is some automatic or constitutional barrier—whether it is a fair thing to do or the right thing to do. And, I have obviously come to the conclusion that in the cases I have seen, it is not, in most situations.

So let me turn to Ms. Sturdevant. In a letter I received this week from the National Arbitration Forum, the NAF cites an ABA study of consumer arbitration that found consumers prevailed in 80 percent of their claims in arbitration compared to just 71 percent in court. How do you respond to the NAF's numbers that seemingly favor arbitration for consumers?

Ms. STURDEVANT. Senator Feingold, there is no information that indicates what they looked at or how they came to that conclusion. So it is very difficult to counter the assertion because it is completely unsupported. But I think more telling is the evidence in the Alabama case that was referred to in Caroline Meyer's article in The Washington Post today, which indicates that 99.6 percent of the time the company wins; that is, the company wins 225 times for every once that a consumer prevails, and I think that is a more believable statistic.

The National Arbitration Forum has been marketing its services to financial institutions for a number of years, and it says in its written solicitations that businesses should bring their business to the National Arbitration Forum because it will improve their bottom line.

Senator FEINGOLD. Let me follow with another argument raised by the National Arbitration Forum. How do you respond to the assertion that arbitration is advantageous to consumers because, without it, consumers may not be able to get a business to agree to arbitrate after a dispute has arisen?

Ms. STURDEVANT. I think that that is very deceptive. I do not think that a consumer, challenging a wrongful business practice, will want to go to arbitration for the reasons I mentioned in my testimony. You cannot get discovery, the arbitrator does not have to follow the rules of law, does not have to follow precedent, cannot give injunctive relief, cannot award punitive damages. So a consumer would not want challenging an unlawful practice to go to that forum.

If a consumer wanted to go to Small Claims Court, then it would not matter whether or not the company agreed. But I think the more significant problem is that I have seen companies adopt this requirement specifically to insulate their wrongful practices from review. When Bank of America, the first bank to adopt mandatory arbitration by a statement stuffer, did it, it is because it was facing a price-fixing case in which the other California-based banks had settled for $55 million, and it was to insulate itself from having to face the accountability of judges and juries that it adopted the clause. And the rest of the banking and financial institutions looked at that and said, “This is a great idea because we will not have to pay. We will not get caught.”

Senator FEINGOLD. Thank you very much, Ms. Sturdevant.

Mr. Mogilnicki, you said that arbitration is cost effective, that not all of the cases are large enough to justify court action and the goal here is to somehow have a neutral third party. What would be wrong in cases involving a small amount of money, with just allowing Small Claims Court to be the cost-effective alternative rather than arbitration.

Mr. MOGILNICKI. I think this issue of what the proper forum is just the right issue. But we believe that the right choice here is to maximize consumer choice. So it is to allow consumers to choose a credit card or other credit arrangements that allows them to go to Small Claims Court, if that is what they prefer, or to choose a different contract entirely; one that allows them to go to arbitration. And so there is nothing inherently wrong with Small Claims Court any more than there is something inherently wrong with arbitration. What we would like to see is a financial marketplace in which credit card issuers and others are able to afford consumers the choice, a choice to agree to a contract that binds into arbitration or, from other providers, a choice of a contract that allows consumers to go to court, including Small Claims Court.

Senator FEINGOLD. Realistically, do you think people will make determinations about which credit card to take based on this choice?

Mr. MOGILNICKI. I do, for the consumers for whom this matters, and for consumers for whom it does not matter, there is no need for legislation.

Senator FEINGOLD. I would suggest that very few people would make the decision based on this, and I do not see it greatly harming your industry if within the context of your contracts they would have an option of either arbitrating or going to Small Claims Court, but that is obviously the nature of our disagreement. Thank you for your answer.

Mr. Maltby, getting to the issue of employer agreements, why is the practice—and I have to say, again, all of these practices trouble me. But the one that bothers me the most, the one that got me involved in this issue is this question of employment discrimination.

If we make agreeing to arbitrate voluntary as my bill does, will we make arbitration unworkable? Would anyone agree to go to arbitration after a dispute arises, for example?

Mr. MALTBY. Senator, there may be a certain intuitive appeal to the idea that if you make it voluntary, people will not choose arbitration, and the whole desire to get this new access to justice will fall apart, but that is just not true. It is not true for a reason, and it is not true for some data. The simple reason is that employees are not stupid. They may not know exactly how much it costs to go to court. They may not know it is $50,000 or more, but they know it is more money than they have got. And if you can show them that the arbitration system is fair, they will choose it. There is absolutely no reason for them not to choose it.

And while the data in this area is not overwhelming, as I indicated in my original testimony, there are at least a dozen major American corporations that have tried voluntary arbitration, some predispute, some post-dispute, and every single one of them worked—every single one. And I mean by that, not that I thought they worked, but that the corporations who set those voluntary programs up considered them to be a success. So, yes, there is intuitive appeal to this idea that it has to be mandatory to get people to use it. But all of the available information says that that idea simply does not hold up when you look at it carefully.

Senator FEINGOLD. Thank you.

Mr. Lorber, let me, again, say for the record because it is so important that this discussion not get off track, that I support alternative dispute resolution as a means of allowing businesses to restrain costs and remain competitive. Could you give us any estimates of the additional cost to business that would result from the enactment of S. 121, which would permit arbitration of Civil Rights claims, only if voluntarily agreed to by both parties after the claim arises? Do you have any sense of what would be the——

Mr. LORBER. No, I do not. All I do know is that if you look at the cost of litigation and it is a cost initially, interestingly enough, borne by the employer, initially, it is substantial. Fifty thousand dollars I think, candidly, understates the cost. And if we are facing 24,000 Federal filings a year right now, these numbers, I mean, one could play with numbers, but they are obviously significant.

Let me just, Senator Feingold, one other point, and I just very briefly, you had indicated quotes in favor of arbitration in and of itself are fine, but you are talking about mandatory arbitration. At least what I quoted, the *Gilmer* decision, and the *Gilmer* progeny, of course, is quotes that involve mandatory pre-employment arbitration. So that this is, when I talk about the *Gilmer* and the *Gilmer* cases, this is what I am talking about. And, indeed, as I cited in my statement, the Supreme Court, in 1998, again, indicated unanimously that private employment arbitration is something that it would look very favorably upon.

Senator FEINGOLD. That is absolutely a fair remark. In fact, I made that distinction. I was talking about the court cases in one context, but an awful lot of the testimony that was favorable to mandatory arbitration today was based on language and quotations that had to do with general arbitration. And I, frankly, think that it gets in the way of the discussion of the core issue here, which you have actually honestly addressed. You have tried to point out the benefits of mandatory arbitration. But I think when you start bringing in arbitration, generally, you are sort of preaching to a very large choir, and it is not really relevant to the issue, the specific issue, of whether mandatory arbitration is worth the costs in terms of the rights that people give up.

And on that note, let me thank all of you. This has been a very good hearing, and all of the witnesses on the first panel. And we look forward to working with you as these pieces of legislation move forward.

[Whereupon, at 4:18 p.m., the subcommittee was adjourned.]

APPENDIX

QUESTIONS AND ANSWERS

RESPONSES OF JILL LAJDZIAK TO QUESTIONS FROM THE SENATE COMMITTEE ON THE JUDICIARY

Question 1. Manufacturers argue that because disputes between dealers and manufacturers are complex commercial disputes, the courts are not the competent venue in which they should be decided. They argue that these disputes are best resolved through arbitration. However, courts have always confronted and resolved all types of commercial and business disputes and continue to do so.

When a dispute arises between an auto dealer and a manufacturer, it many times involves significant amounts of money and a number of complex legal questions. Because of these issues, it seems there are times when a full discovery process and otherdural safeguards of a court of law are necessary. When the full protection of a court of law is necessary in order to properly resolve a dispute, why should not a party to the dispute a accorded these rights?

Answer 1. The Retailer/Saturn Dispute Resolution Process, which includes mandatory binding arbitration, was developed jointly by a group of experienced automobile dealers and Saturn representatives as the desired means of resolving disputes under the franchise agreement. They recognized that both the company and the dealer could have a tremendous financial stake in a dispute and felt their interests would be not only protected, but also enhanced by the mandatory binding arbitration conducted within the Saturn family.

The National Automobile Dealers Association (NADA) was briefed by Saturn representatives and prospective retailers on the dispute resolution process at the time it was developed, and NADA raised some concerns and responded to NADA with the attached letter, which says in part:

"Our team met recently and spent a considerable amount of time reviewing our dispute resolution process in light of your comments. We reaffirmed through consensus that our process is well designed to serve the unique interests of the entire Saturn family. * * * In fact, our dispute resolution process was viewed to be the ONLY [emphasis added] process consistent with the Saturn philosophy and operating style. * * * we drafted our agreement and the dispute resolution process jointly, we intend to implement our plans jointly, and, if we decide that change is appropriate, we have created a joint process in the agreement to make such changes." (See attached letter from prospective Saturn dealers to NADA.)

Since this letter was sent to NADA in January 1988, the Saturn Franchise Operating Team (which consists of eight Saturn retailers and eight Saturn representatives) has met periodically to review the agreement. No changes in the mandatory binding arbitration portion of the dispute resolution process have been suggested.

As a result, which it may seem reasonable to afford "a full discovery process and other procedural safeguards of a court" to the parties in a dispute, there are other ways of handing such concerns to which the parties themselves may choose to agree. It does not seem right that these other approaches to dispute resolution should be banned or limited by law.

Question 2. Can you provide the Committee with the number of contracts between auto dealers and manufacturers that contained mandatory binding arbitration clauses five years ago and the number of contracts that contain these clauses today?

Answer 2. Since this question was also posed to the witness for the Alliance of Automobiles Manufacturers and it applies to the entire auto industry, we have provided the information requested to the Alliance for inclusion in their response.

Question 3. According to you and others who testified on behalf of the automotive industry against S.1020, most sales and service contracts auto dealers and manufacturers do not contain mandatory binding arbitration clauses, and each party is allowed the option of litigation or arbitration. If Congress fails to pass S.1020 now, can we ensure that in the future the option of arbitration or litigation will continue, and, when two parties enter into arbitration they do so voluntarily?

Answer 3. S.1020 proposes to disrupt the agreed upon approach to dispute resolution that the Saturn organization (including its retailer body) has created. For this reason, Saturn opposes passage of this bill.

The Retailer/Saturn Dispute Resolution Process was included in the original franchise agreement between Saturn and its retailers. As a result, prospective Saturn retailers then knew that mandatory binding arbitration was how their business issues with Saturn would be resolved, before making any investment whatsoever. If this approach to dispute resolution was deeded to be unacceptable, the prospective retailers could simply decide not to invest in Saturn—or they cold pursue a Saturn retail store and then work within the Retailer/Saturn process to change the approach. No such changes in the mandatory binding arbitration portion of the dispute resolution process have been sought.

Furthermore, the Saturn process does not allow unilateral company decisions in matters where joint decision-making is provided for. Any changes to the franchise agreement involving the dispute resolution process would have to be approved by the Franchise Operating Team (FOT), a consensus decision-making body comprised of eight retailers and eight Saturn representatives. Over time, when the agreement itself is rewritten, changes will be suggested by a joint task force, and then approved by the FOT before being presented to each retailer.

What other manufacturers may or may not choose to do in the future is their business—a subject of discussion and negotiation between the companies' managements and their dealer organizations. At the present time, however, the protections being sought by the legislation appear to be largely speculative. With so few dealers subject to mandatory binding arbitration today, and the trend over the last few years moving away from the use of these clauses, it is puzzling why Congress would need to enact this legislation. Clearly it will have an adverse impact on some manufacturers, yet it would appear to provide essentially no change or no benefit to most of the remaining body of dealers. If, in the future, the concerns over the use of these clauses prove to be born out, Congress can certainly intervene at that time to provide the protection being sought.

SATURN CORPORATION,
January 29, 1988.

Mr. JAMES T. CAPLINGER,
President, National Automobile Dealers Association, Caplinger Chevrolet Co., Inc., England, AR.

DEAR JIM: The members of the Saturn Marketing Planning Team thank you for your on-going interest in our franchise agreement and marketing plans, and for your courtesy in inviting us to your headquarters to discuss these matters with you.

Our team met recently and spent a considerable amount of time reviewing our dispute resolution process in light of your comments. We reaffirmed through consensus that our process is well designed to serve the unique interests of the entire Saturn family—including Saturn, its dealers and its customers. In fact, our dispute resolution process was viewed to be the only process consistent with the Saturn philosophy and operating style. As we indicated in McLean, we drafted our agreement and the dispute resolution process jointly, we intend to implement our plans jointly, and, if we decide that change is appropriate, we have created a joint process in the agreement to make such changes.

Although we respect the concerns you have raised over this issue, we respectfully ask you to consider the extensive dealer/manufacturer involvement and the many innovative features embraced by this unique agreement. We believe that by continuing to work together as true partners, many of the objectives shared by dealers, manufacturers and NADA will be realized.

Thank you again for your interest. We hope to continue the close working relationship we have enjoyed during the development of Saturn's marketing plans.

Sincerely,

Don Hudler, Saturn Corporation; Greg Baranco, Baranco Pontiac; Jim Butler, Jim Butler Chevrolet; Larry Paul, Larry Paul Oldsmobile-GMC; Rick Hendrick, III, City Chevrolet; Louis King, King Motor Company; Chris MacConnell, Thomson-MacConnell Cadillac; Carl Sewell, Sewell Village Cadillac; Jim Weston, Jim Weston Pontiac-Buick-GMC; Eli Bloom, Myrtle Motors; Dick Deane, Deane Buick; Lou Herwaldt, Lou Herwaldt Oldsmobile; Bob Longpre, Bob Longpre, Inc.; Pete Reynolds, Reynolds Buick/GMC Trucks; Greg Sutliff, Sutliff Chevrolet; John Zimbrick, Zimbrick Inc.

RESPONSE OF JILL N. MACDONALD TO A QUESTION FROM SENATOR FEINGOLD

Answer 1. I testified on behalf of the Alliance of Automobile Manufacturers. Alliance members are 11 car and light truck manufacturers representing more than 90% of U.S. vehicle sales. Alliance members are BMW Group, DaimlerChrysler Corporation, Fiat, Ford Motor Company, General Motors Corporation, Isuzu Motors America, Inc., Mazda, Nissan North America, Toyota Motor Sales, USA, Inc., Volkswagen of America, and Volvo. Members of Alliance do not manufacturer heavy duty trucks and therefore, your question regarding the number of truck manufacturer-dealership agreements that contain mandatory binding arbitration clauses does not pertain to the Alliance. Freightliner Corporation did file written testimony with the Committee and would have testified at the hearing had there been an opportunity for them to do so. A copy of that testimony is attached for ready reference.

RESPONSES OF JILL N. MACDONALD TO QUESTIONS FROM SENATOR GRASSLEY

Answer 1. As I testified at the hearing on March 1, 2000, mandatory binding arbitration has become a preferred way of resolving commercial disputes because: It promotes and expedites resolution of disputes, it promotes harmonious resolution of disputes preserving relationships, it provides certainty of forums of resolving disputes, it is more cost efficient, it eliminates bias, and it provides finality.

Notwithstanding assertions to the contrary heard at the hearing, arbitration is not some lesser form of adjudication. Parties rights to discovery, providing witnesses, etc. are fully protected in arbitration proceedings and in fact are not limited by the very technical rules of evidence in being able to bring before the arbitrators all information they believe important to their dispute. Moreover, arbitration decisions will be set aside if they are procedurally unfair to either side and arbitration is not pursued to avoid state law. In fact, Iowa, Arizona, New York, South Carolina and Wisconsin to name a few require application of their state law in arbitration proceedings.

Another unique feature about arbitration in our industry is that the arbitrators selected are knowledgeable about the industry and are experts on the issues affecting it. Arbitrators bring their considerable expertise to the decision making process unlike, courts where choice of counsel may be more important than the merits of a dispute.

The intent of the Federal Arbitration Act was to allow parties to agree or disagree outside of the overcrowded federal court system. To exempt one industry based on special interests and to prohibit those parties from agreeing voluntarily to arbitration makes no sense. Mandatory arbitration agreements are present in some dealer/manufacturer contracts. They are one part of a complex of arrangement dealers must evaluate in determining whether to invest in a dealership. Most importantly, alternative dispute resolution mechanisms like arbitration provide for a fair, fast, and cost-efficient way to resolve disputes and maintain business relationships.

Answer 2. A chart with the current number of Franchise Agreements with Mandatory Binding Arbitration (MBAC) and a chart number of Franchise Agreements with Mandatory Binding Arbitration (MBAC) in 1995 are attached.

Answer 3. If Congress does not pass S. 1020, it will ensure that contracting parties (dealers and manufacturers) have the right to enter into contracts containing a mandatory arbitration clause and ensure that arbitration is a viable tool for resolving disputes in a less confrontational, faster, and more cost-efficient manner. State laws can and do prevent arbitration clauses from being forced on existing relationships.

Attachment 2
3/29/00

NUMBER OF FRANCHISE AGGREEMENTS WITH *MANDATORY BINDING ARBITRATION CLAUSE (MBAC) in 1995**

MANUFACTURER**	APPROX. # OF DEALERS	DEALERS WITH MBAC	NOTE
Chrysler	4,650	Approximately 1,100	Dealer option at time of agreement except in Alabama.
Ford	5234	0	
General Motors	7753	0	
Saturn	236	236	
Honda and Acura	1254	4	
Suzuki	285	285	
BMW	337	0	
Ferrari	29	29	
Hyundai	483	0	
Isuzu	567	0	
Kia	441	0	
Land Rover	118	0	
Mazda	875	0	
Mercedes-Benz	316	0	
Mitsubishi	495	0	
Nissan/Infiniti	1230	0	
Porsche	194	0	
Rolls-Royce	36	0	
Subaru	603	0	
Toyota Lexus	1190 172	0 0	
Volkswagen	567	0	
Volvo	332	0	
Saab	215	0	

* Excludes agreements with public companies

** Manufacturers listed include members of the Alliance of Automobile Manufacturers and the Association of International Automobile Manufacturers, Inc.

RESPONSES OF PATRICIA STURDEVANT TO QUESTIONS FROM SENATOR GRASSLEY

Question 1. A recently released Study by the Rand Institute for Civil Justice (Class Action Dilemmas, Pursuing Public Goals for Private Gains) discussed the fact that in many consumer disputes the percentage of the settlement awarded to the class counsel exceeded that awarded to the class members combined. On the whole, when consumers proceed as a class, the biggest winners are the class counsel. Moreover, in most consumer class claims, the class counsel award grossly exceeded the amount of work involved on the part of counsel. Would you like to comment on these facts?

Answer 1. On behalf of the National Association of Consumer Advocates, I very much appreciate the opportunity to comment and respond to these follow up questions, but have serious doubt that the assertions in question 1 are indeed facts. We have not yet been able to obtain a copy of the complete Rand Study, but have reviewed the summary and the news release summarizing its findings, which are available on the Rand Website.

If it is a fact that awards of fees to class counsel exceed the sums awarded to class members combined, that could only occur in cases where attorneys fees are shifted to defendants under a statutory fee shifting provision, most likely in cases which result in injunctive, declaratory, or other non-pecuniary relief. As a matter of law, in both federal and state jurisdictions, in a case which results in the recovery of damages for the class, the attorneys fees awarded are generally based on a percentage of the class recovery, usually 30%, or are calculated using the lodestar method, which is based on the number of hours worked multiplied by the hourly rate. Some federal circuits require one, and some the other method, and one circuit requires that both methods be used as a cross check against the other.

In a number of areas Congress has passed legislation recognizing that, as a matter of public policy, private litigation to enforce the law and redress wrongs should be encouraged by permitting fee shifting. Approximately 150 federal laws provide for an award of attorneys fees to the prevailing plaintiff in civil rights, consumer, or environmental cases. A good example is the Magnuson-Moss Consumer Warranty Act, in which Senator Magnuson argued for the fee-shifting provisions in 15 U.S.C. § 2310, urging the need to give industry the incentive to perform its statutory obligations: "One way to effectively meet this need is by providing for reasonable attorney's fees and court costs to the successful litigants, thus making consumer resort to the courts feasible." Sen. Rep. No. 93–151, 1st Sess. pp. 7–8 (1973).

The purpose of these fee shifting statutes is to encourage competent attorneys to take on meritorious cases in the public interest. In such an instance, the law of some circuits does not tie the proper amount of fees to the recovery by the plaintiff. Instead:

"The value of an attorney's services is not only measured by the amount of recovery of plaintiff, but also the non-monetary benefit accruing to others, in this case the public at large from his successful vindication of a national policy to protect consumers * * *."

Fleet Investment Co., Inc. v. Rogers, 620 F.2d 792, 794 (10th Cir. 1980). This case was litigated under the federal Odometer Act, which provides in 15 U.S.C. § 1989 for an award of attorney fees against any person violating the act.

To say that the biggest winners in consumer cases are the class counsel ignores the value of an order enjoining wrongful conduct and disregards the importance of the vindication of the public interest in enforcement of the law. The recovery of fees disproportionate to the recovery on behalf of the class only occurs as a result of statutory entitlement to fees because Congress has determined that encouraging private enforcement of consumer protection and other laws through awards of attorneys fees serves the public interest. Another example is 42 U.S.C. § 1988, which allows for the awarding of attorneys fees in civil rights cases in recognition of the public interest in preventing discrimination based on race, gender, or national origin.

We also dispute the accuracy of the assertion that in "most consumer class claims, the class counsel award grossly exceeded the amount of work involved on the part of counsel". In jurisdictions where the lodestar method is followed, compensation is indeed based on the amount of work performed, with the possibility in some cases for an enhancement to reflect the fact that fees are sometimes awarded years after work was performed, and during that time the attorney was required to expend funds to pay staff and expenses. In other jurisdictions, where awards are based on a percentage of the fund recovered, the law requires that fees be calculated not on the amount of work performed but on the value of the benefit to the class. Regardless of the method by which reasonable fees are determined, class counsel only get paid as a result of action by the courts, which must approve all fee applications.

The thrust of the question, therefore, is either expressing disagreement with existing legislation, which the Congress has enacted over a period of decades, or with the way judges are approving fee awards. If it is the former, the solution is to change the statutes that provide for fee shifting or argue for changes in the decisional law governing proper awards of attorneys' fees. Even if were the case that courts are not doing their job and are awarding fees in excess of what the applicable authorities allow, it is no solution to substitute arbitration for courts. In the arbitral forum, the decision makers are not bound to follow congressional statutory mandates or applicable case law, so that there would be no controls whatever on arbitrators' exercise of their discretion in awarding fees. The factual assertions referred to in question 1, if they are accurate, are not a result of any misconduct by class counsel, but instead reflect disagreement will existing law, which judges as well as class counsel are obliged to follow.

NACA shares the view, which apparently underlies this question, that in some instances there have been abuses by counsel in class actions. Indeed, we promulgated a comprehensive set of Standards and Guidelines for Litigating and Settling Consumer Class Actions meant to address abuses, which is published at 176 F.R.D. 375 (1988). But the fact that some individuals misuse the class action device should not be allowed to obscure the essential point that consumer class actions serve an important function in our judicial system and can be a major force for economic justice. They often provide the only effective means for challenging wrongful business conduct, stopping that conduct, and obtaining recovery of damages caused to the individual consumers in the class. Frequently, many consumers are harmed by the same wrongful practice, yet individual actions are usually impracticable because the individual recovery would be insufficient to justify the expense of bringing a separate lawsuit. Without class actions, wrongdoing businesses would be able to profit from their misconduct and retain their ill-gotten gains Id. at 377.

Question 2. Consumer advocates claim to believe in the efficacy of alternative dispute resolution. If that is the case, how should an acceptable pre-dispute clause be written?

Answer 2. NACA, along with other consumer advocates, endorses the use of alternative dispute resolution, including mediation and arbitration, when parties of equal bargaining strength voluntarily make the choice of these alternatives to traditional adjudication of disputes by the courts. However, we do not believe that it is possible to have meaningful consent by a consumer to a predispute arbitration clause in a contract of adhesion. Arbitration as a method of resolving disputes is a creature of contract premised on the ability of parties of equal bargaining power to chose the method of resolving disputes which will best service their mutual needs. Free choice is the foundation of all alternative dispute resolution mechanisms, including arbitration, and we believe that consent of the parties is a prerequisite to an enforceable agreement, as a matter of both law and policy.

NACA's views are based on and supported by the case law. The Supreme Court has repeatedly recognized that arbitration is a matter of contract between the parties. *See e.g., First Options of Chicago, Inc.* v. *Kaplan* (1995) 514 U.S. 938, 944–945. There, the Court held that in deciding whether the parties agreed to arbitrate a certain dispute, courts should apply ordinary state law principles that govern the formation of contracts, and explained: "After all, the basic objective in this area is not to resolve disputes in the quickest manner possible, no matter what the parties' wishes, but to ensure that commercial arbitration agreements, like other contracts, 'are enforced according to their terms,' and according to the intentions of the parties," citing and relying on *Mastrobuono* v. *Shearson Lehman Hutton, Inc.* (1195) 514 U.S. 52, 56–57, 62–63; *Dean Witter Reynolds Inc.* v. *Byrd,* (1985) 470 U.S. 213, 219–220; *Volt Information Sciences, Inc.* v. *Board of Trustees of Leland Stanford Junior Univ.,* (1989) 489 U.S. 468, 475–476; *Mitsubishi Motors Corp.* v. *Soler Chrysler-Plymouth, Inc.,* (1985) 473 U.S. 614, 626. Thus, as the Court noted in Volt, arbitration is a matter of consent, not coercion.

NACA's view that voluntariness is essential to any acceptable alternative dispute resolution system also finds strong support as a matter of policy in "Justice in the Balance 2020", the Report of the Commission on the Future of the California Courts. This Report was issued by a committee, appointed by the Chief Justice of the California Supreme Court, which for two years studied the propriety of alternative dispute resolution mechanisms as a component of a system of justice. That Report concludes that appropriate alternative dispute resolution "stands for the principle of parties' control over the resolution of their own disputes" at p. 53. The Report recognizes both the importance of choice and the right to adjudication of disputes in court absent consent to an alternative.

When an arbitration clause is placed into a standardized form contract before a dispute arises, the consumer is deprived of any way to intelligently decide if she really wants arbitration or if it will be an appropriate way to resolve that particular dispute. Therefore, we do not believe that there is any way to draft an acceptable pre-dispute clause in a standardized form contract between parties of unequal bargaining strength. It will always be the case in these contracts of adhesion that the clause is drafted by the party of superior bargaining strength and imposed on the weaker party, raising troublesome questions both about the actuality and the perception of unfairness.

Question 3. According to consumer advocates, one of the most egregious aspects of many consumer contracts is the lack of disclosure on the part of many financial institutions. They argue that financial institutions unilaterally insert arbitration clauses into contracts with no notice and without negotiation.

If disclosure is a problem, what form should proper notification take?

Answer 3. The problem with unilaterally imposed, mandatory and binding arbitration clauses is not lack of disclosure, but lack of consent to arbitration by the consumer party. The importance of the fact that financial institutions insert arbitration clauses into contracts without notice or negotiation is that it negates any possibility that consumers could consent to a provision when they do not even know that it exists. The deficiency of such a procedure is not that there is inadequate disclosure, but, more significantly, that there is no manifestation of assent or agreement to arbitration. As noted in answer to Question Number 2 above, the law requires that arbitration be a matter of consent, not coercion. *Volt Information Sciences, Inc.* v. *Board of Trustees of Leland Stanford Junior Univ., supra,* 489 U.S. at 475–476.

It cannot reasonably be disputed that arbitration infringes on constitutionally protected rights to trial by judge and jury. Recently, a California appellate court decided *Badie* v. *Bank of America* (1998) 67 Cal. App. 4th 779,806, rev den (Feb. 1999), a case involving the enforceability of an arbitration clause which the Bank attempted to impose on all of its several million credit card and deposit account customers by a stuffer in their billing statements. The Court held that, because the right to a jury trial is a substantial fundamental right, it cannot lightly be deemed waived, and waiver requires a "clear and unmistakable" or an "unambiguous and unequivocal waiver" of that right. A statement stuffer purporting to change contract terms was found inconsistent with the requirements for waiver of the fundamental right to trial by jury, and the clause was held to be unenforceable.

Thus, the parties' consent is a prerequisite to an enforceable agreement to arbitrate. Notice is not the same as consent, and disclosure will not suffice to constitute waiver of the fundamental constitutional right to a jury trial. The importance of consumers' having access to the courts is underscored by the attempts of unscrupulous wrongdoers to coerce consumers into arbitration, which they perceive as a forum more favorable to them, as a way of insulating their wrongful conduct from any meaningful oversight. In a front page story in the New York Times on March 15, 2000 dealing with predatory mortgage lending, the reporters note that First Alliance Mortgage Company "tried to shunt the case off to arbitration, but a state appeals court, in a crucial ruling, concluded that the elderly couple's signature on a form agreeing to forego lawsuits had been 'obtained by fraud'." A copy of the article is attached.

It would be possible to structure an alternative dispute resolution clause for post-dispute agreement by regulating the content of disclosures necessary to obtain consent, just as Congress regulates the disclosures for extensions of consumer credit under the Truth In Lending Act, 15 U.S.C. § 1605 ("TILA"). For example, Congress could require that such a clause appear in a separate document, in certain size type, be clear and conspicuous, and give consumers the right to decline, just as it did in enacting TILA, and just as many states have done in regulating the sale of insurance.

Question 4. As the Rand study pointed out, most consumer class members have only a small financial stake in the litigation, and representative plaintiffs may play an insignificant role in the litigation. And, because of the manner in which class action rules are commonly applied, class members may not learn of the litigation until it is almost over. As a result, there are few if any active monitors of the class attorney's behavior. Such clientless litigation holds within itself the seeds for questionable practices.

Are mechanisms currently in place to monitor the behavior of class attorneys? Moreover, do you feel that the grossly disproportionate fees awarded to the class counsel in relation to the amount of work involved and the portion awarded to the plaintiffs is indicative of possible malfeasance on the part of many class attorneys?

Answer 4. It is inherent in much class action litigation that class members only have a small financial stake. That is precisely why you need a class. If each individual has large claims, they would have the economic incentive to seek individual representation. *See e.g., Kelly* v. *County of Allegheny,* (1986) 515 A.2d 48 (recognizing the need for class actions when individual damages are small). It is true that class members may play an insignificant role in the litigation, but that is due more to their lack of legal training than the size of their damages. The same is true of people with a huge economics stake in litigation like Bill Gates; they rely on their counsel to protect their interests. That role in class litigation is played by the court, which has a fiduciary duty to absent class members to ensure that their interests are protected at every stage of the litigation pursuant to Federal Rules of Civil Procedure, Rule 23.

It is true that notice to class members may not occur until a case has been settled. But the fact that notice to class members comes at that stage may not be a problem if they have a small stake and play an insignificant role. Even if it is considered problematic, the timing of notice is not class counsel's fault. Under Rule 23(d) the court can order that notice be sent to the class at any time after the class is certified. Often it is defendants who want class notice to be delayed because they fear adverse impact on their business interests. *See Katz* v. *Carte Blance,* 496 F.2d 747 (3rd Cir., 1974), *cert. denied* 419 U.S. 885. In any event, in any class action for damages, notice is given before class members will be bound by any settlement.

Mechanisms currently exist to monitor the behavior of class counsel. As an initial matter, before a case is allowed to proceed as a class action, the court must decide whether class counsel are adequate to fairly and adequately represent the class. Newberg, NEWBERG ON CLASS ACTIONS, § 3.21, p. 3–125, 3rd Ed. (1992). Under the case law, the trial court has the continuing duty to undertake stringent examination of the adequacy of representation by named class representatives and their counsel at all stages of the litigation. *In re General Motors Corp Engine Interchange Litig,* 594 F.2d 1106 (7th Cir. 1978), *cert denied,* 444 U.S. 870 (1979).

Moreover, the Federal Rules of Civil Procedure in Rule 23(e) require court approval before a class action is dismissed or compromised. That rule gives judges the power to protect the interests of absent class members and ensure that any settlement is in their best interests. Newberg notes that a major purpose of Rule 23(e) is to discourage the use of the class action device to provide a windfall to the named plaintiffs and their counsel at the expense of the class, and concludes: "Particularly before there has been any class ruling, the court is in the position to monitor instances of potential abuse for private benefit, while encouraging settlements in the public interest." Newberg, *supra,* at § 11.65, p. 11–182.

As an additional check on the fairness of settlements by class counsel, class members have the opportunity to exclude themselves from any settlement or to file an objection to it pursuant to Federal Rule of Civil Procedure, Rule 23. Objections to the fairness and adequacy of the settlement are decided by the trial courts, which are not reluctant to disapprove class settlements that they find unfair to absent class members, *See e.g., Amchem Products, Inc.* v. *Windsor,* (1997) ____ U.S., 117 S. Ct. 2231; *In re General Motors Corp. Pick-up Truck Fuel Tank Products Liability Litigation,* (1995) 55 F.3d 768 (3rd Cir.), *cert. denied,* ____ U.S., 116 S. Ct. 88. This provides not only a mechanism to monitor the conduct of class counsel in overseeing the adequacy of the recovery they obtain for class members, but also provides oversight over the propriety of the requested fee award.

The Rand Study is entirely in accord with NACA's views. According to the news release issued on November 1, 1999 by the Rand Institute for Civil Justice, the principal finding of the Rand Study is that: [t]he key to improving outcomes and eliminating abuses in class action litigation over money damages is increased regulation of settlements and fee awards by judges equipped with the training, resources and determination to do the job".

Finally, it is NACA's view that "grossly disproportionate fees awarded to the class counsel in relation to the amount of work involved and the portion awarded to the plaintiffs" is a myth, which does not reflect reality or indicate possible malfeasance on the part of many class attorneys. As our answer to question 1 indicates, even in the few cases which there is such disproportion, it may be soundly based on case law and public policy. Framing the question in this way fails to take into account two important points. First is that it is Congress which has limited the possible recovery in consumer class actions under TILA, which is the basis for many class actions in the area of consumer credit. In 1974, Congress amended the act to impose a ceiling on the class action recoveries of $100,000 or 1% of the defendant's net worth, and in 1976 modified that limitation to $500,000 or 1% of net worth, whichever is less. 15 U.S.C. § 1640. It is as a result of that ceiling, imposed to protect defendants, that individual recoveries to consumer class members are often small. Second, consumers and the general public may benefit significantly from class litigation through the cessation of wrongful practices even when class members recover only a small monetary sum as their share of class wide damages.

Question 5. The bottom line is: once a class is certified the risks in proceeding become too great, and pressure to reach a settlement without adequate investigation of the facts and law increases. For defendants the rewards of a settlement are less expensive than a protracted legal battle and the ability to get back to business. Many times, businesses will simply settle to get rid of the lawsuit at an attractive price, rather than because the case was meritorious.

In light of possibly huge wind-falls for class attorneys, what mechanism will prevent the further proliferation of frivolous consumer lawsuits?

Answers. Once again, this question does not reflect the reality that NACA members experience in their practices, in which defendants are unwilling to settle even meritorious cases. Counsel for corporate wrongdoers who are well funded often will engage in a war of attrition against their less affluent adversaries and refuse to participate in settlement discussions even when their clients are plainly liable until after a class has been certified, all the while resisting both discovery and class certification with every procedural device that the Rules of Civil Procedure afford.

While it is true that once class is certified, the defendants face the threats of substantial liability, there are safeguards in place that protect them from frivolous lawsuits. As the preeminent commentator on class actions as explained:

"Because the financial stakes in a class action for damages may be substantial, both courts and prospective defendants have been generously empowered to curb potential class action abuses or frivolous class action. At the outset, it should be recognized that it is squarely against the normal presumption of professional competence as well as against the economic self-interests of prospective class counsel to bring a frivolous class action or strike suit. Empirical evidence shows that the bringing of a class suit of highly doubtful merit virtually never results in a settlement, nuisance value or otherwise, from the defendants. As a practical matter, such suits have no coercive settlement value at all."

Newberg, supra, § 15.29, p. 15–84. The empirical evidence relied upon is a Class Action Study, prepared for the United States Senate Commerce Committee, 93d Cong., 2d Sess. (1974), reprinted in 62 Georgetown L.J. 1123 (1974). Newberg goes on to note that the Federal Rules of Civil Procedure provide the defendant with means of summary dismissal of frivolous lawsuits under Rules 12(b)(6) for failure to state a cause of action, Rule 12(e) for judgement on the pleadings and Rule 56 for summary judgement. Moreover, dismissal and sanctions for the filing of unmeritorious actions are available under Rule 11.

Question 6. Many consumer disputes arise that involve an amount over $1,000, in which there is a genuine dispute with both parties believing their claim is valid. If the dispute involves more than $1,000, it will exceed the limit for small claims court in many jurisdictions; and, the consumer's claim does not involve a situation in which he or she may pursue it on a class basis.

How do you propose that a consumer pursue this claim without arbitration—Superior court? If the amount involved is between $1,000–$5,000, who is going to pay the attorney's fees? From a cost benefit analysis, why would somebody pay $4,000 to pursue a $3,500 dispute?

Answer 6. First, small claims court limits are often higher than $1,000. For example, in California, the limit is $5,000. Second, the Municipal Courts provide another alternative, and are often cheaper and faster than Superior Court. Third, do not suggest that consumers be deprived of the ability to select arbitration, which may well be desirable for resolution of such a consumer's claim. We merely urge that that alternative should not be forced on them by coercion, rather than by their choice.

Whether these disputes are resolved in a judicial or arbitral forum, the availability of fee shifting statues, discussed in answer to question 1 above, make it possible for consumers suing under many federal or state laws to recover fees from the defendant. Congress has taken into account the importance of making consumer access to the courts feasible when it passed the 150 pieces of legislation that provide for an award of attorneys fees against defendants who violate that statute. By these fee shifting provisions, Congress has made it economically feasible for consumers subjected to unlawful business conduct, as well as individuals subjected to discrimination based on race, gender or national origin to obtain redress. If a consumer is the target of wrongdoing, just as Congress repeatedly has recognized, it is appropriate to shift fees to the defendant. And this fee shifting should be one way, unless the plaintiff's claim is frivolous, like Congress provided in enacting Title VII. No consumer should be faced with the possibility of a $10,000 fee award for bringing a $1,000 claim.

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Profiting From Fine Print With Wall Street's Help

By DIANA B. HENRIQUES with LOWELL BERGMAN

MORTGAGED LIVES

A special report.

Bernae Gunderson, a certified paralegal who lives in St. Paul, is not intimidated by fine print. But she was still puzzled by the mortgage documents she got in May 1998 from the First Alliance Corporation. This did not sound like the affordable home equity loan that she and her husband had been promised.

So about 2:30 p.m. on May 26, Mrs. Gunderson called the manager of the mortgage company's local office and asked all the right questions about rates, monthly payments and fees. And she got reassuring answers that confirmed her understanding of the terms of her loan.

But those comforting answers were mostly lies, as revealed in a tape-recording Mrs. Gunderson made of her conversation to play later for her husband, Scott. In fact, $13,000 in fees was added to the loan, and its interest rate was designed to rise a full percentage point every six months. Facing mortgage payments already $150 a month higher than when they first closed on the loan, Mr. and Mrs. Gunderson have been forced to work as much as 10 extra hours a week to meet their payments.

"We have three children, and an extra $150 a month really can help out for clothing and everything else," Mr. Gunderson said in a recent interview. "It does make a lot of difference."

Mrs. Gunderson added, "The stress is unbearable."

The Gundersons are among scores of consumers who have complained to state regulators about First Alliance, a national home-equity lender based in Irvine, Calif. More than a dozen homeowners have already sued. They all assert that the company has used a deceptive sales pitch, delivered by loan officers recruited from big auto dealerships, to lure homeowners into high-cost loans that expose them to the threat of foreclosure and financial ruin.

The company, which steadfastly denies wrongdoing, has also been sued by the AARP and by regulators in five states. One, Washington State, is seeking to suspend it from doing any business there. A California appeals court concluded last year that the company "trained its employees to use various methods, including deception, to sell its services." The federal Justice Department is investigating First Alliance, and the company has withdrawn from an industry trade association because of negative publicity.

But First Alliance still has some very important supporters: the investment banks on Wall Street that help it raise the money lent to people like the Gundersons. Those banks began raising significant amounts of money for the company in the early 1990's, after it had already come under

How First Alliance Profits From Fine-Print Lending With Wall Street's Help

Continued From Page A1

investigation in California for discriminatory lending. An investigation by The New York Times and the ABC News program "20/20" shows they have pumped hundreds of millions of dollars more into First Alliance in recent years, even as civil lawsuits and state investigations have raised increasingly troubling questions about First Alliance's business practices.

The money raised by Wall Street for First Alliance and dozens of similar companies has financed a quiet revolution in the financial habits of millions of Americans whose low incomes or blemished credit histories otherwise prevented them from obtaining conventional loans. Such subprime borrowers, as they are called in the lending industry, have turned in increasing numbers to finance companies that cover the risk of default by charging them significantly higher fees and interest rates.

Since 1989, Wall Street investment banks have sold more than $316.2 billion in bonds for subprime lenders — more than twice the dollar amount of the high-yield, or junk, bonds that companies used to finance takeovers in the 1980's. First Alliance has been a big beneficiary of these new mortgage bonds, receiving nearly $2 billion the last decade, including $103 million raised through Lehman Brothers just three months ago.

William J. Ahearn, a spokesman for Lehman, said the firm's role in selling bonds backed by subprime loans, known in the financial world as underwriting, includes a careful review to make sure investors have the facts they need. He said that Lehman officials were fully aware of First Alliance's legal problems and believed that the company had stepped up its efforts the last 18 months to prevent abuses. Lehman, he said, is an "underwriter, not a regulator."

For much of the last decade, the federal government has largely left regulation of the industry to the states, despite a series of Congressional hearings that revealed rampant abuses. The first round of hearings, in 1994, established that many companies were taking advantage of unsophisticated homeowners — many of them minorities; the second round, in 1998, suggested that the problems were spreading nationwide.

The testimony did not dissuade Wall Street investment banks from vastly expanding their stake in the industry. They have financed lending operations, helped companies sell shares to the public and, in some cases, formed partnerships with the companies.

Consumer advocates contend that First Alliance, whose actions have been extensively documented in court cases and regulatory actions, is typical of an industry that often preys on low- and middle-income people desperate to escape financial difficulties. Industry officials say, however, that subprime lenders can provide a valuable service to consumers whose credit records otherwise disqualify them for conventional loans.

For its part, First Alliance denies "in the strongest terms" that it has a companywide practice of deceiving borrowers and has described some cases cited in regulatory documents as isolated misunderstandings involving a few loan officers. It says it is providing a service to people who would otherwise be unable to obtain credit, and insists that its fees — which it says are now lower, on average, than they once were — are justified by the dangers of lending money to the nation's riskiest borrowers.

"First Alliance's business model is to charge a higher origination fee than most, offset by a lower interest rate than most," explained Brian Chisick, the company's founder and chief executive. That, he continued, gives consumers lower monthly payments and lower total payments over the life of the loan.

"Most borrowers are much more concerned about their monthly payment than the amount of any fees," he added.

Critics counter that, in fact, many First Alliance borrowers — who regulators say are largely people with decent credit histories — wind up paying higher fees on top of higher interest rates than are justified by the risks the lender is taking.

While a few regulators have challenged the high fees, most of the litigation currently pending against First Alliance focuses on the elaborate script its loan officers have been trained to use. The script, regulators say, is designed to deflect questions about rates and fees, swamp borrowers under masses of needless detail and foster a trusting atmosphere that would encourage customers to lower their guard.

But Mrs. Gunderson was still wary enough to double-check her loan with First Alliance, and to tape the call on her telephone answering machine.

Worried about the $13,000 in fees, she sought confirmation that her loan was for about $47,000.

"Right, your amount financed is $46,172," the loan officer, Brian Caffrey, assured her. "That doesn't change."

"Right, right," she continued. "And then the $13,000 goes on top of that? And then interest is charged?"

"No, no, no," he responded.

But the answer should have been yes, yes, yes — the fees were added to the $46,172 that the Gundersons thought they had borrowed, and they are paying interest on those fees over the life of the loan.

Mr. Caffrey said in a recent interview that he was just following the script First Alliance trained him to use — an explanation strongly disputed by Mr. Chisick, who said all company loan officers "are specifically trained to insure borrower understanding of all aspects of their loan."

Mrs. Gunderson later shared her tape-recording with the Minnesota attorney general's office, which attached a transcript of it to court documents filed in its case against First Alliance.

"Everything they told us made sense," she said, "but they were lying through their teeth. And they told all kinds of people the same things that they told us. We just happened to be lucky enough to push a button."

The Business

Making Loans By the Script

At age 60, Brian Chisick has the tanned, broad-shouldered good looks of a native California surfer. But he was born in London, where he lived until age 14, when his family moved to Vancouver, British Columbia. In 1963, he relocated to Orange County, Calif., where after a briefly varied career — he once sold office machines, for example — he found his way into the mortgage business.

In 1971, he and his wife, Sarah, opened the First Alliance Mortgage Company, a consumer finance company that would ultimately rely on two sources of strength: an aggressive sales force recruited from auto dealerships and a ready access to Wall Street.

In its early days, his company was just one of many mom-and-pop consumer finance companies that competed, with only middling success, against stronger savings and loan institutions and commercial banks. But before First Alliance was a decade old, rocketing interest rates and financial deregulation had turned its world upside down.

In 1980, in an effort to salvage the battered savings and loan industry, Congress effectively repealed most state laws limiting the interest rates that lenders could charge for first mortgages on residential property. Two years later, Congress erased most state restrictions on "alternative" loans, including adjustable-rate mortgages.

These steps, intended to help the savings and loan industry, also benefited small consumer finance companies like Mr. Chisick's. Over the next decade their share of the home equity loan market exploded, rising to 32 percent in 1989 from less than 0.5 percent in 1977, according to a recent study by Cathy Lesser Mansfield, a consumer law professor at Drake University in Des Moines.

Mr. Chisick's company flourished in this new competitive environment, and by 1988 he had opened lending offices in seven communities across California. To staff them, he recruited highly paid automobile sales representatives, who were at ease with the "hard sell" but tired of the long evening hours and weekend work that auto sales involved.

Recruits were required to commit to memory an elaborate 27-page sales pitch — known in the early days as "The Loan Officer's Track to Run On," later shortened to the Track. According to court documents filed in a 1988 case in California, loan officers were drilled until they could deliver the sales message flawlessly, slipping back into the script regardless of the questions customers might raise.

"Establish a common bond," the loan officers were taught. "Find this early in the conversation to make the customer lower his guard." The script listed good bond-building topics (family, jobs, children and pets) and emphasized, "It's really important to get them laughing."

It offered another bit of advice: "To soften the blow of dollar amounts, say: 'merely,' 'simply,' 'only,' 'as you know.'"

And if the customer asks questions about the rate and the fees? Just say, "May I ignore your concern about the rate and costs if I can show you that these are minor issues in a loan?"

The company insisted that its employees stick to the script, and managers monitored the loan officers over office intercom systems to make sure they did, according to court documents and numerous interviews with former employees.

In 1988, with testimony from several company whistle-blowers, lawyers for the California Department of Corporations accused the company of imposing harsher terms on loans made to homeowners in neighborhoods with high minority populations — areas that loan officers referred to as "never-never land," according to the state's lawsuit. Regulators also complained that the company's sales pitch deliberately obscured the high points and other fees that borrowers paid.

Mr. Chisick's lawyers denied racial discrimination and said the "never-never land" list had been prepared by some unknown employee, had not been used for at least five years and had never been sanctioned by First Alliance management. In April 1989, First Alliance paid $420,000 to settle the state lawsuit, denying wrongdoing but submitting to two years of state monitoring and agreeing to conduct racial sensitivity training for its staff.

Eight months later, a consumer class-action suit filed in Oakland accused the company of fraudulently concealing its fees and imposing excessive and unjustified charges on borrowers. In 1994, again without acknowledging any liability, the company paid $6.85 million to settle the case.

In its early days, First Alliance raised money for its operations primarily by selling bundles of loans directly to private investors. But in 1993, despite its earlier regulatory trouble and the still-pending consumer lawsuit, it tapped into a much deeper, less expensive source of fresh capital: Wall Street.

The sale of bonds backed by packages of lower-quality mortgage loans was not a new idea, and some small deals had been done as early as 1989. But by the mid-1990's, with professional investors hungry for higher-yielding investments, major Wall Street investment banks stepped up the volume of loan-backed bonds sold to pension funds and other institutions. Suddenly, a vastly larger pool of money became available to subprime lenders like First Alliance.

The process works like this: Wall Street bankers invite investors, typically large institutions like pensions funds and universities, to buy certificates that pay an attractive interest rate over many years. The money raised from those investors is then used to buy groups of loans taken out by consumers through companies like First Alliance. The borrowers' monthly payments cover the interest paid to investors plus a profit to First Alliance. The certificates are roughly equivalent to mutual fund shares, with investors owning a portfolio of loans rather than stocks or bonds.

Between 1994 and 1996, the amount of money raised on Wall Street for subprime lenders rocketed. In 1996 nearly $40 billion worth of subprime loan notes were sold, up from just over $10 billion the year before; within two years, the annual volume was $87 billion.

The business was attractive to Wall Street for two reasons. First, investment banks collected fees for arranging the deals — usually about a third of a penny for every dollar raised. Second, doing the deals gave the investment bankers a steady supply of the popular high-yielding mortgage notes to sell to their institutional customers, who would otherwise shop elsewhere.

By 1996, most of the big investment banks on Wall Street, and some large commercial banks, had plunged into the subprime business; the resulting flood of cash was like a dose of steroids for the industry.

With Wall Street's demand in overdrive, "lenders and mortgage brokers went out and tried to make as many loans as they could to meet the demand," explained Jeffrey Zeltzer, executive director of the National Home Equity Mortgage Association, which represents subprime lenders.

First Alliance was one of the big beneficiaries of this development. John D. Dewey, the consultant who advised the company on its first Wall Street deals, recalled that its business grew more than sixfold once it had access to mortgage market financing.

Its profitability improved significantly as well, since it was paying around 6 percent interest on the money it raised on Wall Street and could lend that money to consumers at an average interest rate of 14 percent, Mr. Dewey said.

The company expanded, and today operates in more than a dozen states from Washington to Florida. California remains its biggest source of customers, but New York, New Jersey and Illinois are close behind.

Buoyed by the robust health that Wall Street's money had generated, First Alliance was able to sell its own shares to public investors in 1996, in a deal that allowed the Chisicks to draw $135 million out of the company. While not politically active, they were generous with their new wealth, contributing to a religious academy in Huntington Beach, Calif., and building the Chisick Auditorium for the Jewish Community Center of Orange County.

The Chisicks' three sons, Jamie, Brad and Mark, have followed their parents into the subprime lending business, operating two affiliated lending companies that have had their own troubles with regulators in recent years.

But life is not all mortgages and philanthropy for the Chisicks. They are listed in property records as the owners of an expensive condominium in Honolulu and a home in a gated community in Santa Ana, Calif., which they bought after their successful public stock offering in 1996.

The year the Chisicks finally grasped the brass ring of extraordinary wealth was also the year that a number of elderly First Alliance customers in the San Jose area began to worry about losing the roofs over their heads.

The Borrowers

Facing Ruin Under a Pile of Fees

First Alliance says it charges high fees because its borrowers have less-than-perfect credit records and are more likely to default on their loans.

But the company tells a different tale to Wall Street. In documents intended to attract investors, it points out that more than three-fourths of its loans are made to people with relatively good credit histories.

A former loan officer said the company mades little effort to distinguish between customers with poor records and those with good credit history, who would qualify for conventional loans.

At First Alliance, "customers with 'A' credit would pay the same high loan fees as customers with 'D' credit," according to a sworn affidavit by Greg Walling, a First Alliance loan-officer-turned-whistle-blower who has cooperated with various state regulators. His suburban Minneapolis office was a few dozen yards from a conventional branch bank, he said in a recent interview. "I wanted to tell some of my better customers that every step they took from my door to that bank would save them $1,000 on their loan," he said.

He was not exaggerating. Court record show that the company has charged loan origination fees, called points, of 25 percent interest rates and big penalties for early repayment.

In his statement, Mr. Chiswick said the company had recently reduced its origination fees to an average of about 10 percent because of what he called the "sound-bite effect of the high origination fees."

Few conventional lenders charge origination fees of more than two points on a loan — that is 2 percent of the total amount — and many state regulators consider fees of more than eight points to be indefensible.

For someone borrowing $100,000 from First Alliance, a fee of 25 points adds $25,000 to the amount on which the customer is paying interest.

The calculation has become all too familiar to Velda Durney, one of the homeowners who have sued First Alliance.

Mrs. Durney's brother built her sage-green ranch house in Fremont, Calif., outside San Jose, in the summer of 1966. It is filled with evidence of a life well lived: photographs of happy school-age grandchildren, fresh-baked carrot cakes cooling in the kitchen, a bowling-trophy-laden sideboard, pushed aside to make room for a quilting frame.

Her husband died soon after the house was finished, and she raised her six children there alone, working for 23 years as a sales clerk at Sears. She managed on a small pension and Social Security — until August 1996, when she refinanced her home through First Alliance.

Mrs. Durney believed she had signed for an 8.5 percent adjustable-rate mortgage for $51,493 that would consolidate a few credit card bills and lower her total monthly payments. In fact, after more than 26 points in fees were added, her loan was for $64,590, and its rate was scheduled to climb every six months until her monthly payments would equal or exceed her original mortgage payments.

Her income simply would not stretch that far, and she began to have nightmares that she would lose her home.

Asked about that loan in an interview in January, the capable Mrs. Durney slumped into a kitchen chair, tears suddenly spilling from behind her stylish wire-framed glasses.

"I can't talk about it without crying," she apologized. "It took away every shred of self-confidence I had."

Besides her peace of mind, she has also lost her privacy. She had to refinance again to get a fixed-rate mortgage, and her monthly payments are still bigger than her pension income will cover. So she makes ends meet, she said, by renting out her two spare bedrooms — which she had done as a favor to church acquaintances in the past but now does with strangers, by necessity.

"I'm getting by," she said last week, "but just barely."

Mr. Chisick said he could not comment extensively on the case because it was still in litigation, but he denied wrongdoing. He added, "All borrowers are given two separate three-day periods to reject the terms of the obligation. She decided not to."

Ed and Joanne Pagter, who lived in nearby Santa Clara, had their own money worries as 1996 began. Mr. Pagter, then 67, ran a part-time pool maintenance business that from Social Security. But he was suffering from severe kidney disease and was unsure how long he would be able to work. Mrs. Pagter, who earned just over $2,100 a month, was nearing retirement from her job at a corporate cafeteria service.

They had abundant equity in their home, but their main financial problem was an adjustable-rate mortgage that was scheduled to increase on Jan. 1 unless they could replace it with a loan that required lower monthly payments.

First Alliance, which had been calling them weekly for several years, assured them that they could. So in January 1996, the couple went to the company's San Jose office.

According to a lawsuit they later filed, the Pagters told Jeffrey E. A. Phillips, a First Alliance loan officer, that their goal was to keep payments as low as possible for the next year so that they could save more, and then to sell their home after Mrs. Pagter retired and to buy a house near their daughter, who lives in Lemoore, Calif.

The Pagters say they were rushed through the closing, signing documents they were not given time to read. No lawyer was present, as is typical in home equity loans. Not until October 1996, when they were selling their Santa Clara home and trying to close on their new one, did they discover the exact terms of their loan, according to their lawsuit.

They had actually borrowed $170,264 from First Alliance — including an origination fee of 13 points, or $19,950 — not $147,000 as they believed. This reduced the equity they had in the old home, so they had to borrow more money quickly to close on the new house.

The Counterattack

Building a Case Against Deception

Looking for help, the Pagters turned to Steinbock & Hofmann, a three-person San Jose law firm that was already representing a number of elderly homeowners with very similar complaints against First Alliance.

The cases became the special passion of Sheila Canavan, the firm's associate. Working on a shoestring — and chided by friends who saw parallels with the financially doomed lawyers in the movie "A Civil Action" — the firm was representing five other homeowners, all complaining of deceptive sales practices by First Alliance.

At the same time, investigators in the Department of Financial Institutions in Olympia, Wash., had opened a file on First Alliance, on the basis of 17 consumer complaints similar to those made by Mrs. Durney and the Pagters.

State officials immediately focused on a 1996 version of the Track, the sales script that the company's loan officers used in their dealings with customers. In June 1997, in an affidavit filed in state court, the lead investigator, Chuck Cross, observed that First Alliance's intent "appears to be to continually play down the import of certain disclosures, borrower about what they are actually obtaining in the transaction."

Mr. Cross was especially concerned that the script borrowed terms from the federal disclosure documents, like "amount financed," and gave them new and misleading definitions. Loan origination fees were never called "points," he said, but instead "prepaid finance charges," or "minimum finance charges." And they were labeled estimates when they were actually firm amounts.

Regulators in other states sought copies of that 1996 sales script, but First Alliance obtained a court order requiring Washington regulators to keep the document secret — an order that remains in place today. (Last March, First Alliance notified the state that it intended to sue Mr. Cross and his superiors for defamation.)

By the end of 1997, Ms. Canavan and her partners in San Jose had filed lawsuits against First Alliance on behalf of the Pagters, Mrs. Durney and four other area homeowners. The company mounted an aggressive defense, insisting that all the terms on the loans had been fully and clearly disclosed. Company lawyers pointed out that by signing closing statements, borrowers had attested to fully understanding the terms of their loans.

Several borrowers in the lawsuit said they had signed the forms in a rush, without having had time to examine them carefully. Others said they had been advised to ignore information in the forms that differed from what they had been told by a loan officer. Still others said they had been assured that the information was in error and would be corrected, or depicted a worst-case situation that was unlikely to arise.

Meanwhile, the Pagter case in San Jose began to inch toward trial. The company tried to shunt the case off to arbitration, but a state appeals court, in a crucial ruling, concluded that the elderly couple's signature on a form agreeing to forgo lawsuits had been "obtained by fraud."

In the decision, the court sharply criticized First Alliance, which it said had "trained its employees to use various methods, including deception, to sell its services."

In his written response, Mr. Chisick called the ruling "incorrect" and "a blatant error."

The ruling, in February 1999, gave the Pagters hope, but settlement discussions with First Alliance dragged through 1999 and broke off inconclusively early this year. It was not until a day after a jury had been chosen for a January trial in San Jose that First Alliance agreed to pay an undisclosed sum to settle the case.

"Ed and I used to joke that they were just waiting for us all to die," said Mrs. Pagter. The joke was prophetic. Mr. Pagter died last October.

Asked why First Alliance had delayed a settlement for so long, given Mr. Pagter's ill health, Mr. Chisick said, "Mr. Pagter was ill when he borrowed the money, so the advancement of his illness was not a factor."

Growing Opposition

Picking Up Allies With Influence

Even an attentive Wall Street investment banker might have missed the early local headlines critical of First Alliance. But the company's legal troubles attracted national attention in May 1998, when the Pagters and their fellow plaintiffs gained a powerful new ally in their fight: the giant AARP.

Jean Constantine Davis, a staff lawyer, said the AARP had been approached by Ms. Canavan's firm and "decided this was definitely something we wanted to look into."

The organization was taking advantage of an unusual facet of California's business laws, called Section 17200, that allows a plaintiff to sue as a "private attorney general," seeking restitution on behalf of all citizens affected by certain deceptive business practices.

State regulators, too, were heading to court. By the end of 1998, Minnesota's attorney general at the time, Hubert H. Humphrey III, had sued First Alliance, accusing it of deceptive sales practices. In Massachusetts, an assistant attorney general, Pamela S. Kogut, had obtained a temporary injunction forcing the company to limit its origination fees to eight points — although a top company executive had argued in court that the company could not make a profit with fees that low. And in Illinois, Attorney General Jim Ryan was suing as well, seeking remedies that included the rescission of all the loans First Alliance has made there.

Steve LeClair, an assistant attorney general in Florida, says that his staff has subpoenaed a "very large volume of records" and is talking with First Alliance "to see if this is something we can resolve without filing a formal complaint."

Florida's primary concern is the origination fees. "They're just so excessively high that it's hard for me to conceive of any way a consumer would agree to that kind of loan if all the facts have been put before them," Mr. LeClair said.

Last April, after years of legal fencing with First Alliance, Washington State regulators finally filed a formal complaint against the company, seeking to suspend its license for two years and to obtain an order that it discontinue deceptive practices.

And in September, First Alliance agreed to settle the consumer protection lawsuits filed against it in Minnesota. While acknowledging no wrongdoing, the company agreed to offer each of its Minnesota customers $4,000 to $6,000 and to read any new customers a simple court-ordered description of its fees and rates before any loan discussions were begun.

Prentiss Cox, a Minnesota assistant attorney general, says the company no longer does business in his state. "That kind of relief suggests the strength of our allegations in the case," he said.

But at best, regulatory efforts like Minnesota's can only protect a statewide segment of consumers: companies can short-circuit such investigations simply by pulling out of one state and moving into another. Some states have strong, clear consumer lending laws and well-financed regulatory agencies — but others do not.

The early waves of scandal from the subprime industry a decade ago prompted Congress in 1994 to adopt legislation requiring greater disclosure by high-cost lenders, but federal action to enforce those laws has been rare. Indeed, the Federal Trade Commission filed the first disciplinary cases under the 1994 law just last summer.

And yet none of these legal problems seems to shake Wall Street's faith in First Alliance or most of the other large subprime lenders that have been the targets of consumer advocates' complaints. To be sure, the high-yield mortgage market grew a bit jittery in late 1998, after revelations of some subprime lenders' questionable accounting practices. But last year, there were more than 200 separate deals totaling more than $75 billion — less than in 1998 but more than in any other previous year.

The Wall Streeters

Raising Money In the Best Circles

No Wall Street investment bank had a bigger share of that reviving 1999 market than Lehman Brothers, Wall Street's fourth-largest brokerage house and one of its oldest and most prestigious names.

First Alliance's initial public offering in 1996 was handled by Friedman Billings & Ramsey, a small investment bank based in Arlington, Va. But through the late 1990's, First Alliance had raised money through a variety of bigger banks and brokerage houses, including Prudential Securities. Then about two years ago, as the AARP lawsuit was added to First Alliance's legal troubles, Lehman Brothers became the company's primary source of financing. In all, it has handled eight separate deals for the company.

Lehman Brothers has not only helped raise money for First Alliance despite its mounting legal troubles but, more recently, has taken a small investment stake in the firm.

Mr. Ahearn, the Lehman spokesman, pointed out that the brokerage house's deals for First Alliance "have been relatively small" compared with Lehman's deals for other companies. And he emphasized that all of First Alliance's mounting legal troubles were carefully reviewed by Lehman and fully disclosed to investors who bought the notes backed by First Alliance mortgages.

Nor did First Alliance's legal difficulties dissuade another important Wall Street supporter: MBIA Insurance, the giant financial insurance company, which has stood behind many of First Alliance's loan deals over the years, guaranteeing that principal and interest will be paid to investors promptly. With MBIA's backing, First Alliance's mortgage-backed notes were awarded Wall Street's highest credit ratings, making them more attractive to institutional investors.

Bruce Legan, a managing director of MBIA, said that his company became increasingly concerned last year about the problem of predatory lending in the subprime market and that it had recently expanded the scope of its review of each subprime deal it agreed to insure.

First Alliance is one of the lenders that have come under greater scrutiny, Mr. Legan confirmed. The insurer's lawyers have reviewed the litigation against the company, he explained, and a major accounting firm conducted "a very extensive review at the operational level."

Mr. Legan declined to say what records had been examined for the assessment, but said: "We have not uncovered evidence that they are engaged in predatory lending."

MBIA's review does not appear to have included interviews with the lawyers or regulators suing First Alliance. Neither Ms. Canavan in San Jose nor regulators in other states can recall any inquiry from MBIA lawyers — or anyone else on Wall Street — about the strength of the evidence against First Alliance.

State regulators' investigations of the company have focused thus far on possible deceptive sales practices and have not yet examined where and how its money was raised.

Some legal theorists say Lehman and other banks that finance the industry can be held accountable under the law passed by Congress in 1994. It holds that borrowers' legal claims against their lenders can also be asserted against any subsequent purchasers of the loans. Some state laws may also provide a weapon, according to experts who cite a well-established legal principle in most states: those who knowingly finance illegal behavior can be held liable for it.

Meanwhile, Mr. Ahearn said that Lehman believed it had fulfilled its legal responsibilities.

The current system "is perfect for washing everybody's hands of any responsibility," said Joshua Zinner, coordinator of a foreclosure prevention project at South Brooklyn Legal Services. "At each step, it gets harder and harder to hold anybody accountable."

The subprime lenders trade group, meanwhile, is "very, very concerned" about the "few rogue lenders" who give the industry a bad name, said Mr. Zeltzer, the group's executive director. He explained that the group's board has recently adopted an industry code of ethics and voluntary standards that it hopes will prevent deceptive or unfair lending practices.

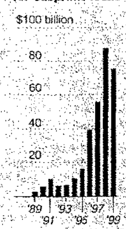
"These are not very happy headlines," Mr. Zeltzer said. "This is not how we want to do business." He added that Wall Street's financing of the "bad apples" as well as the good ones did not "make our job any easier."

THE NEW YORK TIMES, WEDNESDAY, MARCH 15, 2000

How Wall Street Helps Finance High-Cost Loans

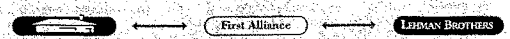
Over the last 10 years, Wall Street investment banks have raised increasing amounts of money to finance so-called subprime loans — high interest loans made to borrowers with less than perfect credit.

Money raised for subprime loans



The top 10 companies underwriting subprime loans *in 1999*

	MARKET SHARE
Lehman Brothers	18.0 %
Bear, Stearns	12.6
Greenwich Capital Markets	12.1
Bank of America Securities	11.9
Merrill Lynch	10.8
Prudential Securities	9.8
Residential Funding	5.6
Salomon Smith Barney	3.8
PaineWebber	3.5
Morgan Stanley Dean Witter	3.0
Chase Securities	2.7



HOMEOWNERS . . . borrow money from First Alliance, which has charged origination fees as high as 25 percent. The company now says its average fee is about 10 points.

FIRST ALLIANCE . . . pockets the origination fees and borrows money from Wall Street at a lower interest than it is charging homeowners.

LEHMAN BROTHERS . . . takes the individual consumer loans arranged by First Alliance, pools them and sells shares in that pooled portfolio to private investors.

Sources: Inside MBS and ABS (top 10 buyers of subprime loans); Asset Backed Alert (amount of subprime loans issued)

The New York Times

A Hard Sell and a Harder Close

First Alliance's loan officers have worked for much of the last decade from a detailed script, known as the Track, which describes the best techniques for winning a customer's confidence and closing a deal. Excerpts follow:

Making connections
Start a conversation based on what the customer is reading in the waiting area.

Get a bunch of lottery tickets and throw one on the desk when you walk in with the customer and say, *Let's see if we can do this without a loan.*

Check our library for these films on Point of View:

Boyz in the Hood (growing up in the inner city)
Fried Green Tomatoes (women's point of view)
Stand and Deliver (Hispanic point of view)

"Good morning, I'm ______, your loan officer. Thanks for being on time. By the way, don't we have a birthday soon?" **(Plus add any small talk you can add from S.I.)**

Note: It's really important to get them laughing. Try the 3-Step Introduction Process. [See Part I, page 5.]

- **Tell a 3rd party story:** *You know I had some folks in the other day in this exact same situation. They had a car that was 8 years old and not very dependable. They were feeling trapped because they couldn't take a trip without worrying about a breakdown. The wife was afraid to drive farther than 10 miles, etc., etc. And, I'm wondering if you're feeling the same way?* Listen & respond.

Couple fighting
Remember when you got married? Wasn't it for better or worse? Well, this is probably the worst, right?

God gave most of us 50 years of potential married life because it takes that long to get it right. Let's get this over with and get on with the good things.

Do you still love each other?

It's OK to fight in here. In fact I want you to get all your fighting done right now. Because, when you leave--no more fighting. Let's get it over with so you can get on with your lives.

Lost Sale Close

When to Use: Use this close when all else fails.

Script: *Pardon me, before we conclude, I wonder if you could help me out. First of all, I want to apologize for being so inept a loan officer. You see, if I had done my job, you would be thinking and planning about your ______ instead of going back to your ___ I want you to know that it's all my fault, and I'm truly sorry.*

Just so I don't make the same mistake again, would you mind telling me what I did that was wrong?

Didn't I cover that? **(And get right back into it.)**

RESPONSES OF LAWRENCE Z. LORBER TO QUESTIONS FROM SENATOR GRASSLEY

Question 1. You stated in your testimony before the Subcommittee that "[i]t is common knowledge that the litigation process is much more time-consuming than arbitration, which is the indisputable advantage that arbitration has over litigation. To say the prohibiting arbitration of employment claims will be fairer or more just ignores the amount of time a party must wait to have the claim resolved. From the perspective of employees and employers, time is critical."

In some instances, however, employers are using arbitration as a means by which to prolong a dispute. I have attached a copy of a letter regarding a case involving Raytheon. Apparently, Raytheon, as a condition of employment, required three former employees to sign mandatory arbitration clauses. Because of the arbitration clauses, when a dispute arose, the employees were compelled to arbitrate the matter. The arbitrator ruled in favor of the employees. Then, despite the fact that the arbitration clause made the arbitration final and binding, it appears the company refused to pay the award, and filed a motion to have the award overturned.

In some employment settings, arbitration seems to impose an additional proceeding, which only serves to prolong the dispute. In assessing the benefits of mandatory arbitration clauses, how can mandating an additional proceeding before a party can pursue his or her claim in court serve to expedite the process of dispute resolution, particularly, if the stronger party is dissatisfied with the result of the arbitration process, and will simply file a motion in court to have the award overturned?

Answer 1. Arbitration provides the most expeditious means of resolving employment disputes. However, the Federal Arbitration Act itself provides for limited review of an arbitrator's award when the award was (1) procured by corruption, fraud or undue means; (2) where there was evident partiality or corruption [by] the arbitrators; (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon good cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party may have been prejudiced; or (4) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the matter submitted was not made. 9 U.S.C. § 10(a).

While arbitration is designed to expeditiously resolve matters without the delays and expenses common to civil litigation, it has never been an unreviewable process. As noted above, the FAA provides for limited review. The vast majority of federal courts have built in additional safeguards. As noted in my testimony, the *Gilmer* decision cited with approval the Court's prior holding in *Mitsubishi* that a party in arbitration does not forgo his or her substantive statutory rights. Simply put, arbitrators must follow the law, see *Shearson/American Express Inc.* v. *McMahon,* 482 U.S. 220 (1987). Further, arbitration awards are subject to judicial review to insure that they do not represent a "manifest disregard" of the law. See *Wilko* v. *Swan,* 346 U.S. 427 (1953). As noted by the Eleventh Circuit, "every other circuit except the Fifth has expressly recognized that 'manifest disregard of the law' is an appropriate reason to review and vacate an arbitration's panel decision." *Montes* v. *Shearson Lehman Bros., Inc.,* 128 F.3d 1456, 1460 (11th Cir. 1997). The District of Columbia Circuit held in *Cole* v. *Burns Int'l Security Service,* 105 F.3d 1465, 1487 (D.C. Cir. 1997), that in employment discrimination cases, the limited review permitted under the "manifest disregard of the law' standard must be "sufficiently rigorous to ensure that arbitrators have properly interpreted and applied statutory law." Indeed, this standard was recently relied upon by the Second Circuit to vacate an arbitration decision in favor of the employer in an age discrimination case. *See Halligan* v. *Piper Jaffray, Inc.,* 148 F.3d 197 (2nd Cir. 1999). The point here is that *both* parties to an arbitration have, and always had a right to a limited review of awards. And in employment discrimination matters, several circuits have expanded the standard for review.

Perhaps even more to the point, this historical review process has absolutely nothing to do with whether the arbitration process is made a part of the employment relationship or is completely voluntary. Since there was general endorsement of arbitration as an expeditious and fair means of resolving employment disputes, it would be an anomaly if those in favor of arbitration, whether voluntary or mandatory, would suggest that judicial safeguards be removed. Indeed, the reported caselaw suggests that these safeguards are of greater importance for employees than employers. And in any event, there can be no legal standard which gives such a right to review to one party in an arbitration but not the other.

With respect to the Raytheon arbitration cited as the basis for this question, it is unclear as to what the issue was before the arbitrator. In particular, there is absolutely no indication from the question or the letter from the employees' counsel as to what the underlying issue was. If the matter was an employment discrimination case, the D.C. Circuit, including the District Court can look to *Cole* for guidance. The letter from the employees' counsel seems to argue both sides of the issue. While they claim that they wanted to try their case in court, they now assert that the arbitration award they otherwise decry should be enforced regardless of the merits of the underlying arbitration. They seem to be arguing their case before the wrong forum.

Question 2. Given the inherent importance of civil rights and the need for the civil rights protection, how do you respond to the argument that civil rights can only be fully protected through the court system, unless this option is voluntarily waived?

Answer 2. This question was fully addressed in my testimony. Simply put, the Congress and the courts have recognized that civil rights and the statutory protections for civil rights can be fully achieved in an adjudication regime involving mandatory arbitration. As fully set forth above and in my testimony, there is no blank check for arbitrators. Indeed, in the *Montes* decision cited in my answer to the first question, the arbitration award was vacated because the arbitration counsel for the employer apparently urged the panel to disregard established Fair Labor Standards Act precedent and regulations in deciding whether the employee was exempt or non-exempt from the FLSA for purposes of determining eligibility for overtime. The employee's rights were obviously fully protected, indeed perhaps even more so had the same argument been advanced to a jury. And in the *Halligan* decision cited in my first answer, the Second Circuit suggested an even more stringent standard for review of awards in discrimination cases. While *Halligan* has been questioned as perhaps going too far, it is indicative of the principle that employee rights are as fully protected in arbitration as they are in court adjudication. Arguments to the contrary simply fall of their own logical inconsistency.

Question 3. Percentage-wise, how prevalent is mandatory arbitration in contracts with American workers?

B. Has there been a trend regarding this percentage, one way or the other, in the last few years? What direction has any trend been moving?

Answer 3. In the time period allotted to respond to the questions, I am able to gather the current data.

RESPONSES OF LEWIS L. MALTBY TO QUESTIONS FROM SENATOR FEINGOLD

Question 1. Why is the practice of employers forcing individuals to choose between accepting employment or signing away their right to go to court particularly troublesome in the civil rights arena?

Answer 1. The growing practice of requiring employees to give up their right to go to court and arbitrate employment disputes threatens to undermine our national effort to create a workplace free of discrimination.

The United States has worked for four decades to eliminate employment discrimination. Many of us can remember the time when segregation and discrimination were not only legal, but normal and accepted aspects of American life.

We have made a sustained national effort to eliminate discrimination. Beginning with the Civil Rights Act of 1964, Congress has carefully constructed a system of federal laws that outlaw almost every form of employment discrimination. And we have done much to make these laws the reality of our country. While our efforts are far from over, equal opportunity now exists in America to an extent we could hardly imagine a generation ago.

Involuntary arbitration of civil rights disputes has the potential to reverse this hard won reform. In a perfect world, people would obey the law automatically, without regard to personal consequences. But in the world in which we actually live, laws need to be enforced to be effective. A statute without a credible enforcement system is of very little value.

Our federal and state courts have been reasonably effective in enforcing civil rights laws. Not every victim of discrimination receives justice from our courts, but employers understand that those who engage in illegal discrimination will generally be held accountable for their actions.

Our courts are able to be effective because they are independent. No employer, no matter how large or powerful, has the ability to write the federal rules of evidence, restrict the range of remedies available to parties, or choose their own judge. Arbitration, however, is not an independent legal system. Arbitration is a private system, designed by the parties to the dispute. Where there is a gross imbalance of bargaining position, the powerful party has the ability to shape the process to their advantage. Employers can and do design arbitration systems that deny remedies approved by Congress, restrict discovery, and allow the employer to choose the arbitrator.

The Federal Arbitration Act does nothing to prevent this injustice. Nothing in the FAA requires employers' arbitration systems to provide even the most basic elements of due process. Moreover, the FAA's preemption of the field prevents the states from requiring due process. Many members of the Uniform State Law Commissioners recognized the need for setting due process standards in their current process of updating and revising the Uniform Arbitration Act but did not do so because this option was preempted by the FAA.

Nor are due process requirements required by the appellate courts. As discussed in the answer to the next question, the circumstances under which a federal court will reverse an arbitrator's ruling are deliberately very narrow. Only in rare cases will the courts disturb an arbitration decision, even when there are due process violations that would be swiftly reversed had they occurred in a lower court.

The lack of legally required due process standards might not be catastrophic if employees had the power to refuse to take their cases to arbitration where the employer's system was unfair. But the Supreme Court in *Gilmer* v. *Interstate/Johnson Lane Corp.* held that employees may be required, as a condition of employment, to use the employers arbitration system.

All of this creates a world in which employers have strong financial incentives to deny due process in arbitration and the current law forces employees to use employers' arbitration system while providing virtually no protection from these due process violations. Employers have the ability to shape the civil rights enforcement system for their employees in a manner that tilts the playing field steeply in the employer's favor. This does not formally repeal our laws against employment discrimination, but the end result could be very much the same.

Question 2. Why is voluntariness so important to having a fair and credible alternative dispute mechanism?

Answer 2. Voluntary choice is essential to making employment arbitration systems fair because due process is not required by law. The Federal Arbitration Act does not require due process, and preempts state laws which might contain such requirements. Contrary to some of the testimony at the March 1 hearing, federal courts do not review arbitration decisions to ensure that due process was provided.

Under the Federal Arbitration Act, the grounds for appellate review are extremely limited. The only grounds to vacate an arbitration award are:

a. Fraud [FAA section 10(a)].

b. Partiality or corruption [section 10(b)].

c. Misconduct by the arbitrator [section 10(c)].

d. Where the arbitrators exceeded their powers [section 10(d)].

FRAUD

These grounds, narrow to begin with, have been rendered even more narrow through judicial interpretation. For example, showing evidence of fraud is not enough to vacate an arbitration decision. Nor is it enough to show the existence of fraud through the preponderance of the evidence. The evidence of fraud must be clear and convincing, the highest legal standard in civil law (*Bonar* v. *Dean Witter Reynolds,* 835 F.2d 1378 (11th Cir. 1988).

But even proving the existence of fraud by clear and convincing evidence is not sufficient to vacate an arbitrator's decision. The petitioner must also demonstrate that the award was procured by the fraud. Unless the petitioner can demonstrate a nexus between the fraud and the arbitrator's decision the decision will be allowed to stand in spite of the fraud (*Forsythe International, S.A.* v. *Gibbs Oil Co. of Texas,* 915 F.2d 1017 (5th Cir. 1990).

This burden is almost impossible to meet. Most arbitration decisions are very spare, and contain little information concerning the course by which the arbitrator reached his or her decision. Without knowing the arbitrator's thought process, one cannot show that it was influenced by the fraud.

PARTIALITY

It is possible to vacate an arbitration award where the arbitrator has demonstrated bias against a party, or has an undisclosed conflict of interest. This provision, however, protects parties only against a corrupt arbitrator who rules in an unjust manner from a bad motive. It offers no protection from an arbitrator who denies a party a fair hearing, or makes rulings that are totally at odds with the law, in the absence of malice.

OTHER MISCONDUCT

Since the only form of misconduct which the courts have recognized as grounds for vacating an award is bias, this section of the FAA has become irrelevant. MacNeil and Speidel's authoritative treatise, *Federal Arbitration Law: Agreements, Awards, and Remedies under the Federal Arbitration Act,* lists not a single case in which an arbitration award was vacated under this section.

EXCEEDING POWERS

The core of this provision is that an arbitrator cannot decide a matter which the parties did not agree to submit to arbitration. An arbitrator who rules upon a dispute which lies outside the bounds of the agreement to arbitrate may well have his or her decision vacated. This rule, while important, contains no requirements for an arbitrator's handling of a dispute which is within the scope of the agreement.

Thus, the FAA on its face provides no grounds for vacating an arbitrator's decision on due process grounds. Faced with the obvious unfairness of such a rule, some courts have interpreted the concept of exceeding powers to include making decisions that are contrary to established law.

But, like all other opportunities for judicial review, the concept that arbitrators must follow the law has been applied very narrowly. As the Supreme Court stated in *Wilko* v. *Swan* (346 U.S. 427 (1953), "interpretations of the law by the arbitrators are not subject to judicial review for error". Following Wilko, courts have generally allowed arbitration decisions which contain an error of law to stand. Only when the arbitrator shows a "manifest disregard for the law" will the decision be vacated.

The court in *Siegel* v. *Titan Indus. Corp.* (779 F.2d 891 (2nd Cir. 1978) defined this standard as "something beyond and different from a mere error in the law or failure on the part of the arbitrators to understand or apply the law." Manifest disregard means that "the arbitrator understood and correctly stated the law but proceeded to ignore it". This standard is obviously one which will seldom be met.

The bottom line is that both Congress and the courts have deliberately chosen to avoid disturbing arbitration decisions, even to the extent of allowing decisions to stand which are obviously wrong. There are benefits to this policy. It would be extremely difficult to achieve the benefits of arbitration with unlimited judicial review.

But if the law does not protect parties in arbitration from unfairness, it must allow them to protect themselves. People must be allowed to decide for themselves whether the enter into arbitration agreements. They must be allowed to walk away from arbitration when the system appears unfair. Without this ability, there is nothing to constrain employer and other powerful parties from deliberately designing unfair arbitration systems for their own financial gain.

ADDITIONAL SUBMISSIONS FOR THE RECORD

VOLKSWAGEN OF AMERICA, INC.,
Washington, DC, March 29, 2000.

Hon. CHARLES E. GRASSLEY,
Chairman, Subcommittee on Administrative Oversight and the Courts, Committee on the Judiciary, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: On March 1, 2000, the Subcommittee on Administrative Oversight and the Courts held a hearing concerning S. 1020, the "Motor Vehicle Franchise Contract Arbitration Fairness Act of 1999." The purpose of this letter is to respond to and correct testimony made by one of the witnesses, Mr. Gene Fondren of the Texas Automobile Dealers Association.

During the hearing and in his written testimony, Mr. Fondren testified: "On October 11, 1999, Volkswagen Credit, Audi Financial Services and Bentley Financial Services notified dealers that all disputes, including tort, would be resolved by binding arbitration and that the laws of the state of Michigan would govern." (See p. 11, 2nd paragraph of written testimony). Mr. Chairman, this statement is true, but is misleading given the content of the proposed legislation and the stated purpose of your hearing.

As both the proposed text of S. 1020 and Senator Feingold's introductory remarks make clear, the purpose of you hearing was to examine the franchise relationships upon which motor vehicles dealer's businesses depend, and not on the many other incidental commercial relationships they may have. You expressly intended a study of the existence and use of mandatory binding arbitration for resolving franchise disputes between motor vehicle manufacturers and their dealers, not a study of motor vehicle financing. The legislative concern with these agreements arises from the perception (with which we disagree) that manufacturers have disproportionate bargaining power with respect to franchise agreements, which are essential to the dealers' operation.

The Volkswagen Credit, Audi Financial Services, and Bentley Financial Services agreements, to which Mr. Fondren refers, solely concern optional financial services between our finance subsidiary and our dealers. They do not in any way involve franchise agreements between the motor vehicle manufacturer and its dealers, which was the issue before the subcommittee and is the focus of S. 1020. As you know, our dealers are not in any way, shape or form required to use the services or the funding of our finance company. The agreements to which Mr. Fondren referred relate to the wholesale inventory financing which we make available to qualifying dealers who wish to use this service. A large proportion of our dealers choose to finance their inventories with other institutions, and our finance company competes every day with every dealer for this business. Even if the franchise relationship were the one-sided contract of adhesion, which the dealers say it is, nothing could be further from the truth with respect to the finance agreements.

Further, as Mr. Fondren knows, these financial services agreements are not franchise agreements as defined by S. 1020. A "motor vehicle franchise contract", as defined in section 2 of S. 1020, is "* * * a contract under which a motor vehicle manufacturer, importer, or distributor sells motor vehicles to any other person for resale to an ultimate purchaser and authorizes such other person to repair and service the manufacturer's motor vehicles." These financing agreements clearly do not fall under that definition.

As a member of the Alliance of Automobile Manufacturers, Volkswagen of America, Inc., opposes S. 1020, and believes the bill would seriously weaken the ability of U.S. state and federal court system to provide alternatives to costly and time-consuming litigation through forms of alternative dispute resolution, like mandatory binding arbitration. The well-established benefits of alternative dispute resolution, like mandatory binding arbitration, are well known by the judiciary and therefore have a preferred status in the law. Forms of alternative dispute resolution, like mandatory binding arbitration, provide a certain forum for resolving disputes in a convenient and efficient manner, which affords parties a final, unbiased decision.

Lastly, Volkswagen of America, Inc., based on the available data, supports the Alliance of Automobile Manufacturers' testimony that the vast majority of franchise contracts between the manufacturers of motor vehicles and its franchised dealers do not contain mandatory binding arbitration clauses. In our case, not one of Volkswagen of America's 567 Volkswagen and 258 Audi dealer franchise contracts contain a mandatory binding arbitration clause. Rather, each of our dealer franchise contracts provide for non-binding arbitration.

Mr. Chairman, Volkswagen of America, Inc respectfully submits this letter as a clarification of the testimony contained in the record for the March 1, 2000 hearing entitled, "Overview of Contractual Binding Arbitration." We would welcome the opportunity to answer questions or provide further information regarding this matter as your convenience.

Sincerely,

W. CHRISTOPHER LEAHY.

WISCONSIN AUTOMOBILE & TRUCK DEALERS ASSOCIATION,
Madison, WI, March 3, 2000.

Re Statement for the record.

Hon. CHARLES GRASSLEY,
Chairman, and Members of the Senate Judiciary Committee, Subcommittee on Administrative Oversight and the Courts.

The origin of state franchise laws was in Wisconsin in 1937–38. Since, nearly all states have franchise laws to give some level of balance on major aspects of the relationship where one party has absolute control.

The U.S. Supreme Court decision to apply the 1925 Federal Arbitration Act to these contracts of adhesion must be corrected by Congress. Why?

State laws in effect are by-passed.

We cannot get a precedent to determine what should be reviewed by the State legislature, since there are no public, written opinions.

Statutory remedies are negated.

The result is arbitration being used as an insurance policy. Limit risk. Spread risk.

These state laws and venues are for serious matters. Voluntary arbitration is most practical for lesser disputes. But when a dealer's lifeblood is at stake, public forums are essential, practical, and in the public interest.

The state laws act as a deterrent to certain behavior. If they can be effectively bypassed by suppressive mandatory binding arbitration schemes, it seems likely we will lose the deterrent factor.

The arbitration plans in place were not negotiated. Just as the franchise agreements themselves, they are written by the manufacturer for the manufacturer. I have read some in which a dealer would be a fool to use arbitration. There would be no way to get full recompense even if you "won."

We need two things:

1. Full access to state statutes and venues;
2. Voluntary arbitration plans after a dispute arises, where the parties agree also to the rules and format of the arbitration.

S. 1020 helps us get back to some level of equity in process. It provides a legislative nod at the federal level that state legislative bodies have legitimacy as well.

We thank the members of the committee, the many sponsors, and particularly the lead co-sponsors, Senator Grassley and Senator Feingold.

After 14 years of work on this issue, it would be wonderful to see it pass this session.

On behalf of the Wisconsin dealers.

Best regards,

GARY D. WILLIAMS, CAE,
President.

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