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Blog – What Does the Federal Arbitration Act's "Policy Favoring Arbitration" Really Favor? Arbitration as a Way of Settling Disputes Rather than "Deciding" Cases

What Does the Federal Arbitration Act's "Policy Favoring Arbitration" Really Favor? Arbitration as a Way of Settling Disputes Rather than "Deciding" Cases

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Introduction

For decades, arbitration practice has been conceptualized as an alternative way to resolve cases, acting much as a court would, but more quickly and cheaply. Recent Supreme Court cases suggest that this concept is wrong, and that arbitration is actually better thought of as a settlement agreement delegating to arbitrators the power to impose a resolution on parties unable to settle their dispute on their own. Reconceiving arbitration as a way to settle cases rather than deciding them will make the practice of arbitration, with its "split-the-baby" results, seeming randomness and opacity, and its primary insulation from appeal, better understood and accepted by parties who today often approach the process with the wrong expectations.

A Shift from the Supreme Court

A few scant weeks ago, the Supreme Court on May 23, 2022 in ***Morgan v. Sundance Inc.***[1] busted a myth that we've all come to believe for decades: that the Federal Arbitration Act ("FAA") embodied "a policy favoring arbitration." The case presented a scenario quite the reverse of what we usually see. The appellant, Robyn Morgan, invoked an arbitration agreement and moved to compel arbitration after having spent eight months litigating her case in a federal district court. Her adversary opposed, claiming that Morgan had waived her right to arbitrate. The Eighth Circuit allowed Morgan to proceed to arbitration because the employer had not shown any prejudice, following the prevailing law that the Supreme Court summarized as follows:

> *Usually, a federal court deciding whether a litigant has waived a right does not ask if its actions caused harm. But when the right concerns arbitration, courts have held, a finding of harm is essential: A party can waive its arbitration right by litigating only when its conduct has prejudiced the other side. That special rule, the courts say, derives from the FAA's "policy favoring arbitration."****[2]***

The Supreme Court's short answer was that an arbitration agreement is a contract like any other and is not entitled to any special waiver provisions not enjoyed by other contracts. It seems that the courts, and the rest of us, have for decades misunderstood what the "policy favoring arbitration" is all about. Said the Court:

> *But the FAA's "policy favoring arbitration" does not authorize federal courts to invent special, arbitration-preferring procedural rules [citation omitted]. Our frequent use of that phrase connotes something different. "Th[e] policy," we have explained, "is merely an acknowledgment of the FAA's commitment to overrule the judiciary's longstanding refusal to enforce agreements to arbitrate and to place such agreements upon the same footing as other contracts" [citation omitted]. Or in another formulation: The policy is to make "arbitration agreements as enforceable as other contracts, but not more so" [citation omitted]. Accordingly, a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation [citation omitted]. If an ordinary procedural rule—whether of waiver or forfeiture or what-have-you—would counsel against enforcement of an arbitration contract, then so be it. The federal policy is about treating arbitration contracts like all others, not about fostering arbitration [citation omitted].****[3]***

And to make sure the point was not lost, the Court in that passage quoted with approval ***National Foundation for Cancer Research v. A.G. Edwards & Sons, Inc.***: "'The Supreme Court has made clear' that the FAA's policy 'is based upon the enforcement of contract, rather than a preference for arbitration as an alternative dispute resolution mechanism'[.]"**[4]**

And so, once again, we see that whatever direction a pendulum swings, it always swings back. At first, we were told that the courts disfavored arbitration. Then, for many decades now, the courts have touted how the FAA embodies a "policy favoring arbitration." Case law under the FAA in some respects put the right to arbitrate on a pedestal. The Supreme Court in the recent *Morgan* case, none-too-subtly put an end to all that. Now, we seem to have settled in the middle: arbitration agreements are simply contracts, no more and no less.

The Arbitration Clause as a Settlement Agreement

But there is, in fact, more. Other recent cases extract a principle from the text of the FAA that has been overlooked. More than mere contracts, arbitration provisions are essentially settlement agreements. Seen as such, the nature of arbitration takes on a different hue.

That quarreling parties might end their disputes in private without invoking the judiciary is an idea that first took hold among merchants in the Middle Ages. Then, most merchants sold their wares at traveling trade fairs. When disputes arose, they needed to resolve them quickly. They could not abide by the normal legal process for a very practical reason — lack of time. They needed to move on to the next fair. But since they were all merchants accustomed to common usages and norms, early arbitrations were resolved for merchants by merchants, without need to resort to lawyers or the legal system. **Merchant arbitration** became common in England and in the English colonies.[5]

Merchant arbitrations stood outside the normal judicial process because their decisions were based on the customs and usages of merchants, rather than judicially established statutory or common law. Merchants were left to settle their own affairs in ways that, like many arbitrations today, often would have defied judicial analysis. Small wonder that the courts would not disturb however merchants decided to settle their affairs.

That merchant arbitrations involved only the denizens of a common calling gave rise to a dichotomy between the "law of merchants" as opposed to the "law of the land." **This dichotomy** found its way into modern case law and is at the root of what has been called — perhaps erroneously — the historical judicial bias or mistrust of arbitration.[6]

For example, in ***Alexander v. Gardner-Denver Co.***[7], the Supreme Court held that labor arbitrators could not decide a racial discrimination claim so as to divest the employee of the ability to bring that claim in federal court. The Court reasoned that the arbitrators' limited role in enforcing collective bargaining agreements made them unsuitable to determine statutory discrimination claims. "[The labor arbitrator's] source of authority is the collective-bargaining agreement, and he must interpret and apply that agreement in accordance with the 'industrial common law of the shop' and the various needs and desires of the parties. The arbitrator, however, has no general authority to invoke public laws that conflict with the bargain between the parties."[8] The Court highlighted, among its reasons for concluding that labor arbitrators could not decide discrimination claims, that "the specialized competence of arbitrators pertains primarily to the law of the shop, not the law of the land."[9]

Securities Arbitration and SCOTUS

Securities arbitrations were, from their inception, typical of those where the "law of the shop" applied. The stock exchanges and the NASD historically treated arbitrations in the same way all merchants did — exclusively as a way of quickly settling disputes between their members. The New York Stock Exchange first began offering arbitration services in 1817 but did not permit customer access to them until 1872.[10] Rather, securities arbitration used to be touted as a "businessman's forum." And so, very much in keeping with *Gardner-Denver*, claims based on violations of the federal securities laws for a long time could not be arbitrated, as the Supreme Court held expressly in ***Wilko v. Swan***.[11]

The idea that arbitration was a way to decide cases, as a lesser mode of trial practice, arose in the context of customers, who, looking for vindication of rights rather than settlements of disputes, became concerned with the quality of arbitrators as judges. When, in ***Shearson/American Exp., Inc. v. McMahon***,[12] the Supreme Court held, overruling *Wilko*, that federal securities law claims were arbitrable, it did so in language centered on the qualifications of arbitrators:

> *[T]he reasons given in* Wilko *reflect a general suspicion of the desirability of arbitration and the competence of arbitral tribunals — most apply with greater force to the arbitration of securities disputes than to the arbitration of legal disputes generally. . . . [T]he mistrust of arbitration that formed the basis for the* Wilko *opinion in 1953 is difficult to square with the assessment of arbitration that has prevailed since that time. This is especially so in light of the intervening changes in the regulatory structure of the securities laws. Even if* Wilko*'s assumptions regarding arbitration were valid at the*

> *time* Wilko *was decided, most certainly they do not hold true today for arbitration procedures subject to the SEC's oversight authority.**[13]***

Unfortunately, in light of this criticism, rereading *Wilko* leads one to ask what the Court was talking about. The *Wilko* decision says absolutely nothing about the competence of arbitrators. It rests rather on the text of **§ 14** of the Securities Act of 1933 (the "Securities Act"),[14] which prohibits "any stipulation" that waives compliance with the Securities Act. The *Wilko* decision Court concluded that an arbitration agreement was a stipulation that waived the parties' right to bring a court case as provided in the Securities Act. But the *Wilko* Court said nothing about the "desirability of arbitration" or "the competence of arbitral tribunals," only that Congress had relegated securities claims exclusively to the courts.

In misattributing *Wilko*'s rationale, the Court in *McMahon* perpetuated a concept of arbitration as an alternative to a judicial proceeding, a form of "litigation lite," and that is how most of us think of arbitration today. Consequently, every arbitration forum has evolved complex procedural rules surrounding the selection of a panel, preparation of pleadings, motions, discovery, scheduling and hearings fairly mimicking a court trial. None of this is necessarily bad, and procedures binding on all parties are essential to ensure a level playing field. And yet, there is a crucial difference between a judicial determination and an arbitral result.

Arbitration as a Settlement Process

By and large, judicial results are binary. A court or a jury will assess the evidence and whichever party manages to prove their contentions by a preponderance — which essentially means establishing a 51% probability of being right — will win the entire cause. The other party, having only established a 49% probability of being right, loses everything. On the other hand, arbitration panels need not strictly follow the law or rules of evidence. They have far more flexibility in arriving at an award that more fairly allocates worth or blame — or if we must be cynical, probability of success — between the parties. Arbitrators' ability to "split the baby" is often decried as a bug in the arbitration system, but it is really a highlight. The actual results of modern securities arbitration often suggest a settlement rather than a decision.

The idea of utilizing the arbitration agreement as a way to settle cases rather than to decide them is right there in **§ 2** of the FAA, hiding, as it were, in plain sight. Section 2 of the FAA states:

> *A written provision in . . . a contract evidencing a transaction involving commerce to* settle by arbitration *a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract. . .* ***[15]***

But it wasn't until 2008 that the Supreme Court took notice of this concept. We see the evolution of the idea through the arc of three cases. First, in ***Preston v. Ferrer***,[16] the Court held that an arbitration agreement supersedes state laws that provide other forums of adjudication. Speaking of Section 2 of the FAA, Justice Ginsburg wrote, "Section 2 'declare[s] a national policy favoring arbitration' of claims that parties contract to settle in that manner." She partially quoted ***Southland Corp. v. Keating***,[17] but the words "contract to settle in that manner" were original to her.[18]

Then, the following year, the Court decided ***Vaden v. Discover Bank***,[19] with Justice Ginsburg again writing for the majority. In *Vaden*, the Court held that in deciding a motion to compel arbitration under the FAA, a district court must look through to the underlying dispute between the parties to determine whether it had jurisdiction. One point of the case is that the FAA alone does not grant a federal district court jurisdiction to compel arbitration, but that the court would need to have either diversity or federal question jurisdiction over the underlying dispute to do so. If the underlying dispute could not have been commenced in district court to begin with, then the disputing parties would have to take their motion to compel arbitration of that dispute to state court.

In describing the FAA, Justice Ginsburg wrote,

> *In 1925, Congress enacted the FAA "[t]o overcome judicial resistance to arbitration," and to declare "'a national policy favoring arbitration' of claims that parties contract to settle in that manner."**[20]***

The quotation was from her own opinion in *Preston* the prior year.[21]

Most recently, Justice Kagan has taken up the late Justice Ginsburg's mantle. In ***Badgerow v. Walters***,[22] the Court held, conversely to its holding in *Vaden*, that when it comes to confirming an arbitration award (as opposed to compelling arbitration), a federal district court's subject matter jurisdiction must come from the status of the parties and *not* from merits of the underlying dispute. As a result, and as a practical matter, only parties who meet the requirements of diversity jurisdiction will be able to confirm arbitration awards in federal court. All others must resort to state court. But note how Justice Kagan, writing for the majority, frames that conclusion:

> *Recall that the two [parties to the arbitration] are now contesting not the legality of Badgerow's firing but the enforceability of an arbitral award. That award is no more than a contractual resolution of the parties' dispute — a way of settling legal claims. And quarrels about legal settlements — even settlements of federal claims — typically involve only state law, like disagreements about other contracts.**[23]***

These cases give us much to think about. Arbitration began historically as a way of settling disputes between those with a common enterprise. When seen as settlement agreements, it becomes much clearer why courts do not get involved. All private parties can settle disputes — even disputes involving statutory and constitutional claims — without a court overseeing either the process of the settlement or the substance of the result. The text of the FAA and these recent cases suggest that the real policy being served is not arbitration *per se*, but settlement agreements, with arbitration agreements being simply settlement agreements through which the parties have delegated the determination of that settlement to the arbitrators.

This is not to say that the way arbitration is conducted should change much as a result. Rather, we should change the way we think about arbitrations. If arbitration is a way of settling cases, then the tendency of arbitrators against winner-take-all results is proper and should be encouraged. Split decisions are more in harmony with reality. Very few cases are black-and-white. There is usually enough fault for all the parties to share. Disputes between industry professionals turn on honest mistakes and misunderstandings more than misfeasance. Disputes with customers are even murkier. Customer losses often result from both customer and broker chasing the same dream, each deluding himself and the other. Fraud and misfeasance exist, but they are far rarer than parties who suffer losses think.

In situations when it is difficult, if not impossible, to say that one side is wholly right and another wholly wrong, split decisions should be the norm. Conceiving arbitration as the outcome of a settlement agreement rather than a lighter shade of litigation will give us greater confidence in accepting seemingly arbitrary awards as not only legitimate, but preferable. Parties and their counsel should therefore approach arbitration expecting awards that will — like all settlements do — leave everyone a little unhappy. Likewise, arbitrators should see their mandate as not primarily to decide who wins and who loses, but to impose upon the parties before them the settlement they should have reached on their own but couldn't.

Of course, arbitrators already do this. To put this in context, on average only 12% of all FINRA arbitrations are resolved by arbitrators after hearings. About 70% of all arbitrations commenced are settled by the parties or through mediation; the rest are withdrawn or decided on papers.[24] To see how arbitrators decided the cases they heard, we reviewed over 1,000 FINRA arbitration awards from 2017 through 2019.[25] In the middle 90% of all awards rendered in customer cases, panels "split the baby" over 30% of the time.[26] Those split awards averaged about 44% of the amount demanded, with most ranging from 17% to 71% of the demand.[27] Likewise, arbitrations pitting firms against each other resulted in split decisions 37% of the time, but with an average award of only about 25% of the amount demanded.[28] However, because split awards are inconsistent with the concept of arbitration as a way to decide cases, it leads to unnecessary criticism.

Conclusion

Recurring concerns about the quality of arbitrators, seemingly random and unexplained awards, and the lack, for the most part, of appellate rights should be seen to be as immaterial to an arbitration award as they are to a settlement agreement. The Supreme Court's language in *Badgerow* and its antecedents, by reconceiving arbitration as a method to settle disputes rather than to decide cases, will help us better align the theory of arbitration with its practice.

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ENDNOTES:

[1] 596 U.S. ___ (slip op. May 23, 2022), available at **www.supremecourt.gov/opinions/21pdf/21-328_m6ho.pdf** (visited 7/11/2022). George H. Friedman published a full analysis of *Morgan* in the **Securities Arbitration Alert** on July 1, 2022, available at **The SCOTUS "Arbitration Quartet" — What You Need to Know - SAA Blog (secarbalert.com)** (visited July 11, 2022).

[2] *Id.*, slip op. at 1.

[3] *Id.*, slip op. at 6.

[4] 821 F. 2d 772, 774 (DC Cir. 1987), available at **www.law.justia.com/cases/federal/appellate-courts/F2/821/772/255565** (visited 7/11/2022).

[5] Sarah Rudolph Cole, *Blurred Lines: Are Non-Attorneys Who Represent Parties in Arbitrations Involving Statutory Claims Practicing Law?* 48 U. Cal. Davis Law Rev. 921, 939-41 (2015), available at **https://lawreview.law.ucdavis.edu/issues/48/3/Articles/48-3_Cole.pdf** (visited 7/11/2022).

[6] *See generally,* Aegis J. Frumento and Stephanie Korenman, *Rethinking Non-Lawyer Advocacy in FINRA Customer Arbitrations,* Sec. Arb. Commentator, Vol. 2016, No. 8 (March 2017), available at **https://www.finra.org/sites/default/files/notice_comment_file_ref/17-34_sac_comment.pdf** (visited 7/11/2022).

[7] 415 U.S. 36, 57-58 (1974), available at **www.supreme.justia.com/cases/federal/us/415/36/** (visited 7/11/2022).

[8] *Id.* at 53.

[9] *Id.* at 57. More recent Supreme Court decisions have thoroughly rejected *Gardner-Denver*'s underlying assumption that arbitrators are not competent to resolve statutory claims, including discrimination claims. *See, e.g.,* ***14 Penn Plaza LLC v. Pyett***, 556 U.S. 247 (2009), available at **https://supreme.justia.com/cases/federal/us/556/247/** (visited 7/11/2022); ***Wright v. Universal Mar. Serv. Corp.***, 525 U.S. 70 (1998), available at **https://supreme.justia.com/cases/federal/us/525/70/** (visited 7/11/2022); ***Gilmer v. Interstate Johnson Lane Corp.***, 500 U.S. 20 (1991), available at **https://supreme.justia.com/cases/federal/us/500/20/** (visited 7/11/2022).

[10] *See* Securities Industry Conference on Arbitration, ***Report on Representation of Parties in Arbitration by Non-Attorneys***, 22 Fordham Urb. L.J. 507, 512 (1995), available at **https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1661&context=ulj** (visited 7/11/2022).

[11] 346 U.S. 427 (1953), available at **https://supreme.justia.com/cases/federal/us/346/427/** (visited 7/11/2022).

[12] 482 U.S. 220 (1987), available at **https://supreme.justia.com/cases/federal/us/482/220/** (visited 7/11/2022).

[13] *Id.* at 231–33.

[14] 15 U.S.C. § 77n, available at **https://www.law.cornell.edu/uscode/text/15/77n** (visited 7/11/2022)

[15] 9 U.S.C. § 2 (emphasis added), available at **https://www.law.cornell.edu/uscode/text/9/2** (visited 7/11/2022).

[16] 552 U.S. 346 (slip op. Feb. 20, 2008), available at **https://supreme.justia.com/cases/federal/us/552/346/** (visited 7/11/2022).

[17] 465 U.S. 1, 10 (1984), available at **https://supreme.justia.com/cases/federal/us/465/1/** (visited 7/11/2022).

[18] In 2005, one of us published an article arguing that the NASD's then-proposed rule requiring arbitrators to explain their decisions if requested was ill-advised because explanations would hamper arbitrators' ability to reach arbitral decisions that "allocated losses among the parties rather than having those losses fall *in toto* upon one side or the other. . . . Such decisions in effect do for the parties what the parties have not been able to do for themselves: They *settle* the case based upon the arbitrators' common sense of what is fair." Aegis J. Frumento, ***Can't Get No Satisfaction! How Explained Decisions Will Undermine the Arbitration Process***, Sec. Arb. Commentator, Vol. 2005, No. 3 (April 2005), at 5 (emphasis original), available at **https://www.sec.gov/rules/sro/nasd/nasd2005032/2005sac3.pdf** (visited 7/11/2022).

[19] 556 U.S. 49 (2009), citations omitted, available at **https://supreme.justia.com/cases/federal/us/556/49/** (visited 7/11/2022).

[20] *Id.* at 58 (2009), citations omitted.

[21] 552 U.S. 346, slip op. at 5.

[22] 596 U.S.___ (slip op. Mar. 31, 2022), available at **https://www.supremecourt.gov/opinions/21pdf/20-1143_m6hn.pdf** (visited 7/11/2022).

[23] *Id.*, slip op. at 6 (citations omitted).

[24] As reported by FINRA Dispute Resolution based on results from 2018 through 2021. **Dispute Resolution Statistics** | FINRA.org. (visited 7/11/2022).

[25] The authors are grateful to Richard P. Ryder and **ArbChek.com** for providing the data needed to report these results.

[26] For purposes of this analysis, we considered all awards that were more that 10% and less than 90% of the amount demanded to be "split decisions." In the entire population of 646 customer awards, customers "lost," recovering less than 10% of their demands (including nothing at all), in more than 59% of cases. They "won," receiving more than 90%, in only 11.3% of cases. We excluded the 32 cases with the smallest demands and the 32 with the highest demands to arrive at 582 cases, the middle 90% of the entire population, for our analysis.

[27] Some of these split decisions may be arbitrators awarding legally correct amounts to prevailing parties, merely denying claimants' unjustified demands rather than truly "splitting the baby." Even so, we believe these statistics are consistent with the anecdotal evidence that arbitrators often impose compromises through their awards.

[28] None of this is to say that legal rights should not play *any* role in arbitral results. In the proper case, they should and they do hold sway. For example, when firms make claims against employees, typically seeking recovery of forgivable loans, employees fare much worse. They lose over 90% of the time. Only 8.8% of awards in those cases are split decisions, and even those tilt decidedly in favor of the firms, returning on average 73% of the amount demanded.

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