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# Rustic Justice: Community and Coercion under the Federal Arbitration Act

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# RUSTIC JUSTICE: COMMUNITY AND COERCION UNDER THE FEDERAL ARBITRATION ACT

KATHERINE VAN WEZEL STONE\*

*Arbitration clauses are appearing in a wide variety of consumer transactions, including routine product purchase forms, residential leases, housing association charters, medical consent forms, banking and credit card applications, and employment handbooks. In the past fifteen years, the Supreme Court has reinterpreted the Federal Arbitration Act (FAA) so as to grant tremendous deference to private arbitral tribunals. By doing so, it has altered the landscape of civil litigation, taking many consumer claims out of the legal system and relegating them to private tribunals. In this Article, Professor Stone assesses the recent trend toward the privatization of civil justice in light of the history of the FAA. The author finds that the FAA, when enacted in 1925, embodied a vision of voluntarism, delegation, and self-regulation within the business and commercial communities. Arbitration under the FAA was conceived as an institution that reflected and defined membership in a shared normative community. She criticizes recent judicial interpretations that condone the use of arbitration to resolve disputes between individuals and entities who, far from sharing in a common normative community, occupy vastly different positions of power vis-à-vis each other. These expansive interpretations facilitate the exercise of invisible coercion in many facets of contemporary life. To remedy the abuses of arbitration, the author proposes that courts adopt a two-tiered approach, in which the degree of deference they grant to arbitral proceedings varies depending upon whether the dispute is between insiders to a self-regulating community or between an outsider and an insider.*

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\* © 1999 Katherine Van Wezel Stone. Professor of Law, Cornell Law School. B.A., Radcliffe College, 1970; J.D., Harvard Law School, 1979. I want to extend my sincere thanks to the many friends and colleagues who provided invaluable criticisms, insights, and suggestions at many stages of this Article. In particular, I thank Gregory Alexander, James Atleson, Lester Brickman, Kevin Clermont, Alex Colvin, Barbara Fried, Robert Gordon, Sarah Gordon, Bob Hillman, Phil Hostak, Duncan Kennedy, Susan Koniak, Paul Shupack, David Schwartz, and William Simon. I also want to thank the participants in legal theory workshops at Cornell Law School, Stanford Law School, and Cardozo Law School. Finally, I want to thank several truly exceptional research assistants: Walter Buble, Audrey Ellis, and Robert Fisher. Despite so much talented assistance, mistakes remain mine alone.

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Now we all know, that arbitrators, at the common law, possess no authority whatsoever, even to administer an oath, or to compel the attendance of witnesses. They cannot compel the production of documents . . . or insist upon a discovery of facts from the parties under oath. They are not ordinarily well enough acquainted with the principles of law or equity, to administer either effectually, in complicated cases; and hence it has often been said that the judgment of arbitrators is but *rusticum iudicium*.<sup>1</sup>

—Justice William Story (1845)

## I. INTRODUCTION

It is likely that someone you know has recently purchased a Gateway computer. It is not likely that the purchaser has noticed the surprise inside the box. Like the boxes of Cracker Jack in the olden days, Gateway computers come with a surprise inside the box. And, like the Cracker Jack toys, the Gateway surprises often disappoint. However, unlike the Cracker Jack's surprise, the Gateway surprise can be a source of long-lasting rather than ephemeral regret.

A Gateway 2000 computer arrives in a box together with numerous advertising brochures, instruction manuals, and forms setting out product descriptions, warranties, and other technical information concerning the purchase. One of these forms, entitled "Standard Terms and Conditions," states, "[a]ny dispute or controversy arising out of or relating to this Agreement or its

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1. *Tobey v. County of Bristol*, 23 F. Cas. 1313, 1321 (C.C.D. Mass. 1845) (No. 14,065) (emphasis added).

interpretation shall be settled exclusively and finally by arbitration.”<sup>2</sup> Arbitration clauses such as this one are often buried in fine print and obscure language so that they are, for all practical purposes, invisible to the average consumer. Even if visible, however, the average consumer has no reason to suspect that the clause is anything but innocuous.

Arbitration is an increasingly common feature of modern life. Once confined to the specialized provinces of international commercial transactions and labor-management relations, arbitration clauses now appear in many day-to-day consumer transactions. Banks frequently include arbitration clauses in their terms for maintaining bank accounts; health maintenance organizations (“HMOs”) routinely have provisions requiring that all disputes between the health consumer and the HMO be arbitrated; employment handbooks often state that employees must utilize arbitration to resolve employment-related disputes; many standard residential and commercial lease forms say that all disputes between the tenant and the landlord must be submitted to arbitration; homeowner associations and residential condominiums frequently include arbitration clauses in their charter documents.<sup>3</sup> Before long, routine consumer products, like Gateway Computers, will come with product and warranty information that includes a mandatory arbitration clause.<sup>4</sup>

The proliferation of private arbitration in consumer transactions is a new feature of modern life, the legal consequences of which have not been adequately addressed. A major reason for the surge in consumer arbitration is widespread dissatisfaction with the civil justice system, with its problems of delay, expense, technicality, and judicial gridlock.<sup>5</sup> Arbitration is part of a larger movement toward alternative dispute resolution (“ADR”), a movement that attempts to develop substitutes for an increasingly dysfunctional civil justice system. Advocates of ADR promote many types of mechanisms,

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2. *Standard Terms and Conditions, contained in GATEWAY GOLD, SERVICE AND SUPPORT* ¶ 10 (July 1995) (copy on file with the *North Carolina Law Review*); see also *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147, 1148 (7th Cir. 1997) (discussing product information for newly purchased Gateway Computer that included an arbitration clause); *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569, 570 (App. Div. 1998) (discussing arbitration agreement included in the box of all Gateway computers shipped after July 3, 1995).

3. See Barry Meier, *In Fine Print, Customers Lose Ability to Sue*, N.Y. TIMES, Mar. 10, 1997, at A1.

4. See *id.*

5. See *infra* notes 148-54 and accompanying text (discussing the arguments in favor of arbitration).

methods, and procedures for resolving conflict, including some well-known devices, such as arbitration, mediation, conciliation, and some newer ones, such as settlement conferences, mini-trials, med-arb, and summary jury trials.<sup>6</sup>

Arbitration is the most venerable ADR mechanism, long predating the modern ADR movement. It differs from other ADR mechanisms because it results not in a consensual resolution of a dispute, but in an award rendered by a third party and imposed on the disputants. Because arbitration yields final resolution of disputes, it is the most potent of the proposed mechanisms, but it is also the one that poses the greatest dangers for the uninitiated.

Arbitration, like all other forms of ADR, operates outside the civil justice system but not outside the law. Law polices the boundaries between arbitration and the legal system, defining the shape and role of arbitration in our legal order.<sup>7</sup> In tandem with the expanded use of arbitration in consumer transactions has been an expansion in the scope of arbitration within the legal order. In recent years, the Supreme Court has reinterpreted the Federal Arbitration Act ("FAA"),<sup>8</sup> the statute that defines the boundary between the public legal system and arbitration. The FAA provides that agreements to arbitrate are "valid, irrevocable, and enforceable."<sup>9</sup> Before the 1980s, the FAA was interpreted as applying only to federal question cases or diversity cases involving commerce that were in federal court.<sup>10</sup> Further, the FAA applied only to cases that were in federal court on an independent federal question basis.<sup>11</sup> In the past fifteen years, however, the Supreme Court has expanded the reach of the FAA and has adopted a national policy of promoting the use of arbitration in all relationships that have a contractual

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6. For a summary of the primary dispute resolution methods, see STEPHEN B. GOLDBERG ET AL., *DISPUTE RESOLUTION—NEGOTIATION, MEDIATION, AND OTHER PROCESSES* 4-5 (2d ed. 1992).

7. Sometimes ADR techniques are annexed to the courts, as in court-mandated arbitration or mediation, in which case they become an extension of the public civil litigation system akin to court-appointed referees or special masters. Usually, however, the term "alternative dispute resolution" refers to mechanisms that operate in the private realm and that constitute a regime of private justice. See, e.g., Jeffrey W. Stempel, *Beyond Formalism and False Dichotomies: The Need for Institutionalizing a Flexible Concept of the Mediator's Role*, 24 FLA. ST. U. L. REV. 949, 950 (1997) (noting the importance of distinguishing purely private mediation from semi-public, court-ordered mediation that occurs pursuant to state statutes).

8. United States Arbitration Act of 1925, ch. 213, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1-307 (1994)).

9. 9 U.S.C. § 2 (1994).

10. See *infra* notes 41-57 and accompanying text.

11. See *infra* note 58 and accompanying text.

element.<sup>12</sup>

This Article describes the expanding scope of arbitration under the FAA and explains the trend in light of the history of the statute. It concludes that the Supreme Court's expansive doctrines, when applied to consumer transactions, contravene the statute's intent and undermine many important due process and substantive rights. In brief, the argument is as follows: The FAA, which made agreements to arbitrate judicially enforceable, was designed to facilitate arbitration between members of trade associations. It was enacted to further a vision of voluntarism, delegation, and self-regulation within the business and commercial communities.<sup>13</sup> Recently, courts have applied the FAA in contexts such as consumer transactions and employment relations that often go far beyond the original understanding of the legislation. By such interpretations of the FAA, courts condone and encourage the use of arbitration to resolve disputes between individuals and entities who, far from sharing in a common normative community, occupy vastly different positions of power vis-à-vis each other. These expansive interpretations of the FAA facilitate the exercise of invisible private coercion in many facets of contemporary life.

#### A. *An Introductory Hypothetical*

An introductory hypothetical will illustrate the current interpretations of the FAA and some of the pitfalls that such an approach entails. The hypothetical is a composite of the recent Seventh Circuit case, *Hill v. Gateway 2000, Inc.*,<sup>14</sup> the recent New York Court of Appeals case, *Brower v. Gateway 2000, Inc.*,<sup>15</sup> and of other cases involving arbitration.

In September 1997, Mr. and Mrs. Harper of Weston, Massachusetts purchased a special model Odyssey computer for \$4000 through an advertisement in *PC World* magazine. The computer system was advertised as containing a state-of-the-art speaker system, an extra fast CD-ROM drive, an exceptional graphics accelerator, a multi-gigabyte hard drive, and other superior features. When the Harpers got the computer home and took it out

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12. See *infra* Part II (discussing the development of a federal policy favoring arbitration).

13. See S. REP. NO. 68-536, at 3 (1925) ("The settlement of disputes by arbitration appeals to big business and little business alike, to corporate interests as well as to individuals.").

14. 105 F.3d 1147 (7th Cir. 1997).

15. 676 N.Y.S.2d 569 (App. Div. 1998).

of its box, they found that it did not live up to their expectations. The speakers made a hissing and static sound, the CD-ROM drive jammed, there was no accelerator, the floppy disk drive destroyed some of their disks, and the keyboard had several keys that stuck. After a month of trying to cure the defects, the Harpers contacted Odyssey and asked them to replace the system. Receiving no satisfaction, the Harpers brought suit in state court alleging breach of warranty, violations of several state consumer protection laws, fraud, and violation of the Racketeer Influenced and Corrupt Organizations ("RICO") Act,<sup>16</sup> the federal racketeering statute.

Odyssey responded to the suit by pointing out that inside the box, along with the computer, was an eight-page brochure setting out the specifications of the product and the terms of the transaction. One of the fifty-odd terms was an arbitration clause, stating that all disputes regarding the product must be arbitrated under the arbitration rules of the Computer Manufacturers Industry Association.

The Harpers had never seen the clause before. Upon inquiry, they learned that the Computer Manufacturers Industry Association arbitration procedures require arbitrations to be held in Phoenix, Arizona before a panel of three retired industry executives. The procedures also state that in order to prevail, a purchaser complaining of a defect has the burden to show that the defect did not result from customer actions or damage in shipping or delivery. In addition, the procedures state that a purchaser cannot recover punitive damages, pain and suffering, or attorney fees.

Odyssey moved to stay the Harpers' legal action and compel arbitration. They claimed that under the Federal Arbitration Act, the Harpers were required to arbitrate. The FAA provides that when disputes are subject to a contractual arbitration provision, a court must stay litigation and compel the parties to arbitrate.<sup>17</sup> The Harpers opposed Odyssey's motion because they believed that the industry panel would be biased against them, they did not want their remedies limited, and they did not want to incur the expense of going to Phoenix to have their case heard. The court held for Odyssey, stayed the litigation, and ordered the parties to arbitrate.<sup>18</sup>

An arbitration was then held before the panel of retired

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16. 18 U.S.C.A. §§ 1961-1968 (1984 & Supp. 1998).

17. See 9 U.S.C. § 3 (1994).

18. This was the result in *Hill v. Gateway 2000, Inc.*, one of the cases on which this hypothetical is based. See *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147, 1151 (7th Cir. 1997).



executives from the computer industry. The arbitrators knew the company personnel from their long careers in the industry and did not want to make waves. They believed that all advertisements are puffery and that consumers should not rely on any representations in them. The arbitrators also believed that the computer the Harpers received was perfectly adequate for ordinary "end-users," who use a computer for household tasks and do not need all the bells and whistles that were alleged to be lacking. In addition, the arbitrators believed that customers who are worried about product performance should purchase maintenance agreements. So they ordered Odyssey to pay the Harpers thirty dollars for a new keyboard and otherwise denied the claim.

Can the Harpers challenge this scenario? Probably not. There is no ground to resist arbitration under the FAA as it has been interpreted in the last ten years. At the arbitration the Harpers will probably lose, and they will have no basis for appeal.

One might argue that the Harpers could avoid the arbitration clause on the ground that the package enclosure was not a contract at all. They did not receive it until after they purchased the product, after the contract was made. Unfortunately, courts have held that a contract can be formed in many ways, not merely by payment of money.<sup>19</sup> Many contracts involve payment first and the revelation of terms later, including contracts to purchase airline tickets and home insurance. Courts usually treat such after-arriving terms as binding, at least when the purchaser had an option to decline the term and cancel the transaction.<sup>20</sup>

Even if the package enclosure had not mentioned arbitration but had stated, "[t]his contract embodies the rules and regulations of the Computer Manufacturers Industry Trade Association," the court would order arbitration if the incorporated trade association rules called for arbitration. It is settled that an arbitration agreement that is incorporated into a contract by reference is enforceable under the

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19. See, e.g., *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1452 (7th Cir. 1996); see also U.C.C. § 2-204(1) ("A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.").

20. See *Hill*, 105 F.3d at 1148-49 (holding that an arbitration clause inside a product box was binding); *ProCD, Inc.*, 86 F.3d at 1452 (holding that the license term inside a computer box was binding); *Brower*, 676 N.Y.S.2d at 571-72 (holding that an arbitration clause inside a product box was binding); see also *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 595-96 (1991) (holding that a forum selection provision on the back of a cruise line ticket was binding).

FAA.<sup>21</sup>

Some courts do not enforce clauses in form contracts involving consumers when the clause is oppressive, is not presented in a prominent manner, or contains terms that parties would not reasonably anticipate would be present.<sup>22</sup> For example, some courts have held that small print on the back of coat check claims tickets are not binding contractual terms because the parties believed the stubs were for identification purposes and did not reasonably believe the stubs would contain contractual terms.<sup>23</sup> But some courts do enforce such clauses on the grounds that parties should reasonably anticipate that there are contractual terms on the tickets.<sup>24</sup> In the case of a ticket containing an arbitration clause, if there was a genuine question about whether the parties reasonably should have perceived the ticket to contain contractual terms, then that issue, and the attendant issue of the enforceability of the arbitration clause, would be for an arbitrator to decide.<sup>25</sup> Only if the Harpers could claim that the arbitration clause itself—as distinct from the contract as a whole—was unconscionable, would it be an issue for a court to resolve.<sup>26</sup> But here where the arbitration clause is a garden-variety arbitration clause, they would be unlikely to prevail on this argument.<sup>27</sup>

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21. See, e.g., *R.J. O'Brien & Assoc. v. Pipkin*, 64 F.3d 257, 260 (7th Cir. 1995); *Hodge Bros. v. DeLong Co.*, 942 F. Supp. 412, 415 (W.D. Wis. 1996); see also *infra* Part IV.B (discussing incorporation of arbitration by reference).

22. See JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 9-44 (3d ed. 1987) (citing cases and discussing the modern view on contracts of adhesion); E. ALLAN FARNSWORTH, *CONTRACTS* § 4.26, at 310-15 (2d ed. 1990) (citing cases and discussing standardized contracts).

23. See generally CALAMARI & PERILLO, *supra* note 22, § 9-43, at 413 (discussing cases denying enforcement of terms in parcel room checks and amusement park tickets); FARNSWORTH, *supra* note 22, at § 4.26, 313-14 & nn.14-16 (same).

24. Courts have gone both ways on documents like steamship, railroad, and airline tickets. See FARNSWORTH, *supra* note 22, § 4.26, at 313-14 & n.17 (citing cases enforcing terms); see also *Carnival Cruise Lines*, 499 U.S. at 595 (enforcing a choice-of-forum clause and noting that the parties admitted that they received actual notice of the term); RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981) (describing the conditions under which unknown terms in standardized agreements are enforceable).

25. According to the separability doctrine of *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967), the defense of lack of assent to the terms of a contract does not defeat the obligation to arbitrate. See *id.* at 402; see also *infra* notes 85-91 and accompanying text (discussing the Court's adoption of the separability doctrine).

26. See *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569, 574-75 (App. Div. 1998) (holding that an arbitration clause that compelled parties to utilize the arbitration rules of the International Chamber of Commerce ("I.C.C.") was unconscionably expensive and burdensome).

27. Cf. *id.* (arguing that while arbitration under the rules of the I.C.C. is so burdensome as to be unconscionable, arbitration under the rules of the American

Alternatively, the Harpers might argue that the package enclosure was a contract of adhesion, that is, a contract that was presented to them in a take-it-or-leave-it fashion and in which they were not able to bargain over the terms. Several courts have held such enclosed arbitration terms were not adhesive because the purchaser had the option of returning the goods or purchasing them elsewhere.<sup>28</sup> But even if the enclosure were found to be a contract of adhesion, a contract of adhesion will be enforced unless it is unconscionable, involves undue surprise, or contravenes public policy.<sup>29</sup> Arbitration can hardly be said to violate public policy—courts repeatedly state that public policy favors arbitration.<sup>30</sup> And at present, it is highly unlikely that any court would say that a standard arbitration clause like the one in this hypothetical is unconscionable or unexpected.<sup>31</sup>

The Harpers might attack the award on the grounds that the industry panel was biased. For arbitration, however, bias is the flip side of expertise. The possibility of arbitral bias is considered the price one pays in exchange for the putative expertise of the arbitrators.<sup>32</sup> The retired executives were on the panel *because* they are experts in the industry, and expertise in arbitration is considered a good thing, not a bad thing. So the retired executives' connection with the industry is a plus, not a minus, and it does not provide a reason for a court to reconsider the Harpers' claim.<sup>33</sup>

The Harpers might try to vacate the arbitral award on the ground that the arbitrators did not correctly interpret state warranty and consumer protection laws. But again, that will not be a reason to vacate the award—the standard for vacating an award under the

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Arbitration Association is not necessarily unconscionable).

28. See *Filias v. Gateway 2000, Inc.*, No. 97 C 2523, 1998 U.S. Dist. LEXIS 20358, at \*5-\*6 (N.D. Ill. Jan. 15, 1998); *Brower*, 676 N.Y.S.2d at 572-73.

29. See *Graham v. Scissor-Tail, Inc.*, 623 P.2d 165, 172-73 (Cal. 1990); *CALAMARI & PERILLO*, *supra* note 22, § 9-44, at 418-24.

30. See, e.g., *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 480-81 (1989); *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983).

31. See, e.g., *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 30-33 (1991); see also *Webb v. R. Rowland & Co.*, 800 F.2d 803, 807 (8th Cir. 1986) (holding that an arbitration clause in a brokerage agreement was not inherently unconscionable).

32. See *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 679 (7th Cir. 1983) ("The parties to an arbitration choose their method of dispute resolution, and can ask no more impartiality than inheres in the methods they have chosen." (citing *American Almond Prods. Co. v. Consolidated Pecan Sales Co.*, 144 F.2d 448, 451 (2d Cir. 1944)); see also *infra* Part VI.A (discussing arbitral bias).

33. See *Merit Ins. Co.*, 714 F.2d at 679; see also *infra* notes 561-68 and accompanying text (discussing courts' views of the advantages of such business relationships).

FAA is “manifest disregard of the law.”<sup>34</sup> This does not mean *incorrect* interpretation of the law, nor an interpretation that differs from one a court would issue.<sup>35</sup> Nor does it mean that an award should be vacated if an arbitrator is ignorant of the law. “Manifest disregard” means deliberate or overt refusal to apply the law.<sup>36</sup> There is no evidence here that the arbitrator deliberately disregarded the law. Indeed, arbitrators are not obligated to write opinions explaining their awards.<sup>37</sup> The arbitrators could have issued an award that gave the Harpers nothing without a word of explanation.

Furthermore, if the state had a law that said that arbitration clauses are not enforceable unless they appear in a prominent place, such as bold print on the face of a contract—a provision that many states have—the Harpers would still lose. The Supreme Court stated as recently as 1996 that such state laws are preempted by the FAA.<sup>38</sup> Thus, the arbitrators’ decision is effectively unassailable in a court.

### B. Overview

The foregoing hypothetical demonstrates the extremely broad scope of private arbitration under the current interpretation of the FAA. The remainder of this Article will detail the doctrinal developments that have been summarized thus far, demonstrate that by extending the scope of the FAA, courts are disregarding the statute’s history, and propose a new approach to arbitration that is more consistent with the statutory intent.

Part II discusses the major Supreme Court cases of the past decade that have expanded the scope of the FAA. In these cases, the

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34. *Wilko v. Swan*, 346 U.S. 427, 436 (1953), *overruled on other grounds by Rodriguez de Quijas*, 490 U.S. at 477.

35. See *Willemijn Houdstermaatschappij, BV v. Standard Microsystems Corp.*, 103 F.3d 9, 12 (2d Cir. 1997); *Siegel v. Titan Indus. Corp.*, 779 F.2d 891, 892-93 (2d Cir. 1985); see also *infra* notes 141-43 and accompanying text (discussing how courts have narrowly interpreted the “manifest disregard of the law” standard).

36. See *Standard Microsystems*, 103 F.3d at 12 (“Manifest disregard of the law may be found . . . if the arbitrator ‘understood and correctly stated the law but proceeded to ignore it.’” (quoting *Bell Aerospace Co. v. Local 516*, 356 F. Supp. 354, 356 (W.D.N.Y. 1973), *rev’d on other grounds*, 500 F.2d 921 (2d Cir. 1974))); *Kanuth v. Prescott, Ball & Turben, Inc.*, 949 F.2d 1175, 1182 (D.C. Cir. 1991) (“‘[M]anifest disregard’ means much more than failure to apply the correct law. ‘Manifest disregard’ may be found, for example, if the panel understood and correctly stated the law but then proceeded to ignore it.”); *Siegel*, 779 F.2d at 892-93 (citing *Bell Aerospace Co.*, 356 F. Supp. at 356).

37. See *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 598 (1960).

38. See *Doctor’s Assocs. v. Casarotto*, 517 U.S. 681, 688 (1996); see also *Perry v. Thomas*, 482 U.S. 483, 489-90 (1987) (discussing state laws specifically aimed at arbitration that are preempted by the FAA).

Court has reinterpreted the FAA and redefined the boundary between the courts and the world of private justice.

Part III addresses the two reasons most frequently offered to explain the courts' newly expansive approach toward arbitration: (1) that courts are attempting to clear crowded dockets; and (2) that courts are merely enforcing the parties' contractual intent. It is argued that neither explanation can adequately explain the recent legal developments concerning arbitration under the FAA.

Part IV examines the legal and social thought of the 1920s and the historical circumstances that led to the enactment of the FAA in 1925. This historical inquiry demonstrates that the FAA was intended to facilitate self-regulation within commercial communities, not to regulate relationships between consumers and large corporations in arm's length, anonymous transactions.

Part V applies the historical insights to the interpretation of the FAA since 1925. It examines the interpretative developments in the FAA that arose in two areas of law in which there is a long history of judicially approved collective self-regulation—securities regulation and labor-management relations. It also traces the relationship between the theory of self-regulation and the use of arbitration in each of these areas.

Part VI demonstrates that the notion of self-regulation as it arose in the securities and labor relations cases has served as a template that courts use in interpreting the FAA. The self-regulatory framework derived from securities and labor regulation has been utilized to compel arbitration, sustain arbitral awards, and deny judicial review in medical malpractice cases, consumer cases, employment relations cases, and any number of other settings that have little in common with those situations in which the self-regulation notion originated. To demonstrate the power of the self-regulation template to shape judicial decision-making, Part VI examines the influence of self-regulation ideology on two especially troublesome issues: (1) arbitral bias as a ground for vacating an award; and (2) compelling arbitration when an arbitration clause is incorporated by reference.

Part VII argues that the courts' current approach to arbitration is inappropriate when applied to consumer transactions. By using the rationale of self-regulation to justify ever greater deference and delegation to institutions of private justice, courts permit private power to substitute for fairness and due process. To remedy these trends, it is proposed that courts adopt a two-tiered approach toward arbitration, in which the degree of deference courts grant to arbitral

proceedings varies depending upon whether the dispute is between two insiders to a self-regulating community or between an outsider and an insider.

Part VIII addresses two further issues: First, while Part VII proposed that courts play a larger role in policing arbitrations between insiders and outsiders to a self-regulating community, there is still the possibility of coercion and abuse of power within self-regulating organizations. It is therefore further proposed that judicial doctrines delineating the degree of autonomy for voluntary associations be applied to define the appropriate degree of deference to insider arbitrations. Second, Part VIII addresses the question of whether arbitration, by reducing court congestion and conserving scarce public resources, is efficient for society as a whole. It is argued that an arbitration system that prevents individuals from vindicating their legal rights is not efficient, and that concerns about lengthy and wasteful litigation are better addressed by reforming judicial procedures and making more use of expedited processes such as small claims courts and special masters. Part VIII concludes that it is necessary to rethink the courts' deferential approach to arbitration under the FAA. It is urged that in some instances it is necessary for courts to go beyond the proposals advanced in Part VII and override arbitration awards even for disputes between members of a self-regulating community. It is argued that certain common norms transcend the boundaries of self-regulation and should be applied to the community as a whole.

## II. THE EXPANDING SCOPE OF THE FEDERAL ARBITRATION ACT

Section 2 of the FAA provides that promises to arbitrate contained in contracts involving maritime transactions or commerce are "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>39</sup> The remainder of the FAA delineates the procedures and remedies available for enforcing such "valid, irrevocable, and enforceable" promises to arbitrate.<sup>40</sup> In the 1980s, over fifty years since its enactment, the FAA was virtually rewritten by the Supreme Court, ushering in a new era in arbitration law.

### A. *The Federalization of Arbitration Law*

In the 1920s, the supporters and drafters of the FAA (then called

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39. 9 U.S.C. § 2 (1994).

40. *See id.* §§ 3-307 (1994).

the United States Arbitration Law) contended that it was enacted pursuant to Congress's Article III power to establish procedures for the federal courts.<sup>41</sup> On this basis, it was long believed that the FAA applied only to cases in admiralty or involving commerce that were brought in federal court on the basis of federal question or diversity jurisdiction.<sup>42</sup> Indeed, there was a serious question about the FAA's applicability in diversity cases.<sup>43</sup>

In 1956, in *Bernhardt v. Polygraphic Co. of America, Inc.*,<sup>44</sup> the Supreme Court declared that arbitration was substantive, not procedural, for purposes of the *Erie* doctrine.<sup>45</sup> In *Bernhardt*, a diversity case, an employee who lived in Vermont sued his New York employer to enforce an employment contract.<sup>46</sup> The defendant moved under § 3 of the FAA for a stay of the litigation on the basis of an arbitration clause in the parties' written agreement.<sup>47</sup> The Court refused to apply the FAA to the action because there was no showing that the plaintiff was working in interstate commerce, a prerequisite to application of the FAA.<sup>48</sup> Because the FAA did not apply, the Court then considered whether arbitration is substantive or procedural for purposes of *Erie*.<sup>49</sup> It applied an outcome-determinative test, reasoning that the use of arbitration rather than litigation could determine the outcome of the case.<sup>50</sup> The Court thus concluded that arbitration was substantive, so state law rather than federal law applied.<sup>51</sup> Having decided that state law must be applied to resolve the arbitration issue, the Court remanded the case to the district court to determine which state's arbitration law, New York's

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41. See Julius Henry Cohen & Kenneth Dayton, *The New Federal Arbitration Law*, 12 VA. L. REV. 265, 275 (1926).

42. See Linda R. Hirschman, *The Second Arbitration Trilogy: The Federalization of Arbitration Law*, 71 VA. L. REV. 1305, 1318-19 (1985).

43. See *id.* at 1316-17.

44. 350 U.S. 198 (1956).

45. See *id.* at 202-03.

46. See *id.* at 199.

47. See *id.*

48. See *id.* at 200-01.

49. See *id.* at 202.

50. See *id.*

51. See *id.* at 202-04. *Bernhardt* was the Supreme Court's last application of its outcome-determinative test under *Erie*. It was also its most extreme application in the sense that the Court held that the very procedure for hearing the dispute was substantive for *Erie* purposes. See *id.* at 202-05. As *Bernhardt* graphically illustrated, the outcome-determinative test allowed seemingly unfettered intrusion into the workings of the federal courts. Two years later, in *Byrd v. Blue Ridge Rural Electric Cooperative*, 356 U.S. 525 (1958), the Supreme Court abandoned the outcome-determinative test and shifted to an interest-based test for distinguishing substance and procedure for purposes of *Erie*. See *id.* at 536-38.

or Vermont's, should apply.<sup>52</sup>

Justice Frankfurter, in a concurring opinion, agreed that the FAA was substantive, but he further argued that, under *Erie*, the FAA was not applicable at all in diversity cases.<sup>53</sup> Justice Douglas's majority opinion did not address this troubling point, which he acknowledged might present "a constitutional question."<sup>54</sup>

In 1967, in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*,<sup>55</sup> the Supreme Court resolved the latent *Erie* problem by holding that the FAA applies in diversity cases.<sup>56</sup> In *Prima Paint*, the Court declared that the FAA was enacted pursuant to Congress's power under the Commerce Clause to enact substantive rules to govern interstate commerce, and thus it could be applied in suits involving commerce or maritime transactions that were brought in a federal court.<sup>57</sup> Unlike most other substantive regulations of commerce, however, the Court in *Prima Paint* stated that the FAA did not create its own federal subject matter jurisdiction, but rather applies only in cases that independently satisfy federal jurisdictional requirements.<sup>58</sup>

Once the Court grounded the FAA squarely on the Commerce Clause, questions arose about the degree to which it preempted state laws that affected arbitration. In 1984, in *Southland Corp. v. Keating*,<sup>59</sup> the Supreme Court resolved these questions by giving the FAA a broad preemptive scope. In *Southland*, a group of California franchisees sued Southland, their franchisor, in California state court for fraud, breach of contract, and violation of California's Franchise Investment Act.<sup>60</sup> The franchise agreement contained a promise to arbitrate "any controversy or claim arising out of or relating to this

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52. See *Bernhardt*, 350 U.S. at 205. In *Bernhardt*, the choice-of-law issue was dispositive because Vermont's then-existing common law provided that agreements to arbitrate were revocable, while New York's arbitration law made agreements to arbitrate irrevocable and enforceable. See *id.* at 204-05.

53. See *id.* at 208 (Frankfurter, J., concurring).

54. *Id.* at 202.

55. 388 U.S. 395 (1967).

56. See *id.* at 404-07.

57. See *id.* at 405. Previously, courts and commentators had maintained that the FAA was enacted pursuant to Congress's power under Article III to create and establish procedures for the federal courts. See, e.g., Cohen & Dayton, *supra* note 41, at 265.

58. See *Prima Paint*, 388 U.S. at 404-05; see also *id.* at 416-18 (Black, J., dissenting) (discussing the jurisdictional dilemmas of *Bernhardt* and *Erie*). See generally Hirschman, *supra* note 42, at 1324-25 (noting the incongruity of *Prima Paint's* conclusion that the FAA created a federal substantive right to arbitration but did not support federal question jurisdiction).

59. 465 U.S. 1 (1984).

60. See *id.* at 3-4.



Agreement.”<sup>61</sup> The California Supreme Court ordered the state common law claims to be arbitrated, but it held that there was no duty to arbitrate the California Franchise Investment Act claims because that Act prohibited waivers of its provisions.<sup>62</sup> The United States Supreme Court reversed. In the majority opinion, the *Southland* Court reiterated its holding in *Prima Paint* that the FAA is based on the Commerce Clause.<sup>63</sup> From this fact it drew the conclusion that the FAA applies in state as well as federal courts.<sup>64</sup> Thus, the majority declared that the FAA overrides state law that conflicts with its purposes.<sup>65</sup> It held that the California franchise law conflicted with the FAA and therefore was preempted.<sup>66</sup> The *Southland* majority further disabled state courts and state law in the arbitration area by holding that § 3 of the FAA—a provision that is expressly limited to *federal* courts and requires them to stay litigation and to grant motions to compel arbitration—also applies in state courts.<sup>67</sup>

*Southland* gave the FAA an extraordinarily expansive preemptive reach. On several subsequent occasions, the Supreme Court has reiterated that states may not legislate to protect their citizens from arbitration obligations.<sup>68</sup> For example, three years after *Southland*, the Supreme Court decided *Perry v. Thomas*,<sup>69</sup> a case in which an employee sued for unpaid commissions under the California Labor Code.<sup>70</sup> The Labor Code had a provision stating that actions for the collection of wages could be maintained “ ‘without regard to the existence of any private agreement to arbitrate.’ ”<sup>71</sup> The Supreme Court ruled that the Labor Code provision, which was specifically designed to protect an individual from an agreement to arbitrate, was preempted by the FAA.<sup>72</sup> It also ruled that state statutory and common law defenses to the enforcement of an arbitration clause

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61. *Id.* at 4.

62. *See* Keating v. Superior Court, 645 P.2d 1192, 1198, 1203 (Cal. 1982), *rev'd sub nom.* Southland Corp. v. Keating, 465 U.S. 1 (1984).

63. *See Southland Corp.*, 465 U.S. at 11.

64. *See id.* at 10.

65. *See id.* at 12-13.

66. *See id.* at 13-15.

67. *See id.* at 15-16.

68. *See, e.g.,* Doctor's Assocs. v. Casarotto, 517 U.S. 681, 687 (1996); Allied-Bruce Terminex Cos. v. Dobson, 513 U.S. 265, 270-73 (1995).

69. 482 U.S. 483 (1987).

70. *See id.* at 484-85.

71. *Id.* at 495 (O'Connor, J., dissenting) (quoting CAL. LAB. CODE § 229 (West 1971)).

72. *See id.* at 490-91.

would be effective in resisting arbitration only if they apply to the validity and enforceability of contracts generally. The Court stated: "A state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with this requirement . . . ."<sup>73</sup>

Recently, the Supreme Court has reiterated its broad approach to preemption under the FAA.<sup>74</sup> In 1995, in *Allied-Bruce Terminex Cos. v. Dobson*,<sup>75</sup> the Court held that the preemptive force of the FAA extends to the full extent of federal commerce power.<sup>76</sup> *Allied-Bruce* involved a dispute between a homeowner, a subsequent purchaser, and an exterminating company that had given the homeowner a lifetime guarantee against termites.<sup>77</sup> The agreement contained an arbitration clause.<sup>78</sup> When termites later infested the premises, the homeowner and the purchaser sued the exterminator in Alabama state court, and the defendant sought a stay pursuant to the FAA.<sup>79</sup> Alabama had a state law that rendered predispute arbitration agreements invalid.<sup>80</sup> The Supreme Court determined that the transaction sufficiently involved commerce to trigger application of the FAA, and it thus refused to give effect to Alabama's anti-arbitration statute.<sup>81</sup>

One year later, in *Doctor's Associates v. Casarotto*,<sup>82</sup> the Court held that a state law that required arbitration clauses to be

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73. *Id.* at 493 n.9 (citing *Southland Corp. v. Keating*, 465 U.S. 1, 16-17 n.11 (1984); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967)).

74. The Supreme Court created a narrow exception to the broad preemption of *Southland* and *Perry* in *Volt Information Sciences, Inc. v. Board of Trustees*, 489 U.S. 468 (1989). In *Volt*, the Court upheld the application of a state law that regulated the procedure to be used in arbitration when the parties had included a choice-of-law clause in their contract. *See id.* at 478-79. The *Volt* Court said that the FAA does not require arbitration under any particular set of procedural rules. *See id.* at 476. Rather, parties may specify the particular rules under which arbitration will be conducted. *See id.* Subsequent cases distinguished *Volt* on the ground that the state law at issue in *Volt* merely regulated the procedure of arbitration, but did not operate to defeat arbitration altogether. *See, e.g., Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 688 (1996); *Allied-Bruce Terminex Cos. v. Dobson*, 513 U.S. 265, 281 (1995).

75. 513 U.S. 265 (1995).

76. *See id.* at 277; *cf. United States v. Lopez*, 514 U.S. 549, 558-59 (1995) (restricting congressional commerce power to regulations in three broad areas: (1) the use of channels of interstate commerce; (2) the instrumentalities of commerce; and (3) those activities having a substantial relation to commerce).

77. *See Allied-Bruce*, 513 U.S. at 268-69.

78. *See id.* at 268.

79. *See id.* at 269.

80. *See ALA. CODE* § 8-1-41(3) (1993).

81. *See Allied-Bruce*, 513 U.S. at 282.

82. 517 U.S. 681 (1996).

conspicuously placed on the first page of a contract was preempted by the FAA.<sup>83</sup> While noting that the Montana law was designed to protect consumers from unwittingly agreeing to one-sided arbitration agreements and to ensure that they had sufficient notice of an arbitration clause, the Supreme Court decided that the state law directly conflicted with the FAA because it was specifically directed at arbitration rather than to all contracts generally.<sup>84</sup>

As a result of *Southland* and its progeny, the provisions of the FAA apply not only to federal question and diversity suits in federal courts, but also to all state court actions "involving commerce" as this term has been broadly defined. State law contract defenses to arbitration can only be raised if they are matters of general law, not if they are provisions directed at arbitration.

The role of state law in regulating arbitration was further diminished by the Supreme Court's adoption of the separability doctrine in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*<sup>85</sup> Before 1967, most courts held that if a party raised a contractual defense grounded in state law that would render the entire contract unenforceable or void, a court rather than an arbitrator must rule on the defense.<sup>86</sup> These courts reasoned that if the contract is invalid, then so too is any promise to arbitrate contained in the contract.<sup>87</sup> In *Prima Paint*, the Supreme Court rejected this approach, and instead ruled that arbitration agreements are separable from the other terms of a contract for purposes of contractual defenses.<sup>88</sup> Thus, it ruled, allegations of flaws in a contract such as fraud, illegality, unconscionability, or lack of consent do not defeat a duty to arbitrate.<sup>89</sup> Rather, such allegations must be heard by the arbitrator.<sup>90</sup> Only if it is shown that there is a contractual flaw in the arbitration clause itself should a court refuse to compel parties to arbitrate.<sup>91</sup>

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83. See *id.* at 686-88; MONT. CODE ANN. § 27-5-114(4) (1997).

84. See *Doctor's Assocs.*, 517 U.S. at 686-88.

85. 388 U.S. 395, 402-04 (1967).

86. See Hirschman, *supra* note 42, at 1330.

87. See, e.g., *American Airlines, Inc. v. Louisville & Jefferson County Air Bd.*, 269 F.2d 811, 816-17 (6th Cir. 1959); *Kulukundis Shipping, Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 986 (2d Cir. 1942). *But see* *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402, 409-10 (2d Cir. 1959) (adopting and explaining the separability doctrine).

88. See *Prima Paint*, 388 U.S. at 402-04.

89. See *id.* at 403-04.

90. See *id.* at 404.

91. See *id.* at 406. Justice Black, in a lengthy dissent, provided a succinct if unflattering description of the separability doctrine:

The Court holds, what is to me fantastic, that the legal issue of a contract's

The separability doctrine together with the rule of *Perry v. Thomas*—that arbitration cannot be defeated by defenses based on arbitration-specific law—means that there are few defenses available to challenge an arbitration agreement. To succeed, a defense must be based on general contract law, but it must be raised specifically in relation to the arbitration clause. Such broad-based, but narrowly honed contract-law defenses are rare.

### B. *The Presumption of Arbitrability and Its Ramifications*

In addition to expanding the scope of the FAA to preempt state law, in the 1980s the Supreme Court also expanded the types of claims that are subject to arbitration promises and thereby enforceable under the FAA. This expansion resulted from the Court's reversal of *Wilko v. Swan*.<sup>92</sup> In 1953, in *Wilko*, the Court held that a dispute between a customer and a brokerage firm that involved alleged violations of the Securities Act of 1933<sup>93</sup> was not amenable to arbitration.<sup>94</sup> *Wilko* stood for many years as a limit on the enforceability of arbitration of statutory rights. But in the 1970s and 1980s, the Court began to cut back on *Wilko*,<sup>95</sup> eventually overruling it altogether.<sup>96</sup> By so doing, the Court expanded the realm of arbitration to embrace not only contractual disputes, but statutory ones as well. The history of *Wilko*'s demise is intertwined with the rise of a bedrock principle of modern arbitration law—the presumption of arbitrability.

In 1983, the Supreme Court announced in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*<sup>97</sup> that there was a

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voidness because of fraud is to be decided by persons designed to arbitrate factual controversies arising out of a valid contract between the parties. And the arbitrators who the Court holds are to adjudicate the legal validity of the contract need not even be lawyers, and in all probability will be nonlawyers, wholly unqualified to decide legal issues, and even if qualified to apply the law, not bound to do so.

*Id.* at 407 (Black, J., dissenting).

92. 346 U.S. 427 (1953), *overruled* by *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

93. Act of May 27, 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. §§ 77a-77aa (1994)).

94. *See Wilko*, 346 U.S. at 428-29, 439.

95. *See, e.g.,* *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221-24 (1985) (holding that when a dispute involves arbitrable state law claims and nonarbitrable Securities Act claims, a court should compel arbitration of the pendent claims); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 517-18 (1974) (holding that *Wilko* does not apply to international commercial transactions).

96. *See Rodriguez de Quijas*, 490 U.S. at 477 (overruling *Wilko*).

97. 460 U.S. 1 (1983).

"liberal federal policy favoring arbitration."<sup>98</sup> From this the Court derived the principle that it should favor arbitration in determining which disputes fall within a promise to arbitrate.<sup>99</sup> It described this presumption of arbitrability as follows:

[Q]uestions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. . . . The [Federal] Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.<sup>100</sup>

In practice, the presumption means that courts will require parties to arbitrate disputes if there is any possibility that the dispute is subject to an arbitration agreement. Thus, parties are required to arbitrate in situations in which it is debatable whether they meant to subject the particular dispute to arbitration in the first place and when they have not clearly waived their right to a judicial forum.<sup>101</sup>

In 1985, in *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,<sup>102</sup> the Supreme Court relied on the presumption of arbitrability to hold that an ordinary arbitration clause will be interpreted to apply not merely to contractual disputes, but also to statutory claims.<sup>103</sup> In *Mitsubishi*, the Court applied the FAA to claims arising under the Sherman Antitrust Act.<sup>104</sup> The underlying dispute arose from a three-party franchise transaction between Chrysler International, a Swiss subsidiary of the Chrysler Corporation, Mitsubishi Motors, a Japanese automobile manufacturer, and Soler Chrysler-Plymouth, an automobile sales franchisee in Puerto Rico.<sup>105</sup> The Sales Contract by which Chrysler and Mitsubishi agreed to provide Soler with vehicles contained a clause calling for arbitration of certain disputes between Mitsubishi and Soler.<sup>106</sup> After the franchise was in effect for about two years, Soler did not meet its

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98. *Id.* at 24.

99. *See id.*

100. *Id.* at 24-25.

101. *See, e.g.,* R.J. O'Brien & Assoc. v. Pipkin, 64 F.3d 257, 260-61 (7th Cir. 1995); Sweet Dreams Unlimited, Inc. v. Dial-A-Mattress Int'l, Ltd., 1 F.3d 639, 642-43 (7th Cir. 1993).

102. 473 U.S. 614 (1985).

103. *See id.* at 628-40.

104. Act of July 2, 1890, ch. 647, 26 Stat. 209 (current version at 15 U.S.C. §§ 1-7 (1994)); *see Mitsubishi Motors Corp.*, 473 U.S. at 616.

105. *See Mitsubishi Motors Corp.*, 473 U.S. at 616-17.

106. *See id.* at 617.

sales quotas and Mitsubishi sought to arbitrate under the clause.<sup>107</sup> Soler counterclaimed against both Mitsubishi and Chrysler, raising numerous contract breaches and statutory claims, including a claim that Mitsubishi and Chrysler had conspired to divide markets in restraint of trade, in violation of the Sherman Act.<sup>108</sup> The arbitration clause did not specifically commit the parties to arbitrate statutory claims nor did it explicitly embrace claims between Soler and Chrysler.<sup>109</sup> Nonetheless, the Court held that in the face of an arbitration clause, it would presume that this particular dispute was within the promise to arbitrate.<sup>110</sup> It stated, “[t]here is no reason to depart from these guidelines where a party bound by an arbitration agreement raises claims founded on statutory rights.”<sup>111</sup> The Court conceded that not all statutory rights are appropriate for arbitration, but it said, “[w]e must assume that if Congress intended the substantive protection afforded by a given statute to include protection against waiver of the right to a judicial forum, that intention will be deducible from text or legislative history.”<sup>112</sup> It held that there was no congressional intent to preclude arbitration of claims arising under the antitrust acts.<sup>113</sup>

*Mitsubishi* was an international case involving parties of three different nationalities and a transaction that spanned several continents. Arguably, its holding could be limited or explained on the basis of the special jurisdictional issues posed by international disputes.<sup>114</sup> Since the *Mitsubishi* decision, however, the Supreme Court has applied its reasoning to wholly domestic disputes.<sup>115</sup>

The first Supreme Court case to hold that statutory rights are amenable to arbitration in a purely domestic context was *Shearson/American Express Inc. v. McMahon*,<sup>116</sup> decided in 1987.

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107. *See id.* at 617-18.

108. *See id.* at 619-20.

109. *See id.* at 617.

110. *See id.* at 626.

111. *Id.* at 626.

112. *Id.* at 628.

113. *See id.* at 627-28.

114. *See Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 518-19 (1974) (determining that courts are more supportive of arbitration in international commercial transactions than in domestic ones because international transactions raise unique concerns).

115. *See Gilmer v. Interstate/Johnson Lane*, 500 U.S. 20, 35 (1991) (holding that claims under the Age Discrimination in Employment Act are arbitrable); *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 481 (1989) (holding that claims under the 1933 Securities Act are arbitrable); *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220, 238-42 (1987) (holding that claims alleging violations of RICO and the 1934 Securities Exchange Act are arbitrable).

116. 482 U.S. 220 (1987).

This case involved a claim by a customer against a brokerage house, alleging various state law fraud claims, violations of the Securities Exchange Act of 1934,<sup>117</sup> and violations of the civil provisions of RICO.<sup>118</sup> The customers had signed an agreement when they opened their accounts that contained a clause stating: "Unless unenforceable due to federal or state law, any controversy arising out of or relating to my accounts . . . shall be settled by arbitration in accordance with the rules, then in effect, of the National Association of Securities Dealers . . .'"<sup>119</sup> The Supreme Court invoked the presumption of arbitrability to hold that all claims, including the Securities Exchange Act and RICO claims, were amenable to arbitration under this clause.<sup>120</sup> It rejected the plaintiff's argument that the Securities Exchange Act should be read to preclude a waiver of a judicial forum, and instead held that arbitration was a suitable means to enforce it.<sup>121</sup> The Court also held that disputes under the RICO statute were suitable for arbitration.<sup>122</sup> Casting doubt on the continuing viability of *Wilko*, the Court stated: "It is difficult to reconcile *Wilko*'s mistrust of the arbitral process with this Court's subsequent decisions involving the Arbitration Act."<sup>123</sup> Two years later, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,<sup>124</sup> another case between a customer and a brokerage house, the Court expressly overturned *Wilko* by ordering arbitration in the dispute concerning the Securities Act of 1933.<sup>125</sup>

In 1991, the Supreme Court applied the reasoning of *McMahon* to the employment setting. In *Gilmer v. Interstate/Johnson Lane Corp.*,<sup>126</sup> the Supreme Court held that an employee's claim of age discrimination was subject to arbitration, so long as the prospective arbitration proceeding was adequate to vindicate the employee's statutory rights.<sup>127</sup> *Gilmer*, an employee of Interstate/Johnson Lane stock brokerage firm, had been fired in 1987 at the age of sixty-two. He brought suit against the firm, alleging that he had been fired in

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117. Act of June 6, 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. §§ 78a-78ll (1994)).

118. See 18 U.S.C.A. § 1964 (1984 & Supp. 1998).

119. *McMahon*, 482 U.S. at 223 (quoting the customer's agreement from *Shearson/American Express Inc.*).

120. See *id.* at 238-42.

121. See *id.* at 227-38.

122. See *id.* at 238-42.

123. *Id.* at 231.

124. 490 U.S. 477 (1989).

125. See *id.* at 481.

126. 500 U.S. 20 (1991).

127. See *id.* at 28.

violation of the Age Discrimination in Employment Act of 1967 (“ADEA”).<sup>128</sup> The defendant moved to compel arbitration under the FAA, on the basis of an arbitration provision contained in the standard securities industry registration form that Gilmer had signed in 1981 when he registered with the stock exchange.<sup>129</sup> Gilmer had executed the stock exchange registration form at the time of hire because it was a requirement of the job.<sup>130</sup> In response to defendant’s motion to compel arbitration, Gilmer argued that he should not be required to arbitrate his ADEA claim because requiring him to do so was inconsistent with the statutory framework of the ADEA.<sup>131</sup> He also argued that the ADEA embodied important social policies that should not be determined in a private tribunal.<sup>132</sup> The Court rejected these arguments, stating that its decisions in *Mitsubishi Motors* and *McMahon* established that “statutory claims may be the subject of an arbitration agreement, enforceable pursuant to the FAA.”<sup>133</sup> The *Gilmer* Court stated that “‘so long as the prospective litigant effectively may vindicate [her] statutory cause of action in the arbitral forum, the statute will continue to serve both its remedial and deterrent function.’”<sup>134</sup> While Congress could decide that certain statutory rights were not amenable to arbitration, the Court said that the burden to show such congressional intent is on the party seeking to avoid arbitration.<sup>135</sup>

These decisions of the 1980s and early 1990s significantly expanded the scope of the FAA. For example, on the basis of *Gilmer*, lower federal courts have upheld arbitration for disputes concerning all types of employment-related statutes, including Title VII, the Whistleblower Protection Act, and the Federal Employee Polygraph Protection Act.<sup>136</sup> The *Gilmer* decision thus opened the door for extensive use of arbitration in nonunion employment

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128. 29 U.S.C.A. §§ 621-634 (1999).

129. *See Gilmer*, 500 U.S. at 24.

130. *See id.* at 23.

131. *See id.* at 26-27.

132. *See id.* at 27. The ADEA lists as its purposes “to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment.” 29 U.S.C. § 621(b) (1994).

133. *Gilmer*, 500 U.S. at 26.

134. *Id.* at 28 (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 637 (1985)).

135. *See id.* at 26.

136. *See generally* Katherine Van Wezel Stone, *Mandatory Arbitration of Individual Employment Rights: The Yellow Dog Contract of the 1990s*, 73 DENV. U. L. REV. 1017, 1034 & nn.126-31 (1996) (citing cases).



settings. Employers, who previously had feared multiple liability under expanding employment legislation designed to protect individual employees, found they could design arbitration systems that would consolidate the claims against them and stack the decks in their favor.<sup>137</sup>

By means of the presumption of arbitrability and the expansion of arbitration to statutory claims, the Supreme Court abandoned its neutrality toward arbitration and moved to a decidedly pro-arbitration position. While the Court often has declared that the purpose of the FAA was to place arbitration “‘upon the same footing as other contracts,’ ”<sup>138</sup> in fact it has placed arbitration clauses in a privileged position—in both state and federal courts.

### C. *Narrowing the Standard of Review*

Courts have also articulated a narrow standard of judicial review of arbitral awards. The FAA delineates four grounds for vacating an arbitration award, none of which concerns the legal or factual “correctness” of the award on the merits.<sup>139</sup> In addition, in 1953 the Supreme Court added a nonstatutory basis for judicial review. In *Wilko v. Swan*,<sup>140</sup> the Court said that awards can be vacated if the arbitrator displayed “manifest disregard” for the law.<sup>141</sup> Since then, courts have applied the “manifest disregard” standard narrowly, ruling that mere error in findings of fact, interpretations of contracts, or rulings on legal issues are not grounds to overturn an award.<sup>142</sup>

137. See *id.* at 1036-37; Barbara Presley Noble, *Attacking Compulsory Arbitration*, N.Y. TIMES, Jan. 15, 1995, at F21.

138. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 219 (1985) (quoting H.R. REP. NO. 68-96, at 2 (1924)); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 511 (1974) (quoting H.R. REP. NO. 68-96, at 2 (1924)).

139. The four statutory grounds for vacating arbitral awards are as follows:

- (a) Where the award was procured by corruption, fraud, or undue means.
- (b) Where there was evident partiality or corruption in the arbitrators . . . .
- (c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient 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 have been prejudiced.
- (d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

9 U.S.C. § 10 (1994).

140. 346 U.S. 427 (1953), *overruled by* *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

141. *Id.* at 436.

142. See *Thomas v. Union Carbide Agric. Prods. Co.*, 473 U.S. 568, 592 (1985); see also *Moncarsch v. Heily & Blase*, 832 P.2d 899, 903-05 (Cal. 1992) (holding that an arbitral award may not be vacated for and error of law on face of award).

Moreover, manifest disregard does not mean inadvertent or negligent error—it means knowing the law and refusing to apply it.<sup>143</sup>

Further, courts have ruled that arbitrators have no obligation to write opinions to accompany their awards.<sup>144</sup> Without an opinion, it is almost impossible for courts to know whether the arbitrator manifestly disregarded the law or not.<sup>145</sup> The manifest disregard standard and the lack of an obligation for arbitrators to write opinions have made arbitral awards virtually bulletproof.

#### D. The “New” Federal Arbitration Act

The combined effect of the broad scope of preemption in *Southland*, the presumption of arbitrability, the application of arbitration to statutory rights, the separability doctrine, and the narrow standard of review is that parties are frequently required to arbitrate disputes that they did not intend to submit to arbitration, their common law and state statutory defenses are removed, and their ability to secure judicial review for arbitral awards is effectively

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143. See, e.g., *Folkways Music Publishers, Inc. v. Weiss*, 989 F.2d 108, 112 (2d Cir. 1993); *Advest, Inc. v. McCarthy*, 914 F.2d 6, 8-9 (1st Cir. 1990); see also *supra* note 36 (citing cases). It is reported that in no commercial arbitration has an award has been vacated on this ground. See Brad A. Galbraith, Note, *Vacatur of Commercial Arbitration Awards in Federal Court: Contemplating the Use and Utility of the “Manifest Disregard” of the Law Standard*, 27 IND. L. REV. 241, 252 (1993). The Fourth Circuit rejects the judge-made “manifest disregard standard” and instead insists that the four grounds listed in § 10 of the FAA are the exclusive grounds for judicial review of an arbitral award. See *Remmey v. Paine Webber, Inc.*, 32 F.3d 143, 146 (4th Cir. 1994). Some circuits have added another nonstatutory ground to the “manifest disregard” standard, asserting that they will overturn awards that do not meet a fundamental rationality test. For example, the Eleventh Circuit upholds an arbitral award if it can discern or infer any rational ground for it from the facts of the case. See *Robbins v. Day, Payne Webber, Inc.*, 954 F.2d 679, 684 (11th Cir. 1992); see also *Swift Indus. v. Botany Indus.*, 466 F.2d 1125, 1131 (3d Cir. 1972) (refusing to enforce an arbitral award on the grounds, inter alia, that the award lacked fundamental rationality). See generally Stephen L. Hayford, *Law in Disarray: Judicial Standards for Vacatur of Commercial Arbitration Awards*, 30 GA. L. REV. 731, 785-98 (1996) (describing the recent development of ‘arbitrary and capricious’ and ‘completely irrational’ tests).

144. See *United Steelworkers v. Enterprise Wheel & Car Corp.*, 363 U.S. 593, 598 (1960); *Robbins*, 954 F.2d at 684; *O.R. Sec., Inc. v. Professional Planning Assocs., Inc.*, 857 F.2d 742, 746 (11th Cir. 1988).

145. The American Arbitration Association takes the position that for commercial arbitrations, the arbitrator should avoid writing opinions and should only write one if both parties request it:

Commercial arbitrators are not required to explain the reasons for their decisions. As a general rule, the award consists of a brief direction to the parties on a single sheet of paper. One reason for brevity is that written opinions might open avenues for attack on the award by the losing party.

American Arbitration Association, *A Guide for Commercial Arbitrators* (visited Feb. 15, 1999) <<http://www.adr.org.guides.comguide.html>>.

eliminated. As a result of these expansive legal doctrines, arbitration clauses are ubiquitous in consumer transactions today. Arbitration clauses are commonplace in construction contracts, residential and commercial lease forms, health maintenance organization subscriber agreements, informed consent forms for medical procedures, bank and credit card applications, homeowner association charters, employment contracts, brokerage contracts in the securities industry, and in most other contracts in the commercial, corporate, and international trade areas.<sup>146</sup> Thus disputes that arise in any of these areas—whether they are of a contractual or a statutory nature—are subject to the mandatory arbitration provisions of the FAA. To a considerable extent, civil litigation in the federal and state courts is being replaced by arbitration in privatized tribunals. Instead of a system based on due process and a generally applicable rule of law, we are developing a system that fits Justice Story's characterization of arbitration, a regime of *rusticum iudicium*<sup>147</sup> or "rustic justice."

### III. TWO COMMON BUT INADEQUATE EXPLANATIONS FOR THE COURTS' APPROACH TO ARBITRATION

There are two common explanations for the courts' dramatic reinterpretation of the FAA and the corresponding transformation of the civil justice system. First, it is sometimes said that the changes in judicial treatment of arbitration are a judicial response to crowded dockets and courthouse gridlock. Alternatively, it is sometimes said that parties who have arbitration clauses in their contracts want to have their disputes arbitrated rather than litigated, so that by upholding and enforcing arbitration agreements, courts are implementing the will of the parties. While both explanations may be operative, neither is sufficient to explain current decisional trends, for reasons that are developed below.

#### A. *The Courthouse Gridlock Explanation*

It has become common sport to rail against the civil justice system for failing to provide prompt and accessible justice. The near-universal disdain for civil litigation has fueled the modern ADR

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146. See Meier, *supra* note 3, at A1 (reporting the extensive use of arbitration in consumer and medical transactions); see also Edward W. Morris, Jr. et al., *Securities Arbitration at Self-Regulatory Organizations*, in 1 SECURITIES ARBITRATION 1992, at 135, 144 (1992) (observing that securities industry arbitrations increased between 1985 and 1990 from 2796 a year to 5332 a year).

147. *Tobey v. County of Bristol*, 23 F. Cas. 1313, 1321 (C.C.D. Mass. 1845) (No. 14,065).

movement.<sup>148</sup> People situated both inside and outside the legal system see arbitration as a way to relieve the systemic problems with the civil justice system. Arbitration is seen as quick, easy, fair, and user-friendly, in contrast to the expensive, oppressive, ponderous, time-consuming, and overly technical prospect of litigation in courts.<sup>149</sup> From this perspective, channeling more disputes to private arbitration is both efficient for society and advantageous for the disputants.

The systemic argument in favor of arbitration has several dimensions. First, it is sometimes said that because judicial dockets are crowded, trivial litigation consumes limited judicial resources, so that society is better off by compelling parties to arbitrate their disputes.<sup>150</sup> Second, it is claimed that arbitration is better for the parties themselves. Arbitration offers speed, accessibility, economy, and substantive justice.<sup>151</sup> Court congestion and expansive discovery

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148. The modern ADR movement is often said to date from the National Conference on the Causes of Popular Dissatisfaction with the Administration of Justice (the Pound Conference), convened by the Judicial Conference of the United States, the Conference of Chief Justices, and the American Bar Association in St. Paul, Minnesota, in 1976. See generally *Addresses Delivered at the National Conference on the Causes of Popular Dissatisfaction with the Administration of Justice*, 70 F.R.D. 79 (1976) (emphasizing the importance of reform); Laura Nader, *The ADR Explosion—The Implications of Rhetoric in Legal Reform*, 8 WINDSOR Y.B. ACCESS TO JUST. 269, 273 (1988) (stating that the Pound Conference sparked a shift towards procedural reform). The participants at the Pound Revisited Conference criticized the civil justice system and urged procedural reforms to reduce the amount and litigiousness of litigation. As part of their rhetoric, they urged harmonious rather than adversarial methods of dispute-resolution. See *id.* at 275.

149. See, e.g., STEPHEN B. GOLDBERG ET AL., DISPUTE RESOLUTION 558 (1985); *cf.* Securities Indus. Ass'n v. Connolly, 883 F.2d 1114, 1118-19 (1st Cir. 1989) (stating that many critics of the burdensome nature of appeals in civil litigation favor arbitration as an alternative); C. Evan Stewart, *Securities Arbitration Appeal: An Oxymoron No Longer?*, 79 KY. L.J. 347, 347 & n.3 (1990-1991) (citing critics who promote arbitration in favor of the civil litigation system, which is seen as "too cumbersome, burdensome, time consuming, formalistic, and expensive").

150. See Warren E. Burger, *Isn't There A Better Way?*, ANN. REP. ON THE STATE OF THE JUDICIARY, Jan. 24, 1982, reprinted in LEONARD L. RISKIN & JAMES E. WESTBROOK, DISPUTE RESOLUTION AND LAWYERS 13-15 (2d ed. 1997) (describing the adversary process as expensive and time consuming, and concluding that "[w]e need to consider moving some cases from the adversary system to administrative processes . . . especially arbitration"); *cf.* Derek Bok, *Law and Its Discontents: A Critical Look at Our Legal System*, 38 REC. ASS'N B. CITY N.Y. 12, 12-13 (1983), reprinted in LEO KANOWITZ, CASES AND MATERIALS ON ALTERNATIVE DISPUTE RESOLUTION 33-36 (1985) (noting the rising costs of litigation and faulting legal education for emphasizing a combative model).

151. See Jean E. Faure, *The Arbitration Alternative: Its Time Has Come*, 46 MONT. L. REV. 199, 199 (1985); Stewart, *supra* note 149, at 347 & n.4 (citing critics of the court system who hail the many virtues of arbitration); *cf.* Constance N. Katsoris, *Securities Arbitration After McMahon*, 16 FORDHAM URB. L.J. 361, 386-87 (1988) (stating that arbitration will resolve conflicts swiftly and cheaply but noting the need for arbitration to

rules make litigation too slow, arduous, and expensive for the parties. Further, the excessive technicality of law relegates litigation to the experts and makes it impossible for ordinary citizens to know their rights or to conduct their affairs. In theory, disputants can control and comprehend arbitration proceedings, and therefore they have confidence in the process and respect for the outcome. Further, if parties arbitrate instead of litigate, they will get decisions based on common sense rather than on arcane legalisms.<sup>152</sup>

In addition, it is often said that the excessive expense of litigation, due to excessive technicality and high lawyer fees, makes the judicial system inaccessible to ordinary folk. And some claim there is systematic injustice in judicial outcomes because the law and the legal process are tilted in favor of the wealthy and the powerful.<sup>153</sup> Thus, the argument goes, arbitration serves redistributive goals—it helps the poor.

Many inside and outside the legal profession have put forward these pro-arbitration arguments in recent years, including such distinguished members of the profession as former-Chief Justice Burger, Judge Richard Posner, and the former President of Harvard University, Derek Bok.<sup>154</sup> Indeed, it is paradoxical that those situated at the very top of the legal profession have been leading the crusade for alternative dispute resolution and for the delegitimation of many aspects of life.

The movement for alternative dispute resolution has also had its skeptics, who raise several questions. First, some question whether there really has been a “litigation explosion” in the first place.<sup>155</sup> For example, Mark Galanter argues that the alleged litigation explosion may not really exist.<sup>156</sup> To the contrary, he claims that we may have

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be freely chosen).

152. Cf. Thomas J. Stipanowich, *Beyond Arbitration: Innovation and Evolution in the United States Construction Industry*, 31 WAKE FOREST L. REV. 65, 67-68 (1996) (noting the rise in alternative dispute resolution and relating it to the decline in overall feelings of community and social connectedness).

153. See, e.g., Bok, *supra* note 150, at 34 (criticizing the cumbersome legal system for offering little access to the poor and middle class, and concluding that “[t]here is far too much law for those who can afford it and far too little for those who cannot”).

154. See *supra* notes 150 & 153.

155. See Laura Nader, *The Recurrent Dialectic Between Legality and Its Alternatives: The Limitations of Binary Thinking*, 132 U. PA. L. REV. 621, 633-37 (1984) (reviewing and criticizing JEROLD S. AUERBACH, *JUSTICE WITHOUT LAW?* (1983), for wrongly assuming the existence of a litigation explosion and therefore failing to explain adequately why there has been a shift from judicial to non-judicial settings for dispute resolution).

156. See Mark Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious*

too little litigation in relation to the number of serious disputes.<sup>157</sup> The Wisconsin Civil Litigation Research Project also found that few disputes end up as lawsuits, and of those, even fewer are litigated.<sup>158</sup> Paul Weiler's study of medical malpractice similarly concluded that far more medical malpractice occurs—malpractice as determined by an examination of case files by an independent panel of doctors—than malpractice lawsuits are filed.<sup>159</sup> Further, a recent study of judicial docket-crowding by William Allen, a long-standing Director of the American Judicature Society, found that federal courts have no more cases on their dockets than they did twenty-five years ago, and that the average caseload per judge has actually gone down.<sup>160</sup> These studies support Galanter's view that the so-called litigation explosion is a myth which has little evidence to support it, but one that nonetheless plays a powerful role in fueling moves to alternative dispute resolution mechanisms.

Second, some skeptics have disputed the claim that alternative dispute resolution provides cheaper, faster, and more accessible justice. Here too empirical studies have found that at least some forms of alternative dispute resolution take as long as litigation and are as costly to the litigants.<sup>161</sup> Indeed, a recent study by the Rand Institute on Civil Justice found that the alleged superiority of ADR mechanisms over the courts is greatly exaggerated.<sup>162</sup>

Third, some critics have also questioned whether alternative dispute resolution provides better justice. Richard Abel and Martha Fineman argue that informal procedures actually disempower people

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*Society*, 31 UCLA L. REV. 4, 69 (1983).

157. On the problematic nature of defining "disputes," see *id.* at 11.

158. See David M. Trubek et al., *The Costs of Ordinary Litigation*, 31 UCLA L. REV. 72, 86-87 (1983).

159. See PAUL C. WEILER, *MEDICAL MALPRACTICE ON TRIAL* 12-13 (1991).

160. See H. William Allen, Remarks at the AALS Meeting, San Antonio, Tex. (Jan. 4, 1996), in Frank E. Sander et al., *Judicial (Mis)Use of ADR? A Debate*, 27 U. TOL. L. REV. 885, 889 (1996).

161. See, e.g., *Stroh Container Co. v. Delphi Indus., Inc.*, 783 F.2d 743, 751 & n.12 (8th Cir. 1986) (discussing how parties are discovering that arbitration is complex, expensive, and time consuming); Jerome Reiss, *Construction Industry Disputes*, in *ARBITRATION: COMMERCIAL DISPUTES, INSURANCE, AND TORT CLAIMS* 69, 73 (Alan I. Widiss ed., 1979) (observing that construction arbitration hearings are lengthy and expensive, often taking longer than comparable trials); Stewart, *supra* note 149, at 349 n.9 (arguing that the increased formality of securities industry arbitration "significantly negate[s]—if not eliminate[s]—the advantages of arbitration").

162. See JAMES S. KAKALIK ET AL., *AN EVALUATION OF MEDIATION AND EARLY NEUTRAL EVALUATION UNDER THE CIVIL JUSTICE REFORM ACT 4* (1996) (finding that neither time nor costs changed significantly as a result of court-ordered referral to ADR).

by individualizing disputes and rendering the disputes invisible.<sup>163</sup> Some feminist scholars have argued that informal mechanisms deny litigants the due process protection of a court, protection that can equalize power relations between wildly unequal parties.<sup>164</sup> Thus, there is a powerful argument that the poor and disadvantaged sectors of society lose in informal settings because such settings amplify their disadvantage and exacerbate problems of inequality.<sup>165</sup>

Some critics of alternative dispute resolution have noted the paradox that the elite members of the profession began calling for increased alternative dispute resolution in the late 1960s and 1970s, at the very time that the legal system was beginning to respond to demands from blacks, women, and other disadvantaged groups for equal rights and legal protection. These critics claim that the call for informality was not a means to expand rights for the disadvantaged, but a response to the expansion of rights for such groups—a way to take back the hard-won gains of the civil rights movements, women's movement, and other such forces for change.<sup>166</sup> For example, Chief Justice Burger said in 1982 that the time had come to move some cases to alternative mechanisms such as mediation and arbitration and that "divorce, child custody, adoptions, personal injury, landlord and tenant cases, and probate of estates are prime candidates."<sup>167</sup> Statements like this support the view that he was advocating second-class justice for the masses and reserving the judicial system for the big-time corporate, antitrust, and patent cases.

Despite the critics of ADR, it is clear that many members of the public, the courts, and the legal profession *believe* there is a serious problem with our civil justice system, and widespread lack of

163. See Richard Abel, *The Contradictions of Informal Justice*, in 1 POLITICS OF INFORMAL JUSTICE: THE AMERICAN EXPERIENCE 267, 267-320 (Richard Abel ed., 1982); Martha Fineman, *Dominant Discourse, Professional Language, and Legal Change in Child Custody Decisionmaking*, 101 HARV. L. REV. 727, 760-68 (1988).

164. See, e.g., Penelope Bryan, *Killing Us Softly: Divorce Mediation and the Politics of Power*, 40 BUFF. L. REV. 441, 449 (1992).

165. See Abel, *supra* note 163, at 267, 267-320. But see William H. Simon, *Legal Informality and Redistributive Politics*, 19 CLEARINGHOUSE REV. 384, 388-90 (1985) (criticizing anti-informalism for its incorrect assumption that procedural formality usually benefits the disadvantaged and for assuming a view of the state that is either implausible or tautological).

166. See, e.g., Nader, *supra* note 148, at 286-87; see also A. Leon Higginbotham, Jr., *The Priority of Human Rights in Court Reform*, 70 F.R.D. 134, 156-57 (1976) (contending that the rights of minorities and women must be protected in courts, not in alternative dispute procedures).

167. Burger, *supra* note 150, at 11; see also Warren E. Burger, *Agenda for 2000 A.D.—A Need for Systematic Anticipation*, 70 F.R.D. 83, 94 (1976) (calling for the wider use of the "well-developed forms of arbitration").

confidence in the legal system is a serious problem in itself. Further, many believe that arbitration offers a palliative, if not a cure, to the problems with the system. Thus, we might be tempted to understand the developing law of arbitration as a response to those beliefs.

While the prevention-of-gridlock explanation no doubt plays a role in the courts' expansion of arbitration's domain, it is not sufficient to explain the major doctrinal shifts of the 1980s. To accept docket-control as a complete and sufficient explanation for this major doctrinal shift would require that we make the excessively cynical assumption that judges care more about their own personal convenience than about fairness and the rule of law. While some have leveled this charge at the federal judiciary,<sup>168</sup> it is more plausible to surmise that there is something else at work that permits judges to be comfortable with the extreme degree of delegation to arbitration that is reflected in the recent FAA jurisprudence. That is, even if judges were trying to reduce their dockets, it is likely that they have a view about the value of arbitration that squares their pro-arbitration jurisprudence with their commitment to fairness and to the rule of law.<sup>169</sup>

No simple account of ideology can explain the courts' expansive approach to arbitration. Both liberal and conservative judges have embraced the move to private arbitration, so the reason for the shift can neither be to disempower the powerless nor to help the disadvantaged. Thus, we must find some other rationale to support the courts' expansive re-interpretation of the FAA.

### *B. The Enforcement of Contracts Explanation*

One might surmise that judges find an adequate comfort-level while granting extreme deference to arbitration by relying on contractual consent. That is, we might ascribe the recent doctrinal developments in the FAA to a belief that by liberally requiring parties to arbitrate, courts are merely enforcing contracts, including agreements to arbitrate. From this perspective, judges need not choose between their own convenience in having short dockets and their obligation to effectuate the rule of law—they can do both. By liberally enforcing arbitration agreements, judges are effectuating the parties' intent and thereby implementing, rather than negating,

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168. See *Cassaretto v. Lombardi*, 886 P.2d 931, 939-41 (Mont. 1994) (Trieweiler, J., specially concurring).

169. See DUNCAN KENNEDY, *A CRITIQUE OF ADJUDICATION: FIN DE SIÈCLE 157-64* (1997) (describing how judges reconcile their personal and ideological preferences with the rule of law).



public policy and the rule of law.<sup>170</sup>

### 1. Actual Consent

The problem with understanding the FAA cases as primarily about enforcing private agreements to arbitrate is that, in many recent cases, courts have applied attenuated notions of consent, compelling arbitration when consent is thin, if not outright fictitious. For example, courts routinely hold parties to arbitration agreements that appear in a document incorporated into a contract by reference, even when one party had no opportunity to see or no reason to anticipate the incorporated term.<sup>171</sup> Courts give effect to blank-check arbitration clauses that are not even arguably within the realm of the parties' reasonable expectations at the time of contracting, such as clauses that are silent on arbitration but which incorporate certain specified terms and procedures "as may be amended from time to time."<sup>172</sup> This treatment of arbitration clauses stands in contrast to judicial treatment of other contractual provisions that are inserted by reference, which courts police for unfairness or undue surprise.<sup>173</sup>

Further, the timing of contracts in relation to their arbitration clauses often belies the existence of actual consent. For example, courts enforce arbitration clauses in cases in which the arbitration term was inserted into the incorporated document *after* the initial contract was made.<sup>174</sup> In addition, courts hold that when arbitration

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170. This rationale underlies the Supreme Court's decision in *Dean Witter Reynolds v. Byrd*, 470 U.S. 213 (1985), in which the Supreme Court ordered arbitration even though to do so in that case entailed the creation of bifurcated proceedings and increased delay. See *id.* at 217. The Court stated that the paramount goal of the FAA is to enforce voluntary agreements to arbitrate, a goal that takes precedence over the goal of quick or efficient disposition of claims. See *id.* at 219. The Court held that pendant state law claims were arbitrable even though the 1934 Securities Exchange Act claim to which they were appended was deemed not to be arbitrable under the FAA. See *id.* at 222.

171. See, e.g., *In re Prudential Ins. Co.*, 133 F.3d 225, 231 (3d Cir. 1998); *R.J. O'Brien & Assoc. v. Pipkin*, 64 F.3d 257, 260-63 (7th Cir. 1995); *U.S. Fidelity Guar. v. West Point Constr. Co.*, 837 F.2d 1507, 1508 (11th Cir. 1988); see also *Pay Phone Concepts v. MCI Telecomms. Corp.*, 904 F. Supp. 1202, 1209 (D. Kan. 1995) (citing cases). But see *Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. 98-1246, 1998 WL 880910, at \*21 (1st Cir. Dec. 22, 1998) (refusing to enforce an arbitration agreement incorporated by reference in a securities industry registration form because the employee was not given the incorporated rules that defined the scope of required arbitration).

172. *Duffield v. Robertson Stephens & Co.*, 144 F.3d 1182, 1185 (9th Cir. 1998); see also *Pay Phone Concepts*, 904 F. Supp. at 1209 (finding that subsequent amendments were enforceable and incorporated by reference).

173. See *RESTATEMENT (SECOND) OF CONTRACTS* § 237(3) (1981); *CALAMARI & PERILLO*, *supra* note 22, § 9-44, at 418-24; *infra* notes 571-76 and accompanying text.

174. See *R.J. O'Brien*, 64 F.3d at 260 (holding that the parties' contract, made in 1985, contained an arbitration clause adopted in 1992 in a referenced document); *Geldermann v.*

procedures are revised, parties are bound by the procedure in effect at the time the dispute reaches a court, not the one in effect at the time a contract was signed *or* at the time that a dispute arose.<sup>175</sup> Courts have also enforced arbitration promises in contracts when the disputes arose *after* the underlying contract expired of its own terms.<sup>176</sup> And in a further departure from ordinary notions of consent, the Eighth Circuit recently enforced an arbitration clause to compel a customer to arbitrate a dispute with a brokerage firm even though the dispute arose several years *before* the parties had signed the arbitration clause.<sup>177</sup>

One example of the degree to which courts strain conventional notions of consent in interpreting arbitration clauses is *R.J. O'Brien & Assoc. v. Pipkin*.<sup>178</sup> In this case, the Seventh Circuit applied an arbitration clause to a commodities broker even though there was no arbitration clause in the contract between the parties *nor* was arbitration mentioned in *any* of the documents that were incorporated by reference.<sup>179</sup> The court reasoned that because arbitration was a common practice in that industry, the parties were deemed to know of the industry practice and to have agreed to utilize it.<sup>180</sup>

The recent use of “shrinkwrap” arbitration agreements creates further departures from actual consent.<sup>181</sup> “Shrinkwrap agreements” are agreements printed on the plastic shrinkwrap in which a product is wrapped or agreements that are enclosed inside the box in which a product is packaged.<sup>182</sup> Most of the cases involving such agreements concern terms of licensing on boxes of computer software that purport to restrict the purchaser’s ability to use the software. Courts

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Commodity Futures Trading Comm’n, 836 F.2d 310, 318 (7th Cir. 1987) (holding that a party consented to arbitration where the party agreed to be bound by subsequent regulation amendments); *Illyes v. John Nuveen & Co.*, 949 F. Supp. 580, 582 (N.D. Ill. 1996) (finding that a party was bound to arbitrate an employment dispute under amended arbitration procedures); *Pay Phone Concepts*, 904 F. Supp. at 1205, 1209 (finding that a party was bound to arbitrate under an amended agreement).

175. See *Kuehner v. Dickinson & Co.*, 84 F.3d 316, 320-21 (9th Cir. 1996); *Pitter v. Prudential Life Ins. Co.*, 906 F. Supp. 130, 134-45 (E.D.N.Y. 1995).

176. See, e.g., *Sweet Dreams Unlimited, Inc. v. Dial-A-Mattress Int’l, Ltd.*, 1 F.3d 639, 643-44 (7th Cir. 1993).

177. See *Houlihan v. Offerman & Co.*, 31 F.3d 692, 695 (8th Cir. 1994).

178. 64 F.3d 257 (7th Cir. 1995).

179. See *id.* at 260-63.

180. See *id.* at 260.

181. See *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147, 1147 (7th Cir. 1997); *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569, 571-73 (App. Div. 1998).

182. See *ProCD v. Zeidenberg*, 86 F.3d 1447, 1449 (7th Cir. 1996) (explaining the term “shrinkwrap license”).

and legal scholars have grappled with the question of whether and under what circumstances courts should enforce terms that are printed on the shrinkwrap or contained in a writing that is inside a box.<sup>183</sup> Some courts have held that by opening the shrinkwrap and using the product, the purchaser displays the requisite elements of contractual assent, at least when the shrinkwrap term in dispute is reasonable and not oppressive.<sup>184</sup> Other courts have refused to enforce shrinkwrap terms on the grounds that they are either proposals for an additional term under section 2-207 of the UCC which, being material, are ineffective, or that they are proposals for a modification under section 2-209 of the UCC, to which there was no assent.<sup>185</sup>

To date, only a few cases have arisen concerning shrinkwrap arbitration clauses. In *Hill v. Gateway 2000, Inc.*,<sup>186</sup> referred to in the introductory hypothetical, Judge Easterbrook enforced an arbitration provision contained in the standard product information card inside the box in which the product came.<sup>187</sup> When parties are on notice that there are additional terms inside, he said, “[a] contract need not be read to be effective; people who accept take the risk that the unread terms may in retrospect prove unwelcome.”<sup>188</sup> The *Hill* case went beyond the other shrinkwrap cases because it imposed the challenged term without regard, or even discussion of, the term’s reasonableness.<sup>189</sup> The court’s reasoning in *Hill* has opened the door

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183. Compare *id.* at 1450-53 (enforcing a shrinkwrap license agreement), with *Arizona Retail Sys. Inc. v. Software Link, Inc.*, 831 F. Supp. 759, 766 (D. Ariz. 1993) (refusing to enforce a shrinkwrap license agreement). For a proposed amendment to deal with standardized license terms contained in standardized and “shrinkwrap agreements,” see U.C.C. § 2B (Proposed Official Draft 1997).

184. See, e.g., *ProCD*, 86 F.3d at 1452-53.

185. See *Step Saver Data Sys. v. Wyse Tech.*, 939 F.2d 91, 105 (3d Cir. 1991); *Arizona Retail Sys.*, 831 F. Supp. at 766.

186. 105 F.3d 1147 (7th Cir. 1997).

187. See *id.* at 1151.

188. *Id.* at 1148.

189. It could be argued that the *Hill* case is at odds with other shrinkwrap cases. The *Hill* court relied on its previous decision in *ProCD*, in which it upheld a shrinkwrap license agreement to limit the use of certain computer software. In recognizing a valid acceptance by the purchaser’s act of using the product, the *ProCD* court upheld the validity of the contract. See *ProCD*, 86 F.3d at 1452-53. But the court in *ProCD* also engaged in a detailed discussion about the economic utility of the license term at issue in order to demonstrate that the license term in dispute was a reasonable one. See *id.* at 1449-50. Indeed, it added that “[o]urs is not a case in which a consumer opens a package to find an insert saying ‘you owe us an extra \$10,000’ and the seller files suit to collect.” *Id.* at 1452. Presumably the *ProCD* court would not enforce the \$10,000 term even though it appeared on the form inside the box. Thus one might argue that an arbitration clause, though not possibly as confiscatory as the pay-us-\$10,000 term, should have been scrutinized for

to more extensive use of shrinkwrap arbitration agreements.<sup>190</sup> The decision would seem to allow manufacturers of all types to insert arbitration provisions in the boxes of their products, and thereby avoid litigation for alleged product defects or other violations of law.

The separability doctrine of *Prima Paint*<sup>191</sup> also permits courts to depart from actual consent in cases involving arbitration clauses. The doctrine says that parties must arbitrate any defenses they raise that address the validity of a contract that contains an arbitration clause. Courts have relied on the separability doctrine to enforce arbitration provisions in contracts that are allegedly void as well as those that are voidable.<sup>192</sup> Normally, if a contract is void or voidable due to fraud, duress, or incapacity, then its terms have no legal effect because there is not the requisite contractual intent.<sup>193</sup> Further, if a contract is void or voidable on such basis, then presumably the arbitration clause contained in the contract is also void.<sup>194</sup> Yet the separability doctrine compels courts to enforce a portion of the contract, notwithstanding any flaws that would render the entire contract a nullity.<sup>195</sup> Thus, the effect of the separability doctrine is to restrict, if not eliminate, contractual defenses based on lack of consent when arbitration clauses are involved.

In addition, the presumption of arbitrability means that arbitration clauses are applied to many disputes that the parties did not believe were within the parties' arbitration clause at all. For example, in *Sweet Dreams Unlimited, Inc. v. Dial-A-Mattress International, Ltd.*,<sup>196</sup> the Seventh Circuit relied on the presumption

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reasonableness and to determine whether it was within the range of terms a reasonable consumer would expect to find. See RESTATEMENT (SECOND) OF CONTRACTS § 211 (1981).

190. In *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569 (App. Div. 1998), the New York Appellate Division adopted the reasoning of the *Hill* court and held that the plaintiffs were subject to an arbitration clause that was contained in the documents that came with their computer system. See *id.* at 572.

191. See *supra* notes 85-91 (discussing the adoption of the separability doctrine in *Prima Paint*).

192. See, e.g., *Sokaogon Gaming Enter. Corp. v. Tushie-Montgomery Assocs., Inc.*, 86 F.3d 656, 659 (7th Cir. 1996); *Herwig v. Hahnman-Albrecht, Inc.*, No. 96-C6107, 1997 WL 72079, at \*3 (N.D. Ill. Feb. 13, 1997).

193. See, e.g., *CALAMARI & PERILLO, supra* note 22, § 9-2, at 337-39 (observing that duress involves either absence of consent or coerced consent).

194. A void contract is one that "produces no legal obligation upon the part of a promisor." *Id.* § 1-11, at 18.

195. See, e.g., *Sokaogon Gaming Enter. Corp.*, 86 F.3d at 659; *Sweet Dreams Unlimited, Inc. v. Dial-A-Mattress Int'l, Ltd.*, 1 F.3d 639, 641 (7th Cir. 1993); *Herwig*, 1997 WL 72079, at \*3.

196. 1 F.3d 639 (7th Cir. 1993).

of arbitrability to enforce an arbitration clause to resolve a dispute that arose after the contract containing the arbitration promise had expired by its own terms.<sup>197</sup> In *Daisy Manufacturing Co. v. NCR Corp.*,<sup>198</sup> the Eighth Circuit compelled arbitration under a standardized contract in which the plaintiff, while signing the contract, had deliberately refused to check off the box signifying agreement to an optional arbitration term.<sup>199</sup>

Thus, in many respects, courts have short-circuited the inquiry into consent when they enforce arbitration clauses under the FAA. For this reason, it cannot be maintained that when courts compel parties to arbitrate or enforce the arbitral results, they are merely implementing the parties' intent.

## 2. Imputed Consent

One might justify the recent arbitration jurisprudence by recharacterizing it as resting not on actual consent, but on imputed consent. After all, if an arbitration term has value to a seller, he should be willing to offer a discount to those buyers who agree to include it in their bargain.<sup>200</sup> In that event, one might impute consent to the buyer on the assumption that she received a net benefit from having an arbitration clause even with the disadvantage such a procedure might entail. For example, if someone were offered a choice of two airline tickets—one at a given price and one at a discounted price but subject to a broad arbitration clause—we might presume the purchaser is able to make a choice about which terms she prefers. While such choices are rarely posed to consumers explicitly, we might further presume that the price of a ticket containing the arbitration clause was already discounted to reflect such an imputed bargain.<sup>201</sup> On this basis, a court could find imputed consent to arbitration even in the absence of actual consent.

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197. See *id.* at 643; see also *Riley Mfg. Co. v. Anchor Glass Container Corp.*, 157 F.3d 775, 781 (10th Cir. 1998) (explaining that “an arbitration provision in a contract is presumed to survive the expiration of the contract unless there is some express or implied evidence that the parties intended to override the presumption”).

198. 29 F.3d 389 (8th Cir. 1994).

199. See *id.* at 393-95.

200. This reasoning was employed by the Supreme Court in *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 594 (1991). See also *ProCD v. Zeidenberg*, 86 F.3d 1447, 1449-50 (7th Cir. 1996) (asserting that consumers benefit from the option to purchase products subject to restrictions in exchange for a lower price).

201. Cf. *Carnival Cruise Lines*, 499 U.S. at 594 (speculating that cruise line passengers might receive a monetary benefit in the form of a lower ticket price because the ticket contained a choice-of-forum clause favorable to the cruise line).

The problem with this analysis is that it goes too far. The same imputation of consent could be made in relation to any transaction, thereby permitting after-the-fact imposition of any self-serving terms a seller might want to impose. Sellers could claim that warranties were disclaimed, or that products were subject to burdensome after-arriving terms without any requirement of proving that the buyer actually assented to them.<sup>202</sup> To avoid this result, we should only impute consent when there is some showing that the imputed consent is based on some real or at least plausible aspect of the exchange.

There are types of contract clauses for which courts usually refuse to impute consent and instead require actual knowledge. Waiver and choice-of-forum clauses are two examples of clauses in which courts require actual knowledge before they will hold a party to the clause.<sup>203</sup> Arguably, both clauses are similar to arbitration clauses in their effect,<sup>204</sup> and it is therefore useful to compare arbitration to waiver in order to illuminate the problem of imputing consent to arbitration clauses in the absence of evidence of actual consent.

Waiver is the "intentional relinquishment of a known right with both knowledge of its existence and an intention to relinquish it."<sup>205</sup> To waive a right, an individual must know of the right and choose to forego it. Before a court can find that a waiver exists, courts require actual knowledge of the legal right and a clear indication of intent to waive it.<sup>206</sup> For example, the UCC requires that a disclaimer of an

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202. In *ProCD*, Judge Easterbrook suggested that if a consumer found an insert inside a package saying "you owe us an extra \$10,000," it would not be enforceable. *ProCD*, 86 F.3d at 1452 (quoting the hypothetical insert). Thus he acknowledged that it is not always reasonable to impute consent to after-arriving terms.

203. The *Hill v. Gateway 2000, Inc.* case can be distinguished from *Carnival Cruise Lines* on this basis. In *Carnival Cruise Lines*, the Supreme Court gave effect to a choice-of-forum clause that appeared on the back of a cruise ticket and thereby rejected the plaintiff's attempt to litigate her tort claim in her home state. See *Carnival Cruise Lines*, 499 U.S. at 595-97. While acknowledging that the contractually specified forum imposed an insurmountable hardship on the plaintiff, the Supreme Court enforced the choice-of-forum clause nonetheless. See *id.* at 594. The Court noted, however, that the plaintiff had acknowledged that she had received actual notification of the clause at the time the contract was formed. See *id.* at 595.

204. See Lester Brickman, *Attorney-Client Fee Arbitration: A Dissenting View*, 2 UTAH L. REV. 277, 280 (1990) (arguing that arbitration is the functional equivalent of a waiver of important rights).

205. 2 BOUVIER'S LAW DICTIONARY 3417 (8th ed. 3d rev. 1914).

206. See *County of Albermarle v. Massey*, 32 S.E.2d 228, 230 (Va. 1944). The court in *County of Albermarle* stated: "There can be no waiver unless the person against whom the waiver is claimed had full knowledge of his rights and of facts which will enable him to take effectual action for the enforcement of such rights." *Id.* (quoting 29 THE AMERICAN AND ENGLISH ENCYCLOPEDIA OF LAW 1093-94 (David S. Garland & Charles

implied warranty must be "conspicuous" to be effective.<sup>207</sup> There is a powerful argument that courts should require an even higher showing of actual knowledge and consent before enforcing an arbitration clause than they would apply to a typical waiver clause.<sup>208</sup> With arbitration, unlike waiver, there is no specific right being relinquished *ex ante*. Parties to an arbitration agreement, even if they know the arbitration term is present, do not know which, if any, of their substantive or procedural rights they are relinquishing. Arbitration merely involves a shift from a judicial forum to a private forum for future disputes; its impact on substantive rights is unknowable *ex ante*. Because an arbitration clause refers to no substantive right at all, the individual signatory cannot know what right is subject to prospective waiver.<sup>209</sup>

There is an additional difference between arbitration and waiver that argues for differential treatment of the two clauses for purposes of imputing consent. With arbitration, the question of whether the shift of forum to arbitration will ultimately involve the loss of substantive rights is altogether speculative at the time that the clause is signed. Parties to arbitration clauses, like parties to contracts generally, rarely contemplate the possibility of any dispute at all; they contemplate that the contract will be performed, not breached.<sup>210</sup> Parties even less often contemplate that the forum selected for resolving any potential disputes might prejudice them. Parties are likely to assume that arbitration will provide a reasonable panoply of due process protections and that any award will be subject to judicial review. The consenting party, therefore, is likely to view the shift in

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Parterfield eds., 2d ed. 1895)); *May v. Martin*, 137 S.E.2d 860, 865 (Va. 1964) ("Waiver is the intentional relinquishment of a known right, with both knowledge of its existence and an intention to relinquish it.").

207. U.C.C. § 2-316(2) (incorporating U.C.C. § 1-201(10)).

208. *Cf. Faretta v. California*, 422 U.S. 806, 835 (1975) (explaining that before a party can waive a right to counsel, the court must make the defendant "aware of the dangers and disadvantages of self-representation, so that . . . 'he knows what he is doing and his choice is made with eyes open.'" (quoting *Adams v. United States ex rel. McCann*, 317 U.S. 269, 279 (1942))).

209. In a similar context, courts impose strict scrutiny on clauses that release or limit liability and only enforce such limitations if the parties knew the precise rights being waived. *See, e.g., Yauger v. Skiing Enters., Inc.*, 557 N.W.2d 60, 62 (Wis. 1996) (noting that courts will not enforce exculpatory clauses that "fail[] to disclose to the signers exactly what rights they were waiving"); *Belger Cartage Serv., Inc. v. Holland Constr. Co.*, 582 P.2d 1111, 1119 (Kan. 1978) (finding that courts will not enforce clauses limiting liability "unless the limitation is fairly and honestly negotiated and understandingly entered into").

210. *See* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 227-28 (1995).

forum as inconsequential in regard to whatever rights she might have in whatever dispute might arise.<sup>211</sup> It is not until after an arbitration is held and an award is rendered that a party can tell whether or not her substantive rights were protected. Thus, a party who consents to an arbitration clause has at best consented to a hypothetical event, the likelihood and impact of which she is likely to discount.<sup>212</sup>

For these reasons, it is unrealistic to believe that parties who agree to arbitration clauses have agreed in any sense to a discounted price in return for the arbitration term. Nor is it reasonable to believe that consumers as a group may have so consented to their use. Rather, the prevalence of arbitration clauses in consumer transactions represents windfalls to the sellers, not cost-saving devices for the buyers.<sup>213</sup>

If courts are not merely enforcing contracts when they compel parties to arbitrate, then their expansive approach to the FAA remains unexplained. It is contended that judicial support for arbitration is best understood by exploring the relationship between arbitration and the ideal of self-regulation. An examination of the history of the FAA reveals that the ideal of self-regulation has shaped the FAA from its inception.

#### IV. THE HISTORY OF THE FEDERAL ARBITRATION ACT

##### A. *The Genesis of Arbitration*

Private dispute resolution dates back hundreds of years in the Western world.<sup>214</sup> Arbitration originated in Roman and Canon law and was revived in the Middle Ages in European civil law systems.<sup>215</sup> In the common law, arbitration has been a feature of dispute

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211. In *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991), the Supreme Court emphasized that the shift of forum in arbitration agreements does not alter the parties' substantive rights. See *id.* at 29. But see Paul D. Carrington, *Regulating Dispute Resolution Provisions in Adhesion Contracts*, 35 HARV. J. ON LEGIS. 225, 225-30 (1998) (criticizing that notion).

212. On the problem of choice in situations where parties are likely to unduly discount risks, see Mark Kelman, *Choice and Utility*, 1979 WIS. L. REV. 769; Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563 (1982).

213. See *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 597 (1991) (Stevens, J., dissenting).

214. See Cohen & Dayton, *supra* note 41, at 266 (referring to the long history of arbitration to settle commercial disputes, going back to business disputes during the medieval period).

215. See E.C. Weiss, *Arbitration in Germany*, 43 LAW Q. REV. 205, 205-06 (1927).



resolution since the fourteenth century, if not before.<sup>216</sup> Early forms of arbitration were dispute resolution procedures created and administered by trade groups—merchant or producer communities.<sup>217</sup> These groups set norms of conduct and business standards for members of a trade or a business community, and they established procedures whereby respected members of the community resolved disputes between members.<sup>218</sup> Disputes often blended allegations of contractual breaches with allegations of breaches of customary practices of the trade.<sup>219</sup> In the arbitration, community elders were expected to resolve the dispute by drawing on the formal and informal norms of the community.<sup>220</sup>

The craft guilds in sixteenth-century Europe had a well-defined role within the legal order. Nation-states delegated authority to the guilds to set standards for labor productivity, work quality, and norms of conduct for members of their crafts.<sup>221</sup> The national legal systems also delegated to them the authority to resolve disputes regarding enforcement of contracts and norms between members of the community and to apply sanctions such as fines and exclusion from the trade.<sup>222</sup>

In England from the seventeenth century onward, many mercantile disputes were resolved by arbitration conducted by the merchant and craft guilds.<sup>223</sup> The merchant guilds established arbitration tribunals because they felt that the courts were not sufficiently knowledgeable about commercial customs and were

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216. See *Red Cross Line v. Atlantic Fruit Co.*, 264 U.S. 109, 120-25 (1924) (discussing the history of arbitration); Harry Baum & Leon Pressman, *The Enforcement of Commercial Arbitration Agreements in the Federal Courts*, 8 N.Y.U. L.Q. 238, 239 & n.3 (1930). Holdsworth reports evidence of arbitration practiced by merchants in England in the medieval period. See 14 SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 187 (1964).

217. See H.W. ARTHURS, "WITHOUT THE LAW": ADMINISTRATIVE JUSTICE AND LEGAL PLURALISM IN NINETEENTH-CENTURY ENGLAND 50-54 (1985).

218. See *id.* at 63-67.

219. See SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 92-96 (3d ed. 2d prtg. 1966).

220. See ARTHURS, *supra* note 217, at 63-67.

221. See JAMES R. FARR, HANDS OF HONOR: ARTISANS AND THEIR WORLD IN DIJON, 1550-1650, at 16-19 (1988).

222. For examples of the adjudicatory power of the English guilds, see Sabra A. Jones, *Historical Development of Commercial Arbitration in the United States*, 12 MINN. L. REV. 240, 243-45 (1928).

223. See 5 HOLDSWORTH, *supra* note 219, at 130; 6 SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 635 (2d ed. 2d prtg. 1966); Baum & Pressman, *supra* note 216, at 239.

excessively slow and cumbersome.<sup>224</sup> The arbitration tribunals were composed of experts in the trade, who applied the usages and practices of the trade as their source of law.<sup>225</sup> Later, these informal tribunals were reorganized by the trade associations, together with the municipal authorities, and became the London Court of Arbitration, which is jointly managed by the London Chamber of Commerce and the City of London.<sup>226</sup>

In nineteenth-century Germany, courts of arbitration were established by the stock exchanges of the city-states, the chambers of commerce, and the local associations of dealers in coffee, colonial products, and other items.<sup>227</sup> These courts used panels of merchants from the trade group to decide internal disputes on the basis of norms of the trade and without regard to legal standards.<sup>228</sup> Often the sanctions they imposed were also outside the law, such as the sanction of blacklisting the disobedient party.<sup>229</sup>

The use of private arbitration in the United States has a similar history. In the colonial period, arbitration was used within a common industry in a particular locality to settle internal disputes.<sup>230</sup> For example, the New York Chamber of Commerce set up an arbitration system in 1768 in order to "sett[e] business disputes according to trade practice rather than legal principles,"<sup>231</sup> and it is considered the oldest surviving arbitration committee in the United States.<sup>232</sup>

In the late nineteenth and early twentieth century, arbitration in the United States expanded along with the growth of trade associations. In 1927, the American Arbitration Association's *Year Book on Commercial Arbitration in the United States* listed over 1000 trade associations that had systems of arbitration for their members.<sup>233</sup> Most of the arbitration systems utilized a panel of

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224. See 5 HOLDSWORTH, *supra* note 219, at 130.

225. See 5 *id.*

226. See Cohen & Dayton, *supra* note 41, at 280.

227. See Weiss, *supra* note 215, at 206.

228. See *id.*

229. See *id.* at 206-07.

230. See Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1095 (1993).

231. LINDA R. SINGER, *SETTLING DISPUTES: CONFLICT RESOLUTION IN BUSINESS, FAMILIES, AND THE LEGAL SYSTEM* 5 (1990).

232. See Nathan Isaacs, *Two Views of Commercial Arbitration*, 40 HARV. L. REV. 929, 934-35 (1927); see also NATIONAL INDUSTRIAL CONFERENCE BOARD, *TRADE ASSOCIATIONS: THEIR ECONOMIC SIGNIFICANCE AND LEGAL STATUS* 278 (1925) (describing the influence of the New York Chamber of Commerce in encouraging the use of arbitration procedures).

233. See AMERICAN ARBITRATION ASSOCIATION, *YEAR BOOK ON COMMERCIAL*

arbitrators drawn from the trade association's membership<sup>234</sup> and counseled the arbitrators to apply their knowledge of the trade to bring about an equitable resolution to the dispute.<sup>235</sup>

One example of such an arbitration system is the New York City Cotton Textile Merchants Association (the "Association"). In the early twentieth century, the Association developed standardized rules for its trade that were later codified as the Worth Street Rules.<sup>236</sup> The Rules set detailed product standards for the trade, including standards for shrinkage, color-fastness, tensile strength, identification of blended fabrics, and so forth.<sup>237</sup> In addition, the rules set out detailed arbitration procedures.<sup>238</sup> The Association urged all members to insert language in their contracts stating: "Any controversy arising under, or in relation to, this contract shall be settled by arbitration."<sup>239</sup> The Worth Street Rules contemplated that arbitrators would apply not merely contractual terms but industry norms as defined by the Rules themselves.<sup>240</sup> According to the

ARBITRATION IN THE UNITED STATES (1927).

234. See, e.g., *Arbitration Plan of the Food Trade*, in SELECTED ARTICLES ON COMMERCIAL ARBITRATION 115, 116 (Daniel Bloomfield ed., 1927) (directing that the arbitration panel is to be two wholesale grocers and one broker or two brokers and one wholesale grocer); *National-American Wholesale Lumber Association Inc.*, in SELECTED ARTICLES ON COMMERCIAL ARBITRATION, *supra*, at 123, 126 (directing that arbitration panels consist of three people selected from a list of six that contains at least three members of the trade association).

235. For example, the *National Dried Fruit Association Rules for Arbitration* state: "Arbitrators should proceed on the one great principle of exact equity as between the parties. Technical breaches of the letter of an agreement where its spirit has been observed and no resulting damage is shown, should be disregarded." *Arbitration Plan of the Food Trade*, *supra* note 234, at 120.

236. See WORTH STREET RULES (rev. ed. 1964); Frederic P. Houston, *Textile Transactions*, in ARBITRATION: COMMERCIAL DISPUTES, INSURANCE, AND TORT CLAIMS, *supra* note 161, at 145, 147-49.

237. WORTH STREET RULES, *supra* note 236, t 18-25, 99-128.

238. Under the Worth Street Rules, arbitrators are drawn from an "official panel of arbitrators" compiled by the General Arbitration Council of the Textile Industry ("the Council"). *Id.* at 38. This list includes, but is not limited to, "selected members of the various divisions of the textile industry represented in the Council." *Id.* at 37. A single arbitrator selected by the parties can hear disputes. See *id.* at 38. However, if the parties cannot agree on an arbitrator, a dispute between two parties is heard by a panel of three arbitrators, and a dispute among three parties is heard by a panel of five arbitrators. See *id.*

The Rules provide for privacy of the proceeding, and for the exclusion of irrelevant material. See *id.* at 34. The Rules also set out a standard form for the submission and for the acknowledgment of the award. See *id.* at 35. In addition, the Rules provide that each side shall be responsible for any expenses of its own witnesses. See *id.* at 40.

239. *Id.* at 3. For a description of the arbitration procedure, see *id.* at 32-42.

240. See *id.* at 42 ("Arbitrators shall apply these Rules in the manner best calculated to obtain a just and speedy determination of the controversy.")

drafters, the Rules “have come to be recognized as the standard code of procedure and trade custom applicable to the purchase and sale of cotton textiles and allied lines.”<sup>241</sup>

### B. *Arbitration Under the Common Law in the Nineteenth Century*

Despite the proliferation of arbitration in commercial communities in the United States in the late nineteenth and early twentieth century, arbitration remained outside of and in tension with the legal system. Common law courts would not grant specific performance on agreements to arbitrate because they said agreements to arbitrate were revocable by either party until the arbitral award was rendered.<sup>242</sup> According to the “revocability doctrine,” the arbitrator was an agent of the parties acting jointly, so that the agency agreement could be revoked by either party at any time before an arbitral award.<sup>243</sup> Thus, if one party to an arbitration agreement refused to arbitrate, the other party was powerless to compel arbitration, or to obtain a stay of litigation if the other side brought suit in court. In most states, the party seeking arbitration could go to court for damages for breach of the promise to arbitrate, but the courts awarded only nominal amounts—at most the cost of preparing for the arbitration that never occurred.<sup>244</sup> Thus, a party seeking to arbitrate had no effective remedy against a party who refused to abide by an arbitration agreement.<sup>245</sup>

The American doctrine of revocability had its origins in English arbitration law and is thought to have originated in a 1609 decision by

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241. *Id.* at 3. The arbitration provisions of the Worth Street Rules were published in 1921 under the title *Commercial Arbitration as Conducted by the Committee on Arbitration of the Association of Cotton Textile Merchants of New York*. See AMERICAN ARBITRATION ASSOCIATION, *supra* note 233, at 205-09.

242. See, e.g., *In re Smith & Service*, 25 L.R. 545, 547 (Q.B.D. 1890) (“A Court of Equity had no power to decree specific performance of an agreement to refer to arbitration . . .”).

243. See 14 HOLDSWORTH, *supra* note 216, at 190.

244. See Baum & Pressman, *supra* note 216, at 242-43. The federal courts followed the state common law rule. See *Aktieselskabet Korn-Og Foderstof Kompagniet v. Rederiaktiebolaget Atlanten*, 250 F. 935, 937 (2d Cir. 1918); Baum & Pressman, *supra* note 216, at 244.

245. While common law courts would not grant specific enforcement to a promise to arbitrate, once an arbitration was held and an award was rendered, most courts would enforce it. See *Brazill v. Isham*, 12 N.Y. 9, 14 (1854) (dismissing the trial court judgment in favor of a valid arbitral award); *Reizenstein v. Hahn*, 12 S.E. 43, 44 (N.C. 1890) (affirming the lower court’s enforcement of an arbitration award). At common law, arbitral awards were binding, and in many jurisdictions they could be converted into a judgment of the court. See *Red Cross Line v. Atlantic Fruit Co.*, 264 U.S. 109, 121-23 (1924).

Lord Coke in *Vynior's Case*.<sup>246</sup> This case involved the enforcement of a bond to ensure compliance with arbitration procedures that the parties had established.<sup>247</sup> The King's Bench enforced the bond, but Lord Coke stated, in dicta, that the promise to arbitrate established a revocable agency relationship with the arbitrator.<sup>248</sup> This dicta became the basis for the revocability doctrine.<sup>249</sup>

The revocability doctrine was not particularly problematic for the early merchant craft guilds because they could, like the plaintiff in *Vynior's Case*, include a hefty bond that would be forfeited by any party resisting arbitration. In 1697, however, Parliament enacted the Statute of Fines and Penalties, which forbade the use of penalty bonds to remedy a breach of contract.<sup>250</sup> Thereafter, a party with an arbitration clause could only sue for damages for its breach—damages that were at best a nominal amount to compensate for the expense of preparing for arbitration.<sup>251</sup> At that point, parties who wanted to enforce arbitration agreements needed to obtain specific performance, and for that the revocability doctrine was a serious obstacle.

Gradually, with a series of enactments beginning at the end of the eighteenth century and continuing throughout the nineteenth century, the English Parliament abandoned the revocability doctrine.<sup>252</sup> The earliest of these statutory measures enabled parties to make arbitration submissions a Rule of Court, for which noncompliance was punishable by contempt. The English arbitration act of 1854,<sup>253</sup> also known as the Common Law Procedure Act, provided that parties were entitled to judicial review of arbitral decisions on issues of law,<sup>254</sup> and in 1889, Parliament enacted a statute making all agreements to arbitrate future or present disputes irrevocable, "except by leave of a court or judge."<sup>255</sup>

246. 77 Eng. Rep. 595 (K.B. 1609).

247. The imprint of *Vynior's Case* on the revocability doctrine is widely acknowledged. See, e.g., JULIUS HENRY COHEN, *COMMERCIAL ARBITRATION AND THE LAW* 53-55 (1918).

248. See *id.* at 92-95.

249. For a detailed explication of *Vynior's Case*, see *id.* at 84-102.

250. See Statute of Fines and Penalties, 8 & 9 Will. 3, ch. 11, § 8 (1697) (Eng.); 12 SIR WILLIAM HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 519-20 (2d prt. 1966).

251. See COHEN, *supra* note 247, at 150-51.

252. For a concise history of the nineteenth century English statutes about arbitration, see 14 HOLDSWORTH, *supra* note 216, at 196-98.

253. 17 & 18 Vict., ch. 125, § 5 (1854) (Eng.).

254. See Soia Mentschikoff, *Commercial Arbitration*, 61 COLUM. L. REV. 846, 855-56 (1961).

255. Arbitration Act, 1889, 52 & 53 Vict., ch. 49, § 1 (Eng.).

In America, by contrast, the revocability doctrine held firm throughout the nineteenth century. There were two quite different justifications offered for it. The first was that parties are not competent, by private contract, to “oust the court of jurisdiction.”<sup>256</sup> The “ouster” rationale for the doctrine actually originated in England, but quickly took firm hold in both federal and state courts in the United States.<sup>257</sup> For example, the Supreme Court stated in 1874 in *Insurance Co. v. Morse*:<sup>258</sup> “Agreements in advance to oust the courts of the jurisdiction conferred by law are illegal and void.”<sup>259</sup> It further stated that parties could neither create nor diminish the jurisdiction of the courts by contract.<sup>260</sup> The ouster rationale became the primary explanation for U.S. courts’ refusal to grant specific performance to agreements to arbitrate.<sup>261</sup>

There was another rationale articulated for the courts’ stance on arbitration in the nineteenth century. In *Tobey v. County of Bristol*,<sup>262</sup> Justice Story explained that while a court of equity had no objections to arbitration tribunals, it would not compel parties to participate in an arbitration because it could not ensure that the process would be fair and equitable. He stated:

[W]hen [courts of equity] are asked to proceed farther and to compel the parties to appoint arbitrators whose award shall be final, they necessarily pause to consider, whether such tribunals possess adequate means of giving redress, and whether they have a right to compel a reluctant party to submit to such a tribunal, and to close against him the doors of the common courts of justice, provided by the government to protect rights and to redress wrongs. One of

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256. See, e.g., *U.S. Asphalt Ref. Co. v. Trinidad Lake Petroleum Co.*, 222 F. 1006, 1008 (S.D.N.Y. 1915) (discussing the “oust the jurisdiction” rationale for opposing private arbitration agreements).

257. See COHEN, *supra* note 247, at 153-69 (tracing the history of the “oust the jurisdiction” doctrine in England and America); see also 14 HOLDSWORTH, *supra* note 216, at 190 (describing the common law rule that a party to an arbitration can end the arbitration before an award is given as a precursor to the “oust the jurisdiction” doctrine). See generally Hirschman, *supra* note 42, at 1310 & n.27 (citing cases).

258. 87 U.S. (20 Wall.) 445 (1874).

259. *Id.* at 451; see also *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 985 (2d Cir. 1942) (describing and criticizing the “oust the court of jurisdiction” doctrine).

260. See *Morse*, 87 U.S. (20 Wall.) at 451.

261. See Hirschman, *supra* note 42, at 1310-11 & n.29 (noting tension between the revocability doctrine and the ouster rationale but finding that the practical outcome was the same—both meant that “one party to an arbitration agreement could not use the court system to compel arbitration”).

262. 23 F. Cas. 1313, 1320-21 (C.C.D. Mass. 1845) (No. 14,065).

the established principles of courts of equity is not to entertain a bill for the specific performance of any agreement where it is doubtful whether it may not thereby become the instrument of injustice, or to deprive parties of rights which they are otherwise fairly entitled to have protected.<sup>263</sup>

Despite this alternate rationale, by the 1920s, the ouster-of-jurisdiction explanation for the revocability doctrine became the dominant, if not universal, understanding of arbitration law.<sup>264</sup> Story's view—that the courts disapproved of executory promises to arbitrate because they wanted to ensure a fair hearing—was almost totally forgotten or ignored.<sup>265</sup> Thus narrowed in its interpretation, the revocability doctrine became a straw man that courts and commentators set out to attack.

### C. *Arbitration and the Rise of Trade Associations*

In the early twentieth century, the commercial bar in New York initiated a campaign to overturn the common law rule of revocability.<sup>266</sup> Commercial lawyers saw arbitration as essential to enable the business community to resolve disputes quickly, and they wanted the courts to facilitate rather than thwart its use. As one prominent commercial lawyer explained, businessmen have no quarrel with the common law rules, but they want "speedy determination of the facts and then a prompt determination of their rights under the facts as found."<sup>267</sup> Businessmen also wanted their disputes to be resolved by insiders to the trade. As one contemporary lawyer said, arbitration offered "a proceeding which would provide a decision by experts well versed in the facts of the dispute. It was cheap; it was friendly; it was private; it was

263. *Id.* at 1321. Story further enumerated the many due process failings of arbitration in the passage quoted at the outset of this Article. He ended with the question: "Ought then a court of equity to compel a resort to such a tribunal by which, however honest and intelligent, it can in no case be clear that the real legal or equitable rights of the parties can be fully ascertained or perfectly protected?" *Id.*

264. See, e.g., FRANKLIN D. JONES, TRADE ASSOCIATION ACTIVITIES AND THE LAW 193-94 (1922); Baum & Pressman, *supra* note 216, at 240; Joseph Wheless, *Arbitration as a Judicial Process of Law*, 30 W. VA. L.Q. 209, 214-15 (1924).

265. See Paul L. Sayre, *Development of Commercial Arbitration*, 37 YALE L.J. 595, 609 (1927). One of the few commentators to note Story's view and to argue that it presented a principled rationale for the revocability doctrine was Charles Newton Hulvey. See Charles Newton Hulvey, *Arbitration in Commercial Disputes*, 15 VA. L. REV. 238, 242-43 (1928).

266. See Charles L. Bernheimer, *Introduction to COHEN, supra* note 247, at vii-xii.

267. COHEN, *supra* note 247, at 1, 3.

businesslike; it was convenient."<sup>268</sup>

The impetus for changing the law of arbitration in the early twentieth century was closely connected with the rise of trade associations.<sup>269</sup> Trade associations had been a feature of American life since the colonial era, but in the late nineteenth and early twentieth century new trade associations formed at unprecedented rates.<sup>270</sup> Bankers, hardware dealers, lumbermen, textile manufacturers, canners, tobacco manufacturers, and the like came together to form local, regional, and national associations. The National Industrial Conference Board issued a report on trade associations in 1925 that found there were between 800 and 1000 national trade organizations in the United States, most of which had been formed since the 1890s.<sup>271</sup> When local and state trade associations were added, the Department of Commerce estimated that there were some 2000 state and 7700 local associations.<sup>272</sup> The trade associations themselves combined to form state associations and state chambers of commerce, and in 1914 they formed the United States Chamber of Commerce.<sup>273</sup>

Trade associations set industry standards for production and devised form contracts to standardize terms of dealings between members of a trade.<sup>274</sup> Such standardized practices were seen as a way to minimize commercial disputes and achieve certainty and order in the anarchic world of competitive trade.<sup>275</sup> For the same reasons, trade associations established their own internal arbitration systems to resolve disputes between association members.<sup>276</sup>

The growth of commercial arbitration went hand in hand with

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268. Philip G. Phillips, *The Paradox in Arbitration Law: Compulsion as Applied to a Voluntary Proceeding*, 46 HARV. L. REV. 1258, 1261 (1933); see also Wheless, *supra* note 264, at 210-11 (stating that arbitration is the "most effective mode yet devised" to avoid the "law's delays"). It is interesting to note that these virtues—speed, expertise, accessibility, affordability, and confidentiality—are the same that are touted today in defense of expanding the domain of arbitration.

269. See, e.g., Martin Gang, *Commercial Arbitration in California*, 15 CAL. L. REV. 289, 292-99 (1927) (discussing trade associations and the movement to obtain judicial support for arbitration in California).

270. See NATIONAL INDUSTRIAL CONFERENCE BOARD, *supra* note 232, at 11-13.

271. See *id.* app. at 326. All data on numbers of trade associations involve imprecise estimates due to problems of definition and double-counting. See *id.* app. at 319-26.

272. See *id.* app. at 325-26.

273. See ROBERT H. WIEBE, *BUSINESSMEN AND REFORM: A STUDY OF THE PROGRESSIVE MOVEMENT 18-25* (1962).

274. See NATIONAL INDUSTRIAL CONFERENCE BOARD, *supra* note 232, at 276.

275. See *id.* at 275-76.

276. See *id.* at 276-77; see also JONES, *supra* note 264, at 194-95 & n.2 (listing some of the national trade associations that had adopted arbitration systems as of 1922).



the explosive growth of trade associations in the 1920s. By 1927, the American Arbitration Association compiled information on over 1000 trade associations that had systems of arbitration for their members.<sup>277</sup> These internal arbitration systems were designed to resolve disputes over contract interpretation and industry standards.<sup>278</sup> They were means to achieve uniformity, articulate ethics, and police malfeasance among trading partners. One advocate noted that arbitration was integral to the mission of trade associations because it facilitated uniform enforcement of industry standards and at the same time dispersed knowledge of trade standards and evolving trade customs to members of the trade.<sup>279</sup> Arbitration was also praised for its ability to resolve disputes between trade association members in a manner that preserved the cohesiveness of the organization.<sup>280</sup> Arbitration, it was said, could restore confidence, promote trust, and keep business running smoothly.<sup>281</sup> It created goodwill between members in an association and between the industry and the rest of society.<sup>282</sup> Trade-association arbitrations were touted as proceedings with fewer technicalities, "much more with an aim to homespun justice, than . . . actions in the courts."<sup>283</sup> For these reasons, some contemporaries claimed that the availability of arbitration was the most valuable feature of trade-association membership.<sup>284</sup>

Early twentieth century trade associations urged and even sometimes required their members to use form contracts with a standard arbitration clause for their business transactions.<sup>285</sup> In these standard clauses, parties agreed to use an industry-specific arbitration system to adjudicate all disputes.<sup>286</sup> The characteristic trade-association arbitration was an informal proceeding headed by a respected member of the trade group in which the "elder" would resolve disputes between group members on the basis of the norms,

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277. See AMERICAN ARBITRATION ASSOCIATION, *supra* note 233.

278. See Mentschikoff, *supra* note 254, at 852-53.

279. See JONES, *supra* note 264, at 196.

280. See *id.* at 196-97.

281. See FRANCES KELLOR, *ARBITRATION IN THE NEW INDUSTRIAL SOCIETY* 14 (1934).

282. See *id.* at 29-30; see also JONES, *supra* at 264, at 197 (stating that "arbitration [is] a conservator of good will and preserver of prosperity").

283. Cohen & Dayton, *supra* note 41, at 279-80.

284. See JONES, *supra* note 264, at 197.

285. See Harlan F. Stone, *The Scope and Limitation of Commercial Arbitration*, PROC. ACAD. POL. SCI. CITY N.Y., July 1923, at 195, 195-96.

286. See Mentschikoff, *supra* note 254, at 849; Philip G. Phillips, *Commercial Arbitration Under the N.R.A.*, 1 CHI. L. REV. 424, 426-27 (1933).

customary practices, and unstated understandings of the community.<sup>287</sup>

*D. The New York City Chamber of Commerce's Campaign to Overturn the Revocability Doctrine*

As the trade association movement picked up momentum in the early years of the twentieth century, business leaders and their lawyers mounted pressure to eliminate the revocability doctrine and make agreements to arbitrate enforceable by specific performance. They were reinforced in their determination by a 1915 decision of Judge Charles Hough in *U.S. Asphalt Refining Co. v. Trinidad Lake Petroleum Co.*,<sup>288</sup> in which the court criticized the revocability doctrine and stated that there was no reasoned basis for it other than stare decisis.<sup>289</sup> The *U.S. Asphalt Refining* decision emboldened the New York Chamber of Commerce to initiate a concerted effort to reverse the revocability doctrine.<sup>290</sup> It commissioned a well-known commercial lawyer, Julius Henry Cohen, to represent the Chamber as amicus curiae in another pending case, *Spiritusfabriek Astra v. Sugar Products Co.*, in which the plaintiff was challenging the revocability doctrine and seeking to enforce an arbitration agreement.<sup>291</sup>

Cohen's first-hand knowledge of arbitration dated back to 1910, when he helped frame the Protocols of Peace for the New York City ladies' garment industry that settled the 1910 city-wide strike.<sup>292</sup> Cohen was then counsel for the garment industry employers' association. Together with Louis D. Brandeis, who was special counsel for the International Ladies' Garment Workers Union, Cohen helped design an arbitration system to resolve disputes in the garment industry and to avoid industrial strife in the future. The Protocols established a permanent Board of Arbitration, made up of representatives of the union, employers, and the public, who were empowered to settle grievances and disputes.<sup>293</sup> Five years later, Cohen wrote a book about the arbitration system of the Protocols, crediting it with bringing labor peace, better working conditions, and industrial democracy to American industry.<sup>294</sup>

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287. See *supra* notes 234-35 and accompanying text.

288. 222 F. 1006 (S.D.N.Y. 1915).

289. See *id.* at 1008.

290. See Bernheimer, *supra* note 266, at xi-xii.

291. See *id.* at xi.

292. See JULIUS HENRY COHEN, *LAW AND ORDER IN INDUSTRY* at xii (1916).

293. See *id.* at 32-38.

294. See *id.* at 229-41.

After 1910, Cohen moved into the field of commercial arbitration with zeal. He was a member of the Committee on Arbitration of the New York Chamber of Commerce, and he frequently lectured on the subject to professional groups.<sup>295</sup> He expanded his 1916 brief in the *Spiritusfabriek Astra* case into a book-length treatise called *Commercial Arbitration and the Law*,<sup>296</sup> that advocated the repeal of the revocability doctrine.<sup>297</sup>

Cohen's book was a carefully crafted argument for making commercial arbitration agreements specifically enforceable. It began with a detailed history of the use of commercial arbitration in England and the United States dating back to colonial times.<sup>298</sup> Cohen quoted an editorial in the *London Times* from 1891 describing the role of trade experts in deciding disputes:

"Long before 1883 there had grown up a class of arbitrators who, with all their shortcomings, were expeditious and acquainted first-hand with the subject-matter of dispute. All their lives they had handled the cotton, wool, or seeds over which the parties were quarreling. They had written, made advances, bought and sold upon the documents, the construction of which was in question. They had obeyed, perhaps helped to form, the trade customs to which the disputants appealed. That class of experts has increased. Their skill has grown with experience, and it is altogether too late to think of ousting them."<sup>299</sup>

He then quoted a contemporary report of the American Judicature Society prepared by Samuel Rosenbaum, who wrote: "What was true in 1891 is even more true in 1916, and every business has its expert arbitrators, generally older and seasoned veterans who were in the thick of the fight for years and retired to make way for the younger men."<sup>300</sup>

Cohen then presented a detailed and careful discussion of the twists and turns of the common law revocability rule, taking issue

295. See 1924 NATIONAL CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS PROCEEDINGS 82-83 (1924) [hereinafter 1924 PROCEEDINGS] (providing the address of Julius Henry Cohen to the Conference regarding the proposed Uniform Arbitration Act).

296. See COHEN, *supra* note 247, at xv (explaining his decision to expand his brief into a treatise).

297. See *id.* at xiii-xiv.

298. See *id.* at 1-9.

299. COHEN, *supra* note 247, at 8 (quoting Editorial, TIMES (London), May 8, 1891, at 9).

300. *Id.* at 8-9 (quoting SAMUEL ROSENBAUM, AMERICAN JUDICATURE SOC'Y, BULLETIN XII: COMMERCIAL ARBITRATION IN ENGLAND 53 (1917)).

with Lord Coke's logic in *Vynior's Case*.<sup>301</sup> He argued that there were errors in Lord Coke's reasoning and in the subsequent treatment of *Vynior's Case* by later judges. After thoroughly criticizing the errors of the revocability doctrine and extolling the virtues of commercial arbitration, Cohen concluded by asking: "Why should such a movement be hampered by the continuance of a rule unsound in public policy, bad in legal theory, obsolete historically and unsupported by sound legal precedent? . . . [I]f repudiation of one's promise to arbitrate is . . . *immoral*, why continue to lend legal sanction to it?"<sup>302</sup>

While *Commercial Arbitration and the Law* was a masterful combination of ancient common law analysis and contemporary policy argument, it was misleading in several respects. First, Cohen described the courts' justification of the revocability rule as grounded solely on the "oust the courts of jurisdiction" rationale.<sup>303</sup> He argued that the ouster rationale was altogether specious because there were many instances in our legal system in which parties were permitted to select the courts in which their cases were tried or even were permitted to take their cases away from courts altogether, such as choice-of-law clauses and parties' own pre-trial settlements.<sup>304</sup> Cohen also impugned the ouster doctrine by suggesting that it originated in the days when judges relied on fees from the cases they decided.<sup>305</sup> He thus explained the doctrine as a product of judicial self-interest and turf protection, goals hardly worth preserving.<sup>306</sup> Having disposed of the ouster theory of the revocability doctrine, Cohen rested his case.

Cohen's argument appeared stronger than it was because he misstated Story's position on the revocability doctrine. Rather than presenting Story's views fully, he utilized selective quotations from the *Tobey* case to characterize Story's position as simply another example of the ouster argument.<sup>307</sup> Thus Cohen never tackled the argument that common law courts have an obligation to ensure that fair procedures are in place before ordering parties to submit to them. One result of Cohen's work was that later writers proceeded

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301. See *supra* notes 246-49 (discussing *Vynior's Case*).

302. COHEN, *supra* note 247, at 281.

303. See *id.* at 153.

304. See *id.* at 16-18.

305. See *id.* at 254.

306. But see Hulvey, *supra* note 265, at 242 (arguing that attributing the revocability doctrine to judges' fear that they would lose their fees is "unfair" and "not justified").

307. See COHEN, *supra* note 247, at 250-52.

as Cohen did, merely attacking and debunking the "oust the jurisdiction" argument and ignoring Story's fundamental fairness argument altogether.<sup>308</sup>

Cohen's book became the manifesto of the commercial community in its battle to reverse the revocability doctrine.<sup>309</sup> As one contemporary said of it:

No fruitful union of legal finality and business practice in this connection could be brought about here until it was shown that Coke was wrong. Coke was finally unhorsed by Julius Henry Cohen . . . whose researches in black-letter texts of Norman-French decisions proved that Coke did not know his common law as well as modern lawyers.<sup>310</sup>

The book was followed by an avalanche of pleas from the commercial law community urging courts and legislatures to change the law of arbitration. In the following years, the New York Chamber of Commerce joined with the New York Bar Association to propose a statute to the New York legislature to change the common law rule. The statute, which Cohen drafted, was patterned on the English arbitration law of 1889,<sup>311</sup> with one significant difference: the proposed New York law did not contain a provision for de novo judicial review of questions of law.<sup>312</sup> This difference was not accidental, for the New York Chamber of Commerce vehemently opposed any judicial review of arbitral awards.<sup>313</sup>

In 1920, Cohen's bill passed the New York legislature and became the New York Arbitration Act.<sup>314</sup> The New York statute made arbitration agreements "valid, irrevocable, and enforceable save on such grounds as exist at Law or in Equity for the revocation of any contract."<sup>315</sup> The New York statute served as a template for

308. See *Kulukundis Shipping v. Amtorg Trading Corp.*, 126 F.2d 978, 983 (2d Cir. 1942); see also *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 220 n.6 (quoting the legislative history of the FAA to show that Congress wanted to repudiate the ouster doctrine when it enacted the FAA in 1925).

309. See, e.g., Bernheimer, *supra* note 266, at xi-xii.

310. *Business and Law Join in Arbitration*, 115 INDEPENDENT 725, 725 (1925), quoted in Phillips, *supra* note 268, at 1259 n.9.

311. Arbitration Act, 1889, 52 & 53 Vict., ch. 49, § 1 (Eng.); *supra* text accompanying note 255.

312. The subsequent federal law also failed to provide for de novo review of questions of law, as is found in the English law. See *Wilko v. Swan*, 346 U.S. 427, 437 (1953), overruled by *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477 (1989).

313. See Isaacs, *supra* note 232, at 934-35.

314. 1920 N.Y. Laws ch. 275, § 2 (current version at N.Y. C.P.L.R. 7501-7514 (McKinney 1998 & Supp. 1999)).

315. N.Y. Civil Practice Act § 1448 (1920).

the Federal Arbitration Act, enacted five years later.

In a 1921 article in the *Yale Law Journal*, Cohen responded to critics who had expressed concern that the statute would permit stronger parties to take advantage of weaker ones.<sup>316</sup> In defense of the statute, Cohen gave a misleading but telling description of its provisions. He described the new statute as preserving a significant role for the courts in policing arbitration.<sup>317</sup> For example, he noted that if the existence of a valid contract were in dispute, then under § 3 of the statute either party could request a jury trial on that issue.<sup>318</sup> While this result may have been his intent as drafter of the statute, it has been interpreted differently.<sup>319</sup> In addition, Cohen said that under the New York statute, arbitral awards may be vacated for “fraud, corruption, partiality, *mistake*, or similar misconduct, or if the arbitrators have exceeded their jurisdiction or made an imperfect award.”<sup>320</sup> Today, neither mistake of fact nor mistake of law is a ground to vacate an arbitral award,<sup>321</sup> nor was it in Cohen’s time.<sup>322</sup> Rather, in 1930, one scholar wrote in the *Harvard Law Review* that “it is universally true that the findings of the arbitrators with respect to fact are final and will not be reviewed by the courts.”<sup>323</sup>

Cohen also stated in his 1921 article that under the New York statute, “[t]he award may then be enforced as a judgment, and as such, an appeal may be taken from it. And, similarly, from an order

316. See Julius Henry Cohen, *The Law of Commercial Arbitration and the New York Statute*, 31 *YALE L.J.* 147 (1921).

317. See *id.* at 149.

318. See *id.*

319. Under the contemporary legal framework of arbitration, issues of contract validity are determined by the arbitrator, unless there is a challenge not to the validity of the entire contract but merely to the validity of the arbitration clause. See *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 401 (1967) (interpreting an equivalent clause in the FAA). Even the early case, *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978 (2d Cir. 1942), made the question of the existence of a valid contract a matter for a judge and not a jury question under the FAA. See *id.* at 985.

320. Cohen, *supra* note 316, at 149 (emphasis added).

321. See, e.g., *Sims v. Siegelson*, 668 N.Y.S.2d 20, 22 (App. Div. 1998).

322. See, e.g., *Cobb v. Dolphin Mfg. Co.*, 15 N.E. 438, 440-41 (N.Y. 1888) (refusing to overturn an arbitrator’s award so long as it was “just and equitable,” as required by the parties arbitration agreement); *Hano v. Isaac H. Blanchard Co.*, 199 N.Y.S. 227, 230 (App. Div. 1922) (holding that “a court of law possesses no supervisory jurisdiction” on issues such as “the partiality, corruption, or misbehavior of the arbitrator, or fraud extraneous to the award”); *D. Goff & Sons v. Rheiauer*, 192 N.Y.S. 92, 94 (App. Div. 1922) (“[I]n the absence of fraud, corruption, or misconduct of the arbitraors, . . . their finding will not be disturbed.”); *Itoh & Co. v. Boyer Oil Co.*, 191 N.Y.S. 290, 292 (App. Div. 1921) (“[A]ny finding of fact or conclusion of law of an arbitrator will not be reviewed.”).

323. Phillip G. Phillips, *Rules of Law or Laissez-Faire in Commercial Arbitration*, 47 *HARV. L. REV.* 590, 598 (1930).

vacating an award the right of appeal is preserved."<sup>324</sup> This statement too is an incorrect description of the law of arbitration then and now. Under both the New York and federal statutes, there is no appeal of the merits of arbitral rulings to a court; there is only the possibility of a motion to vacate based on the narrow statutory grounds or for "manifest disregard of the law."<sup>325</sup>

Cohen summed up his defense of the New York statute by raising the specter of the discredited ouster argument. He stated that under the statute, "supervision of arbitrations by the court is preserved. Instead of being ousted of jurisdiction over arbitrations, the courts are given jurisdiction over them, and where fraud, palpable mistake, or failure to consider the evidence in the case is presented, the party aggrieved has his ready recourse to the courts."<sup>326</sup> Cohen's 1921 account of the New York statute describes a more expansive scope of judicial review of arbitral awards than has ever existed under the FAA or under the New York statute. It was his attempt to appease critics of the New York arbitration act who claimed that the statute was an evasion of due process.<sup>327</sup>

The New York Court of Appeals upheld the 1920 Act against a constitutional challenge in *In re Herman Berkovitz*.<sup>328</sup> Julius Cohen and Kenneth Dayton served as Counsel for the New York Chamber of Commerce, as amicus curiae. Judge Cardozo, writing for the court, held that the statute did not abrogate the right to a jury trial, did not subvert the "dignity and power" of the state court, nor did it impair the obligation of contract.<sup>329</sup> Comparing arbitration to a release or covenant not to sue, Cardozo held that arbitration was consistent with the public policy of the state.<sup>330</sup>

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324. Cohen, *supra* note 316, at 149.

325. Wilko v. Swan, 346 U.S. 427, 437-38 (1953), *overruled on other grounds by* Rodriguez de Quijas v. Shearson/Am. Express Inc., 490 U.S. 477 (1989).

326. Cohen, *supra* note 316, at 150.

327. To this effect, Cohen wrote:

[T]he rights of both parties are reasonably safeguarded, and no common-law or constitutional right to a jury trial or to the protection of the courts is taken from them, except so far as by their express agreement they themselves have provided that the arbitrators, instead of court and jury or court without jury, shall pass upon certain questions of fact better suited for decision by them than by strangers to the customs and practices of the trade.

*Id.* at 149-50.

328. 130 N.E. 288 (N.Y. 1921).

329. *Id.* at 290.

330. *See id.* at 291.

*E. From the New York Statute to the Federal Arbitration Act*

After the enactment of the New York arbitration statute, the Arbitration Society of America was formed to promote the use of arbitration in industry.<sup>331</sup> By 1924, over 1000 leading businesses and over sixty-five trade groups had joined, and the Society had decided over 500 arbitration cases.<sup>332</sup> This group, which later became the American Arbitration Association (“AAA”), advocated that parties include pre-dispute promises to arbitrate as standardized terms in their business dealings.<sup>333</sup> This simple device, they claimed, would “compel the parties to arbitrate.”<sup>334</sup> The AAA also drafted a model arbitration act—the “Draft Act”—which, like the New York statute, made agreements to arbitrate irrevocable and specifically enforceable.<sup>335</sup>

Within three years of the enactment of the New York statute, New Jersey and Massachusetts adopted similar measures.<sup>336</sup> By 1933, twelve states, including New Jersey and Massachusetts, had enacted the Draft Act.<sup>337</sup> Some states, however, resisted the New York approach on the ground that to enforce predispute arbitration agreements would permit stronger parties to coerce weaker ones.<sup>338</sup> They were also critical of the New York approach for its failure to provide judicial review on matters of law.<sup>339</sup> Illinois rejected the New York approach and enacted an arbitration law that permitted the

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331. See Wheless, *supra* note 264, at 228-30. In 1922, Columbia Law School Dean Harlan Stone reported:

Zeal for the arbitration principle which has hitherto been devoted to securing the enactment of legislation is now being . . . directed toward inducing merchants to make the widest use of arbitration as the simplest, the least expensive, the most expeditious and the most satisfactory method of disposing of controversies between business men.

Stone, *supra* note 285, at 195-96.

332. See AMERICAN ARBITRATION ASSOCIATION, *supra* note 233, at 1142-53 (listing businesses and trade groups).

333. See Wheless, *supra* note 264, at 231. The AAA standard arbitration clause was exceedingly broad, reading: “‘Any controversy or claim arising out of or relating to this contract or the breach thereof, shall be settled by arbitration, in accordance with the rules then obtaining, of the American Arbitration Association . . . .’” Phillips, *supra* note 268, at 1277 n.87 (quoting CODE OF ARBITRATION: PRACTICE AND PROCEDURE OF THE AMERICAN ARBITRATION TRIBUNAL 205 (Frances Keller ed., 1931)).

334. Wheless, *supra* note 264, at 231.

335. See Phillips, *supra* note 268, at 1264-65.

336. See *id.* at 1263.

337. See *id.* at 1262-63.

338. See 1924 PROCEEDINGS, *supra* note 295, at 69-70 (statement of W.H.H. Piatt, Commissioner from Missouri).

339. See *id.* at 63 (statement of Joseph F. O’Connell, Commissioner from Massachusetts).



enforcement of agreements to arbitrate that were made *after* the dispute arose.<sup>340</sup> Further, Illinois adopted the English rule of providing judicial review of arbitral awards on matters of law.<sup>341</sup> In 1924, after considerable internal debate between the two competing approaches, the Commissioners on Uniform State Laws rejected the New York approach and adopted the Illinois approach.<sup>342</sup>

Also in the early 1920s, the American Bar Association ("ABA") debated which type of arbitration law to recommend to the states. In 1921, it delegated the task of drafting a model state arbitration act to its Committee on Commerce, Trade and Commercial Law.<sup>343</sup> That Committee drafted a model bill that tracked the language of the New York statute. Despite the efforts of the Commissioners on Uniform State Laws to sway the ABA to the Illinois approach, the ABA opted in 1922 for the approach of its own Committee.<sup>344</sup>

In 1922, the ABA Committee on Commerce, Trade and Commercial Law also drafted a federal statute, the Commercial Arbitration Act, based on the New York statute, to submit to Congress.<sup>345</sup> Julius Cohen served on this committee and was the major drafter of both pieces of legislation.<sup>346</sup> In 1923, Congress held hearings on the proposed act. The ABA Committee revised the bill in 1923 and 1924 to accommodate congressional criticisms.<sup>347</sup> Then, in 1925, five years after the enactment of the New York statute, the United States Arbitration Act (later renamed the Federal Arbitration Act) passed both Houses of Congress unanimously.<sup>348</sup>

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340. See Act of June 11, 1917, 1917 Ill. Laws 202 (current version at 710 ILL. COMP. STAT. ANN. 5/1-22 (West 1992)); 1924 PROCEEDINGS, *supra* note 295, at 60 (statement of Hollis R. Bailey, Commissioner from Massachusetts).

341. See 1924 PROCEEDINGS, *supra* note 295, at 63 (statement of Joseph F. O'Connell, Commissioner from Massachusetts).

342. See *id.* at 163.

343. See Alfred N. Heuston, *The Settlement of Disputes by Arbitration*, 1 WASH. L. REV. 243, 244 & n.8 (1925); *Report of the Committee on Commerce, Trade and Commercial Law*, 46 REP. A.B.A. 309, 355 (1921).

344. See *Transactions of the Forty-Fifth Annual Meeting of the American Bar Association*, 47 REP. A.B.A. 19, 52-53 (1922); *Report of the Committee on Commerce, Trade and Commercial Law*, 47 REP. A.B.A. 288, 289, 318-21 (1922).

345. See *Report of the Committee on Commerce, Trade and Commercial Law*, *supra* note 344, at 289, 315-18.

346. See *id.* at 295.

347. See Jones, *supra* note 222, 249-50; Committee on Commerce, Trade and Commercial Law, *The United States Arbitration Law and its Applications*, 11 A.B.A. J. 153, 153 (1925).

348. See United States Arbitration Act of 1925, ch. 213, 43 Stat. 883 (codified as amended at 9 U.S.C. §§ 1-307 (1994)); Moses H. Grossman, *Trade Security Under Arbitration Laws*, 35 YALE L.J. 308, 312-13 n.9 (1925).

The United States Arbitration Act contained all the essential features, and most of the wording, of the New York Arbitration Act. Like the New York statute, the federal statute made agreements to arbitrate present or future disputes “valid, irrevocable, and enforceable”;<sup>349</sup> it provided that when there is a contract containing an arbitration clause, a court must stay litigation and grant specific performance of the promise to arbitrate;<sup>350</sup> and it provided only four narrow grounds for judicial review.<sup>351</sup>

F. *The Federal Arbitration Act and Herbert Hoover’s Associationalism*

The arbitration acts of the 1920s were not historical anomalies—they were part of a larger social and political ethos in the United States in the 1920s that is described as “associationalism.”<sup>352</sup> This new social philosophy had its origins in the trade association movement of the early twentieth century and picked up momentum during World War I.<sup>353</sup> During the war, private associations were given unprecedented governmental powers and authority.<sup>354</sup> The government turned to private sector associations, such as the Chamber of Commerce and the American Federation of Labor, to staff the war agencies and advisory boards.<sup>355</sup> The experience of “war guildism” gave rise to a new regulatory philosophy. As one contemporary scholar observed:

The unprecedented war demands changed entirely the attitude of the government toward trade associations. . . . Continuous contact between the agencies of demand and of supply was absolutely essential for the intelligent conduct of the war. But with the exceedingly rapid increase in the war

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349. United States Arbitration Act § 2.

350. *See id.* § 3.

351. *See id.* § 10; *see also supra* note 139 (listing the four grounds).

352. *See, e.g.,* Ellis Hawley, *Herbert Hoover, the Commerce Secretariat, and the Vision of an “Associative State,” 1921-1928*, 61 J. AM. HIST. 116, 118 (1974) (describing the trend towards associationalism and away from the old industrialism).

353. *See* RUDOLPH J.R. PERITZ, *COMPETITION POLICY IN AMERICA, 1888-1992: HISTORY, RHETORIC, LAW* 78 (1996); Ellis Hawley, *Three Facets of Hooverian Associationalism: Lumber, Aviation, and Movies, 1921-1930*, in *REGULATION IN PERSPECTIVE* 95, 97 (Thomas K. McGraw ed., 1981); *see also* Allen R. Kamp, *Between-the-Wars Social Thought: Karl Llewellyn, Legal Realism, and the Uniform Commercial Code in Context*, 59 ALB. L. REV. 325, 373-75 (1995) (describing the growth of trade associations from the 19th century to the 1920s).

354. *See, e.g.,* VALERIE JEAN CONNER, *THE NATIONAL WAR LABOR BOARD* 18 (1983).

355. *See id.* at 21, 28.

demands, the government soon found it more and more difficult, if not impossible, to deal with individual units in industry. Therefore, in order to carry out its production program promptly and effectively, the government not only encouraged the organization of trade associations, but set up machinery for the control of industry, which necessitated complete organization of each industry.<sup>356</sup>

Herbert Hoover was a champion of trade associations and a spokesman of the new associationalism.<sup>357</sup> During World War I, Hoover served as the Director of the Food Administration, where he conducted a major study of waste in industry.<sup>358</sup> From his experience in the wartime agency, he concluded that efficiency and productivity in industry could best be attained and waste could best be eliminated by voluntary associations of businessmen that could share expertise, engage in joint research, set uniform product standards, and promulgate codes of conduct for the trade.<sup>359</sup> Hoover developed a sophisticated philosophy about the relative roles of government and industry in the economy in achieving efficiency. He advocated government facilitation of business cooperation, and he believed that regulatory power should be delegated to strong autonomous trade associations.<sup>360</sup> He envisioned a government that operated not through direct regulation, but through promotional conferences, expert inquiries, and other forms of public-private cooperation.<sup>361</sup> According to Robert Rabin, "[a] strong case can be made that Hoover espoused the single most influential and coherent regulatory philosophy between the Progressive Era and the New Deal."<sup>362</sup>

Hoover became Secretary of Commerce in 1922, and in that capacity, he promoted collaboration between industry and government in order to eliminate waste in industry, foster efficiency,

356. JOSEPH HENRY FOTH, *TRADE ASSOCIATIONS: THEIR SERVICES TO INDUSTRY* 21-22 (1930); see also NATIONAL INDUSTRIAL CONFERENCE BOARD, *supra* note 232, at 25-27 (discussing how the exigencies of World War I led the government to work with and rely upon trade associations).

357. See Hawley, *supra* note 353, at 98-99.

358. See generally HERBERT HOOVER, *THE MEMOIRS OF HERBERT HOOVER: YEARS OF ADVENTURE, 1874-1920*, at 239-80 (1951) (discussing Hoover's time at the Food Administration).

359. See BENJAMIN S. KIRSH, *TRADE ASSOCIATIONS: THE LEGAL ASPECTS* 14 (1928) (quoting Herbert Hoover from 1922 SECRETARY OF COM. ANN. REP. 30). See generally Hawley, *supra* note 352, at 117-19 (describing Hoover's support of a synthesis between the old and new systems).

360. See Hawley, *supra* note 353, at 99.

361. See *id.* at 118-21.

362. Robert L. Rabin, *Federal Regulation in Historical Perspective*, 38 STAN. L. REV. 1189, 1237 (1986).

and enhance productivity.<sup>363</sup> He convened a Conference of Trade Association Executives in 1922 and oversaw the publication of a Department of Commerce report on trade associations in 1923.<sup>364</sup> He worked closely with trade associations throughout his tenure at the Commerce Department, sponsoring over 3000 conferences with trade groups to discuss the elimination of waste and the furtherance of efficiency.<sup>365</sup> He directed Commerce Department officials to work with the trade associations to create codes of ethics—business practices which were then promulgated by the Department as standards of fair practices.<sup>366</sup> He also requested the ABA Committee on Commerce, Trade and Commercial Law draft the federal legislation that became the FAA.<sup>367</sup>

Described as “the St. Paul of the Association Movement,”<sup>368</sup> Hoover crusaded for his vision of associationalism amongst other agencies and departments of government.<sup>369</sup> He encouraged the Federal Trade Commission to promote self-regulation in industry.<sup>370</sup> He contended that trade associations were beneficial rather than predatory forms of business cooperation, and he urged then-Attorney General Harry Daugherty to ease antitrust enforcement against them.<sup>371</sup> When Harlan Fiske Stone, Columbia Law School Dean and an adherent to Hoover’s associationalist philosophy, became Attorney General under President Coolidge, Hoover worked with Stone to bring a test case concerning the legality of information-sharing activities of trade associations under the antitrust laws.<sup>372</sup> By the time the lawsuit reached the Supreme Court, Stone had been appointed to the Court and wrote the opinion in *Maple Flooring*

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363. See JONES, *supra* note 264, at vii; Rabin, *supra* note 362, at 1241-42; see also LOUIS GALAMBOS, *COMPETITION AND COOPERATION: THE EMERGENCE OF A NATIONAL TRADE ASSOCIATION* 74-75 (1966) (describing Hoover’s collaborative efforts with the cotton textile industry). See generally Hawley, *supra* note 352, at 123-29 (describing efforts to make government more efficient and less paralyzed).

364. See KIRSH, *supra* note 359, at 34.

365. See HERBERT HOOVER, *THE MEMOIRS OF HERBERT HOOVER: THE CABINET AND THE PRESIDENCY, 1920-1933*, at 62 (1951).

366. See *id.* at 172-73; see also PERITZ, *supra* note 353, at 86-87 (describing standard-setting in the lumber industry).

367. See *Report of the Committee on Commerce, Trade and Commercial Law*, *supra* note 344, at 293-94.

368. GALAMBOS, *supra* note 363, at 74.

369. See Hawley, *supra* note 352, at 136-37.

370. See *id.* at 100; see also Rabin, *supra* note 362, at 1237-38 (discussing Hoover’s efforts at the Food Administration).

371. See Correspondence between Herbert Hoover, Secretary of Commerce, and Harry Daugherty, Attorney General (1922), reprinted in JONES, *supra* note 264, at 324-35.

372. See PERITZ, *supra* note 353, at 87-88.

*Manufacturing v. United States*,<sup>373</sup> eliminating the prior restrictions on trade associations and giving them wide latitude to share cost, quantity, and price information without violating the antitrust laws.<sup>374</sup>

Hoover's model of regulation was neo-corporatist; it advocated that public powers be delegated to private agents to engage in self-regulation.<sup>375</sup> He wanted to help businessmen in their quest to transform the interventionist trends of the progressive era into government-sanctioned self-regulation.<sup>376</sup> As historian Ellis Hawley has written:

[Hoover] envisioned both a new kind of societal "regulation" and a new kind of government. Within society a systematized network of cooperative associations and councils would provide the ordered freedom needed for continued economic and social progress; and government, as Hoover proposed to use it, would function not as a regulator but as an aide in developing and operating these societal mechanisms.<sup>377</sup>

Hoover's associationalism was part of what has been termed the "new capitalism" of the 1920s. New capitalists rejected progressive models of government intervention in the economy, advocating instead a vision of self-regulation of business through trade associations.<sup>378</sup> The new capitalists' utopia was one in which "enlightened corporate stewards should be allowed greater freedom to monitor industrial practices through collective private association and consultation, with government serving but a modest role."<sup>379</sup>

A cornerstone of Hoover's self-regulatory vision was the expansive use of commercial arbitration. He established an information bureau within the Commerce Department to promote and monitor the progress of commercial arbitration.<sup>380</sup> He advocated national and state legislation to facilitate and legalize arbitration, and he worked closely with the ABA and the chambers of commerce on the enactment of the New Jersey, Massachusetts, and Oregon

373. 268 U.S. 563 (1925).

374. See PERITZ, *supra* note 353, at 87-88 (discussing *Maple Flooring Mfg. v. United States*, 268 U.S. 563 (1925)).

375. See Gerald P. Berk, *Approaches to the History of Regulation*, in REGULATION IN PERSPECTIVE, *supra* note 353, at 187, 197.

376. See PERITZ, *supra* note 353, at 86; WIEBE, *supra* note 273, at 222-23.

377. Hawley, *supra* note 353, at 99.

378. See ROBERT F. BURK, *THE CORPORATE STATE AND THE BROKER STATE: THE DUPONTS AND AMERICAN NATIONAL POLITICS 1925-1940*, at 16-17 (1990).

379. *Id.* at 17.

380. See HOOVER, *supra* note 365, at 68-69.

arbitration statutes.<sup>381</sup> He was a principal advocate of the FAA, introducing bills on the subject in Congress in 1923, 1924, and 1925.<sup>382</sup> In a report to Congress in 1926, Hoover claimed credit for these legislative victories, bragging that the Commerce Department had made substantial progress in promoting the use of commercial arbitration within industry.<sup>383</sup> He stated that commercial arbitration “eliminates waste by removing ill will, by saving costs of litigation, by preventing undue delays ... and by strengthening contractual relations.”<sup>384</sup>

Hoover served as Honorary President of the AAA from its inception in 1926.<sup>385</sup> In 1927, Hoover wrote in a foreword to the AAA’s *Year Book on Commercial Arbitration in the United States*:

I have been for many years of the conviction that the arbitration of commercial disputes in place of avoidable litigation is an agency of the first rank in the promotion of business efficiency. . . .

The reason for the rapid rise of the commercial arbitration movement from a dream and a theory to a reality and practical adoption lies in the adaptability of arbitration to the multiple problems that arise in dealings between units of organized business. Within a chamber of commerce or a trade association it is possible to standardize many of the differences and conflicts which arise in the performance of everyday contracts. Such inevitable conflicts are often amenable to prompt settlement by those who know the particular trade and enjoy the confidence of the parties in dispute.<sup>386</sup>

He praised commercial arbitration for relieving the taxpayer of the costs of litigation as well as for curbing waste, reducing costs, and promoting industrial good-will.<sup>387</sup> Echoing the optimistic blending of private interest with public good that characterized the new capitalism, Hoover wrote that with arbitration, “business taxes itself to pay the cost of keeping commercial peace.”<sup>388</sup>

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381. *See id.* at 69.

382. *See id.* at 68-69.

383. *See id.* at 62-63, 68-69.

384. *Id.* at 69.

385. *See* AMERICAN ARBITRATION ASSOCIATION, *supra* note 233, at 1.

386. Herbert Hoover, *Foreword* to AMERICAN ARBITRATION ASSOCIATION, *supra* note 233, at vii.

387. *See id.* at vii-viii.

388. *Id.* at vii.

### G. *The Problem of Insiders and Outsiders in the 1920s*

In the 1920s, most supporters of the FAA and the state arbitration laws intended the new statutes to apply to disputes between members of the same trade association or between participants in a common line of business.<sup>389</sup> Even Julius Cohen, the champion of arbitration within trade associations and drafter of the FAA of 1925, cautioned about the limits of arbitration in other contexts. In an article he co-authored in 1926, he wrote:

Not all questions arising out of contracts ought to be arbitrated. It is a remedy peculiarly suited to the disposition of the ordinary disputes between merchants as to questions of fact—quantity, quality, time of delivery, compliance with terms of payment, excuses for non-performance, and the like. It has a place also in the determination of the simpler questions of law—the questions of law which arise out of these daily relations between merchants as to the passage of title, the existence of warranties, or the questions of law which are complementary to the questions of fact which we have just mentioned.<sup>390</sup>

Few scholars or lawyers considered problems that might be posed if arbitration agreements were made binding upon persons who were not engaged in a common trade or members of a common trade association. There was a paradox, however: It was not necessary to have laws to compel arbitration in disputes between trade association members because membership in a common organization created not only a spirit of cooperation but also the availability of “extra-judicial methods” for enforcing arbitration agreements.<sup>391</sup> As one lawyer noted at the time, the by-laws of many trade associations provided that members who refused to arbitrate disputes would be expelled.<sup>392</sup> Others authorized lesser penalties,

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389. See, e.g., Comment, *Arbitration and Award: Commercial Arbitration in California*, 17 CAL. L. REV. 643, 664 (1929) (“[A]rbitration may be successful only where both parties are willing to arbitrate, or where the parties are members of trade or industrial organizations in which there are common interests, conducive to co-operation.”).

390. Cohen & Dayton, *supra* note 41, at 281. Justice Black quoted this language in his dissent in *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 415 n.13 (1967) (Black, J., dissenting).

391. Phillips, *supra* note 268, at 1261.

392. See Phillips, *supra* note 286, at 428; see also NATIONAL INDUSTRIAL CONFERENCE BOARD, *supra* note 232, at 286-87 (giving the example of by-Laws of the National-American Wholesale Lumber Association that authorized expulsion of any member who refused to arbitrate).

such as publishing in the industry trade journal the name of any member who refused to arbitrate a dispute with another member.<sup>393</sup> For their part, the courts upheld such measures when they were challenged.<sup>394</sup> Thus, one is left to wonder why the commercial community felt that making agreements to arbitrate legally enforceable was such a high priority.

Despite this seeming paradox, the problem of arbitration between insiders and outsiders received little attention in the 1920s. One group that did consider the problem was the National Industrial Conference Board ("NICB"). In 1925, the NICB addressed the problem in a volume compiling data on trade associations of that year, but it did so in a manner that revealed further how powerful was their assumption that arbitration occurred only between parties who were both insiders to a type of business or commercial community.<sup>395</sup> The NICB distinguished two types of trade associations for purposes of designing arbitration systems. It said when a trade association contains persons or enterprises active in successive stages in the process of fabricating and distributing a single product or product group, it is a "relatively simple matter" to establish and operate an arbitration system because "[t]he members of these associations . . . habitually deal with one another, and the disagreements and disputes which arise are confined, in large measure, to parties within the immediate and direct jurisdiction of the trade organization."<sup>396</sup> But for trade associations representing just one stage in the production or marketing process, such as one representing only buyers or only sellers, the NICB stated that arbitration is more complicated.<sup>397</sup> Members of these single-stage trade associations, which comprise the vast majority of trade associations, do not normally deal with each other in the course of commerce. Rather, the members of such associations usually have commercial controversies with outsiders, "and the problem arises of inducing parties beyond the direct jurisdiction of the association to submit their claims to the judgment of a tribunal which functions under the auspices of an organization representing their opponents in interest."<sup>398</sup>

To solve this problem, the NICB recommended that trade

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393. See NATIONAL INDUSTRIAL CONFERENCE BOARD, *supra* note 232, at 284.

394. See Phillips, *supra* note 286, at 426-28.

395. See NATIONAL INDUSTRIAL CONFERENCE BOARD, *supra* note 232, at 275-87.

396. *Id.* at 280.

397. See *id.* at 283-84.

398. *Id.*



associations of the latter type join with their counterparts in related trades to establish joint arbitration boards.<sup>399</sup> The NICB stated: "Through the joint sponsorship of arbitration rules and machinery by several such associations, an entirely healthy pressure can be exerted on both sides of regular commercial transactions to adopt and abide by covenants to arbitrate disputes . . . ."<sup>400</sup> Thus, the NICB's solution to the insider-outsider problem in arbitration was to expand the definition of insiders from the boundaries of the trade association proper to members of related industries who engage in regularized and repeat transactions with one another. Arbitration before a joint board, it said, "corresponds very closely to that prevailing in the case of a trade association which, by the very scope of its organization, encompasses persons and concerns engaged in various stages of the producing and marketing process."<sup>401</sup> This type of joint board arbitration, then, is nonetheless between members of a shared commercial community, a community defined functionally by repeat business interactions in the normal course of commerce. The joint board arbitration, while technically between insiders and outsiders to a specific trade association, would resolve disputes between entities in a shared normative community occupying relatively comparable positions within it. The NICB's proposal further assumed that the joint board's arbitration rules would be fashioned from the joint participation of the organizations of each party to the dispute—organizations in which each party has an opportunity to help frame policies and principles.<sup>402</sup>

As will be shown below, the interpretative history of the FAA in its first sixty-five years embodied the NICB's conception of arbitration as an institution reflective of and embedded in membership in a shared normative community.

## V. ARBITRATION AS SELF-REGULATION WITHIN A NORMATIVE COMMUNITY

Part IV described how the FAA was enacted in response to the commercial community's desire to strengthen the internal arbitration systems of trade associations.<sup>403</sup> The historical assumption that

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399. *See id.*

400. *Id.* at 283-84. The Conference Board gave examples of existing joint arbitration boards in the shoe and boot industry, the motion picture industry, and the grocery trade. *See id.* at 284-86.

401. *Id.* at 284.

402. *See id.* at 283-86.

403. *See supra* Part IV.C; *see also* Phillips, *supra* note 268, at 1261-62 (describing the

arbitration would be used to resolve disputes between persons that shared customs, usages, and norms in their mutual dealings casts light on the courts' current approach to arbitration. The courts' expansive interpretation of the FAA and their willingness to delegate the adjudication of statutory rights to private arbitration may be reasonable in the context of early twentieth century trade associations, but it is problematic when transposed to disputes between wholly unrelated individuals or individuals whose business dealings are on an ad hoc, one-shot basis.

The recent doctrines that have expanded the scope of the FAA are based on the image of the early twentieth century trade association and exemplify a misapplication of the ancient guild ideal. The guild ideal has a descriptive dimension and a prescriptive dimension: As description, it claims that there are self-regulating normative subcommunities that exist within our larger body politic; as prescription, it advocates that law should permit these communities a significant measure of autonomy from the rest of society. By treating arbitration as a creation of normative subcommunities, courts grant them wide discretion so that they can perform a self-regulatory function.

We can thus understand the courts' facilitation of expansive uses of arbitration as not only docket-clearing, but also as reflecting their predisposition to grant autonomy to self-regulating organizations and normative subcommunities within the larger society. Courts can justify delegation of judicial authority on the basis of an implicit assumption that arbitration provides a means for the creation, expression, and affirmation of shared norms within subcommunities. On this basis they not only delegate authority to the subcommunities, they also approve the substantive justice produced by the application of their customary norms.

By affirming self-regulation, courts accomplish two important goals with one wave of the judicial wand: By granting a petition to compel arbitration or transforming an arbitral award into a judgment, they both affirm autonomy for normative communities and, at the same time, alleviate docket-crowding. They achieve a simultaneous blending of private gain and public good that Professor Frederico Cheever has termed, in a different context, "private magic."<sup>404</sup>

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legislative intent of arbitration law—to encourage settlement amongst business people).

404. Frederico Cheever, *Public Good and Private Magic in the Law of Land Trusts and Conservation Easements: A Happy Present and a Troubled Future*, 73 DENV. U. L. REV. 1077, 1078 (1996) (portraying land trusts as "private magic" in the double sense of "magic" as the production of an illusion "by the use of sleight of hand," and as a technique that

One sees the guild ideal operating sub silentio in many of the leading cases that have established the modern law of arbitration. Many decisions explicitly or implicitly rely on the rationale that they must defer to arbitration in order to support a system of self-regulation.<sup>405</sup> Many of the pivotal cases in the interpretation of the FAA arose in two fields—the securities industry and collective bargaining—both contexts in which jurists and participants have expressly embraced the concept of self-regulation as their central regulatory ideal. Below is a discussion of the role of self-regulation in the development of arbitration in the securities industry and collective bargaining.

### A. *Self-Regulation and Arbitration in the Securities Industry*

#### 1. Self-Regulation Under the Securities Exchange Act of 1934

Since the nineteenth century, the major stock exchanges have tenaciously asserted and jealously guarded their self-regulating autonomy. In the early decades of the twentieth century, the New York and Chicago Stock Exchanges refused to incorporate on the ground that as voluntary associations they were not creatures of the State. Rather, they claimed that they were like private clubs, entitled to set their own rules of conduct and to select and discipline their own members.<sup>406</sup>

In the 1910s and 1920s, many states moved to regulate the sale of securities and to require registration and licensing of brokers, dealers, and securities offered for sale.<sup>407</sup> The industry's trade association, the International Bankers Association ("IBA"), responded with a campaign to exempt the stock exchanges from any such regulation. The IBA successfully campaigned for uniform state securities laws that would deter fraudulent practices but that would also contain an exemption for securities listed on the New York and Chicago Stock Exchanges.<sup>408</sup> It also succeeded in 1930 in convincing the ABA to approve a model corporation act that called for registration of brokers, dealers, and nonexempt securities, but

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attempts to "assure human control over supernatural agencies").

405. See *infra* notes 466-80 and accompanying text.

406. See Richard W. Jennings, *Self-Regulation in the Securities Industry: The Role of the Securities and Exchange Commission*, 29 LAW & CONTEMP. PROBS. 663, 663 n.2 (1964).

407. See MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 5-7 (1970).

408. See *id.* at 23-24.

exempted securities listed on the New York, Chicago, or any other “‘recognized and responsible stock exchange.’”<sup>409</sup> The stock exchanges thus escaped regulation at both the federal and state levels—a victory for the industry in its pursuit of self-regulation. According to historian Michael Parrish, the consequence of the model act was to

delegate[] enormous power and responsibility to private institutions and voluntary associations. . . . [T]he extent to which states abandoned formal regulatory powers to private organizations was one more indication of the extravagant confidence displayed during the decade [of the 1920s] by all levels of government in the ability of private decision making and self regulation to manage effectively vast areas of the American economy.<sup>410</sup>

In 1929, as the IBA was extolling the virtues of self-regulation, the stock market crashed. State legislatures turned against the IBA’s approach and revised their statutes to impose more regulations on the industry and remove the exemptions for the exchanges.<sup>411</sup> However, President Hoover retained his philosophical commitment to associationalism, minimal governmental intervention, and trade association voluntarism.<sup>412</sup> As the stock market continued its downward slide from 1929 to 1931, Hoover ignored calls for national securities regulation and instead exhorted the business community to maintain wages and employment levels voluntarily.<sup>413</sup> Democrats in Congress, on the other hand, pressed for federal regulation of the securities markets as the Great Depression deepened.<sup>414</sup>

The stock exchanges retained their private club status and immunity from formal legal supervision until 1934.<sup>415</sup> The desperate

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409. *Id.* at 23-26 (quoting ABA NATIONAL CONFERENCE, HANDBOOK AND PROCEEDINGS 235-66 (1930)).

410. *Id.* at 27.

411. *See id.* at 30.

412. *See supra* notes 357-88 and accompanying text (discussing Hoover’s role in the “associationalism” movement).

413. *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 5-6 (rev. ed. 1995).

414. *See id.*

415. *See* Jennings, *supra* note 406, at 667-69. For example, in *Weidenfeld v. Keppler*, 82 N.Y.S. 634 (App. Div. 1903), the New York Appellate Division refused to issue a writ of mandamus to reinstate a member who claimed he was wrongfully suspended from the New York Stock Exchange. *See id.* at 638. The court held that because the Exchange had neither a charter nor a franchise from the State its decisions over membership were beyond the scope of governmental supervisory power. *See id.* at 635-37. “[T]he privilege of membership in a voluntary association is derived exclusively from the body that

nature of the times, however, produced change. The Democrats gained control of the House of Representatives in the 1930 election for the first time in twelve years.<sup>416</sup> Once seated, they joined with progressive Republicans and set to work on enacting securities regulation and reform.<sup>417</sup> The Senate Banking Committee initiated hearings on the stock exchanges in 1932.<sup>418</sup> These congressional efforts ultimately resulted in the Securities and Banking Acts of 1933,<sup>419</sup> the Securities Exchange Act of 1934,<sup>420</sup> and the creation of the Securities and Exchange Commission ("SEC").<sup>421</sup>

The issue of self-regulation of the exchanges was debated extensively in the passage of the 1934 Securities Exchange Act.<sup>422</sup> The original bill would have imposed substantial direct regulation on the exchanges—it would have set limits on loans from brokers to investors, abolished floor traders, proscribed several types of market manipulation, and given the Federal Trade Commission the power to approve or disapprove exchange rules and regulations.<sup>423</sup> After several revisions and heated debate,<sup>424</sup> the bill that was finally enacted established the SEC and contained registration and disclosure requirements for stock exchanges and firms issuing securities.<sup>425</sup> The 1934 Act also gave the SEC authority to approve or disapprove internal stock exchange rules.<sup>426</sup> But instead of imposing extensive regulation, the 1934 Act gave the existing twenty-one exchanges control over disciplinary action of their own memberships and delegated to them primary responsibility for enforcing the Securities Exchange Act and Commission ("SEC") regulations.<sup>427</sup>

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bestows it and may be conferred or withheld at its pleasure." *Id.* at 637 (citation omitted). On some occasions, equity courts intervened in cases in which unincorporated labor unions expelled members for failing to utilize fair procedures. *See, e.g., Fales v. Musicians' Protective Union, Local 198, 99 A. 823 (R.I. 1917).*

416. *See* SELIGMAN, *supra* note 413, at 8.

417. *See id.* at 8-9.

418. *See id.* at 13.

419. *See* Securities Act of 1933, ch. 38, 48 Stat. 74 (current version at 15 U.S.C. §§ 77a-77aa (1994)); Banking Act of 1933, ch. 89, § 32, 48 Stat. 194 (current version at 12 U.S.C. § 78 (1994)).

420. Act of June 6, 1934, ch. 404, 48 Stat. 881 (current version at 15 U.S.C. §§ 78a-78ll (1994)).

421. *See* SELIGMAN, *supra* note 413, at 13.

422. *See* PARRISH, *supra* note 407, at 113-44.

423. *See* SELIGMAN, *supra* note 413, at 85-87.

424. *See id.* at 89-100.

425. *See* Securities Exchange Act of 1934, ch. 404, § 4, § 6, § 13, 48 Stat. at 885-86, 894-95.

426. *See* § 23(a), 48 Stat. at 901; SELIGMAN, *supra* note 413, at 99-100.

427. *See* § 28(b), 48 Stat. at 903; PARRISH, *supra* note 407, at 210; SELIGMAN, *supra* note 413, at 100; Jennings, *supra* note 406, at 676; Richard L. Stone & Michael A. Perino,

Thus, the 1934 Act affirmed the self-regulatory role of the exchanges and limited the SEC to an oversight role in internal matters.<sup>428</sup>

In the early years, the SEC's leaders were deeply imbued with the self-regulatory philosophy.<sup>429</sup> Faced with the job of regulating a skeptical, if not hostile, industry, the SEC relied on self-regulation and voluntarism to implement its goals.<sup>430</sup> William O. Douglas, the then-third Chairman of the SEC, who served from 1937 to 1939, articulated and implemented a coherent framework for the interpretation of the new and as yet unformed law. Douglas believed that the SEC should affirm the self-regulation of the industry and impose minimal external regulation.<sup>431</sup> In 1936, Douglas told a congressional committee:

“My philosophy was and is that the national securities exchanges should be so organized as to be able to take on the job of policing their members so that it would be unnecessary for the Government to interfere with that business, . . . . Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.”<sup>432</sup>

Douglas explained his belief in self-regulation two years later, on January 7, 1938, in a speech to the Hartford Bond Club: “From the broad public viewpoint, such [self-]regulation can be far more effective [than direct regulation]. . . . Self-regulation . . . can be pervasive and subtle in its conditioning influence over business practices and business morality.”<sup>433</sup> Douglas continued, “[b]y and

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*Not Just A Private Club: Self Regulatory Organizations as State Actors When Enforcing Federal Law*, 1995 COLUM. BUS. L. REV. 453, 456-57.

428. See Jennings, *supra* note 406, at 670.

429. See PARRISH, *supra* note 407, at 181; Jennings, *supra* note 406, at 677.

430. See PARRISH, *supra* note 407, at 209.

431. As Joel Seligman writes, “[Douglas’s] *bel ideal* was industry self-regulation under the close supervision of a government agency.” SELIGMAN, *supra* note 413, at 158. Douglas’s predecessor, James Landis, also adopted a self-regulation approach to accounting practices in the early years of the SEC. Because both the 1933 and 1934 Securities Acts use disclosure as their primary mechanism for policing the industry, the issue of proper accounting requirements and techniques assumed central importance. In 1938, Landis announced that he would permit registrants to rely on standards developed by the accounting profession rather than impose its own. See PARRISH, *supra* note 407, at 207. It was an approach that reflected delegation to the industry to establish its own regulatory norms. See *id.* at 207-08. A minority of the SEC commissioners disagreed with this startling approach. See *id.* at 207. Within a year even Landis questioned the wisdom of permitting the accounting profession’s own professional association to determine the shape and parameters of required disclosure. See *id.* at 208.

432. WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE* 82 (James Allen ed., 1940) (quoting Douglas’s address to a congressional committee).

433. *Id.* at 678.

large, government can operate satisfactorily only by proscription. That leaves untouched large areas of conduct and activity . . . [with] some of it lying beyond the periphery of the law in the realm of ethics and morality."<sup>434</sup>

Douglas's leadership of the SEC followed from these principles. For example, after the stock market collapse of 1937, Douglas decided that complete reorganization of the New York Stock Exchange's internal governance structure was necessary. He publicly threatened that if the exchange did not put its own house in order, he would use the powers of the SEC to engage in more direct regulation.<sup>435</sup> In response, the New York Exchange undertook a self-study and recommended sweeping changes in its methods of operation.<sup>436</sup> In May of 1938, the SEC approved these recommendations, deferring to exchange rule-making and declining to impose standards of conduct directly.<sup>437</sup>

In addition to promoting self-regulation in the governance of the New York Exchange, Douglas encouraged self-regulation in the over-the-counter ("OTC") market.<sup>438</sup> Unlike the organized exchanges, it was difficult to conceptualize self-regulation of the OTC market because there were over 6000 OTC dealers and brokers in the country but no unified organizational structure.<sup>439</sup> Douglas approached the challenge by convening a conference of leading members of the investment banking community and asking them to devise a plan to encourage the OTC dealers to form voluntary organizations.<sup>440</sup> Out of these efforts came the Maloney Act, a statute that permits associations of brokers and dealers to register under the 1934 Securities Exchange Act.<sup>441</sup> Registered associations are granted the benefits of self-regulation available to the stock exchanges.<sup>442</sup> Under the auspices of the Maloney Act, the National Association of Securities Dealers ("NASD") was established in

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434. *Id.*

435. See Richard W. Jennings, *Mr. Justice Douglas: His Influence on Corporate and Securities Regulation*, 73 YALE L.J. 920, 945 (1964).

436. See *id.*

437. See SELIGMAN, *supra* note 413, at 166-67. Seligman is critical of this result, terming the SEC's 1938 deference to Exchange rule-making a "highly expensive compromise." *Id.* at 167.

438. See *id.* at 185.

439. See *id.*

440. See *id.* at 185-86.

441. See Maloney Act, ch. 677, 52 Stat. 1070 (1938) (current version at 15 U.S.C. § 78o-3 (1994)).

442. See § 1, 52 Stat. at 1070-75.

1939.<sup>443</sup> Chairman Douglas thus established a pattern of securities regulation whereby the SEC relied on self-regulation of the industry by encouraging participants to form organizations and by delegating to the organized exchanges a significant role in standard setting, oversight, policing, and disciplining violators—a pattern that his successors have followed.<sup>444</sup>

Courts often rely on the history of self-regulation of the stock exchanges to justify the broad deference and minimal oversight they accord to internal rules and disciplinary proceedings of the securities industry.<sup>445</sup> In *Silver v. New York Stock Exchange*,<sup>446</sup> the Supreme Court stated that the 1934 Act created a “federally mandated duty of self-policing by exchanges.”<sup>447</sup> One component of this duty was “the obligation to formulate rules governing the conduct of exchange members.”<sup>448</sup> Lower federal courts have therefore made the self-regulation principle operative. For example, in *Walck v. American Stock Exchange, Inc.*,<sup>449</sup> the Third Circuit refused to imply a private right of action for a claim that the stock exchange failed to enforce its own rules on the grounds that Congress deliberately created “a system of exchange ‘self-regulation’ subject to limited governmental oversight.”<sup>450</sup> It was improbable, continued the court, that Congress “authorized by implication authority in the federal courts to intervene in the self-regulatory system at the instance of an injured investor.”<sup>451</sup> Rather, the court stated, Congress chose self-regulation not only because widespread government regulation would be expensive and ineffective, but also because “‘self regulation has significant advantages in its own right.’”<sup>452</sup>

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443. See 6 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 2794-95 (3d ed. 1990).

444. See PARRISH, *supra* note 407, at 184, 216; SELIGMAN, *supra* note 413, at 349, 439.

445. See *infra* note 466 and accompanying text (listing cases).

446. 373 U.S. 341 (1963).

447. *Id.* at 352.

448. *Id.* at 353.

449. 687 F.2d 778 (3d Cir. 1982).

450. *Id.* at 785 (citing SUBCOMMITTEE ON SECURITIES OF THE COMM. ON BANKING, HOUSING AND URBAN AFFAIRS, 93D CONG., *SECURITIES INDUSTRY STUDY* 137-43 (Comm. Print 1973) [hereinafter *SENATE STUDY*]).

451. *Id.* at 786.

452. *Id.* (quoting *SENATE STUDY*, *supra* note 450, at 149). The court quoted William O. Douglas’s statement that self-regulation can establish and enforce “‘ethical standards beyond those any law can establish.’” *Id.* (quoting *SENATE STUDY*, *supra* note 450, at 149 (quoting S. REP. NO. 73-792, at 13 (1934))).



## 2. A Brief History of Arbitration in the Securities Industry

Self-regulation in the securities industry takes the form of delegation of governmental authority both to the exchanges' own rule-making capacity and to their internal dispute-resolution processes. The securities industry has one of the oldest arbitration systems in the country, long pre-dating the 1934 Act or the 1933 Act ("Securities Acts") or the FAA. The New York Stock Exchange ("NYSE") has provided a mechanism for voluntary arbitration to resolve disputes between stock exchange members since at least 1845.<sup>453</sup> The NYSE Constitution of 1869 expanded the voluntary arbitration system to permit nonmembers to use the arbitration mechanism in disputes with members so long as the nonmembers agreed to abide by the NYSE arbitration rules.<sup>454</sup>

The NASD established a system of arbitration in 1968 that permitted nonmembers to arbitrate disputes with members if all parties agreed.<sup>455</sup> At that time, nonmembers were not required to arbitrate disputes with members—the procedure was available to them if they chose it.<sup>456</sup> Also, nonmembers were only permitted to arbitrate existing disputes; they could not commit themselves in advance to arbitrate all disputes.<sup>457</sup> In 1972, the NASD changed its rules to make arbitration mandatory for NASD members if customers sought to require members or associated persons to arbitrate disputes.<sup>458</sup> Customers were not, however, required to utilize the arbitration system.<sup>459</sup>

By 1972, then, both the NYSE and the NASD required members to arbitrate disputes with customers if the customer so requested, but the customer had the choice of arbitrating or litigating her dispute in court.<sup>460</sup> In the next decade, arbitration for customers ceased to be optional. In the early 1980s, some large securities firms began to require that all customers agree to arbitrate all disputes.<sup>461</sup> It has

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453. See Norman S. Poser, *Making Securities Arbitration Work*, 50 SMU L. REV. 277, 280 (1996).

454. See *id.* at 281. The NYSE arbitration rules were revised in 1925 to provide a standardized submission agreement that nonmembers were required to sign if they chose to utilize the arbitration system. See *id.*

455. See *id.*

456. See Deborah Masucci, *Securities Arbitration—A Success Story: What Does the Future Hold?*, 31 WAKE FOREST L. REV. 183, 185 (1996).

457. See Poser, *supra* note 453, at 281-82.

458. See Masucci, *supra* note 456, at 185.

459. See Poser, *supra* note 453, at 281-82.

460. See *id.*

461. See, e.g., *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 215 (1985) (describing

been suggested that the securities industry may have been the first industry to include mandatory arbitration clauses in the printed forms they gave to customers.<sup>462</sup>

Despite the expansion of arbitration pursuant to the stock exchanges' internal rules, until 1987, arbitration played only a limited role in the exchanges. *Wilko v. Swan*<sup>463</sup> served as a barrier to the arbitration of disputes that involved alleged violations of the Securities Acts.<sup>464</sup> Over time, however, courts found ways to limit the reach of *Wilko* and subject more and more securities industry disputes to arbitration. For example, some courts enforced agreements to arbitrate securities law violations in disputes between two members of an exchange by reasoning that § 28(b) of the 1934 Act, which made arbitration binding for disputes between an exchange and its members, overrode the anti-waiver provision of the 1934 Act.<sup>465</sup>

In their quest to limit the effect of *Wilko*, courts often cited the self-regulatory nature of the stock exchanges as justification for expanding the scope of securities arbitration.<sup>466</sup> For example, in *Axelrod & Co. v. Kordich, Victor & Neufeld*,<sup>467</sup> the Second Circuit cited the industry's self-regulation as the rationale for holding that a nonmember could compel a member of an exchange to arbitrate an allegation of fraud in violation of the Securities Acts.<sup>468</sup> In doing so, the court distinguished *Wilko* on the grounds that the legislative policy of protecting investors, which served as the basis of *Wilko*, was

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the arbitration clause in the Customer's Agreement that the plaintiff signed when he first invested his funds with Dean Witter in 1981).

462. See Poser, *supra* note 230, at 1097.

463. 346 U.S. 427 (1953), *overruled by* Rodriguez de Quijas v. Shearson/Am. Express Inc., 490 U.S. 477 (1989).

464. See *Dean Witter Reynolds*, 470 U.S. at 215-16 n.1 (assuming that *Wilko* applied to the 1934 Act); see also *supra* notes 92-96, 140-41 (discussing *Wilko*).

465. See, e.g., *Tullis v. Kohlmeier & Co.*, 551 F.2d 632, 635-36 (5th Cir. 1977) (holding that *Wilko* does not bar arbitration of disputes between members of an exchange); see also *Axelrod & Co. v. Kordich, Victor & Neufeld*, 451 F.2d 838, 841-42 (2d Cir. 1971) (limiting *Wilko* to cases in which it is the customer, not the exchange member, resisting arbitration).

466. See, e.g., *Drayer v. Krasner*, 572 F.2d 348, 359-60 (2d Cir. 1978); *Tullis*, 551 F.2d at 638; *Muh v. Neuburger, Loeb & Co.*, 540 F.2d 970, 972-73 (9th Cir. 1976); *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1214 (2d Cir. 1972); *Axelrod*, 451 F.2d at 840-41; *Lehman Bros. v. Certified Reporting Co.*, 939 F. Supp. 1333, 1337 (N.D. Ill. 1996); *S.G. Marx & Assocs. v. Philadelphia Stock Exch.*, Civ. A. No. 92-620, 1992 WL 174701, at \*4 (E.D. Pa. July 20, 1992); *Bender v. Smith Barney, Harris Upham & Co.*, 789 F. Supp. 155, 158 (D.N.J. 1992); *N. Donald & Co. v. American United Energy Corp.*, 585 F. Supp. 533, 535-36 (D. Colo. 1984); *Pelzman v. Paine, Webber, Jackson, & Curtis, Inc.*, No. 82-1322, 1983 WL 1338, at \*3 (D.D.C. July 12, 1983).

467. 451 F.2d 838 (2d Cir. 1971).

468. See *id.* at 840-41.

not operative in this case.<sup>469</sup> Rather, the court said, when a nonmember sought to compel arbitration and a member of the exchange was seeking to avoid arbitration, there was no reason to refuse to order arbitration.<sup>470</sup>

Similarly, in *Tullis v. Kohlmeyer & Co.*,<sup>471</sup> the Fifth Circuit used the self-regulatory nature of the industry to limit the reach of *Wilko*. In holding that partners in a securities firm must arbitrate their dispute with the firm, the court stated that *Wilko* only barred mandatory arbitration of customer-exchange member disputes, not disputes between exchange members.<sup>472</sup> It explained its result as follows: "Congress clearly intended to preserve for the stock exchanges a major self-regulatory role. This policy . . . would be weakened significantly if the arbitration which the exchange deems desirable could be avoided at the will of any party claiming a securities law violation."<sup>473</sup>

In *Muh v. Newburger, Loeb & Co.*,<sup>474</sup> the Ninth Circuit relied on the self-regulatory nature of stock exchanges to hold that parties were required to arbitrate a dispute that had arisen after both parties had terminated their membership in the stock exchange.<sup>475</sup> "It would seem strange indeed," the court noted, "that with such a significant integrated method of dispute settlement one party could frustrate the purpose of the Exchange rules and the federal policy favoring arbitration by the mere expediency of resignation from the Exchange."<sup>476</sup>

In 1972, in *Rust v. Drexel Firestone, Inc.*,<sup>477</sup> a banking firm employee sought to avoid arbitrating his dispute over commissions with his employer by contending that the stock exchange arbitration provision was adhesive and that he had agreed to it under duress.<sup>478</sup> Judge Weinfeld dismissed these arguments without much discussion because "the rule requiring employer and employee to submit their differences to arbitration comes within the self-regulatory power vested in the Exchange."<sup>479</sup> In *Rust*, Weinfeld, offered a thoughtful

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469. *See id.* at 842-43.

470. *See id.*

471. 551 F.2d 632 (5th Cir. 1977).

472. *See id.* at 638.

473. *Id.* (citation omitted).

474. 540 F.2d 970 (9th Cir. 1976).

475. *See id.* at 972-73.

476. *Id.* at 973.

477. 352 F. Supp. 715 (S.D.N.Y. 1972).

478. *See id.* at 716-17.

479. *Id.* at 717.

explanation of why courts grant broad discretion to securities industry arbitration proceedings. Weinfeld wrote:

The Exchange, in its self-regulatory role has a legitimate interest in deciding how disputes between its members and their employees are to be resolved; it has a legitimate interest in fostering harmonious relations among the varied groups whose daily activities play a role in the complex operations of the Exchange. Considering that interest, it is not unreasonable to require those engaged in such operations to resolve their disputes, which oftentimes may center about practices peculiar to the Exchange, through prompt and economic arbitration rather than by drawn out litigation before judges of fact who may be without experience in the trade practices and customs.<sup>480</sup>

### 3. Overcoming the Constraint of *Wilko*

Despite the courts' faith in the self-regulation of the securities industry arbitration system, there was growing public criticism of the industry in the 1960s and 1970s for its failure to enforce exchange rules and its inadequate provisions for due process.<sup>481</sup> In the 1970s, the SEC published a series of studies that concluded that self-regulation was not working.<sup>482</sup> In 1975, in response, Congress amended the statute to impose additional procedural protections into the self-regulating organization's ("SRO") arbitration procedures.<sup>483</sup> The 1975 amendments increased SEC authority over the SROs by requiring SEC approval for all new SRO rules and giving the SEC

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480. *Id.* at 718.

481. *See, e.g.,* Lewis D. Lowenfels, *A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD*, 64 CORNELL L. REV. 375, 376-92 (1979) (criticizing securities industry arbitrations for numerous due process inadequacies); Sam Scott Miller, *Self-Regulation of the Securities Markets: A Critical Examination*, 42 WASH. & LEE L. REV. 853, 884-87 (1985) (urging closer governmental monitoring of self-regulating organizations (SROs)). *But see* Norman S. Poser, *Reply to Lowenfels*, 64 CORNELL L. REV. 402, 414 (1979) (disputing Lowenfels's critique of securities industry arbitrations). *See generally* Stone & Perino, *supra* note 427, at 460-61 (claiming that by the mid-1980s it was clear that the self-regulatory framework of the SROs was inadequate).

482. *See Securities and Exch. Comm'n Report of Special Study of Securities Markets*, H.R. DOC. NO. 88-95, pt. 4, at 501-739 (1964); *see also* Susan K. Foster, Note, *Financial Planning: Is It Time for a Self-Regulatory Organization?*, 53 BROOK. L. REV. 143, 176-79 (discussing criticisms of the operation of SROs). *See generally* SELIGMAN, *supra* note 413, at 440 (stating that under "the Nixon-Ford presidential administration, deficiencies in several aspects of industrial self-regulation had become glaringly apparent").

483. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 4, 1975 U.S.C.A.N. (89 Stat.) 97, 108 (current version at 15 U.S.C. § 78f(d)(2) (1994)); Stone & Perino, *supra* note 427, at 460-61.

power to add to or delete existing SRO rules.<sup>484</sup> Thus, the 1975 amendments to the statute threatened to impose greater governmental controls on the industry's arbitration procedures. The industry successfully resisted the trends toward greater regulation, however, and in fact acquired greater self-regulatory power as a result of the Supreme Court's rulings in the 1980s.

In 1987, in *Shearson/American Express Inc. v. McMahon*,<sup>485</sup> the Supreme Court addressed the impact of the 1975 amendments on the self-regulatory role of the exchanges.<sup>486</sup> The Court held that a suit brought by a customer against a broker alleging, inter alia, violations of the 1934 Securities Exchange Act and civil RICO violations, was subject to a mandatory predispute arbitration agreement.<sup>487</sup> The plaintiff argued that the legislative history of the 1975 amendments demonstrated that Congress intended to retain the pre-existing legal rulings, including the ruling in *Wilko*, which the Committee Reports explicitly mentioned.<sup>488</sup> Justice O'Connor responded by stating that Congress must have meant to retain not only the Court's ruling in *Wilko*, but also the cases that had limited *Wilko*'s reach.<sup>489</sup> In justifying the holding that that disputes alleging violations of the 1934 Securities Exchange Act are arbitrable, Justice O'Connor stated that when Congress enacted the 1934 Act, it wanted to support the self-regulatory role of stock exchanges.<sup>490</sup> From this fact, she concluded that it was appropriate to delegate to the exchanges authority to hear and decide cases alleging statutory violations.<sup>491</sup> Thus, Justice O'Connor interpreted the 1975 amendments to the 1934 Act, which imposed additional oversight over the self-regulatory aspects of the stock exchange, as evidence that Congress intended to strengthen the autonomy of the exchanges as SROs.<sup>492</sup> Two years later, in *Rodriguez de Quijas v. Shearson/American Express, Inc.*,<sup>493</sup> the Court explicitly overruled *Wilko*.<sup>494</sup>

As a result of *McMahon* and *Rodriguez de Quijas*, securities

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484. See § 16, 1975 U.S.C.C.A.N. (89 Stat.) at 147-48, 150 (current version at 15 U.S.C. § 78s(b)-(c) (1994)). See generally Stone & Perino, *supra* note 427, at 461-63 (discussing the Securities Act Amendments of 1975).

485. 482 U.S. 220 (1987).

486. See *supra* notes 116-23 (discussing *McMahon*).

487. See *McMahon*, 482 U.S. at 238, 242.

488. See *id.* at 236-37.

489. See *id.* at 237.

490. See *id.* at 235.

491. See *id.* at 234-35.

492. See *id.* at 233-35.

493. 490 U.S. 477 (1989).

494. See, e.g., *id.* at 485.

firms now require customers, employees, and others with whom they do business to use the industry's arbitration system for all types of disputes, whether the dispute is between members or between members and nonmembers, and whether the alleged wrongdoing was a contractual issue or a statutory one. Although investors often attempt to resist arbitration,<sup>495</sup> courts routinely enforce predispute agreements to arbitrate.<sup>496</sup> Thus, courts give securities industry arbitrations autonomy and deference in furtherance of the ideal of self-regulation.

The effects of *McMahon* and *Rodriguez de Quijas* have extended far beyond the securities industry, establishing the arbitrability of statutory disputes of all sorts. The subsequent cases of *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,<sup>497</sup> holding that antitrust act claims are amenable to arbitration,<sup>498</sup> and *Gilmer v. Interstate/Johnson Lane Corp.*,<sup>499</sup> holding that claims under the Age Discrimination in Employment Act are arbitrable,<sup>500</sup> rely upon the reasoning of these earlier securities industry cases. For example, the *Gilmer* majority referred to its opinion in *Mitsubishi* to support its conclusion that arbitration was adequate to protect the plaintiff's substantive rights,<sup>501</sup> and it relied on the *Rodriguez de Quijas* and *McMahon* opinions to reject the plaintiff's argument that the arbitration agreement should not be enforced because of the unequal bargaining power.<sup>502</sup>

One could distinguish securities industry arbitration cases from other types of cases involving arbitration of statutory claims on the ground that under the Securities Acts, there is a possibility of SEC oversight of the SROs and their arbitration tribunals, a possibility that does not exist when violations of other statutory rights are alleged. Thus, one could argue, deference to arbitration is justifiable in the securities context because there is governmental input into the

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495. See, e.g., Deborah Lohse, *NASD Rule for Damages Is Criticized*, WALL ST. J., Feb. 3, 1997, at C1 (describing the controversy over a proposal by the NASD to cap arbitration awards for investors).

496. See *supra* notes 592.

497. 473 U.S. 614 (1985).

498. See *id.* at 640; see also *supra* notes 102-15 (discussing *Mitsubishi*).

499. 500 U.S. 20 (1991).

500. See *id.* at 35; see also *supra* notes 126-35 (discussing *Gilmer*).

501. See *Gilmer*, 500 U.S. at 26 (citing *Mitsubishi*, 473 U.S. at 628).

502. See *id.* at 33. The *Gilmer* Court stated: "Relationships between securities dealers and investors . . . may involve unequal bargaining power, but we nevertheless held in *Rodriguez de Quijas* and *McMahon* that agreements to arbitrate in that context are enforceable." *Id.* (citing *Rodriguez de Quijas v. Shearson/Am. Express, Inc.*, 490 U.S. 477, 484 (1989); *Shearson/Am. Express Inc. v. McMahon*, 482 U.S. 220, 230 (1987)).

arbitration procedures, whereas in the context of arbitrations wholly within the private sector, such as employment discrimination allegations or private antitrust allegations, less delegation is appropriate and more judicial oversight is required. Until now, courts have not made this distinction, but have instead readily expanded the *McMahon* rationale to settings in which there is no governmental oversight of the arbitration process.<sup>503</sup>

### B. *Self-Regulation Under Collective Bargaining*

The other area of law that has had a powerful influence on the development of FAA doctrine is labor law and collective bargaining. Labor cases are cited extensively in FAA cases as precedent for delegating enforcement of legal rights to arbitration and restricting the scope of judicial review.<sup>504</sup> Indeed, many of the cases interpreting the FAA in the 1980s and 1990s relied on cases interpreting the National Labor Relations Act ("NLRA")<sup>505</sup> in the 1960s.<sup>506</sup>

In labor law, as in securities regulation, self-regulation has been a central theme in the interpretation and implementation of the statutory scheme. In both areas, courts have relied on the capability of the regulated entity to self-regulate to justify granting considerable autonomy to private arbitration. Further, both the NLRA and the Securities Exchange Act were enacted in the 1930s, and both rely on governmental agencies for their implementation. In each case, the agency has delegated its authority to pre-existing private organizations that have long had internal governance structures, including private dispute resolution mechanisms.

Self-regulation in labor relations is a particular conception of collective bargaining. In the United States, formalized collective bargaining between large powerful unions and large employer associations dates back to the late nineteenth century.<sup>507</sup> While collective bargaining has often been described as industrial democracy, it was not until the post World War II era that the

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503. See, e.g., Stone, *supra* note 136, at 1033 n.120 (citing cases in which courts compel parties to arbitrate employment-related claims).

504. See, e.g., *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) (referring to the presumption of arbitrability in *Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574 (1960)).

505. Act of July 5, 1935, ch. 372, 49 Stat. 449 (current version at 29 U.S.C. §§ 151-169 (1994)).

506. See *infra* notes 537-39 and accompanying text.

507. See John R. Commons, *Industrial Relations*, in *TRADE UNIONISM AND LABOR PROBLEMS* 1, 3-4 (John R. Commons ed., 1921) (describing negotiations in the coal-mining industry).

concept of collective bargaining as joint self-regulation by labor and management developed. A key element in the move to reconceptualize collective bargaining as labor-management self-regulation was the rise of labor arbitration.<sup>508</sup>

### 1. A Brief History of Arbitration in Labor Relations

Today arbitration and collective bargaining are assumed to be coterminous, if not synonymous, institutions. It is usually assumed that all collective agreements contain arbitration procedures and that all disputes arising under the agreements are subject to arbitration. However, from the late nineteenth century until the 1930s, the enforcement of collective bargaining agreements was a problematic undertaking. Courts would not permit unions to sue to enforce them because unions were unincorporated associations.<sup>509</sup> An individual worker could only enforce a collective bargaining agreement if the worker could show that the union acted as his agent in negotiating the contract, or if the contract represented a custom or usage that he knew of and acceded to when he accepted employment.<sup>510</sup> These were difficult tests to satisfy, and as a result, enforcement of collective bargaining agreements was generally left to the vicissitudes of moral suasion and parties' economic power.<sup>511</sup> Beginning in the 1920s, a few state courts permitted workers or unions to enforce collective bargaining agreements as ordinary contracts, and thus to sue for their breach, but those states were in the minority.<sup>512</sup>

In light of the difficulties of enforcing collective agreements, some unions turned to grievance arbitration—arbitration of disputes concerning the interpretation and enforcement of a collective bargaining agreement—as a means of enforcing collective

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508. See Katherine Van Wezel Stone, *The Legacy of Industrial Pluralism: The Tension Between Individual Employment Rights and the New Deal Collective Bargaining System*, 59 U. CHI. L. REV. 575, 622-24 (1992) [hereinafter Stone, *Industrial Pluralism*]; Katherine Van Wezel Stone, *The Post-War Paradigm in American Labor Law*, 90 YALE L.J. 1509, 1523-25 (1981) [hereinafter Stone, *The Post-War Paradigm*].

509. See Stone, *The Post-War Paradigm*, *supra* note 508, at 1518 & n.34.

510. See CHRISTOPHER L. TOMLINS, *THE STATE AND THE UNIONS: LABOR RELATIONS, LAW, AND THE ORGANIZED LABOR MOVEMENT IN AMERICA, 1880-1960*, at 83 (1985).

511. See Katherine Van Wezel Stone, *Rethinking Voluntarism: Labor and the State in the Progressive Era* (unpublished manuscript, on file with the *North Carolina Law Review*).

512. See, e.g., *Goldman v. Cohen*, 227 N.Y.S. 311, 313-15 (App. Div. 1928); *Schlesinger v. Quinto*, 194 N.Y.S. 401, 407-11 (App. Div. 1922). See generally Stone, *The Post-War Paradigm*, *supra* note 508, at 1519-21 (discussing cases in which courts enforced rights in collective bargaining agreements).



agreements. Grievance arbitration was introduced into American labor relations in the 1910s and 1920s in the garment industries,<sup>513</sup> but it was slow to spread to other industries.<sup>514</sup> In part this delay occurred because arbitration did not guarantee unions a means to enforce collective agreements or remedy employer breaches. As with commercial arbitration, parties to labor management arbitration agreements could easily avoid them, given the historical disinclination of common law courts to enforce executory agreements to arbitrate.<sup>515</sup> Moreover, unions were wary of empowering outsiders to decide disputes about the meaning of their contracts.<sup>516</sup>

During World War II, the attitude of courts and unions toward grievance arbitration began to change. The War Labor Board ("WLB"), intent on maintaining labor peace to ensure stable wartime production, saw arbitration as a method of resolving disputes without strikes and thus made arbitration the preferred method for resolving workplace disputes.<sup>517</sup> The WLB encouraged parties to include arbitration clauses in their collective bargaining agreements and accorded arbitration awards substantial deference.<sup>518</sup> After the war, many of the same officials who had staffed the WLB became professional labor arbitrators who encouraged widespread use of arbitration as the natural outgrowth of a collective bargaining relationship.<sup>519</sup>

In 1947, Congress enacted section 301 of the Labor Management Relations Act ("LMRA"),<sup>520</sup> which stated: "Suits for violation of contracts between an employer and a labor organization . . . may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties."<sup>521</sup> On its face, this provision gave federal courts jurisdiction to hear and decide labor

513. See COHEN, *supra* note 292, at 61; Wm. M. Leiserson, *Constitutional Government in American Industries*, 12 AM. ECON. REV. 56, 58 (Supp. 1922).

514. See Stone, *The Post-War Paradigm*, *supra* note 508, at 1514 n.24.

515. See *Kulukundis Shipping Co. v. Amtorg Trading Corp.*, 126 F.2d 978, 982 (2d Cir. 1942); see also Cohen & Dayton, *supra* note 41, at 265 (noting that arbitration agreements were historically "revocable at will").

516. See, e.g., SAMUEL GOMPERS, 2 SEVENTY YEARS OF LIFE AND LABOR 26 (1925) (expressing his opposition to "submitting determination of industrial policies to courts").

517. See JAMES B. ATLESON, *LABOR AND THE WARTIME STATE: LABOR RELATIONS AND LAW DURING WORLD WAR II 60-65* (1998).

518. See *id.*

519. See *id.* at 56-58.

520. Act of June 23, 1947, ch. 120, 61 Stat. 136 (codified as amended at 29 U.S.C.A. §§ 141-187 (1998)).

521. 29 U.S.C. § 185(a) (1994).

disputes. But a number of labor law scholars and practitioners urged the courts to interpret section 301 in a manner that respected the emerging role of arbitration in resolving contractual disputes.<sup>522</sup>

In 1957, Justice Douglas declared the national labor policy to be the promotion of private arbitration to resolve disputes concerning the enforcement and interpretation of collective bargaining agreements. In *Textile Workers Union v. Lincoln Mills*,<sup>523</sup> he interpreted section 301 as a directive to the federal courts to develop a federal common law of collective bargaining, the centerpiece of which was support for and deference to private arbitration.<sup>524</sup> Since *Lincoln Mills*, courts have made private arbitration the central feature of our collective bargaining system.<sup>525</sup>

In 1960, in three cases known as the *Steelworkers' Trilogy*, the Supreme Court adopted a set of legal doctrines that have created a privileged role for arbitration within our collective bargaining system. First, in *United Steelworkers of America v. American Manufacturing Co.*,<sup>526</sup> the Court held that courts should grant specific enforcement of promises to arbitrate without regard to the merits of the underlying dispute.<sup>527</sup> Thus it ruled that parties who agree to arbitration provisions can be required to arbitrate meritless, even frivolous, claims.<sup>528</sup> Second, in *United Steelworkers v. Warrior & Gulf Navigation Co.*,<sup>529</sup> the Court held that agreements to arbitrate were not only judicially enforceable but were enforceable on the basis of a presumption of arbitrability.<sup>530</sup> And finally, in *United Steelworkers v. Enterprise Wheel & Car Corp.*,<sup>531</sup> the Court held that courts should enforce arbitral awards without reviewing the merits of the award.<sup>532</sup> It stated that an arbitral award should be enforced so long as "it

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522. See, e.g., Archibald Cox, *Current Problems in the Law of Grievance Arbitration*, 30 ROCKY MTN. L. REV. 247, 265 (1958); Archibald Cox, *Reflections Upon Labor Arbitration*, 72 HARV. L. REV. 1482, 1512 (1959); Archibald Cox, *The Legal Nature of Collective Bargaining Agreements*, 57 MICH. L. REV. 1, 36 (1958); Harry Shulman, *Reason, Contract, and Law in Labor Relations*, 68 HARV. L. REV. 999, 1023-24 (1955).

523. 353 U.S. 448 (1957).

524. See *id.* at 451.

525. See, e.g., *United Paperworkers Int'l Union v. Misco, Inc.*, 484 U.S. 29, 36-37 (1987) (noting the preference for private arbitration in labor disputes); *Boys Mkts., Inc. v. Retail Clerks Union, Local 770*, 398 U.S. 235, 252 (1970) (noting the integral role arbitration plays in collective bargaining).

526. 363 U.S. 564 (1960).

527. See *id.* at 569.

528. See *id.* at 568.

529. 363 U.S. 574 (1960).

530. See *id.* at 585.

531. 363 U.S. 593 (1960).

532. See *id.* at 599.

draws its essence from the collective bargaining agreement."<sup>533</sup> Furthermore, the Court stated that arbitrators have no obligation to write opinions or to give reasons for their awards.<sup>534</sup> Therefore, if an award could plausibly have drawn its essence from the agreement, it must be enforced.<sup>535</sup> The *Enterprise* Court's formulation of the arbitrator's obligations creates what might be termed a "presumption of arbitrator regularity"—a presumption that the arbitrator acted within the scope of his authority and that the award drew its essence from the collective agreement. The de facto presumption of arbitrator regularity from the *Enterprise* case parallels the presumption of arbitrability adopted in the *Warrior & Gulf* case.<sup>536</sup> Together, the two presumptions make labor arbitration almost impossible to avoid and render arbitral awards practically immune from attack.

At the same time that the courts expanded the scope and autonomy of labor arbitration, the National Labor Relations Board (the "Board") did so as well. It adopted a policy of deferring to private arbitration to resolve disputes that implicated both statutory and contractual issues.<sup>537</sup> In 1964, the Supreme Court upheld the Board's deferral policies, holding that it was appropriate for the Board to give deference to arbitration over judicial or administrative mechanisms for resolving the disputes because arbitration had a "pervasive, curative effect."<sup>538</sup>

These cases established well-known doctrines in U.S. labor law. Together, they make private arbitration the central and distinctive feature of our collective bargaining system. Indeed, the Supreme Court has since indicated on more than one occasion that arbitration lies at the heart of the system of collective bargaining established by the NLRA.<sup>539</sup>

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533. *Id.* at 597.

534. *See id.* at 598.

535. *See id.* at 599.

536. *See United Steel Workers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 582-83 (1960).

537. *See Collyer Insulated Wire Co.*, 192 N.L.R.B. 837, 839 (1971); *Dubo Mfg. Corp.*, 142 N.L.R.B. 431, 433 (1963); *Spielberg Mfg. Co.*, 112 N.L.R.B. 1080, 1082 (1955).

538. *Carey v. Westinghouse Elec. Corp.*, 375 U.S. 261, 272 (1964).

539. *See, e.g., Boys Mkts., Inc. v. Retail Clerks Union, Local 770*, 398 U.S. 235, 241 (1970); *see also Litton Fin. Printing Div. v. NLRB*, 501 U.S. 190, 204 (1991) (holding that "the arbitration duty is a creature of the collective-bargaining agreement" (quoting *Nolde Bros. v. Bakery Workers*, 430 U.S. 243, 250-51 (1977))); *United Paperworkers Int'l Union v. Misco, Inc.*, 484 U.S. 29, 38 (1987) ("[I]t must be remembered that grievance and arbitration procedures are part and parcel of the ongoing process of collective bargaining.").

## 2. Justice Douglas and Labor Arbitration as Self-Regulation

The Supreme Court decisions that established the central role of arbitration in the labor context were, ironically, but coincidentally, written by Justice William O. Douglas.<sup>540</sup> Douglas wrote the opinions in *Lincoln Mills*, the *Steelworkers' Trilogy*, and *Carey v. Westinghouse*,<sup>541</sup> which together mandated that the courts and the NLRB defer to private arbitration and refrain from engaging in judicial review of arbitral awards. Revisiting his views of the role of self-regulation in the securities exchanges that he implemented when he was chairman of the SEC in the 1930s, Justice Douglas justified the deference to labor arbitration on the ground that the unionized workplace was self-regulating. He described labor-management relations in the workplace as a microcosmic democracy and collective bargaining as an exercise in "industrial self-government."<sup>542</sup> As he noted: "The collective bargaining agreement . . . is more than a contract; it is a generalized code to govern a myriad of cases which the draftsmen cannot wholly anticipate."<sup>543</sup> He continued, "[t]he collective agreement covers the whole employment relationship. It calls into being a new common law—the common law of a particular industry or of a particular plant. . . . A collective bargaining agreement is an effort to erect a system of industrial self-government."<sup>544</sup>

Douglas concluded that in the unionized workplace, as in the securities exchanges, courts should support the self-regulatory

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540. Douglas was not alone in characterizing the unionized workplace as industrial self-government. In the years after World War II, a group of labor relations scholars, including Dean Harry Shulman of Yale Law School and Archibald Cox of Harvard used the same metaphor to argue for a particular interpretation of the labor laws. A central aspect of the self-regulatory ideal, and the mini-democracy metaphor they employed, was the central role of arbitration. See Archibald Cox, *Some Aspects of the Labor Management Relations Act, 1947*, 61 HARV. L. REV. 1, 1 (1947); Harry Shulman, *Reason, Contract, and Law in Labor Relations*, 68 HARV. L. REV. 999, 1002-03 (1955). See generally Stone, *The Post-War Paradigm*, *supra* note 508, at 1514-15 (summarizing the industrial pluralist view that the collective-bargaining process between labor and management is seen as a mini-democracy).

541. 375 U.S. 261 (1964).

542. *United Steelworkers v. Warrior & Gulf Navigation Co.*, 363 U.S. 574, 581 (1960). In this view, management and labor are like political parties in a representative democracy—each represents its own constituency and, as in a legislature, engages in debate and compromise. Thus, management and labor together determine wages and working conditions through a legislative-type process. These rules are embodied in the collective bargaining agreement, which the industrial pluralist metaphor calls a statute or a constitution. See Cox, *supra* note 540, at 1.

543. *Warrior & Gulf Navigation Co.*, 363 U.S. at 578.

544. *Id.* at 578-80.

aspects of the community and permit its internal arbitration system to adjudicate disputes. As he commented: “[T]he grievance machinery under a collective bargaining agreement is at the very heart of the system of industrial self-government. Arbitration is the means of solving the unforeseeable by molding a system of private law for all the problems which may arise . . . .”<sup>545</sup>

Douglas’s reasoning in the labor decisions interpreting § 301 of the LMRA has been used extensively as authority for expanding the reach of arbitration under the FAA. For example, the presumption of arbitrability that the Supreme Court announced for the FAA in *Moses Cone Memorial Hospital v. Mercury Construction Co.*<sup>546</sup> in 1983 is phrased in terms almost identical to the language the Court used twenty years earlier in *Warrior & Gulf Navigation Co.*<sup>547</sup> Similarly, courts have hoisted other arbitration doctrines from the labor context and applied them to arbitration under the FAA. For example, *Nolde Bros. v. Local No. 358, Bakery Workers*,<sup>548</sup> a § 301 case in which the Court applied an arbitration clause to a dispute that arose after the collective bargaining agreement containing the arbitration clause had expired, has been used as authority to extend arbitration clauses beyond their expiration dates in nonlabor settings.<sup>549</sup>

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545. *Id.* at 581.

546. 460 U.S. 1 (1983).

547. See Jonathan R. Nelson, *Judge-Made Law and the Presumption of Arbitrability: David L. Threlkeld & Co. v. Metallgesellschaft Ltd.*, 58 BROOK. L. REV. 279, 303 (1992) (noting that the Court transplanted the presumption of arbitrability from *Warrior & Gulf* to *Moses H. Cone* and arguing that there was neither federal labor policy nor international commercial considerations to justify such a fundamental transformation in arbitration jurisprudence); see also *Moses Cone Mem’l Hosp.*, 460 U.S. at 24-25 (holding that “any doubts concerning the scope of arbitrable issues [under collective bargaining agreements] should be resolved in favor of arbitration.”); *Warrior & Gulf Navigation Co.*, 363 U.S. at 582-83 (“An order to arbitrate . . . should not be denied unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute. *Doubts should be resolved in favor of coverage.*” (emphasis added)).

548. 430 U.S. 243 (1977).

549. See, e.g., *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 942-44 (1995) (conflating § 301 cases and FAA cases concerning arbitration); *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 56-58 (1995) (same); *Sweet Dreams Unlimited, Inc. v. Dial-A-Mattress Int’l, Ltd.*, 1 F.3d 639, 643 (7th Cir. 1993) (applying reasoning of *Nolde Bros.*, a § 301 case concerning the applicability of arbitration after a collective agreement has expired, to an FAA case).

## VI. SELF-REGULATION AS A TEMPLATE FOR INTERPRETING THE FEDERAL ARBITRATION ACT

In the last ten years courts have extended their desire to promote self-regulation to many areas of life, areas that go far beyond securities regulation and labor law. Self-regulation has formed a template that informs many of the courts' recent expansive interpretations of the FAA. The template of self-regulation has led courts to expand the scope of arbitration in contexts that bear little resemblance to the self-regulating communities on which the template is based. To illustrate, two controversial areas of arbitration law—arbitral bias and consent to arbitrate contained in incorporated terms—are discussed below.

### A. *Arbitral Bias*

The self-regulation template has informed the development of the law regarding when a court may vacate an arbitral award on the basis of arbitral bias. One of the four statutory grounds for which a court may vacate an arbitrator's decision under the FAA is “[w]here there was evident partiality or corruption in the arbitrators.”<sup>550</sup> In 1968, in *Commonwealth Coatings Corp. v. Continental Casualty Co.*,<sup>551</sup> Justice Hugo Black interpreted the “partiality or corruption” provision to require that an arbitral award be vacated when a member of an arbitration panel had previous business dealings with one of the parties.<sup>552</sup> While no actual bias or partiality was shown in that case, Justice Black stated that there existed the possibility of bias and that the possibility was sufficient to justify vacating the award.<sup>553</sup> He reasoned that it was more important for arbitrators than judges to be impartial because arbitrators have free rein in deciding cases without the prospect of judicial review.<sup>554</sup>

In the 1980s, Justice Black's approach to the issue of arbitral bias in *Commonwealth Coatings Corp.* was eviscerated in the lower

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550. 9 U.S.C. § 10(a)(2) (1994); see also *supra* note 139 (listing the four statutory grounds for vacating arbitral awards).

551. 393 U.S. 145 (1968) (plurality opinion).

552. See *id.* at 147-50 (plurality opinion).

553. See *id.* at 147-49 (plurality opinion).

554. See *id.* at 148-50 (plurality opinion). Justice Byron White concurred, but did not agree to the strict test that Black advocated. See *id.* at 150 (White, J., concurring). Justice Abe Fortas dissented, arguing that actual bias should be shown before an award is vacated. See *id.* at 153-54 (Fortas, J., dissenting). There is a tragic irony here, because Fortas was forced to resign from the Court in 1969 in a controversy over the appearance of a conflict of interest in prior business dealings. See LAURA KALMAN, ABE FORTAS: A BIOGRAPHY 359-78 (1990).

courts.<sup>555</sup> In 1983, Judge Posner held that a prior business relationship was no reason to vacate an arbitral award.<sup>556</sup> He explained, “[t]here is a tradeoff between impartiality and expertise. The expert adjudicator is more likely than a judge or juror not only to be precommitted to a particular substantive position but to know or have heard of the parties.”<sup>557</sup> Posner observed that parties select arbitrators for their expertise, and thus that same expertise should not be used to vacate an award.<sup>558</sup> If parties want impartiality, they can have an Article III judge;<sup>559</sup> if they choose arbitration, it can be assumed that they want expertise in the industry.<sup>560</sup>

Posner’s reasoning has carried the day.<sup>561</sup> No longer are prior business dealings considered a negative factor on an arbitral panel—such professional relationships are now considered acceptable and even desirable features of arbitration. For example, in *Morris v. Metriyakool*,<sup>562</sup> the Supreme Court of Michigan upheld an arbitral award by a medical malpractice panel made up of a doctor, a representative of a hospital, and a representative of an insurance company.<sup>563</sup> The court rejected the plaintiff’s argument that the panel members’ pecuniary interest in keeping malpractice rates low would predispose them to oppose the plaintiff’s claim.<sup>564</sup> The court stated that the panel members did not have a “direct pecuniary interest” in the outcome of the case, so there were no grounds to vacate the award.<sup>565</sup> Rather, it determined that physicians and hospital administrators had shared interests with patients in the

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555. See, e.g., Elizabeth A. Murphy, Note, *Standards of Arbitrator Impartiality: How Impartial Must They Be?* *Lifecare International, Inc. v. CD Medical, Inc.*, 1996 J. DISP. RESOL. 463, 470. Because Black’s opinion was a plurality that required Justice White’s concurring vote to establish a majority, state and federal courts have followed White’s view that they should apply a lower standard of impartiality to arbitrators than they do to judges. See, e.g., *Merit Ins. Co. v. Leatherby Ins. Co.*, 714 F.2d 673, 681-82 (7th Cir. 1983) (rejecting Justice Black’s “potential bias” test); *International Produce, Inc. v. A/S Rosshavet*, 638 F.2d 548, 551 (2d Cir. 1981) (same).

556. See *Merit Ins. Co.*, 714 F.2d at 680.

557. *Id.* at 679.

558. See *id.*

559. See *id.*

560. See *id.* (“The parties to an arbitration chose their method of dispute resolution, and can ask no more impartiality than inheres in the method they have chosen.” (citing *American Almond Prods. Co. v. Consolidated Pecan Sales Co.*, 144 F.2d 448, 451 (2d Cir. 1944))).

561. See Murphy, *supra* note 555, at 474 (observing that courts view impartiality issues as choices parties make in a tradeoff between expertise and impartiality).

562. 344 N.W.2d 736 (Mich. 1984).

563. See *id.* at 743.

564. See *id.* at 741.

565. *Id.* at 740.

treating of illness.<sup>566</sup> It commented: “Neither physicians nor hospital administrators have professional interests that are adverse to patients or even malpractice claimants on a consistent, daily basis.”<sup>567</sup>

Courts have used similar reasoning to justify upholding the arbitral awards of industry panels in a variety of contexts.<sup>568</sup> Their reasoning relies on the notion that arbitrations are a part of a community in which the arbitrators, like the elders in the craft guilds of old, embody and apply community norms that are shared by both sides to the dispute. In this role, the arbitrators’ prior dealings in the trade and with the parties is a positive attribute—these dealings establish their expertise as well as their stature in the field. Instead of being a ground for disqualification, expertise is a *sine qua non* for qualification as decision-maker. Under this view of arbitration, Posner is clearly correct that expertise should not be a reason for disqualifying or a reason to vacate an arbitral award.

Current uses of arbitration, however, are a far cry from the craft guild model. For example, even though doctors, patients, and hospital administrators all share a common involvement in health care, it defies reason to view them as participating as co-equal members in a shared community. If one sees arbitration not as a feature of shared normative communities but rather as a proceeding devised by insiders to be imposed on outsiders, the prospect of prior business dealings causing arbitral bias is a real and troublesome problem. If one abandons the guild model and begins with the current contexts for arbitration, then Justice Black’s position that standards of arbitral impartiality must be more stringent than standards imposed on judges is clearly correct.

### *B. Consent When Arbitration Is Incorporated by Reference*

Another area of arbitration law in which courts are guided by a desire to support self-regulating communities is when arbitration is incorporated by reference rather than appearing among the contract terms. Contracts frequently state that they incorporate the rules of a given trade association without mentioning that an arbitration procedure is one component of the rules. It is well established that

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566. *See id.* at 741.

567. *Id.*

568. *See, e.g., Hoffman v. Cargill, Inc.*, 968 F. Supp. 465, 473-74 (N.D. Iowa 1997) (upholding arbitration in a dispute between a farmer and a grain mill distributor when the arbitration panel was comprised of grain distribution executives); *Sims v. Siegelson*, 668 N.Y.S.2d 20, 22-23 (App. Div. 1998) (upholding an award issued by the Diamond Dealers Club arbitration panel making a father responsible for debts of his son).



parties are responsible for the contracts they sign, even if they have not read them.<sup>569</sup> This "duty to read" means, *inter alia*, that courts hold parties to terms that they have incorporated by reference into their contracts, even if the party seeking to avoid the incorporated term had no knowledge of these terms at the time the contract was made.<sup>570</sup>

A competing principle of contract law exists, however, that says that a party is not bound by a contractual term of which he was unaware and which he had no reason to suspect was in the agreement.<sup>571</sup> For example, the Rhode Island Supreme Court stated: "A person is not bound by the terms of a written agreement if he had no knowledge of its terms because the manner in which they are embodied in the instrument would not lead a reasonable person to suspect that the terms are part of the contract."<sup>572</sup> This principle is also found in section 211 of the Second Restatement of Contracts, which states:

(1) Except as stated in Subsection (3), where a party to an agreement signs or otherwise manifests assent to a writing . . . he adopts the writing as an integrated agreement with respect to the terms included in the writing.

....

(3) Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.<sup>573</sup>

One application of the no-enforcement-of-unexpected-terms principle is that courts can scrutinize contracts and invalidate terms if the terms are oppressive and not within a party's reasonable expectation, that is, not within the range of terms the offeree could reasonably expect to find in the contract.<sup>574</sup> The same principle

569. See John D. Calamari, *Duty to Read—A Changing Concept*, 43 *FORDHAM L. REV.* 341, 341 (1974).

570. See CALAMARI & PERILLO, *supra* note 22, § 9-42, at 410.

571. See *id.* § 9-44; see also RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981) (stating that one party cannot take advantage of another party's ignorance relating to a term if the first party knows that the second party would not assent to the agreement if the second party knew of the term's presence).

572. *Drans v. Providence College*, 383 A.2d 1033, 1037-38 (R.I. 1978) (relying on *Goldstein v. Rhode Island Hospital Trust National Bank*, 296 A.2d 112, 116 (R.I. 1972)); see also FARNSWORTH, *supra* note 22, § 4.14, at 263-64 (noting that the trend is toward relieving parties of contractual terms they have not read if the drafter used artifice to prevent the recipient from reading it or if consumers are involved).

573. RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (1981).

574. See, e.g., *Aviall, Inc. v. Ryder Sys., Inc.*, 913 F. Supp. 826, 831-32 (S.D.N.Y. 1996);

applies to terms contained in standard form contracts but which are either buried in a sea of fine print or otherwise not conspicuous to the signing party.<sup>575</sup>

Courts also police contracts with incorporated terms by interpreting the incorporated terms narrowly. They sometimes insist that incorporated terms be designated with specificity in order to prevent one party from taking advantage of the other by inserting a reference to a broad and open-ended, self-serving term that the other party had no reason to suspect was present.<sup>576</sup> The strict scrutiny courts impose on incorporated terms is a policing mechanism to ensure consent and/or protect the weaker party in the face of obscure, one-sided contractual terms.

Because courts exercise a policing role when confronted with one-sided incorporated terms in contracts generally, one might expect courts to police arbitration agreements that are incorporated by reference for unfairness, oppression, or surprise. Until the late 1980s, courts did just that.<sup>577</sup> They imposed heightened scrutiny of arbitration clauses that were inserted by reference because they believed that a contractual provision as important as an arbitration clause—which is in effect a waiver of a right to sue—should be express to be enforceable.<sup>578</sup> For example, the New York courts

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Stirlen v. Supercuts, Inc., 60 Cal. Rptr. 2d 138, 145-47, 158-59 (Ct. App. 1997); Buraczynski v. Eyring, 919 S.W.2d 314, 320-21 (Tenn. 1996).

575. See, e.g., Williams v. Walker-Thomas Furniture Co., 350 F.2d 445, 449 (D.D.C. 1965); Henningsen v. Bloomfield Motors, Inc., 161 A.2d 69, 86 (N.J. 1960). See generally CALAMARI & PERILLO, *supra* note 22, § 9-43, at 412-14 (stating that a term may not be enforced when it is placed in such a way that it is unlikely to come to the attention of the party signing the contract).

576. See, e.g., Chiacchia v. National Westminster Bank, 507 N.Y.S.2d 888, 889-90 (App. Div. 1986) (noting that a trial was required to determine whether a safe deposit rental agreement that stated it incorporated “rules and regulations of the bank” contained sufficient specificity to incorporate the bank’s Rules for Safe Deposit Box Service). See generally Robert Whitman, *Incorporation by Reference in Commercial Contracts*, 21 MD. L. REV. 1, 2-7 (1961) (citing cases).

577. See, e.g., C. Itoh & Co. v. Jordan Int’l Co., 552 F.2d 1228, 1234-35 (7th Cir. 1977); Medical Dev. Corp. v. Industrial Molding Corp., 479 F.2d 345, 349 (10th Cir. 1973); Amoco Oil Co. v. M.T. Mary Ellen, 529 F. Supp. 227, 229-30 (S.D.N.Y. 1981); see also Riverdale Fabrics Corp. v. Tillinghast-Stiles Co., 118 N.E.2d 104, 106 (N.Y. 1954) (invalidating a clause that attempted to incorporate an arbitration clause by reference to the Cotton Yarn Rules of 1938); Weiner v. Mercury Artists Corp., 130 N.Y.S.2d 570, 571-72 (App. Div. 1954) (invalidating a claim that attempted to incorporate an arbitration clause by reference to the rules of the American Federation of Musicians). See generally Whitman, *supra* note 576, at 16-17 (noting a trend in the courts towards requiring specific mention of an arbitration clause in the body of a document in order to render it enforceable).

578. See, e.g., Castagna & Son, Inc. v. Alan Michel Plumbing, Inc., 462 N.Y.S.2d 486, 487 (App. Div. 1983); Riverdale Fabrics Corp., 118 N.E.2d at 106. Similar reasoning has

adopted a principle that "an agreement to arbitrate must be clear and direct, and must not depend upon implication, inveiglement or subtlety" to be enforceable.<sup>579</sup> As the New York Court of Appeals stated in 1954: "Parties are not to be led into arbitration unwittingly through subtlety."<sup>580</sup> Requiring a clear and unequivocal waiver of legal rights is not unique to arbitration. Courts have often held that contractual provisions that involve disclaimers of warranties, confessions of judgment, or other waivers of legal rights must be explicit and clear to be enforced.<sup>581</sup>

Until the 1980s, courts were particularly skeptical of arbitration clauses in contracts in which the drafter was a member of the trade association and the party seeking to avoid arbitration was not.<sup>582</sup> The New York Court of Appeals noted that such contracts appear to have been drafted with a deliberate intent of avoiding the mention of arbitration, leaving "unwary trader[s]" to learn of the arbitration provision only when a dispute arose.<sup>583</sup> The court stated that "the form of words favored by these trade associations appears to have been designed to avoid any resistance that might arise if arbitration were brought to the attention of the contracting parties as the exclusive remedy in case of disputes."<sup>584</sup> But in the late 1980s, state courts abandoned their policing approach to arbitration clauses

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been used by courts to hold that a counteroffer containing an arbitration clause was a material modification under U.C.C. § 2-207, and thus required an affirmative acceptance by the offeror to be effective. *See, e.g., In re Doughboy Indus.*, 233 N.Y.S.2d 488, 494-95 (App. Div. 1962).

579. *In re Doughboy Indus.*, 233 N.Y.S.2d at 493; *see also* *Waldron v. Goddess*, 461 N.E.2d 273, 274 (N.Y. 1984) (holding that an arbitration provision in an expired employment contract would not be extended by implication but only by express means); *EIS Group/Cornwall Hill Dev. Corp. v. Renaldi Constr., Inc.*, 546 N.Y.S.2d 105, 106 (App. Div. 1989) (holding that because the contract between a developer and a contractor did not contain a clear and unequivocal arbitration agreement, arbitration would not be compelled).

580. *Riverdale Fabrics Corp.*, 118 N.E.2d at 106.

581. *See, e.g., Petersen v. Hubschman Constr. Co.*, 389 N.E.2d 1154, 1159 (Ill. 1979) (holding that a disclaimer of warranty of habitability must be explicit to be enforced); *Tassan v. United Dev. Co.*, 410 N.E.2d 902, 909 (Ill. Ct. App. 1980) (holding that a disclaimer of warranty of habitability clause that appeared in the same size type as other clauses was not effective because it was not sufficiently conspicuous nor explained); *Cutler Corp. v. Latshaw*, 97 A.2d 234, 236-37 (Pa. 1953) (holding that a confession of judgment and warrant of attorney clause appearing in fine type on the back of a contract, although referenced on the front, is ineffective).

582. *See, e.g., Riverdale Fabrics*, 118 N.E.2d at 106. *See generally* *Whitman*, *supra* note 576, at 17-18 & n.87 (citing cases in which courts were hesitant to force nonmembers to arbitrate).

583. *Riverdale Fabrics*, 118 N.E.2d at 106.

584. *Id.*

incorporated by reference. Instead, they began to enforce arbitration clauses that were incorporated by reference even when the contract was silent on the existence of the arbitration clause.<sup>585</sup>

One reason for the change was the 1987 Supreme Court decision in *Perry v. Thomas*.<sup>586</sup> In *Perry*, the Court stated that under the FAA the existence of a valid agreement to arbitrate must be determined by reference to state law, but any state law or legal doctrine that is specific to arbitration is preempted by the FAA.<sup>587</sup> Thus, only state laws governing the enforceability of contracts generally can be used as a defense to arbitration under the FAA.<sup>588</sup> The *Perry* Court's admonition that courts may not rely on arbitration-specific doctrines to invalidate arbitration agreements led courts to hold that state law doctrines requiring strict scrutiny of arbitration clauses that were incorporated by reference were no longer valid.<sup>589</sup> Similarly, state contract law doctrines that required an explicit and unequivocal waiver of a right to sue before finding that parties had agreed to binding arbitration were held to be preempted.<sup>590</sup> The result was that whereas general contract law provides latitude for courts to protect consumers in their dealings with large organized interests by relieving them of oppressive and unexpected contractual terms, courts interpreted *Perry* to deny courts that latitude when they were dealing with arbitration clauses.

Courts need not have interpreted *Perry* in that way. They could have characterized the judicial treatment of arbitration clauses incorporated by reference as an application of the more general doctrine that courts can refuse to enforce unexpected and oppressive incorporated terms and terms that waive legal rights, rather than as an application of a special rule for arbitration clauses.<sup>591</sup> If the

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585. See *infra* notes 594-610 and accompanying text.

586. 482 U.S. 483 (1987); see also *supra* notes 69-73 and accompanying text (discussing *Perry*).

587. See *Perry*, 482 U.S. at 489-91.

588. See *id.* at 492-93 & n.9.

589. See, e.g., *Progressive Cas. Ins. Co. v. C.A. Reaseguradora Nacional de Venez.*, 991 F.2d 42, 46 (2d Cir. 1993); *Cook Chocolate Co. v. Salomon, Inc.*, 684 F. Supp. 1177, 1182 (S.D.N.Y. 1988).

590. See *Progressive Cas. Ins. Co.*, 991 F.2d at 45-46.

591. See U.C.C. § 2-302 & cmt. 1 ("The principle is one of the prevention of oppression and unfair surprise, and not of disturbance of allocation of risks because of superior bargaining power." (citation omitted)); see also RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. b (1981) (characterizing unconscionable contract terms to be such "as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other" (quoting *Hume v. United States*, 132 U.S. 406, 411 (1889))).

practice of strictly scrutinizing arbitration clauses incorporated by reference was characterized as an application of these more general contract law principles, then it would not contravene *Perry* to continue to apply them.

The retreat from heightened scrutiny and the substitution of an "anything goes" approach to arbitration clauses that are incorporated by reference began, not surprisingly, in securities cases. In the mid-1980s, the Second, Third, and Seventh Circuits independently held that a broker who was a member of a stock or commodity exchange was required to arbitrate his dispute with a customer even though the broker had not consented to do so.<sup>592</sup> These cases relied on the fact that the broker, by becoming a member of the exchange, had agreed to abide by its rules, including any subsequent amendments thereto. The courts held that membership in the exchange was sufficient to constitute consent to arbitration, whether or not there was contractual assent.<sup>593</sup>

One example of this new trend was *Geldermann v. Commodity Futures Trading Commission*,<sup>594</sup> in which the Seventh Circuit compelled parties to arbitrate a dispute between a member of a commodities exchange and a customer.<sup>595</sup> The broker, who resisted arbitration, had previously applied to join the Chicago Board of Trade ("CBOT"), where he promised to "observe and be bound by the Charter, Rules, and Regulations of the Association, and all amendments subsequently made thereto."<sup>596</sup> At that time, the CBOT had no mandatory arbitration provision for customer-initiated claims, but it later amended its regulations to add such a provision.<sup>597</sup> Geldermann claimed that he never consented to be bound by the arbitration rule.<sup>598</sup> The court rejected his claim, ruling that Geldermann, by becoming a member of the Association and by agreeing to be bound by its rules, had waived his right to a judicial forum and had consented to be bound by arbitration procedures later

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592. See *Geldermann v. Commodity Futures Trading Comm'n*, 836 F.2d 310, 319 (7th Cir. 1987); *Patten Sec. Corp. v. Diamond Greyhound & Genetics, Inc.*, 819 F.2d 400, 406 (3d Cir. 1987); *Paine, Webber, Jackson & Curtis v. Chase Manhattan Bank, N.A.*, 728 F.2d 577, 580 (2d Cir. 1984).

593. See, e.g., *Geldermann*, 836 F.2d at 318; *Patten Sec. Corp.*, 819 F.2d at 406.

594. 836 F.2d 310 (7th Cir. 1987).

595. See *id.* at 323-24.

596. *Id.* at 318 (quoting Regulation 205.00, Rules and Regulations of the Board of Trade of the City of Chicago).

597. See *id.*

598. See *id.*

adopted by the Association.<sup>599</sup>

Similarly, in *Cook Chocolate Co. v. Salomon Inc.*,<sup>600</sup> the District Court for the Southern District of New York required the plaintiff cocoa bean buyer to arbitrate his claims against a trading firm because his contract incorporated “[a]ll relevant terms and conditions of the Cocoa Merchants’ Association of America.”<sup>601</sup> The court stated that the plaintiff, who belonged both to the cocoa merchants’ trade association and the relevant commodities exchange, both of which required the use of arbitration, could not claim that the obligation to arbitrate was not within his expectations.<sup>602</sup>

The result in each of these cases was derived from the fact that both parties were members of the trade association or stock exchange, not from a specific arbitration provision that was express or incorporated by reference into a contract. The courts used the fact of membership of both contracting parties to overcome any claims one party might make that it was being compelled to arbitrate unwittingly. Reliance on the fact of shared membership in a common endeavor has also led courts to impose arbitration when there was not only no express arbitration agreement between them, but also no mention of arbitration in documents that they had incorporated by reference.<sup>603</sup>

In a setting of joint membership, both parties can not only be presumed to know of and have shared in making the arbitration rules, they also can be presumed to share in the normative principles and precepts that an arbitrator will bring to bear in deciding the dispute. In this sense, the disputing parties and the arbitrators are all members of a shared normative community. The template of arbitration as a creation and reflection of shared values within a normative community makes sense in such a setting and leads to justifiable results.

The security industry cases turn on membership in a shared trade association or stock exchange, but they have also been used as

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599. See *id.* at 318-19. But see Richard H. Fallon, Jr., *Of Legislative Courts, Administrative Agencies, and Article III*, 101 HARV. L. REV. 916, 991-92 & n.414 (1988) (criticizing *Geldermann* and arguing that “conditioning the practice of a lawful trade on the ‘waiver’ of a constitutional right is coercive in every practical sense; to call this a ‘waiver’ is to render the concept meaningless”).

600. 684 F. Supp. 1177 (S.D.N.Y. 1988).

601. *Id.* at 1180 (quoting the contract at issue).

602. See *id.* at 1183.

603. See *R.J. O’Brien & Assoc. v. Pipkin*, 64 F.3d 257, 259, 261 (7th Cir. 1995) (compelling parties who were both registered with the National Futures Association to arbitrate).

authority for compelling arbitration of disputes between members and nonmembers when there was a contract that incorporated the rules of a trade association or exchange " 'as they may be amended from time to time.' " <sup>604</sup> One particularly troubling case in which a court extended the incorporation by reference approach beyond the member-member situation was *Pay Phone Concepts, Inc. v. MCI Telecommunications Corp.*, <sup>605</sup> in which the district court held that the plaintiff, a pay phone owner, was required to arbitrate his dispute with MCI. <sup>606</sup> The plaintiff's contract with MCI made no mention of arbitration, but some time after the contract was made, MCI amended its Tariff on file with the Federal Communications Commission to provide for binding arbitration of all disputes. <sup>607</sup> The court held that the plaintiff, who was unaware of the Tariff amendment and had never consented to arbitrate disputes with MCI, was nonetheless bound to do so because its contract with MCI contained a vague reference to the MCI Tariff. <sup>608</sup> The court stated that the plaintiff was presumed to know not only the terms of the Tariff at the time the contract was made, but also that the carrier might change the Tariff from time to time. <sup>609</sup> Further, the plaintiff was expected to know that the Tariff, which normally pertains to rates to be charged, might also be amended to add an arbitration provision. <sup>610</sup> This case illustrates the absurd results that occur when courts extend the reasoning of cases involving joint membership to member-nonmember situations.

## VII. REASSESSING THE COURTS' APPROACH TO SELF-REGULATION

### A. *A Distinction Between Insiders and Outsiders*

Once we understand the courts' expansive interpretation of the FAA as a form of delegation of judicial and legislative authority to

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604. *Illyes v. John Nuveen*, 949 F. Supp. 580, 582 (N.D. Ill. 1996) (quoting NATIONAL ASSOCIATION OF SECURITIES DEALERS, UNIFORM APPLICATION FOR SECURITIES INDUSTRY REGISTRATION OR TRANSFER (FORM U-4) (1979)). The *Illyes* court required a bond analyst to arbitrate a dispute with a former employer on the basis of an initial U-4 application even though NASD procedure was amended after the employee's hiring to require employment disputes be arbitrated. *See id.* at 583; *see also* *Hodge Bros. v. Delong Co.*, 942 F. Supp. 412, 419 (W.D. Wis. 1996) (holding that a nonmember was bound to arbitrate under the rules of trade association).

605. 904 F. Supp. 1202 (D. Kan. 1995).

606. *See id.* at 1204, 1209.

607. *See id.* at 1204.

608. *See id.* at 1207.

609. *See id.*

610. *See id.*

self-regulating communities, we can critically assess the virtues and limitations of such an approach. It becomes immediately clear that arbitration has very different virtues and limitations depending upon whether it used to resolve disputes between two members of a normative community such as a trade association or a stock exchange, or whether it is used in disputes between insiders to a community and others who remain outside. Today many arbitration clauses are found not in contracts between equals in a shared community, but rather in contracts of adhesion between insiders and outsiders, such as between a powerful association and a nonmember or between a big corporation and a consumer. Therefore, while substantial deference to arbitration may be appropriate in a dispute between equally situated members of the medical community, for example, it is not appropriate to require patients alleging malpractice to take their cases to a panel of medical community insiders who are likely to be more sympathetic to the medical professional than to the patient.

The use of arbitration in disputes between insiders and outsiders raises problems not merely of overt arbitrator bias; it also poses problems of more subtle bias that exists when the arbitrator has fundamentally different perspectives than one of the parties. Outsiders are disadvantaged in such settings because insiders know the norms, share the norms with the arbitrators, and expect the norms to govern resolution of their disputes. Moreover, the fact that most association arbitration procedures are informal often works to the disadvantage of the outsider. Outsiders do not have ready access to relevant information, knowledge of the historical background and precedents, or ability to garner potentially helpful witnesses, making it ever more difficult to prove their case.<sup>611</sup>

The differences between insider-outsider arbitrations and insider-insider arbitrations justify differential levels of judicial deference. While to date, courts have not made such a distinction, such a distinction could protect outsiders in cases where blanket application of pro-arbitration policies leads to injustice. There are several doctrinal mechanisms courts could use to protect outsiders from the potentially oppressive arbitration systems designed and maintained by insiders. For example, courts could use the

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611. From a practical perspective, the information the outsider requires to meet its burden of proof is often in the insider's possession. See, e.g., David S. Schwartz, *Enforcing Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 1997 WIS. L. REV. 33, 46-49 (discussing a case in which the lack of discovery hindered the plaintiff in employment discrimination arbitration).



unconscionability doctrine to impose greater scrutiny on arbitration agreements between insiders and outsiders where there is a danger that the outsider has been compelled to waive statutory rights, agree to one-sided arbitral procedures, or submit to a biased forum. Some courts are beginning to adopt this approach in the area of employment arbitration between employers and nonunion workers.<sup>612</sup>

Alternatively, courts could require that minimal due process be provided before enforcing an arbitral award in a dispute between an insider and an outsider.<sup>613</sup> Such an approach would find support in the dicta in *Gilmer v. Interstate/Johnson Lane Corp.*,<sup>614</sup> which suggested that to be enforceable, an arbitration procedure must provide minimal standards of due process.<sup>615</sup>

Courts could also protect outsiders in insider-outsider arbitrations by changing the standard of review of arbitral outcomes. They could abandon the judge-made "manifest disregard" and

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612. See *Cole v. Burns Int'l Sec. Servs.*, 105 F.3d 1465, 1479-83 (D.C. Cir. 1997) (stating that minimal due process protections must be present to avoid such arbitrations being held unconscionable); *Stirlen v. Supercuts, Inc.*, 60 Cal. Rptr. 2d 138, 158-59 (Ct. App. 1997) (holding that an arbitration agreement which significantly limited employees' remedies, shortened the statute of limitations, eliminated employees' rights to recover for many statutory and common law actions, and did not similarly apply to the employer was so one-sided as to be unconscionable); see also Thomas E. Carbonneau, *Arbitration and the U.S. Supreme Court: A Plea for Statutory Reform*, 5 OHIO ST. J. ON DISP. RESOL. 231, 272-73 (1990) (proposing amendments to the FAA to ensure consent and due process in arbitration).

While the separability doctrine prevents courts from using the unconscionability doctrine to invalidate an arbitration clause when an entire agreement is alleged to be unconscionable, courts could scrutinize arbitration clauses contained within an agreement for substantively unconscionable features. See *Doctor's Assocs. v. Casaratto*, 517 U.S. 681, 687 (1995); see also *Brower v. Gateway 2000, Inc.*, 676 N.Y.S.2d 569, 574-75 (App. Div. 1998) (holding that excessive costs involved in arbitration under the International Chamber of Commerce rules rendered that portion of the arbitration award unconscionable).

613. Some recent cases have suggested that arbitration awards must result from a fundamentally fair procedure to be enforceable. See, e.g., *Rosenberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 995 F. Supp. 190, 201-10 (D. Mass.), *aff'd on other grounds*, 163 F.3d 53 (1st Cir. 1998); *Hoffman v. Cargill, Inc.*, 968 F. Supp. 465, 474-76 (N.D. Iowa 1997).

614. 500 U.S. 20 (1991).

615. See *id.* at 31 (suggesting in dicta that minimal procedural protections, such as limited opportunities for discovery, are required for affirmation of an arbitral award). There is also some authority for a minimal due process test for arbitration under the antitrust laws. See *Silver v. New York Stock Exch.*, 373 U.S. 341, 361 (1963) (suggesting that a trade association's arbitration agreement would be a per se violation of the antitrust laws unless it contained minimal procedural protections). The interpretation by the court in *Silver* was narrowed in *Northwest Wholesale Stationers v. Pacific Stationary & Printing Co.*, 472 U.S. 284 (1985). See *Northwest Wholesale Stationers*, 472 U.S. at 291-93 (limiting *Silver* to a group boycott case).

instead impose de novo review for questions of law decided in arbitration. Recently some scholars have suggested that courts review arbitral awards de novo for questions of law in the areas of attorney-client arbitration and employment arbitration.<sup>616</sup> A more general use of judicial review for questions of law would assure that arbitration complies with external law while preserving the fact-finding role of the arbitrator.

Another approach courts could take to police the fairness of arbitration in insider-outsider cases is to rule that arbitration under the FAA is state action and so constitutional Due Process Clause protections apply.<sup>617</sup> To date, a few courts have held that the Due Process Clause applies to disciplinary and arbitration proceedings in the securities industry,<sup>618</sup> but most other courts have rejected this reasoning.<sup>619</sup> Applying the Fifth Amendment Due Process Clause to arbitration would convert arbitration under the FAA from a forum for private justice to an adjunct to the legal system.

A different approach to policing arbitration in disputes between insiders and outsiders is to reconsider the revocability doctrine. As Robert Ellickson has demonstrated, some self-governing communities have powerful enforcement means outside the law to police and sanction members who violate their norms.<sup>620</sup> Indeed, he

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616. See Brickman, *supra* note 204, at 307 (proposing courts review attorney fee arbitral awards to “ensure that ethical and fiduciary standards have been properly applied”); Martin H. Malin & Robert F. Ladenson, *Privatizing Justice: A Jurisprudential Perspective on Labor and Employment Arbitration from the Steelworkers Trilogy to Gilmer*, 44 HASTINGS L.J. 1187, 1240 (1993) (proposing “de novo judicial review of arbitral interpretations of law” in employment arbitration); see also Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court’s Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 710-11 (1996) (advocating that courts overturn arbitral awards that are “clearly unfounded and inconsistent with applicable law”).

617. Recently, some scholars have argued that arbitration was state action and should be subject to Fifth Amendment standards. See, e.g., Richard C. Reuben, *Public Justice: Toward a State Action Theory of Alternative Dispute Resolution*, 85 CAL. L. REV. 577, 609-41 (1997); Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court’s Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TUL. L. REV. 1, 40-47 (1997).

618. See, e.g., R.J. O’Brien v. Pipkin, 64 F.3d 257, 262 (7th Cir. 1995) (holding that because individuals registering with a commodity exchange are required, by the Commodity Exchange Act, 7 U.S.C. §§ 1-26 (1994), to agree to the exchange’s own rules, the exchange is exercising a governmental function and, must therefore accord registrants due process in the registration process); see also Stone & Perino, *supra* note 427, at 486 (finding that “no federal court cases have held that any constitutional rights other than due process rights apply in connection with enforcement actions instituted by SROs”).

619. At present there is a split in the circuits on the issue of the application of the Fifth Amendment to securities industry disciplinary arbitrations. See Stone & Perino, *supra* note 427, at 486-92.

620. See ROBERT ELLICKSON, *ORDER WITHOUT LAW* 56-64 (1994). Ellickson refers

argues that norms are self-enforcing within self-governing communities. Ellickson's study of cattle farmers in Shasta County, California vividly illustrates how insiders tend to abide by their community's dispute resolution systems even in the absence of a statute to compel them to do so.<sup>621</sup> It is therefore reasonable to assume that insiders to trade associations or other such self-regulating and norm-generating communities will tend to abide by their arbitration agreements with or without the FAA to compel them to do so.

If it is true that self-regulating communities generate self-enforcing norms, then little would be lost by amending the FAA to reinstate the revocability doctrine. Such an amendment would operationalize a distinction between insiders and outsiders without requiring courts to make that classification. It would give outsiders the option to decline to use the community's own arbitration system and utilize the civil litigation system instead, while at the same time it would permit insiders, who are subject to the informal sanctions of a self-regulating community, to do so. Reviving the revocability doctrine therefore has the potential of retaining use of arbitration where it is appropriate without imposing it where it does not belong.

### *B. Defining a Self-Regulating Community*

Most of the foregoing proposals for policing arbitration between insiders and outsiders assume that courts are able to tell the difference between arbitration in "insider-outsider" disputes and "insider-insider" disputes. Other than the proposal to resurrect the revocability doctrine, the proposals require courts to have a robust definition of a normative self-regulating community and a way to determine membership thereto. While full development of such a definition is another project for another day, the relevant features of self-regulating communities can be briefly described.

Membership in a normative community must involve, at the very least, two features: (1) common experiences; and (2) the opportunity

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to normative self-regulating communities as "close-knit groups, which he defines as a group where "informal power is distributed amongst group members and the information pertinent to informal control circulates easily among them." *Id.* at 177-78; see also Lisa Bernstein, *Merchant Law in Merchant Court: Rethinking the Code's Search for Immanent Business Norms*; 144 U. PA. L. REV. 1765, 1771-82 (1996) (discussing the arbitration structure of the National Grain and Feed Association, which uses a more formalistic system of rules, as compared to the course of dealing and course of performance rules by which courts assess disputes under the UCC).

621. See ELLICKSON, *supra* note 620, at 55-64, 79-81.

to participate in framing the shared institutions, values, and rules that grow out of that common experience. The requirement of common experiences provides the necessary basis for a normative community, but it is not sufficient. The role of participation becomes clear when we consider two settings in which arbitration is frequently utilized and much criticized—franchise relationships and employment relationships.

Many of the most controversial cases decided under the FAA involve franchise or employment situations. *Southland Corp. v. Keating*<sup>622</sup> involved a dispute between a franchisee and a franchisor about alleged acts of fraud and breach of contract.<sup>623</sup> *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*<sup>624</sup> involved a franchise relationship between Chrysler and Soler in which the franchisee accused the franchisor of violations of the Sherman Antitrust Act.<sup>625</sup> *Doctor's Associates v. Casaretto*<sup>626</sup> involved an attempt by a franchisee to arbitrate fraud and breach of good faith claims.<sup>627</sup> In each case, the franchisor gave the franchisee an arbitration agreement at the outset of the relationship, and when the franchisee later attempted to assert legal rights against the franchisor, the latter successfully raised the arbitration clause as a bar to the action.

Employment cases are a close analog to franchise cases. In employment cases, the employer typically requires the employee to agree to an arbitration provision at the outset of the relationship as a condition of entry. When the employee subsequently attempts to bring a legal claim against the employer, the latter raises the arbitration clause as a bar.<sup>628</sup>

Franchise and employment cases look like insider-insider cases because in both situations the parties to the dispute—franchisee and franchisor or employee and employer—share an economic interest in the well-being of a common enterprise. In both settings, the disputants are likely to wear the same company insignia and attend

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622. 465 U.S. 1 (1984).

623. *See id.* at 3-4, 17.

624. 473 U.S. 614 (1985).

625. *See id.* at 619, 620.

626. 517 U.S. 681 (1996).

627. *See id.* at 682-83.

628. For example, in *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20 (1991), an employer successfully compelled an employee to utilize an arbitration system, to which the employee was forced to consent in order to obtain employment, for adjudicating the employee's age discrimination claim. *See id.* at 23. Since *Gilmer*, many lower courts have likewise required employees to arbitrate employment-related claims that employees sought to litigate. *See Stone, supra* note 136, at 1023 (citing cases).

the same company picnics. The franchise and employment relationships, however, are different from stock exchange or trade association cases in one important respect: Arbitration does not emerge from participation in a shared normative community in which both parties participate. In the franchise and employment cases, the party seeking to avoid arbitration—the franchisee or employee—did not play a participatory role in framing the rules, norms, and customs of the community. Rather, the arbitration agreement was the ticket of entrance into the community. The arbitration clause is typically contained in the franchise agreement or the employer handbook, and the applicant franchisee/employee is told they cannot enter the “community” if they decline it. At the moment that the arbitration procedures are proposed, the individual employee or franchisee is an outsider who has played no role in shaping the procedures or the norms which it embodies. Therefore the arbitration process does not reflect the existence of a shared community and norms. For this reason, franchise-franchisor and employee-employer relationships are insider-outsider pairings, similar to customer-stockbroker or patient-doctor relationships. While they involve shared experiences and economic interdependency, there is no shared participation in defining the norms of the community.<sup>629</sup>

#### VIII. THE SCOPE OF SELF-REGULATION WITHIN THE BROADER COMMUNITY

This Article has advocated a two-tiered approach to arbitration—a deferential approach to arbitration for insider-insider disputes and a restrictive approach for insider-outsider disputes. Such an approach would cure some of the present abuses in the use of arbitration, but it raises two further issues. First, while the case has been made for policing the use of arbitration between insiders and outsiders, it remains to consider whether there should also be some level of policing for arbitrations between insiders to self-regulating communities. Within such communities we do not want considerations of law and public policy to be excluded altogether.<sup>630</sup> As presently interpreted, the FAA permits self-regulating

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629. See Gregory S. Alexander, *Dilemmas of Group Autonomy: Residential Associations and Community*, 75 CORNELL L. REV. 1, 44-47 (1989) (arguing that homeowner associations lack genuine participatory self-governance and thus do not foster civic participation or small-scale democracy).

630. See Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984) (arguing that courts play a constructive role by “explicat[ing] and giv[ing] force to the values embodied in authoritative texts such as the Constitution and statutes”).

communities to opt out of many publicly enacted obligations.<sup>631</sup> We need to question the degree to which such groups should be able to do this. After all, laws are enacted for the community at large, and there is a larger public interest in having others obey them. Furthermore, even within self-regulating communities, there are often power imbalances, coercive practices, and opportunism that should be amenable to judicial redress.

#### A. *Voluntary Associations and the Limits of Autonomy*

The question of whether to permit collective waiver of public norms, and which public norms should be amenable to collective waiver, implicates the larger question of the role of voluntary associations in society. Voluntary associations have always been an important aspect of American democracy,<sup>632</sup> but at the same time courts have long imposed limits on the claims of group autonomy.<sup>633</sup> The question of which groups should be able to self-regulate, and on which issues, is a subject of ongoing and intense debate.<sup>634</sup> These issues are both complicated and simplified by the fact that most members of our society participate in overlapping and changing self-regulating communities.<sup>635</sup> For example, many Americans are

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631. The combination of the “manifest disregard” standard of review of arbitral awards and the presumption of arbitrability has this effect. See *supra* notes 146-47 and accompanying text.

632. See ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 319-32 (Henry Steele Commager ed. & Henry Reeve trans., Oxford Univ. Press 1947) (1840).

633. See, e.g., *Employment Div. v. Smith*, 494 U.S. 872, 890 (1990) (affirming a state’s prohibition on the use of peyote by religious group); *Lyng v. International Union*, 485 U.S. 360, 368 (1988) (upholding the Amendment to Food Stamp Act precluding payment of food stamps to families of striking workers); *Board of Dirs. of Rotary Int’l v. Rotary Club*, 481 U.S. 537, 548 (1987) (determining that requiring Rotary Clubs to admit women “does not require the clubs to abandon or alter” any of their activities or basic goals and therefore did not abridge the members’ associational rights); *Roberts v. United States Jaycees*, 468 U.S. 609, 628-29 (1984) (affirming state ruling requiring Jaycees to admit women as members); *Marchioro v. Chaney*, 442 U.S. 191, 199 (1979) (upholding state law requiring each major political party to have a State Committee made up of two persons from each county).

634. Compare Mark D. Rosen, *The Outer Limits of Community Self-Governance in Residential Associations, Municipalities, and Indian Country: A Liberal Theory*, 84 VA. L. REV. 1053, 1140-44 (1998) (arguing that communities that are “political perfectionists” should be able to establish “sub-federal sovereigns”), with Christopher L. Eisgruber, *The Constitutional Value of Assimilation*, 96 COLUM. L. REV. 87, 102-03 (1996) (arguing that it is unconstitutional to grant religious communities such as Kiryas Joel substantial degrees of autonomy). See generally Kathleen M. Sullivan, *Defining Democracy Down*, AM. PROSPECT, Nov.-Dec. 1998, at 91 (critiquing NANCY L. ROSENBLUM, *MEMBERSHIP AND MORALS* (1998)).

635. See ROSENBLUM, *supra* note 634; Stewart Macaulay, *Private Government*, in *LAW AND THE SOCIAL SCIENCES* 445 (Leon Lipson & Stanton Wheeler eds., 1986); John Rawls,

members of homeowners associations, attend church, belong to a rotary club or similar civic association, and are members of a political party, all at the same time. The fact of overlapping associative ties makes the inquiry more complicated because it exponentially increases the number of instances in which conflicting claims to self-governance arise; yet the same fact simplifies the task of delineating competing claims to self-governance because the multiplicity of associative claims makes it clear that what is required is not an absolute approach but rather one that permits the application of overlapping norms.<sup>636</sup>

Not only do most people participate in multiple associations, associations also differ markedly in their demands for allegiance and their role in their members' lives. At one end of a spectrum lies associations such as video clubs or the American Express Company, which call its patrons "members" but involve only minimal contact between members and the organization. At the other end lie "totalistic" religious communities such as the Rajneesh, the Church of Scientology, or the Satmar Chasidim.<sup>637</sup> These communities, sometimes termed "political perfectionists," require members to live together under a governance structure that embodies and imposes the group's values on all aspects of the members' lives.<sup>638</sup> Between these extremes lie the great multitude of organizations which assert claims of membership and invoke affective ties—trade unions, political parties, sports clubs, trade associations, and the like. Some are more and some are less encompassing with respect to members' lives, but unlike political perfectionist organizations, participation in one mid-level voluntary association does not preclude members from participating in others.

The question of how much deference to afford arbitration by each of these types of associations is one aspect of the larger question of how much autonomy to give them. Arbitration between members and minimalist associations like video clubs are like insider-outsider cases, where the individual stands in the position of a consumer confronting a large corporation. There it is appropriate to apply the low standard of deference advocated for insider-outsider cases. On

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*The Idea of an Overlapping Consensus*, 7 OXFORD J. LEGAL STUD. 1 (1987).

636. See ROSENBLUM, *supra* note 634, at 50-65 (arguing that multiple allegiances and overlapping values are a necessary prerequisite to public morality).

637. See Rosen, *supra* note 634, at 1082-86 (describing practices of Rajneesh, the Church of Scientology, and Kiryas Joel as "political perfectionists"); ROSENBLUM, *supra* note 634, at 98-103 (discussing "totalistic" associations).

638. See Rosen, *supra* note 634, at 1064-71 (defining "political perfectionists").

the other hand, in totalistic associations, the problem of determining how much deference to give to the group's own dispute resolution processes is unlikely to arise because any attempt by an insider to utilize an outside court to resolve a dispute rather than to utilize the group's own processes will transform the insider into an outsider. That is, part of the definition of membership involves a commitment to utilize the group's own processes to resolve internal disputes.<sup>639</sup>

Mid-level associations, then, are the ones that require us to consider what degree of deference or autonomy is appropriate in insider-insider cases. To resolve this question, we can draw upon the growing body of law about associational rights to determine which issues should be amenable to a group's own internal adjudicatory machinery and which should not. Already courts are engaged in mapping the boundaries of associational autonomy in cases involving claims of First Amendment religion, speech, and associational rights. Courts have developed a series of doctrines to determine when groups are subjected to external regulation and when they are not. Courts have held, for example, that religious groups are subject to generally applicable criminal law so long as the law is not targeted at religion nor unduly burdensome on religious practices.<sup>640</sup> Courts have also held that private clubs are subject to § 1983 claims of equal protection so long as doing so "does not require the clubs to abandon or alter" any of their activities or basic goals and therefore does not abridge the members' associational rights.<sup>641</sup>

While the issue of when to permit groups to substitute arbitration procedures for courts is not the same as when to permit groups to escape regulation altogether, a similar methodology could be employed. If judges reviewed the results of arbitration on questions of law, as proposed above, they would begin to map the interface between private justice and public norms. A court confronted with a challenge to an arbitral award on the grounds that the award violated an external law would be forced to consider whether and to what extent the publicly promulgated values embodied in the particular external law should be able to trump the internal law of the self-regulating community. In their opinions, courts would be forced to define the scope of associational rights and the distinctive virtues of self-regulation as they articulate reasons for locating the interface between private and public norms where they

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639. *See id.* at 1089-1106.

640. *See Employment Div. v. Smith*, 494 U.S. 872, 878-80 (1990).

641. *See Roberts v. United States Jaycees*, 468 U.S. 609, 630 (1984) (affirming the state ruling requiring Jaycees to admit women as members).



do. Thus, the proposal to redefine the standard of judicial review for arbitration and to permit judicial review of arbitral awards on questions of law would initiate reasoned discussion of the issue. The current judicial approach of blind deference to arbitral fora and rubber-stamp enforcement of arbitral awards enables courts to duck the hard issues of self-regulation and associational autonomy in a democratic society.

### B. *Allocative Efficiency*

A second issue that arises from any proposals to modify the law of arbitration is the extent to which the present arbitration law is efficient. One might argue that even if arbitration does not always accurately reflect the parties' consent and despite occasional unfair results in particular cases, arbitration is efficient for society as a whole. Lawsuits are time-consuming and entail tremendous transaction costs, so any device that reduces those inefficient expenditures is desirable. The courts have so overburdened society with excessive due process, discovery, and delay that any expedited process should be preferred.

While this argument has some merit, it proves too much. Under this reasoning, any expedited judicial system would be preferable to the current system. Any alternative to full-blown litigation, such as small claims courts, specialty courts, or special masters, would provide the same efficiencies claimed for arbitration. Yet small claims courts, specialty courts, or special masters differ from arbitration in that they preserve and reinforce, rather than evade and expunge, the norms of our larger society. These alternative forms of expediting dispute-resolution address the perceived crisis in our civil justice system while maintaining the virtues of a public tribunal for providing justice. Thus, the efficiency argument makes a case for meaningful court reform, not necessarily for substituting courts with arbitration.

The efficiency argument for arbitration also ignores the role of enforcement of substantive rights for our society as a whole. Many economists and legal scholars understand the primary role of tort litigation not as compensation to the individual plaintiff but deterrence to others.<sup>642</sup> While large damage judgments in tort cases

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642. See, e.g., WILLIAM LANDES & RICHARD POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 9-12 (1987); STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 247 (1987); A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 *HARV. L. REV.* 870, 954-55 (1998).

may actually compensate some victims for their losses, the system is far too unpredictable and random to be truly compensatory in all cases.<sup>643</sup> If the primary goal of the legal system is deterrence rather than compensation, then the efficiency value of arbitration must be questioned. That is, while the civil justice system may be erratic and time-consuming from the vantage point of the individual litigant, it could well be efficient for society as a whole. Legal awards play a significant role in the enforcement of laws and the deterrence of violations.<sup>644</sup> Arbitration, with its tendency to eliminate or reduce corporate liability and its de facto limit on damages, undermines these goals.

To the extent that our legislators enact laws because the public wants them, then we have a public interest in having those laws enforced. A fortiori, dispute resolution methods that dilute enforcement and permit violators to escape liability are contrary to the public good. From this perspective, compelling consumers to arbitrate statutory claims in tribunals that are biased against them is highly inefficient for society as a whole.

### C. Conclusion

This Article has argued that we must rethink the trend toward increased deference to private judicial systems. Arbitration is quickly becoming the primary forum for determining consumer claims, and it is likely that arbitration will soon be used not merely to determine claims of defective product performance, but also claims of injury from dangerous products. For example, to return to the introductory hypothetical, if the computer that the Harpers purchased had exploded in Mr. Harper's face when he turned it on and blinded him, the arbitration clause that came in the box with the product would have required that his tort claim be heard by the

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643. See Cass R. Sunstein et al., *Assessing Punitive Damages (with Notes on Cognition and Valuation in Law)*, 107 YALE L.J. 2071, 2075-76 (1998).

644. There is presently a heated debate about whether punitive damages are properly included in tort remedies, and if so, under what circumstances they should issue. Compare Polinsky & Shavell, *supra* note 642, at 962 (proposing a formula for assessing punitive damages), with Sunstein et al., *supra* note 643, at 2109-30 (proposing an alternative approach to awarding punitive damages). Without taking a position on whether or in what manner punitive damages should be assessed, it is sufficient to note that whether damages are punitive or compensatory, or something in between (as in the Polinsky/Shavell model), they can only deter wrongful conduct if they are in fact assessed. Further, damages are more potent as deterrents if they are assessed in a public arena. Arbitration clauses that permit injurers to evade liability, and to evade liability in secret, do not serve deterrence goals.

industry-run arbitration panel. Such a result is troubling for anyone who believes that the enforcement of law is necessary to deter anti-social conduct.

I have proposed that courts reconsider their expansive approach to arbitration and exercise oversight over the invisible world of private associations. In particular, I suggest they distinguish between insiders and outsiders to a self-regulating community when deciding which arbitral awards to enforce. When arbitration is used between persons who are differentially situated in relationship to a self-regulating community, courts should not automatically compel parties to arbitrate and then rubber stamp the resulting awards. Rather, they should police agreements to arbitrate for unconscionability, impose minimal standards of fairness on the arbitral process, and engage in judicial review of questions of law. Legitimate concerns about court congestion and excessive litigation can be addressed through alternative dispute resolution methods without blind deference to a wholly privatized form of arbitration.

The present regime of rustic justice embodies a vision of society as a collection of legally autonomous and morally disconnected subcommunities. While there is some truth to this description of our associational life, it does not capture the many ideals, values, and sensibilities that bind us together.<sup>645</sup> The varied, overlapping, and shifting associational ties in American society constitute an experience of pluralism that promotes certain moral and political values and permits what Nancy Rosenblum calls a "democracy of everyday life" to flourish.<sup>646</sup> In addition to, or perhaps because of, our robust associational life, we participate in a common culture and thus we all benefit from a public intellectual space in which general norms are debated, determined, and enforced.<sup>647</sup> Thus, we need to question whether the fractionated and privatized world of rustic justice is a world we want to embrace.<sup>648</sup>

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645. See generally ALAN WOLFE, *ONE NATION, AFTER ALL* (1998) (documenting the deep degree of consensus about fundamental values in American society).

646. ROSENBLUM, *supra* note 634, at 349-63.

647. See Fiss, *supra* note 630, at 1085-87.

648. See Alexander, *supra* note 629, at 1-7; Margaret Jane Radin, *Property and Personhood*, 34 STAN. L. REV. 957, 978-91 (1982).