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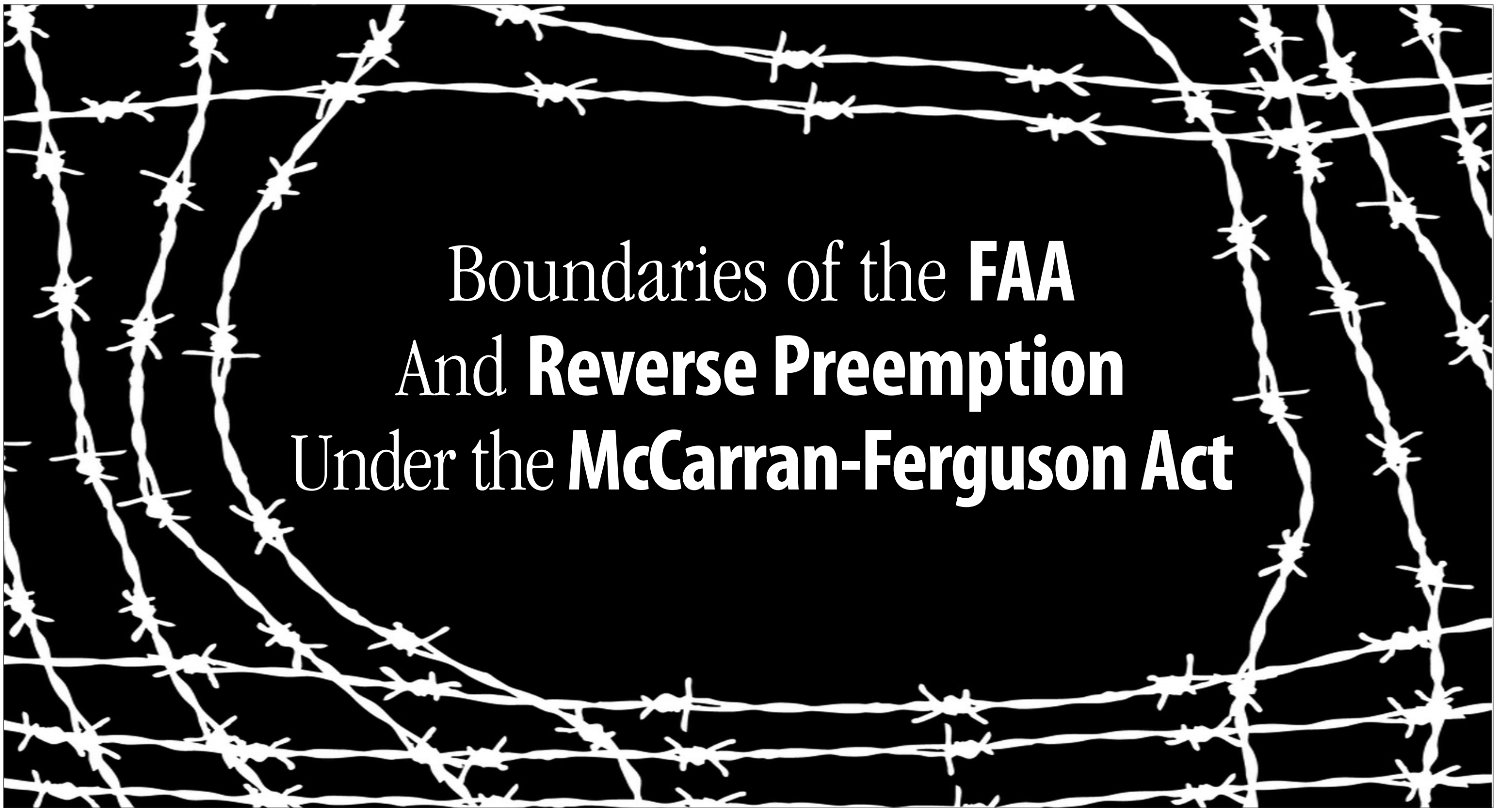

Boundaries of the **FAA** And **Reverse Preemption** Under the **McCarran-Ferguson Act**

BY ALEXANDER D. HARDIMAN AND PETER A. HALPRIN

The Federal Arbitration Act ensures that arbitration agreements are enforceable. Except when they're not.

Writing in 1974, Supreme Court Justice Potter Stewart described the intent and purpose of the Federal Arbitration Act (the FAA) as follows:

> Reversing centuries of judicial hostility to arbitration agreements, [the Act] was designed to allow parties to avoid "the costliness and delays of litigation," and to place arbitration agreements "upon the same footing as other contracts… ." Accordingly, the Act provides that an arbitration agreement … . "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

See *Scherk v. Alberto-Culver*, 417 U.S. 506, 511 (1974).

The excerpt outlines two crucial concepts that have underpinned judicial interpretations of the FAA. First, the FAA is a declaration of the "national policy favoring arbitration," and the FAA generally will preempt state laws that restrict arbitration or mandate terms in arbitration agreements that conflict with the FAA. See *Southland v. Keating*, 465 U.S. 1, 10 (1984); ("liberal federal policy favoring arbitration agreements"); *Moses H. Cone Mem'l Hosp. v. Mercury Constr.*, 460 U.S. 1, 24 (1983). Second, despite this strong policy, a party seeking to avoid arbitration is entitled to assert the full gamut of contractual and equitable defenses. See 9 U.S.C. §2; *Walker v. Ryan's Family Steak Houses*, 400 F.3d 370, 377 (6th Cir. 2005) ("Thus, generally applicable state-law contract defenses like fraud, forgery, duress, mistake, lack of consideration or mutual obligation, or unconscionability, may invalidate arbitration agreements.").

Although the trend in dispute resolution is the proliferation of arbitration clauses into all aspects of agreements in the consumer goods, products and service industries, there has been growing resistance from some legislatures and consumer groups against the inability of state legislatures to restrict the use or terms of arbitration agreements under state law because of the FAA. One area in particular—insurance and the McCarran-Ferguson Act—may offer a blueprint for those groups to advocate for reform in other areas.

Challenging Arbitration Agreements

There are a number of contractual and equitable defenses that parties have used to successfully avoid arbitration.

The advantages of arbitration are well known. One of the foremost advantages—party autonomy—demonstrates the contractual

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nature of arbitration. Arbitration facilitates party autonomy in that it allows parties broad freedom to agree upon the rules and procedures applicable to their arbitration. See Gary B. Born, "International Arbitration: Law and Practice" 12-13 (2012). However, this advantage can only truly be enjoyed where the parties to an arbitration agreement enjoy equal bargaining power and the ability to freely negotiate its terms. As the use of arbitration clauses has proliferated in recent years, so too have the challenges to arbitration clauses on these grounds. Recognizing the fact that parties may not have equal bargaining power, courts that have refused to enforce arbitration agreements have primarily permitted the relatively weaker party to an arbitration agreement to avoid arbitration on the grounds of fairness and unconscionability.

Fairness and Unconscionability. Courts have refused to compel arbitration where the stronger party sets up a dispute resolution process "utterly lacking in the rudiments of even-handedness." *Hooters of Am. v. Phillips*, 173 F.3d 933, 935 (4th Cir. 1999).

In *Hooters*, a former Hooters bartender threatened to sue Hooters for alleged sexual harassment suffered during her tenure as an employee. Hooters responded that the former employee was required to submit her claims to arbitration. Hooters then filed suit to compel arbitration.

The Hooters arbitration program conditioned employee eligibility for raises, transfers, and promotions on employees signing an agreement to arbitrate employment-related disputes. The agreement provided that the resolution of claims would be in conjunction with rules promulgated by the company. When the agreement was provided to Hooters' employees, the employees were given five days to review and then accept or reject the agreement. The employees were not given a copy of the rules promulgated by the company.

The rules promulgated by the company included the following provisions: (1) the employee must provide notice of their claim without requiring Hooters to file any responsive pleadings or to notice its defenses; (2) the employee must provide the company with a list of fact witnesses and a summary of facts known to each and Hooters is not required to reciprocate; (3) both sides appoint an arbitrator and the two arbitrators select a third from a list created by Hooters; (4) members of Hooters' management can serve as the third arbitrator; (5) Hooters can move for summary dismissal, but an employee cannot seek summary judgment; (6) Hooters has the sole right to cancel the agreement to arbitrate; and (7) Hooters has the right to modify the rules whenever it wishes and "without notice" to the employee. See id. at 938-39.

After the trial court denied Hooters' efforts to compel arbitration, Hooters appealed. The U.S. Court of Appeals for the Fourth Circuit, however, held that Hooters had materially breached the arbitration agreement with its employee "by promulgating rules so egregiously unfair as to constitute a complete default of its contractual obligation to draft arbitration rules and to do so in good faith." 173 F.3d at 938.

Increased third-party financing may theoretically make **more money available** for litigation, but would **responsible investors** competing in a robust marketplace ever cause increased **frivolous** litigation?

Courts have also refused to compel arbitration where the arbitration agreement is an unenforceable adhesion contract. *Walker v. Ryan's Family Steak Houses*, 400 F.3d 370 (6th Cir. 2005). In *Walker*, the defendant restaurant corporation required prospective employees to complete an application packet. The application packet included an arbitration agreement that the prospective employee was required to sign to be considered for a position. The notice was followed by five pages of single-spaced rules and procedures governing the arbitration procedure. However, the hiring protocol was not always followed properly and some of the employees, including certain plaintiffs in the suit, were interviewed and hired without first executing their arbitration agreements. In fact, for such employees, management would require them to sign the agreements after they were hired.

After a group of former employees filed a class action seeking unpaid wages and related penalties, the restaurant moved to enforce the arbitration agreements and compel arbitration. The Sixth Circuit found that the employees at issue, who were hired without first executing their agreements, risked termination if they refused to sign. See id. at 385. Based upon this, the court held that the restaurant had significantly more power over these employees as "the threat of termination from one's current employment would appear to be sufficient in itself to demonstrate 'absence of a meaningful choice' for the party occupying the weaker bargaining position." See id.

Hooters and *Walker* exemplify how litigants have challenged arbitration agreements based on the terms of an arbitration clause being fundamentally unfair or unconscionable. Given the rise in the use of arbitration agreements and resulting litigation over the enforceability of those agreements, the courts are likely to see an increasing number of these kinds of challenges.

Reverse Preemption and McCarran-Ferguson. In addition to the contract-based defenses, such as fairness and unconscionability, in certain instances parties to an arbitration agreement may be able to avoid arbitration where state statutes bar enforcement of such agreements, notwithstanding the FAA. One such example of this is in the context of insurance specific anti-arbitration statutes.

The McCarran-Ferguson Act declares that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance … unless such Act specifically relates to the business of insurance." 15 U.S.C. §1012(b). The McCarran-Ferguson Act was an attempt to turn back the clock from the Supreme Court's decision finding that insurance was a transaction of commerce, to assure that the activities of insurance companies in dealing with their policyholders would remain subject to state regulation." *Sec. & Exch. Comm'n v. National Sec.*, 393 U.S. 453, 459 (1969).

Thus, the McCarran-Ferguson Act "reverse preempts" a federal law to the extent a federal law invalidates, supersedes, or impairs the state law that regulates the business of insurance. See, e.g., *Riverview Health Institute v. Medical Mutual of Ohio*, 601 F.3d 505, 513 (6th Cir. 2010). Therefore, "[i]f the state has an anti-arbitration law enacted for the purposes of regulating the business of insurance, and if enforcing, pursuant to the Federal Arbitration Act, an arbitration clause would invalidate, impair, or supercede that state law, a court should refuse to enforce the arbitration clause." *McKnight v. Chicago Title Ins.*, 358 F.3d 854, 857 (11th Cir. 2004).

Based on McCarran-Ferguson's "reverse preemption," both federal and state courts have held that state statutes that invalidate or limit arbitration clauses in insurance contracts are indeed "enacted for the purpose of regulating the business of insurance" and thus not preempted by the FAA. See *Standard Security Life Ins. v. West*, 267 F.3d 821, 823-24 (8th Cir. 2001) (holding that FAA was reverse preempted under McCarran-Ferguson Act by provision of Missouri Arbitration Act prohibiting arbitration clauses in insurance contracts); *Stephens v. American Int'l Ins.*, 66 F.3d 41, 45-46 (2d Cir. 1995) (holding that anti-arbitration provision of Kentucky Liquidation Act was exempt from preemption by FAA under McCarran-Ferguson Act); *Mutual Reinsurance Bureau v. Great Plains Mutual Ins.*, 969 F.2d 931, 934-35 (10th Cir. 1992) (holding that Kansas statute providing that written agreement to arbitrate is invalid if contained in contract of insurance was enacted for purpose of regulating business of insurance and thus McCarran-Ferguson Act precluded application of FAA), cert. denied, 506 U.S. 1001, 113 S. Ct. 604, 121 L.Ed. 2d 540 (1992); *Friday v. Trinity Universal of Kansas*, 262 Kan. 347, 939 P.2d 869, 872-73 (1997) (holding that McCarran-Ferguson Act prevented FAA from preempting Kansas statute invalidating arbitration clauses in insurance contracts; homeowners could not be compelled to arbitrate dispute with insurer).

In *Nat'l Union Fire Ins. v. Personnel Plus, Ins.*, 2013 U.S. Dist. LEXIS 102278, 14-15 (S.D.N.Y. July 22, 2013), however, the court reached a different result. In considering a challenge to an arbitration clause under a California statute requiring submission of insurance policies to a state agency before they may be enforced, the court found that because the state statute did not specifically address arbitration clauses contained in the policies that had not been filed, there was no conflict with the FAA and therefore no McCarran-Ferguson "reverse preemption."

As evidenced by *Personnel Plus*, the extent to which McCarran-Ferguson can be used to invalidate arbitration clauses in the insurance context is dependent on the state statute at issue and will likely continue to be a hotly contested area as litigants continue to test the boundaries of the doctrine.

An additional wrinkle in the debate over the boundaries of McCarran- Ferguson's "reverse preemption" power over the FAA occurs when the insurance company involved is a foreign company. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Convention, requires courts of contracting countries to give effect to an agreement to arbitrate in a matter covered by an arbitration agreement and also to recognize and enforce awards made in other countries, subject to specific limited exceptions. The Convention has been made part of the FAA. See 9 U.S.C. §201.

The Supreme Court noted:

> The goal of the Convention, and the principle purpose underlying American adoption and implementation of it, was to encourage the recognition and enforcement of commercial arbitration agreements in international contracts and the unify the standards by which agreements to arbitrate are observed and arbitral awards are enforced in signatory countries.

Scherk, 417 U.S. at 519 n.15. In the insurance context, however, the issue is whether McCarran-Ferguson can "reverse preempt" the FAA in cases involving insurance arbitration clauses issued by foreign-based insurance companies from countries that are signatories to the Convention as it would in cases in which the FAA would otherwise supersede a state statute regulating the arbitration of insurance disputes.

In *Stephens v. American International Ins.*, the Second Circuit reasoned that the act adopting the Convention prevents the Convention from being self-executing and, therefore, constitutes an "Act of Congress" or a legislative act that would be subject to the provisions of McCarran-Ferguson. See *Stephens v. American International Ins.*, 66 F.3d 41 (2d Cir. 1995). Thus, the court in *Stephens* held that a treaty is only "[t]o be regarded in the courts of justice as equivalent to an act of legislature, whenever it operates of itself, without the aid of any legislative provision." See id. at 45 (internal citations omitted). Accordingly, the Second Circuit held that because an adoption act was necessary, the Convention is not self-executing and a Kentucky state-law provision barring arbitration, owing to McCarran-Ferguson, was held to trump the Federal Arbitration Act notwithstanding the New York Convention and the involvement of a foreign based insurance company.

Recent case law, however, has been critical of the Second Circuit's holding in *Stephens* and courts have found that when a foreign-based insurance company is involved, the New York Convention trumps McCarran-Ferguson's "reverse preemption" of the FAA.

In *Safety National Cas. v. Certain Underwriters at Lloyd's, London*, 587 F.3d 714 (5th Cir. 2009), in response to the policyholder's argument that a Louisiana anti-insurance arbitration statute "reverse preempted" the FAA pursuant to McCarran-Ferguson, the Fifth Circuit rejected the Second Circuit's reasoning in *Stephens* and held that because the insurance company was foreign, and the New York Convention was not an "Act of Congress," the FAA provisions regarding the New York Convention were not preempted by McCarran-Ferguson and the state anti-arbitration statute was therefore invalidated by the FAA.

The Fourth Circuit reached a similar result in *The ESAB Group v. Zurich Ins.*, 685 F.3d 376 (4th Cir. 2012). In *ESAB Group*, a policyholder sought to avoid an arbitration clause contained in an insurance policy sold by a foreign insurance company on the basis of a South Carolina law that makes insurance policy provisions requiring the arbitration of insurance disputes unenforceable. See S.C. Code Ann. §15-48-10(a). The Fourth Circuit held that the McCarran-Ferguson Act did not "reverse preempt" the New York Convention provisions of the FAA because McCarran-Ferguson was limited to the regulation of domestic legislation, not legislation such as the New York Convention that concerned international commerce. *ESAB Group*, 685 F.3d at 390.

The Future of Restrictions on Arbitration

Although recent legislative activity has not resulted in the passage of federal legislation aimed at reforming mandatory pre-dispute arbitration clauses, consumer groups and state legislatures continue to push for such legislation. While the FAA in many cases supersedes any state legislation that seeks to restrict arbitration in the interests of protecting consumers, consumers may be able to avoid arbitration in some cases by using the typical contract defenses, such as fairness and unconscionability. In addition, McCarran-Ferguson's "reverse preemption" in the insurance context could present a blueprint for limited legislative reform in areas such as elder law or health care, which many groups contend require additional protections against the uniform use of arbitration clauses.