SB 33 (DODD) ARBITRATION AGREEMENTS
JOB KILLER

July 5, 2017

TO: Members, California State Assembly

FROM: California Chamber of Commerce
American Insurance Association
California Ambulance Association
California Apartment Association
California Bankers Association

California Building Industry Association
California Business Roundtable
California Community Banking Network
California Credit Union League
California Forestry Association
California Land Title Association
California Retailers Association
Camarillo Chamber of Commerce
Civil Justice Association of California
Claremont Chamber of Commerce
Computing Technology Industry Association – CompTIA
Consumer Data Industry Association
Culver City Chamber of Commerce
El Centro Chamber of Commerce
Electronic Transactions Association
Financial Services Institute
First American Corporation
Greater Conejo Valley Chamber of Commerce
Internet Coalition
Investment Company Institute
Long Beach Area Chamber of Commerce
National Federation of Independent Business
Orange County Business Council
Oxnard Chamber of Commerce
Redondo Beach Chamber of Commerce
Santa Maria Valley Chamber of Commerce Visitor & Convention Bureau
Securities Industry and Financial Markets Association
Simi Valley Chamber of Commerce and Visitor Center
South Bay Association of Chambers of Commerce
Southwest California Legislative Council

SUBJECT: SB 33 (DODD) ARBITRATION AGREEMENTS
OPPOSE – JOB KILLER

The California Chamber of Commerce and the organizations listed above respectfully **OPPOSE SB 33 (Dodd)**, as amended on July 3, 2017, which has been labeled a **JOB KILLER**, because it unfairly attacks the use of arbitration agreements in consumer contracts with "financial institutions" as broadly defined, is likely preempted by the Federal Arbitration Act (FAA), violates the rules of the Financial Industry Regulatory Authority (FINRA), and will negatively impact "financial institutions" with unnecessary and costly class action litigation that does not ultimately benefit the consumer.

SB 33 Broad Definition of "Financial Institution" Includes Securities and Insurance Brokers/Agents:

Despite recent amendments, **SB 33** still applies to more industries than just banks. By broadly defining "financial institution" to include any individual or entity licensed by Division 1 (commencing with Section 25000) of Title 4 of the Corporations Code, this definition applies to securities firms and brokers, who may be dually licensed to sell both securities and insurance products. Accordingly, insurance products are still included.

SB 33 Will Create Costly Litigation That Primarily Benefits Class Action Trial Attorneys, Not the Consumer:

SB 33 precludes the enforcement of a valid arbitration agreement for claims of fraud with a financial institution. **SB 33** is sponsored and supported by trial attorneys who would prefer class action litigation as opposed to arbitration because it provides a significantly higher financial recovery for trial attorneys. Recent examples of attorney fee awards in recent consumer class actions illustrate this issue: *Perkins v. LinkedIn Corporation,* United States Northern District of California, Case No. 5:13-cv-04303-LHK (2016), in which it was alleged LinkedIn wrongfully used members' contact information. The case settled for $13 million, the

funds divided as follows: (1) $1,500 for the named plaintiffs; (2) no less than $10 per class member; and, (3) **$3,250,000 for attorney's fees and costs**; and *Lim, et. al., v. Vendini, Inc*., Superior Court for the County of Santa Clara, Case No. 1-14-cv-259897 (2014), in which it was alleged personal identifying information of customers was compromised. The case settled for $3,000,000, the funds divided as follows: (1) $2,500 for named plaintiffs; (2) up to $3,000 per class member for unreimbursed losses as a result of the identity theft or up to $1,000 for unreimbursed expenses as a result of the identity theft; and, (3) $**652,340 for attorney's fees.** Accordingly, by precluding the enforcement of a valid arbitration agreement, consumer attorneys, the sponsors and supporters of **SB 33**, can pursue more costly class action litigation where they recover higher fee awards.

SB 33 Creates Unnecessary Litigation for Impacted Industries to Establish that it is Preempted Under the Federal Arbitration Act, as Emphasized by a Recent United States Supreme Court Opinion delivered by Justice Kagan on May 16, 2017:

On May 16, 2017, the United States Supreme Court struck down a Kentucky decision that invalidated an arbitration agreement with a nursing home that was executed by family members who had a power of attorney for the patient in *Kindred Nursing Centers Ltd. Partnership v. Clark*, 2017 WL 2039160. The Kentucky court determined that arbitration was such a significant issue that, in order for the agreement to be valid, the power of attorney form must specifically allow the individual to agree to arbitration on behalf of the principal or, in this case, the patient. In a 7 to 1 decision written by Justice Elena Kagan, the Court emphatically rejected this decision. In the opinion, the Court reemphasized that "***The FAA preempts any state rule discriminating on its face against arbitration – for example, a 'law prohibit[ing] outright the arbitration of a particular type of claim***." (emphasis added); *See also DIRECTV v. Imburgia*, 136 S.Ct. 463 (2015); *Marmet Health Care Center, Inc. v. Brown*, 132 S. Ct. 1021 (2012); *AT & T Mobility LLC v. Concepcion*, 131 S.Ct. 1740, 1747, 179 L.Ed.2d 742 (2011); *Doctor's Associates, Inc. v. Cassarotto*, 517 U.S. 681 (1996).

SB 33 suffers from the same fatal flaw. On its face, **SB 33** prohibits the arbitration of specific claims – i.e., those arising from a "purported contractual relationship" created fraudulently by the "unlawful use of personal identifying information" with a financial institution. As indicated in *Kindred Nursing Centers, supra*, a state law that seeks to limit arbitration in this manner is preempted by the FAA. Moreover, **SB 33** acknowledges that there is a valid agreement to arbitrate that has been consented to by the consumer. The opinion in *Kindred Nursing Centers* also emphasizes that "[t]he Act's key provision, once again, states that an arbitration agreement must ordinarily be treated as 'valid, irrevocable, and enforceable.' A rule selectively finding arbitration contracts invalid because improperly formed fares no better under the Act than a rule selectively refusing to enforce those agreements once properly made." **SB 33** acknowledges a valid agreement, but basically refuses to enforce the terms of that agreement for certain claims, which the Court just indicated on May 16, 2017, is preempted.

Forcing employers impacted by **SB 33** to challenge the constitutionality of this law will create further unnecessary litigation. The *Kindred Nursing Centers* case took approximately eight years to finally be resolved by the Supreme Court. Requiring California businesses to exhaust financial resources and time in costly litigation to establish that **SB 33** is similarly preempted is unnecessary and will only harm these businesses ability to thrive in California.

SB 33 is Preempted Under Financial Industry Regulatory Authority (FINRA) Rules.

FINRA is a quasi-governmental, independent regulatory organization that was created and registered with the Securities and Exchange Commission (SEC) pursuant to the 1938 Maloney Act amendments to the Securities and Exchange Act of 1934 (Exchange Act). FINRA's mission is to protect investors and preserve the integrity of the securities marketplace by regulating, examining, and taking enforcement action against its members, which include nearly 4,000 broker-dealer firms and nearly 650,000 individual brokers.

The Financial Industry Regulatory Authority (FINRA) is the successor to the National Association of Securities Dealers. FINRA is subject to the direct oversight of the SEC and all FINRA rules must be reviewed and approved by the SEC to ensure their consistency with the Exchange Act. See 15 U.S.C. § 78s(b)(1), 78s(g).

Following SEC approval, FINRA rules have the force of federal law. See 15 U.S.C. § 78s(c); *Shearson/American Exp., Inc. v. McMahon*, 482 U.S. 220, 234 (1987) (upholding SEC-approved FINRA arbitration clauses and procedures); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Nat'l Ass'n of Sec. Dealers, Inc.,* 616 F.2d 1363, 1367 (5th Cir. 1980) (noting that Congress provided FINRA with "governmental power. . . to enforce . . . compliance by members of the industry with . . . the Exchange Act" through SEC supervision). Thus, FINRA rules can preempt state law even though FINRA is a private organization. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 127 (1973) (quoting *Silver v. N.Y. Stock Exch*., 373 U.S. 341, 361 (1963)) ("[C]onflicting law . . . should be pre-empted by exchange self-regulation 'only to the extent necessary to protect the achievement of the aims of the Exchange Act.'").

California law is in accord. In *Mayo v. Dean Witter Reynolds, Inc*., 258 F.Supp.2d 1097 (N.D. Cal. 2003), the court held that California ethical standards that included specific disclosure requirement for arbitrators was preempted: "[T]his Court concludes that the Exchange Act and the federal regulatory scheme established pursuant to the Exchange Act, and the FAA preempt application of the California standards . . ." In 2005, the California Supreme Court reinforced this precedent, holding that California's arbitrator disclosure requirements were similarly preempted by the Exchange Act and FAA. *Jevne v. Superior Court*, 35 Cal. 4th 935 (2005).

In this case, under FINRA Rule 12200, a broker must arbitrate any dispute with a customer if arbitration is requested by the customer, or required by a written agreement, and the dispute arises in connection with the business activities of the member. FINRA Code of Arbitration Procedure for Customer Disputes, Rule 12200. In addition, under FINRA Rule 13200, all intra-industry disputes between a brokerage firm and a broker must be arbitrated if the dispute arises out of the business activities of firm or broker. FINRA Code of Arbitration Procedure for Industry Disputes, Rule 13200.

As currently drafted, **SB 33** specifically includes securities brokers, dealer's representatives, and advisors within its definition of "financial institution," and specifically prohibits the arbitration of claims for fraud and unlawful use of personal identifying information. FINRA Rules 12200 and 13200, however, specifically allow the arbitration of all claims arising out of the business activities of the brokerage firm or broker. There is no exception or exclusion under FINRA Rules for claims of fraud or unlawful use of personal identifying information. Consequently, **SB 33** is in direct conflict with FINRA Rules and should be preempted, consistent with California law.

SB 33 Will Create Further Litigation Over Ambiguous Terms and Application:

SB 33 will create further litigation regarding the ambiguous terminology utilized and the uncertainty regarding how courts will interpret such ambiguity. Ambiguity, inconsistency, and confusion, only serves to benefit trial attorneys and their ability to pursue more costly litigation with higher attorney fee recoveries, not consumers.

1. **<u>Purported Contractual Relationship</u>:**

SB 33 states that a respondent cannot be compelled to arbitration regarding a "purported contractual relationship." This term is undefined and will create significant litigation over what relationships are included or excluded. California law specifically identifies the essential elements of a contract in Civil Code Section 1550. California law also specifically identifies the basis to invalidate, revoke or render a contract unenforceable under Civil Code Sections 1565-1579; 1597-1599; 1608; 1667-1668. Under existing law, there are only two choices: (1) a valid contract; or (2) an invalid/unenforceable contract.

SB 33 seems to create a third option of "purported contractual relationship" that was created fraudulently without the consumer's consent and with the unlawful use of the consumer's personal identifying information. It is completely unclear what "purported contractual relationship" means or how it differs from existing law. Existing law already invalidates contracts that are created fraudulently. This third contractual option of a "purported contractual relationship" that is "created fraudulently" will create significant confusion over how this law applies and ultimately will lead to additional litigation, leaving the courts to determine what was intended.

2. **SB 33 Creates Confusion Between Who Is Respondent and Consumer:**

SB 33 proposes to amend Code of Civil Procedure Section 1281.2, which refers to "petitioners" and "respondents" of a motion to compel arbitration, meaning the parties to the litigation. Instead of applying and utilizing these same terms, **SB 33** includes a "consumer" as a new party to the process, that is not necessarily the respondent or proponent. This inconsistency in terms will create confusion and litigation over its meaning. Through legislative construction, courts will have to determine the intent of why "consumer" was utilized in this section instead of "respondent." Does **SB 33** allow a "respondent" to avoid arbitration based on any contract with any consumer? Is the consumer the respondent? This inconsistent terminology adds another layer of ambiguity and concern to this bill that will create further litigation.

3. **SB 33 Is Ambiguous as to the Determination of "Purported Contractual Relationship" Created Fraudulently by Unlawfully Using the Consumer's Personal Identifying Information:**

SB 33 states that, upon a petition to compel arbitration, the court must determine whether the arbitration agreement involves a "financial institution" that is seeking to apply a written contract to arbitrate to the creation of a "purported contractual relationship" created fraudulently by the "unlawful use of consumer personal identifying information." It is unclear how the court would make this determination. If by simply alleging these causes of action in a complaint the court may ultimately deny arbitration and send the entire case to litigation, then all arbitration agreements would be undermined. Notably, nothing in **SB 33** requires a court to bifurcate claims that fall within this provision from other causes of action alleged that should be compelled to arbitration under a valid contract. Comparatively, if **SB 33** requires a court to make a factual determination that a "purported contractual relationship" created fraudulently by the "unlawful use of consumer personal identifying information" exists, then **SB 33** essentially turns a petition to compel arbitration into a substantive, dispositive motion on the validity of the claims asserted. At the outset of the case, the parties would have to litigate the existence of a fraudulent relationship or unlawful use of consumer personal identifying information, which undermines the very point of arbitration.

SB 33 Applies to Existing Contracts:

As amended, **SB 33** specifies that the provisions of the bill do not go into effect until January 1, 2018**.** The bill does not limit its application, however, to only those contracts created after January 1, 2018, thereby invalidating all existing consumer contracts with a financial institution that include an arbitration provision that requires the arbitration of any and all disputes arising from the relationship and is applied after January 1, 2018. This retroactive application on existing contracts will create significant costs and potential litigation for financial institutions.

For these reasons, we must **OPPOSE SB 33** as a **JOB KILLER.**

cc: The Honorable Bill Dodd
Tom Dyer, Office of the Governor
Gregory Milkonian, Assembly Republican Caucus
Alison Merrilees, Assembly Committee on Judiciary
District Offices, Members, California State Assembly