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Open Courts

Financial reform could allow more lawsuits.

BY MARISA MCQUILKEN

President Barack Obama's sweeping plan to reform the financial regulatory system would create a new consumer protection agency, toughen regulations, and close loopholes blamed for contributing to the financial crisis.

It could also open the floodgates for more litigation against banks and other financial institutions, say lawyers who represent the industry.

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NEW RULES: President Barack Obama, announcing his plan for financial regulatory reform.

AP PHOTO/JEW

Financial reform plan could prompt suits

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They point to two pieces of Obama's proposal that are getting red-flagged in e-mail alerts and prompting calls from financial clients. One piece says states should be allowed to impose stiffer regulations on financial institutions than the federal government—a signal that Obama is changing course on Bush-era policies that favored pre-emptive federal standards. The other piece threatens to do away with mandatory arbitration clauses that have become common in contracts between consumers and broker-dealer firms.

Both changes are favored by consumer rights advocates, who view the existing policies as hurdles to court access. Of course, the entire plan still has to win approval from Congress, and lawyers say both proposals are likely to be among the most contentious issues. "At this point, people are still digesting the entire package," said W. Hardy Callcott, a financial regulatory partner in Bingham McCutchen's San Francisco office. "But I've certainly had [clients] express concern about both the pre-emption and the mandatory arbitration issues."

None of this should come as much of a surprise. Obama's appointments at consumer protection agencies have been lauded by consumer groups. And his May 20 memo to agency and department heads stating that pre-emption of state law "should be undertaken only with full consideration of the legitimate prerogatives of the States and with a sufficient legal basis" was a clear indication that the Bush administration's support for pre-emption had come to a grinding halt.

Said Pamela Gilbert, a consumer protection and products liability partner at Washington's Cuneo Gilbert & LaDuca, "This is really a welcome swing of the pendulum."

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ANDREW SANDLER: The co-chair of financial services firm BuckleySandler said the practical effect of more lawsuits created by financial reform would be to increase the cost of borrowing for consumers who can't afford it.

"The focus should be on making sure that an arbitration process is fair to consumers," said Andrew Sandler.

'UNPRECEDENTED TIMES'

Of course, it isn't welcomed by everyone. Lawyers who represent federally chartered banks are already crafting an argument against subjecting them to what they claim will be a patchwork of state laws. If that language makes it through Congress, lawyers say it will give plaintiffs new avenues to sue their clients.

"It will create significant additional litigation, the practical effect of which will be to increase the cost of borrowing for those who can least afford more additional costs," said Andrew Sandler, co-chair of the Washington-based financial services law firm BuckleySandler.

Obama's plan, which calls for the creation of an agency called the Consumer Financial Protection Agency, asserts that the new agency's rules should serve "as a floor, not a ceiling," for state laws policing financial institutions, regardless of whether the institution is federally chartered.

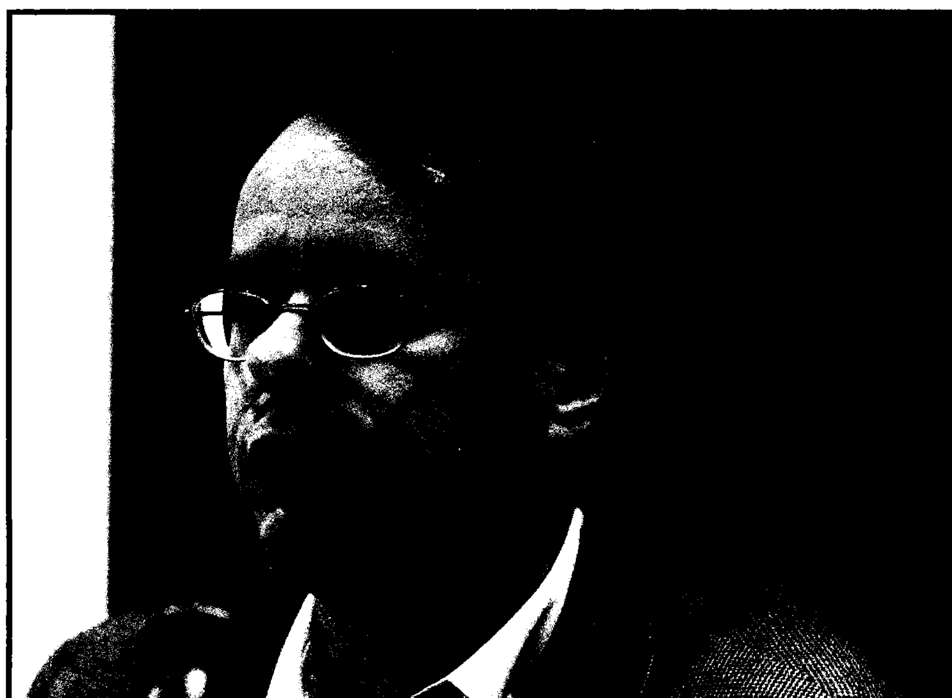
But the banks are kicking back. Such institutions, said Washington Morrison & Foerster financial services partner Oliver Ireland, "are a creature of the federal government, and they can't be regulated by the states under the supremacy clause" of the U.S. Constitution. Obama's plan "is saying we would go back by statute and change that."

Although Ireland believes the language is too far-reaching, he said, "What can make it through Congress these days in the financial world is hard to say. We're dealing in unprecedented times."

During the past decade, the federal government has moved to limit states' authority over financial institutions. The National Securities Markets Improvement Act, passed in 1996, took away from states some authority to regulate securities. The Office of the Comptroller of the Currency and the Office of Thrift Supervision—both housed in the U.S. Department of the Treasury—have also issued pre-emptive rules. Lawyers say the language in Obama's plan could be strong enough to repeal many of these positions—creating a logistical nightmare for institutions that operate in multiple states.

"You have national markets for retail financial services, and if those national markets then have to comply with a maze of state laws, it's very, very difficult and much more costly to deliver services," Ireland said.

Not so, said Edmund Mierzwinski, consumer program director at the U.S. Public Interest Research Group. "There are no circumstances I can think of where there are 51 state laws," he said. "Even if there were in the financial marketplace, I would argue that, since everything is digital and computerized, that the cost of compliance is not anywhere near what the banks claim."



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W. HARDY CALLCOTT: The financial regulatory partner at Bingham McCutchen said he's already had clients express concern about the pre-emption and mandatory arbitration parts of the financial reform package.

LIMITING ARBITRATION

Then there's the issue of mandatory arbitration—a major priority for the plaintiffs' bar. Broker-dealer firms typically require account holders to agree to arbitrate any disputes, rather than sue in court. For obvious reasons, it's not a popular policy among trial lawyers. But Obama is now calling on the Securities and Exchange Commission to study the use of arbitration. And for the plaintiffs' bar, the plan, which suggests that "mandating a particular venue and up-front method of adjudicating disputes—and eliminating access to courts—may unjustifiably undermine investor interests," is a welcome shift in attitude.

"We support any effort to eliminate one-sided forced arbitration clauses," said Linda Lipsen, senior vice president of public affairs at the American Association for Justice, in an e-mail. "Forced arbitration has been used as a shield to avoid accountability, and this proposal, if enacted, would help safeguard the legal rights of consumers."

It's another piece of the Obama proposal raising concern across the financial services industry. Defense lawyers argue that it could lead to rules that are too severe. According to the Financial Industry Regulatory Authority—an independent securities regulator—the number of arbitrated cases increased a staggering 85% in 2009 to more than 3,000, thanks to the market downturn. If the Obama plan passes, said Bingham's Callcott, "More than half of these cases will move to a court forum."

Said Sandler, "I think there is a place for arbitration of individual disputes and believe that the focus should be on making sure that an arbitration process is fair to consumers."

For now, determining what's fair is up to Congress. Both sides of the issue agree on one thing—that it will be a tough fight.

Marisa McQuilken can be contacted at marisa.mcquilken@incisivemedia.com.