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Recent Second Circuit Opinion Invalidates Class Action Waiver Provision in a Commercial Contract

By John K. Gisleson

In an effort to avoid class action litigation, many businesses include a waiver of class action claims in their contracts, limiting dispute resolution to arbitration of claims on an individual rather than class action or collective basis. This is consistent with Section 2 of the Federal Arbitration Act ("FAA"), which 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." Although the waiver of class action claims may be freely negotiated, the allegedly injured party still may seek to evade that waiver by asserting a contract defense to its enforcement, such as that the waiver is unconscionable or procured by fraud or duress. Courts will evaluate the proposed waiver on a case-by-case basis depending on the claims asserted and whether relief can be achieved in an economically feasible way through arbitration of individual claims.

The U.S. Court of Appeals for the Second Circuit recently invalidated a class action waiver included as part of an arbitration clause in a contract between American Express and certain of its merchants because arbitration of plaintiffs' antitrust claims on an individual (as opposed to class action) basis would be prohibitively expensive. *In re: American Express Merchants' Litigation*, (Docket No. 06-1871) (Decided March 8, 2011). The district court had granted American Express' motion to compel arbitration pursuant to the FAA, leaving it to the arbitrator to decide if the waiver was enforceable. In reversing that decision, the Second Circuit first observed that the issue of enforceability of the waiver is for a court to determine, not an arbitrator. The Second Circuit then recognized the "firm principle of antitrust law that an agreement which in practice acts as a waiver of future liability under the federal antitrust statutes is void as a matter of public policy." According to the Second Circuit, "[o]ther Circuits also have observed that a plaintiff could challenge a class action waiver clause on the grounds that it would be a cost prohibitive method of enforcing a statutory right, provided that a plaintiff set forth sufficient proof to support such a finding." "[W]hen a party seeks to invalidate an arbitration agreement on the ground that arbitration would be prohibitively expensive, [that] party bears the burden of showing the likelihood of incurring such costs."

The Second Circuit evaluated the "fiscal impracticality of pursuing individual claims" by comparing the cost to litigate against the potential recovery associated with an individual claim. To meet their burden of proving fiscal impracticality, plaintiffs submitted to the district court a detailed affidavit from economist Gary L. French, Ph.D., an employee of a financial consulting firm retained by the plaintiffs. The economist's affidavit stated that the purpose of his affidavit was "to provide an expert opinion concerning the likely costs and complexity of an expert economic study concerning the liability and damages relating to this action, and to compare this with the potential recovery of damages by an American Express Card merchant with annual sales volume of $10 million or less, such as most if not all of the named plaintiffs in this litigation, and to provide my opinion as to whether it would be economically rational for such a merchant to pursue a recovery of damages given the likely out-of-pocket costs of the arbitration or litigation proceeding." The expert concluded that it would not be rational to pursue the antitrust claim on an individual basis because the cost of the antitrust study would exceed the maximum potential recovery. The antitrust study was estimated to cost in excess of $300,000, while the largest potential individual recovery would be significantly less than $50,000. American Express "brought no serious challenge to the plaintiffs' demonstration that their claims cannot reasonably be pursued as individual actions, whether in federal court or in arbitration."

According to the Court, the expert affidavit "demonstrates that the only economically feasible means for enforcing [plaintiffs'] statutory rights is via a class action." Although the antitrust laws include fee-shifting for a prevailing plaintiff and the recovery of litigation expenses, the Court rejected that remedy as insufficient to protect the statutory rights of plaintiffs. The

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"Clayton Act's fee-shifting provisions [are] inadequate to alleviate our concerns given the low expert witness reimbursement rate. 'Even with respect to reasonable attorney's fees, which are shifted under Section 4 of the Clayton Act, the plaintiffs must include the risk of losing, and thereby not recovering any fees, in their evaluation of their suit's potential costs.'" The Court therefore invalidated the waiver because it "flatly ensures that no small merchant may challenge American Express' tying arrangements under the federal antitrust laws."

The Court emphasized, however, that it did *not* hold that class action waivers "are per se unenforceable in the context of antitrust actions. Rather, we hold that each case which presents a question of enforceability of a class action waiver in an arbitration agreement must be considered on its own merits, governed with a healthy regard for the fact that the FAA 'is a congressional declaration of a liberal federal policy favoring arbitration agreements.'"

The *American Express* decision follows a decision by the U.S. Supreme Court last year holding that "a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so." *Stolt-Nielsen SA v. AnimalFeeds International Corp.*, 130 S. Ct. 1758, 1775 (2010). In that case the arbitration clause was silent on whether class claims could be included in an arbitration proceeding. "[P]arties are 'generally free to structure their arbitration agreements as they see fit.'" Courts and arbitrators must "give effect to … contractual limitations" and "give effect to the intent of the parties." Because the contract was "silent" on class arbitration, there was nothing to indicate that Defendant affirmatively agreed to class arbitration. As a result, the arbitration panel erred in concluding that class arbitration was appropriate. The "differences between bilateral and class action arbitration are too great for arbitrators to presume, consistent with their limited powers under the FAA, that the parties' mere silence on the issue of class-action arbitration constitutes consent to resolve their disputes in class proceedings." *Id.* at p.23. Thus, although a company may not be able to contractually insulate itself from certain types of class actions, it still should have control over where any class action will proceed. By either leaving arbitration clauses silent as to class action claims or making it clear that the company does not agree prospectively to class action arbitration, a company, when faced with a potential class action, should be able to either consent to class arbitration or insist that the class action proceed in a court. Indeed, that is precisely what happened in the American Express litigation. After the Second Circuit invalidated the class action waiver in American Express' arbitration clause, the Court "[remanded the case] to the district court to 'allow Amex the opportunity to withdraw its motion to compel arbitration,'" which it apparently did.

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Class action waivers can be an effective way to limit financial exposure in litigation. However, companies need to be aware that those clauses may still be challenged in court. ◆

For assistance in negotiating, crafting, or litigating class action waivers, please contact John K. Gisleson (Pittsburgh), Theresa E. Loscalzo (Philadelphia), or Stephen J. Shapiro (Philadelphia). For antitrust advice, please contact Carl J. Schaerf (New York). For more information about Schnader's Financial Services Litigation and Antitrust and Trade Regulation Practice Groups, please contact:

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