Emerging Perspectives On The Fundamental Fairness Of Mandatory Arbitration Coupled With Class Action Bans

The subprime mortgage meltdown has had wide-ranging economic repercussions. But it has also shaken trust in certain institutions and altered previously held perspectives. On this score, one consequence of the meltdown appears to be the increased willingness of courts and policy makers to reevaluate the notion that mandatory arbitration coupled with a ban on class actions is fair to consumers. This emerging perspective has evolved in parallel with the exponential growth in the nature and scope of mandatory arbitration. Finding a consumer contract of any import without an arbitration clause is next to impossible, with the notable exception of FNMA mortgage instruments, as a few years back FNMA decided not to buy consumer paper containing mandatory arbitration provisions.

Now that the ubiquitous arbitration clause has been joined with a blanket ban on class actions, the effect is to put a large "X" through Rule 23. This appears to be the intent of arbitration proponents: "[T]he primary question asked by companies considering arbitration is 'Can we cut off class actions by requiring arbitration?' " Myriam Gilles, *Opting Out of Liability*: *The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 Mich. L. Rev. 373, 397, n. 123 (2005)(discussing from a historical perspective the evolution of mandatory arbitration clauses as a way to avoid class actions). "Defendants use arbitration agreements, at least in part, to prevent class proceedings." Peter J. Kreher & Pat D. Robertson III, Comment, *Substance, Process, and the Future of Class Arbitration*, 9 Harv. Negot. L. Rev.

409, 423 (2004). One critic has termed this movement "do it yourself" law reform.

> One might call this the 'do it yourself' approach to law reform: the company need not convince any legislature to pass revised laws, nor persuade any judicial body to change court rules, but rather merely *choose to eliminate the pesky class action on its own*... .

Jean R. Sternlight & Elizabeth J. Jensen, *As Mandatory Binding Arbitration Meets The Class Action, Will The Class Action Survive? Efficient Business Practice or Unconscionable Abuse?* 42 Wm. & Mary L. Rev. 1, 11 (2000)(emphases added).

Although mandatory arbitration alone limited class actions, the Supreme Court's decision in the *Bazzle* case expressly left the door open to class-wide arbitrations. *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444, 123 S. Ct. 2402 (2003)(rejecting argument that contract's silence on availability of classwide arbitration necessarily precludes it, and holding that arbitrator determines whether classwide arbitration may proceed). In light of *Bazzle*, a burgeoning trend accelerated – companies refined the arbitration device to further insulate themselves from liability by incorporating a ban on class proceedings into the arbitration provision. See Jean R. Sternlight & Elizabeth J. Jensen, *Using Arbitration to Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse*? 67-SPG Law & Contemp. Probs. 75 (2004).

These contract clauses "waive not only the right to participate in class actions, but also the right to participate in class-wide arbitrations or to aggregate claims with others in any form of judicial or arbitral proceeding." Gilles, *Opting Out*

of Liability, 104 Mich. L. Rev. 373, 376, n. 15. The widespread use of these devices has been characterized by one scholar as part of a "stampede in fashioning pre-dispute binding arbitration agreements drafted to cover every imaginable cause of action arising … under consumer law." Sandra F. Gavin, *Unconscionability Found*: *A Look At Pre-Dispute Mandatory Arbitration Agreeements 10 Years After Doctor's Associates v. Casarotto*, 54 Clev. State L. Rev. 249, 258 (2006).

Since their inception, these class action bans have mostly been upheld, with most courts simply reciting the traditional mantra that arbitration still provides a forum and that there is no substantive right to a class action.[1] But recently, a number of courts have begun to look beyond the form of the contract and carefully scrutinize the actual effect

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[1] *See, e.g.*, *Hawkins v. O'Brien*, 2009 WL 50616 (Ohio App. 2 Dist. Jan. 9, 2009) (relying on procedural versus substantive dichotomy upholds lower court order compelling arbitration); *Brower v. Gateway 2000*, 246 A. D. 2d 246 (N.Y. 1st Dep't 1998))(class action ban not unconscionable or contrary to public policy); *Walther v. Sovereign Bank*, 386 Md. 412, 872 A.2d 735 (Md. 2005) (same, citing "the strong policy made clear in both federal and Maryland law that favors the enforcement of arbitration provisions"); *Fonte v. AT&T Wireless Services, Inc.*, 903 So. 2d 1019 (Fla. Ct. of App., 4th Dist. 2005), *review denied*, 918 So. 2d 292 (2005) (no non-waivable right to class action); *Crawford v. Great American Cash Advance, Inc.*, 284 Ga. App. 690, 644 S.E. 2d 522 (Ga. App. March 29, 2007) (upholding lower court order to arbitrate over unconscionability claim under state law); *Strand v. U.S. Nat'l Bank, N.A.*, 2005 N.D.68, 693 N.W. 2d 918 (N.D. March 31, 2005) (restricting purely procedural right to bring class action not unconscionable).

of these bans, particularly in small dollar consumer cases. These decisions have found that where these clauses effectively disenfranchise consumers, they create an impermissible "*de facto* liability shield" for the drafter. *See e.g., Kristian v. Comcast Corp.*, 446 F.3d 25, 61 (1st Cir. 2006)(coining the phrase and borrowing from a line of consumer cases in invalidating an unconscionable "*de facto* liability shield" in a consumer antitrust action).

Still the jurisprudence goes both ways. Some courts, even recently, have found nothing offensive to notions of fairness in the coupling of mandatory arbitration with a class action ban. *See e.g., Gay v. CreditInform*, 511 F.3d 369 (3d Cir. 2007) (upholding the combination in small consumer dispute involving claims with approximate $39 value); *Delta Funding Corp. v. Harris*, 189 NJ 28, 912 A.2d 104 (NJ 2006)(class action waiver-arbitration combo upheld in context of large claims involving home mortgages).

Nevertheless, while mandatory arbitration-class action bans are not *per se* unconscionable, the arc of the judicial trend suggests that skepticism is the new order of the day.2 This article tracks this trend, which also has parallels in federal and state

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2 One indication of how the trend will play out will certainly come from the Supreme Court's decision in *Stolt-Nielsen v. Animalfeeds International Corp.*, No. 08-1198, to be argued on December 9, 2009. The petitioners effectively seek to have the court overturn *Green Tree Financial v. Bazzle*, an outcome which could conceivably have the effect of persuading courts to find that the Federal Arbitration Act preempts state law that invalidates class action bans regardless of the disenfranchising effect those provisions may have.

legislation, legal commentary, and in the popular media as well.

The Trend Uses An Effect Based Analysis To Evaluate The Enforceability Of Arbitration Clauses With Class Action Bans

The growing perception is that in particular circumstances the real-world effect of arbitration clauses containing class action bans is to insulate the drafter from any systemic challenge to illegal conduct, much less any liability. In effect, the mechanism, while characterized by its proponents as advancing fairness and judicial economy, has instead "been used as a sword to strike down access to justice instead of as a shield against prohibitive costs'." *Luna v. Household Finance Co*., 236 F.Supp.2d 1166, 1179 (W.D.Wash. 2002) *quoting Mendez v. Palm Harbor Homes, Inc*., 111 Wash.App. 446, 465, 45 P.3d 594 (2002). Courts now increasingly look at the real world effect of contractual provisions both as they deprive consumers of remedies and undermine the social contract:

> If the class mechanism prohibition [in the arbitration clause] here is enforced, Comcast will be essentially shielded from private consumer antitrust enforcement liability, even in cases where it has violated the law. Plaintiffs will be unable to vindicate their statutory rights. Finally, the social goals of federal and state antitrust laws will be frustrated because of the "enforcement gap" created by the *de facto* liability shield.

Kristian, 446 F. 3d at 52.

The common theme that is emerging from the courts, state regulators and policymakers is that

arbitration clauses which, in reality, are simply contract terms that allow companies to "opt out of liability" for treating consumers unfairly, will no longer be tolerated because "the [clause] becomes in practice the exemption of the party from responsibility for [its] own fraud, or willful injury to the person or property of another'." *Discover Bank v. Superior Court*, 36 Cal.4th 148, 162-163, 113 P.3d 1100 (Cal. 2005).

Class Action Bans Found To Violate A Fundamental Public Policy To Ensure Fair Access to Consumer Remedies

The evolution of the law in analyzing class action bans has brought a specific focus upon the ban's chilling, unfair effect on the individual's ability to vindicate statutory rights. The most recent case to adopt this analysis is *Feeney v. Dell Computer, Inc.*, 454 Mass. 192, 908 N.E. 2d 753 (Mass. 2009).3 In *Feeney* the Massachusetts Supreme Judicial Court found Dell's class action ban to violate the state's fundamental public policy in favor of consumer class actions brought under its consumer protection act. 908 N.E. 2d at 766.4

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3 Although the 9th Circuit just issued a non-published decision in *Masters v. DirecTV*, No. 08-55825 (9th Cir. November 19, 2009) which, without much discussion, held that DirecTV's arbitration clause with class action ban violated California's fundamental public policy, citing Discover Bank and numerous other California cases to that effect.

4 Interestingly, this case had another plaintiff, Dedham Health and Athletic Club, a business, which was suing under c. 93A's business remedy, contained in section 11 of the statute.

The case challenged Dell's collection of Massachusetts' sales tax on the purchase of optional service contracts sold in conjunction with the purchase of Dell computers. Dell's contract required that purchasers pursue any claims against it through arbitration and mandated that any such claims be arbitrated on an individual basis. The Court first noted that it is "universally accepted that public policy sometimes outweighs the interest in freedom of contract, and in such cases the contract will not be enforced." *Id*. at 762-63. In Massachusetts, the court noted, the consumer protection act, G.L. c. 93A, represented a statutory codification of the state's strong public policy in favor of enabling consumers to privately vindicate their rights. *Id*.

The Court examined the evolution of c. 93A, which in its earliest version contained no private right of action for consumers but instead was enforced solely by the Attorney General. Recognizing the limited resources the Attorney General had and the urgent need to provide consumers with a means to enforce the rights that c. 93A bestowed upon them, in 1969 the legislature amended the statute to provide that private right of action, a fee shifting provision in favor of prevailing consumers, and a provision for such consumers to bring class actions under the statute. *Id*. The Court noted that the major obstacle to private consumer redress was the economic disincentive inherent in small dollar consumer claims – that it was virtually impossible for a consumer to get a lawyer to bring a small dollar claim on an individual basis. As such, the Court cited one of its seminal c. 93A decisions, *Leardi v. Brown*, 394 Mass. 151, 164 (1985) for the principle that "one of the basic purposes" of c. 93A was to provide a mechanism " for vindicating claims which, taken individually, are too small to justify

legal action but which are of significant size if taken as a group". *Id*., at 763.

The Court found that this policy of promoting private remedies through the aggregation of small dollar consumer claims via class actions was undermined by Dell's class action ban. In having this effect, Dell's class action ban "defeats 'the presumption' that arbitration provides 'a fair and adequate mechanism for enforcing *statutory* rights'." *Id*., quoting *Kristian v. Comcast Corp.,* 446 F.3d 25,54 (1st Cir.2006).

The Court was not done with Dell's class action ban, though. It went on to cite two other reasons that the ban violated Massachusetts' public policy. First, it undermined the public policy in favor of deterring business misconduct. The Court pointed out that deterrence was one of the two basic functions of class actions, "especially when small individual claims are involved". *Id*., at 764, quoting 2 A. Conte & H.B. Newberg, Class Actions § 4.36, at 314 (4th Ed. 2002), among others.[5]

Second, the ban adversely affects the interests of putative class members, who are not only deprived of the right to have their rights vindicated through the class action, but who, in the absence of a class action may not even realize

[5] To underscore its point about deterrence, the Court also quoted *In re Am. Express Merchants' Litig.,* 554 F.3d 300, 320 (2d Cir. 2009)(allowing enforcement of class action waiver in credit card acceptance agreement would grant corporation "de facto immunity from antitrust liability by removing the plaintiffs' only reasonably feasible means of recovery"); and *Dale v. Comcast Corp.,* 498 F.3d 1216, 1224 (11th Cir. 2007) ("Corporations should not be permitted to use class action waivers as a means to exculpate themselves from liability for small-value claims").

that their rights were violated. "In this sense, the right to participate in a class action under G.L. c. 93A is a public-not merely a private-right: it protects the rights of consumers as a whole." *Id*.

Dell argued that c. 93A's fee shifting provision, coupled with the Attorney General's enforcement powers, provided sufficient incentive for consumers to bring individual claims and sufficient protection of consumer interests generally, through AG enforcement actions. *Id*. The Court rejected these arguments, noting that the fee shifting provision's ability to induce lawyers to take on cases was effectively "illusory" in small dollar cases (Feeney's claim was for $13.64). It also pointed out that c. 93A's legislative history demonstrated that one of the principal reasons for the private remedy and class action provisions was that the Attorney General lacked the resources to be the sole enforcer of consumer rights in the state. *Id*.

The Court concluded, using strong and emphatic language, that Dell's clause was unenforceable:

> We decline to enforce a prohibition on class actions in a consumer contract where to do so would in effect sanction a waiver of the right to proceed in a class action under G.L. c. 93A. Allowing companies that do business in Massachusetts, with its strong commitment to consumer protection legislation, to insulate themselves from small value consumer claims creates the potential for countless customers to be without an effective method to vindicate their statutory rights, a result clearly at odds with our public policy.

Id., at 765.

As emphatic as *Feeney's* statement is, it simply advances the trend in the jurisprudence. On this score, Dell's provision has not fared well when examined by the courts. For example, in Illinois, where the court held that a class action ban in Dell's contract, which, as in Massachusetts, contained with Texas choice-of-law clause, also violated a fundamental public policy of Illinois. *Wigginton v. Dell, Inc.*, 382 Ill. App. 3d 1189, 890 N.E. 2d 541, 321 Ill. Dec. 819 (Ill. App. Ct. 2008). Similarly, in New Mexico, the court also refused to enforce the Texas choice-of-law provision and held, in light of the small dollar claims involved, that the class action ban was contrary to New Mexico's fundamental public policy of encouraging the resolution of such small consumer claims. *Fiser v. Dell Computer Corporation*, 144 N.M. 464, 188 P.3d 1215 (2008).

And in terms of accurate legal forecasting, *Feeney* validates the Pennsylvania Supreme Court's view of Massachusetts law on this issue. In *Thibodeau v. Comcast Corporation,* 2006 Pa. Super. 346, 912 A.2d 874 (2006) the Pennsylvania Supreme Court held that the class action ban in Comcast's customer agreement was unconscionable. Even though the plaintiff was a Massachusetts resident, the Court found no reason to do a choice of law analysis, as it presumed that Massachusetts' law was the same as Pennsylvania law on this issue, a conjecture which *Feeney* validated.

The Illusion Of The Opt- Out

This effect-based analysis looks beyond the literal provisions of these bans, which always provide that consumers are technically allowed to bring their claims individually in some forum, or ostensibly allow the "choice" of opting out. *Feeney* and its

predecessors soundly reject the first notion, and in reality, the opt-out is just another illusory "right" that serves only as semantic cover for the disenfranchising effect of the class action ban. The principle remains the same – the unfair disenfranchising effect invalidates these provisions. In short, the opt out provision merely strengthens the *de facto* liability shield by giving it the illusion of being penetrable and therefore enforceable, while the reality remains that, without the class action mechanism, no customer will be able to enforce compliance with consumer protection laws.

For example, in *Firchow v. Citibank (South Dakota), N.A.,* 2007 WL 64763 (Cal. Ct. App. 2007) the court upheld the trial court's denial of a motion to compel arbitration, relying upon *Discover Bank* in finding that the arbitration clause's embedded class action ban was substantively unconscionable. In addition, *Firchow* found the provision procedurally unconscionable because Citi would not renew a credit card issued to any consumer who opted out of the arbitration provision. The court noted that this made the opt-out right illusory.

The Ninth Circuit explained why, in this context, it is necessary to look at the effect of the opt-out right. *Hoffman v. Citibank (South Dakota), N.A.,* 546 F.3d 1078 (9th Cir. 2008). As California has a fundamental public policy against class action waivers, a business cannot subvert that policy by making Californians subject to choice of law clauses which apply laws which do not recognize this policy, or the doctrines that support it. As such, where Californians are being deprived of rights based on a contract which invokes a class action ban, albeit via the laws of another state, California's policy against enforcing such bans provides its courts with ample legal basis to invalidate the choice of law clause. *Hoffman,* at 1083.

> The California courts have explained the need for this policy, reasoning that a defendant could "essentially grant[ ] itself a license to push the

> boundaries of good business practices to their furthest limits, fully aware that relatively few, if any, customers will seek legal remedies" and that "[t]he potential for millions of customers to be overcharged small amounts without an effective method of redress cannot be ignored."

Id. (citations omitted).

Although a different twist on the method of depriving consumers of the right to legal vindication, the opt-out still must be examined in context. For this reason *Kristian* emphasizes the need for courts to recognize the real world effect of class action bans, and implicitly, of the opt-out device by which they may be presented: "[w]e are not required to close our eyes to the … [reality of the circumstances]. … We see no reason to ignore the obvious." *Kristian,* 446 F. 3d at 52. *Kristian* noted the similarities in effect of the class action ban it struck down to that in *Ting v. AT&T,* 319 F.3d 1126, 1130 (9th Cir. 2003), a consumer case which also struck down an exculpatory class ban:

> The parallels between the effect of the class action ban in *Ting* and the class mechanism bar [here] is impossible to ignore. If the class mechanism prohibition here is enforced, Comcast will be essentially shielded from private consumer antitrust enforcement liability, even in cases where it has violated the law. Plaintiffs will be unable to vindicate their statutory rights. Finally, the social goals of federal and state antitrust laws will be frustrated because of the "enforcement gap" created by the *de facto* liability shield.

446 F. 3d at 61.[6]

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[6] Just as *Feeney* quoted *Muhammad v. County Bank*, 189 N.J. 1, 21, 912 A.2d 88 (2006) for the proposition that

Tracking The Trend

Kristian does not break new ground, instead it is supported by reference to decisions which mirror its own analysis, invoking other consumer cases which found that class action bans make it economically unfeasible to bring claims challenging unfair business practices. 446 F.3d at 60.

A Wisconsin decision describes the arc of this trend. Acknowledging that a majority of courts had upheld class action bans until very recently, the Wisconsin Court of Appeals nevertheless said " [w]e are, however, persuaded by what appears to be a growing minority of courts that a ban of class-wide relief is a significant factor (and in at least one instance a determinative factor) in invalidating an arbitration provision as unconscionable". *Coady v. Cross Country Bank, Inc.*, 299 Wis.2d 420, 729 N.W.2d 732, 746 (Wis.App. 2007).

"An arbitration agreement that eliminates the right to a class-wide proceeding may have 'the substantial effect of contravening the principle behind class action policies and chilling the effective protection of interests common to a group'." *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165, 1176 n.13 (9th Cir. 2003), *cert. denied*, 540 U.S. 1160 (2004). This *de facto* liability shield is not merely the effect of the class action ban, but its intent as well. As one of the seminal class action ban decisions bluntly puts it:

> [T]he manifest one-sidedness of the no class action provision at issue here is blindingly obvious … This provision is clearly meant to prevent

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the attorney's fee inducement was illusory in small dollar cases. *Feeney* at 764.

> customers, such as Szetela**Error! Bookmark not defined.** and those he seeks to represent, from seeking redress….

Szetela v. Discover Bank, 97 Cal.App.4th 1094, 1100-01, 118 Cal.Rptr.2d 262 (2002).

This effect-based analysis looks beyond the literal provisions of the ban, as typically those provisions technically allow individuals to bring their claims individually in some forum. In reality, however, the *effect* of these provisions make it difficult or impossible to challenge widespread practices.

The View From The Coast

Certainly, California is the forum in which class action bans have been treated to the most searching scrutiny, and skepticism. Perhaps the seminal case of the post-2005 era is *Discover Bank Superior Court,* 36 Cal.4th 148, 30 CalRptr.3d 76, 113 P.3d 1100 (2005). In *Discover* California Supreme Court rejected a class action ban because, among other things, consumer class actions are "inextricably linked to the vindication of substantive rights." *Id.,* at 1109. Although the court noted that not "all class action waivers are necessarily unconscionable," those involving "one-sided, exculpatory contracts in a contract of adhesion" are "generally unconscionable" under California law. *Id.*, at 1109-10.

The Ninth Circuit used the *Discover Bank* analysis in invalidating Cingular's arbitration/class action ban in *Shroyer v. New Cingular Wireless Services, Inc.*, 498 F.3d 976 (9th Cir. 2007). The court synopsized the *Discover Bank* analysis as requiring a three part analysis: (1) whether there is an adhesion contract; (2) involving small dollar claims; and (3) the consumers claim that the drafter is carrying out "a scheme to deliberately cheat large numbers of consumers out of

individually small sums of money.' *Id*., at 983, citations omitted. The court found that Cingular's class action ban met all three tests, although not all three were necessary to invalidate such a ban. "Although there are most certainly circumstances in which a class action waiver is unconscionable under California law despite the fact that all three parts of the *Discover Bank* test are not satisfied, it is unnecessary to explore those circumstances here because the instant action satisfies them all and cannot be distinguished from *Discover Bank." Id.*

The state of Washington's jurisprudence, both state and federal, mirrors that of California. For example, in *Scott v. Cingular Wireless*, 161 P.3d 1000 (Wash. 2007), the Washington Supreme Court invalidated Cingular's class action ban, basing its decision upon *Shroyer.* The Court noted that class actions are essential deterrents to business misconduct, particularly of the small dollar variety, and that Cingular's class action ban was an "unconscionable violation of this State's policy to protect the public and foster fair and honest competition . . . because it drastically forestalls attempts to vindicate consumer rights." *Id.,* at 1005-06. It further explained its rationale, expressing that Cingular's class action ban undermined the public policy of the Washington Consumer Protection Act by "dramatically decreasing" the possibility that Cingular customers would be able to act as private attorneys general. The court held that the ban made it extremely unlikely that consumers could bring small dollar value lawsuits, and thereby effectively exculpated Cingular from liability for those claims.

Following *Scott*, the Court unanimously held unenforceable AT&T's class action ban, which invoked New York law, because enforcing the ban under New York law would conflict with the "strong Washington State public policy in support of the use of class action claims to pursue actions for small-dollar damage claims under the Washington State

Consumer Protection Act." *McKee v. AT&T Corp.*, 191 P.3d 845, 852 (Wash. 2008). See Also *Lowden v. T-Mobile USA*, 513 F.3d 1213 (9th Cir. 2008) (class action ban is unconscionable in light of Washington Supreme Court's opinion in *Scott v. Cingular Wireless*, 161 P.3d 1000 (Wash. 2007). And Arizona has found a class action ban unconscionable even with the availability of attorneys' fees and the possibility of administrative enforcement. *See Cooper v. QC Financial Services, Inc.*, 503 F. Supp. 2d 1266 (D. Ariz. 2007).

While acknowledging that courts generally favor arbitration in appropriate cases, the decisions which reject class action bans implicitly find the device to be the do-it-yourself tort reform that Prof. Sternlight warns against. In *Luna*, a Washington state case, for example, the court struck down a class action ban in a consumer finance contract, noting that it "was likely to bar actions involving practices applicable to all potential class members, but for which an individual consumer has so little at stake that she is unlikely to pursue her claim." 236 F. Supp. 2d at 1179. The court cited an earlier Washington state case, *Mendez v. Palm Harbor Homes, Inc.*, 111 Wash. App. 446, 465, 45 P.3d 594 (2002), which refused to compel arbitration on similar grounds, while acknowledging the general enforceability of arbitration provisions:

> Avoiding the public court system to save time and money is a laudable societal goal. But avoiding the public court system in a way that effectively denies citizens access to resolving everyday societal disputes is unconscionable. Goals favoring arbitration of civil disputes must not be used to work oppression.

The common theme, that recurs throughout the anti-ban caselaw, is that class bans which operate to exempt businesses from responsibility for their own illegal actions are unconscionable because "the waiver becomes in practice the exemption of the party "from responsibility for [its] own fraud, or willful injury to

the person or property of another." *Discover Bank v. Superior Court*, 36 Cal.4th 148, 162-163, 113 P.3d 1100 (Cal. 2005).

In *Vasquez-Lopez v. Beneficial Oregon, Inc.*, 210 Or.App. 553, 152 P.3d 940 (Or.App. 2007), the Oregon appeals court found that a class action ban in a mortgage loan contract was unconscionable because it gave the defendant "a virtual license to commit, with impunity, millions of dollars' worth of small-scale fraud". The court first acknowledged the importance of class actions: "the opportunity that the class action ban denies to borrowers is, in many instances, a crucial one, without which many meritorious claims would simply not be filed." *Id*., at 570. It then quoted an earlier decision of the California Supreme Court, which it found was directly applicable to the case before it:

> Frequently numerous consumers are exposed to the same dubious practice by the same seller so that proof of the prevalence of the practice as to one consumer would provide proof for all.

Id. quoting Vasquez v. Superior Court of San Joaquin County, 4 Cal.3d 800, 808, 94 Cal.Rptr. 796, 484 P.2d 964, 968-69 (1971).

Vasquez-Lopez was followed by the Ninth Circuit in *Chalk v T-Mobile*, 560 F.3d 1087 (9th Cir. 2009), which invalidated T-Mobile's class action ban embedded in its arbitration clause. In *Chalk*, the Ninth Circuit explicitly invoked the effect of the clause as the reason for its invalidation, that effect being its preclusion of the ability of consumers to bring small dollar claims. "[B]ecause T-Mobile's class action waiver is identical *in effect* to the class action waiver in *Vasquez-Lopez*, it is substantively unconscionable as a matter of Oregon law"(emphasis added).

The Ninth Circuit put a large punctuation mark on this principle in a case challenging Blockbuster's "End of Late Fees" promotion. *Creighton v.*

Blockbuster, Inc., 321 Fed.Appx. 637, 2009 WL 905465 (9th Cir. 2009). Ms. Creighton claimed fraud and deception because, while Blockbuster did eliminate its "late fee," imposed when a customer returned a movie after deadline, it replaced it with a "restocking fee" imposed when a customer returned a movie after deadline. The charge was a few dollars, and so not the type of damage that a consumer would bring an individual claim over. Blockbuster's class action ban made that negligible individual claim the only means of redress. An open and shut case under the effects-based analysis: "A class action waiver in a consumer contract where damages are likely to be small is substantively unconscionable under Oregon Law." *Id.* at *1, citing *Vazquez-Lopez* and *Chalk*.

Building on these principles, the court in *Coneff v. AT&T, Inc.*, 620 F.Supp.2d 1248 (W.D. Wash. 2009) held that without a class action, the vast majority of AT&T's customers would never obtain justice—and for that reason refused to enforce its class action ban. Relying upon *Scott* and *McKee*, the Court noted the claims alleged "implicate a fundamental public policy of Washington. A prohibition on the Plaintiff's ability to initiate a class-action lawsuit would violate the rights protected by the Washington CPA and the case law that has interpreted those rights." *Id*. at 1255. The Court therefore found the ban unconscionable under Washington law, because it would "effectively exculpate" AT&T from potential liability for violations of the Washington state consumer protection act. unfair or deceptive acts or practices in commerce. "The Court will not condone such a broad and exculpatory practice," noting that the central purpose of class actions is to curb fraudulent business practices such as those claimed by the consumers in *Coneff*. *Id*. at 1259.

The *Coneff* court concluded by noting the trend this article documents:

> Lastly, the Court recognizes that recent

> jurisprudence views class-action waivers unfavorably. Dating back to the beginning of 2008, there have been at least seven different courts in five different jurisdictions that have refused to enforce class-action waivers (citations omitted). And as the Court noted above, even the *Carideo* case which Defendants heavily rely upon has been remanded by the Ninth Circuit. *See In re Carideo*, 550 F.3d 846 (9th Cir. 2008). *This ruling is therefore consistent with the modern trend.*

Id. at 1260 (emphasis added).

The Most Recent Second And Third Circuit Decisions On This Issue Adopt The Effect Based Analysis

The cases that make up this trend often frame the issue as follows: Is the recovery so small that, absent using the class device, no reasonable person would ever bring the claim in the first place? If so, does this circumstance effectively eviscerate rights to pursue remedy?

On that score, *Feeney* quoted the Supreme Court:

> The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's [usually an attorney's] labor.

Amchem Prod., Inc. v. Windsor, 521 U.S. 591, 617, 117 S.Ct. 2231, 138 L.Ed.2d 689 (1997).[7]

The principle that a class ban cannot be used to prevent claims from ever being brought was reiterated by the Court of Appeals for the Second Circuit. *American Express Merchants' Litigation*, 554 Fed 3rd 300 (2nd Cir. 2009). The Second Circuit reversed the district court and held that an arbitration agreement containing a class action ban is unenforceable where the evidence indicates that the underlying claim would not have been brought, because of its meager size and its complexity, except using the class action device.

The Circuit Court reached this conclusion even after first noting that "it is difficult to overstate the strong federal policy in favor of arbitration, a policy we have often and emphatically applied." *Id.*, at 302. The court carefully noted the difference between analyzing the enforceability of an arbitration clause, compared to the enforceability of a class action ban.

Significantly, the court noted the fact-specific nature of that analysis, emphasizing that class action bans are not *per se* enforceable or unenforceable. The issue turns on the evidence offered to show the impairment the ban creates to enforcement and prosecution of the underlying claim.

> While we are conscious of this debate, we are thankful that we need not resolve it on this appeal. That is, we do not decide whether class action waiver provisions are either void or enforceable per se. Rather, we are concerned solely with the class action waiver contained in the contract between the parties before us on this appeal. We conclude that, on the record before us, the plaintiffs have

[7] The Supreme Court was in turn quoting the Seventh Circuit, from *Mace v. Van Ru Credit Corp.*, 109 F.3d 338, 344 (7th Cir. 1997).

> adequately demonstrated that the class action waiver provision at issue should not be enforced because enforcement of the clause would effectively preclude any action seeking to vindicate the statutory rights asserted by the plaintiffs.

Id., at 304.

After the Second Circuit weighed in, the Third Circuit issued its decision in *Homa v. American Express*, 554 Fed 3rd 225 (3rd Cir. 2009). Following on the heels of *Gay v. Creditinform*, the Third Circuit effectively eviscerated that case by finding as follows.

Amex contended that the Federal Arbitration Act preempted New Jersey law prohibiting contract terms that ban class actions. The Court found that the New Jersey Supreme Court's *Muhammad* decision invalidated the class action ban, but not the underlying arbitration clause. The court pointed out that the Supreme Court has specifically held that arbitration clauses are subject to generally applicable state contract law defenses such as unconscionability. In *Gay*, the Third Circuit had stated that the FAA preempted Pennsylvania law invalidating a class action ban. But the *Homa* court said that the preemption language in *Gay* was merely dicta. *Id*., at 229.

The Court also rejected the choice of law clause, which invoked Utah law. The Court relied upon the assumption that individual consumer claims were small dollar claims, and, as such, it would violate fundamental principles of New Jersey public policy to apply Utah law to uphold the class action ban. *Id*., at 231. The court referenced the *Muhammad* case's strong language about New Jersey public policy. The Court speculated that the New Jersey Supreme Court would likely hold that New Jersey had a much greater interest in the rights of its

consumers under its consumer protection laws than Utah would have in barring class action claims against American Express. *Id*., at 233. Finally, reinforcing the effect-based analysis, the Court held that "if the claims at issue are of such low value as effectively to preclude relief if decided individually, then, under *Muhammad*, the application of Utah law to the class action waiver is invalid and the class-arbitration waiver is unconscionable." *Id*., at 233.8

Similar Perspectives Across The Country

The one-sided nature of the class ban contributes to its unconscionability as well. As a preface to the uniformity of perspective across the country, a Ninth Circuit case succinctly outlines the problematic nature of these unfair contract provisions. The class action ban has only the guise of reciprocity, in reality it is "patently one-sided," because the benefit of the ban flows only to the drafter. *Ingle v. Circuit City Stores, Inc*., 328 F.3d 1165, 1177 (9th Cir. 2003). Such a contract provision, "so one-sided as to be oppressive," is substantively unconscionable. *Id*. The Ninth Circuit spoke plainly about this transparent device and its underlying motive:

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8 *But see Kaneff v. Delaware Title Loans, Inc*., No. 08-1007 (3rd Cir. Nov. 24, 2009). The court describes the "vexing issue … of the extent to which low income borrowers may have access to legal remedies that they waived [via arbitration] in a desperate attempt to borrow needed cash." It then finds of a 300% interest rate and other onerous terms that Kaneff's challenges to those provisions as unconscionable "are wanting", without further explanation, upholding the trial court's referral of the case to an arbitrator, "as the arbitrator will consider those claims when s/he decides the validity of the agreement as a whole." *Id*. at 14.

> Circuit City, through its bar on class-wide arbitration, *seeks to insulate itself* from class proceedings while conferring *no corresponding benefit to its employees* in return. This one-sided provision proscribing an employee's ability to initiate class-wide arbitration *operates solely to the advantage of Circuit City*. Therefore, because Circuit City's prohibition of class action proceedings in its arbitral forum is manifestly and shockingly one-sided, it is substantively unconscionable.

Id., at 1176 (emphases added).

A number of other cases adopt this perspective, invalidating similar bans and focusing on exculpatory effect. In *Muhammad v. County Bank of Rehoboth Beach*, 189 N.J. 1, 912 A.2d 88 (N.J. 2006), the New Jersey Supreme Court struck down a class action ban in a payday loan contract. The court noted that its analysis of "the public interests affected by the contract," required it "to determine whether the effect of the class-arbitration bar is to prevent plaintiff from pursuing her statutory consumer protection rights and thus to shield defendants from compliance with the laws of this State." *Id.*, at 19. While noting that the class action ban was not exculpatory in the strictest sense, the court found that because the individual damages at issue were minimal, its effect was to render individual enforcement of the plaintiff's and other consumers' statutory rights "difficult if not impossible" and that "[i]n such circumstances a class-action ban can act effectively as an exculpatory clause." *Id.*, at 19. As the court observed:

> To permit the defendants to contest liability with each claimant in a single, separate suit, would, in many cases give defendants an advantage which would be almost equivalent

> to closing the door of justice to all small claimants. This is what we think the class suit practice was to prevent.

Id., at 20.

Courts have responded similarly when plaintiffs showed that class action bans effectively preclude vindication of their rights. In a similar vein, *Powertel Inc. v. Bexley*, 743 So.2d 570, 575 (Fla.App. 1 Dist. 1999) held that the class action ban insulated *Powertel* from any liability, removing a potentially powerful deterrent against over-reaching:

> The arbitration clause also effectively removes Powertel's exposure to any remedy that could be pursued on behalf of a class of consumers. …. The prospect of class litigation ordinarily has some deterrent effect on a manufacturer or service provider, but that is absent here.

Likewise, in *State ex rel. Dunlap v. Berger*, 211 W.Va. 549, 562-563, 567 S.E.2d 265, 278-79 (W.Va. 2002) the West Virginia Supreme Court cited the loss of an incentive to comply with the law when class proceedings were unavailable, and the harm this causes both the individual consumer and the public at large:

> Class action relief-including the remedies of damages, rescission, restitution, penalties, and injunction-is often at the core of the effective prosecution of consumer, employment, housing, environmental, and similar cases.

Id., citing Riverside v. Rivera, 477 U.S. 561, 575, 106 S.Ct. 2686, 2694, 91 L.Ed.2d 466, 480 (1986) ("'If the citizen does not have the resources, his day in court is denied him; the ... policy which he seeks to assert and vindicate goes unvindicated; and the entire Nation, not just the individual citizen, suffers.' 122

Cong.Rec. 33313 (1976) (remarks of Sen. Tunney).") Thus, the court noted, allowing class bans in employment and consumer contracts "would go a long way toward allowing those who commit illegal activity to go unpunished, undeterred, and unaccountable." *Id.* Where this is the result, the class ban is unenforceable.

A representative sampling illustrates this point. *Leonard* v. *Terminix Int'l Co.*, 854 So.2d 529, 539 (Ala. 2002) (class action ban unconscionable under Alabama law where it forecloses p1aintiffs from seeking practical redress through a class action and "restrict[s] them to a disproportionately expensive individual arbitration"); *Rollins, Inc.* v. *Garrett*, 2006 WL 1024166 (11th Cir. April 19, 2006) (per curiam) (recognizing that exculpatory class action bans are invalid under Florida law, citing *Powertel*); *S.D.S. Autos, Inc.* v. *Chrzanowski, et al.*, 2007 WL 4145222, at *3 (Fla. Ct. App. Nov. 26, 2007) (class action ban unconscionable because it "deprive[s] the plaintiff of the ability to obtain meaningful relief for alleged statutory violations"); *Skirchak* v. *Dynamics Research Corp.*, 432F. Supp. 2d 175, 181 (D. Mass. 2006*), aff'd*, 508 F.3d 49 (lst Cir. 2007) (class action ban unconscionable under Massachusetts law "because it may effectively prevent[] employees from seeking redress of [statutory] violations" and "removes any incentive for [the employer] to avoid the type of conduct that might lead to class litigation in the first instance"); *Wong* v. *T-Mobile U.S.A.*, 2006 WL 2042512 (E.D. Mich. July 20, 2006) (class action ban unenforceable under Michigan law because the right to a class action ... is certainly necessary for the effective vindication of statutory rights, at least under the facts of this case. Defendant makes much of the fact that it contributes toward plaintiffs' arbitration costs, but in order for arbitration to be feasible, the

amount at issue must also exceed the value in time and energy required to arbitrate a claim.").9

Wide Ranging Responses To Arbitration And Class Action Bans

The old perception and principle – that arbitration is presumed fair unless the plaintiff proves

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9 *See also Lozada* v. *Dale Baker Oldsmobile, Inc.*, 91 F. Supp. 2d 1087, 1105 (W.D. Mich. 2000) (class action ban unenforceable where it impermissibly waived remedies normally available under consumer protection statutes); *Doerhoff v. Gen. Growth Props., Inc.*, 2006 WL 3210502 6 (W.D. Mo. Nov. 6, 2006)(New York choice of law clause, under which class action ban would have been enforceable, was unconscionable under Missouri law because ban violates fundamental public policy of Missouri); *Whitney v. Alltel Communications, Inc.*, 173 S.W.3d 300, at 313-14 (Mo. 2005)(wireless company's class action ban substantively unconscionable because it would effectively strip consumers with small claims of remedies and insulate the corporation from liability); *Schwartz v. Alltel Corp.*, No. 86810, 2006 WL 2243649, at *5 (Ohio Ct. App. June 29, 2006) (class action ban unconscionable under Ohio law because "[b]y prohibiting its customers from filing suit as a class, Alltel prevents the cost effective use of class action litigation that can end abusive practices by large corporations in those instances in which individual claims are ineffective"); *Thibodeau* v. *Comcast Corp.*, 912 A.2d 874, 886 (Pa. Super. Ct. 2006) (class action ban unconscionable under Pennsylvania law, because, if enforced, the defendant would be "immunized from the challenges brought by [the plaintiff], brought by any class member, or effectively from any minor consumer claims").

otherwise – is giving way to a show me attitude engendered by a growing awareness that "*de facto* liability shields" are inherently unfair. As plaintiffs' lawyers have been arguing for some time now, with increasing degrees of success, the notion that mandatory arbitration is fair, especially when combined with a class action ban, is a distortion of the reality that consumers and their lawyers experience.

Broadsides By Two Prominent Regulators And A Public Relations Debacle

California and Minnesota, in separate suits, accused the National Arbitration Forum of bias, consumer fraud and apparent collusion with creditors. "In reality", as the state of California recently said in a broadside leveled at the National Arbitration Forum, one of the industry's biggest operators, the "[arbitration] process is the *antithesis* of fair", at least as NAF practices it. *People of the State of California v. National Arbitration Forum, et al*, San Francisco County Superior Court No. 98-473569 (filed March 24, 2008)(emphasis added). This lawsuit targeted NAF's debt collection "arbitration mill", an aspect of NAF's business whereby it "is retained by debt collectors and serves their interests alone in a non-neutral, biased and unfair manner" and "churn[s] out arbitration awards in favor of debt collectors and against California consumers, often without regard to whether consumers actually owe the money sought by the debt collectors…."

The California AG's suit focused on arbitrator bias, whereas most other cases advance the premise that an arbitration-class action ban provides an effective "get out of jail free" card for the drafter. The suit emphasized that NAF's own documents show that NAF arbitrators *"decided in*

favor of the business entity and against the consumer 100% of the time." (emphasis in original). For this reason, California described NAF "arbitrations of consumer debt matters [as] a sham - the sole purpose of which is to assist its debt collector clients collecting money from consumers by creating an *appearance* that a fair and neutral arbitration has occurred and resulted in an enforceable award." (emphasis added).

On July 14, 2009, the Minnesota Attorney General filed a lawsuit against NAF containing some of the most shocking allegations yet leveled against the arbitration industry, seeking remedies for consumer fraud, false advertising, and violation of Minnesota's consumer protection act. *State of Minnesota v National Arbitration Forum, Inc., et al,* Hennepin County District Court, 4th Judicial District, July 14, 2009. The Attorney General's lawsuit claimed that while NAF "represents to the public, the courts, and consumers that it is independent, operates like an impartial court system, and is not affiliated with any party" in fact, it "works alongside creditors behind the scenes—against the interests of consumers—to convince creditors to place mandatory pre-dispute arbitration clauses in their customer agreements and to appoint the Forum as the arbitrator of any disputes that may arise in the future."

The AG's suit also extensively described and documented NAF's affiliation with Accretive, LLC, a New York hedge fund group that owns one of the country's major debt collection enterprises. The AG alleged that Accretive, through opaque financial affiliations, "invested $42 million in the National Arbitration Forum and obtained governance rights in it." Accretive then allegedly formed and funded a debt collection agency called Axiant, LLC, which acquired the assets and collections operations of three of the country's largest debt collection law firms. The AG stated that "[t]hrough these transactions, the

Accretive hedge fund group simultaneously took control of one of the country's largest debt collectors and became affiliated with the Forum, the country's largest debt collection arbitration company." The AG claimed that NAF concealed these affiliations with the collections industry, so that, for example, consumers did not know that nearly 60% of the consumer debt collection arbitration claims that NAF handled in 2006 alone were filed by the same three law firms whose collections operations were acquired by Axiant.

The AG's complaint contrasted NAF's deliberate representations that it has "no relationship with any party" and does not "counsel our users", with allegations that NAF "works closely with creditors behind the scenes to: (1) encourage them to file arbitration claims as an alternative way to collect debt from consumers; (2) draft arbitration clauses, advise creditors on arbitration legal trends, and in some cases, help them draft claims to be filed against consumers; and (3) refer them to debt collection law firms, which then file arbitration claims against consumers in the Forum." To induce creditors to do business with it, the AG claimed that NAF "makes representations that align itself against consumers, including, for example, that '[t]he customer does not know what to expect from Arbitration and is more willing to pay,' that consumers 'ask you to explain what arbitration is then basically hand you the money,' and that '[y]ou [the creditor] have all the leverage [in arbitration] and the customer really has no choice but to take care of the account'."

To sum up, the AG concluded that "[i]n short, the National Arbitration Forum reaches out to, and in some cases actively assists, the very corporations that may bring collection arbitrations against consumers — outreach that is at odds with the Forum's public image of independence, neutrality, similarity to a court, and lack of ties to parties that appear before it and that is not in the best interests of ordinary

consumers." *See* Complaint. ¶¶1-4, 19-112, *State of Minnesota v National Arbitration Forum, Inc.*

In a blockbuster announcement, just five days after filing her complaint, the Minnesota AG announced that she had signed a consent decree with NAF under which it agreed to get completely out of the consumer debt arbitration business by the end of the week. "I am very pleased with the settlement. To consumers, the company said it was impartial, but behind the scenes, it worked alongside credit card companies to get them to put unfair arbitration clauses in the fine print of their contracts and to appoint the Forum as the arbitrator. Now the company is out of this business." Minnesota Attorney General Lori Swanson's Press Release, July 19, 2009.

Attorney General Swanson also called upon Congress to "ban fine print mandatory arbitration clauses" and testified before Congress on the topics of the NAF consent judgment and unfair arbitration clauses generally. Swanson also encouraged other regulators and policymakers to "use whatever authority they have to look at other possible remedial relief in this area."

The rapidity and breadth of the Minnesota Attorney General's settlement is stunning, and it represents perhaps the most striking evidence that the old paradigm is rapidly deteriorating. Cracks in the facade have been appearing more rapidly as arbitration has become ubiquitous in consumer contracts, and therefore subject to greater scrutiny by policymakers. Recent highlights include: JPMorgan Chase and Bank of America dropping mandatory arbitration clauses from their consumer credit card contracts; FNMA's decision that it would no longer buy mortgage loans containing arbitration clauses; abuses in the nursing home industry, covered up for years because mandatory arbitration clauses kept the horror stories under wraps; and most recently the debacle concerning Halliburton's attempt to compel arbitration of the rape charges brought by Jamie

Leigh Jones.[10]

Ms. Jones, a 19 year old woman working for KBR, a former Halliburton contractor in Iraq, had to agree to arbitration as a condition of her employment. She alleged in a 2007 lawsuit that she was gang raped by fellow employees in the company compound. The response to Ms. Jones' lawsuit was the inevitable motion to compel arbitration, the argument being that "[t]he alleged attack occurred at Jones's barracks, so it "is inextricably linked to her employment at that site". It appears that "[e]ven rape can be job-related in the weird world of mandatory arbitration." *Rape, Broker, Customer Suits Hushed in Big Fight*, Bloomberg News April 28, 2009, available at http://www.bloomberg.com/apps/news?pid=email_en&sid=aJu8sav0XeZQ.

Ms. Jones challenged the arbitration clause, and Texas federal judge Keith Ellison found in her favor, *Jones v. Halliburton Company*, 2008 WL 2019463, *10 (S.D. Tex., May 9, 2008)("This court does not believe that plaintiff's bedroom should be considered the workplace, even though her housing was provided by her employer."). Halliburton appealed to the 5th Circuit, which upheld the district court. *Jones v. Halliburton Company*, No. 08-20380, Sept. 15, 2009. Sen. Al Franken subsequently got an amendment to the FY2010 Defense Appropriations Bill passed in the Senate, despite all but nine Republican senators voting nay. The amendment would prohibit the Department of Defense from doing business with contractors who required mandatory arbitration of claims involving Title VII of the civil rights act or any tort arising out of alleged sexual assault or harassment. Franken Amendment No. 2588.

Such horror stories, coupled with the NAF fiasco, with state Attorneys General accusing NAF of what amounts to conspiracy and fraud in its arbitration business, has fueled the debate in

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[10] Wall Street Journal, April 11, 2008, page A-1.

Congress, as well as in the states, where a number of bills relating to mandatory arbitration are pending.

The evolving recognition that mandatory arbitration clauses and the class action bans that are embedded within them deprive numerous constituencies of the ability to vindicate their rights is now recognized in legislation pending before Congress. The Arbitration Fairness Act (H.R. 1020), filed on February 12, 2009, would prohibit pre-dispute binding mandatory arbitration clauses in all consumer, employment, medical, securities and franchise contracts. The findings of Congress that prompted this Act include the following:

> Many corporations add to their arbitration clauses unfair provisions that deliberately tilt the systems against individuals, including provisions that strip individuals of substantive statutory rights, [and] ban class actions …. While some courts have been protective individuals, *too many courts have upheld* even egregiously unfair mandatory *arbitration clauses in deference to a supposed Federal policy favoring arbitration over the constitutional rights of individuals*. (emphasis added).

Conclusion

This "evolution" in the thinking of courts and legislators concerning the fairness and utility of arbitration and class action bans, coupled with the current administration's much more consumer-friendly stance, indicates a growing awareness in all quarters that the true purpose and effect of the arbitration mechanism in consumer contracts is likely to lead to its demise as an effective "de facto liability shield."

If the fight is really about arbitration, then why have the class action ban? The obvious answer - and it is obvious to most courts, the media, legislators and policymakers - is that the real world effect, and intent,

is to prevent these disputes from being brought and resolved in a class action. The effect, and clearly the intent as well, is not to give the parties a choice between arbitration and court, it is to deprive consumers of their only real world shot at vindication through forming an alliance through a class action, *either* in court or the arbitral forum.

Class action bans are simply the latest attempt to contract away potential liability in an effort that began with arbitration agreements generally. The primary question asked by companies considering arbitration is 'Can we cut off class and class actions by requiring arbitration?' " Gilles, *supra*, at 397, n. 123 (discussing from a historical perspective the evolution of mandatory arbitration clauses as a way to avoid class actions). The use of an explicit class prohibition is merely another evolutionary step in this progression. See Jean R. Sternlight & Elizabeth J. Jensen, *Using Arbitration to Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse?* 67-SPG Law & Contemp. Probs. 75 (2004). But evolution oftentimes encounters dead ends, and as the preceding outline of the landscape shows, it may be getting too warm for arbitration and the class action ban to survive.