

## Class Action Defense Strategy Blog

Up-to-date information on class action litigation

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## [Second Circuit Court of Appeals Finds Arbitration Provision Waiving Class Actions Unenforceable And Applies Stolt-Nielsen to Deny Class Arbitration](#)

By [Judy Suwatanapongched](#)

On July 12, 2010, the United States Court of Appeals for the Second Circuit held an arbitration provision barring class actions unenforceable because the provision was unconscionable under California law. Then, citing the recent decision in [Stolt-Nielsen S.A. v. AnimalFeeds International Corp.](#), 130 S. Ct. 1758 (2010), the Second Circuit affirmed the denial of the defendants' motion to stay and compel arbitration because the parties had not agreed to class arbitration.

In [Fensterstock v. Education Finance Partners](#), 09-1562-CV (July 12, 2010), Plaintiff brought a class action suit in the Southern District of New York against Defendants Education Finance Partners and Affiliated Computer Services ("ACS"). Plaintiff asserted California state law claims for fraudulent and deceptive practices in connection with the consolidation and servicing of his student loan. Although Plaintiff made timely payments on his loan and was not subject to any fees or charges, his payments were treated as payment of interest only. Plaintiff alleged that Defendants applied this scheme of misallocating money so that at the end of the repayment period, consumers would have to pay an "enormous lump-sum payment." The accumulated damages at the time Plaintiff filed the action was \$263.19. However, Plaintiff estimated that this amount would grow to "several thousands of dollars" by the time his final payment was due. Plaintiff also alleged the contract was one of adhesion and should be declared void as against public policy.

Defendants moved to stay the action and compel Plaintiff to individual arbitration per their contract's arbitration clause. The arbitration clause provided that all claims must proceed to mandatory, binding arbitration. If any claims were made as part of a class action, the arbitration of such claims must proceed on an individual basis. The clause further provided that the Federal Arbitration Act ("FAA") and, to the extent applicable, the State law governing the transaction

governed the clause. A severability provision stated that if any portion of the arbitration clause was deemed invalid or unenforceable, the remaining portions would remain in force. Defendants argued this clause was not unconscionable because Plaintiff was a sophisticated lawyer when he signed the agreement. Defendants also argued that if the arbitration clause was unenforceable under California law, the FAA preempts California law.

The district court denied the motion to stay and compel arbitration. First, the court found that the FAA does not preempt California law if the agreement to arbitrate is unenforceable on grounds such as fraud, duress, or unconscionability. Second, the court applied the three-prong test established in Discover Bank v. Superior Court, 36 Cal. 4th 148 (2005), and found the class waiver unconscionable. The court rejected the argument that the sophistication of the party could defeat a procedural unconscionability claim. The court also rejected Defendants' contention that the damages suffered by the consumers would "ultimately range in the thousand of dollars" and be sufficiently large to justify pursuing their claims individually. Since it took 20 months for Plaintiff to accrue \$263.19 in damages, the court found it would take years for class members to accrue damages large enough to justify bringing individual claims.

Defendant ACS appealed the denial and the Second Circuit Court of Appeals affirmed the district court's decision. The Court of Appeals agreed that the FAA did not preempt California law because generally applicable contract defenses, like unconscionability, did not contravene the FAA. The Court of Appeals, like the district court, gave no weight to the sophistication of Plaintiff or his opportunity to choose from alternative sources of consolidation loans. The Court of Appeals also applied the Discover Bank factors. First, the Court of Appeals found this was a contract of adhesion. Second, the dispute involved small amounts of damages. Although ACS calculated Plaintiff's ultimate damages as \$6,300, the Court of Appeals found this future damages amount largely speculative. Third, it was alleged that the party with the superior bargaining power had carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money. Accordingly, the Court of Appeals affirmed the decision that the class waiver was unconscionable.

Finally, having found the class waiver provision unenforceable, the Court of Appeals applied Stolt-Nielsen to hold that it had no authority to compel class arbitration when the parties had not agreed to it. In this particular case, the arbitration clause explicitly prohibited class action arbitrations. Therefore, Defendants could not sever the class waiver provision and allow class action arbitrations.

In sum, because the class action waiver was unconscionable under California law and the parties did not agree that an arbitration could proceed on a class-wide basis, the Court of Appeals for the Second Circuit affirmed the district court's denial of Defendants' motion to stay and compel arbitration.