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Gateway Widens Doorway to Imposing Unfair Binding Arbitration on Consumers

by Jean R. Sternlight

When Rich and Enza Hill opened the boxes to their new Gateway 10th Anniversary computer system, they had no idea they were trading their right to a jury trial for binding arbitration. Nonetheless, the Seventh Circuit Court of Appeals has held that because the boxes contained a "Standard Terms and Conditions Agreement" including an arbitration clause, the Hills waived their right to sue Gateway in court when they failed to return the computer within 30 days.¹ Instead, the Hills could only file a claim against Gateway in arbitration, and pay fees totaling at least \$2,000 to get there.²

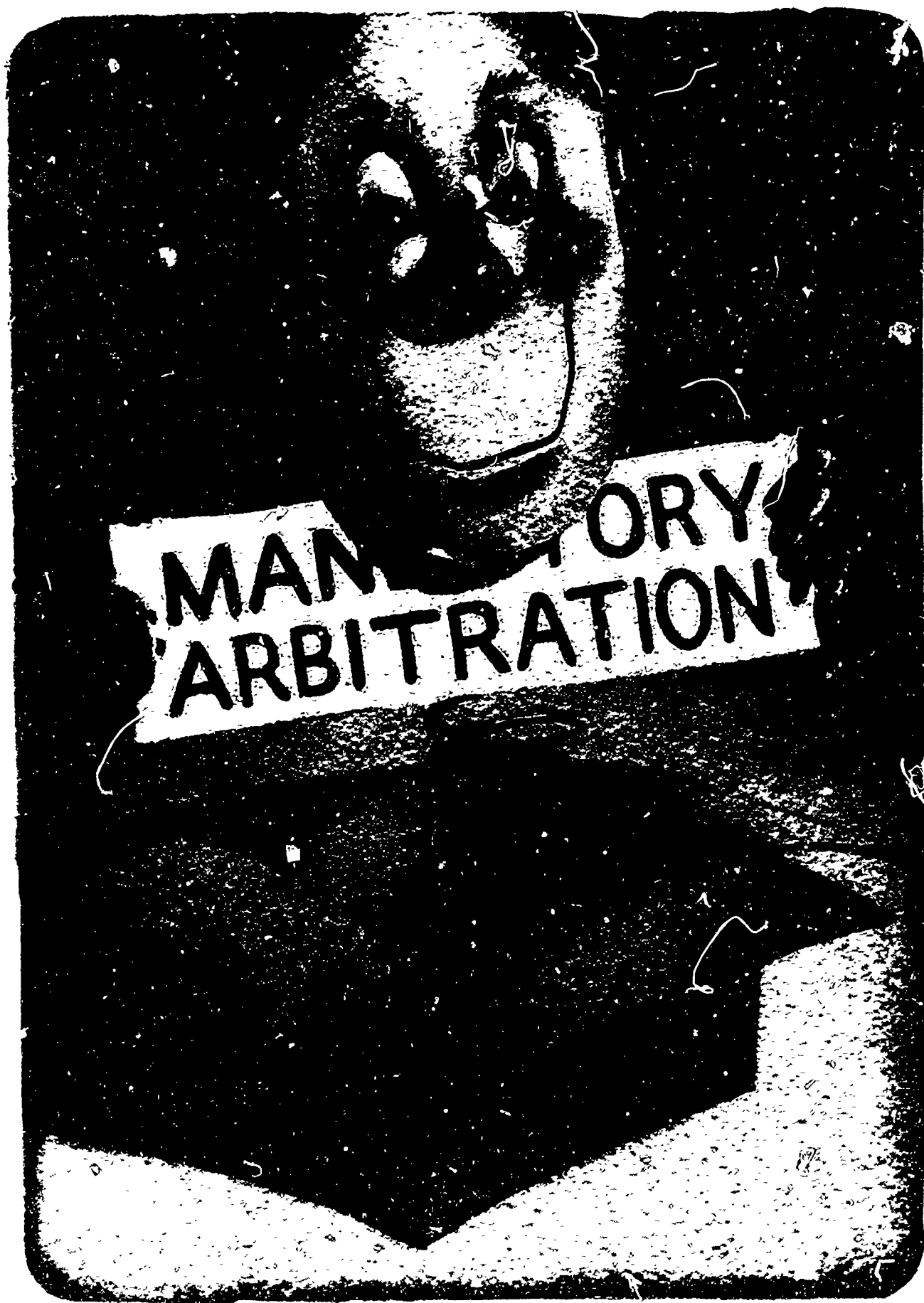
Hill v. Gateway,³ is but the most extreme example of a series of court decisions that allow large companies to impose potentially unfair binding arbitration agreements on unwitting consumers. When a California bank sent its customers an envelope stuffer announcing that all future claims against the bank must be arbitrated rather than litigated, thereby precluding such consumers from having their claims heard by a jury, a California state court upheld the clause.⁴ At least one Florida bank, First Union, has similarly sent their customers mailings announcing in small print that all future disputes with

the bank must be arbitrated rather than litigated.⁵ In a less extreme case, Florida's Fifth District Court of Appeal held that consumers who purchased pest extermination services were required to arbitrate not only contractual disputes but also personal injury claims that allegedly resulted from the extermination, where they signed an arbitration clause as part of the contract.⁶ In the health care context, the Utah Supreme Court, in *Sosa v. Paulos*,⁷ found that a doctor could require a patient to arbitrate any future medical malpractice complaint before a panel of specialists in the doctor's own field because the patient signed an arbitration clause among a number of other documents just a few minutes before she went into surgery.⁸

The *Gateway* decision is more striking than these and many other pro-arbitration cases because the Hills literally had no chance to escape the arbitration clause other than by making the heroic effort of returning their new computer. Realistically, they had no chance to even learn of the existence of the arbitration clause before the computer was ordered, paid for, and delivered. While the Seventh Circuit implied potential buyers might learn about Gateway's arbitration program through

advertisements, the Gateway web page, or conversations with Gateway personnel, these options are illusory. Neither the advertisements⁹ nor the web page made any mention of arbitration.¹⁰ Further, even had the Hills somehow had the prescience to ask a salesperson about arbitration,¹¹ it is not at all clear they could have obtained a copy of the clause.¹² Even once the computer was delivered it is by no means clear that a typical consumer would have noticed or understood the arbitration clause contained on page 3, paragraph 10 of the statement of terms document, which was packed together with the computer, monitor, keyboard, lots of software, and multiple sets of instructions.

States' statutory attempts to protect their consumers from unfair arbitration clauses have been largely unsuccessful because courts have found that state laws that single out arbitration contracts for more hostile treatment than other contracts are preempted by the Federal Arbitration Act,¹³ as long as the contract involves interstate commerce.¹⁴ For example, the Supreme Court held preempted a Montana statute requiring adequate notice of an arbitration provision contained in a contract,¹⁵ as well as an Alabama statute entirely prohibiting pre-dispute arbi-



Art by Joe McFadden

tration agreements.¹⁶ In *Securities Industry Ass'n v. Lewis*,¹⁷ the district court held preempted a Florida statute requiring that parties to securities arbitration agreements be provided the option of presenting their claims before a nonindustry arbitration panel.¹⁸

The outcome in *Gateway*, however, is questionable on federal statutory, common law, and constitutional grounds.¹⁹

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First, the Magnuson-Moss Act,²⁰ passed in 1974 "to improve the adequacy of information available to consumers, [and] prevent deception,"²¹ provides that consumers cannot, prior to their assertion of a claim, be deprived of their right to sue merchants in court. While the Act allows merchants to establish informal dispute settlement procedures,²² the Act and the accompanying regulations and legislative history imply that these procedures must be non-binding.²³ In comments issued together with the regulations the FTC explicitly rebutted claims of some industry representatives that warrantors ought, in advance of a dispute, be allowed to require consumers to resort to binding arbitration. It stated:

The Rule does not allow for this for two reasons. First, . . . Congressional intent was that Section 110 Mechanisms not be legally binding. Second, even if binding Mechanisms were contemplated by Section 110 of the Act, the Commission is not prepared, at this point in time, to develop guidelines for a system in which consumers would commit themselves, at the time of product purchase, to resolve any difficulties in a binding, but nonjudicial proceeding. The Commission is not now convinced that any guidelines which it set out could ensure sufficient protection for consumers against warrantors, even if the Congressional report had not made clear, as it did, that it wished for such mechanisms to not be binding.²⁴

While the agency commentary accompanying the Magnuson-Moss Warranty Act regulations observes that a warrantor may offer consumers the option of binding arbitration, once a dispute has arisen,²⁵ the regulations prohibit warrantors from mandating binding arbitration prior to the occurrence of the dispute.²⁶

Gateway is also questionable as a matter of contract law. While it is clear that buyers and seller entered a contract regarding purchase and sale of the computer, that contract did not necessarily include an arbitration provision. Judge Easterbrook, writing for the majority, essentially concluded that a contract for arbitration was formed because the buyers accepted delivery of the computer and then failed to return it within 30 days.²⁷ Yet, pursuant to the more traditional contract analysis offered by the buyers, the contract was formed when, by accepting payment, faxing a confirmation, and shipping the computer, *Gateway* accepted the purchase offer made by the Hills over the

phone. Buyers argue that because their offer did not contain an arbitration clause, the supplemental terms contained in the box were simply a proposal for additional or modifying terms which the buyers did not accept.²⁸ Uniform Commercial Code §2-207 governs such situations.²⁹ Where, as in *Gateway*, the contract was not between two merchants, §2-207 provides that if a party accepts a contract but also states different or additional terms than were offered, those terms are regarded as mere "proposals for addition" and not modifications to the contract.³⁰ Here, because the contract was entered between consumers and merchant prior to the shipment of the computer, it would seem that the Hills should not be bound by the proposal for an arbitration clause.³¹

Third, although courts have generally rejected attempts to challenge private arbitration agreements on constitutional grounds, finding a lack of state action and/or waiver of such claims,³² commentators are increasingly raising the possibility of such an argument.³³ The state often throws its weight behind private arbitration by interpreting asserted agreements broadly to favor arbitration over litigation.³⁴ Where courts rely on such a preference in their interpretation of an arbitration agreement the court arguably engages in state action that calls into play constitutional protections.³⁵ Given the existence of state action, enforcing an unfair mandatory binding arbitration agreement that was not knowingly and voluntarily accepted by the consumer³⁶ will often violate the Seventh Amendment right to a jury trial for claims brought at common law in federal court.³⁷ If the state participates in enforcing such a waiver, it also potentially acts unconstitutionally in violation of the Fourteenth Amendment's guarantee of due process³⁸ and Article III's guarantee of the right to present a claim to a federal court judge.³⁹

Finally, *Gateway* is unwise as a matter of policy. Judge Easterbrook bases his conclusion that "[p]ractical considerations support allowing vendors to enclose the full legal terms with their products," on a "straw man," asserting that requiring cashiers to read such terms over the phone would simply "anesthetize" or anger potential customers.⁴⁰ This analysis is flawed because it fails to consider alternative

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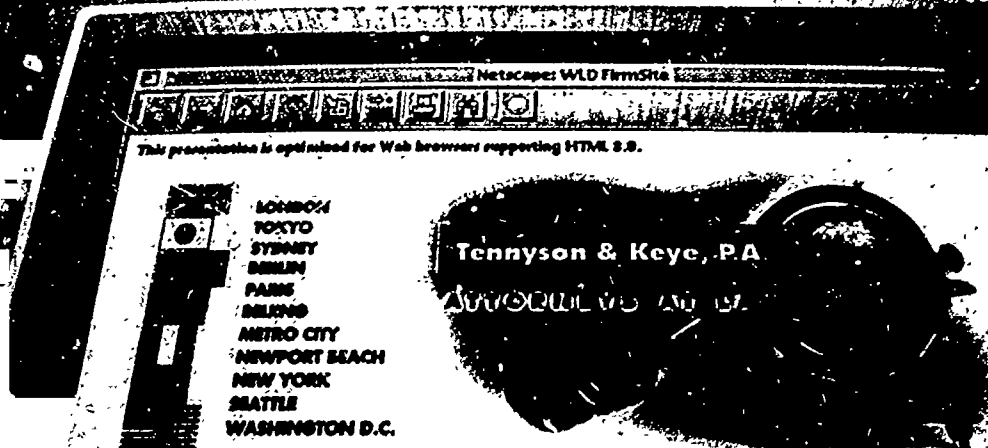
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ways to regulate dealer conduct and because it ignores the potential significance of allowing companies to require consumers to trade their litigation rights for arbitration. Companies can use such clauses not only to take away a consumer-friendly jury but also to force consumers to bring claims in a distant and thus expensive forum, to impose high extra arbitration costs, to deny consumers needed discovery, to deprive consumers of recovery for punitive damages, and to prevent consumers from using the economical class action procedures that would be available in court.⁴¹ The *Gateway* provision itself was unfair in some of these ways. It required that the dispute would be heard under International Chamber of Commerce rules which demand the filing party to pay at least \$2,000 for the services of the ICC and its arbitrator. What kind of sense would it make for a consumer with a dispute over a \$4,000 computer to pay half that amount in arbitration fees alone?⁴² The clause also required all claims to be brought in Chicago, which would certainly be quite expensive for those customers who, unlike the Hills, did not live in Chicago.⁴³ Finally, the ICC rules make no provision for discovery, which could well prove crucial to a consumer's claim of fraud or defect.

Assuming that the imposition of an arbitration clause may have a significant impact on consumers, *Gateway* unreasonably shifts to consumers both the search costs of ascertaining the existence of such a clause and the return cost of avoiding such a clause. While it might not make sense to require cashiers to read extensive terms to customers, surely it would not be unreasonable to require the company to alert customers to the existence of such an important clause. *Gateway* might easily have done so in any number of ways: by noting the existence of the arbitration clause in its advertisements where it already mentioned the limited warranty; by requiring its cashiers to mention the arbitration clause and then offering to read it or send it upon the customer's request; or by at least including mention of the clause on the written confirmation that the company sent to its customers prior to shipment of the computer.⁴⁴ While none of these methods would guarantee that customers were not unfairly and unwittingly deprived of their right to litigate dis-

putes in court, such methods would at least decrease the likelihood of such an outcome. It is simply wrong to rest waiver of a constitutional right on the assumption that a consumer would both read in detail all of the documents enclosed with a new computer and then take the dramatic and expensive step of returning the brand new computer to its shipper.⁴⁵ Moreover, given the realities of consumer behavior, it would be preferable to flatly prohibit merchants from requiring consumers to waive their litigation rights in favor of binding arbitration. At a minimum merchants should be barred from imposing arbitration clauses that are unfair.

The *Gateway* arbitration clause was not as bad for consumers as it might have been. At least the clause did not, as some clauses do, require disputes to be heard by biased decision makers⁴⁶ nor limit the consumers' rights to punitive damages.⁴⁷ However, *Gateway* gives companies virtually free rein to develop their own unfair clauses and impose them after the fact on unwitting consumers. Either courts or the Congress should take steps quickly to protect consumers from such practices. We should not allow foxes to design the chickens' coop. □

⁴¹ *Hill v. Gateway*, 105 F.3d 1147 (7th Cir. 1997) (rehearing denied). The arbitration clause was on page 3, paragraph 10 of the standard terms document, and the clause was not highlighted nor displayed in large print. (Clause on file with author).

⁴² The arbitration clause provided that arbitration would be governed by the International Chamber of Commerce Rules of Arbitration. These rules, normally applied to large transactions between companies located in different countries, require the party filing a dispute for up to \$50,000 to pay administrative expenses of \$2,000. The rules further provide that the arbitrator's fee in such cases shall be at least \$2,000 up to a maximum of 15 percent of the value of the claim. While these fees can apparently be split between the parties, they do not include additional costs a party must generally pay such as for an attorney or for travel.

⁴³ 105 F.3d 1147.

⁴⁴ *Badie v. Bank of America*, 1994 WL 660730 (Cal. App. Dep't Super. Ct. 1994).

⁴⁵ Barry Meier, *In Fine Print, Customers Lose Ability to Sue*, N.Y. Times, March 10, 1997, at 1.

⁴⁶ *Terminix International Co. v. Ponzio*, 693 So. 2d 104 (Fla. 5th D.C.A. 1997). Cf. *Terminix International Co. v. Michaels*, 688 So. 2d 1013 (Fla. 4th D.C.A. 1996) (customers who signed standard agreement calling for arbitration in connection with purchase

of pest extermination services were not required to arbitrate personal injury claims relating to pest extermination). The Florida Supreme Court has observed that "[u]nder Florida law . . . arbitration is a favored means of dispute resolution and courts indulge every reasonable presumption to uphold proceedings resulting in an award." *Roe v. Amica Mutual Insurance Co.*, 533 So. 2d 279 (Fla. 1988).

⁴⁷ 924 P.2d 357 (Utah 1996).

⁴⁸ *Id.* at 379. The Utah Supreme Court held that the clause would be enforceable only if the evidence supported the doctor's claim that the patient was given a copy of the agreement when she left the hospital. In so holding the court emphasized the fact that the patient had 14 days within which to revoke the clause had she decided she did not wish to be bound by its terms. Nonetheless, it is probably a very rare patient who, upon returning home from surgery, would read through all the papers she signed and take the step of revoking her agreement to arbitration. Other arguably unfair decisions include *Cohen v. Wedbush, Noble, Cooke, Inc.*, 841 F.2d 282 (9th Cir. 1988) (securities customers held bound by arbitration clause although plaintiffs claimed brokerage misled them by failing to inform them of the meaning and effect of the clause); *DeGaetano v. Smith Barney, Inc.*, 1996 WL 44226 (S.D.N.Y. 1996) (employee held bound by arbitration provision even though she signed only a general agreement setting out "principles of employment" and was not actually provided with a copy of the arbitration agreement); *McCarthy v. Providential Corp.*, 1994 U.S. Dist. LEXIS 10122 (N.D. Cal. 1994) (senior citizen homeowners held bound by arbitration clause contained within vast array of loan documents provided at closing).

⁴⁹ Although the advertisement did mention a limited warranty, the purchasers had no reason to believe that the warranty would be used to deprive them of rights rather than to provide them with protections should the product turn out to be defective.

⁵⁰ Of course, even if the web page had mentioned such a clause many computer customers might well not have a computer that would allow them to peruse the web page in the first place.

⁵¹ In all likelihood, few customers would have been focusing on the presence or absence of an arbitration clause. Rather, they would probably have been thinking about the \$4,000 they were spending on the computer system, about all of the pleasure and time savings they would get from their new computer, and perhaps about the potential difficulties they would face in setting up the new system.

⁵² This author's persistent attempts to procure a copy of the arbitration provision from *Gateway* sales and customer service representatives did not prove productive. *Gateway's* failure to provide this information promptly would seem to violate the Magnuson-Moss Warranty-Federal Trade Commission Improvement Act, 15 U.S.C. §2302; 16 C.F.R. §§701.3, 702.3, 703.2 (written warranty shall include information about any informal dispute resolution pro-

cedure and shall promptly be made available to any consumer upon request).

¹² 9 U.S.C. §51 *et seq.*

¹⁴ Although states' protective legislation would apply in the absence of interstate commerce, the Supreme Court has defined the term broadly to cover the full range of Congress' authority to regulate all "commerce in fact." *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995).

¹⁵ *Doctor's Associates v. Casarotto*, 116 S.Ct. 1652 (1996).

¹⁶ *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995).

¹⁷ 751 F. Supp. 205 (S.D. Fla. 1990).

¹⁸ The statute at issue was FLA. STAT. §517.122, which provides that where securities brokers require their customers to arbitrate claims they must provide the customers "the option of having arbitration before and pursuant to the rules of the American Arbitration Association or other independent non-industry arbitration forum as well as any industry forum."

¹⁹ Plaintiffs apparently did not present to the court the Magnuson-Moss or constitutional arguments discussed in this article, and also did not make all of the contract law arguments set out here.

²⁰ 15 U.S.C. §§2301 *et seq.*

²¹ 15 U.S.C. §2302(a).

²² 15 U.S.C. §2310(a)(3).

²³ The statute provides that the informal dispute resolution procedure must comply with regulations adopted by the Federal

Trade Commission, 15 U.S.C. §2310(a)(2), and that the consumer may pursue a legal remedy only after resorting to the appropriate internal procedure. 15 U.S.C. §2310(a). The FTC rules explicitly state that "decisions of the [informal dispute] mechanism shall not be legally binding on any person." 16 C.F.R. §703.5(j). See also 16 C.F.R. §703.5(g) (consumer who is dissatisfied with informal decision may pursue legal remedies). The legislative history of the statute is clear that the informal dispute procedures were envisioned as a prerequisite rather than a substitute for court remedies. Remarks of Congressman Moss, 119 Cong. Rec. 972 (Jan. 12, 1973); H.R. Rep. 93-1107, 93d Cong., 2d Sess. 41 reprinted in 1974 U.S.C.A.N. 7702, 7723. See generally *Wilson v. Waverlee Homes, Inc.*, 954 F. Supp. 1530 (M.D. Ala. 1997) (given restrictions of Magnuson-Moss, mobile home manufacturer may not compel consumer to arbitrate claims against manufacturer based on arbitration agreement between consumer and retailer).

²⁴ 40 Fed. Reg. 60168, 60210 (1975). See also *id.* at 60211 ("reference within the written warranty to any binding, non-judicial remedy is prohibited by the Rule and the Act").

²⁵ 40 Fed. Reg. 60168, 60211 (1975).

²⁶ 16 C.F.R. §703.5(j). Even assuming for the sake of argument the validity of a pre-dispute agreement to binding arbitration of a consumer claim, the FTC rules prohibit

companies from using ADR mechanisms that are unfair in certain ways. Companies cannot charge consumers any fee for use of the mechanism, 16 C.F.R. §703.3(a), nor have the disputes decided by persons who are employed by the company for any purpose other than to resolve disputes. 16 C.F.R. §703.4(a)(1). The company is also supposed to ensure that the decision maker is sufficiently "insulated" from the warrantor, for example in terms of personnel decisions, that the decision will not be biased. 16 C.F.R. §703.3(b). The clause at issue in *Gateway* is impermissible because the ICC rules require consumers to share the arbitration fees and costs.

²⁷ While the court is not explicit as to how the contract was formed, it implies that the vendor was the offeror and the buyer the offeree. 105 F.3d at 1148-49. The analysis drew from the Seventh Circuit's earlier decision in *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996), holding that a software purchaser was bound by a license agreement where the box mentioned that the software was governed by a license and where the license was provided in the manual and appeared on a user's screen every time the program was run. *Gateway* is a more extreme case than *ProCD* in at least two respects. First, the *Gateway* customers received no notification at all, prior to delivery, that they would be subject to an arbitration clause. Second, an arbitration clause is a waiver of constitutional rights, as opposed

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to a waiver of mere economic interests.

²⁸ *Hill v. Gateway 2000, Inc.*, No. 96-3294, Responsive Brief of Appellees at 13-14 (on file with author).

²⁹ The *Gateway* court observed that U.C.C. §2-207 is irrelevant where there is only one form, and not a "battle of the forms" between the two parties, 105 F.2d at 1150, but did not expressly state whether or how the provision applied to the computer sale. However, by its terms the section does seem to apply to this situation where the shipper accepted the buyer's offer and then submitted additional terms. Further, even if U.C.C. §2-207 is in fact irrelevant it would seem that the buyers never accepted the arbitration clause. It has long been established that mere silence is not sufficient to accept a contract. Restatement (Second) of Contracts §69 provides, in relevant part, that silence does not constitute acceptance except "[w]here the offeror has stated or given the offeree reason to understand that assent may be manifested by silence or inaction, and the offeree in remaining silent and inactive intends to accept the offer . . . [or] [w]here because of previous dealings or otherwise, it is reasonable that the offeree should notify the offeror if he does not intend to accept." Neither exception applies in this instance.

³⁰ Even where the contract is between merchants, terms that "materially alter" the original offer do not automatically become part of the contract. Arbitration clauses have been held to constitute material terms that may not be incorporated absent affirmative assent, even against merchants. *E.g., Diskin v. J.P. Stevens & Co.*, 836 F.2d 47, 50-51 (1st Cir. 1987). The new terms also do not modify a contract between merchants if the offer expressly limited acceptance to the terms of the offer or if notification of objection to the new terms was previously given or is given within a reasonable time after notice of them is received. U.C.C. §2-207.

³¹ The "Standard Terms and Conditions" agreement enclosed with the computer did include a statement that by keeping the computer the customers agreed to be bound by the terms. However, pursuant to the U.C.C. and standard contract law this preliminary statement itself should not have been binding on the Hills.

³² *E.g., Terminix International Co. v. Ponzio*, 693 So. 2d 104, 108 (Fla. 5th D.C.A. 1997) ("The short answer to these [constitutional] arguments is that the plaintiffs waived these rights by consenting to arbitrate disputes 'arising out of ... the agreement'"). See also *FDIC v. Air Florida*, 822 F.2d 833, 833 (9th Cir. 1986) (rejecting challenge to constitutionality of arbitration based on lack of state action).

³³ *E.g., Richard C. Reuben, Public Justice: Toward a State Action Theory of ADR*, 85 CAL. L. REV. 577 (1997) (arguing that role of state courts in compelling arbitration and confirming arbitral results is sufficient to give rise to state action); Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers and Due Process Concerns*, forthcoming 72

TULANE L. REV. (Nov. 1997) (arguing that reliance on state preference for arbitration over litigation gives rise to state action, and that unknowing waivers do not meet constitutional standards). Cf. *Shelley v. Kraemer*, 334 U.S. 1 (1948) (state court violated equal protection clause by granting injunctive relief to a litigant seeking to enforce a privately negotiated racially restrictive covenant).

³⁴ *E.g., Moses H. Cone Memorial Hospital v. Mercury Constr.*, 460 U.S. 1, 24-25 (1983) ("Questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. . . . The Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability").

³⁵ See generally Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court's Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers and Due Process Concerns*, forthcoming 72 TULANE L. REV. (Nov. 1997).

³⁶ While constitutional rights are subject to waiver, courts generally "indulge every reasonable presumption against waiver." *Aetna Ins. Co. v. Kennedy*, 301 U.S. 389, 393 (1937). *Fuentes v. Shevin*, 407 U.S. 67 (1972), held that a waiver of procedural due process rights must be clear, and further implied that even a clear waiver might be struck down on grounds of involuntariness. Applying these standards, the *Gateway* computer purchasers and most other consumers should not be found to have waived their constitutional rights to a jury trial, due process, and an Article III judge. See generally Sternlight, *Rethinking*, *supra* note 35, at 53-82.

³⁷ Many state constitutions provide similar rights for claims brought in state court. However, courts might find that the FAA preempts such state constitutional provisions.

³⁸ Sternlight, *Rethinking*, *supra* note 35, at 96-118. Although not all binding arbitration clauses would likely be found to violate due process, those that were unfair or biased would do so.

³⁹ *Id.* at 93-96. The Article III claim could be raised only by those litigants who would have had a right to sue in federal court.

⁴⁰ 105 F.3d at 1149.

⁴¹ See generally Jean R. Sternlight, *Panacea or Corporate Tool: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U.L.Q. 637, 674-697 (1996) (arguing that companies can use binding arbitration to secure strategic advantages over consumers, employees, and franchisees).

⁴² The arbitration fee is over and above any attorneys' fees and travel costs the customer must also pay. At least in litigation the judge is free.

⁴³ By contrast, had the consumers been able to bring a lawsuit they would have been permitted to bring it in any jurisdiction where they could secure personal jurisdiction over *Gateway*.

⁴⁴ *Hill v. Gateway 2000, Inc.*, No. 96-3294, Responsive Brief of Appellees at 7 (discussing *Gateway* shipping procedures) (on file with author).

⁴⁵ Because most consumers will believe it is statistically unlikely they would need to sue *Gateway*, they will tend to under-value the cost imposed by the arbitration clause and will not likely return the computer they have so eagerly awaited. Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 217 (1995). See also Sternlight, *Panacea*, *supra* note 41, at 688-693 (critiquing assumption of consumer rationality).

⁴⁶ In theory, both the FAA, 9 U.S.C. §10(a)(2) and the Magnuson-Moss Act regulations, 15 C.F.R. §§703.3 & 703.4, prohibit the use of biased arbitrators. However, in practice courts have often refused to credit consumers' claims of bias. *E.g., Sosa v. Paulos*, 924 P.2d 357 (Utah 1996) (refusing to strike arbitration clause on ground that alleged medical malpractice victim was required to present claim to doctors in defendant's specialty area).

⁴⁷ Courts have sometimes struck such clauses as in violation of an underlying federal statute. *E.g., Graham Oil Co. v. ARCO Prods. Co.*, 43 F.3d 1244 (9th Cir. 1994) (arbitration clause which, *inter alia*, precluded recovery of punitive damages held void under federal Petroleum Management Protection Act).

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