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Should an Arbitration Provision Trump the Class Action? No: Permitting Companies to Skirt Class Actions Through Mandatory Arbitration Would be Dangerous and Unwise

Jean R. Sternlight
University of Nevada, Las Vegas -- William S. Boyd School of Law

Should an Arbitration Provision Trump the Class Action?

Yes: Permitting courts to strike bar on class actions in otherwise clean clause would discourage use of arbitration

By Carroll E. Neesemann

At first glance it might appear that four recent cases in California federal and state courts evidence a trend toward increased power for consumers and employees to challenge pre-dispute arbitration agreements. But not so fast. The state of the law elsewhere seems quite different. Presumably, even in California, the last word has not been written on the issue. In any case, steps can be taken to improve the likelihood of enforcement of arbitration agreements. And there are road maps to guide companies in writing arbitration agreements that are fair and more likely to stand up, even when they preclude class actions.

Grounds for invalidity

Arbitration agreements with consumers and employees have long been upheld, despite being contained in contracts of adhesion. Under the Federal Arbitration Act (FAA), a pre-dispute agreement to arbitrate is to be enforced like any other contract and not burdened with special limitations.[1] Generally, contracts of adhesion between parties of unequal bargaining power are enforceable unless they exhibit some additional infirmity. The U.S. Supreme Court has approved numerous arbitration agreements that apparently had been imposed on plaintiffs who had little or no bargaining power. Six involved claims of customers or employees in the securities industry.[2] Two were franchise cases.[3] One involved an auto distributorship against a manufacturer.[4] Another concerned a homeowner.[5] Two recent cases addressed the claims of a borrower[6] and an employee,[7] respectively.

Unconscionability

One ground that *can* invalidate an arbitration agreement is unconscionability. In the words of the Supreme Court, "[G]enerally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate

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No: Permitting companies to skirt class actions through mandatory arbitration would be dangerous and unwise

By Jean R. Sternlight

Companies are deliberately using mandatory arbitration to prevent consumers and employees from joining together in class actions. As Carroll Neesemann has explained, eliminating the class action is a "strong incentive" of those companies that impose the requirement of arbitration on consumers and employees.[1] Mr. Neesemann defends this phenomenon, and his article offers companies and their attorneys some tips on how to effectively use arbitration to insulate themselves from the threat of class actions. By contrast, this essay argues that it is dangerous and unwise to permit companies to use mandatory arbitration to exempt themselves from class action suits.

The phenomenon of eliminating class actions

Companies have recently begun to use arbitration clauses explicitly to proscribe consumers or employees from joining together in class actions. A clause imposed by credit card provider MBNA states in relevant part, "[N]o claim may be brought as a class action or as a private attorney general. You will not have the right to act as a class representative or participate as a member of a class of claimants with respect to any claim." Numerous other companies have adopted similar language, which is geared to prevent customers or employees from joining together in class actions either in arbitration or in litigation. Drafters of these clauses know that if they can eliminate class actions, they can often eliminate claims exposure altogether because individual claims will not be brought.[2]

The limitation on class actions within arbitration as well as litigation is significant. Although many have assumed that a class action arbitration is a sort of procedural oxymoron, arbitral class actions are well established in California[3] and have been brought in several other jurisdictions as well.[4] California attorneys who have participated in arbitral class actions describe the process as quite similar to the litigated class action. These attorneys explain that the court decides "class" issues such as the definition of the class and the terms of the class notice, and that the fact finding is then turned over to the arbitrators.[5]

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Jean Sternlight is John D. Lawson Professor of Law at the University of Missouri-Columbia School of Law. She can be reached at sternlightj@missouri.edu.

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Is the class action a good thing?

Although Carroll Neesemann and potential defendants may not like class actions,[6] the U.S. Congress and Supreme Court have clearly endorsed the procedural device. Tracing its roots to the Middle Ages, the modern class action was made part of the Federal Rules of Civil Procedure in 1966. In 1980, the Supreme Court set out some of the many advantages of the class action procedure:

> I[t] may motivate [plaintiffs] to bring cases that for economic reasons might not be brought otherwise, [thereby] vindicating the rights of individuals who otherwise might not consider it worth the candle to embark on litigation in which the optimum result might be more than consumed by the cost . . . . [T]he financial incentive that class actions offer . . . is a natural outgrowth of the increasing reliance on the 'private attorney general' for the vindication of legal rights . . . . Where it is not economically feasible to obtain relief within the traditional framework of a multiplicity of small individual suits for damages, aggrieved persons may be without any effective redress unless they may employ the class-action device.[7]

More recently, in *Ortiz v. Fibreboard Corporation*, the Supreme Court again explained that the class action is highly advantageous because of the "opportunity to save the enormous transaction costs of piecemeal litigation. . . ."[8]

Because the class action allows claims to be brought that could not otherwise be filed, it is reviled by potential defendants and beloved by potential plaintiffs and those who seek to ensure that our laws are properly enforced. Whether compared to individual litigation or to individual arbitration, class actions help deal with problems of lack of information and lack of financing for small claims.

Specifically, consumers often lack the knowledge that their contract may be illegal, and employees may well not realize that they are being discriminated against or otherwise treated illegally. But when such potential claimants are included in a class, they are afforded notice of the claim and typically given an opportunity to choose whether to participate in the class action.

The resolution of individual claims through arbitration is no adequate substitute for the resolution of group claims in a class action.

Further, even when consumers or employees begin to suspect that they are being treated illegally, it often makes no sense for them to bring claims individually. Only an irrational and/or independently wealthy consumer would take the time and spend the money to fight claims regarding issues such as excessive check bouncing charges or improper phone billing policies. Many employees are in a similar position when they don't earn a great deal of money to start with, can't prove large dollar losses, and don't want to run the risk of being fired. When claims are small, the individual plaintiffs will not be able to afford to hire attorneys, nor will rational attorneys take such claims on a contingent fee basis. Thus, as a California appellate court explained, the class action prohibition is used to obtain "virtual immunity" for the company from small claims.[9]

Arbitration itself offers no adequate solution to these problems. Arbitration is not always quicker and cheaper than litigation. In the employment context, many plaintiffs in arbitration have found that they must pay thousands and thousands of dollars in filing fees and arbitrator hourly fees simply to get the services of a neutral that they could procure in court for a mere filing fee.[10] Further, even if arbitration were shown to be quicker and cheaper, it has never been demonstrated that consumers or employees who pursue individual claims in arbitration, without the assistance of an attorney, have a decent likelihood of prevailing on their claims.[11]

Moreover, the district court in *Ting v. AT&T*[12] points to an even more fundamental problem: many of the group claims that are typically brought in class actions are not even subject to resolution on an individual basis. After having examined the types of claims that had actually been brought against AT&T in the previous year, the district court reached the following conclusion:

> It appears that the principal types of claims which members of the class can expect to litigate outside small claims court are not individual billing disputes or disputes about poor service, but claims of intentional misconduct, such as discrimination or harassment in the course of providing service, credit reporting problems and problems relating to identity theft and claims that involve practices or problems that pertain to all or a group of consumers. Examples of group claims include complaints about the way AT&T is measuring the length of a call or complaints that AT&T has misrepresented the terms of a calling plan in its advertising. If a consumer complains about such a practice, AT&T can try to satisfy the consumer by making a billing adjustment, but it cannot change its practice as to only that consumer without being considered discriminatory under the FCC's standards.[13]

In other words, the resolution of individual claims through arbitration is no adequate substitute for the resolution of group claims in a class action. As the *Ting* court concluded, "It would not have been economically feasible to pursue the claims in these cases on an individual basis, whether the case was

brought in court or in arbitration."[14] While Mr. Neesemann contends that such claims "appear to be . . . within the jurisdiction of regulatory entities set up to police such practices,"[15] his position fails to recognize that our legal system is dependent on suits brought by individual victims and not merely by poorly funded regulatory agencies. As the *Ting* court explained, "[T]he FCC does not appear to have concerned itself with obtaining individual relief for the complainants, even in situations where the FCC has concluded the carrier committed an 'egregious' practice."[16]

Some might suggest that if an individual consumer or employee lacks the knowledge or financial wherewithal to bring a claim individually, then the claim must not be worth bringing. However, in approving the use of class actions both Congress and the Supreme Court have recognized that a group claim may be important to support enforcement of the law, even where an individual claim might not be viable. It is unjust for a company to illegally take small amounts of money from millions of consumers or employees simply because no individual consumer or employee can bring a legal challenge to that action.[17]

Some might also suggest that because class actions are sometimes abused by plaintiffs or their attorneys, companies are justified in using arbitration clauses to protect themselves. However, while there is no doubt that some class action settlements have brought more benefit to the plaintiffs' attorneys than to the class members, these problems cry out for legislative reform rather than companies' self-help. Proposed reforms to the class action are currently under review at various levels including Congress. Revisions to the class action process should be implemented by legislative bodies and rules drafters, after having considered all sides' perspectives, rather than by companies seeking to maximize their own self interest. If we have learned nothing else from the Enron debacle, at least it has illustrated that leaving companies to regulate themselves does not always serve the public interest.

Challenges under existing law

Under existing law at least two types of legal challenges can be brought to prevent companies from using arbitration clauses to insulate themselves from class actions.[18] Sometimes eliminating the opportunity to proceed by class action can be attacked as unconscionable, and sometimes eliminating the opportunity to proceed by class action can be shown to violate the terms of a particular federal statute. Both challenges require that plaintiffs make a strong factual showing.

The unconscionability argument

To establish that an arbitration clause is unconscionable, plaintiffs must usually attack it on both procedural and substantive grounds. Courts will not void clauses based on generalized attacks,[19] so plaintiffs must be sure to build strong factual records using documents, affidavits and depositions.[20] The procedural element is usually fairly easy to establish where the arbitration clause has been imposed on a mandatory basis. Substantively, while the precise wording varies from jurisdiction to jurisdiction, a contract is usually deemed to be unconscionable when it is substantially one-sided or unreasonable.

When a class action prohibition operates entirely to deprive plaintiffs of a viable forum for their claim, either in arbitration or in litigation, plaintiffs should be able to show that the prohibition is substantively unconscionable. The federal court in *Ting* made just such a finding:

> [T]he prohibition on class actions will prevent class members from effectively vindicating their rights in certain categories of claims, especially those involving practices applicable to all members of the class but as to which any consumer has so little at stake that she cannot be expected to pursue her claim. . . . The ban is effectively one-sided since it is hard to conceive of a class action suit that AT&T would file against its customers. And the only justification advanced for it, that it will limit AT&T's costs of litigation, is insufficient to overcome numerous determinations by legislators and courts, . . . that class action treatment offers the public a vehicle for vindicating legal rights when individual claims are not economically feasible. For all these reasons, the ban on class actions is substantively unconscionable.[21]

At least four other courts have similarly concluded that a prohibition on class actions helped to render a mandatory arbitration provision, or the class action prohibition itself, substantively unconscionable.[22] While Mr. Neesemann is correct that in some cases other factors also contributed to these courts' findings of unconscionability, the courts' decisions provide no support for the position that a "mere" class action prohibition should be permissible so long as the arbitration clause does not contain other unfair features. Rather, when the class action prohibition operates entirely to deprive claimants of a viable forum in either litigation or arbitration for their claims, that prohibition alone ought to be sufficient to render the clause unconscionable.[23]

When a clause prohibiting class action operates to entirely deprive claimants of a viable forum in either litigation or arbitration for their claims, that prohibition alone ought to be sufficient to render the clause unconscionable.

Admittedly, the unconscionability argument cannot and should not be used to void all class action prohibitions. By its nature, the argument is fact-dependent. Thus, in those cases where plaintiffs'

individual claims are such that individualized arbitration is an adequate forum, the class action prohibition may not be unconscionable. But where, as the court found in *Ting*, the company is using the class action prohibition contained in the arbitration clause "to shield itself from liability"[24] by making it "very difficult for anyone to vindicate her rights"[25] in any forum, then courts should find such prohibitions unconscionable.

The statutory argument

It is now well established that mandatory arbitration clauses must fall when they are found to prevent plaintiffs from vindicating federal statutory rights. Thus, the Supreme Court and numerous federal circuits have explained that arbitration clauses are invalid when they impose excessive costs or deny plaintiffs remedies to which they are entitled under federal law.[26]

A need for legislative action?

It is clear that companies are already heeding the advice of Carroll Neesemann and others by attempting to use arbitration clauses as a shield to protect themselves from both arbitral and litigated class actions. What is not yet clear is whether courts will put their imprimatur on companies' efforts to eliminate class actions. If courts follow *Ting* and prove willing to use unconscionability and statutory doctrines to limit companies' efforts at self-protection, then no legislation may be needed. But, if most courts fail to follow this lead and instead allow companies to use arbitration clauses to insulate themselves from liability, then legislative action will be required.

The "due process" protections urged by Mr. Neesemann are meaningless in situations in which companies are using class action prohibitions to prohibit consumers or employees from pursuing claims in any forum. What is the value of a "fair" process or an impartial arbitrator when the reality is that the class action prohibition will eliminate all claims?

Arbitration clauses are inherently unfair when they contain class action prohibitions that eliminate plaintiffs' opportunity to vindicate their rights in any forum.

Depending upon the language and legislative history of the particular federal statute under which they are suing, plaintiffs may similarly be able to argue that the arbitration clause is invalid because it prevents them from proceeding in a class action, as provided for by statute. In the consumer context, plaintiffs have attempted to make this argument under the Truth in Lending Act, but the claim has failed more often than it has succeeded.[27] With respect to employment claims, courts are mixed as to whether the Fair Labor Standards Act's Section 216(b) guarantees plaintiffs a right to proceed collectively.[28] Whether or not courts ultimately accept plaintiffs' arguments that either or both of those statutes preserve plaintiffs' right to proceed collectively, plaintiffs may convince courts that other statutes provide that right, or Congress may be convinced to pass legislation that protects that right in new or existing statutes.

Arbitration clauses are inherently unfair when they contain class action prohibitions that eliminate plaintiffs' opportunity to vindicate their rights in any forum. If the courts prove unable to resist companies' efforts to eliminate class actions, Congress will have to step in to restore this important procedural device and the role it has played in assuring justice in the United States.

Endnotes

[1] Carroll E. Neesemann, "Trumping the Class Action with Arbitration," 8 Disp. Resol. Mag. Spring 2002.

[2] *See* Edward Wood Dunham, "The Arbitration Clause as Class Action Shield," 16 FRANCHISE L.J. 141, 141 (1997) ("Absent unusual circumstances . . . the franchisor with an arbitration clause [prohibiting class actions] should be able to require each franchisee in the potential class to pursue individual claims in a separate arbitration. Since many (and perhaps most) of the putative class members may never do that . . . strict enforcement of an arbitration clause should enable the franchisor to dramatically reduce its aggregate exposure.").

[3] *See, e.g.*, Keating v. Superior Court, 31 Cal. 3d 584 (Cal. 1982), *rev'd on other grounds*, Southland Corp. v. Keating, 465 U.S. 1 (1984); Blue Cross of California v. Superior Court, 78 Cal. Rptr. 2d 779 (Cal. App. 1998), *cert. denied*, 527 U.S. 1003 (1999); Izzi v. Mesquite Country Club, 231 Cal. Rptr. 315 (Cal. Ct. App. 1986).

[4] One Pennsylvania appellate court stated that arbitral class actions are possible. Dickler v. Shearson Lehman Hutton, Inc., 596 A.2d 860, 867 (Pa. Super. 1991). One arbitrator in South Carolina certified a class and awarded more than $20 million to plaintiffs in a consumer class action. *See* Douglas J. Fisher, *Conseco Finance to Pay $20M in S.C.*, APOnline, July 26, 2000, *available at* 2000 WL 24550570. This case, *Lackey v. Green Tree Financial Corp.*, is currently on appeal to the South Carolina Supreme Court.

[5] *See* Jean R. Sternlight, *As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?*, 42 WM. & MARY L. REV. 1, 40-42, 44-45 (2000).

[6] In another article similar to Mr. Neesemann's, two attorneys who represent banks and financial institutions argue that those entities are being preyed upon by consumers and their attorneys, and thus must use arbitration clauses to defend themselves. Alan S. Kaplinsky & Mark J. Levin, *Excuse Me, But Who's The Predator? Banks Can Use Arbitration Clauses as a Defense*, BUS. L. TODAY, May-June 1998.

[7] Deposit Guarantee National Bank v. Roper, 445 U.S. 326, 338-39 (1980).

[8] 527 U.S. 815, 860 (1999).

[9] Szetela v. Discover Bank, No. G029323, 2002 WL 652397, *4 (Cal. App. April 22, 2002) ("Fully aware that few customers will go to the time and trouble of suing in small claims court, Discover has instead sought to create for itself virtual immunity from class or representative actions, despite their potential merit . . . .").

[10] Nor is arbitration necessarily quicker, as hearings may sometimes extend over weeks, months or years in order to accommodate the schedules of arbitrators, counsel and parties.

[11] Although Mr. Neesemann asserts that it

may be easier to find contingent fee representation for arbitrated than litigated matters, and that plaintiffs do better in arbitration than in litigation, Neesemann article at n. 39, he cites no evidence to support these propositions. In *Ting*, the district court noted that AT&T failed to produce any evidence that any of the cases plaintiffs sought to bring would be economically feasible to pursue under the arbitration provision. 182 F. Supp. 2d at 919. Moreover, if it were really true that plaintiffs are better off in arbitration than litigation, why would companies need to mandate arbitration rather than make it available to interested plaintiffs on a post-dispute basis?

[12] 182 F. Supp. 2d 902 (N.D. Cal. 2002).

[13] *Id.* at 915.

[14] *Id.* at 918.

[15] Neesemann at n. 39.

[16] 182 F. Supp. 2d at 919.

[17] *See* Szetela v. Discover Bank, No. G029323, 2002 WL 652397, at *4-5 (Cal. App. April 22, 2002) (observing that it is both unconscionable and violative of public policy to permit a company to overcharge millions of customers by small amounts of money without affording them an effective means of redress, and that this practice grants the company "a 'get out of jail free' card while compromising important consumer rights").

[18] Plaintiffs can attack the arbitration clause on an expedited basis by seeking an injunction voiding the clause. This approach will often be preferable to raising the arguments defensively, in response to a motion to compel arbitration.

[19] The Supreme Court's recent decision in *Green Tree Financial Corp. v. Randolph*, 531 U.S. 79 (2000), makes this point once again, holding that while arbitration clauses can be voided on the ground that the fees are excessive, it is plaintiff's responsibility to present facts establishing that the mandated fees render the arbitral forum inadequate. The *Ting* court's extensive discussion of the factual record presented by the plaintiffs illustrates the importance of a strong showing on the facts. *See* Ting v. AT&T, 182 F. Supp. 2d 902 (N.D. Cal. 2002).

[20] Plaintiffs may well need to insist on their right to conduct discovery in order to make this factual showing.

[21] Ting v. AT&T, 182 F. Supp. 2d 902 (N.D. Cal. 2002).

[22] For cases relying in part on a class action prohibition to hold the entire arbitration clause unconscionable, *see* Ramirez v. Circuit City Stores, 76 Cal. App. 4th 1229, 1235-37 (1999); Powertel v. Bexley, 743 So. 2d 570, 576 (Fla. App. 1999); Lozada v. Dale Baker Oldsmobile, 91 F. Supp. 2d 1087, 1104-05 (W.D. Mich. 2000). In *Szetela v. Discover Bank*, No. G029323, 2002 WL 652397 (Cal. App. April 22, 2002), the court held unconscionable the portion of the arbitration clause prohibiting class actions and ordered that portion of the clause severed. *See also* In re Knepp, 229 B.R. 821, 929 (1999) (refusing to enforce arbitration clause imposed on debtor in part because it would prejudice prosecution of plaintiff's claim as a class action).

[23] Alternatively, in some circumstances it may be appropriate for the court to strike the class prohibition and permit the suit to proceed as an arbitral class action. *See* Szetela v. Discover Bank, No. G029323, 2002 WL 652397 (Cal. App. April 22, 2002).

[24] 182 F. Supp. 2d at 939.

[25] *Id.*

[26] *See, e.g.*, Green Tree Financial Corp. v. Randolph, 531 U.S. 79, 90-91 (2000) (recognizing that mandatory arbitration clause would be invalid if high costs of arbitration precluded consumer from presenting her claim, but holding consumer had failed to make that factual showing); McCaskill v. SCI Mgmt. Corp., No. 00-2839, 2002 WL 507500 (7th Cir. April 4, 2002) (invalidating arbitration clause imposed on Title VII claimant on the ground that the clause would have required claimant to pay her own attorney fees, even if she prevailed); Perez v. Globe Airport Sec. Serv., Inc., 253 F.3d 1280, 1287 (11th Cir. 2001) (holding unenforceable mandatory arbitration provision that required equal sharing of costs).

[27] The claim succeeded in *Lozada v. Dale Baker Oldsmobile Inc.*, 91 F. Supp. 2d 1087 (W.D. Mich. 2000). But, the contrary decision in Johnson *v. West Suburban Bank*, 225 F.3d 366 (3d Cir. 2000) is more typical.

[28] *Compare* Bailey v. Ameriquest Mortgage Co., No. Civ. 01-545 (JRTFLN), 2002 WL 100391 (D. Minn. Jan. 23, 2002) (holding, in FLSA case brought by a group of account executives, that "the inability to proceed collectively, particularly when considered in connection with [other unfair provisions] has the effect of rendering plaintiff's individual claims impractical to pursue," and stating "[t]he right to proceed collectively is particularly critical to these plaintiffs, who . . . have relatively small individual claims.") *with* Adkins v. Labor Ready, Inc., 185 F. Supp. 2d 628 (S.D. W. Va. 2001) (finding elimination of class action does not violate FLSA, and explaining that given the type of relief available under FLSA, including attorney fees and liquidated damages, an attorney should not be dissuaded from bringing a small dollar claim in an arbitral forum) *and* Marzek v. Mori Milk & Ice Cream Co., No. 01-C6561, 2002 WL 226761 (N.D. Ill. Feb. 13, 2002) (stating that arbitration clause does not necessarily preclude use of class action in FLSA claim but that, even if it did, such prohibition would not necessarily be barred).