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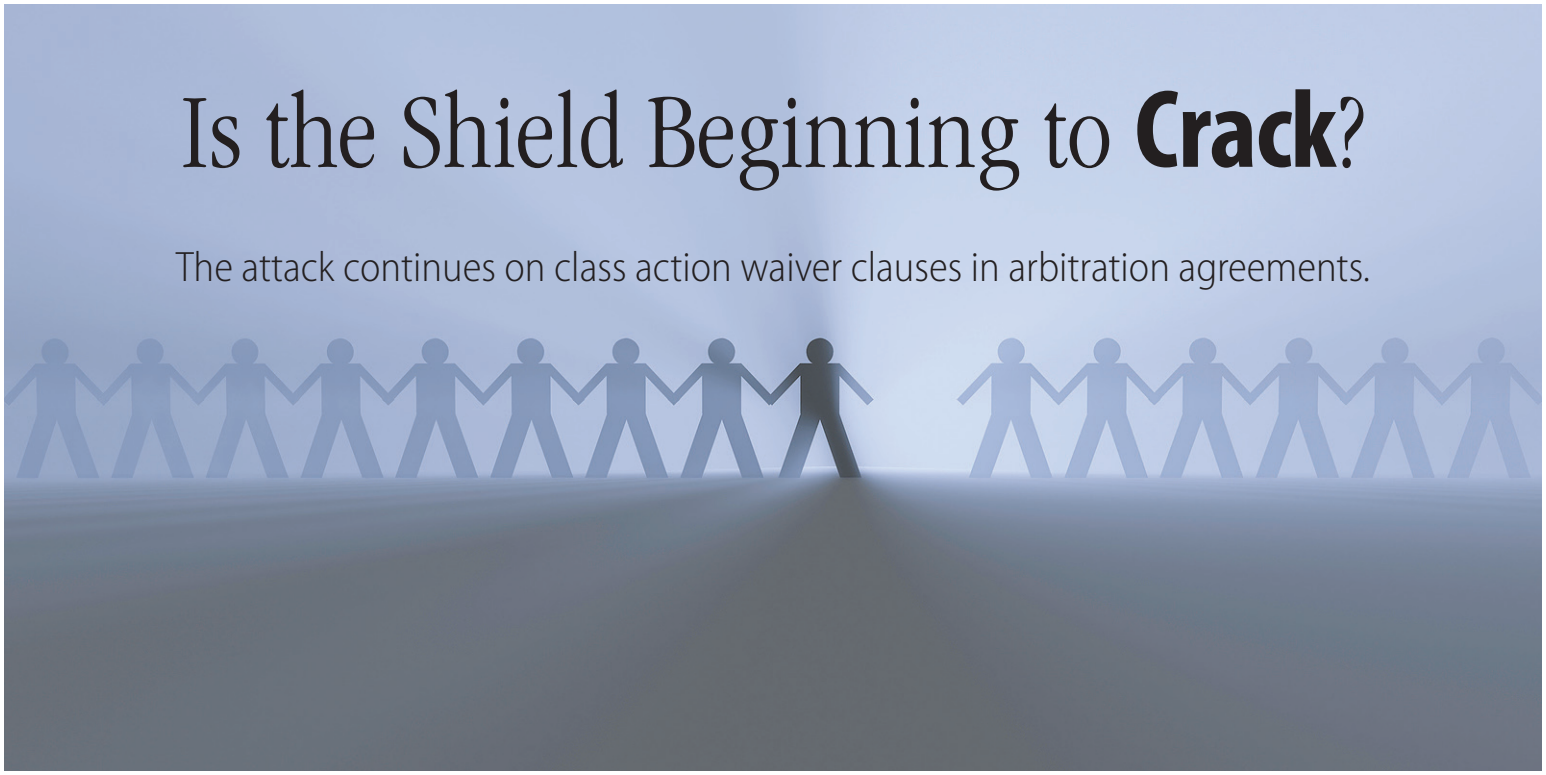
Is the Shield Beginning to **Crack**?

The attack continues on class action waiver clauses in arbitration agreements.



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BY CHRISTOPHER J. KELLER AND MICHAEL W. STOCKER

IN RECENT YEARS, many U.S. businesses have come to see class action waiver clauses in arbitration agreements as the silver bullet that will put the threat of class action liability to rest. These hopes are not unfounded, as such clauses, when upheld, can all but eliminate the potential for corporate liability in a broad cross-section of cases, from consumer services to employment.

However, predictions of the demise of the class action may be premature: 2010 has seen a series of decisions in multiple circuits suggesting that this shield against litigation may be beginning to crack, and the recent passage of the Dodd-Frank Financial Reform Act will likely accelerate these changes.

The principle underlying class action lawsuits is simple: that multiple individual claims against a common defendant can be aggregated into a single suit brought by a representative plaintiff, so long as the representative has the same interests in the litigation as the rest of the plaintiff class. The prerequisites for class litigation in federal court are set out in Rule 23 of the Federal Rules of Civil Procedure, and similar provisions exist in state law throughout the United States.

There are several benefits to the class action device. First, it helps ensure that monetary recoveries are distributed to the entire class equally, rather than to the first plaintiffs who happen to file a case. Second, plaintiffs' class litigation also helps ensure that courts do not impose incompatible standards of conduct for losing defendants to follow.

Third, aggregation of similar claims conserves the resources of the courts and the parties, reducing duplicative efforts. Last, by aggregating claims too small to justify individual lawsuits, class actions help deter conduct that causes widespread harm but would otherwise be inefficient to pursue on an individual basis. As the Seventh Circuit puts it, "[t]he realistic alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30." *Carnegie v. Household Int'l Inc.*, 376 F.3d 656, 661 (7th Cir. 2004).

The current debate over class action waiver clauses in the United States is animated principally by this last consideration. Unlike the E.U., where strong and well-funded governmental entities are charged with the protection of consumers and shareholders, the United States

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has long relied on private class actions as a deterrent to misconduct, especially in the areas of employment and consumer protection. The First Circuit has pointed out that class actions effectively "permit citizens to function as private attorneys general." *Skirchak v. Dynamics Research Corp.*, 508 F.3d 49, 58 (1st Cir. 2007).

Massive class actions recently certified by American courts illustrate the quasi-regulatory role of the class mechanism in this country. In *Dukes v. Wal-Mart Stores Inc.*, 603 F.3d. 571 (9th Cir. 2010), the court of appeals upheld the certification of a class that could consist of as many as 1.5 million women who are current or former Wal-Mart employees who allegedly suffered sexual discrimination in pay and promotion.

U.S. businesses seeking to avoid defending class action litigation are not without recourse, however. For decades, companies have employed arbitration agreements to ensure that conflicts be resolved without resort to the courts.

Agreements to Arbitrate

Agreements to arbitrate are valid and enforceable under the Federal Arbitration Act (FAA), 9 U.S.C. §2, a statute intended to ensure the enforcement of the terms of private agreements to arbitrate. See, e.g., *Volt Info. Sciences Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989). Indeed, the U.S. Supreme Court has held that under the FAA, general contract defenses are the only limits on the scope of agreements to arbitrate. *Perry v. Thomas*, 482 U.S. 483, 489-90 (1987).

Arbitration agreements alone, however, are no bar to use of the class mechanism, as the FAA does not prohibit class arbitration. See *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444, 451 (2003) (establishing standard to be applied by a decision maker in determining whether contract may permissibly be interpreted to permit class-wide arbitration).

As a result, arbitration agreements in recent years have come to include class action waiver provisions in an effort to ensure that arbitration proceeds on a bilateral, rather than a class, basis. This addition has permitted companies in some jurisdictions to virtually eliminate their exposure to class actions. As one commentator explains, "[n]ow 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." Roddy, John J., "Emerging Perspectives on the Fundamental Fairness of Mandatory Arbitration Coupled With Class Action Bans," Practicing Law Institute, Corporate Law and Practice Course Handbook Series (2010).

Partly because these clauses are so effective at stifling class actions, they have faced frequent challenge from plaintiffs who assert that such agreements are unenforceable under state laws forbidding the enforcement of unconscionable contracts.

The 'Unconscionable' Attack

In contract law, unconscionability analysis takes into account both procedural and substantive factors.

The key consideration in determinations of procedural unconscionability is whether the parties to a contract have equal bargaining power. Courts are more likely to find procedural unconscionability in contracts that are essentially adhesive: agreements in which one party had little ability to negotiate its terms.

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In analyzing substantive unconscionability, courts look for contract terms that are unusually one-sided, especially agreements that are effectively exculpatory for one party. See, e.g., *Discover Bank v. Superior Court of Los Angeles*, 36 Cal. 4th 148, 160 (2005)(observing that exculpatory contract clauses are substantively unconscionable).

The question of whether class action waiver clauses may be found unenforceable under state law has been the subject of protracted and heated debate. Courts approaching the issue are confronted with two distinct but overlapping issues: first, whether the enforceability of these clauses is something that should be determined by the court or by arbitrators. The second and more vexed question is whether the FAA permits courts to refuse to order enforcement of class action waiver clauses under state law unconscionability rules.

A consensus among the circuits now exists that courts, not arbitrators, are to make the first determination. The most recent court to weigh in on the issue is the Third Circuit, which issued an en banc decision in July concluding that unconscionability challenges to class action agreements present a threshold question of arbitrability that must be reserved for the courts. *Puleo v. Chase Bank USA, N.A.*, 605 F.3d 172, 194 (3d Cir. 2010).

In *Puleo*, plaintiffs brought a putative class action in Pennsylvania state court against Chase Bank, challenging a retroactive credit card rate increase. Under the cardholders' agreement with Chase, disputes over rate increases were subject to an agreement to arbitrate that included a provision forbidding class actions.

After the case was removed to federal court, the district court dismissed the class claim and compelled arbitration on an individual basis only. The plaintiffs then argued to the Third Circuit that, while they agreed that their claims should be subject to arbitration, their unconscionability challenge should have been decided by an arbitrator rather than the district court.

A divided en banc panel concluded that the unconsionability challenge presented a question of arbitrability that must be decided by the court, because it called the "valid[ity] of the arbitration agreement itself into question." Id. at 180. In so ruling, the Third Circuit joined the First, Second, Fifth, Sixth, Seventh, Eighth, Ninth, Tenth and Eleventh circuits, which had previously come to similar conclusions.

If for the Courts, Can They Say No?

The question of whether courts can decline to enforce class action waivers as unconscionable has proved to be far more controversial. For some years, it appeared that foes of the class action mechanism had the upper hand, as many courts rejected unconscionability challenges to waiver provisions.

For example, in *Gay v. CreditInform*, 511 F.3d 369 (3d Cir. 2007), the Third Circuit enforced a class action waiver provision in an arbitration agreement. In *Gay*, the court rejected the plaintiff's argument that an agreement covering credit monitoring services was unconscionable because of a class waiver clause. The court reasoned, inter alia, that because the plaintiff could obtain a full range of recourse in individual arbitration proceedings, denial of class action would not impede access to justice. The court also pointed out that because state and federal regulators have the ability to regulate the defendant's practices, the class action device was not the only means to police the defendant company's behavior.

More recently, many courts have expressed concern that class action waiver clauses represent too sharp a restriction on access to justice. In *Shroyer v. New Cingular Wireless Services Inc.*, 498 F.3d 976 (9th Cir. 2007), the Ninth Circuit held that the FAA does not preempt unconscionability challenges under state law, and found a class action waiver provision to be unconscionable under California law. The court determined that the consumer contract was one of adhesion, and that the waiver provision was intended to permit the company to carry out a scheme to deliberately cheat large numbers of individual consumers out of small amounts of money, sums too small to litigate on an individual basis.

Accordingly, the court ruled that the class action arbitration provision in the plaintiff's service contract was "both procedurally and substantively unconscionable and, therefore, unenforceable." Id. at 981. The court held that the arbitration clause was unenforceable and remanded the case for the district court to consider Shroyer's class action lawsuit. Id. at 993.

In *Homa v. American Express Company*, 558 F.3d 225 (3d Cir. 2009), a putative class action case brought by a consumer alleging that American Express violated New Jersey's Consumer Fraud Act, the Third Circuit refused to enforce a class action waiver clause, holding that it violated fundamental public policy under New Jersey law. Id. at 230. The court reasoned that the class arbitration waiver would leave a consumer without any practical way to pursue a small claim and could consequently operate to preclude a New Jersey consumer from relief. Id. at 230-231. Accordingly, the court denied the defendant's motion to compel arbitration and to dismiss the class action. Id. at 233.

The Second Circuit recently reached a similar conclusion in *Fensterstock v. Education Finance Partners*, 611 F.3d 124 (2d Cir. 2010), holding that a student loan agreement forbidding a borrower from making claims on a class-wide basis in arbitration or litigation was unconscionable under California law. The court held that the FAA does not preempt California law because the California statutory and common law unconscionability doctrine, a general contract defense, applies equally to clauses waiving rights to pursue class actions in litigation or class arbitration. The court then held the waiver clause unconscionable under California law. Id. at 141.

Courts concluding that class action waiver clauses are unenforceable are not free to order that arbitration proceed on a class basis, however. In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, No. 08-1198, 130 S.Ct. 1758 (April 27, 2010), the Supreme Court held that imposing class arbitration on parties who have not explicitly agreed to authorize class arbitration is inconsistent with the FAA. Id. at 1775.

Further Guidance From High Court

The Supreme Court will soon offer significant further guidance on the enforceability of class action waiver clauses. The Court has granted certiorari in *AT&T Mobility v. Concepcion*, No, 09-893, 130 S.Ct. 3322 (May 24, 2010), a consumer suit alleging that AT&T Mobility acted fraudulently when it charged sales tax on a phone that it had advertised as "free" upon the purchase of service.

The recently enacted Dodd-Frank Act provides the newly created **Bureau** of **Consumer Financial Protection** with the **authority** to **regulate** mandatory pre-dispute arbitration agreements between the consumer and financial product or service providers.

When the plaintiff sought to litigate the claim as a class action, AT&T invoked an arbitration provision in the sales contract that prohibited class actions. The district court denied AT&T's motion to compel arbitration and AT&T appealed. *Laster v. T-Mobile USA Inc.*, No. 05cv1167 DMS (JAB), 2008 WL 5216255 (S.D. Cal. 2008).

The Ninth Circuit held that the FAA did not preempt California law regarding unconscionability, and that the waiver clause was unconscionable under California law because it would undermine the deterrence provided by the class action mechanism. *Laster v. AT&T Mobility LLC*, 584 F.3d 849 (9th Cir. 2009). In coming to this conclusion, the Ninth Circuit arguably applied the standard of conscionability that is higher than what is normally applied to contracts in general.

AT&T Mobility asked the Supreme Court to weigh in, filing a petition for writ of certiorari presenting the following question: "Whether the Federal Arbitration Act preempts States from conditioning the enforcement of an arbitration agreement on the availability of particular procedures—here, class-wide arbitration—when those procedures are not necessary to ensure that the parties to the arbitration agreement are able to vindicate their claims." On May 24, 2010, the court granted the petition.

The essence of AT&T's argument is that class-wide arbitration is not necessary to protect the consumers' rights because the arbitration clause in its form contract "essentially guarantee[s]" that any consumer who filed a claim would be made whole. Brief for Petitioner-Appellant at 13, *Laster v. AT&T Mobility*, No. 09-893 (9th Cir. Oct 27, 2009) (citing *Laster*, 584 F.3d at 856 n.9). AT&T also argues that the FAA preempts California state law because California courts analyzing arbitration agreements for unconscionability apply a less demanding standard than is used for other kinds of contracts, effectively discriminating against arbitration agreements. Id.

If the Supreme Court limits its decision to the unusual facts presented in the case, the impact of its ruling may not be significant. Although AT&T's arbitration contract contained a class action waiver clause, it also included a variety of pro-consumer provisions that are generally absent in such agreements, diminishing the prospect that enforcement of the waiver clause would preclude access to justice. On the other hand, a broad decision that the FAA effectively trumps unconscionability challenges under state law could bring many kinds of class actions to a virtual stand-still.

Even if the Supreme Court were to stake out such a position, however, it is possible that legislative and regulatory action would still prevent universal reliance on class action waiver clauses in arbitration agreements.

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act provides the newly created Bureau of Consumer Financial Protection with the authority to regulate mandatory pre-dispute arbitration agreements between consumer and financial product or service providers. Upon completing required formal study of the use of binding arbitration agreements in the consumer financial services industry, the Bureau may use its regulatory powers to limit or fully prohibit arbitration agreements in financial services.

In 2011, consumers and businesses alike will keep a careful eye on these rapid changes in the law governing class action waiver provisions. The evolution of the law in this area may have a profound impact not only on business litigation, but on access to justice for many Americans.