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Commentary

Unconscionable Consumer Class Action Waivers And The Federal Arbitration Act

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Consumer class actions have flooded the courts for many years. But in the past few years the possibility of class actions before arbitral tribunals has spawned a host of new issues. One of the most important issues is whether the consumer's right to proceed by class action may be waived in conjunction with an agreement to arbitrate all disputes. The stakes are high for large consumer services companies, notably but not only in wireless telecommunications, especially when variable monthly charges beyond the basic service fee are not well-understood by or well-explained to the customer. There is potential for abuse and fraud in billing, or at least the perception of it. Claims of aggrieved individual consumers are too small to warrant pursuit in arbitration, but the small sums involved, multiplied by millions of customers, represent a material part of the earnings of the companies that seek to enforce class action waivers in their customer agreements. Not surprisingly, the class action bar has entered the field aggressively.

A number of judicial decisions have considered two related questions: *first*, alleged unenforceability of class action waivers under state law contract principles of unconscionability, and *second*, whether state law on unconscionability may be applied to invalidate an arbitration agreement without offending the Federal Arbitration Act ("FAA").

For arbitration practitioners, the second question is perhaps more compelling than the first. This so-called "FAA pre-emption" issue is the focus of this article. Section 2 of the FAA provides that an arbitration agreement "is valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." When a court determines that a waiver of the right to proceed by class action runs afoul of state law, but the waiver is embedded in and not severable from an arbitration clause, the issue presented is: do the state law grounds for finding the class action waiver unenforceable constitute "*grounds . . . for the revocation of any contract.*" On this point, federal courts of appeals in the Third and Ninth Circuits have reached completely opposite, and not reconcilable, conclusions in recent decisions.

This article explores those cases and concludes that the Ninth Circuit's approach, which holds that state law is not pre-empted by the FAA, and that unconscionable class action waivers in arbitration agreements may be denied enforcement without violating the FAA, represents the view that is more persuasive and attuned to settled principles of federal arbitration law.

A. Judicial Challenges To Arbitral Class Action Waivers Based On State Law: An Overview

Such cases follow a predictable procedural pattern. Plaintiffs commence a class action lawsuit in federal court based upon diversity of citizenship, or less frequently a federal question (where the claim is based on a federal statute). The plaintiff will have individually signed a contract with the defendant that requires

all disputes involving or relating to the contract to be resolved by arbitration, and the contract further provides that the plaintiff waives any right to proceed in arbitration (or in court) by a class action and undertakes to pursue in arbitration only her respective individual claims. Based on those contract provisions, the corporate defendant moves to compel arbitration and to stay or dismiss the action, based upon the FAA. The plaintiff responds that the class action waiver in the arbitration clause is unconscionable under applicable state law, and renders the entire arbitration agreement in which the waiver is found unenforceable.

B. The Third Circuit Position: FAA Pre-Empts State Law, Class Action Waiver In Arbitration Clause Enforceable Even If Unconscionable Under State Law

In Gay v. Creditinform, 511 F.3d 369 (3d Cir. Dec. 19, 2007), the U.S. Court of Appeals for the Third Circuit affirmed a District Court judgment that upheld the arbitration clause in the customer agreement of a so-called “credit repair” company (which offers the service of helping the customer to improve his or her credit rating). That arbitration clause required all disputes to be resolved in arbitration “*on an individual basis and not consolidated with any other claim.*” 511 F.3d at 375. Finding Virginia law applicable to determine unconscionability, and that contracts are unconscionable under Virginia law only if “*grossly unequal bargaining power [exists] at the time the contract is formed,*” (*id.* at 391, internal citation omitted), the Court held that there was no unconscionability because the credit repair service was not an indispensable or even highly valuable service that the consumer would likely have to purchase from one provider or another.

But the Court, perhaps reluctant to have its decision depend entirely on the very high threshold for unconscionability under Virginia law, went on to analyze the question under the law of the forum State, Pennsylvania. It is this portion of the opinion in Gay that is of particular interest to arbitration (and class action litigation) practitioners. Pennsylvania appellate court precedents had held that arbitration provisions in certain consumer contracts were unconscionable, because they contravened the public policy of the State to encourage collective enforcement of

meritorious claims that would not be asserted individually due to cost. Upon the hypothesis that the clause before the Court would have been stricken as unconscionable under Pennsylvania law, the Court proceeded to consider whether the state-law principle that would invalidate the clause is one which, in the words of Section 2 of the FAA, is a “*ground[] [that] exist[s] in law or in equity for the revocation of any contract.*” Referring to the U.S. Supreme Court’s decision in Perry v. Thomas for the proposition that “*a court may [not] rely on the uniqueness of an agreement to arbitrate as a basis for a state-law principle holding that enforcement [of the arbitration agreement] would be unconscionable,*” (*id.* at 394), the Court held that Pennsylvania’s principles for refusing enforcement of arbitration clauses with class action waivers did in fact depend upon the uniqueness of the agreement to arbitrate, and therefore were not consistent with the FAA. In this regard, the Court stated:

[T]here is no escape from the fact that [the Pennsylvania precedents] deal with agreements to arbitrate, rather than with contracts in general, and thus they are not in harmony with Perry. It would be sophistry to contend, in the words of Perry, that the Pennsylvania cases do not ‘rely on the uniqueness of an agreement to arbitrate as a basis for a state-law holding that enforcement would be unconscionable’... After all, though the Pennsylvania cases are written ostensibly to apply general principles of contract law, they hold that an agreement to arbitrate may be unconscionable simply because it is an agreement to arbitrate. A finding that the arbitration provisions in those cases are unconscionable can be reached only by parsing the provisions themselves to determine what they provide.

Id. at 395 (internal citation omitted).

Arguably the Third Circuit read Perry v. Thomas too literally, and overextended the principles of federal arbitration policy upon which it is based, resulting in an unnecessarily narrow berth for state public policy encouraging class actions by declining to enforce class action waivers in consumer adhesion contracts. Perry

held that under the Supremacy Clause of the U.S. Constitution, the FAA pre-empted a California labor statute that guaranteed a judicial forum for employee wage claims against employers, notwithstanding arbitration clauses in employment contracts. The explicit purpose of the state law was to guarantee a judicial forum and to nullify a private agreement to arbitrate. This, Perry held, impermissibly subverted federal arbitration policy such that the state statute had to give way. Quoting from Southland Corp. v. Keating, 465 U.S. 1 (1984), Justice Marshall for the Court stated: “*In enacting Section 2 of the Act, Congress declared a national policy favoring arbitration and withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration.*” 482 U.S. at 489. Recently in reaffirming Southland and Perry, the Court drew attention to the statement in Southland that Section 2 “*forecloses state legislative attempts to undercut the enforceability of arbitration agreements.*” Preston v. Ferrer, 128 S. Ct. 978, 983 (2008).

The literal text of Section 2 of the FAA permits the Court to decline enforcement of an arbitration clause, if that clause is unenforceable on grounds applicable to any contract. Unconscionability is a ground for denying enforcement to contracts generally. But the reasons for finding unconscionability are usually contract-specific. The Pennsylvania courts’ objections to class action waivers in arbitration agreements had nothing to do with the procedural consequences of choosing arbitration. Those objections were based on the tendency of class action waivers to immunize corporations from liability if claims are only economically viable to pursue when aggregated by members of a common class. The state law principle was not arbitration-specific, albeit its application did require the Court to examine the terms of an agreement to arbitrate because the class action waiver was found in that portion of the contract and the waiver applied to arbitration proceedings only because the contract excluded litigation entirely.

C. The Ninth Circuit Position: FAA Does Not Pre-Empt State Law, Class Action Waiver In Arbitration Clause Unenforceable If Unconscionable Under State Law

The Third Circuit position in Gay on FAA “pre-emption” in the context of unconscionable class ac-

tion waivers conflicts with that of the Ninth Circuit, which, four months earlier in Shroyer v. New Cingular Wireless Services, Inc., 498 F.3d 976 (9th Cir. Aug. 17, 2007), had held that a class action waiver in the arbitration clause of cellular phone customer agreement was unconscionable under California law, and that denial of enforcement was consistent with, and not pre-empted, by the FAA. The Ninth Circuit’s approach to the FAA pre-emption issue, unlike that of the Third Circuit, started from the simple premise that unconscionability is a contract principle of general application: “*It is well-established that unconscionability is a generally applicable contract defense, which may render an arbitration provision unenforceable.*” 498 F.3d at 981 (internal citation omitted). Rejecting the argument that the unconscionability principles applied here to invalidate the arbitration clause would impermissibly “*subject arbitration clauses to special scrutiny*”, the Court found no conflict with the FAA. Like the Third Circuit in Gay, the Ninth Circuit looked to Perry v. Thomas for the applicable principles. But the Ninth Circuit found different guidance in Perry than did the Third Circuit, notably the Court’s statement in Perry that: “*A state law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with*” Section 2’s requirement that the grounds for non-enforcement should be those generally applicable to any contract. The Ninth Circuit’s view was that the application of unconscionability principles to an arbitration clause containing a class action waiver was “*simply a refinement of the unconscionability analysis applicable to contracts generally in California.*” Those general principles were, in essence, absence of meaningful choice as to the contract terms, and contract terms unreasonably favorable to one party. *Id.* at 987-88.

Twice more in the early months of this year, the Ninth Circuit followed its analysis in Shroyer to find that class action waivers in arbitration agreements were unconscionable under state law, and that the state law principles were not pre-empted by the FAA because they were applicable equally to arbitration agreements and contracts generally. The Court expressly declined to follow the Third Circuit’s decision in Gay, but engaged in no discussion of Gay’s fundamentally different position as to when state law unconscionability principles are, for purposes of the FAA, rules generally applicable to all contracts.

D. Analysis: FAA Pre-Emption And Forum-Neutrality Of State Law Rules Invalidating Arbitration Agreements.

It would appear that the Third Circuit position in Gay does not reconcile federal arbitration policy with state law in a way that is faithful to Supreme Court precedent interpreting and applying the FAA. Perry and Preston hold that state laws designating a judicial or administrative forum for the resolution of particular categories of claims are inherently at odds with federal arbitration policy because they remove from the parties to the contract the ability to choose arbitration as the method of dispute resolution for that category of cases. The state law principles involved in those cases were not common law grounds for the setting aside of any contract, but special laws concerning forum selection having a special impact on agreements to arbitrate. But in cases like Gay and Shroyer, the fact that the offending class action waiver clause is found in an arbitration agreement is incidental to, and not instrumental to, the finding of unconscionability. The application of state law principles of unconscionability in these cases involves no judgment about the relative attributes of arbitral and non-arbitral forums.

Under Perry and Preston, a state law rule that sets aside an agreement to arbitrate because of a perceived shortcoming of arbitration or a perceived advantage of a different forum violates Section 2 and should be pre-empted. But a state contract law principle that sets aside an agreement to arbitrate on grounds applicable to all contracts, which is to say on grounds that are *forum neutral*, i.e. that neither favor nor disfavor arbitration, should not be pre-empted and should be available to deny enforcement of an arbitration agreement. It is too broad a reading of Section 2 to hold, as does Gay, that state law unconscionability principles may not be applied to class action waivers if those waivers are found in an agreement to arbitrate. The fact that the Court must scrutinize terms contained in an arbitration clause does not necessarily and automatically mean that the Court is engaged in making a value judgment about arbitral versus judicial dispute resolution. The specific application to dispute resolution of general principles of unconscionability (adhesion contracts, absence of choice, unequal bargaining power, etc) does not offend federal arbitration policy where those principles are applied in a *forum neutral* fashion, i.e. they are

not applied for the purpose of preferring judicial or administrative dispute resolution instead of arbitration. The vices of class action waivers as identified by the Ninth Circuit in Shroyer are present whether the dispute proceeds in arbitral or a judicial forum. The holding that an arbitration clause containing a non-severable class action waiver is unconscionable is forum neutral, and therefore consistent with Section 2 and federal arbitration policy.

The Third Circuit's position also provides unfortunate guidance for lower courts. Consider Davis v. Dell, Inc., 2007 U.S. Dist LEXIS 94767 (D.N.J. Dec. 28, 2007). In Davis, the Magistrate Judge found that Dell Computer's class action waiver in an arbitration clause was not unconscionable under either Texas or New Jersey contract law, but nevertheless went on to consider the FAA pre-emption issue upon the hypothesis that there was invalidity under state law. The Court understood Gay to mean that "*a state law decision that holds an arbitration agreement unconscionable on the basis of a class action waiver provision due to the fact that the provision is contained in an arbitration agreement rather than in "contracts in general" is not consistent with federal law.*" *Id.* at *25. While this is a not very precise rendition of the holding in Gay, still there is not much more strength to the analytical foundation of Gay than the fact that the class action waiver was found in the arbitration clause and not elsewhere in the contract. In two other federal district court decisions within the Third Circuit, Gay's holding was misconstrued even more egregiously, to mean that a federal district court can only invalidate an arbitration agreement if the *entire contract* containing the arbitration clause is unenforceable under state law. This is unquestionably not what was stated in Gay, and not what Congress had in mind in Section 2 of the FAA.

Conclusion

Whether class action waivers found in arbitration agreements are unconscionable under state law will depend upon the detailed terms of the agreement to arbitrate and the applicable state law. But as a general matter common law principles of unconscionability as applied to such waivers entail no judgments by courts or arbitrators about the relative desirability of arbitration or litigation in court as a method to resolve disputes. Whether there is a contract of adhesion that gives the consumer a take-it-or-leave-it

contract proposition, and whether the waiver terms operate to immunize corporations from liability for consumer fraud because individual claims are inevitably uneconomical to pursue whereas class claims are quite the opposite, are forum neutral issues of state contract law applied in the setting of consumer class action disputes, and in the cases to date the un-

conscionability analysis applied by state and federal courts would have been equally applicable had there been no arbitration agreement and had the class action waiver applied only to litigation in court. FAA pre-emption principles should not present an obstacle to invalidation of class action waivers under state law in this context. ■

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