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Class Action Arbitration Waivers Under Attack

Drafting and Defending Employment and Consumer Arbitration Waivers

A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:

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Tuesday, July 7, 2009

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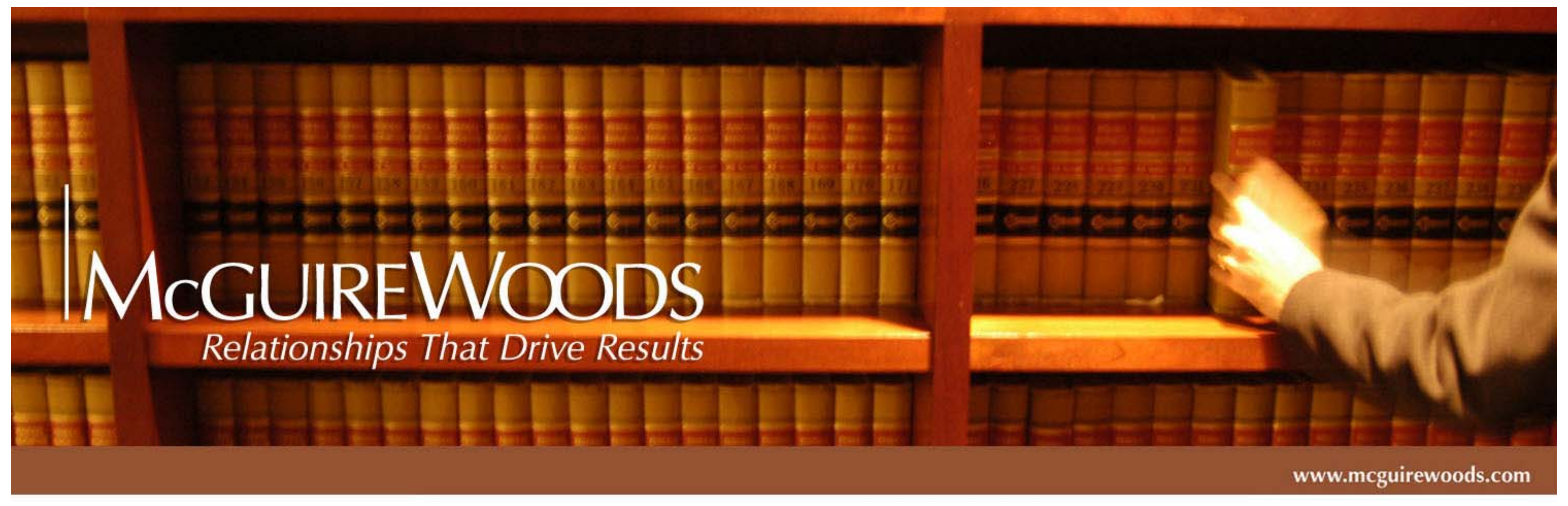

Recent Case Law Summary – Class Action "Waiver" Provisions in Arbitration Agreements

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NEW CASES

- **Homa v. Am. Express Co.,**
  558 F.3d 225 (3d Cir. 2009)
- **In re: Am. Express Merchs.' Litig.,**
  554 F.3d 300 (2d Cir. 2009)
- **Chalk v. T-Mobile USA, Inc.,**
  560 F.3d 1087 (9th Cir. 2009)
- **Franco v. Athens Disposal Co.,**
  171 Cal.App.4th 1277, 90 Cal.Rptr.3d 539 (2009)
- **Sanchez v. W. Pizza Enters., Inc.,**
  172 Cal.App.4th 154, 90 Cal.Rptr.3d 818 (2009)
- **Laster v. T-Mobile USA, Inc.,**
  252 Fed.Appx. 777 (9th Cir. 2007)
- **McKee v. AT&T Corp.,**
  164 Wn.2d 372, 191 P.3d 845 (Wash. 2008)

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Homa v. Am. Express Co., 558 F.3d 225 (3d Cir. 2009)

Facts:

- Plaintiff filed a class action in New Jersey against American Express and American Express Centurion Bank [at 226-27]
- Complaint asserted that AMEX misrepresented the terms of its "Blue Cash" credit card reward program [at 226]
- Cardholder Agreement included a provision requiring arbitration of all claims upon election of either party and specifically required all claims to "be arbitrated on an individual basis . . . [with] no right or authority for any Claims to be arbitrated [as] a class action." [at 227]
- Utah law governed [at 227]

Posture: District Court dismissed action with prejudice because of arbitration agreement

Issue: Is waiver of class action in agreement made under Utah Law enforceable under New Jersey law?

Held: No; waiver is against public policy and therefore unenforceable

Homa v. Am. Express Co., (continued)

Reasoning:

- Court analyzed the class waiver under Restatement (Second) of Conflicts of Laws § 187(2) [at 227]
  - Law of the chosen state (Utah) should apply unless it "would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue" [at 227-28]
- Court: Class waiver violates fundamental public policy of New Jersey [at 230]

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Homa v. Am. Express Co., (continued)

Reasoning (continued):

- Court relied on Muhammad v. County Bank of Rehoboth Beach, Del., 912 A.2d 88 (N.J. 2006), which held that "'the public interest at stake in . . . consumers' ability to effectively pursue their statutory rights under [New Jersey's] consumer protection laws' constituted the 'most important' reason for holding a similar class-arbitration waiver unconscionable" [at 230]
- Contract of adhesion – class waivers in consumer contracts of adhesion are "problematic" because "disputes between the contracting parties predictably involve small amounts of damages" [at 231]

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Homa v. Am. Express Co., (continued)

Reasoning (continued):

- Court also assumes as true the plaintiffs' allegations on a 12(b)(6) standard
  - The "claims at issue are of low monetary value"; and
  - Because of the nature of the individual class members' claims few, if any, could afford to seek legal redress if the case could not be resolved on a class basis [at 231]
- Court ultimately held that, based on the pleadings, the class arbitration waiver provision was unconscionable and trumped Utah law, which approves of class waivers by statute [at 232-33]

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In re: Am. Express Merchs.' Litig., 554 F.3d 300 (2d Cir. 2009)

Facts:

- AMEX merchants sued AMEX on class basis for antitrust violations [at 304-08]
- AMEX's merchant agreement stated:

  Any Claim shall be resolved upon the election by you or us, by arbitration pursuant to this arbitration provision and the code of procedure of the national arbitration organization to which the Claim is referred in effect at the time the Claim is filed. Claims shall be referred to the National Arbitration Forum (NAF), JAMS/Endispute (JAMS), or the American Arbitration Association (AAA), as selected by the party electing to use arbitration. If a selection by us of one of these organizations is unacceptable to you, you shall have the right within thirty (30) days after you receive notice of our election to select one of the other organizations listed to serve as arbitrator administrator.

  . . . .

  IF ARBITRATION IS CHOSEN BY ANY PARTY WITH RESPECT TO A CLAIM, NEITHER YOU NOR WE WILL HAVE THE RIGHT TO LITIGATE THAT CLAIM IN COURT OR HAVE A JURY TRIAL ON THAT CLAIM . . . . FURTHER, YOU WILL NOT HAVE THE RIGHT TO PARTICIPATE IN A REPRESENTATIVE CAPACITY OR AS A MEMBER OF ANY CLASS OF CLAIMANTS PERTAINING TO ANY CLAIM SUBJECT TO ARBITRATION. THE ARBITRATOR'S DECISION WILL BE FINAL AND BINDING. NOTE THAT OTHER RIGHTS THAT YOU WOULD HAVE IF YOU WENT TO COURT MAY ALSO NOT BE AVAILABLE IN ARBITRATION. [at 306-07]

Posture: District Court dismissed action because of arbitration agreement

Issue: Is waiver of class action enforceable under federal law?

Held: No; waiver is against public policy and therefore unenforceable

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In re: Am. Express Merchs.' Litig., (continued)

Reasoning:

- Court framed the issue as one of litigation costs, and Plaintiffs had expert testimony that:
  - Average recovery for an individual plaintiff would be about $40,000 (after trebling damages) [at 317]
  - Expert fees alone for each individual case would exceed $1 million [at 317]
- Relevant antitrust statutes provided for recovery of fees
  - Court found this unpersuasive because "the plaintiffs must include the risk of losing, and thereby not recovering any fees, in their evaluation of their suit's potential costs" [at 318]

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In re: Am. Express Merchs.' Litig., (continued)

Reasoning (continued):

- Court found that the high cost of individual litigation means enforcement of the waiver gives AMEX "de facto immunity from antitrust liability" [at 320]
- Court provided two caveats:
  - Size of plaintiff is irrelevant, size of potential recovery vs. litigation costs for individual plaintiff is the key inquiry [at 320]
  - Arbitration agreements are not per se unenforceable [at 321]

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Chalk v. T-Mobile USA, Inc., 560 F.3d 1087 (9th Cir. 2009)

Facts:

- Plaintiffs purchased a wireless internet card for their PC [at 1090]
- Plaintiffs sued, claiming device was ineffective [at 1090]
- Suit brought as class action [at 1090]
- Terms and Conditions of the Service Agreement contained a mandatory arbitration clause, which provides that the parties will arbitrate all claims, and, in doing so, will follow the American Arbitration Association's published wireless industry arbitration rules. The clause states that each party agrees to pay its "own other fees, costs and expenses including those for counsel, experts, and witnesses." Also stated:

  Neither you nor we may be representative of other potential claimants or a class of potential claimants in any dispute . . . YOU AND WE ACKNOWLEDGE AND AGREE THAT THIS SEC. 3 WAIVES ANY RIGHT TO A JURY TRIAL OR PARTICIPATION AS A PLAINTIFF IN A CLASS ACTION. IF A COURT OR ARBITRATOR DETERMINES THAT YOUR WAIVER OF YOUR ABILITY TO PURSUE CLASS OR REPRESENTATIVE CLAIMS IS UNENFORCEABLE, THE ARBITRATION AGREEMENT WILL NOT APPLY AND OUR DISPUTE WILL BE RESOLVED BY A COURT OF APPROPRIATE JURISDICTION. . . . SHOULD ANY OTHER PROVISION OF THIS ARBITRATION AGREEMENT BE DEEMED UNENFORCEABLE, THAT PROVISION SHALL BE REMOVED, AND THE AGREEMENT SHALL OTHERWISE REMAIN BINDING. [at 1090]

Posture: District Court dismissed action because of arbitration agreement

Issue: Is waiver of class action enforceable under Oregon law?

Held: No; waiver is unconscionable and therefore unenforceable

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Chalk v. T-Mobile USA, Inc., (continued)

Reasoning:

- Oregon law considers both (1) procedural unconscionability and (2) substantive unconscionability
  - Only substantive unconscionability is "absolutely necessary" [at 1093]
- Procedural unconscionability: either (1) oppression or (2) surprise [at 1093]
  - Oppression – unequal bargaining power and no real negotiation [at 1093-94]
    - Here, the contract is adhesive [at 1094]
    - But this alone does not make it oppressive [at 1094]
  - Surprise – there was no surprise here [at 1094]

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Chalk v. T-Mobile USA, Inc., (continued)

Reasoning (continued):

- Substantive Unconscionability
  - Issue: whether the agreement is "unfairly one-sided" [at 1094]
  - Here, this contract was adhesive [at 1094]
  - Contract is unenforceable if this is combined with terms that are unreasonably favorable to the party with greater power [at 1094]
- Court: unreasonably favorable to T-Mobile "for two distinct reasons" [at 1095]
  - The class action waiver "is entirely unilateral in effect" [at 1095]
  - It "prevents individuals from vindicating their rights" [at 1095]

Chalk v. T-Mobile USA, Inc., (continued)

Reasoning (continued):

- Cost of pursuing each claim outweighs potential relief [at 1095]
- Here, claim would be for $693.63 [at 1096]
  - But Court did not emphasize particular amount [at 1096-97]
  - Instead, it suggested that the key was that the waiver "creates [a] disincentive to litigate" [at 1096]
- Note: "the substantive unconscionability of T-Mobile's class action waiver is magnified by its requirement that each party bear its own costs." [at 1096 n.7]
  - "Where the possibility of an award of attorney fees is eliminated, the costs … become even more onerous" and more likely to preclude litigation [at 1096 n.7]

Franco v. Athens Disposal Co., 171 Cal.App.4th 1277, 90 Cal.Rptr.3d 539 (2009)

Facts:

- Plaintiff, a trash truck driver, sued for violations of the Labor Code
- Alleged that employer failed to pay overtime and denied meal and rest breaks
- Employment agreement had an arbitration clause that waived class action:

  [B]oth you and the Company forgo and waive any right to join or consolidate claims in arbitration with others or to make claims in arbitration as a representative or as a member of a class or in a private attorney general capacity. . . . No remedies that otherwise would be available to you individually or to the Company in a court of law, however, will be forfeited by virtue of this agreement. . . . The parties in any such arbitration will be limited to you and the Company . . . . [at 1284]

Posture: Trial court dismissed action because of class action waiver in agreement

Issue: Is waiver of class action enforceable under California law?

Held: No; waiver is against public policy and therefore unenforceable

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Franco v. Athens Disposal Co., (continued)

Reasoning:

- These statutory rights are not waivable [at 1294]
  - In practice, these waivers are exculpatory clauses [at 1295]
- Therefore, the court applied the factors in Gentry v. Superior Court, 42 Cal.4th 443, 463, 64 Cal.Rptr.3d 773, 165 P.3d 556 (2007):
  - Modest size of the potential individual recovery [at 1297]
  - Potential for retaliation against members of the class [at 1297]
  - That class members might be ill-informed about rights [at 1297]
  - "other real world obstacles to the vindication of class members' rights to overtime pay through individual arbitration" [at 1297]

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Franco v. Athens Disposal Co., (continued)

Reasoning (continued):

- Application of the factors here:
  - First, awards in wage/hour cases "tend to be modest" [at 1295]
    - Here, potential recovery is as much as $26,500 [at 1295]
      - » In Gentry, claim of $37,000 was insufficient [at 1295]
    - Possibility of attorney fees does not create incentive [at 1295]
      - » Attorneys risk not prevailing [at 1295]
      - » Also risk court not awarding all of the fees [at 1295]

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Franco v. Athens Disposal Co., (continued)

Reasoning (continued):

- Second, a current employee is at risk of retaliation [at 1296]
  - Athens had a non-retaliation policy, but the Court looked at the effect of it and found that employees still feared retaliation [at 1296]
- Third, some may be unaware of their rights [at 1297]
- Fourth, preventing class actions may allow employers to violate laws with minimal penalty [at 1297]

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Sanchez v. W. Pizza Enters., Inc., 172 Cal.App.4th 154, 90 Cal.Rptr.3d 818 (2009)

Facts:

- Delivery driver for Domino's franchise [at 161]
- Paid $.80 per trip, not per mile; argues it is below minimum wage [at 161]
- Arbitration agreement stated that any dispute that the parties are unable to resolve informally will be submitted to binding arbitration, the arbitrator must be approved by both parties, the parties waive the right to a jury trial, the arbitration fees will be borne by Western Pizza, and "[e]xcept as otherwise required by law, each party shall bear its own attorney fees and costs." The arbitration agreement also includes a waiver of class arbitration, stating: "the Arbitrator shall not consolidate or combine the resolution of any claim or dispute between the two Parties to this ADR Agreement with the resolution of any claim by any other party or parties, including but not limited to any employee of the Company. Nor shall the Arbitrator have the authority to certify a class under Federal Rule of Civil Procedure Rule 23, analogous state rules, or Arbitrator's rules pertaining to class arbitration, and the Arbitrator shall not decide claims on behalf of any other party or parties." [at 161-62]

Posture: Trial Court found arbitration agreement unenforceable

Issue: Is class action waiver enforceable under California law?

Held: No; waiver is against public policy and therefore unenforceable

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Sanchez v. W. Pizza Enters., Inc., (continued)

Reasoning:

– the Court should determine whether the agreement is unconscionable
  - a clear statement that the arbitrator should decide unconscionability might allow the arbitrator to decide [at 166 & n.3]

– Under Gentry factors, the agreement is against public policy and unenforceable:
  - Modest size of the potential individual recovery
  - Potential for retaliation against members of the class
  - Fact that absent members might be ill-informed
  - Other real world obstacles to the vindication of rights [at 167-68]
  - NOTE: no need for procedural unconscionability [at 169 n.4]

Sanchez v. W. Pizza Enters., Inc., (continued)

Reasoning (continued):

- The rest of the arbitration agreement is unconscionable
  - Procedural Unconscionability
    - An element of it must be present [at 171-72]
    - A spectrum, between negotiation and oppression [at 171-72]
    - This case is closer case than Gentry, because the clause states it is "not a mandatory condition of employment" [at 174]
    - BUT still unequal bargaining power with management [at 174]
    - AND agreement suggests there are multiple arbitrators to choose from, but actually is only one [at 174-75]
  - Substantive Unconscionability
    - The lesser evidentiary issues are not an issue because the arbitrator normally has discretion to limit these [at 177]
    - Not providing for a neutral arbitrator is substantively unconscionable [at 177-78]

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Laster v. T-Mobile USA, Inc., 252 Fed.Appx. 777 (9th Cir. 2007)

Facts:

- Arbitration provision in a cell phone contract
- Brief document signed by the consumers referred to a longer document
  - Customer 1 had references to arbitration agreement in the signed document
  - Customer 2 did not have references to arbitration in the signed document

Posture: Trial Court held that class action provision was unenforceable

Issue: Is the class action waiver enforceable under California law?

Held: No; waiver is unconscionable and therefore unenforceable

Laster v. T-Mobile USA, Inc., (continued)

Reasoning:

- Court found the arbitration agreement to be not substantively distinguishable from the provision in Shroyer v. New Cingular Wireless Servs., 498 F.3d 976, at *5-9 (9th Cir. 2007) [at 778-79]
- Arbitration agreement in Shroyer stated:

  You and Cingular agree that YOU AND CINGULAR MAY BRING CLAIMS AGAINST THE OTHER ONLY IN YOUR OR ITS INDIVIDUAL CAPACITY, and not as a plaintiff or class member in any purported class or representative proceeding. Further, you agree that the arbitrator may not consolidate proceedings of more than one person's claims, and may not otherwise preside over any form of representative or class proceeding, and that if this specific proviso is found to be unenforceable, then the entirety of this arbitration clause shall be null and void.
- Court reiterated its rejection of the "marketplace alternative" rationale
- Court affirmed the reasoning of the trial court, found at Laster v. T-Mobile USA, Inc., 407 F.Supp.2d 1181 (S.D. Cal. 2005)

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Laster v. T-Mobile USA, Inc., (continued)

Reasoning (continued):

- Procedural Unconscionability
  - Issue is where on the "continuum" of procedural unconscionability these fall [at 1188]
  - Adhesion contracts are "take it, or leave it" in nature [at 1188]
  - Customer 2: no ability to negotiate, because she had to discover the provision herself [at 1189]
  - Customer 1: "closer call" because of the warnings of the arbitration agreement [at 1189] within the 13-page document
    - » BUT because of the "take it, or leave it" nature, it is deemed to be a contract of adhesion and therefore procedurally unconscionable [at 1189]

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Laster v. T-Mobile USA, Inc., (continued)

Reasoning (continued):

- Discover Bank elements:
  - The class action waiver is contained in a consumer contract of adhesion, in which small amounts are at issue [at 1190]
  - It is alleged that the party with the superior bargaining power has carried out a scheme deliberately to cheat large numbers of customers out of individually small amounts of money [at 1190]
- Moreover, under Discover Bank, attorney fees are not a substitute

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McKee v. AT&T Corp., 164 Wn.2d 372, 191 P.3d 845 (Wash. 2008)

Facts:

- AT&T long-distance service in November 2002
- Plaintiff alleged he was improperly charged a $20 per year tax surcharge
- AT&T later sent him a contract [at 379]
- Dispute Resolution section forbids class actions; requires claim must be brought within 2 years; required secrecy of arbitration; limits consumer's rights to punitive damages [at 380]

Issue: Is the class action waiver provision enforceable under Washington law?

Held: No; waiver is unconscionable and therefore unenforceable

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McKee v. AT&T Corp., (continued)

Reasoning:

- Under Washington law agreement may be either procedurally or substantively unconscionable [at 396]
- Substantive unconscionability alone is sufficient to support a finding of unconscionability [at 396]
- Substantive unconscionability
  - Class Action Waiver
    - A small amount at stake for each individual
      - This agreement did not provide for attorneys fees, but even if it did, in an earlier case that did not matter [at 397]
      - Also, as in another case, the availability of a small claims' court or low-cost arbitration does not help, because it is still not practicable for the individual to pursue "such amounts" [at 397]

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McKee v. AT&T Corp., (continued)

      » Because amounts "were too small to be worth the time and energy, let alone the nominal filing fee" for small claims court [at 397]
    - Even worse, this does not even allow awarding of attorney fees unless provided for in a statute [at 397]
- Procedural unconscionability
  - Mailed the conditions 10 to 14 days after subscribed for service
  - AT&T retained the right to unilaterally change the provisions
  - Consumer deemed to have agreed to the changes by continuing to use AT&T service
  - At no time was the consumer required to read and sign or affirmatively acknowledge acceptance of the terms and conditions
- Because the court found substantive unconscionability, no need to look for procedural unconscionability

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SUMMARY OF RECENT CASE LAW

- Unconscionability
  - Procedural Unconscionability
  - Substantive Unconscionability
- Against Public Policy

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Unconsionability

- Two Elements
  - Procedural Unconscionability: surprise/oppression
    - Adhesion contract
      - » This alone does not make it procedurally unconscionable (Chalk)
      - » If clause is not mandatory, it can still be procedurally unconscionable (Sanchez)
    - Does consumer choice make the contract non-adhesive, and thus not procedurally unconscionable?
      - » California has decided no (Lester)

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- Substantive Unconscionability: exceedingly one-sided terms
  - Basic test: if it creates a "disincentive to litigate" (Chalk), such as:
    - » Unilateral or one-sided in effect
    - » Cost of pursuing the claim outweighs potential relief
  - Attorney's fees is usually irrelevant
  - No attorney fees provision "magnified" the unconscionability (Chalk)

– Recent cases all invalidated the waivers, even when:

- the signed document has references to arbitration (Laster)
- there is meaningful choice among arbitrators (Sanchez)
- consumer affirmatively read/signed/acknowledged the clause, and did not assent by inaction (McKee; Lester)

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Against Public Policy

- If waiver is of an unwaivable statutory right (e.g., right to minimum wage)
- Court undertakes inquiry under Gentry factors (Franco, Sanchez, Homa, In re AMEX Merchs.)
  - modest size of potential individual recovery
  - potential for retaliation against members of the class
  - fact that class members might be ill-informed about rights
  - other obstacles to vindication of class members' rights
- Even large individual claims allowed, such as $26,500 or $37,000
- Availability of attorney fees for prevailing party may not matter (Franco, In re AMEX Merchs.)

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LEGISLATIVE UPDATES

- Consumer Financial Protection Agency
- Consumer Financial Protection Agency Act of 2009
- Arbitration Fairness Act of 2009

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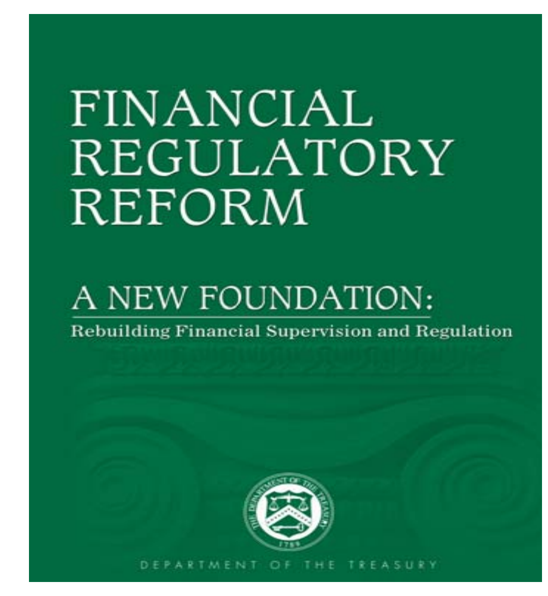
Consumer Financial Protection Agency



10. ***To improve incentives for compliance, the CFPA should have authority to restrict or ban mandatory arbitration clauses.***

Many consumers do not know that they often waive their rights to trial when signing form contracts in taking out a loan, and that a private party dependent on large firms for their business will decide the case without offering the right to appeal or a public review of decisions. The CFPA should be directed to gather information and study mandatory arbitration clauses in consumer financial services and products contracts to determine to what extent, and in what contexts, they promote fair adjudication and effective redress. If the CFPA determines that mandatory arbitration fails to achieve these goals, it should be required to establish conditions for fair arbitration, or, if necessary, to ban mandatory arbitration clauses in particular contexts, such as mortgage loans.

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Consumer Financial Protection Agency Act of 2009

- New bill introduced by Obama administration on June 30, 2009
- SEC. 1025. AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.
  The Agency, by rule, may prohibit or impose conditions or limitations on the use of agreements between a covered person and a consumer that require the consumer to arbitrate any future dispute between the parties arising under this title or any enumerated consumer law if the Agency finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of consumers.

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Arbitration Fairness Act of 2009 (HR 1020 & SB 931)

- "No predispute arbitration agreement shall be valid or enforceable if it requires arbitration of an employment, consumer, franchise, or civil rights dispute."

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Recent Trends in Arbitration And Considerations in Drafting Arbitration Provisions

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Background

- Advantages of arbitration
  - Reduced transaction costs
  - Less adversarial than litigation
  - Fair, expeditious process to resolve disputes
- Congressional and Judicial Support for Arbitration
  - Federal Arbitration Act adopted in 1925 to reverse long-standing judicial hostility to arbitration
  - Act provides that arbitration agreements must be enforced, unless there is a generally-applicable rule of state law that would authorize invalidating *any* contract
  - Series of Supreme Court decisions in 1980s and 1990s holding that a variety of federal statutory claims are subject to arbitration and that anti-arbitration state law is preempted by the FAA produced significant growth in the use of arbitration, particularly in the consumer and employment context

Limits on Arbitration

- Unconscionability principles apply to arbitration clauses in consumer and employment contracts
- Courts have invalidated arbitration clauses found to be unfair, citing a number of different factors, either alone or in combination. These include, for example:
  - Excessive costs
  - Unfair appointment of arbitrators
  - Requiring that arbitration be kept confidential
  - Limitations on arbitrator's ability to award relief available in court such as attorneys' fees or punitive damages
  - Shortening the statute of limitations period
  - Requiring arbitration to take place at a location inconvenient to the non-business party (especially when it is in the business's home state and the forum is across the country from the plaintiff)

Class-Action Waivers in Arbitration Provisions

- Most hotly contested issue in arbitration law today is whether arbitration provisions that require individual arbitration are enforceable
- Traditionally arbitration had been done on an individualized basis. Until 2003, most federal courts of appeal had held that arbitration takes place on an individual basis, and that class actions were not permitted
- In 2003, the Supreme Court held in the *Bazzle* case that when an arbitration provision is silent as to whether class actions are permitted, it is for an arbitrator to decide whether a class arbitration can go forward
- Many businesses therefore:

  (1) made it explicit that their arbitration provisions precluded class actions, and that

  (2) the arbitration clause would be void unless arbitration took place on an individual basis

Arguments For and Against Class Waivers

- Opponents of arbitration:
  - Class-action device is essential
  - With respect to small claims, they argue that individuals are unlikely to pursue claims, so aggregation is necessary in order to attract lawyers to file lawsuits
- Proponents of arbitration:
  - Class-action device is just like any other procedural device, like jury trials, that can be waived
  - As long as arbitration fees are low, consumers can effectively vindicate their rights
  - Many statutes provide for attorneys' fees which creates incentives for lawyers to take these cases
  - Class actions impose high litigation costs that are passed on to consumers and to employees in the form of higher prices and lower wages
  - Class actions provide class members with little or no benefit; the winners are the lawyers (both plaintiffs' side and defense side)
- Courts around the country are divided on this issue.

Key Points on Drafting Enforceable Arbitration Provisions

- Arbitration provision should be designed to ensure that the arbitration process is fair and attractive to customers or employees; this creates a better process for the parties and increases the likelihood of court approval
- Here are some important elements:
  - **Low-cost or cost-free arbitration:** Make arbitration affordable for customers and employees. If possible, offer to pay the full costs of arbitration
  - **Do not impose limits on legal remedies**. Some of the concerns that we have mentioned should be avoided: For example,
    - Limiting the company's punitive or consequential damages
    - Precluding recovery of attorneys' fees, or
    - Imposing an unusually short statute of limitations
  - Offer a **convenient location** for the non-business party, and the option of a telephone or desk arbitration (particularly in consumer contracts)
  - Consider using premiums

Legislation

- In some ways, what is happening in Congress could be the most important development in arbitration law.
- The trial bar has actively been lobbying Congress to eliminate arbitration. The American Association for Justice (formerly ATLA) spent $1.15 million last quarter on lobbying expenses, including on a number of anti-arbitration bills
- The trial lawyers have adopted a two-pronged strategy. They have pushed both “narrow” bills that affect particular sectors and a broad bill that would wipe out virtually all pre-dispute arbitration
  - Nursing homes
  - Auto sales and financing
  - Mortgage financing
  - Livestock and poultry contracts

The "Arbitration Fairness Act"

- The proposed Arbitration Fairness Act (H.R. 1020/S.931) would drastically change federal arbitration law
- Makes **unenforceable**:
  - **all** "**predispute arbitration agreements**" in employment, consumer, and franchise contracts
  - arbitration agreements for any dispute arising under civil rights statutes
- **Applies retroactively** to all pre-existing arbitration agreements, so long as the "dispute or claim . . . arises on or after" its effective date—invalidating hundreds of millions of arbitration agreements
- Would **preempt** state policies favoring arbitration
- **Broad reach and language** potentially threatens to undercut the use of **international arbitration**
- Senate version would reverse the holding in recent *Pyett* decision, which involved whether federal anti-discrimination claims are subject to arbitration clauses contained in collective bargaining agreements

Best Practices for Enforcing Class Action Waivers in Court

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Class Action Waivers: Overview

- Class action waivers are contractual provisions, typically in consumer contracts or employment agreements, providing that parties can only pursue relief on an individual basis and that the parties cannot join others in a particular action or pursue claims through a class or representative action.
- Class waivers in consumer contracts, and to a lesser extent employment agreements, have been litigated and continue to be litigated in state and federal courts throughout the country, but there is a great disparity in court's approach to class action waivers

Class Action Waivers: Courts Are Split

- The First Circuit and the Ninth Circuit as well as state supreme courts in California, Washington, New Jersey and Illinois have held that certain provisions in arbitration agreements that preclude class arbitration are unconscionable and/or against public policy.

- Conversely, the Third, Fourth, Fifth, Seventh and Eleventh Circuits, as well as state courts in Colorado, Delaware, Ohio, Georgia, Maryland, North Dakota, Tennessee, and Texas have upheld certain class waivers in arbitration provisions.

Class Action Waivers: Enforcing Them in Court

- Courts that have addressed the enforceability of class action waivers have focused on:
  - the nature of the transaction between the business and consumer or employee
  - how the agreement was formed
  - how it was communicated to consumers or employees
  - what arbitration fees are involved
  - the peculiarities of a particular state's law, and
  - the value or foreseeable value of underlying claims that are subject to the class waiver

Hypothetical

You represent the defendant in a suit challenging a class action arbitration waiver. How do you persuade the judge to enforce the waiver?

- Location, location, location
  - Which state's law controls? Class action waivers have been struck down in some jurisdictions, but not all.
  - Even in California, where such waivers have been struck down, you can get a court to enforce one if the contract has a properly worded choice of law clause that provides for the law of a jurisdiction (for example, Delaware) where waivers have been upheld.

Hypothetical (continued)

- Fairness of Clause: A contract containing a class action arbitration waiver is more likely to be enforced if the business assumes the cost of the arbitration.
  - See *Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal. 4th 83 (Cal. 2000)

- Assuming language of the clause is consistent, highlight that individual damages are not limited and discovery is available.

Hypothetical (continued)

- Argue that a class action arbitration waiver is merely a procedural device.
  - Consumers are not losing any rights, no remedies are being eliminated, damages are not curtailed, discovery isn't being limited - it's just a procedural alternative.

Hypothetical (continued)

- Timing
  - Arguing against a challenge that the provision is unconscionable needs to be done early or you waive your right to bring it up in litigation
- Evidence
  - Formation Issues
    - No Adhesion Contract
    - No Change in Terms
    - Choice of law (Jurisdiction of Service, Contracting)
    - Anticipated or Foreseeable Damages or Injury
  - Class Action Not Only Device to Address Wrongs
    - Other Individually Filed Cases
    - Claimed Damages Significant

In The News

MAY 2008

LOEB & LOEB adds Knowledge.

The following article appeared in *California Litigation* magazine (Vol. 21 No 1 2008)

Class Action Waivers in Consumer Contracts and Employment Agreements in California

By: Michael Mallow

Given the unprecedented rise in class action litigation, especially in California, more and more businesses have included class action waivers in consumer contracts and employment agreements. Businesses believe these provisions are needed to combat what is perceived to be extortive class action litigation. Consumer and employee rights advocates contend these class action waivers constitute an attempt by business to negate one of the only effective means of ensuring businesses do not rip off consumers or cheat employees. Given the magnitude of the litigation dollars at stake, class action waivers have become a polarizing issue that has been litigated with extraordinary vigor.

Class action waivers are contractual provisions, typically in consumer contracts or employment agreements, providing that parties can only pursue relief on an individual basis and that the parties cannot join others in a particular action or pursue claims through a class or representative action. Class waivers in consumer contracts, and to a lesser extent employment agreements, have been litigated and continue to be litigated in state and federal courts throughout the country, but there is a great disparity regarding the proper use or prohibition of such provisions. For example, the First Circuit and the Ninth Circuit as well as state supreme courts in California, Washington, New Jersey and Illinois have held that certain provisions in arbitration agreements that preclude class arbitration are unconscionable and/or against public policy. Conversely, the Third, Fourth, Fifth, Seventh and Eleventh Circuits, as well as state courts in Colorado, Delaware, Ohio, Georgia, Maryland, North Dakota, Tennessee, and Texas have upheld certain class waivers in arbitration provisions.

Dozens of decisions handed down in the last three years illustrate that determining whether a class waiver is enforceable depends on the nature of the transaction between the business and consumer or employee, how the agreement was formed, how it was communicated to consumers or employees, what arbitration fees are involved, the peculiarities of a particular state's law, and the value or foreseeable value of underlying claims that are subject to the class waiver.

The purpose of this article is to summarize the two leading class action waiver decisions in California, provide a snapshot of California's far reaching—but not absolute—prohibition against class waivers and interplays with other jurisdictions, like Delaware, where class waivers are appropriate.

Discover Bank v. Superior Court of Los Angeles

The landmark class action waiver case in California, and perhaps the case most cited by non-California courts, is *Discover Bank v. Superior Court of Los Angeles*, 36 Cal. 4th 148 (Cal. 2005). In this case, the California Supreme Court held that "under some circumstances, the law in California is that class action waivers in consumer contracts of adhesion are unenforceable, whether the consumer is

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being asked to waive the right to class action litigation or the right to classwide arbitration." *Id.* at 153.

The case began when plaintiff Christopher Boehr filed suit in California state court against Discover Bank, alleging that the cardmember agreement for his Discover credit card, which contained a Delaware choice-of-law provision, violated Delaware's Consumer Fraud Act. Boehr claimed that Discover represented that late payment fees would not be assessed if payment was received by a certain date, but such fees were actually assessed if payment was received after 1:00 pm on that date. Boehr was assessed a late fee of $29.00 when his payment was received after 1:00 pm on the payment due date.

Discover filed a motion to compel arbitration on an individual basis and for dismissal of the class action complaint, citing a provision in the cardmember agreement that precluded class action arbitration. The cardholder agreement specifically provided that "[n]either you nor we shall be entitled to join or consolidate claims in arbitration by or against other cardmembers with respect to other accounts, or arbitrate any claim as a representative or member of a class or in a private attorney general capacity." The agreement also said that the Federal Arbitration Act would govern the agreement.

In a rollercoaster series of decisions, the trial court initially granted Discover's motion in its entirety under Delaware law, but reversed itself because after the trial court rendered its decision, the Court of Appeal in *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094 (2002), held that a virtually identical class action waiver was unconscionable. Consequently, the trial court struck the class action waiver clause from the agreement, ordered plaintiff to arbitrate his claims individually, and left open the possibility that plaintiff may succeed in certifying an arbitration class under California law. Discover filed a writ seeking reinstatement of the trial court's initial order and the Court of Appeal granted the writ, asserting that the California rule prohibiting class action waivers was preempted by the FAA. The California Supreme Court granted review.

From the start of the Court's opinion, it was clear that Discover's class action waiver would not fair well under California law. The Supreme Court began its analysis by touting the benefits of class actions, indicating that without class actions, individual actions in consumer cases like *Discover*, where the representative plaintiff's claim was a mere $29.00, would be impracticable because the amount of individual recovery would be too small to justify litigation costs. The Court also noted that when compounded by the number of individuals who may have been subjected to allegedly wrongful business practices, millions of dollars may actually be at stake, and thus, class actions hold unscrupulous sellers who stand to reap significant profit from small individual frauds, accountable for wrongful conduct. Moreover, the Court indicated that, in general, class actions conserve judicial resources. In short, the Court did not accept Discover's position that class actions are an overly abused and extortive litigation procedure that needed to be curtailed through contractual waivers signed by a business' customers.

In determining whether the class waiver in Discover's arbitration clause was enforceable, the Court first analyzed whether the class waiver provision was procedurally and substantively unconscionable. The Court found that the class waiver in the Discover agreement fit within both categories. It explained that the procedural element of an unconscionable contract generally takes the form of a contract of adhesion, which is a contract drafted and imposed by the party with superior bargaining power on the party with significantly less or no bargaining power. An adhesion contract may also contain the element of surprise. Most significantly, an adhesion contract may exist when an agreement is not and cannot be negotiated because the party with the superior bargaining power only allows the other party to accept or reject the agreement in its entirety. Substantively, unconscionable contracts are generally considered one-sided.

Applying these principals to the Discover agreement, the court noted that card holders were notified of the change to the cardmember agreement which included the classwide arbitration in the form of a "bill stuffer" and that card holders were deemed to have accepted the new terms by continuing to use their card. The court also noted that class action waivers are "indisputably one-sided… it is difficult to envision circumstances under which the provision might negatively impact Discover Bank, because credit card companies typically do not sue their customers in class action lawsuits" (citing *Szetela*).

The court concluded its unconscionability analysis saying,

> We do not hold that all class action waivers are necessarily unconscionable. But when the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then, at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party "from responsibility for [its] own fraud, or willful injury to the person or property of another." (Civ. Code, § 1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced.

Id. at 162-63.

The Federal Arbitration Act and Preemption

The California Supreme Court then went on to address the issue of whether the Federal Arbitration Act, 9 U.S.C. §1 et seq. ("FAA"), preempts California's rule against class action waivers, as the appeals court had concluded. The FAA is silent on class actions and class action arbitration, probably because such actions were largely unknown when the FAA was enacted in 1925. Section 2 of the FAA provides:

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. § 2.

The last phrase of Section 2 is the Achilles heal that the California Supreme Court exploited in holding that Discover's preemption argument was unpersuasive.

Addressing the appellate court's ruling that when class waivers are contained in arbitration provisions, the FAA preempts California law prohibiting such waivers, the Court distinguished the U.S. Supreme Court case of *Perry v. Thomas*, 482 U.S. 483 (1987) relied on by the appellate court. The Court indicated that the section of California's labor code that was at issue in *Perry* required wage disputes to be settled in court rather than by arbitration. Because this law specifically prohibited arbitration, it was preempted by Section 2 of the FAA which requires that arbitration agreements be enforced. The *Perry* court wrote that Section 2 of the FAA "provides the touchstone for choosing between state-law principles and the principles of federal common law…. Thus state law, whether of legislative or judicial origin, is applicable if that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally" and not of arbitration agreements in particular. *Id.* at 492 n.9. Because, the labor code did not apply to contracts generally, it was subject to preemption under the FAA.

Similarly, the Court noted that in *Doctor's Assoc., Inc. v. Casarotto*, 517 U.S. 681 (1996), the U.S. Supreme Court held that a Montana statute, requiring an arbitration clause to be printed in capital letters and underlined on the first page, was preempted by the FAA because it applied only to arbitration agreements and not to contracts generally.

Because the law regarding unconscionability applies to any contract, the Supreme Court rejected the appellate court's conclusion that the FAA preempted California's law prohibiting unconscionable class action waivers.

Choice of Law and a Surprise Ending

Finally, the Court turned to the issue of the cardmember agreement's choice-of-law provision. The court remanded this issue to the appeals court and provided some guidance for determining whether the Delaware choice-of -law provision would control.

The court explained that if the appeals court finds that the claims at issue fall within the scope of a choice-of-law clause, it must next evaluate the clause's enforceability pursuant to the Restatement Second of Conflict of Laws. Specifically, the appeals court must first determine whether the chosen state has a substantial relationship to the parties or their transaction, or whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law. If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a

fundamental policy of California, and if it is, the court must then determine whether California has a materially greater interest than the chosen state in the determination of the particular issue.

In subsequent proceedings, the California Court of Appeal held that the Delaware choice-of-law provision was appropriate because Discover Bank is domiciled in Delaware and because Delaware law requires that a revolving credit plan between a Delaware-chartered bank and an individual borrower shall be governed by the laws of Delaware. (Del. Code Ann., tit. 5, § 956.) Having concluded that Delaware had a substantial relationship to the parties and that there was a reasonable basis for the contractual choice of Delaware law, the court applied Delaware law to the issue of whether the class action arbitration waiver was valid. In a somewhat surprising turn of events, especially given the Supreme Court's public policy discussing regarding the purported benefits of class action litigation, the appellate court, citing *Edelist v. MBNA Am. Bank* (Del. Super.Ct. 2001) 790 A.2d 1249, concluded that the class action arbitration waiver was enforceable. 134 Cal. App. 4th 886 (2005).

Consumer Class Action Waivers and the Ninth Circuit

The U.S. Court of Appeals for the Ninth Circuit has addressed the issue of class action waivers in consumer contracts several times. In *Shroyer v New Cingular Wireless, Inc.*, 498 F.3d 976 (9th Cir. 2007), the Ninth Circuit was asked to consider whether a class arbitration waiver in New Cingular Wireless Service Inc.'s standard contract for cellular phone services was unconscionable under California law, and whether the Federal Arbitration Act preempted a holding that the waiver is unenforceable. The court held that the waiver is unconscionable, and thus unenforceable, and that the invalidation of the contract provision is not preempted by the Federal Arbitration Act. The court reversed the district court's order compelling arbitration. (The court came to a similar conclusion in *Lowden v. T-Mobile USA, Inc.*, 2008 U.S. App. LEXIS 1190 (9th Jan. 22, 2008) (applying Washington law); *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165 (9th Cir. 2003) and *Ting v. AT&T*, 319 F.3d 1126 (9th Cir. 2003)).

The Ninth Circuit discussed California law, noting that a contract provision is unenforceable due to unconscionability only if it is both procedurally and substantively unconscionable (citing *Armendariz v. Found. Health Psychcare Servs., Inc.*, 24 Cal. 4th 83 (Cal. 2000) and *Discover Bank*, 36 Cal. 4th 148 (Cal. 2005)). However, the two types of unconscionability need not both be present to the same degree: "California courts apply a "sliding scale," so that the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.' (citations omitted).

The Ninth Circuit outlined the three-part inquiry used by the California Courts of Appeal in order to determine whether a class action waiver in a consumer contract is unconscionable (citing *Cohen v. DirecTV, Inc.*, 142 Cal. App. 4th 1442 (2006); *Klussman v. Cross Country Bank*, 134 Cal. App. 4th 1283 (2005); *Aral v. EarthLink, Inc.*, 134 Cal. App. 4th 544 (2005)). Under this three-part inquiry, courts are required to determine: (1) whether the agreement is "a consumer contract of adhesion" drafted by a party that has superior bargaining power; (2) whether the agreement occurs "in a setting in which disputes between the contracting parties predictably involve small amounts of damages;" and (3) whether "it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money." The Ninth Circuit concluded that the case at hand satisfied all three prongs.

The Circuit Court noted that Cingular 's agreements for cellular phone services are contracts of adhesion. Under California law, a contract of adhesion is defined as a standardized contract, imposed upon the subscribing party without an opportunity to negotiate the terms. Cingular presented the customers with take-it-or-leave-it standardized contracts, which it had prepared, not allowing them to negotiate its terms and forcing customers who would not accept a class action waiver to not extend their Agreements with Cingular. In addition, compared to the individual class members, Cingular had substantially greater bargaining power as a large, sophisticated corporation, particularly since many class members faced termination fees and the costs of obtaining replacement services if they did not sign the Agreements with Cingular.

Second, the Court noted that Cingular Agreements occurred in a setting in which disputes between the contracting parties predictably involve small amounts of damages. Third, following the language in *Discover*, Shroyer's

complaint alleged expressly alleged that the party with the superior bargaining power carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money. Shroyer alleged that for the purpose of increasing profits, Cingular took the deliberate action of inducing thousands of AT&T customers to enter into Cingular Agreements by misrepresenting to customers that their services would be improved only if they would enter into contract extensions with Cingular.

The court also noted that its conclusion was similar to that reached by district judges in the Northern, Central and Southern Districts of California in at least ten other cases. See *Bradberry v. T-Mobile USA, Inc.*, No. 06-6567, 2007 U.S. Dist. LEXIS 34826 (N.D. Cal. Apr. 27, 2007); *Winig v. Cingular Wireless, LLC*, 06-4297, 2006 U.S. Dist. LEXIS 73137 (N.D. Cal. Sept. 27, 2006); *Hoffman v. Cingular Wireless, LLC*, No. 06-1021, 2006 U.S. Dist. LEXIS 79067 (S.D. Cal. Oct. 26, 2006); *Page v. Verisign, Inc.*, No. 06-0906 (S.D. Cal. Aug. 3, 2006); *Herrington v. Verisign, Inc.*, No. 1915 (S.D. Cal. Aug. 3, 2006); *Stern v. Cingular Wireless Corp.*, 453 F. Supp. 2d 1138 (C.D. Cal. July 24, 2006); *Janda v. T-Mobile, USA, Inc.*, No. 05-3729, 2006 U.S. Dist. LEXIS 15748 (N.D. Cal. Mar. 17, 2006); *Ford v. Verisign, Inc.*, No. 05-0819, 2006 U.S. Dist. LEXIS 88856 (Mar. 8, 2006); *Cervantes v. Pacific Bell Wireless*, No. 05-1469, 2006 U.S. Dist. LEXIS 89198 (S.D. Cal. Mar. 8, 2006); *Laster v. T-Mobile United States, Inc.*, 407 F. Supp. 2d 1181 (S.D. Cal. Nov. 30, 2005).

Employment Agreements: Gentry v Superior Court (No. S141502. Aug. 30, 2007)

Robert Gentry filed suit against Circuit City for violations of California's minimum wage and overtime laws. When he was hired, he was given an "Associate Issue Resolution Package" and a copy of Circuit City's "Dispute Resolution Rules and Procedures," pursuant to which employees are afforded various options, including arbitration, for resolving employment-related disputes. By electing arbitration, the employee agreed to "dismiss any civil action brought by him in contravention of the terms of the parties' agreement." The agreement to arbitrate also contained a class arbitration waiver, which provided: "The Arbitrator shall not consolidate claims of different Associates into one proceeding, nor shall the Arbitrator have the power to hear arbitration as a class action . . ." The arbitration agreement also contained several limitations on damages, recovery of attorney fees, and the statute of limitations making a potential recovery through arbitration less favorable to employees than what employees are provided under applicable statutes. The packet included a form that gave the employee 30 days to opt out of the arbitration agreement. Gentry did not opt out.

After providing a lengthy discussion about the benefits of class action litigation to resolve employment disputes, the Court held that the prohibition of classwide relief would undermine the vindication of employees' unwaivable statutory rights and would pose a serious obstacle to the enforcement of the state's overtime laws.

The Court also noted that "a federal district court recently concluded that an arbitration agreement with a class arbitration waiver was inconsistent with the minimum wage and overtime provisions of the Fair Labor Standards Act (FLSA). "In this case, the imposition of a waiver of class actions may effectively prevent . . . employees from seeking redress of FLSA violations. The class action provision thereby circumscribes the legal options of these employees, who may be unable to incur the expense of individually pursuing their claims. In this respect, the class action waiver is not only unfair to . . . employees, but also removes any incentive for [the employer] to avoid the type of conduct that might lead to class action litigation in the first instance. The class action clause is therefore substantively unconscionable. (*Skirchak v. Dynamics Research Corp., Inc.* (D.Mass. 2006) 432 F.Supp.2d 175, 181.)"

The Court specifically stated that it was not prohibiting class action waivers in every overtime case. But, the Court noted that,

> when it is alleged that an employer has systematically denied proper overtime pay to a class of employees and a class action is requested notwithstanding an arbitration agreement that contains a class arbitration waiver, the trial court must consider the factors discussed above: the modest size of the potential individual recovery, the potential for retaliation against members of the class, the fact that absent members of the class may be ill informed about their rights, and other real world obstacles to the vindication of class members' right to overtime pay through individual arbitration. If it concludes, based on these factors, that a class arbitration is likely to be a significantly more

> effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration, and finds that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations, it must invalidate the class arbitration waiver to ensure that these employees can "vindicate [their] unwaivable rights in an arbitration forum." The kind of inquiry a trial court must make is similar to the one it already makes to determine whether class actions are appropriate. "[T]rial courts are ideally situated to evaluate the efficiencies and practicalities of permitting group action . . . ." Class arbitration must still also meet the "community of interest" requirement for all class actions, consisting of three factors: "(1) predominant common questions of law or fact; (2) class representatives with claims or defenses typical of the class; and (3) class representatives who can adequately represent the class." (citations omitted)

The Court remanded the case with the following admonition,

> in cases like the present, the trial court would be comparing class arbitration with the individual arbitration methods the employer offers, rather than comparing individual with classwide litigation. We do not foreclose the possibility that there may be circumstances under which individual arbitrations may satisfactorily address the overtime claims of a class of similarly aggrieved employees, or that an employer may devise a system of individual arbitration that does not disadvantage employees in vindicating their rights under section 1194. But class arbitration waivers cannot, consistent with the strong public policy behind section 1194, be used to weaken or undermine the private enforcement of overtime pay legislation by placing formidable practical obstacles in the way of employees' prosecution of those claims.

The Future of Class Action Waivers in California

Although the California Supreme Court has stated in both the consumer and the employment context that it is not prohibiting class action waivers *per se*, it is clear that California is a very hostile environment for businesses seeking to enforce these provisions. That said, do class action waivers have any future in California? The answer is "they might," but businesses seeking to use such waivers will need to think hard about the nature of their business, the nature of their relationship with the consumers or employees who would challenge the waiver, the manner in which the waiver is offered to and accepted by the consumer or employee and the likely remedies that could be impacted by the waiver.

In the consumer context, class waivers may have a bit more viability. With the possible exception of claims brought under the California Consumer Legal Remedies Act, a consumer could be subject to a class action waiver if such is not procedurally or substantively unconscionable or, as was the case in *Discover*, the law of a more favorable jurisdiction can legitimately govern the relationship of the parties. Given the dollars at stake, there is little doubt that businesses will try to exploit the lack of a *per se* ban on class waivers, which will no doubt be countered by consumers seeking to close the door on the issue. In the end, there are still creative solutions that may promote fairness and equality for both consumers and businesses. For example, it would be interesting to see how a court would react if consumers were offered one price for a product or service if that product or service does not come with a class waiver as part of the agreement for the product or service and a lower price if the consumer opted to waive the right to a class action. Of course, it may cost the business a bit of money up front if consumers choose the latter, but those challenging the class waiver in this context should have a harder time of arguing the waiver is unconscionable, especially after the consumer enjoyed the benefits of his or her decision.

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Drafting Fair, Efficient and Enforceable Arbitration Agreements

best practices

situation

Arbitration provisions in standard consumer and employment contracts provide a simple and informal way to resolve relatively small disputes. Consumers and employees benefit from a quick, inexpensive and convenient resolution. The business achieves greater certainty and lower legal costs by reducing the risks from litigation and, in particular, lawyer-driven class action lawsuits that do little to benefit the putative clients.

in-house counsel challenge

Guided by the strong pro-arbitration policy of the Federal Arbitration Act, most courts enforce arbitration agreements containing class waivers. Some courts, however, have declined to enforce agreements to arbitrate on an individual basis. To maximize the odds of a class waiver being upheld, inside counsel must craft an arbitration agreement that courts will deem fair to consumers and employees.

approach adopted

Establish a simple pre-arbitration process to resolve most claims amicably. One approach is to create a Web site that provides consumers or employees with instructions on how to file a claim. A pre-arbitration notice procedure will increase the chances of resolving the dispute quickly and preserving the consumer or employee relationship.

Make arbitration affordable for customers/employees. If feasible, offer to pay the full costs of arbitration. Where claims are small, also consider incentive payments that increase potential recoveries for consumers and their attorneys.

Don't limit legal remedies. Courts deemed early arbitration agreements unfair because they limited the company's punitive or consequential damages, precluded recovery of attorneys' fees or had an unusually short statute of limitations.

Early arbitration clauses also required the claim to be brought in the company's home territory. For a small claim, that's impractical. Ensure that the location is convenient to the plaintiff.

Protect your company with a non-severability provision. If the court won't uphold individual arbitration, the provision will prevent the court from forcing you into high-risk class arbitration.

Finally, because state laws vary, establish a team of lawyers familiar with the laws to defend your arbitration clause regardless of where the dispute occurs.

measuring success

An arbitration provision is worth adopting to reduce dispute resolution costs. A successful arbitration provision is fair to all parties; is more likely to be enforced; enhances customer/employee relationships; and gradually lowers a company's litigation costs, particularly in the context of consumer and employment claims.

implementation steps

- Develop a pre-arbitration process to resolve claims amicably.
- Offer to pay costs of arbitration and financial incentives to ensure that the arbitration process is affordable.
- Make sure that the arbitration location is convenient to the plaintiff.
- Do not limit remedies available in arbitration such as punitive or consequential damages.
- Include a non-severability clause, which voids the entire arbitration agreement if a class arbitration prohibition is struck down.
- Rely on a team of lawyers capable of defending your arbitration agreement in any jurisdiction.

future issues to consider

The law governing the enforceability of arbitration agreements continues to evolve. While much of the action is taking place in the lower state and federal courts, the U.S. Supreme Court has taken an interest in the Federal Arbitration Act and whether it pre-empts state law rules that would deny enforcement of arbitration agreements. Businesses should keep an eye on future arbitration law developments.

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As members of Mayer Brown LLP's Litigation and Supreme Court and Appellate practice groups, Partner Evan M. Tager and Associate Archis A. Parasharami have extensive experience drafting arbitration agreements and defending their enforceability in courts throughout the country.

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California Appellate Court Invalidates Class-Arbitration Waiver in Employment Agreement

Areas of Interest

Consumer Litigation & Class Actions

Employment

Supreme Court & Appellate

United States

On March 10, 2009, a California appellate court held that an employee's agreement to arbitrate on an individual basis was unenforceable with respect to a plaintiff-employee who had filed a putative class-action lawsuit alleging the denial of meal and rest periods. *Franco v. Athens Disposal Co., Inc.*, case no. B203317. *Franco* is the latest in a string of decisions in which California state courts have declined to enforce class-arbitration waivers in the employment context. The decision is of interest to employers that use arbitration agreements with their California employees and, more broadly, to all businesses operating in California that use arbitration agreements.

In *Franco*, the Second District Court of Appeal relied heavily on *Gentry v. Superior Court*, 42 Cal.4th 443 (2007), in which the California Supreme Court held that class-arbitration waivers are unenforceable as a matter of California public policy when they would "undermine the vindication of unwaivable statutory rights"—there, the right to overtime pay under the Labor Code. *Franco* expanded *Gentry*'s reasoning in two ways.

First, the *Franco* court concluded that the right to meal and rest periods, governed by the California Labor Code and administrative Wage Orders issued under the Code, "cannot be waived." The court held that the class waiver in Franco's arbitration agreement was unenforceable under the factors identified in *Gentry* for determining whether "class arbitration is likely to be a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration." For example, the court found that the total potential damages for meal and rest period violations were likely to be too small for the case to be pursued as an individual claim. In addition, as in *Gentry*, the court found that the employees' possible fear of retaliation could deter them from suing their employer—even though the employer had instituted a non-retaliation policy. Also, the court concluded that, because some individuals might be unaware of their legal rights, class-wide notice would be more likely to inform former and current employees of their allegedly violated rights.

Second, while in *Gentry* the California Supreme Court had been careful to separate its "unwaivable statutory rights"/public policy analysis from its discussion of unconscionability, *Franco* appears to treat those issues as one and the same.

In addition to holding that the class arbitration waiver was invalid, the *Franco* court also held that the entire arbitration agreement was unenforceable because it prohibited an employee from acting as a private attorney general under the Labor Code Private Attorneys General Act of 2004—and thus from seeking civil penalties on behalf of other current and former employees. That restriction, the court held, "imped[ed] *Gentry*'s goal of" comprehensive enforcement of the statute.

Franco makes clear that state courts in California are continuing to refuse to enforce class arbitration

waivers in employment arbitration agreements. Moreover, *Franco* is not alone. On March 17, the Second District again refused to enforce an employment arbitration agreement that required individual rather than class arbitration. *Sanchez v. Western Pizza Enters., Inc.*, case no. B203961. Thus, employers that wish to use arbitration agreements in California should carefully consider both their litigation strategy in light of *Franco* (and *Gentry*) and examine both the substance and presentation of the arbitration clauses in their contracts.

For more information about the topics raised in this Client Alert, please contact Donald M. Falk, Daphne Hsu, Jerome M.J.F. Jauffret, John Nadolenco, Archis Parasharami and Bronwyn F. Pollock.

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Client Alert

MAYER • BROWN

March 23, 2009

California Appellate Court Again Strikes Down Class-Arbitration Waiver in Employment Agreement

Areas of Interest

Supreme Court & Appellate

Employment

Consumer Litigation & Class Actions

United States

On March 17, yet another California appellate court held that an employer could not enforce an employee's agreement to arbitrate employment disputes on an individual basis. The plaintiff in *Sanchez v. Western Pizza Enters., Inc.*, No. B203961, had filed a putative class-action lawsuit alleging that his employer did not adequately reimburse employees for driving expenses incurred in the performance of job duties; as a result, the plaintiff claimed, employees were paid less than the legal minimum wage. The decision is of interest to employers that use arbitration agreements with their California employees and, more broadly, to all businesses operating in California that use arbitration agreements.

In *Sanchez*, the Second District Court of Appeal relied heavily on *Gentry v. Superior Court*, 42 Cal.4th 443 (2007), in which the California Supreme Court held that class-arbitration waivers are unenforceable as a matter of California public policy when they would "undermine the vindication of unwaivable statutory rights"—in *Gentry*, the right to overtime pay under the California Labor Code. As one of a series of recent cases interpreting and applying *Gentry*, *Sanchez* is significant in several ways.

First, the *Sanchez* court concluded that a trial court's determination that a "class arbitration waiver is unenforceable under…*Gentry*" is reviewed for abuse of discretion because it "depends largely on consideration of the efficiencies and practicalities of permitting group action in the particular case." Second, the *Sanchez* court concluded that an employee's California statutory rights to be reimbursed for job expenses and to receive minimum wages are "unwaivable." The court held that the class waiver in Sanchez's arbitration agreement was unenforceable under the factors identified in *Gentry* for determining whether "a class arbitration waiver impermissibly interferes with unwaivable statutory rights." In particular, the court found that "any individual recovery of the difference between the amounts paid for reimbursement of delivery expenses and the amounts actually incurred is likely to be modest," as was "any individual recovery for the alleged failure to pay minimum wage as a result." In addition, as in *Gentry*, the court found that employees' possible fear of retaliation could deter them from suing their employer. Also, the court concluded that Sanchez had "presented evidence that most of the drivers are immigrants with limited English language skills who are likely to be unaware of their legal rights." The court held that, in light of its consideration of the first three *Gentry* factors, it did not have to consider the fourth factor—"other real world obstacles to the vindication of class members' rights…through individual arbitration."

Third, by contrast with the same court's recent decision in *Franco v. Athens Disposal Co., Inc.*, No. B203317, the *Sanchez* court separated its analysis of "unwaivable statutory rights" and public policy from its discussion of unconscionability. Under the latter analysis, the *Sanchez* court held that the entire arbitration agreement was unenforceable. The court acknowledged that the arbitration agreement did not distort the "presentation of the benefits of arbitration to the degree that was present in *Gentry*," and furthermore, that it did not limit the limitations periods, punitive damages, or availability of other

remedies. In addition, the contract expressly stated that arbitration "is not a mandatory condition of employment."

Nevertheless, the court found a degree of procedural unconscionability for two reasons. First, the court speculated that "the inequality in bargaining power between the low-wage employees and their employer makes it likely that the employees felt at least some pressure to sign the arbitration agreement." Second, the court noted that, although "the arbitration agreement suggests that there are multiple arbitrators to cho[o]se from," in reality "the designated arbitration provider includes only one arbitrator." As a result, the court concluded, "the arbitrator selection process [is] illusory and creates a significant risk" that the employer will be a "'repeat player' before the same arbitrator" and will therefore "reap a significant advantage." Having found both the class arbitration waiver and arbitrator selection clause substantively unconscionable, the court declined to sever the two clauses because "these provisions considered together indicate an effort to impose on an employee a forum with distinct advantages for the employer."

Sanchez makes clear that state courts in California are continuing to refuse to enforce class-arbitration waivers in employment agreements. Thus, employers that wish to use arbitration agreements in California should carefully consider both their litigation strategy in light of *Sanchez* (and *Gentry*) and examine both the substance and presentation of the arbitration clauses in their contracts.
For more information about the topics raised in this Client Alert, please contact Donald M. Falk, Rita Lomio, John Nadolenco, and Archis A. Parasharami.

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