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CLASS ARBITRATION

Arbitration provisions provide many advantages to businesses, but some companies have also begun to use them to prevent class actions. Courts are now struggling with ''second-generation'' arbitration clauses that are intended to prevent classwide arbitration, attorney Edward K.M. Bilich says.

While some observers worry that such clauses may sound a death knell for consumer class actions, Bilich argues that the reality is more complex. He also questions whether classwide arbitrations can adequately provide both the quick and inexpensive resolutions of arbitrations and the due process protections of class action law.

He predicts that courts will continue to review these contracts on a case by case basis, and that the U.S. Supreme Court is likely to weigh in again. If necessary, fairness may demand that Congress address class arbitration.

Consumer Arbitration: A Class Action Panacea?

BY EDWARD K.M. BILICH

In recent years, many businesses have begun putting arbitration provisions in their standard-form consumer contracts for goods and services. Some companies have adopted these provisions to take advantage of the benefits associated with arbitration—lower cost, more confidentiality, and greater speed and efficiency than traditional dispute resolution in the courts.[1] Many

[1] *See, e.g.*, Mark Fellows, ''The Same Result as in Court, More Efficiently: Comparing Arbitration and Court Litigation Outcomes,'' *Metropolitan Corporate Counsel* 32 (July 2006); *see also* Steven C. Bennett, *Arbitration: Essential Concepts* 6-8 (ALM Publishing 2002).

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businesses, however, have undoubtedly also adopted arbitration provisions for an additional purpose—to prevent plaintiffs' attorneys from aggregating consumer claims into powerful class actions, turning what would ordinarily be very small claims into a threat of devastating liability. Indeed, articles have touted arbitration provisions—and especially those that prohibit class treatment of claims in arbitration—as a way of defanging the plaintiffs' class action bar.[2]

Courts have struggled with the implications of small-claims consumer arbitration, and are now struggling with what this article will term ''second-generation'' consumer arbitration clauses, which purport to prohibit class arbitration of consumer disputes that are sent to arbitration. This article provides an overview of the issues and makes predictions about potential developments in the law.

The ''Extinct[ion]'' of Consumer Class Actions?

Some commentators have complained that the increasing use of arbitration clauses in standard consumer contracts will essentially eliminate the ability of the plaintiffs' bar to bring class actions in an effort to vindicate consumer rights and regulate business behavior. By forcing consumers to bring claims individually in arbitration instead of collectively in court, critics contend, arbitration clauses inhibit plaintiffs' attorneys from turning numerous complaints about small wrongs into something worth pursuing in court.[3] Writing of businesses' adoption of second-generation arbitration clauses that prohibit class claims in arbitration, one scholar recently argued that business interests ''are winning'' in their efforts to discourage consumer disputes ''because [companies] have developed a new set of tools powerful enough to imperil the very viability of class actions in many—actually most—areas of the law.''[4] This scholar believes that as a result of these second-generation arbitration clauses, ''with a handful of exceptions, class actions will soon be virtually extinct.''[5]

The reality is more complex. At the threshold, standard-form contracting does not govern every aspect of modern life. Numerous ''consumer'' situations simply are not susceptible to interposing a written contract, let alone an arbitration clause. But even granting that standard-form consumer contracts are widespread, and assuming that increasing numbers of those contracts will include some form of arbitration provision, courts will continue to struggle over the extent to which arbitration provisions are enforced—especially clauses that purport to prevent consumers from bringing class claims in arbitration.

The Enforcement Issue—Public Policy Meets Public Policy

The struggle over arbitration of consumer disputes pits two strong competing public policies against each other: arbitrability versus unconscionability. The Federal Arbitration Act (FAA) and its state counterparts were adopted in the early part of the last century to overcome judicial resistance to arbitration and to put arbitration provisions on a level footing with other contractual provisions. The notion was that if parties freely agree in their private arrangements to resolve disputes without recourse to the courts, then courts should honor those agreements.

Court resistance to arbitration continued throughout much of the last century. Beginning in the 1980s, however, the United States Supreme Court issued a string of decisions that created a strong federal presumption in favor of arbitration of disputes that were governed by contracts that included arbitration clauses.[6]

But arbitration is a creature of contract: If there is no agreement to arbitrate, a party cannot be forced to arbitrate. When assessing arbitration clauses in standard-form contracts, the relevant question is what the parties—and particularly the consumer—agreed to do. The doctrine that plaintiffs' counsel bring into play most often to oppose arbitration of consumer disputes is unconscionability, which generally asks whether a contract provision (i) was imposed upon one party that had no meaningful choice in the matter (procedural unconscionability) and (ii) unreasonably favors the other party (substantive unconscionability).

A standard-form consumer contract may be an adhesion contract, given to a consumer on a take-it-or-leave-it basis, and thus may be procedurally unconscionable. Businesses have addressed issues relating to procedural unconscionability, however, by making sure that their arbitration clauses are prominently displayed and clearly explain precisely what rights the parties are foregoing by agreeing in advance to arbitrate any disputes.

Furthermore, procedural unconscionability does not necessarily prevent enforcing an arbitration clause within a contract if the clause is written in a balanced manner that does not unreasonably favor the business over the consumer—the ''substantive'' question. In fact, the clear trend in the courts favors enforcing arbitration agreements in standard-form contracts, so long as those provisions are both evenhanded and clearly spelled out.

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Does that mean that class treatment of a vast array of small-damage consumer disputes will inevitably either wither away in arbitral tribunals, or die on the vine because attorneys will not bring potential class actions that could end up in arbitration? Not necessarily. The question instead becomes whether claims sent to arbitration can be arbitrated on a *class* basis. In other

[2] *See, e.g.*, Alan S. Kaplinsky & Mark J. Levin, ''Alternative to Litigation Attracting Consumer Financial Services Companies,'' 1 *Cons. Fin. Serv. L. Rep.* 1 (June 27, 1997).

[3] *See, e.g.*, Jean R. Sternlight, ''As Mandatory Binding Arbitration Meets the Class Action, Will the Class Action Survive?'' 42 *Wm. & Mary L. Rev.* 1 (2000); Myriam Gilles, ''Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action,'' 104 *Mich. L. Rev.* 373 (2005).

[4] Gilles, *supra*, at 375.

[5] *Id.*

[6] *See, e.g., Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1 (1983); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.*, 473 U.S. 614 (1985).

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words, can a ''class action'' essentially proceed before an arbitrator?

This question has occupied the courts for many years. Where an arbitration clause is silent on the issue of whether class claims are permitted, courts have split on whether to permit arbitration. The Supreme Court, however, dodged this issue in *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), ruling that the arbitrator (instead of the courts) should have determined whether a class arbitration was permitted because the contracts in those cases were ambiguous.[7]

But what if—as is the case with second-generation arbitration provisions—the clause expressly prohibits class claims? Most courts have enforced such provisions, including a North Carolina Court of Appeals decision just a few months ago.[8] Some other courts, however, have been struck by the apparent one-sided nature of such provisions, particularly where the consumer claims are so small that individuals would not pursue relief unless they can aggregate numerous claims in a single action. Applying the doctrine of unconscionability (or parallel doctrines concerning vindication of statutory rights), such courts have declined to enforce restrictions on class relief.[9]

For example, earlier this year, the United States Court of Appeals for the First Circuit ruled in *Kristian v. Comcast Corp.*, 446 F.3d 25 (1st Cir. 2006), that an arbitration provision frustrated the statutory purposes of federal and state antitrust laws if applied, as written, to prevent class treatment in arbitration of the small claims at issue. Severing that provision (and certain others) from the agreement, the First Circuit ordered arbitration.[10] In early August, the New Jersey Supreme Court ruled in *Muhammad v. County Bank of Rehobeth Beach*, No. A-39-05, 2006 WL 2273448 (N.J. Aug. 9, 2006), that a similar ''second-generation'' arbitration provision purporting to bar class arbitration was unconscionable and frustrated the statutory purposes of the New Jersey Consumer Fraud Act. And in early October, the Illinois Supreme Court, in *Kinkel v. Cingular Wireless LLC*, No. 100925 (Oct. 5, 2006), while recognizing that class-action waivers by themselves are not per se unconscionable, found an provision that barred class claims in the circumstances of that case was unconscionable and unenforceable:

> These circumstances include a contract of adhesion that requires the customer to arbitrate all claims, but does not reveal the cost of arbitration, and contains a liquidated damages clause that allegedly operates as an illegal penalty. These provisions operate together to create a situation where the cost of vindicating the claim is so high that the plaintiff's only reasonable, cost-effective means of obtaining a complete remedy is as either the representative or a member of a class.

As in *Kristian*, the *Muhammad* and *Kinkel* courts determined that the class-claims bars were severable, and ordered arbitration of the disputes.

At some point, the United States Supreme Court will be forced to step in and provide some guidance relating to ''second-generation'' consumer arbitration clauses.[11] Class-arbitration prohibition provisions are potentially powerful mechanisms for inhibiting consumer class claims, but only if they work as intended. Uncertainty breeds additional litigation. And if such provisions end up putting parties in a class arbitration despite the plain language in the contract, that may end up being the worst possible result for all concerned.

''Class Arbitrations''—A Nightmare Scenario?

In response to the Supreme Court's *Bazzle* decision and other rulings, major arbitration organizations in the United States have taken steps to accommodate the possibility of class arbitrations. Both the American Arbitration Association and JAMS have promulgated rules specifically designed to provide for class treatment of claims in arbitration.[12]

But ''class arbitration'' is virtually an oxymoron. If the purposes behind arbitration include keeping outcomes informal, confidential, expeditious, low-cost, and out of the courts, class arbitrations meet none of those goals.

Class actions generally require that class members be notified of the proceedings and have an opportunity to exclude themselves. In keeping with that notion, both the AAA and JAMS rules provide for notice and opt-out

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[7] As others have recently noted in these pages, the *Green Tree* decision is not a model of clarity. *E.g.,* David S. Clancy, ''Re-evaluating *Bazzle*: The Supreme Court's Celebrated 2003 Decision Says Much Less About Class Action Arbitration Than Many Assume,'' 7 *Class Action Litig. Report.* 649 (2006).

[8] *See, e.g.,* Martin C. Bryce Jr., ''Red State Versus Blue State: Surprisingly Most (But Not All) Courts In Both 'Red' And 'Blue' States Enforce Express Class Action Waivers In Consumer Arbitration Agreements,'' 59 *Consumer Fin. L. Q. Rep.* 222 (2005) (listing numerous federal and state decisions through 2005); *see also, e.g., Tillman v. Commercial Credit Loans Inc.*, 629 S.E.2d 865 (N.C. Ct. App. 2006).

[9] *See, e.g., Ting v. A T & T,* 319 F.3d 1126 (9th Cir. 2003); *Discover Bank v. Sup. Ct.*, 36 Cal. 4th 148 (2005); *Luna v. Household Fin. Corp. III,* 236 F. Supp. 2d 1166 (W.D. Wash. 2002); *Lozada v. Dale Baker Oldsmobile Inc.*, 91 F. Supp. 2d 1087 (W.D. Mich. 2000); *Powertel Inc. v. Bexley*, 743 So. 2d 570 (Fla. Dist. Ct. App. 1999); *W. Va. ex rel. Dunlap v. Berger*, 567 S.E.2d 265 (W. Va. 2002).

[10] After receiving the First Circuit decision, defendants withdrew their demand for arbitration, and that case is now proceeding in court upon plaintiffs' motion for class certification. See ''Courts Weigh in on Class Action Bans in Arbitration,'' 42 *Trial* 16, 18 (Sept. 2006).

[11] As noted, many decisions voiding class-arbitration prohibitions rest upon state law unconscionability, which is a ground recognized by the FAA for refusing to enforce an arbitration provision under certain circumstances. Nevertheless, to the extent state or federal courts may be applying a different—and stricter—standard of unconscionability to arbitration clauses than other contractual provisions, as some have alleged, this would raise an issue of FAA preemption susceptible to Supreme Court review. *See* Michael G. McGuinness & Adam J. Karr, ''California's 'Unique' Approach to Arbitration: Why This Road Less Traveled Will Make All the Difference on the Issue of Preemption Under the Federal Arbitration Act,'' 2005 *J. Disp. Reso.* 61 (arguing that California is discriminating against arbitration provisions); Jack Wilson, '' 'No-Class-Action Arbitration Clauses,' State-Law Unconscionability, and the Federal Arbitration Act: A Case for Federal Judicial Restraint and Congressional Action,'' 23 *Quinnipiac L. Rev.* 737, 792-836 (2004) (noting possibility of federal review of potential FAA preemption).

[12] *American Arbitration Association Supplemental Rules for Class Arbitration* (Oct. 8, 2003); *JAMS Class Action Procedures* (February 2005). Even the National Arbitration Forum, which has not adopted any rules specifically providing for class arbitration, has modified its joinder rules to provide for joinder of other parties in an arbitration not only ''as agreed to by the Parties'' but also ''as required by applicable law.''

rights. But such provisions cut against both informality and confidentiality. Indeed, the AAA rules provide that ordinary rules of confidentiality do not apply to class arbitrations.

Nagging issues of fairness remain—for defendants and class members alike.

Moreover, both AAA and JAMS rules provide for the possibility of repeated court intervention in the ongoing arbitration, which would drive up cost and slow down the proceedings. Perhaps such proceedings would still be more expeditious than traditional litigation, because discovery tends to be more limited in arbitration and arbitrators tend to rule on issues more expeditiously than courts. Nevertheless, nagging issues of fairness remain—for defendants and class members alike.

For example, much of the court intervention contemplated by both the AAA and JAMS rules is designed to ensure that courts have the opportunity to review threshold issues of whether the arbitration clause permits class proceedings (where there is an ambiguous provision) and, if so, whether the dispute is susceptible to class treatment. With respect to the decision whether to certify a class, the emerging consensus in federal court is that a *court* cannot certify a class action unless it is confident, after ''rigorous analysis,'' that the standards for class treatment have been satisfied.[13] If a class action is not manageable, and if it is not susceptible to adjudication based upon common facts and representative proofs adduced by class representatives, then it cannot be tried on a class basis consistent with due process.[14]

The AAA rules specifically provide a time period during which parties can challenge the arbitrator's clause-construction and class certification rulings in court. The JAMS rules provide that the arbitrator ''may'' set forth her determination in a manner that could be appealed to court (a so-called ''partial final award''), but does not have to do so. Even if these important early rulings are appealable to court, however, courts traditionally apply an extremely lenient standard of review to arbitral awards, with a presumption that the arbitrator's ruling is correct. Mere errors of fact or law generally will not suffice to overturn an arbitral award. As one court recently recognized, its ''review of [an] arbitrator's decision to certify an opt-out class is extremely limited''—indeed, '' 'among the narrowest [standards of review] known to the law.' ''[15] If a court reviewing an arbitral decision cannot meaningfully review the legal and factual merits of the arbitrator's class certification analysis, it cannot provide any assurance that class treatment of the dispute would meet basic notions of fundamental legal fairness.[16]

In the same vein, neither the AAA nor the JAMS rules provide for immediate review of decisions relating to whether and how an arbitration ''class'' receives notice of the dispute and the opportunity for exclusion. Notice and opt-out rights are critical in traditional class actions involving money damages because those rights ensure fundamental fairness for absent class members. If class members do not receive due process, they will not be bound by any decision, and any victory by a defendant would be unenforceable against the next putative class member who brings suit on the same claim. But if and when notice of a ''class'' arbitration is finally reviewed by a court after an arbitrator's decision, the background rule is that a deferential standard of review would again presumably apply. Such deference would provide no assurance that class members were afforded rights that they would receive as a matter of course in court proceedings, and thus no assurance that the ''class'' arbitration proceedings would be binding on absent class members.

Perhaps even more troubling, courts have traditionally been unwilling to find that private arbitrations constitute ''state action''—without which constitutional guarantees of due process do not attach.[17] A compelling case may be made for the argument that when courts are being called upon to confirm interlocutory decisions of arbitrators that purport to affect the property rights of hundreds, thousands, or even millions of people, state action is implicated.[18] But to the extent courts hesitate or refuse to apply traditional due-process protections to arbitrations, that makes class arbitrations an even more unsettling prospect.

Finally, there are other broad public policy issues at stake. Class actions serve public policy by having written, public decisions in cases of broad public importance. At bottom, do we really want such decisions rendered by arbitrators?

The Crystal Ball

Does all this mean either that consumer class actions will be killed off by arbitration provisions that expressly forbid class arbitration, or that class members and defendants will be doomed to participate in ''class'' arbitrations that cannot meet basic standards of due

[13] *See, e.g., Gen. Tel. Co. v. Falcon,* 457 U.S. 147, 161 (1982); *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 744 (5th Cir. 1996); *Andrews v. A T & T Co.*, 95 F.3d 1014, 1023 (11th Cir. 1996).

[14] *See, e.g., Amchem Prods. Inc. v. Windsor*, 521 U.S. 591, 621 (1996) (''Subdivisions (a) and (b) [of Rule 23] focus court attention on whether a proposed class has sufficient unity so that absent members can fairly be bound by decisions of class representatives.'').

[15] *Long John Silver's Restaurants Inc. v. Cole*, 409 F. Supp. 2d 682, 684 (D.S.C. 2006) (citation omitted).

[16] By contrast, although appellate courts review trial courts' class certification decisions for abuse of discretion, such abuse is found ''where the district court's decision rests upon a clearly erroneous finding of fact, an errant conclusion of law or an improper application of law to fact.'' *In re Prudential Ins. Co. of Am. Sales Practice Litig. Agent Actions,* 148 F.3d 283, 299 (3d Cir.1998). And contemporary federal appellate court decisions have not hesitated to apply a searching scrutiny to class certification decisions, even under an abuse of discretion standard, because of the critical fairness interests at stake. *See, e.g., Castano,* 84 F.3d 734; *In re Am. Med. Sys. Inc.*, 75 F.3d 1069 (6th Cir. 1996); *Szabo v. Bridgeport Machs. Inc.*, 249 F.3d 672 (7th Cir. 2001); *Broussard v. Meineke Discount Muffler Shops Inc.*, 155 F.3d 331 (4th Cir. 1998); *Andrews*, 95 F.3d 1014; *Newton v. Merrill, Lynch, Pierce, Fenner & Smith Inc.*, 259 F.3d 154 (3d Cir. 2001).

[17] *See generally* Maureen A. Weston, ''Universes Colliding: The Constitutional Implications of Arbitral Class Actions,'' 47 *Wm. & Mary L. Rev.* 1711, 1742 (2006).

[18] *Id.*

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process? The answer to both questions should be—and I expect will be—no. Courts will generally enforce arbitration provisions, but will struggle with second-generation arbitration clauses that purport to prohibit class actions in arbitration. It is unlikely that even second-generation provisions will entirely snuff out consumer class actions. As in the *Muhammad* and *Kinkel* cases, unconscionability law will likely continue to motivate some courts to avoid enforcement of such provisions. But the Supreme Court is likely going to have to provide guidance in this area.

To the extent ''class'' arbitrations become a prominent part of the legal landscape, courts will be forced to apply more rigorous scrutiny to decisions involving class treatment of claims in arbitration, and practitioners and arbitration sponsors will have to take a harder look at the rules purporting to govern class actions in arbitration. Basic fairness will demand it, and if such scrutiny is not forthcoming from the courts, litigants, and arbitral entities, congressional action will be required.

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