

## ARBITRATION OR ADJUDICATION?

### AN EXAMINATION OF ARBITRATION CLAUSES IN CONSUMER CONTRACTS

#### INTRODUCTION

Contractual agreements specifying arbitration procedures in place of traditional court-based conflict resolution have been utilized since the early 1900's. Originally used primarily in commercial contracts, arbitration clauses soon became commonplace, first in employment contracts and later in contracts involving transactions by consumers. In this paper, the author will analyze the viability of arbitration clauses as currently contained in many consumer contracts. Court decisions upholding or striking down such clauses will be explored, then the author will present a proposed modification to existing statutory law designed to prevent the exploitation of consumers while still allowing the appropriate application of arbitration clauses in consumer contracts.

#### STATUTORY HISTORY

Although arbitration clauses were frequently included in commercial contracts early in the previous century, such clauses were frequently overturned by courts hesitant to yield power within their jurisdiction to arbitrators.<sup>1</sup> Responding to the widespread invalidation of these clauses, and declaring that such arbitration clauses were in the public interest, Congress passed the Federal Arbitration Act, 9 U.S.C. §1, *et seq.* ("FAA") in 1925. The FAA provides that an arbitration agreement in a contract involving interstate commerce "shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>2</sup> Therefore the FAA provides the remedy of specific performance against parties refusing to honor arbitration clauses. The FAA also preempts state statutes that conflict with arbitration clauses<sup>3</sup> by singling out arbitration clauses from other contractual provisions for disfavored treatment.<sup>4</sup> The

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<sup>1</sup> Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 10 OHIO ST. J. ON DISP. RESOL. 267, 319 (1995). Most of the invalidated arbitration clauses were contained in commercial contracts between members of the same industry. In this context, all parties involved were familiar with the norms and customs that governed the industry, reducing the need for legal accountability. Under these circumstances arbitration clauses were inherently equitable and the need for judicial oversight was lessened.

<sup>2</sup> 9 U.S.C. § 2 (2001).

<sup>3</sup> Under the Erie doctrine, federal courts must decide cases according to state substantive law and federal procedural law. Because the FAA was "outcome determinative," the Supreme Court ruled in *Bernhardt v. Polygraphic Co. of America*, 350 U.S. 198 (1956), that the FAA was substantive rather than procedural. This was at odds with the understanding of Congress, which had intended the FAA to be procedural in nature. As a result the Supreme Court eventually ruled that the FAA applied as substantive law in state as well as federal courts (*Moses H. Cone Mem'l Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 20 (1983)) thereby greatly increasing the significance of the FAA's contractual approach.

FAA's contract law approach effectively holds that contract law must be applied to an agreement to arbitrate in exactly the same fashion as any other contractual clause.

In spite of the passage of the FAA, until the mid 1970's courts often refused to enforce agreements to arbitrate claims created by contractual agreement in such areas as employment discrimination, antitrust, and securities. Such courts often relied upon the grounds that it would violate "public policy" to enforce such agreements.<sup>5</sup> In the past twenty years, however, the courts have been more willing - even eager - to apply the FAA's strict contractual approach to arbitration clauses. As a result, arbitration clauses have become increasingly prevalent, not only in commercial contracts, but also in employment discrimination, antitrust, securities, and consumer agreements as well.

Proponents of arbitration clauses argue that such agreements reduce the cost of doing business by limiting corporate exposure to expensive class action suits and by ameliorating the excessive costs and delays of litigation. Consumer advocates, on the other hand, argue that such clauses limit the right of consumers to obtain appropriate relief and allow corporations to disadvantage consumers by unfairly limiting consumers' access to the judicial system where they would otherwise be able to enforce their rights. This paper will focus on arbitration clauses commonly found in consumer contracts. The author will examine the issues raised by consumer arbitration, review relevant case law, and propose an amendment to the FAA that would allow consumer arbitration clauses to be enforced while maintaining the rights of consumers who are presented with arbitration contracts.

#### CONSTRUCTION OF THE ARBITRATION CLAUSE

Typically, compulsory arbitration clauses are presented to customers as a part of a contract of adhesion. The consumer rarely, if ever, has the ability to negotiate substantive terms present in these contracts. As an example, AT&T has presented to its customers a "Consumer Services Agreement" containing the following wording:

This section provides for resolution of disputes through final and binding arbitration before a neutral arbitrator instead of in a court by a judge or a jury or through a class action. By enrolling in or paying for these services, you agree to the prices, charges, terms and conditions in this agreement. If you do not agree to the prices, charges, terms and conditions do not use the services and cancel the services immediately by calling AT&T.

AT&T also unilaterally limits its liability through the following language:

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<sup>4</sup> Volt Info. Services, Inc. v. Bd. of Trustees of the Leland Stanford Jr. Univ., 489 U.S. 468, 478 (1989).

<sup>5</sup> Stephen J. Ware, *Arbitration and Unconscionability After Doctor's Associates, Inc. v. Casarotto*, 31 WAKE FOREST L. REV. 1001, 1001 (1996) [hereinafter *Arbitration and Unconscionability*].

If our negligence causes damages to person or property, we will be liable for no more than the amount of direct damages to the person or property. For any other claim, we will not be liable for more than the amount of our charges for the services during the affected period. We will also not be liable for punitive, reliance or special damages. These limitations apply even if the damages were foreseeable or we were told they were possible, and they apply whether the claim is based on contract, tort, statute, fraud, misrepresentation, or any other legal or equitable theory.<sup>6</sup>

The AT&T contract also contains language requiring the consumer to pay certain arbitration expenses, specifying that the terms and conditions of the arbitration may be unilaterally changed by AT&T with no specified advance notice and with as little notification as a posting on the AT&T web site- and specifying the venue of the arbitration hearing.

### THE CASE IN FAVOR OF BINDING ARBITRATION

Businesses have turned to arbitration as a major strategy to prevent future losses and allow expenses to be accurately predicted. The Supreme Court has uncritically embraced the FAA and has held that the FAA mandates that such clauses be upheld even when the clause is present in a contract of adhesion, and even when the impartiality of the arbiter has been brought into question. For example, in a case involving securities arbitration, the Supreme Court rejected arguments that the clause should not be enforced because the arbitrator might not be neutral and might not rule according to applicable law. The court upheld binding arbitration, holding that there remained "sufficient" judicial review to assure that arbitrators would rule in accordance with statutory law.<sup>7</sup>

It is important to note that the initial impetus toward passage of the FAA was the commercial public's widespread dissatisfaction with the cost and delay associated with litigation.<sup>8</sup> It was thought, at the time of passage, that the FAA would "permit the courts to devote their energy to matters for which they are specially organized, and which they are better fitted to handle."<sup>9</sup> Modern courts have taken this reasoning as justification for the widespread validation of arbitration clauses.

Notwithstanding the apparent benefits to businesses, some consumers may also welcome the opportunity to arbitrate their disputes. Proponents of arbitration contend that arbitration is faster and less expensive than litigation, and thus the use of arbitration in simple collection actions should be beneficial to

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<sup>6</sup> Plaintiff's Brief at ¶ 21, 31, *Ting vs. AT&T*, 202 WL S7254 (N.D. Cal. 2002). In the *Ting* case, the mandatory arbitration clause presented to the plaintiff by defendant AT&T was struck down by the Northern District of California in its decision of January 2002.

<sup>7</sup> *Shearson/American Express v. McMahon*, 482 U.S. 220, 228-9 (1987). Section 10 of the FAA limits the authority of judicial review. Even this narrowly limited right of review, however, was held sufficient by the court to assure compliance with applicable statutory law.

<sup>8</sup> H.R. Rep. No. 96, at n. 2 (1924).

the consumer.<sup>10</sup> Interestingly, this approach is similar to the reasoning that first resulted in the passage of the FAA. In spite of the original intention to benefit both businesses and consumers, consumers have sometimes been frustrated by deficiencies in the arbitration process as it has actually been implemented, as outlined *infra*.

Businesses argue that enforced arbitration lowers costs in several ways. First, it does away with juries, therefore, reducing the likelihood of high damage awards against businesses. Second, it reduces the public exposure of a company to adverse publicity associated with a consumer action. Third, by encompassing a nationally uniform set of procedures, interstate businesses are spared the cost of adapting to differing procedural rules of the different state judicial systems. Fourth, the finality of arbitration sharply limits the cost of any appeals by limiting judicial review to that narrowly allowed under §10 of the FAA. Fifth, arbitration may deter consumer claims by requiring the consumer to pay all or part of the costs of arbitration, which are often greater than court filing fees. Sixth, arbitration may eliminate the possibility of class action suits against a business. Seventh, arbitration may limit the amount of discovery available to consumers; thereby reducing the amount of time and money the business must spend on the discovery process and making it harder for consumers to prove their claims.<sup>11</sup> These reductions in costs, in a perfectly competitive market, will at least be partially returned to consumers in the form of reduced prices.<sup>12</sup> In the perfect market, any actions that complicate the arbitration process (such as allowing broad discovery) will have the effect of increasing arbitration costs and, therefore, ultimately increasing the cost of goods to the consumer. The effects of changes in arbitration procedures in the real world are, however, more difficult to predict.

Finally, many other countries, including England, Germany, Italy and Switzerland, provide for mediation of commercial disputes with appropriate judicial oversight. Their experience with arbitration has been positive and may serve as a model for the greater use of arbitration in the United States.<sup>13</sup>

#### THE CASE AGAINST BINDING ARBITRATION

Critics of binding arbitration base their objections on several grounds. Foremost, they contend, these clauses should not be upheld because they are substantively unfair portions of contracts of adhesion

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<sup>9</sup> Anthony S. Fiotto, *Note: The United States Arbitration Act and Preliminary Injunctions: A New Interpretation of an Old Statute*, 66 B. U. L. REV. 1041, 1047 (1986).

<sup>10</sup> Dwight Golan, *Developments in Consumer Financial Services Litigation*, 43 BUS. LAW. 1081, 1091 (1988).

<sup>11</sup> Stephen J. Ware, *Paying the price of Progress: Judicial Regulation of Consumer Arbitration Agreements*, 2001 J. DISP. RESOL. 89, 90 (2001) [hereinafter *Paying the Price of Progress*].

<sup>12</sup> *Id.*

<sup>13</sup> *Arbitration and Unconscionability*, *supra* note 5, at 1004.

and therefore do not represent terms bargained-for on an equal basis by the parties. Indeed, because they are treated as contractual provisions under the FAA, arbitration agreements may be challenged under the same criteria as any other contractual provision. General contractual defenses such as unconscionability, frustration of purpose, fraud, duress, or surprise may defeat an arbitration clause. The characteristics of a contract of adhesion, it is argued, are inherently unfair to the disadvantaged party (almost always the consumer) and therefore should not be upheld as a matter of public policy.

First, many arbitration clauses contain language requiring consumers to advance or pay for a significant portion of arbitration expenses. Frequently these fees are far higher than the value of the plaintiff's claims.<sup>14</sup> Some arbitration clauses contain a provision requiring the loser in arbitration to pay the winning side's attorney and arbitration fees. Such language may expose a consumer to catastrophic debt in return for the chance to pursue what is a relatively minor claim. In Maryland, as well as in many other states, such a provision is contrary to the state Consumer Protection Act reflecting legislative policy, not against arbitration, but in favor of the protection of consumer rights.<sup>15</sup> Maryland's Consumer Protection Act, typical of many, embodies a one-way attorney's fee provision whereby prevailing consumer plaintiffs recover fees but prevailing business defendants do not.<sup>16</sup> Other statutory law may also be unilaterally rewritten by arbitration clauses. For example, statutes of limitation may be shortened and venue may be specified.<sup>17</sup>

Second, by prohibiting class actions, arbitration clauses prevent plaintiffs with small damages from aggregating those claims to make actions against businesses feasible.<sup>18</sup> Without the ability to consolidate multiple small claims, consumers may be left without a practical forum in which to adjudicate their complaints. Thus businesses are protected at the expense of consumers.

Third, arbitration clauses may deprive consumers of their statutory rights, such as those remedies available under Consumer Protection Acts or Truth in Lending Acts. Under the FAA an arbitrator is not

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<sup>14</sup> *Appellant's Reply Brief*, Wells v. Chevy Chase Bank, Md. Court of Appeals, No. C-99-000202, Trial Lawyers For Public Justice, at [http://www.tlpj.org/briefs/51246\\_2.htm](http://www.tlpj.org/briefs/51246_2.htm) (visited May 8, 2002).

<sup>15</sup> The U.S. Supreme Court has ruled that when statutory relief is awarded under a remedial statute it is usually awarded against the party violating statutory law. *Christiansburg Garment Co. v. EEOC*, 434 U.S. 412, 413 (1978). ("The 'loser pays all' rule would treat unsuccessful consumer plaintiffs as if they themselves were guilty of violating the Consumer Protection Act.").

<sup>16</sup> *Id.* at 418.

<sup>17</sup> There is no guarantee for the consumer that the specified venue will be convenient. Under the rules of the American Arbitration Association (which frequently govern), venue may be determined by the administrator. American Arbitration Association, Commercial Arbitration Rules §11 (1984)

<sup>18</sup> Generally arbitration agreements will contain a clause prohibiting class actions. Such class action waivers, when properly drafted, are most often upheld by the courts. *See* *Gras v. First Capital Corp.*, 346 N.J. Super. 42 (App. Div. 2001).

bound, as a court would be, to rule according to statutory and case law.<sup>19</sup> Thus the arbitration clause may act as an exculpatory clause insulating the business from its statutory obligation.<sup>20</sup> Such a result unfairly deprives the consumer of the protection intended by the legislature. Trade articles have even stated that arbitration may be used a “defense” for banks against consumer claims, and as a “powerful deterrent to class action lawsuits.”<sup>21</sup>

A fourth disadvantage of arbitration is that while serving the purpose of resolving conflict in an expeditious manner, it has no function in changing normative behaviors.<sup>22</sup> Because judicial decisions are both public<sup>23</sup> and precedent-setting, such decisions provide meaningful remedies not just to the parties involved, but also to all similarly situated persons. Under arbitration there is no incentive for businesses to modify their behavior to act in accordance with statutory law designed to protect consumers. As such, the legislative intent favoring consumer protection is frustrated.

#### PARTICULAR ISSUES

Numerous specific issues relating to the enforcement of arbitration clauses have been identified and determined by the courts. Many of these relate to elements of state contractual law. Such state law is important because a valid state law defense to a contract will nullify an arbitration clause. Under the *Erie* doctrine, federal courts will apply state law when deciding the validity of a term of the contract such as an arbitration clause. With this background in mind, representative decisions involving specific issues relating to the enforcement of arbitration clauses in consumer contracts will be reviewed.

#### Purpose and Jurisdiction

Case law in this area revolves heavily around the jurisdiction of courts over cases involving contracts containing arbitration clauses. Under the FAA, the presence of an enforceable arbitration provision means that a court does not possess jurisdiction over the case and must refer it to arbitration pursuant to §4 of the Act.<sup>24</sup> Therefore, the first question a court must address is whether the arbitration provision present in

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<sup>19</sup> *Wilko v. Swan*, 346 U.S. 427, 436 (1953). The Court did rule in this case, however, that it had the ability under FAA §10 to vacate an award if made in “manifest disregard” of the law.

<sup>20</sup> *Brief of Amicus Curiae*, Green Tree Financial Corp.- Alabama v. Larketta Randolph, No. 98-6055, *Brief to U.S. Court of Appeals for the 11th Cir. at 8.*, Trial lawyers for Public Justice, at <http://www.tlpj.org> (visited May 8, 2002).

<sup>21</sup> Alan Kaplinsky, *Excuse Me, But Who's The Predator: Banks Can Use Arbitration Clauses As A Defense*, BUS. LAW, May/June 1998, at 24, 25-26.

<sup>22</sup> Budnitz, *supra* note 1, at 342.

<sup>23</sup> Most arbitration agreements provide that the results of the arbitration proceeding remain confidential.

<sup>24</sup> *Harris v. Green Tree Fin. Corp.*, 183 F.3d 173, 179 (3d Cir. 1999).

a contract is enforceable because if it is, the court will lack jurisdiction.<sup>25</sup> The party seeking to avoid arbitration of a claim ostensibly subject to arbitration bears the burden of proving that the claim is not suited to arbitration.<sup>26</sup> Federal law will determine whether an issue governed by the FAA is referable to arbitration.<sup>27</sup> As noted in a securities litigation case, “arbitration is simply a matter of contract between the parties; it is a way to resolve those disputes, but only those disputes that the parties have agreed to [arbitrate].”<sup>28</sup> Applicable state law regarding contract defenses may be applied to invalidate arbitration agreements without contravening the FAA.<sup>29</sup> The court is obligated to refer questions regarding the enforceability of the terms of the underlying contract to the arbitrator once it is satisfied that the making of an agreement for arbitration or the failure to comply with the arbitration agreement is not an issue.<sup>30</sup>

The clause concerning arbitration is properly separated from the remainder of the contract. The validity of the arbitration clause itself must first be decided because if the arbitration clause is valid, then the court will refer the case to arbitration. In a case involving arbitration surrounding the nationalization of the banana industry in Nicaragua, the court held that it was improper to look into the validity of the contract as a whole instead of examining the agreement to arbitrate separately.<sup>31</sup> The *Standard Fruit* court utilized an approach wherein the agreement to arbitrate is examined independently from the remainder of the contract. If the agreement to arbitrate is held to be valid under, then the arbitrator, rather than the court, will decide issues relating to the remainder of the contract. In another case wherein a distributor filed a claim against a manufacturer for unfair competition and conspiracy, the court ruled these claims were within the scope of the broad arbitration clause present in the contract. Essential to this judgment was the court’s finding that the manufacturer’s attempts to destroy the distributor’s business via interference with the distributor’s dealer and customer base touched upon matters covered by the agreement.<sup>32</sup>

### Contractual Language

In order for an agreement to arbitrate to be enforceable, the exact language of the contract must be examined. The contract must state, on its face, such an agreement.<sup>33</sup> The Ninth Circuit reviewed a case

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<sup>25</sup> *Lloyd v. MBNA Am. Bank, N.A.*, No. 01-1752, 2002 LEXIS 1027, at \*1 (3d Cir. Jan. 7, 2002).

<sup>26</sup> *Id.* at \*4.

<sup>27</sup> *Harris*, 183 F.3d at 178.

<sup>28</sup> *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 943 (1995), as quoted in *Harris*, 183 F.3d at 178.

<sup>29</sup> *Doctors Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).

<sup>30</sup> *Harris*, 183 F.3d at 179.

<sup>31</sup> *Republic of Nicar. v. Standard Fruit Co.*, 937 F.2d 469 (9th Cir. 1991), *cert. denied* 503 U.S. 919 (1992).

<sup>32</sup> *Norcom Elecs. Corp. v. CIM USA Inc.*, 104 F. Supp. 2d 198 (S.D.N.Y. 2000).

<sup>33</sup> *Commercial Metals Co. v. Balfour, Guthrie & Co.*, 577 F.2d 264 (5th Cir. 1978).

involving a contract for the sale of a tank car of coconut oil. The contract contained a clause stating that the agreement was subject to the published rules of the National Institute of Oil Seed Products and one of the Institute's rules provided for arbitration of disputes. The buyer was not a member of the Institute and the contract made no specific mention of arbitration. The court held that the intention to arbitrate was not sufficiently expressed as to show that the buyer had relinquished the right to legal remedy.<sup>34</sup>

However, the arbitration agreement need not be specifically stated in the contract if stated in other documents forming the agreement between the parties. In such a case the court is justified in examining documents beyond the four corners of the contract itself. In a case involving a maritime charter, the court read the contract of carriage in conjunction with the bills of lading (which contained the arbitration clause) in order to determine that the arbitration clause was binding upon the parties.<sup>35</sup>

#### Cost of Arbitration

Arbitration costs, as contrasted with court costs, are frequently borne, at least partially, by the consumer. These costs may substantially exceed the recovery sought. The Supreme Court has stated, "[T]he existence of large arbitration costs could preclude a litigant...from effectively vindicating her federal statutory rights in the arbitral forum."<sup>36</sup> These costs may begin at \$500 per day and may exceed several thousand dollars.<sup>37</sup> In return for these costs, consumers receive no guarantee of an independent impartial judge, have no right to discovery and no guarantee of due process.

In a case involving an attempt by a telecommunications provider to specify binding arbitration, a federal court enjoined the arbitration clause finding, *inter alia*, that arbitration costs would exceed \$1800 per day.<sup>38</sup> Frequently the financial resources of a business far outstrip those available to an individual consumer.

In certain circumstances the consumer simply cannot pay the costs associated with arbitration because of reduced financial circumstances. In such cases, bankruptcy courts have held that the inability of a bankrupt consumer to pay arbitration costs due to the consumer's bankruptcy may effectively void an arbitration clause.<sup>39</sup>

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<sup>34</sup> Western Vegetable Oils Co. v. Southern Cotton Oil Co., 141 F.2d 235 (9th Cir. 1944).

<sup>35</sup> Midland Tar Distillers, Inc. v. M/T Lotos, 362 F. Supp. 1311 (S.D.N.Y. 1973).

<sup>36</sup> Green Tree Fin. Corp.- Alabama v. Randolph, 531 U.S. 79, 85 (2000).

<sup>37</sup> Knepp v. Credit Acceptance Corp. (In re Knepp), 229 B.R. 821, 821 (Bankr. N.D. Ala. 1999).

<sup>38</sup> Ting v. AT&T, 2002 WL 57254 (N.D. Cal. Jan. 15, 2002). The court relied upon the testimony of the American Arbitration Association in making this determination.

<sup>39</sup> Knepp, 229 B.R. at 837.

A clause that holds a party responsible for part or all of the cost of arbitration may also void an arbitration agreement when the underlying complaint is based upon a statutory cause of action that contains a provision for the award of attorney's fees should the party be successful. In a Title VII Illinois case in which the plaintiff had signed an employment agreement specifying binding arbitration, the Seventh Circuit ruled that the forfeiture of the statutory remedy of attorney's fees rendered the arbitration agreement unenforceable.<sup>40</sup> Stating that the availability of attorney's fees was "integral to the purposes of the statute,"<sup>41</sup> the court relied upon a Ninth Circuit case in which the court held that parties may "not be forced to surrender the statutorily mandated rights and benefits that Congress intended them to possess."<sup>42</sup> Therefore, in cases in which the right to attorney's fees is integral to the statute, the courts have been reluctant to sever the attorney's fees clause from the arbitration agreement and instead have held the entire agreement to be unenforceable.

### Duress

Duress has been held to be a ground for the revocation of an arbitration provision. In a case involving injury to two maintenance workers, the court refused to uphold an arbitration agreement when it was shown that the workers involved were pressured to sign an agreement in spite of the fact that neither worker could speak or read English, that the contracts they signed were in English, and that they were not given translations of the agreements.<sup>43</sup>

### Fraud

An arbitration clause is not enforceable if the inclusion of the clause was based upon fraud or coercion. However, a dispute involving fraud in the transaction does not render a non-fraudulent arbitration clause unenforceable.<sup>44</sup> In order to invalidate an arbitration clause, the fraud must relate specifically to the arbitration clause and not to the contract generally. In a securities case where it was alleged that the signatures on the contract were forged, the court held that the signatures related to the arbitration clause as well as the contract as a whole. Therefore, the court ruled, the resulting arbitration clause should not be upheld and the matter decided by the court rather than by an arbitrator.<sup>45</sup> In a contract between tool

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<sup>40</sup> McCaskill v. SCI Mgmt. Corp., No. 00-C-1543, 2002 (7th Cir. April 4, 2002).

<sup>41</sup> *Id.*

<sup>42</sup> Graham Oil Co. v. ARCO Products Co., 43 F.3d 1244, 1248 (9th Cir. 1994).

<sup>43</sup> Prevot v. Phillips Petroleum Co, 133 F. Supp. 2d 937 (S.D. Tex. 2001).

<sup>44</sup> Scherk v. Alberto Culver Co., 417 U.S. 506 (1974).

<sup>45</sup> Dougherty v. Mieczkowski, 661 F. Supp. 267 (D. Del. 1987).

distributors and franchisees, however, it was argued that the franchisees had been fraudulently induced to enter into a franchise agreement and termination agreement containing an arbitration clause. There the court ruled that the arbitration clause applied and that an exception to the FAA would only arise if the fraud induced the arbitration clause specifically and not the agreement as a whole.<sup>46</sup>

### Illegality of Contract

An “illegal” contract is a contract whose enforcement would violate public policy. The argument that a different part of the underlying contract is illegal does not nullify an agreement to arbitrate. In a case involving arbitration relating to alleged irregularities in a shipment of wool, the court held that illegality involving part of a contract did not invalidate an agreement to arbitrate.<sup>47</sup> Similarly, arbitration agreements contained in a “Customer’s and Standard Option Agreement” were upheld notwithstanding the consumer’s argument that the contract was an illegal adhesion contract. The court in this case noted that that deference would be given to the arbitration clause because there was “nothing explicitly or inherently unfair or oppressive about arbitration clauses.”<sup>48</sup> In another case the court held that notwithstanding allegations that one signature to an arbitration agreement was forged and the other signature was obtained by undue influence, the FAA did not permit arbitration to be stayed pending the determination of the validity of the contract itself.<sup>49</sup>

### Lack of Mutuality

Mutuality is commonly argued as a contractual defense to arbitration clauses. A typical arbitration clause against which the mutuality defense is invoked calls for the consumer to be bound by arbitration but allows the business to adjudicate certain specified claims in court. Courts, however, have largely dispensed with the requirement of reciprocal promises provided a contract is supported by sufficient consideration.<sup>50</sup> In a case involving a scheme in which a finance company solicited homeowners for improvements that were contracted for and financed through high-rate second mortgages,<sup>51</sup> the court held the arbitration clause in the standardized finance contract to be valid in spite of the plaintiff’s claim of lack of mutuality. The court

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<sup>46</sup> *Newton v. Snap-On Tools Corp.*, 783 F. Supp. 1019 (E.D. Ky. 1991).

<sup>47</sup> *Robert Lawrence Co. v. Devonshire Fabrics, Inc.*, 271 F.2d 402 (2<sup>nd</sup> Cir. 1959).

<sup>48</sup> *Aronson v. Dean Witter Reynolds, Inc.* 675 F. Supp. 1324 (S.D. Fla. 1987).

<sup>49</sup> *Paramore v. Inter-regional Fin. Group Leasing Co.*, 68 N.C. App. 659, 316 S.E.2d 90 (1984).

<sup>50</sup> RESTATEMENT (SECOND) OF CONTRACTS § 79 (1981).

<sup>51</sup> *Harris*, 183 F.3d at 180. The repairs performed were often of low quality. When the homeowners attempted to bring suit against the finance company they were blocked by the finance company’s invocation of the arbitration agreement in the contract.

noted that mutuality was not a contractual requirement and that “mutuality of obligation” was not required provided the underlying contract was supported by adequate consideration.<sup>52</sup> However, the consideration analysis offered by the court ignores the alternative (and more appropriate) assertion, that lack of mutuality demonstrates the unconscionability of the associated arbitration clause rather than standing alone as a ground for contractual rescission. In a similar home improvement financing case where the arbitration clause was “as broad... as it is possible to draft” the court never reached the mutuality argument, holding instead that since the agreement to arbitrate was valid the arbitrator, rather than the court, would decide the mutuality argument.<sup>53</sup>

Recently however, the Ninth Circuit has held in two cases that a lack of mutuality may void an otherwise enforceable arbitration clause.<sup>54</sup> Both of these cases involved contracts wherein a business reserved all its remedies while at the same time restricting the consumer to filing claims in arbitration. Whether this trend will expand beyond the Ninth Circuit remains to be seen.

#### Inconvenient Forum

Case law relating to inconvenience of the arbitral forum as a reason to void an arbitration clause yields mixed results. In an agreement stipulating arbitration in Belgium, an American company was bound to that forum notwithstanding the American company’s argument that such a forum was unreasonable given the defendant’s economic dominance in Belgium, and the inconvenience and expense incurred by the American company arbitrating in a forum that was both remote and foreign in language.<sup>55</sup> However, in a case wherein an arbitration clause in a contract for the shipment of an automobile limited venue to New York, the clause was held unconscionable and, as such, invalid.<sup>56</sup>

The courts of Virginia have subsequently followed the later approach. In a case in which a service contract was sold to a consumer in Virginia but specified arbitration in Los Angeles, the arbitration clause was held to be unenforceable.<sup>57</sup>

#### Limitations on Class Action Suits

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<sup>52</sup> *Id.*

<sup>53</sup> Dorsey v. H.C.P. Sales & Greentree Fin. Servicing Corp., 46 F. Supp. 2d 804 (N.D. Ill. 1999).

<sup>54</sup> Circuit City Stores, Inc. v. Adams, 2002 LEXIS 1686 (9th Cir. Feb. 4, 2002); Ticknor v. Choice Hotels International, Inc., 165 F.3d 931 (9th Cir. 2001).

<sup>55</sup> Sam Reisfeld & Son Imp. Co. v. S.A. Eteco, 530 F.2d 679 (5th Cir. 1976).

<sup>56</sup> Miller v. AAACon Auto Transp., 434 F. Supp. 40 (S.D. Fla. 1977), *aff’d without opinion*, 614 F.2d 292 (5th Cir. Fla. 1980), *reh’g denied*, 616 F.2d 568 (5th Cir. Fla. 1980), *cert. denied*, 449 U.S. 918 (1980).

<sup>57</sup> Philyaw v. Platinum Enterprises, Inc., 2001 LEXIS 10 (Va. Cir. Ct. Jan 9, 2001).

In a New Jersey case involving consumer loan agreements, the plaintiffs argued that arbitration clauses that precluded class actions by the plaintiffs contravened public policy and were thus unenforceable. The court found that there existed a recent trend favoring contractual provisions requiring resolution of claims between parties on an individual rather than a collective basis and, therefore, rejected the plaintiff's argument and upheld the arbitration provision.<sup>58</sup> In another case, the federal courts upheld an arbitration provision that precluded class action suits in claims based on the Truth in Lending Act. The court held that "Congress did not expressly favor class action litigation over arbitration as a method of solving Truth in Lending claims."<sup>59</sup> This last case is particularly significant because the court assumed for purposes of the decision that the parties were in "distinctly different bargaining positions." The court stated that in the absence of legislative mandates or overriding public policies, arbitration was an "appropriate forum."<sup>60</sup> Noting that there was no cohesive precedent favoring class actions as a preferred remedy, the court held that arbitration was an appropriate, if not favored, forum.

#### Unconscionability

Unconscionability is the most frequently cited reason for holding arbitration clauses to be unenforceable. Unconscionability may be either procedural or substantive, or, more commonly, both. Substantive unconscionability refers to contract terms that are "unreasonably favorable" to one side.<sup>61</sup> Procedural unconscionability deals with the process of contract formation rather than the specific terms of the contract. It encompasses "not only the employment of sharp practices and the use of fine print and convoluted language, but a lack of understanding and an inequality of bargaining power."<sup>62</sup> Substantive unconscionability is case specific and difficult to generalize. Examples of substantive unconscionability include, but are not limited to, the specification of non-neutral arbitrators, restrictions on arbitable claims, restrictions on remedies, and the unilateral imposition of a forum distant to the consumer, thus deterring arbitration. Most state courts require a showing of both substantive and procedural unconscionability before granting relief. However a strong showing of one form of unconscionability may mitigate a weak showing of the other. For example a showing of the complete absence of a party's ability to understand the terms of a contract may result in relief against a substantively fair arbitration clause.<sup>63</sup>

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<sup>58</sup> *Gras v. First Capital Corp.*, 123 N.J. Super. 456 (App. Div. 2001).

<sup>59</sup> *Sagal v. First USA Bank, N.A.*, 69 F. Supp. 2d 627 (3d Cir. 1999).

<sup>60</sup> *Id.*

<sup>61</sup> E. ALLAN FARNSWORTH, *CONTRACTS* §4.28 (2nd Ed. 1990).

<sup>62</sup> *Id.*

<sup>63</sup> *Arbitration and Unconscionability, supra*, note 5 at 1030.

The finding of unconscionability requires a two-fold determination: that the terms of the contract are both unreasonably favorable to the drafter and that there is no meaningful choice on the part of the other party regarding acceptance of the provisions.<sup>64</sup> Form contracts have been upheld by the Supreme Court as enforceable even when entered into by parties of differing bargaining power so long as the terms are not substantively unconscionable. In a case involving a forum selection clause present in the “fine print” of a cruise ship ticket, the court held that “benign” clauses, such as a forum selection clause, would be enforced, “[e]ven when they are not the product of negotiation and are drafted by one party with superior bargaining power.”<sup>65</sup>

In a case where it was alleged that the arbitration clause was “buried in boilerplate,” the court nevertheless upheld the arbitration clause, holding that the language was “clear and unambiguous” and that the agreement had been freely assented to.<sup>66</sup> The federal courts have been loath to hold boilerplate language requiring arbitration to be unenforceable given the strong presumption in favor of arbitration propounded by the FAA. The federal courts have also extended this presumption in favor of arbitration beyond the commercial context and into the consumer arena. In a case where a boilerplate arbitration agreement on the reverse side of a contract to provide pest control services was upheld, the court stated, “language that is clear and unambiguous must be enforced.”<sup>67</sup> In a case decided by the Supreme Court, it was held that an arbitration clause printed in small type (rather than in “underlined capital letters on the first page of the contract,” as required by a Montana statute) was nevertheless enforceable. Because the FAA places arbitration clauses on the same footing as other contractual terms the state could not require arbitration clauses to be singled out for special treatment such as requiring distinctive typography.<sup>68</sup> Recently courts have become more willing to entertain challenges against boilerplate arbitration contracts. In a recent North Carolina case, an arbitration clause included in consent for medical treatment was held unenforceable on the grounds of procedural unconscionability.<sup>69</sup>

Substantive unconscionability on its own has also generally been held not to invalidate arbitration agreements. The mere presence of a contract of adhesion does not automatically void a contract and inequality in bargaining power is not, on its own, a valid basis on which to invalidate an arbitration

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<sup>64</sup> *Bensalem Township v. International Surplus Lines Ins. Co.*, 38 F.3d 1303, 1312 (3d Cir. 1994).

<sup>65</sup> *Shute v. Carnival Cruise Lines*, 499 U.S. 585 (1991).

<sup>66</sup> *Harris*, 183 F.3d at 182.

<sup>67</sup> *Troshak v. Terminix International, L.P.*, No. 98-1727, 1998 LEXIS 9890 (E.D. Pa., 1998).

<sup>68</sup> *Casarotto*, 517 U.S. at 684

<sup>69</sup> *Milon v. Duke Univ.*, No. 549A01 (N.C., 2002).

agreement.<sup>70</sup> In *Gilmer*, the court enforced a securities firm employee's agreement to arbitrate even though every securities firm required such an agreement as a condition of employment. Although Justice Stevens' dissent raised "concern about the inequality of bargaining power between an entire industry, on one hand, and an...individual employee on the other," the majority held that mere inequality of bargaining power was not sufficient to hold that arbitration agreements are never enforceable.<sup>71</sup>

#### Relationship to The Magnuson-Moss Warranty Act

The Magnuson-Moss Warranty Act ("Act"), 15 U.S.C.S. §§2301-2312, provides standards for consumer warranties and preserves for consumers the right to bring suit for the breach of written or implied warranties. The Act may therefore be in conflict with arbitration clauses in consumer contracts that restrict the right of consumers to bring suit under a broad range of circumstances. Early decisions of the courts deferred judgment on the question of whether the FAA superseded the Act when a warranty specified arbitration. For example, in a case involving defects in a mobile home, the Eleventh Circuit held that the failure to include the arbitration clause in the warranty itself violated the Act and voided the arbitration clause present in the sales contract.<sup>72</sup> However the *Cunningham* court reserved decision on the broader question, specifically stating, "[w]e do not decide whether Magnuson-Moss makes arbitration agreements unenforceable as to all Magnuson-Moss claims."<sup>73</sup> *Cunningham* was followed by the Middle District Court of Alabama in a similar case also involving warranty issues and mobile homes.<sup>74</sup> However, in another recently decided case involving a mobile home sale, the Mississippi Supreme Court held that the Magnuson-Moss Act superseded the FAA because the Act had been enacted more recently and was more specific than the FAA.<sup>75</sup> The *Parkerson* court followed the Eleventh Circuit's holding in *Wilson v. Waverlee Homes, Inc.*<sup>76</sup> wherein after a "meticulous analysis" of the history of the Act the court held that "it was Congress' intent that

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<sup>70</sup> *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 33 (1991).

<sup>71</sup> *Id.* at 43. (Stevens, J. dissenting)

<sup>72</sup> *Cunningham v. Fleetwood Homes of Georgia, Inc.*, 253 F.3d 611 (11th Cir. 2001).

<sup>73</sup> *Id.* at 623.

<sup>74</sup> *Adkins v. Palm Harbor Homes, Inc.*, 157 F. Supp. 2d 1256 (M.D. Ala. 2001).

<sup>75</sup> *Parkerson v. Smith*, No. 2000-CA-00549-SCT, 2002 MISS LEXIS 91 (Miss. March 7, 2002). It was noted that the language of the Act clearly indicated that by enacting it, Congress intended to preserve for consumers the right to bring suit for breach of written or implied warranties. The Mississippi Court cited, *HCSC Laundry v. United States*, 450 U.S. 1, 6 (1981) in which it was held that "Where statutory provisions are in irreconcilable conflict, the more recently enacted and more specific statute controls over an earlier and more general statute.

<sup>76</sup> *Wilson v. Waverlee Homes, Inc.*, 954 F. Supp. 1530 (M.D. Ala. 1997) aff'd 127 F.3d 40 (11th Cir. 1997).

any non-judicial dispute resolution procedures would be nonbinding, and consumers would always retain the right of final access to court.”<sup>77</sup>

### TRANSACTION COSTS

Proponents of the economic theory of law argue that the law should allocate the resources of society so as to extract the maximum benefit from these resources.<sup>78</sup> Judge Posner is perhaps the best-known advocate of this philosophy. Advocates of consumer arbitration often argue that this approach makes sense because it lowers transaction costs as compared to litigation. However, from a societal standpoint, the cost of an individual piece of litigation to the parties is less important than the costs to society as a whole. In addition to direct administration costs, there are many other monetary and non-monetary costs generated in other parts of the arbitral system.<sup>79</sup> Under narrowly conceived economic theory these costs are improperly left unconsidered. These costs include the following: administration and processing costs (the direct cost of handling the dispute), disorder costs (the cost of a dissatisfied citizenry), enmity costs (the costs engendered by increased anxiety as a result of the social interactions between individuals with differing lifestyles and values), disparity costs (costs associated with resentment between “haves” and “have nots”), disaffection costs (costs related to the dissatisfaction with social institutions) and oppression costs (the costs reflecting prejudice against certain groups).<sup>80</sup> A fundamental goal of process selection<sup>81</sup> should be the minimization not only of the administrative costs of an individual case, but the overall costs, tangible and intangible, of a given class of disputes. This calculus extends much beyond the Posnerian administrative cost. Indeed, it may be argued that non-monetary costs should be weighed differently than monetary costs because such costs weigh more heavily on the human spirit.

In addition to the costs enumerated above, consumers in arbitration procedures incur information costs that far exceed the information costs borne by their commercial adversaries and, thus, there is market failure that impairs efficiency. A typical consumer has little prior knowledge of the arbitration process or of specific avenues of arbitration. It has been said that “advantages accrue to the ‘repeat players’ [in

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<sup>77</sup> Parkerson, 2002 MISS LEXIS 91 at 11, quoting Wilson at 1538.

<sup>78</sup> Robert A. Baruch Bush, *Dispute Resolution Alternatives and the Goals of Civil Justice: Jurisdictional Principles for Process Choice*, 1984 WIS. L. REV. 893, 908 (1984) [hereinafter *Goals of Civil Justice*].

<sup>79</sup> *Id.* at 929.

<sup>80</sup> *Id.* at 935.

<sup>81</sup> Process selection is the decision as to what particular process (adjudication, arbitration, mediation) to employ to resolve a particular conflict or class of conflicts.

arbitration].”<sup>82</sup> This is because the “repeat players,” who are generally the companies in this context, are advantaged, either consciously or unconsciously, by arbitrators who are eager to retain the companies who hire them. Thus, even an arbitration clause allowing the “mutual” selection of an arbitrator rings hollow, as the information costs to the consumer to obtain the information necessary to choose a fair arbitrator is prohibitive. Even if the consumer is able to obtain this information it may be extremely difficult for her to find an arbitrator who is truly objective. The state legislature in California has recognized this problem and has recently introduced legislation “reforming” the arbitration industry by, among other things, ending financial conflicts between arbitration providers and corporate defendants, removing malpractice immunity from arbitrators, and banning mandatory binding arbitration in certain types of contracts (employment and health).<sup>83</sup> The California proposal also seeks to preclude arbitrators from engaging in “repeat player” business, recognizing that such conduct results in an appearance of impropriety.

Another unintended effect of widespread arbitration is that the unpublished nature of arbitration decisions does nothing to provide guidance to future parties as to the legality of future conduct. The extra cost involved in constantly reestablishing standards of normative conduct is not taken into account in the classical determination of transaction costs. Indeed, the secret nature of arbitration decisions does nothing to encourage “bad actors” to mend their ways. The incentive, rather, is for a merchant who employs questionable practices to continue those practices as the worst that will happen under arbitration is for her to be put where she would have been had she not acted improperly in the first place.

#### UNDER WHAT CIRCUMSTANCES SHOULD MANDATORY ARBITRATION AGREEMENTS IN CONSUMER CONTRACTS BE ENFORCED?

The decision to enforce an arbitration agreement included as part of a typical, standard pre-printed consumer contract is a difficult one for the court. The enforcement of such a contract deprives the consumer of one of the basic fundamental rights guaranteed in the constitution: the right to a jury trial. Such rights should not easily be abridged. A powerful party must not be permitted to block a weaker party’s access to the courts. Justice Hugo Black stated, “[u]nder our constitutional system courts stand against any winds that blow as havens of refuge for those who might otherwise suffer because they are helpless, weak,

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<sup>82</sup> Jeremy Senderowicz, *Consumer Arbitration and Freedom to Contract: A Proposal to Facilitate Consumers’ Informed Consent to Arbitration Clauses in Form Contracts*, 32 COLUM. J.L. & SOC. PROBS. 275, 278 (1999) [hereinafter *Informed Consent to Arbitration Clauses*].

<sup>83</sup> Kevin Livingston, *Taking On Arbitration*, at <http://www.law.com/regionals/ca/stories/edit0312a.shtml> (Mar. 12, 2002).

outnumbered or because they are non-conforming victims of prejudice and public excitement.”<sup>84</sup> Although commercial interests must also be protected, companies are frequently in a superior position in terms of bargaining power and access to legal expertise. If we are to follow Justice Black’s admonition, courts should make special efforts to protect the weaker consumers, particularly when general state law does so and the arbitration process serves as an end run around those protections.

It is also important to review the history of the Federal Arbitration Act. As originally passed it was developed to permit merchants to mutually negotiate a method to resolve disputes in a non-judicial forum. The FAA was originally designed to apply to sophisticated parties of equal bargaining power. Over the years, however, the courts have expanded the reach of the FAA far beyond this sphere. Courts must decide if the statutory presumption in favor of arbitration is appropriately implemented when one party to a contract is an unsophisticated consumer and the agreement itself is buried in a boilerplate contract of adhesion. As the case law cited above indicates, courts have more often than not upheld challenges to arbitration brought under the FAA. Under circumstances involving parties of markedly disparate resources, such holdings may not be equitable.

Consumer contracts requiring arbitration have become widespread, and in certain types of transactions, entire segments of the market for certain goods may become closed to a party seeking to preserve her constitutional rights to have her complaints adjudicated by the courts. These consumers, when agreeing to arbitration, are waiving these rights; not in a knowing, willful, and voluntary fashion, but rather in a coerced fashion, as a pre-condition to receiving basic goods and services. These terms are not truly negotiated for by the buyer, but instead are presented in a “take it or leave it” fashion by an entire industry. Rather than being negotiated, these terms are non-negotiable. Form contracts serve an important purpose in modern commerce and it would be unreasonable to require a merchant to negotiate a contract with each and every consumer.<sup>85</sup> However the facilitation of commerce must be tempered by the need to insure justice for all parties.

Although arbitration may be inoffensive when applied as originally intended, it has become increasingly omnipresent and even sinister in its unbridled application to consumer contracts. Proponents of arbitration argue that the direct transaction costs of arbitration are lower than the costs of traditional litigation. They ignore the associated monetary, informational and societal costs of arbitration and the unavailability of the class action remedy that may leave a disgruntled consumer possessing a small claim with no reasonable forum in which to seek remedy, and may swamp an otherwise buoyant dispute resolution

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<sup>84</sup> *Chambers v. Florida*, 309 U.S. 227, 241 (1940).

process in a tidal wave of transaction costs. Inherent in the decision to employ arbitration clauses in consumer contracts is an unavoidable tension between corporate profitability (and the theoretical argument that minimizing corporate costs of doing business reduces the cost of goods and services to society) on one side versus the detriment to the individual consumer as measured by her involuntary waiver of the otherwise available remedies of the class action, treble damages and the availability of the established court system to redress her grievances on the other. This tension is not easily overcome.

As a way around this dilemma, Jeremy Senderowicz of Columbia University has advocated an amendment to the FAA aimed at “ensuring the true consent by consumers to arbitration clauses.”<sup>86</sup> His proposal is to require that any arbitration clause present in a consumer contract be accompanied by a detailed explanation of the procedural differences between arbitration and court-based conflict resolution, along with an explanation to the consumer of the rights she is signing away. He would also forbid a merchant offering a contract to a non-merchant from conditioning its services upon the presence of an arbitration clause in the contract.<sup>87</sup> While this modification seeks to “reconfigure the bargaining dynamics between merchant and customer”<sup>88</sup>, this proposal provides no protection against a merchant who charges a confiscatory premium in return for the consumer’s decision to retain the privilege of adjudicating a dispute in a court of law rather than before an arbitrator. While the goal of reestablishing a balance between the merchant and her customer is laudable, in practice this proposal is likely to lead to even greater costs.

In light of the above shortcomings, it is this author’s opinion that arbitration clauses in consumer contracts should, as provided for under the FAA, continue to be judged under the same standard as other contractual provisions. Just as the FAA proscribes arbitration clauses from being unfairly disfavored, it similarly should be understood to preclude the unfairly favorable treatment of such clauses. The rights of consumers must be protected as intended by state legislatures, which may have enacted consumer protection statutes. The FAA should not be used as a shield by merchants against consumer protection statutes.

This may be accomplished through the use of legislation limiting the rights of merchants to contractually abrogate important consumer rights and remedies, including the right to pursue a class action, the right to affordable access to justice, the right to statutorily authorized remedies and the right to recover punitive and treble damages. Under the author’s proposal, it would be illegal for any contract to limit the

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<sup>85</sup> Knepp, 229 B.R. at 838.

<sup>86</sup> *Informed Consent to Arbitration Clauses*, *supra* note 82, at 278.

<sup>87</sup> *Id.* at 302. The merchant would be allowed to charge an unspecified premium for the exclusion of the arbitration clause.

availability of certain procedural remedies such as class actions, or to restrict remedies otherwise available to consumers under existing consumer protection acts (such as treble or punitive damages). Legislation could also include limits on arbitration fees charged to consumers, however, such limitations would have to be narrowly tailored so as to be fair to both merchants and non-merchants alike. Such provisions would be pro-consumer rather than anti-arbitration, and thus should withstand an FAA based challenge.<sup>89</sup> Legislative provisions such as these would decrease societal transaction costs and maximize the benefit to society. Legislatures and courts should be mindful of the need for consumers to have an impartial and affordable forum for legitimate complaints relating to unfair business practices. By acting in such a manner the legal system will assure that the rights of both consumers and merchants are equitably maintained and that appropriately negotiated and drafted contracts are enforced as the parties intended them.

Lorne B. Sheren  
Seton Hall University School of Law

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<sup>88</sup> *Id.* at 305.

<sup>89</sup> Since these provisions would apply to Uall contract provisions and not only to arbitration clauses, the FAA principle that arbitration clauses may not be uniquely disfavored would not be violated.