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Focus

Supreme Court Gets Into Split Over Class-Action Arbitrations

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In 1982, in *Keating v. Superior Court*, 31 Cal.3d 584 (1982), the California Supreme Court sanctioned the hybrid procedure of class arbitration. *Keating*, however, left unanswered the question of whether an express ban on classwide arbitration could be unenforceable as an unconscionable agreement under state law.

In the past several years numerous jurisdictions have begun to address the issue, but there is no clear consensus. See, e.g., *Szetela v. Discover Bank*, 97 Cal.App.4th 1094 (2002) (holding that a no-class-action provision is unconscionable); *Snowden v. Checkpoint Check Cashing*, 290 F.3d 631 (2002) (arbitration agreement's bar to class actions was not unconscionable because plaintiff could potentially recover fees under applicable law).

On June 27, the California Supreme Court became the latest court to join this split of authority by holding, in *Discover Bank v. Superior Court*, by 4-3 margin, that class action waivers in consumer contracts of adhesion are unenforceable.

In *Discover Bank*, the plaintiff, a California credit-card holder, alleged that Discover Bank represented to its card holders that late payment fees would not be assessed if payment was received by a specific date — although, in reality, the bank assessed a late fee if payment was not received by 1:00 p.m. on the due date. The credit card agreement contained an arbitration agreement that was added pursuant to a change-of-terms provision in 1999, almost 13 years after plaintiff started using a Discover Bank credit card.

The arbitration clause precluded both sides from participating in classwide arbitration: "neither you nor we shall be entitled to join or consolidate claims in arbitration by or against other card-members 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 change-of-terms provision was accompanied by a notice that if a card holder did not wish to accept the new terms, he/she must notify Discover Bank and cease to use the account. Continued use of the account was deemed to be acceptance of the arbitration clause.

In 2001, the plaintiff, a California resident, filed a putative class action against Discover Bank alleging two causes of action for breach of contract and violation of the Delaware Consumer Fraud Act. In his complaint, the plaintiff acknowledged that his substantive claims are governed by federal law and the law of Delaware, but he contended that issues related to the enforceability of the contract are governed by California law.

Discover Bank moved to compel arbitration of the plaintiff's individual claims based on the arbitration clause and its class action waiver. The trial court initially granted the motion, but upon reconsideration — after the court of appeal's decision in *Szetela v. Discover Bank*, 97 Cal.App.4th 1094 (2002) — held that the class action waiver was unconscionable. The court also conducted a choice-of-law analysis concluding that enforcing the class action waiver under Delaware law would violate a fundamental public policy of California.

The court of appeal reversed, ignoring the class action waiver issue but holding that a California rule prohibiting class action waivers was pre-empted by the Federal Arbitration Act. Plaintiff then asked for review by the California Supreme Court and his request was granted.

The California Supreme Court's majority opinion, written by Justice Carlos Moreno, begins with the historical justification for class actions, and the important role of the class action remedy "in deterring and redressing wrongdoing." The court emphasizes the value of the class action procedure, observing that without it, "small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights."

With those principles in mind, Moreno turns to the facts before the court holding that class action waivers in one-sided contracts of adhesion are substantively unconscionable because they "operate effectively as exculpatory contract clauses that are contrary to public policy."

While acknowledging that not all class action waivers are, in the abstract, exculpatory clauses, the court holds that in a consumer action where damages are small the class action is the only effective way to halt a defendant's wrongdoing. In such circumstances, according to the majority, a class action waiver effectively exculpates a defendant from liability.

The majority rejects the argument that class actions are merely procedural devices because "class actions and arbitration are, particularly in the consumer context, often inextricably linked to the vindication of substantive rights."

The majority also rejects the dissent's argument, without really explaining its reasoning, that the potential availability of attorney fees to the prevailing party in arbitration, availability of small claims litigation, government prosecution or informal resolution, can save a clause from substantive unconscionability.

Moreno then turns to the court of appeal's holding that the Federal Arbitration Act pre-empts California rules against class action waivers. In reaching its conclusion, the court of appeal cited to *Perry v. Thomas*, 482 U.S. 483 (1987), in which the U.S. Supreme Court held that Section 2 of the Federal Arbitration Act pre-empted California Labor Code Section 229, which authorizes an action for collection of wages "without regard to the existence of any private agreement to arbitrate."

The majority rejects the court of appeal's analysis, holding that Section 2 of the Federal Arbitration Act and *Perry* deal with pre-emption of a state laws directed specifically at arbitration agreements.

The majority holds that *Perry* does not apply because a rule that class action waivers in consumer arbitration agreements are substantively unconscionable is a rule of contract law generally — and that it "applies equally to class action litigation waivers in contracts without arbitration agreements as it does to class action arbitration waivers in contracts with such agreements."

The court then notes that it derives its authority to find class action waivers in consumer arbitration agreements unconscionable from Section 2 of the Federal Arbitration Act, pursuant to which a state court may refuse to enforce an arbitration agreement based on generally applicable contract defenses, such as fraud and unconscionability.

Having held that, at least under the facts before the court, class action waivers in arbitration agreements are substantively unconscionable, and that such a rule is not pre-empted by the Federal Arbitration Act, the court remanded the case to the court of appeal to determine whether the Delaware choice of law provision in the Discover Bank credit card agreement requires the enforcement of the class arbitration waiver. The majority does provide the court of appeal with the caveat that "if there is a fundamental conflict with California law, the court must then determine whether California has a materially greater interest than" Delaware and, if so, "the choice of law shall not be enforced."

Justice Marvin Baxter wrote a concurring and dissenting opinion in which Justices Ming Chin and Janice Rogers Brown joined. Baxter agrees with the majority that "federal law does not compel enforcement of contractual class actions waivers simply because they are contained in arbitration agreements."

Baxter disagrees, however, with the majority's use of the facts before it, as a vehicle to address California's policy on class action waivers. The bulk of Baxter's dissenting opinion focuses on his argument that under California's choice of law rules, Delaware law — which permits class action waivers in consumer contracts — should govern the validity of the arbitration agreement.

The dissent also disagrees with the majority's elevation of the class action procedure to a substantive remedy in and of itself: "class actions are provided only as a means to enforce substantive law. . . . They must not be confused with the substantive law to be enforced." The dissent then lays out the various means by which Discover Bank could be called to account for its alleged wrongdoing, such as informal individual resolution, one-on-one arbitration, availability of the small claims forum and government prosecution.

According to the dissent, the availability of such means for redressing the alleged wrongdoing calls into question the majority's fear that upholding the class action waiver would absolve a defendant's objectionable conduct.

While the majority uses forceful language against class action waivers in arbitration agreements, its unconscionability reasoning is quite narrow, and its holding is limited to cases involving consumer contracts of adhesion in settings in which the dispute involves small amounts of damages - and settings in which "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."

Even in its narrow reasoning, the holding seems somewhat problematic, leaving unaddressed the dissent's remark that there are means other than the class action procedure available to provide redress for, and deter, the type of wrongdoing alleged in *Discover Bank*, such as proceedings in small claims court or one-on-one arbitration where the fees are advanced by the defendant.

Indeed, nearly a month before the Supreme Court issued its decision in *Discover Bank*, one California appellate court, relying on the same reasoning as the dissent's in *Discover Bank*, held that an arbitration clause that contained a ban on class actions was not unconscionable. *Parrish v. Cingular Wireless*, 129 Cal.App.4th 601 (2005). The *Parrish* court reasoned that while it is true that the ban on class-wide arbitration tends to favor Cingular, it "does not affect the choice of forum. The limitation is only on the breadth of the arbitration proceeding - that is, the manner in which the arbitration is to occur."

The court emphasized the fact that "the arbitration clause here expressly permits the customers to obtain relief in small claims court. Moreover, the costs of arbitration are paid by Cingular ... . Cingular subscribers are not deterred from seeking redress for small amounts."

Under those circumstances the court held the arbitration clause and its prohibition of class actions to be enforceable. Finally, the *Discover Bank* opinion fails to address the compelling practical reasons that militate against class arbitration such as lack of any appellate review or the absence of any clear guidelines — in either the California Code of Civil Procedure or the Federal Rules of Civil Procedure — for arbitrators to handle class actions.

In the end, regardless of whether the California Supreme Court reached the correct result, the debate is sure to rage on until the U.S. Supreme Court issues its pronouncement on the matter.

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