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CLASS ACTION ARBITRATIONS: THE CHALLENGE FOR THE BUSINESS COMMUNITY

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Until relatively recently, the concept of a class action in an arbitration would have seemed bizarre, especially in an arbitration authorized by a standard commercial contract. Even more bizarre would have been a class action procedure imposed on a party to the arbitration agreement who had not explicitly authorized the arbitrator to determine the rights of absent parties. The world has changed dramatically in just a few years. These changes pose serious problems for businesses, especially for firms that routinely include arbitration clause as the preferred – or required – mechanism for resolving disputes with their customers, clients, or suppliers.

How did this happen? What problems does this development pose? How big are the problems? What can the well-counseled company do about it? These are the subjects of this presentation.

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I. *Green Tree* v. *Bazzle* Gives the Green Light for Class Action Arbitration.

The principal source of the emerging phenomenon of class-wide arbitrations is the 2003 decision by the plurality of a sharply divided Supreme Court in *Green Tree Financial Corp*. v. *Bazzle*, 539 U.S. 444 (2003). In *Bazzle*, the lender had entered into standard-form contracts with a number of borrowers who obtained home improvement loans. As is not unusual, the contracts contained a clause – governed by the Federal Arbitration Act – providing that all disputes

> "relating to this contract or the relationships which result from this contract . . . shall be resolved by binding arbitration by one arbitrator selected by us with the consent of you."

The case involved two sets of consumers who initially brought lawsuits challenging lending processes. Before both lawsuits were referred to arbitration at the lender's demand, one of the cases had been certified as a class action. Over the lender's objection, the arbitrator (the same arbitrator for both suits, as it turned out) proceeded to administer the first claim in accordance with the initial court-approved class certification and also certified the second matter as a class-wide arbitration as well. He eventually awarded over $19 million in statutory damages to the two classes. The South Carolina Supreme Court ultimately upheld the class award, reasoning that there was nothing in either the contracts or the Federal Arbitration Act to preclude such a procedure in an arbitration.

The United States Supreme Court affirmed the judgment, but without a majority opinion. Four Justices joined in the lead opinion written by Justice Breyer. The plurality opinion began with the threshold question whether the contracts between the lender and the consumers *forbade* class actions. The lender insisted that they did, because they appeared to speak about submitting to arbitration any dispute between the lender and the

particular signatories. The state supreme court, however, had viewed the contract as silent on the issue of class-wide arbitration and concluded that, consequently, they implicitly *allowed* such arbitral procedures.

Justice Breyer's opinion concluded that the state court was wrong to interpret the contract. Reflecting the modern trend to defer to arbitrators on questions of contract interpretation, he focused on the existence of a dispute about what the contract did or did not allow as a matter of arbitral procedure. Since there was a plausible dispute about the meaning and intent of the contract on the question whether it allowed class-wide arbitral proceedings, he concluded that the question what kind of proceeding the contract allowed was a matter for the arbitrator, not a court, to decide. The opinion thus distinguished the Court's earlier opinions in *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002), and *First Options of Chicago, Inc.* v. *Kaplan*, 514 U.S. 938 (1995), which established that some "gateway" questions – such as whether the parties entered into a valid agreement to arbitrate – are for the court to decide.

The Court's disposition was tentative. The plurality was uncertain whether the arbitrator had made an independent determination of contractual meaning or had simply followed the lead of the state trial court, which had interpreted the contract language as permitting class actions and actually had certified the case for class treatment before referring the claims to arbitration. Accordingly, the plurality concluded that the case had to go back to the arbitrator for an independent, *de novo* interpretation of the contract.

Four justices dissented. The principal dissent for three Justices conclude that the question whether an arbitration agreement allows class-wide treatment is a matter for the courts to resolve. Construing the contractual language – the rather typical contract

language – that apparently referred just to the signatories to the particular contract, the dissenters concluded that the state supreme court was wrong in concluding that the contracts allowed class-wide arbitrations.

The decisive vote to send the case back to the arbitrator came from Justice Stevens. His brief, cryptic opinion noted his view that the Federal Arbitration Act leaves to state law whether class-action arbitrations are permissible and that the state supreme court had interpreted state law as allowing for such proceedings. He also commented that, "[a]rguably," the question of contract interpretation should have been made "in the first instance" by the arbitrator, but the decision to conduct such a proceeding did not violate state law as the state supreme court interpreted it. Therefore, he would have simply left the state judgment in place. He grudgingly cast the decisive vote to send the case back to the arbitrator simply because Justice Breyer's opinion "expresses a view of the case close to my own."

This muddled disposition has been the source of considerable mischief in the ensuing years. The Supreme Court's decision in *Bazzle* leaves open several critical questions:

- Does an arbitration clause in a particular contract allow or forbid class treatment of related claims, if the clause is silent on that topic?
- Does applicable state law authorize parties to litigate the claims of a class in an arbitration?
- How should arbitrators go about resolving those questions?
- What role should the courts have in monitoring class determinations in arbitrations?

- May a company validly insist on banning demands for class-wide arbitration and still be able to require resort to arbitration of disputes, especially in consumer-related cases?

II. The Arbitration Managers React.

One immediate response to *Bazzle* involved the efforts by companies, particularly in consumer businesses, to modify their standard arbitration clauses to bar class-wide treatment. At the same time there was a flurry of activity among the organizations that administer arbitrations as they tried to figure out how to cope with the likely upsurge in demands for class treatment in arbitrations, a development that they correctly forecast. They recognized that many companies with standard-form contracts containing arbitration clauses would promptly amend them to attempt to bar demands for class treatment. This would raise a policy question whether to handle cases with such preclusive terms. In addition, they recognized that, just as with class-action rulings in civil litigation, an arbitrator's preliminary ruling on whether to allow class treatment could either pronounce the death-knell for a claim, if denied, or coerce settlement, if sustained. Therefore, it seemed useful to develop some efficient way of getting prompt judicial review of the class-treatment decision.

The American Arbitration Association promptly promulgated a set of Supplementary Rules for Class Arbitrations in 2003. See http://www.adr.org/sp.asp?id=21936. Reflecting the approach taken in the *Bazzle* plurality opinion, the AAA supplementary rules require that the arbitrator decide in the first instance whether a class action is even permissible under the contract and under applicable state law. If the arbitrator decides that a class action is permissible, the AAA

rules then provide guidance for determining whether actually to certify a class. The rules essentially mirror the standards set forth in Rule 23 of the Federal Rules of Civil Procedure. They also address the all-important question of notice to absent class members.

What is most imaginative and practical about the AAA rules is the *requirement* that the arbitrator set forth the ruling on the class-action issues in a “Class Construction Award” that either party may immediately seek to have enforced or vacated in court. Through this mechanism, the parties can learn before they embark on litigating the merits of the dispute whether and to what extent the courts will allow the arbitration actually to bind a class. The relevant AAA rule provides:

> “**3. Construction of the Arbitration Clause**
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> “Upon appointment, the arbitrator shall determine as a threshold matter, in a reasoned, partial final award on the construction of the arbitration clause, whether the applicable arbitration clause permits the arbitration to proceed on behalf of or against a class (the ‘Clause Construction Award’). The arbitrator shall stay all proceedings following the issuance of the Clause Construction Award for a period of at least 30 days to permit any party to move a court of competent jurisdiction to confirm or to vacate the Clause Construction Award. Once all parties inform the arbitrator in writing during the period of the stay that they do not intend to seek judicial review of the Clause Construction Award, or once the requisite time period expires without any party having informed the arbitrator that it has done so, the arbitrator may proceed with the arbitration on the basis stated in the Clause Construction Award. If any party informs the arbitrator within the period provided that it has sought judicial review, the arbitrator may stay further proceedings, or some part of them, until the arbitrator is informed of the ruling of the court.”

Suppose, though, that the applicable arbitration clause purports to *bar* a demand for class-wide arbitration. The AAA Executive Committee adopted a policy somewhat less hostile to such efforts than the original JAMS policy (discussed below) but still rather-stand-offish. The AAA policy declares that the organization will decline to accept such cases for administration unless, and only to the extent that, a court enforces the

demand for arbitration in the face of such a contractual bar. The AAA Policy statement, adopted in 2005, provides:

> "The Association is not currently accepting for administration demands for class arbitration where the underlying agreement prohibits class claims, consolidation or joinder, unless an order of a court directs the parties to the underlying dispute to submit any aspect of their dispute involving class claims, consolidation, joinder or the enforceability of such provisions, to an arbitrator or to the Association." http://www.adr.org/classarbitrationpolicy.

Under this policy, a company facing a demand for class-wide arbitration may invoke a prohibition in the contract clause barring such treatment. It may sue under the Federal Arbitration Act to compel arbitration on a non-class basis or refuse to arbitrate unless the claimant sues to compel arbitration on a class-wide basis. In either event, the demand will not proceed before the AAA until the court decides whether to sustain the class-limiting clause.

As part of its program for handling class arbitrations, the AAA explicitly waived the normal policy of confidentiality. Any company considering referring arbitrations to the AAA for administration must recognize that, if the claimant demands class-wide treatment, virtually everything about the arbitration, including the eventual award, will be public. The applicable class-action rules provide:

> "**9. Confidentiality; Class Arbitration Docket**
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> "(a) The presumption of privacy and confidentiality in arbitration proceedings shall not apply in class arbitrations. All class arbitration hearings and filings may be made public, subject to the authority of the arbitrator to provide otherwise in special circumstances. However, in no event shall class members, or their individual counsel, if any, be excluded from the arbitration hearings.
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> "(b) The AAA shall maintain on its Web site a Class Arbitration Docket of arbitrations filed as class arbitrations. The Class Arbitration Docket will provide certain information about the arbitration to the extent known to the AAA, including:
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> "(1) a copy of the demand for arbitration;
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> "(2) the identities of the parties;
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> "(3) the names and contact information of counsel for each party;

"(4) a list of awards made in the arbitration by the arbitrator; and

"(5) the date, time and place of any scheduled hearings.

"10. Form and Publication of Awards

"(a) Any award rendered under these Supplementary Rules shall be in writing, shall be signed by the arbitrator or a majority of the arbitrators, and shall provide reasons for the award.

"(b) All awards rendered under these Supplementary Rules shall be publicly available, on a cost basis."

Since it adopted a public docket for cases in which class treatment is sought, the AAA has posted a list of hundreds of such cases on its docket. The cases are searchable by the name of the parties. See http://www.adr.org/sp.asp?id=25562. This docket is the best evidence of the huge number of arbitrations that have turned into class actions – one of the nightmares that many companies thought that they were avoiding by requiring arbitration as a standard feature of their contracts, particularly in consumer-related businesses.

Another major organization that administers arbitrations, JAMS, flip-flopped, on its policy for dealing with arbitration clauses that attempt to bar requests for class treatment. As an organization headquartered in California, JAMS was particularly sensitive to the pro-consumer philosophy of the California legislature and many California judges. It assumed that California courts would not enforce such clauses, especially in consumer-related or employment contracts, and that the legislature would promptly outlaw the prohibitions if it became necessary to do so. As a result, JAMS reacted to *Bazzle* by announcing that it would refuse to accept for administration any consumer-related demand for arbitration arising from a clause containing a prohibition against class treatment, unless the respondent company waived the limitation. That policy presented JAMS' corporate users with a grim, Hobson's choice. They could stand

on the contractual ban and thus risk losing an arbitral forum, especially if the contract specified JAMS arbitration. Or they could preserve an arbitral forum by acquiescing in JAMS' pre-condition that they waive the bar to class treatment.

JAMS's corporate users were understandably furious at what they considered this pro-consumer tilt, and they made clear that there were other alternative forums for administered arbitrations. They noted that arbitrations may arise under the laws of states that may be willing to enforce such prohibitions as not inherently unfair or invalid. In response to this business pressure – or perhaps after more careful reflection – JAMS abandoned the policy and announced that it would accept cases based on arbitration clauses containing bans on class-treatment and would leave it to the arbitrators, in the first instance, to decide whether to enforce or disregard the limitation. The 2005 reversal-of-course explained:

> "In November of 2004, JAMS announced a policy regarding the administration of arbitrations where there is a contract that contains a clause prohibiting consumers from joining class action arbitrations.
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> "JAMS is withdrawing its policy for the following reasons:
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> "The initial statement of the policy suggested to some that JAMS had deviated from its core value of neutrality. We want to reaffirm to all of our constituencies that we have a fundamental responsibility and commitment to absolute neutrality and the highest ethical and professional standards.
>
> "Recent court decisions on the validity of class action preclusion clauses have varied by jurisdiction. In this legal environment, our attempt, as a national ADR provider, to bring uniformity to the administration of class wide arbitrations stemming from these clauses has created concern and confusion about how the policy would be applied. Accordingly, we are retracting the previously announced policy and reaffirm that JAMS and its arbitrators will always apply the law on a case by case basis in each jurisdiction." http://www.jamsadr.com/press/show_release.asp?id=198.

Meanwhile, in January 2005 JAMS promulgated its own "Class Action Procedures," a set of special rules when a party seeks arbitration "on behalf of or against a class or purported class." See http://www.jamsadr.com/rules/class_action.asp. Like

the comparable AAA rule, JAMS Rule 2 calls upon the arbitrator to construe the arbitration clause and to "determine as a threshold matter whether the arbitration clause permits the arbitration to proceed on behalf of or against a class." Borrowing a page from the earlier, but more elaborate AAA rules, the JAMS rule authorizes the arbitrator to "set forth his or her determination in a partial final award subject to immediate court review." The rest of the rules are similar to the AAA rules in adopting in substance the standards used in Rule 23 of the Federal Rules of Civil Procedure for determining whether, if otherwise permitted under the contract, a class action is appropriate and how any notice of the proceedings is to be given.

III. Arbitrators and Courts Tilt in Favor of Arbitral Class Actions.

What have arbitrators done with the authority that the Supreme Court in *Bazzle* delegated to them? While it is impossible to canvass all of the rulings, there appears to be a strong and unmistakable trend toward allowing claimants to pursue class treatment of issues that are arbitral under most standard arbitration clauses, at least where the clause does not explicitly prohibit or restrict class treatment. And the courts generally are sustaining the validity of such interpretations as permissible under state law.

The issue arises when the arbitration clause is silent on the question whether the claimant may transform the claim into a class-wide proceeding. Two threshold questions then emerge, both of which are for the arbitrator to resolve in the first instance: Does the contract language, silent on the question, permit the arbitrator to construe the agreement as allowing class treatment, and if so, does state law authorize class actions in arbitrations?

Two recent cases in the federal and state courts in New York illustrate the issues and the apparent trend in decisions.

The first is *JSC Surtneftegaz* v. *President & Fellows of Harvard College* (S.D.N.Y. 04 Civ.6069, October 11, 2007). Unlike a lot of the consumer cases in which the class-action issue typically arises, the *Harvard* case involved commercial investments. Harvard's investment managers – among the best in the market – had purchased American Depositary Receipts (ADRs) tied to preferred shares of a Russian oil and gas company. They complained that the company had intentionally undervalued its net profits in order to depress the amount of dividends that the company was required to pay out to its investors. The investment agreement called for resolving disputes through arbitration. Harvard submitted to the AAA a "demand for class arbitration." After several years of wrangling, a three-arbitrator panel, dividing 2-1, issued a Class Construction Award finding that the arbitration clause "does not preclude this arbitration from proceeding on a class basis." The majority stressed that the members of the class were all parties to the same agreement, and the arbitration clause broadly called for arbitration relating to "any claim" by "any party."

Harvard sued to confirm the interim award, and the company countered with a motion to vacate, claiming that New York law bars class arbitration unless the agreement expressly provides for it. The company cited a number of federal and state cases applying New York law for the proposition that, at least as of 1998 when the parties entered into the contract, "no New York court had ever allowed a class arbitration to proceed under a contract that was silent on the issue." The company also cited a post-*Bazzle* decision by another federal judge in 2006, *Stolt-Nielsen SA* v. *Animalfeeds Int'l*

Corp., 435 F. Supp.2d 382 (S.D.N.Y. 2006) (the "Animal Feeds case"). In that case, the arbitral panel had been chaired by one of the country's most respected and experienced arbitrators, Gerald Aksen. In concluding that an arbitration clause that was silent on the matter should be construed as allowing class treatment, the Aksen panel explained that it was "struck that Respondents have been unable to cite any post-*Bazzle* panels or arbitrators that construed their clauses as prohibiting a class action." But on petition to vacate the clause construction award, the Judge Rakoff concluded that the "arbitral panel had manifestly disregarded applicable New York law by allowing class arbitration to proceed when the governing agreement was silent on the matter."

In the *Harvard* case, however, Judge Berman declined to follow his colleague's lead and instead sided with Harvard and the panel's award allowing it to represent a class. His analysis was straight-forward, taking only four pages: Review of an arbitral award is quite limited. Performing a function that the Supreme Court in *Bazzle* had held that arbitrators are "well situated" to perform, the panel construed the contract as not precluding class arbitrations. Apart from other, limited grounds that were not even invoked, an award may be set aside only if the arbitrators acted in "manifest disregard" of the law. Whether or not the company was correct about New York law regarding class arbitrations, the arbitral panel had discussed and analyzed the precedents in reaching the contrary conclusion. Even if the interpretation of New York law was wrong, it was at most "mere error" and not the kind of "egregious" misapplication of law that rises to the level of "manifest disregard." End of story; arbitral decision enforced.

The second decision is even more recent, handed down in November 2007. Like the *Harvard* case, it arose under the AAA class-action procedures. A New York City

doctor filed a class-arbitration demand against Oxford Health Plans of New York, Inc., claiming that Oxford had deliberately denied or delayed legally-required reimbursement of fees for medical services that he and other physicians had rendered. He claimed that millions of dollars had been mishandled in this way. The standard "Consultant Physician Agreement" that he and hundreds of other doctors had signed was to be governed by New York law and called for arbitration of disputes. The agreement was silent on the question of class claims. The doctor contended that silence meant that such claims were not prohibited; Oxford responded that the language of other portions of the agreement, referring specifically to Oxford's relationships with the individual physician, necessarily reflected an understanding that the arbitration clause was similarly limited to resolving individual disputes. Oxford also contended that, when the parties entered into the contract in 1998, New York precedents forbade class arbitration, so that state of the law must have reflected the parties' understanding of their contract.

The panel's Class Construction Award, as in the *Harvard* case, came out in favor of class treatment by a 2-1 vote. The majority concluded that New York law was unclear as of the date the parties signed the agreement on the question whether a class arbitration was available in the absence of a specific agreement to that effect. In any event, even if the parties did not contemplate the possibility of a class arbitration when they entered into the contract, the majority held that there was "nothing unfair to Oxford about permitting one now," as the majority concluded New York law now would allow.

Another respected and experienced arbitrator, William H. Baker, filed a lengthy – and in my view persuasive – dissent. He emphasized, through a careful review of the case law, that at the time the parties entered into the contract, New York law appeared to

bar class actions in arbitration, unless the contract expressly authorized them. This was consistent with the approach Judge Rakoff had taken in the Animal Feeds case in holding that the Aksen panel had "manifestly disregarded" the law by construing New York law as allowing class arbitrations absent an explicit agreement to that effect. Moreover the language of the agreement was consistent with that understanding of New York law, in his view, because all of the other references throughout the document assumed that the contract was regulating the relationship between Oxford and the *particular* physician signatory. Baker also rejected the contention that it would violate public policy to deny the doctor a class remedy. He pointed to several New York cases that had ruled that explicit prohibitions on class treatment in arbitration are enforceable and not unconscionable.

For a while it looked as if Bill Baker's dissent would carry the day. When Oxford moved to vacate the Class Construction Award, Justice Karla Moskowitz of the New York Supreme Court, New York County, set aside the decision. *Cheng*. v. *Oxford Health Plans, Inc.* (N.Y. Sup. Ct. N.Y. Co. No. 604083/2001, December 5, 2006). Seeking a more searching judicial review of the arbitral ruling than normally applicable under the Federal Arbitration Act, Oxford presented evidence that "every one of the more than 20 AAA arbitrators or arbitration panels that have considered the question have ruled in favor of class arbitration," thus allegedly suggesting bias in the class-construction process. Justice Moskowitz concluded, though, that these lopsided figures did not establish that *this* panel was biased and she found no reason to fashion a novel and more intrusive standard of judicial review.

Applying the higher "manifest disregard" standard, however, the judge concluded that the majority decision had to be set aside. She reasoned that, if the law is settled when the parties signed a contract, they are deemed to incorporate that law into their relationship. She declared that the law at the time the parties signed their agreement "is clearly set forth in the Baker dissent." That law, as she and Bill Baker read it, "did not permit class arbitration" in an arbitration. Since Baker's dissent has explored the law correctly, she concluded that, by reaching the contrary decision, "the Panel majority . . . either refused to apply it or ignored it altogether."

Unfortunately, that mode of analysis did not recognize the limits of the highly restrictive standard of judicial review under the "manifest disregard" standard. And the Appellate Division recently reversed for that reason. See *Cheng* v. *Oxford Health Plans Inc.*., ___ App. Div.2d ___ (1st Dep't No. 604083, November 13, 2007). The court unanimously concluded that the "manifest disregard" standard only allows a court to vacate an arbitral ruling when there is "more than an erroneous interpretation of the law;" the error must amount to "egregious impropriety." The appellate court concluded that, even if the panel majority had made "an error or mistake of law," the panel "did not state certain law as controlling and then deliberately ignore it, but instead, after analyzing case offered by both sides," concluded that Oxford had not "successfully" demonstrated that its view of the law was correct.

Two things are particularly notable about this case. First, no one contested Oxford's showing that virtually *every* AAA panel that had addressed the issue has construed an arbitration clause as *allowing* the claimant to seek class treatment so long as the clause *does not expressly bar* such treatment. That is, silence implies consent.

Indeed, in a recent article that Bill Baker published, he reported that in every one of *38* such AAA cases, the arbitrators "held that a silent clause permits class arbitration." *Class Arbitration in the United States: What Foreign Counsel Should Know*, DISPUTE RESOLUTION INTERNATIONAL 4, 19 (June 2007). Second, the "manifest disregard" standard makes the arbitral decision almost impossible to overturn, even if wrong, so long as the arbitrators do not fall into the virtually unimaginable trap of simultaneously acknowledging controlling law and defiantly declaring that they will not follow it.

IV. The Courts Split on the Validity of Standard-Form Waivers of Class Treatment.

The principal mechanism for trying to avoid these problems, at least prospectively, is to incorporate in the contract providing for arbitration an additional clause that explicitly bars a disgruntled party from seeking class treatment. Under a line of Supreme Court decisions culminating most recently with *Buckeye Check Cashing, Inc*. v. *Cardegna*, 546 U.S. __, 126 S.Ct. 1204 (2006), a challenge to the validity of the *arbitration clause* in a contract – as distinct from a challenge to the validity of the overall contract – poses a question of law that is to be decided by the court, not the arbitrator. Therefore, the forum for testing the validity of a contractual ban on class treatment of an otherwise required arbitration is a court room. Moreover, as the Court's decision in *Bazzle* implies, it is up to the states to decide whether to allow class actions in arbitrations; the Federal Arbitration Act does not preempt that choice. As a result, the courts uniformly apply state law to determine whether a contractual provision banning class treatment in arbitration is enforceable.

The judicial reaction to clauses of this type is still evolving. On the one hand, courts that sustain them reason that, just as arbitration is a creature of contract, the parties

to an otherwise legitimate contractual requirement to arbitrate their grievances also may limit the scope of the arbitration so as to preclude class claims. On the other hand, the courts that reject these limits view them as tipping over the edge of unconscionability any adhesion-like contracts that require arbitration of even small disputes and then make it impractical actually to pursue the arbitration.

First, let's take a look at some of the most recent cases invalidating the clauses. For example, in *Dale* v. *Comcast Corp*., 498 F.3d 1216 (11th Cir. 2007), the Eleventh Circuit a few months ago held unenforceable a clause in a cable television contract that both required arbitration and prohibited class treatment. The claimants had filed a class action in the state court seeking recovery of allegedly excessive costs passed through to cable subscribers. The cable company removed to federal court and moved to compel arbitration. The cable subscribers' contract required arbitration, insisted that all parties to the arbitration "must be individually named," and specified that there

> "shall be no right or authority for any claims to be arbitrated or litigated on a class-action or consolidated basis . . . on behalf of the general public (such as a private attorney general), other subscribers, or other persons similarly situated."

The Eleventh Circuit reversed the district court's order compelling arbitration under these provisions, holding the "class action waiver unconscionable" under Georgia law. Citing the Supreme Court's early decision in *Prima Paint Corp*. v. *Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967), the court of appeals concluded that the enforceability of the agreement to arbitrate poses a question of law for the court. Under another Supreme Court case, *Doctor's Assocs*. v. *Casarotto*, 517 U.S. 681, 686-87 (1996), a party resisting a demand for enforcement of a contractual clause requiring arbitration may invoke any of the standard contract defenses, "such as fraud, duress, or unconscionability . . . ."

The court of appeals concluded that, applying the case-by-case method of adjudication, the facts in that case made the ban on class-action arbitrations unconscionable as a matter of law. What the court found decisive was that the subscribers alleged that their individual overcharges had amounted to barely $10, while the class of subscribers in their county had been overcharged collectively by about $39,000. The court explained:

> "Without the benefit of a class action mechanism, the subscribers would effectively be precluded from suing Comcast for a violation of [a federal statute]. The cost of vindicating an individual subscriber's claim, when compared with his or her potential recovery, is too great."

In applying this balancing calculus, the court expressly followed the lead of the First Circuit in *Kristian* v. *Comcast Corp*. 446 F.3d 25 (1st Cir. 2006), which had similarly refused to enforce the same kind of no-class-action arbitration clause in proceedings brought by Comcast subscribers in the Boston area.

In reaching this result, the Eleventh Circuit distinguished three of its earlier cases in which it had refused to find class-action waivers unconscionable. See *Caley* v. *Gulfstream Aerospace Corp.*, 428 F.3d 1359 (11th Cir. 2005); *Jenkins* v. *First Am. Cash Advance of Ga. LLC.*, 400 F3d 868 (11th Cir. 2005); and *Randolph* v. *Green Tree Fin. Corp. – Ala.*, 244 F.3d 814 (11th Cir. 2001). The point of distinction between *Dale* and those cases, according to the latest panel, was that in those cases the earlier panels had emphasized the "automatic, or likely, award of fees and costs available to a prevailing plaintiff for the claims asserted" in those cases. The probable availability – as distinct from a mere possibility – of an award of attorneys' fees made it at least theoretically feasible to secure counsel to press the individual claims there.

The remedy imposed was draconian – at least for Comcast. After concluding that "the Comcast class action waiver is unconscionable," the court declared that "the class action waiver cannot be severed from the Agreement [to arbitrate]," and as a result "the entire arbitration provision is rendered unenforceable." Therefore, Comcast lost both the opportunity to require arbitration of the dispute and the ability to foreclose its exposure to a class action. The net result is that the subscribers may proceed with a class action in court.

California has long been skeptical about class action waivers, although it has not absolutely prohibited them. See, *e.g.*, *Keating* v. *Southland Corp*. 31 Cal. 3d 584 (1982) *rev'd on other grounds*, 465 U.S. 1 (1984) (recognizing courts' power to order class arbitrations but questioning whether particular circumstances may make such arbitrations unfair either to the opposing party or to class members). Resolving a split among the state's appellate courts in 2005, the California Supreme Court in *Discover Bank* v. *Superior Court*, 36 Cal. 4th 148, 153 (2005), declared that "at least in some circumstances, the law in California is that class action waivers in consumer contracts of adhesion are unenforceable." In that case the court found "generally unconscionable" contract clauses in consumer agreements that "required arbitration of all disputes and prohibited classwide arbitration." The conclusion that such a combination is generally unconscionable rested on the court's assumption that individual claims may be "insufficient to justify" a lawsuit against an "unscrupulous seller" and that a class action would have a "therapeutic effect on those sellers who indulge in fraudulent practices." The court left a little wiggle room to allow such waivers in consumer contracts, if the

amounts of individual claims are not too small and if the clauses are not really adhesion contracts.

Not surprisingly, since *Discover Bank*, the California courts are generally finding "no-class-action" clauses in consumer-related contracts to be unenforceable as unconscionable. See, *e.g*., *Firchow* v. *Citibank (South Dakaota), N.A*. (Cal. App. 2d Dist. B187081, January 10, 2007); *In re Cingular Cases* (Cal. App. 4th Dist. D047603, January 17, 2007); *Gatton* v. *T-Mobile USA, Inc*. 152 Cal App.4th 571 (Cal. App. 2007)..

In another recent case, decided in August 2007, the California Supreme Court divided 4-3 in developing a different rationale to cast doubt about the validity of a clause requiring arbitration of an employment dispute on a non-class basis. See *Gentry* v. *Superior Court of Los Angeles County*, __ Cal. 4th __ (S141502, August 30, 2007). The employee was seeking statutory overtime pay. The applicable California statute made the right to such overtime pay non-waivable. Reasoning that the non-waivability of this statutory right established a fundamental public policy of the State, four of the seven members of the court concluded that a contractual provision interfering with enforcement of statutory protection of similarly situated workers may be void as offending "public policy." Even though backpay awards often run into thousands of dollars and the statute allows the successful employee to recover attorneys' fees, the majority concluded that the ban on class actions in arbitration may unduly interfere with effective vindication of the statutory right. The court added, as bootstrap arguments, that some class members may not sue on their own, because they fear retaliation or are ignorant of their rights. Therefore, the class mechanism sweeps in claimants who otherwise might not press their own rights.

As with its earlier decision in *Discover Bank*, the court left the door slightly ajar to enforcing no-class-action clauses in employment-rights cases, if a court concludes that a particular claim does not really lend itself to class treatment or that the prohibition is otherwise fair. The court suggested that the lower courts confronting these clauses should evaluate several factors in deciding whether to uphold the ban on class actions. The factors include whether other members of the proposed class may not know about their rights, whether there is a possibility of retaliation if they try to vindicate those rights, and whether the relatively small size of an individual recovery or any other real-world factors would, as a practical matter, leave important rights un-vindicated.

The three dissenters gave greater weight to principles of freedom of contract and the advantages of encouraging arbitration instead of court cases. Whether correctly or not, the dissenters viewed arbitration as a less costly alternative to litigation and reasoned that, even if it may be difficult to press small, individual claims in court, arbitration does not necessarily impose similar obstacles to vindicating individual claims.

A recent Ninth Circuit case applying California law contains an interesting analysis of the preemption question. See *Shroyer* v *New Cingular Wireless Services, Inc*. __ F.3d __ (9th Cir. No. 06-55694, August 17, 2007). Adhering to a long line of Ninth Circuit and California state precedents, the Ninth Circuit declared that no-class-action clauses in consumer contracts of adhesion – virtually any standard-form contract to which a consumer must subscribe in order to obtain a service – are both substantively and procedurally unconscionable. The court then carefully analyzed the argument that this doctrine conflicts with the policy of the Federal Arbitration Act to encourage arbitration, a policy that reflects a desire to promote efficiency in resolving disputes. Judge

Reinhardt's characteristically tendentious opinion responded: "if we were to hold that class arbitration conflicts with the Federal Arbitration Act in light of the Act's secondary concept of efficiency, the indisputable result would be to undermine the primary objective of encouraging arbitration because far fewer individual consumers will participate in arbitration absent the class action device."

The two other West Coast states are equally hostile to "no-class action" clauses. The Washington Supreme Court in *Scott* v. *Cingular Wireless*, 161 P.3d 1000 (Wash. 2007), agreed that the class action waiver in a contract for cellular telephone service is substantively unconscionable. In *Vasquez-Lopez* v. *Beneficial Oregon, Inc*. (Ore. App. A125270, January 31, 2007), the Oregon Court of Appeals also found that such a clause in a lending agreement was both unenforceably unconscionable and not severable from the arbitration clause itself. As a result, the court affirmed a judgment for compensatory damages and $237,000 in *punitive* damages that a jury awarded after the trial court had refused to compel arbitration under the contract. The case illustrates the potentially high cost that a company confronts, if it couples an arbitration requirement with a no-class-action clause. The whole mechanism may collapse and the company will find itself before a jury capable of awarding punitive damages.

Like California, Pennsylvania has a fairly consistent line of cases holding that "no class action" clauses are unconscionable, at least when found in what the courts classify as "consumer contracts of adhesion." See, *e.g*., *Thibodeau* v. *Comcast Corp*., 2006 Pa. Super. 306 (2006), and cases cited. A careful reader may note that the cable and satellite television industries and phone companies provide a lot of grist for the mill in this area of litigation.

At the moment, the states invalidating "no class action" clauses appear to be in the minority, but their number is growing. The Wisconsin intermediate appellate court recently joined the minority ranks. See *Coady* v. *Cross Country Bank*, 729 N.W.2d 732 (Wis. Ct. App. 2007). Although recognizing that a majority of federal and state courts have enforced class action waivers and found them enforceable, the Wisconsin court announced that it was "persuaded by what appears to be a growing minority of courts that a waiver of class-wide relief is a significant factor . . . in invalidating an arbitration provision as unconscionable." For this proposition, the court cited appellate decisions not only in California but also in Alabama, Florida, West Virginia, Illinois, and New Jersey as among the "growing minority" of courts that have found such clauses unconscionable.

The court also disregarded a choice-of-law provision in the contract that would have had the clause evaluated under a more favorable state's regime; the court concluded that including such a choice-of-law clause in a consumer contract of adhesion (there, a bank's standard credit-card agreement) could not evade the protection of local law.

There are, of course, many cases going the other way, as indeed we saw in discussing the latest Eleventh Circuit case invalidating a no-class-treatment clause. That panel took pains to distinguish three earlier cases in the same circuit reaching the opposite result. In addition, the Oregon appellate court acknowledged the current majority rule when it decided to line up with the "growing minority" that refuse to enforce these clauses.

For instance, in May 2007, the federal district court in Washington, D.C., declined to follow a California decision in a similar case and instead upheld an arbitration

agreement that barred class-wide proceedings. Both cases involved claims against satellite television broadcaster DirecTV. In Washington, the federal judge opted to borrow neighboring Maryland's more hospitable attitude toward such clauses. In *Szymkowicz* v. *DirecTV*, 2007 WL 1424652 (D.D.C. May 9, 2007), Judge Friedman quoted a passage from the Maryland Court of Appeals in *Walther* v. *Sovereign Bank*, 872 A.2d 735 (Md. 2005), stating:

> "Numerous courts, both federal and state, have rigorously enforced no-class-action provisions in arbitration agreements and found them to be valid provisions of such agreements and not unconscionable."

The Appellate Division for the First Department in New York has agreed:

> "Given the strong public policy favoring arbitration . . . and the absence of a commensurate policy favoring class actions, we are in accord with authorities holding that a contractual proscription against class actions . . . is neither unconscionable nor violative of public policy." *Ranieri* v. *Bell Atlantic Mobile*, 759 N.Y.S.2d 448 (App. Div. 1st Dep't 2003).

An interesting twist on all this appears in a March 2007 decision by the Maryland Court of Special Appeals, *Doyle* v. *Finance America, LLC,* 918 A.2d 1266 (Md. Ct. Spec. App. 2007). There the borrowers had filed a class action in court claiming that they and other borrowers had been charged excessive interest. The loan agreement contained a clause requiring arbitration and also prohibiting class treatment. The applicable language was this:

> "Only disputes involving you and us may be addressed in the arbitration. The arbitration shall not address any dispute on a 'class wide' basis nor shall it be consolidated with any other arbitration proceeding. This means that the arbitration will not address disputes involving other persons that may be similar to the disputes between you and us."

In response to the finance company's demand for arbitration, the borrowers insisted that they were entitled to proceed in court with their class action, because the contract only barred class treatment *in an arbitration*. They argued that, by implication,

the contract required arbitration only if they chose to proceed with non-class claims and that the ban focusing only on class claims in arbitration meant that they were free to opt out of arbitration entirely by bringing a class action in court.

The Maryland appellate court rejected that clever argument. The court gave both provisions of the contract their normal meaning, requiring arbitration instead of litigation and banning class claims in such arbitration. The court explained:

> "Although it may have been wise to expressly include a 'no-class-action' provision in the Agreement, we cannot say that [the finance company's] failure to do so renders the class action provision in the Agreement any less clear."

The court then had to address the frequent argument that the arbitration clause was itself void for unconscionability, because – allegedly – it would cost $1550 in arbitral fees just to assert the borrowers' claim to recover their own over-payment of $1539. The court first referred to the decision by its Court of Appeals in 2005 rejecting the argument that "no-class-action" provisions are inherently unconscionable. The *Doyle* court added:

> "Although a minority of jurisdictions take the position that 'no-class-action' provisions are unenforceable, Maryland stands firmly in the majority." Fn. 6.

Turning to the standard "death knell" argument as presented on the particular facts, the court was somewhat more equivocal. The argument is, of course, that if the claimant cannot proceed on a class-wide basis, then as a practical matter he cannot proceed at all. The appellate court did not reject that argument as unsound in principle, but merely held that the evidence adduced in the trial court had not in fact demonstrated to the trial judge's satisfaction that the borrowers would incur "prohibitive costs."

That way out of the bind does not offer much comfort for companies seeking to enforce "no class treatment" prohibitions in consumer-related cases. The court simply cited a series of cases establishing that the issue of unconscionability must be resolved on

a case-by-case basis in light of hard evidence that the consumer would face disproportionate costs if required to arbitrate on a non-class basis. The implication is both obvious and ominous: if the consumer can produce such evidence – and it is not hard to imagine being able to develop the evidence – the company may be forced either to relinquish the arbitral forum or the ban on class treatment. That, ironically, was the original JAMS policy.

Another case upholding one of these clauses also reflects the prevailing tension. The federal court in New Jersey recently enforced an arbitration agreement to forestall a class action that an American Express card holder had filed in that court. *Homa* v. *American Express*, 2007 WL 1585168 (D.N.J. May 31, 2007). The card member agreement specified that disputes are to be resolved through arbitration and that no class-action mechanism will be available. The agreement also declared that Utah law would apply. The plaintiff/would-be class representative relied on a decision by the New Jersey Supreme Court that had found unconscionable a no-class-action clause in a consumer contract. See *Muhammad* v. *County Bank*, 912 A.2d 88 (NJ 2006). The plaintiff contended that this decision established fundamental state policy to which the federal court sitting in New Jersey should defer.

Instead, the district court enforced the agreement. Acknowledging the decision in *Muhammad*, the court concluded that the New Jersey Supreme Court had relied on a more fact-intensive analysis of the context in which class-action waivers are invoked and did not establish a policy that such waivers are inherently unconscionable. In this case the court found more persuasive the decisions by other courts enforcing arbitration agreements, even though they contained similar waivers.

The majority of courts that still are willing to enforce “no class action” clauses rely on the general policy of the Federal Arbitration Act to promote arbitration and to allow the parties to contract for the type of arbitration they prefer. They reason that such clauses are not inherently unfair, especially if the cost-bearing terms of the arbitration and of the forum selected do not impose on the claimant an unavoidable financial burden that renders the arbitral remedy illusory.

I should note, though, that in my admittedly unscientific survey, there are more cases being currently reported that strike down “no class action” clauses or at least refuse to enforce them in particular circumstances than cases upholding the clauses. This may be what the Oregon appellate court intuited in the *Vasquez-Lopez* case when it spoke of joining the “growing minority” of courts rejecting these clauses.

Finally, there may be other sources of law that determine whether there can be a class-wide arbitration. For example, for disputes between securities firms and their customers, the NASD has an elaborate process for arbitrations, but new provisions prohibit class arbitrations and also prohibit referring disputes to mandatory arbitration when the customer is part of a putative class in a court case, unless the customer voluntarily opts out of the class. As recently adopted, Rule 13204 of the NASD Code of Arbitration (effective April 2007) provides:

> **“13204. Class Action Claims**
>
> “(a) Class action claims may not be arbitrated under the Code.
>
> “(b) Any claim that is based upon the same facts and law, and involves the same defendants as in a court-certified class action or a putative class action, or that is ordered by a court for class-wide arbitration at a forum not sponsored by a self-regulatory organization, shall not be arbitrated under the Code, unless the party bringing the claim files with NASD one of the following:
>
> “(1) a copy of a notice filed with the court in which the class action is pending that the party will not participate in the class action or in any recovery that

may result from the class action, or has withdrawn from the class according to any conditions set by the court; or

"(2) a notice that the party will not participate in the class action or in any recovery that may result from the class action.

"(c) The Director will refer to a panel any dispute as to whether a claim is part of a class action, unless a party asks the court hearing the class action to resolve the dispute within 10 days of receiving notice that the Director has decided to refer the dispute to a panel.

"(d) A member or associated person may not enforce any arbitration agreement against a member of a certified or putative class action with respect to any claim that is the subject of the certified or putative class action until:

"The class certification is denied;

"The class is decertified;

"The member of the certified or putative class is excluded from the class by the court; or

"The member of the certified or putative class elects not to participate in the class or withdraws from the class according to conditions set by the court, if any.

"This paragraph does not otherwise affect the enforceability of any rights under the Code or any other agreement."

Adopted by SR-NASD-2004-011 eff. April 16, 2007.

V. What Can Companies Do About All This?

These developments are disturbing for the counsel who are responsible for managing a company's dispute-resolution program, but there are some steps that corporate counsel can take to try to control the process. Here are some ideas.

- Insert in standard-form contracts a clause expressly forbidding class treatment or consolidation of separate arbitrations. The preclusion may not survive in some jurisdictions, but the *absence* of such a prohibition virtually guarantees that a claimant will be able to pursue a class arbitration.

- Use a "choice of law" clause that refers to the internal law (exclusive of conflict-of-law principles) of a state that (a) has ruled that no class actions are permitted in arbitration unless the parties expressly agree to such procedure and/or (b) has been willing to enforce "no class action" clauses. Of course, to have enforceable effect,

especially in consumer contracts, the forum whose law is to be selected must have some plausible relation to the parties or to the transaction.

- Consider whether, if a "no class action clause" fails as unconscionable, the company would rather confront a class action in an arbitral forum or in court. The problem is one of "severability." When courts strike down these clauses, some find that they are not "severable" from the obligation to arbitrate, so the arbitration clause itself becomes unenforceable and the claimant is free to proceed in court, with a class action, if the claimant so desires. Others simply disregard the "no class action" clause and leave the company committed to arbitrate but on a class-wide basis. That may be the worse course, because arbitral rulings both on establishing a class and granting ultimate relief will be subject to far less judicial or appellate review than would be comparable rulings in court. Therefore, the contract language should specify what happens if a court decides that an arbitration could proceed on behalf of a class, despite the presence of a "no class action" clause.

- Minimize the potential size of any class action that cannot be avoided. In deciding that class treatment is appropriate in arbitrations, some judges and arbitrators have emphasized that all members of the putative class signed the same contract or the same standard-form agreement. Varying the language of standard-form clauses somewhat, such as on a state-by-state or period-by-period basis, could help limit the establishment or scope of any class.

- Insert a clause that authorizes either *de novo* judicial review of any rulings relating to class certifications or at least calls for review for legal error or abuse of discretion. While the courts generally have resisted efforts to enlarge the scope of

judicial review by including such provisions in arbitration clauses, it cannot hurt to try. Litigating class claims in arbitration is relatively new. The standards for class actions are peculiarly legal – derived from Rule 23 of the Federal Rules – and arbitrators have no particular expertise in making these determinations. So there is at least some chance that the courts would entertain an authorization to take a hard look at arbitrators' rulings on class issues, if the contract calling for arbitration invites the courts to do so.

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