Mandatory Arbitration:

quick relief for consumers— or a new shield against meritorious claims?

By Todd Turner, Esquire

Arbitration has been used as an alternative method of dispute resolution in America for over 200 years.[i] In 1925, the Federal Arbitration Act[ii] (FAA) was developed primarily to facilitate dispute resolution in the commercial context between persons of equal bargaining power.[iii] Arbitration is often heralded as a quick and inexpensive means of resolving disputes. However, "[a]rbitration is not a perfect system of justice, nor is it designed to be."[iv]

Unfortunately, many companies are now using arbitration as a mechanism to restrict their customers' access to relief. Mandatory arbitration agreements in adhesion contracts are now employed by stronger parties who seek to avoid lawsuits and force weaker parties into arbitration.[v]

Not only are these clauses inserted into adhesion contracts, some companies will unilaterally add arbitration provisions to existing contracts by mailing a clause to customers along with bills or account statements.[vi] The validity of these "amendments" to the original contract will depend on state law.[vii] A customer may also be found to have consented to the new arbitration clause if she continued to do business with the other party (i.e., if she used her credit card after receiving notice of the new provision).[viii]

At least one court has observed that "unconscionable mandatory arbitration agreements" offer a new means "of circumventing state consumer protection."[ix] In fact, the actual aim of many mandatory arbitration clauses in consumer contracts is to install an insuperable insulation to any legal recourse for the customer.

One of the problems with arbitration "is that whatever the rules of law may be, arbitrators are not bound to follow them and their handiwork is subject to only the most perfunctory judicial oversight."[x] Arbitration awards are not only subject to a very limited judicial review, the arbitration process itself lacks the procedural safeguards that are afforded to litigants in the judicial system.

The Eighth Circuit Court of Appeals has described the arbitration process as follows: "In the arbitration setting we have almost none of the protections that fundamental fairness and due process [usually] require. . . . Discovery is abbreviated if available at all. The rules of evidence are employed, if at all, in a very relaxed manner. The factfinders (here the panel) operate with almost none of the controls and safeguards [expected in litigation].[xi]

Arbitration is not an attractive alternative for aggrieved consumers with relatively small individual claims. Generally, arbitration does not provide for the payment of attorneys' fees and costs to a prevailing consumer. There is also no guarantee that the victim will recover statutory penalties or punitive damages. Meanwhile, the costs of arbitration often make it prohibitive as a means of relief for small monetary claims. Finally, arbitration clauses usually prevent multiple consumers' ability to combine their claims and pursue a class action. In many instances, the consumer's only chance for relief hinges on her ability to defeat a "mandatory" arbitration clause.

Contract defenses.

There are several factors to consider when challenging "mandatory" arbitration. First of all, the entire contract should be reviewed to determine whether there are defenses which may preclude its enforcement. The validity of the contract and the arbitration clause are based on state law.[xii]

Consequently, traditional state-law contract defenses can be raised to defeat arbitration.[xiii] Defenses such as

fraud, duress, unconscionability and incapacity may defeat the entire contract which would prevent arbitration.[xiv] The nature of the dispute must also be within the scope of the arbitration clause. "[A] party cannot be required to submit to arbitration any dispute which he has not agreed to submit."[xv]

Lack of Mutuality.

Fortunately for Arkansans, the state's high court has refused to enforce non-mutual arbitration clauses. Through a recent line of cases, the Court has held that arbitration is not appropriate unless both parties are required to arbitrate.[xvi] In other words, one party cannot reserve the right to seek relief in court while demanding that the other party submit to arbitration. The mutuality concept is that "neither party is bound unless both are bound."[xvii] This rule ensures that arbitration clauses are fair to both parties.[xviii]

The mutuality requirement arose frequently in the context of lawsuits against payday lenders.[xix] Many lenders placed arbitration clauses in their agreements that purported to force the borrowers to seek arbitration of any disputes. Meanwhile, the lenders had the right to go to court if the borrower did not re-pay the loan.

The Supreme Court observed the inherent unfairness of this result and held that the common-law requirement of mutuality of obligations is applicable when reviewing the enforceability of an arbitration clause. Despite a "belief" that arbitration agreements provide a quick and inexpensive method to resolve disputes, those agreements "should not be used as a shield against litigation by one party" who simultaneously reserves solely to itself "the sword of a court action."[xx] If a contract lacks mutuality, it is clearly unenforceable under Arkansas law.

Unconscionability.

Arbitration clauses can also be defeated if they are unconscionable. Courts often distinguish between "procedural" and "substantive" unconscionability. Procedural unconscionability arises in adhesion contracts where there are factors such as disparate sophistication and bargaining power between the parties.[xxi] Substantive unconscionability involves allegations that the clause is oppressive, unfair or so one-sided that its enforcement would be unduly harsh to the other party.[xxii] Unconscionability issues are reviewed on a case-by-case basis.[xxiii]

Some courts have used reasoning similar to the mutuality analysis to determine whether a one-sided arbitration clause should be held unconscionable. In one case, a consumer's claim against a cell phone provider was not subject to arbitration because the provider could seek relief in court while the customer was obligated to arbitrate. The court held that the clause was so one-sided that it was unconscionable as a matter of state law and refused to compel arbitration.[xxiv]

The type of claim.

Even if there is a valid agreement to arbitrate, the agreement must encompass the particular dispute.[xxv] If the quarrel involves matters beyond the scope of the agreement, the subject will not be arbitrable.

Arbitration may also be inappropriate for certain types of disputes. The Arkansas Arbitration Act prohibits arbitration of torts and insurance claims.[xxvi] These claims are not exempted from the FAA.[xxvii] Most businesses which use arbitration as a shield against litigation will provide that the arbitration shall be governed by the FAA. Moreover, it is likely that the Arkansas General Assembly will be asked to expand the scope of the Arkansas act so that it can be employed by those who may wish to further frustrate consumers' ability to seek legal relief.

Unconscionable costs.

Arbitration can be a very expensive process. As an example, assume that a credit card company charges its cardholder an illegal $5.00 fee each month for a year. When the consumer discovers the illegal charge, she hires an attorney (on a contingent-fee agreement) who sues the company for simple breach of contract.[xxviii] If she prevailed, she could receive judgment for her actual damages of $60.00, plus judgment for her reasonable attorney's fees and costs.[xxix] Such a result would fulfill the objective of contract restitution because the consumer would be made whole for her injuries. Even if she did not prevail, she would only have lost her filing fee.

If the same cardmember was forced to arbitrate, she would have to pay the initial arbitration fee up front. While this fee varies among arbitration associations, it would most certainly exceed the cost of a district or circuit court filing fee.[xxx] The cardmember must then pay the costs of administration and the arbitrator's fees, including his travel and out-of-pocket expenses.[xxxi] These costs could run as high as $700.00, *excluding the arbitrator's compensation and expenses,* for a half-day proceeding.[xxxii] The consumer would also be responsible for some or all of the costs incurred in renting a hearing room or any other related expenses.[xxxiii] In this example, if the consumer prevailed, she would receive a judgment of $60.00. If the arbitrator ruled that the parties were equally responsible for costs, the consumer's share would be a minimum of $350.00 *(once again, excluding the arbitrator's compensation and expenses)* even though she won the case. She would also be responsible for her own attorney's fees.[xxxiv] In this example, she clearly would not be made whole.

The Public Citizen, a non-profit consumer advocacy organization, published a report on the cost of arbitration in 2002.[xxxv] The report reflected that the cost to initiate arbitration "is almost always higher than the cost of filing a lawsuit."[xxxvi] Public Citizen found that the costs imposed to administer arbitration can be up to "five thousand percent higher in arbitration than in court litigation" and concluded that the costs serve as a deterrent, "often preventing a claimant from even filing a case."[xxxvii]

The United States Supreme Court has observed that "the existence of large arbitration costs could preclude a litigant . . . from effectively vindicating her federal statutory rights in the arbitral forum."[xxxviii] However, there is no

CONTINUED ON PAGE 32

MANDATORY

CONTINUED FROM PAGE 31

per se rule to determine when the potential costs may invalidate arbitration. Instead, most courts will consider the issue on a case-by-case basis.[xxxix]

A party alleging unconscionability because of arbitration expenses must make a record to demonstrate the potential prohibitive costs.[xl] This may also be accomplished by demonstrating that the claimant has limited income or an inability to pay excessive fees. However, neither prohibitive costs nor a party's inability to pay them will *automatically* render an arbitration clause unconscionable.[xli]

Many consumer-protection statutes are remedial in nature and provide penalties as a measure to deter oppressive and unfair activities. Arbitration cannot guarantee that the objectives of state and federal consumer protection statutes will be accomplished.

Unconscionable terms.

In addition to prohibitive costs, there are other factors which can cause arbitration clauses to be unconscionable. For example, a requirement that arbitration occur at an inconvenient locale may render a clause unenforceable. In a case involving a dispute over a franchise agreement, a hotel franchisee in Montana objected to arbitration because, *inter alia*, the proceeding would be conducted at the franchisor's headquarters in Maryland.[xlii] The Ninth Circuit Court of Appeals observed that lack of mutuality and unconscionability defenses were arguably "limited to consumer contracts."[xliii] However, the Court applied the doctrines to the franchise agreement and refused to enforce the arbitration clause.

Prevention of class-action claims.

Many mandatory arbitration clauses specifically prohibit a party from representing others who have similar claims as an effort to prevent class actions. The issue of whether claims can be arbitrated on a class-wide basis is unsettled. However, the basic notion of the class-action mechanism is that it is designed to facilitate the resolution of similar, mass claims.[xliv] The Supreme Court has observed that in many cases, "aggrieved persons may be without any effective redress unless they employ the class action device."[xlv] In fact, in cases involving a large number of relatively small, similar claims, the class-action procedure is often favored.[xlvi]

The Supreme Court has held that the threshold determination of whether class-wide arbitration is available under an enforceable arbitration clause is one that must be resolved by the arbitrator.[xlvii] Some arbitration associations have developed rules to handle class-wide arbitration.[xlviii] However, most clauses in adhesion contracts are designed to preclude such a result and a defendant would probably never agree to allow multiple consumers to combine their claims into a single proceeding. Moreover, even in class-wide arbitration, remedies such as statutory damages and attorneys' fees may still elude the prevailing claimants.

The use of arbitration clauses to defeat class-action relief can give rise to a due process argument. Some courts have denied arbitration when it would have defeated a class-action claim.[xlix] Such a prohibition can make an arbitration clause so one-sided that it is unconscionable.[l] Others have held that the prohibition of class-wide arbitration does not render a clause unenforceable.[li]

Conclusion.

The FAA was designed to facilitate an alternative form of dispute resolution for willing parties of equal bargaining power.[lii] In that context, it can be a fair and efficient means of resolving contract rights and disputes. Regrettably, arbitration clauses are now being drafted and inserted into form, adhesion contracts as a device to protect the drafter from liability for even intentional violations of remedial, consumer-protection statutes. In such instances, an attorney should scrutinize the transaction to determine whether the contract or the mandatory arbitration clause is unconscionable or unenforceable. •

Todd Turner is a member of the firm of Arnold, Batson, Turner & Turner, P.A. in Arkadelphia. He received the Arkansas Trial Lawyers Association Consumer Advocate Award in 2000. He has represented consumers in over 40 class-action cases.

Endnotes

i Hancock v. Hillegas, 2 U.S. 380 (1797).

ii 9 U.S.C. § 1, et seq.

iii Jenkins v. First American Case Advance of Georgia, LLC., 313 F. Supp. 2d 1370 (S.D. Ga. 2004); Harding, Margaret M., "The Clash between Federal and State Arbitration Law and the Appropriateness of Arbitration as a Dispute Resolution Process," 39 Harv. J. on Legis. 281, 289 (2002).

iv Hoffman v. Cargill, 236 F.3d 458, 462 (8th Cir. 2001).

v Jenkins, 313 F.Supp.2d at 1377-78.

vi Perry v. FleetBoston Fin. Corp., 2004 U.S. Dist. LEXIS 12616 (E.D. Pa. July 6, 2004).

vii Id., (arbitration was not enforceable when there was a unilateral change by credit card company); Discover Bank v. Shea, 827 A.2d 358 (N.J. Super. Ct. 2001)(Discover's unilateral attempt to add arbitration clause was ineffective). Other courts have reached the opposite result. Bank One v. Coates, 125 F. Supp. 2d 819 (S.D. Miss. 2001)(unilateral addition of arbitration clause authorized by Ohio law).

viii See Perry, 2004 U.S. Dist. LEXIS 12616)("If plaintiffs had used their credit cards, they would have manifested their assent to the new term, and the change would no longer be unilateral.")

ix Jenkins, 313 F.Supp.2d at 1377.

x Id. At 1378 citing Knapp, Charles L., "Taking Contracts Private: The Quiet Revolution in Contract Law," 71 Fordham L. Rev. 761, 782-83 (2002).

xi Hoffman, 236 F.3d at 463-64, quoting Lee v. Chica, 983 F.2d 989 (8th Cir. 1993).

xii First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938 (1995).

xiii Doctor's Associates, Inc. v. Casarotto, 517 U.S. 681 (1996); May Const. Co., Inc. v. Benton, 320 Ark. 147, 895 S.W.2d 521 (1995).

xiv These defenses may be raised to defeat arbitration clauses if they are otherwise generally applicable contract defenses. Id.; 9 U.S.C. § 2.

xv United Steelworkers of America v. Warrior & Gulf Nav. Co., 363 U.S. 574, 582 (1960).

xvi Showmethemoney v. Williams, 342 Ark. 112, 27 S.W.3d 361 (2001). See also, Tyson Foods v. Archer, 2004 Ark. LEXIS 107 (Ark. February 19, 2004); Cash in A Flash Check Advance of Arkansas, LLC. v. Spencer, 348 Ark. 459, 74 S.W.3d 600 (2002); The Money Place, LLC v. Barnes, 349 Ark. 411, 78 S.W.3d 714 (2002); F & G Fin. Serv., Inc. v. Barnes, 349 Ark. 505, 78 S.W.3d 720 (2002); Tay-Tay, Inc. v. Young, 349 Ark. 369, 78 S.W.3d 721 (2002); The/Fre, Inc. v. Martin, 349 Ark. 503, 78 S.W.3d 722 (2002); EZ Cash Advance, Inc. v. Harris, 347 Ark. 132, 60 S.W.3d 436 (2001); Hawks Enter., Inc. v. Andrews, 75 Ark. App. 372, 57 S.W.3d 778 (2001).

xvii Showmethemoney, 342 Ark. at 120.

xviii See e.g. Arnold v. United Companies Lending, Corp., 511 S.E.2d 854 (W. Va. 1998).

xix See fn. 10. The Tyson case is remarkable because the plaintiffs (hog farmers) alleged large, commercial damages as opposed to relatively small, individual consumer claims.

xx Showmethemoney, 342 Ark. at 121.

xxi East Ford, Inc. v. Taylor, 826 So.2d 709, 714 (Miss. 2002).

xxii Id.

xxiii Banc One Acceptance Corp. v. Hill, 367 F.3d 426 (5th Cir. 2004).

xxiv Iberia Credit Bureau, Inc. v. CIngular Wireless LLC, 2004 LEXIS 15030 (5th Cir. July 21, 2004) (applying Louisiana law).

xxv Pro Tech Ind., Inc. v. URS Corp., 2004 U.S. App. LEXIS 15431 (8th Cir. July 27, 2004); Gannon v. Circuit City Stores, Inc., 262 F.3d 677 (8th Cir. 2001).

xxvi Ark. Code Ann. § 16-108-201(b)(2) ("This subsection shall have no application to personal injury or tort matters, employer-employee disputes, nor to any insured or beneficiary under any insurance policy or annuity contract.")

xxvii 9 U.S.C. § 1, et seq.

xxviii The consumer may have other statutory claims, but breach of contract will suffice for this example.

xxix As the prevailing party in a contract action under Arkansas law, she could recover her attorney's fees and costs under Ark. Code Ann. § 16-22-308.

xxx For example, the American Arbitration Association's initial filing fees start at $500, plus a $200 case administration fee, for claims involving less than $10,000.00 in dispute. www.adr.org. The AAA's fees will be used for purposes of the hypothetical example in this article.

xxxi AAA Commercial Arbitration Rules, R-50 & R-51.

xxxii See fn. 30.

xxxiii AAA Commercial Arbitration Rules, R-51.

xxxiv Since attorney's fees are so uncertain in arbitration, it would be unlikely that she could retain counsel on a contingent fee basis.

xxxv A summary of the report, can be found at www.lawmemo.com/arb/res/cost.htm.

xxxvi Id.

xxxvii Id.

xxxviii Green Tree Financial Corp. v. Randolph, 531 U.S. 79 (2000).

xxxix See e.g. Bradford v. Rockwell Semiconductor Sys., 238 F.3d 549 (4th Cir. 2001).

xl The inquiry typically involves the "claimant's ability to pay the arbitration fees and costs" and whether the difference in cost between arbitration and litigation "is so substantial as to deter the bringing of claims." Musnick v. King Motor Co., 325 F.3d 1255, 1260 (11th Cir. 2003); Gipson v. Cross Country Bank, 294 F.Supp.2d 1251 (M.D. Ala. 2003).

xli See e.g. Pro Tech Ind., Inc. v. URS Corp., 2004 U.S. App. LEXIS 15431 (8th Cir. July 27, 2004)(despite party's inability to pay costs, court held that contract was not unconscionable at time of its formation).

xlii Ticknor v. Choice Hotels, International, Inc., 265 F.3d 931 (9th Cir. 2001)

xliii Id. at 942.

xliv This topic is discussed in detail at Turner, Todd M., "Arbitrations v. Class Actions: Clashing Procedures for the Resolution of Mass Consumer Claims," ATLA Docket, Fall 2001, p. 8.

xlv Deposit Guar. Nat.l Bank v. Roper, 445 U.S. 326, 339 (1980).

xlvi See e.g. USA Check Cashers v. Island, 349 Ark. 71, 76 S.W.3d 243 (2002).

xlvii Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444 (2003) (Since the arbitration clause was enforceable, it was up to the arbitrator to decide if a class of claims could be combined for arbitration.)

xlviii See e.g. AAA's policy on class arbitration at www.adr.org.

xlix Ingle v. Circuit City Stores, Inc., 328 F.3d 1165 (9th Cir. 2003); Keating v. Superior Court, 645 P.2d 1192(1982) rev'd on other grounds sub norm. Southland Corp. v. Keating, 465 U.S.1 (1984).

l Szetela v. Discover Bank, 97 Cal. App. 4th 1094 (2002) (even though both parties were precluded from seeking class-action relief, it was clear that Discover would never have any class-action claims against its customers. Thus, the clause was one-sided and unconscionable.)

li See e.g. Iberia Credit Bureau, Inc., 2004 LEXIS 15030 (5th Cir. July 21, 2004); Randolph v. Green Tree Fin. Corp., 244 F.3d 814 (11th Cir. 2001).

lii Jenkins, 313 F. Supp. 2d at 1377-78.