Why and How We Should Ban Class-Action Bans

Conference on "The Future of Arbitration"
George Washington University Law School, March 17-18, 2011

Deepak Gupta

In *AT&T Mobility v. Concepcion*, the Supreme Court will decide whether corporations may ban class actions in the fine print of their standard-form contracts with consumers and employees. Specifically, the legal question before the Court is whether the Federal Arbitration Act preempts state-law rulings that class-action bans in arbitration agreements are unconscionable.

As counsel for the respondents in *Concepcion*, I have expressed my view on how that question should be resolved under existing Supreme Court precedent: The Court should hold that the FAA does not preempt the state-law rulings because the state law at issue does not discriminate against arbitration. I am grateful to the organizers of this conference, Alan Morrison and Roger Trangsrud, for the opportunity to consider the same problem free of real-world constraints. That is, the organizers have asked the participants to address what the law *should* be, without limiting ourselves to existing Supreme Court precedent.

In what follows, I offer a brief explanation of why, as a policy matter, we should ban class-action bans. I then turn to the far more difficult questions the organizers have raised about how we should go about accomplishing that goal: Do we need a single rule governing all class-action bans? Should it be a legislative or judicial rule? Categorical or noncategorical? If noncategorical, what lines should we draw—what kinds of class-actions, if any, should corporations be allowed to ban, and how do we go about making these decisions?

Why We Should Ban Class-Action Bans

Class-action bans are provisions in adhesion contracts that deny consumers and employees the right to pursue any classwide relief against the drafter in any forum—whether in litigation or arbitration. They have become ubiquitous in consumer contracts and increasingly common in employment contracts. If enforced, class-action bans preclude classwide relief under consumer protection, antitrust, civil rights, and labor and employment statutes, among others. Given limited public resources, private enforcement of these statutes is essential. And because consumers' and employees' claims often cannot be pursued effectively except through class-actions—particularly when the individual damages are small, the legal theories and defenses are complex, and the cost of discovery and proof are especially high—the bans would allow many potential defendants to opt out of liability altogether.[1]

Indeed, businesses have adopted mandatory arbitration clauses and class-action bans precisely for the purpose of preventing consumers from bringing legitimate claims. As Judge Posner has famously put it: "The realistic alternative to a class action is not 17 million individual suits, but zero individual suits, as only a lunatic or a fanatic sues for $30."[2] Recognizing that reality, businesses made a concerted effort in the 1990s to adopt mandatory arbitration clauses foreclosing class actions to eliminate their exposure to claims of any sort.[3] One recent empirical study demonstrated that major corporations "overwhelmingly selected arbitration as the method for resolving consumer disputes and permitted litigation as the method for resolving business disputes."[4] The authors concluded that businesses "do not view consumer arbitration as offering a superior combination of cost savings, expeditious decision-making, consistency, and justice" but instead "view consumer arbitration as a way to save money by avoiding aggregate dispute resolution."[5]

That an individual's "claim may be so small, or the plaintiff so unfamiliar with the law, that he would not file suit individually," are among the chief justifications for the class action.[6] The class-action mechanism "overcomes the problem that small individual recoveries may fail to provide an adequate incentive for a litigant to investigate a claim."[7] The Supreme Court has repeatedly recognized these features of the class device.[8] In the language of economics, detecting and investigating fraud requires individuals to incur information, monitoring, and transaction costs, which may actually exceed the individuals' net loss.[9] Class actions spread these costs, preventing individuals from having to bear them alone.[10]

Class-action bans, on the other hand, force consumers to unknowingly incur those costs, which are normally borne by all similarly situated people and those who act as private attorneys general. It is not reasonable to impose that burden on consumers who lack real bargaining power and who do not really assent to the terms of adhesion contracts. From an *ex ante* perspective, class-action bans are unfair because they force consumers to give up any benefits that class actions may have for them—either as named plaintiffs in a class action or, more likely, as beneficiaries of the compensatory, deterrent, and cost-spreading effects of class actions brought on their behalf by others. When consumers enter into a transaction, they generally have no reason to believe they will be able to (a) monitor for and detect fraud and (b) recognize that fraud as unlawful, or (c) hire a lawyer to do those things for them. "Most individuals are too preoccupied with daily life and too uninformed about the law to pay attention to whether they are being overcharged or otherwise inappropriately treated by those with whom they do business."[11]

In short, class-action bans are corporate get-of-jail-free cards. They do not actually repeal consumer and civil rights protections, but they accomplish the same thing by means of private legislation tucked into the fine print of adhesion contracts that nobody reads.

How We Should Ban Class-Action Bans

The conference organizers have asked a series of difficult questions about *how* we should go about resolving the problem of class-action bans. In an ideal world, yes, there would be a single rule governing the enforceability of class-action bans—a rule that would forbid businesses from imposing class-action bans on consumers or employees. Such a rule would provide needed certainty to businesses and individuals alike, reduce the costly and unproductive threshold litigation over the enforceability of arbitration agreements that currently plagues much consumer litigation, preserve citizens' ability to bring legitimate claims, and ensure some measure of corporate accountability in our legal system.

Imagining such a rule is one thing, but coming up with a politically realistic means of achieving it is quite another. The quest to end the pernicious effects of mandatory arbitration for consumers and employees poses unique obstacles. The first obstacle, of course, is the Supreme Court. Since the 1980s, the Court has consistently encouraged the expansion of arbitration, without much regard for the important differences between its voluntary use in the commercial context and its involuntary imposition on consumers and employees with comparatively less bargaining power. Scholars and litigators have for years railed against the Supreme Court's apparent blindness to this problem, without any apparent effect. Thus, most pro-reform observers believe that legislation at the federal level is required. A second obstacle is the almost complete lack of public awareness. Despite the ubiquity of mandatory arbitration clauses, Americans are blissfully unaware that they have signed away their right to access the courts. Many Americans find this out only when it's too late—when they have suffered from predatory lending, employment discrimination, or other illegal practices. This lack of awareness makes it extremely difficult to mobilize support for arbitration reform in Congress. A third, and closely related problem, is the lack of data on arbitration—a direct byproduct of its secrecy. And last, but certainly not least, is the highly-organized, well-funded opposition: It is not easy to pass legislation that is opposed by the entire business community.

One approach that consumer and civil rights advocates have taken is not to target the class-action bans themselves, but the mandatory arbitration clauses in which they are typically found. This has the virtue of preserving not only class actions, but the individual's right to a day in court and, with it, the right to a neutral decision-maker, full discovery, appeal rights, and the opportunity to produce public precedent that is binding on actors who engage in similar future

conduct. In crafting reforms along these lines, "it is critical to distinguish between commercial arbitration voluntarily agreed to by parties of approximately equal bargaining power, and commercial arbitration forced upon unknowing consumers, franchisees, employees or others through the use of form contracts."[12]

Along these lines, the proposed federal Arbitration Fairness Act would ban mandatory pre-dispute arbitration clauses in consumer and employment contracts.[13] The bill has been continually reintroduced in the last several Congresses and is supported by a broad coalition of consumer and civil rights groups, but it faces widespread opposition from virtually the entire business community. Its already uncertain prospects have diminished considerably since last year's midterm elections.

A more successful and promising legislative approach has been to target mandatory pre-dispute arbitration clauses in particular contexts, such as mortgage lending and auto contracts, or with certain favored groups, such as military servicemembers, veterans, nursing-home patients, and poultry farmers.[14] Some of this legislation has taken the form of outright bans on pre-dispute arbitration, while other legislation has delegated authority to impose such a ban on an administrative agency. The recent Dodd-Frank Wall Street Reform Act takes both approaches, banning arbitration in the mortgage context but delegating broader authority to limit or ban arbitration in financial-services contracts to the new Consumer Financial Protection Bureau.

These narrower reforms have had some success because they do not face opposition from the entire business community, because they benefit from the mobilization of support surrounding substantive legislation targeting particular practices, and in some cases because they benefit certain politically favored groups. At the same time, they bring some of the virtues of incrementalism. They chip away at the overall edifice of mandatory arbitration and invite the question: Why is mandatory arbitration unacceptable in some consumer or employment contexts, but not in others?

Absent comprehensive federal legislation (or absent intervention by the Supreme Court), however, the problem of class-action bans will remain largely a question of state law. Specifically, if the Supreme Court rules in favor of the consumers in *AT&T v. Concepcion*, general state contract law will remain available to police class-action bans. For the most part, this role has fallen to the state courts, which have developed a nonuniform body of law governing the enforceability of class-action bans under the contract doctrines of unconscionability and public policy. (A smaller body of federal law also addresses the same question under a vindication-of-federal-rights approach, invalidating bans that would, for example, undermine the ability of plaintiffs to enforce antitrust law.)

Over the past six years, the trend among the states has been strongly in favor of invalidating class action bans, with recent decisions from the highest courts of California, Illinois, Massachusetts, New Jersey, New Mexico, North Carolina, and Washington all invalidating bans. None of these decisions, however, is categorical. Rather, the courts have adopted a nuanced approach that invalidates class-action bans only where it is clear that the ban will have an exculpatory effect—that is, where the claims are not so large that they can feasibly brought as individual claims. The common law is well suited to developing a body of law along these lines, but states' factbound, nuanced approach is likely to generate continued satellite litigation over the enforceability of the bans.

The ability of state law to address the problem legislatively is also limited, because it must function within the parameters of the FAA, which prohibits discrimination against arbitration. One legislative approach that has thus far gotten very little traction is the attempt to craft a single rule of contract law governing the enforceability of class-action bans. Maryland's legislature, for example, is currently considering a bill to ban class action bans. Utah, on the other hand, has legislation on its books providing just the opposite rule: That class-action bans are deemed enforceable.[15]

Apart from the inevitable nonuniformity, both state common-law adjudication and state legislation leave open the danger that contract drafters will continue to modify the terms of their standard-form contracts to evade consumer-protective rules. As contracts scholar David Horton has persuasively argued, drafters will predictably respond to judicial decisions voiding procedural terms by unilaterally amending their terms again.[16] Drafters will include, for example, choice-of-law provisions selecting Utah law. Indeed, the landmark *Discover Bank* case in California—in which the California Supreme Court invalidated a class-action ban—resulted on remand in enforcement of that very same ban under Delaware law.[17] Or drafters will insert illusory consumer protections designed to evade unconscionability doctrine; opt-out provisions, for example, have already convinced some courts that the contracts containing those provisions are in some sense consensual and therefore not procedurally unconscionable—even though virtually no consumers actually will use the opt-out mechanism in advance of a dispute.

Unfortunately, no solution short of comprehensive federal legislation can avoid these dangers.

Notes

[1] *See generally* Myriam Gilles, *Opting Out of Liability: The Forthcoming, Near-Total Demise of the Modern Class Action*, 104 MICH. L. REV. 373, 412-22 (2005) (detailing "the vast potential reach of collective action waivers" as a shield for corporate misconduct in the consumer, antitrust, civil rights, and employment contexts); Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN L. REV. 1631, 1651-52 (2005).

[2] *Carnegie v. Household Int'l, Inc.*, 376 F. 3d 656, 661 (7th Cir. 2004).

[3] *See* Alan S. Kaplinsky and Mark J. Levin, *Excuse Me, But Who's the Predator?*, 7 Bus. L. Today 24, 26 (1998) (urging lenders to impose arbitration in financial-services contracts because, "[s]tripped of the threat of a class action, plaintiffs' lawyers have much less incentive to sue"); *see also* Gilles, 104 MICH. L. REV. at 396-99 (describing strategy of adopting arbitration as a class-action shield).

[4] Theodore Eisenberg, et al., *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. Mich. J. L. Reform 871, 883 (2008); *see also* Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 373-74 (2007) (comparing prevalence of arbitration provisions incorporated into companies' consumer contracts to those incorporated into their major commercial contracts; finding corporations create clauses forcing consumers into arbitration far more often than they mutually agree with each other to enter into binding pre-dispute arbitration); Samuel Issacharoff & Erin F. Delaney, *Credit Card Accountability*, 73 U. CHI. L. REV. 157, 173 (2006) ("Every indication is that the imposed arbitration clauses are nothing but a shield against legal accountability by the credit card companies.").

[5] Eisenberg, 41 U. MICH. J. L. REFORM at 894-95.

[6] *Phillips Petroleum v. Shutts*, 472 U.S. 797, 873 (1985).

[7] *Muhammad v. County Bank of Rehoboth Beach,* 912 A.2d 88, 100 (N.J. 2006) ("Without the availability of a class-action mechanism, many consumer-fraud victims may never realize that they may have been wronged."); *see Kinkel v. Cingular Wireless, LLC*, 857 N.E.2d 250, 263-76 (Ill. 2006) ("The typical consumer may feel that such a charge is unfair," but, without an attorney, will not "be aware that he or she has a claim that is supported by law"); *Gentry v. Superior Court*, 165 P.3d 557, 567 (Cal. 2008) ("[I]ndividual employees may not sue because they are unaware that their legal rights have been violated.").

[8] *See Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 161 (1974) ("A critical fact in this litigation is that petitioner's individual stake in the damages award he seeks is only $70. No competent attorney would undertake this complex antitrust action to recover so inconsequential an amount. Economic reality dictates that petitioner's suit proceed as a class action or not at all."); *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 809 (1985) ("Class actions . . . may permit the plaintiffs to pool claims which would be uneconomical to litigate individually. For example, this lawsuit involves claims averaging about $100 per plaintiff; most of the plaintiffs would have no realistic day in court if a class action were not available."); *Amchem Products, Inc. v. Windsor*, 521 U. S. 591, 617 (1997) ("The policy at

the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth someone's (usually an attorney's) labor.").

[9] *See* Bruce Hay, *Procedural Justice: Ex Ante vs. Ex Post*, 44 UCLA L. Rev. 1803, 1815-16 (1997) ("[E]ffective deterrence of undesirable behavior may require costly investments by the beneficiary of such deterrence.").

[10] *See Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S. 326, 338 n.9 (1980); RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW § 21.11 (6th ed. 2003).

[11] DEBORAH HENSLER ET AL., CLASS ACTION DILEMMAS 68 (2000).

[12] Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration*, 74 WASH. U. L.Q. 637, 642-43 (1996).

[13] Arbitration Fairness Act of 2009, H.R. 1020, 111th Cong. § 4 (2009).

[14] *See, e.g.,* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §1028(c), 124 Stat. 1376, 2004 (2010) (codified at 12 U.S.C.A §5518 (West Supp. 2010)) (granting the Consumer Protection Bureau the authority to issue rules banning or restricting predispute arbitration clauses in consumer financial services contracts following a study on the use of arbitration); Talent-Nelson Amendment to Defense Authorization Act, 10 U.S.C. §987(e)(3) (2006) (providing the Defense Department with authority to ban or restrict mandatory arbitration clauses in lending agreements to military servicemembers; enacted along with usury caps and other substantive consumer-protection measures).

[15] *See* Utah Code Ann. 70C-4-105(1) (authorizing class-action bans in open-end consumer credit contracts). (My understanding is that this legislation was drafted by co-panelist Alan Kaplinsky.)

[16] *See* David Horton, The *Shadow Terms: Contract Procedure and Unilateral Amendments*, 57 UCLA L. Rev. 605 (2010).

[17] *Discover Bank v. Superior Court*, 36 Cal. Rptr. 3d 456, 461 (Cal. Ct. App. 2005).