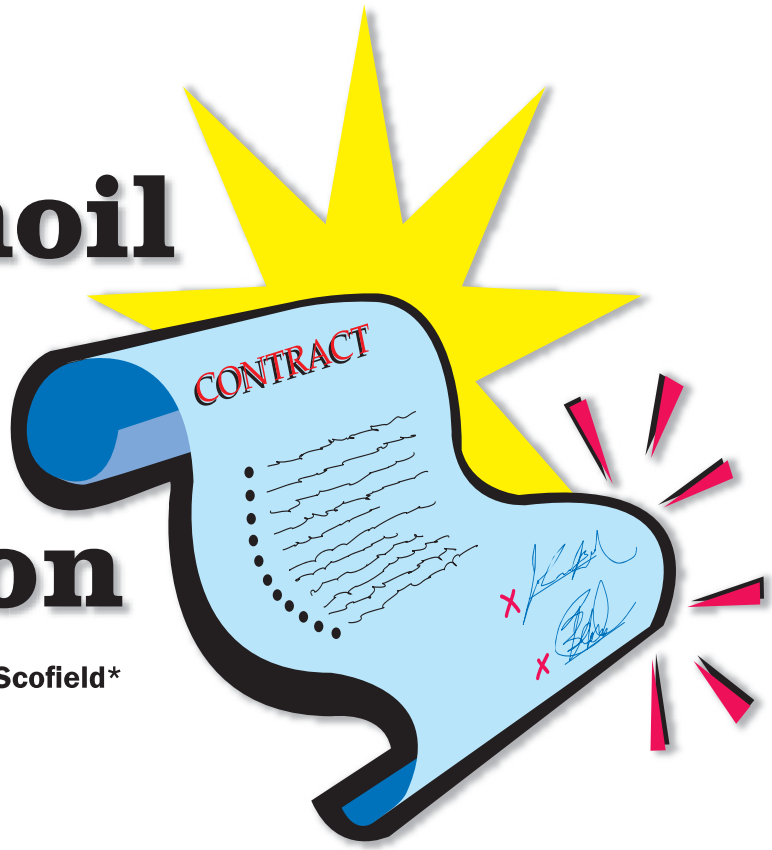
More Turmoil in Class Arbitration



By Jason Scofield*

There has been quite a bit of change and confusion lately in the field of class arbitration. Until recently it was unclear whether the Federal Arbitration Act ("FAA")[1] prohibited or allowed class arbitration. In 2003, the United States Supreme Court determined that the FAA allowed class arbitrations in cases where the contract was silent on the matter.[2] However, the opinion did not address instances where an arbitration clause explicitly prohibited class arbitration? The California Supreme court examined precisely this issue in Discover Bank v. Superior Court of Los Angeles. [3]

Background

Discover Bank involved a credit card issued by Discover Bank to the plaintiff.[4] When the card was issued, the contract was silent as to class arbitration.[5] Later, a contract modification was sent in the mail, which included a waiver of class arbitration.[6] The modification was assumed to be accepted by the customer unless the customer notified Discover Bank in writing.[7] The customer only had two options; accept the modification or cancel the account.[8] In addition to the class waiver, the contract contained a choice of law provision specifying that Delaware law was to be used in all disputes arising under the contract.[9]

In his suit, the plaintiff alleged the credit card contract had a provision that stated if payment was received on a certain date, it would not be considered late.[10] Allegedly, Discover Bank's actual practice was to charge a late fee for all payments received after an undisclosed 1:00 p.m. "cut-off time" on the stated date.[11] The plaintiff filed a putative class action suit in the Los Angeles County Superior Court alleging breach of contract and violation of the Delaware Consumer Fraud Act. [12] Discover Bank moved to compel arbitration on an individual basis and to dismiss the class action on the basis of the class action waiver in the arbitration agreement.[13]

The trial court initially ruled in favor of Discover Bank, but was forced to reconsider after the Fourth District Court of Appeal decided an almost identical class arbitration waiver was invalid in *Szetela v. Discover Bank*.[14] Upon reconsideration, the trial court found *Szetela* to be controlling and struck down the class arbitration waiver portion of the contract.[15] The court then remanded the case to the arbitrator, leaving open the opportunity to file for class arbitration.[16] Discover Bank appealed to have the trial court's original ruling reinstated.[17] The court of appeals ruled in favor of Discover Bank, holding that the FAA preempted the California state law against class waivers.[18] The California Supreme Court then granted review and reversed the court of appeals.

The Court's Analysis

1. Validity of Class Arbitrations

The California Supreme Court began its analysis by acknowledging the validity of class arbitration. In 1982 the Court stated in *Keating v. Superior Court* that "[d]enial of a class action in cases where it is appropriate may have the effect of allowing an unscrupulous wrongdoer to retain the benefits of its wrongful conduct." [19] In *Keating*, a group of California 7-Eleven franchise owners sued Southland Corporation under the California Franchise Investment Law.[20] The franchise contract called for mandatory arbitration.[21] The plaintiffs wanted a class action lawsuit or, in the alternative, class arbitration.[22] The court in *Keating* ultimately allowed class arbitration, but in that case there was no waiver of class action in the contract or arbitration agreement.[23] *Keating*, however, did establish that class arbitration itself is valid procedural mechanism.

The court then turned to an analysis of *Szetela* and policy issues.[24] In *Szetela*, Discover Bank improperly charged fees for exceeding credit limits and imposed other improper penalties, causing one of the many cardholders to sue.[25] The class waiver in *Szetela* was almost identical to the one found in the Discover contract, and the waiver was found to be "unconscionable."[26] The court in both *Szetela* and *Discover* found the class waiver to be substantively unconscionable due to its one-sided and oppressive nature. Additionally, the *Discover*

court noted that because the waiver was included as a bill stuffer after the initial contract was signed, it was also procedurally unconscionable.[27] The court went so far as to say: "[s]uch one-sided, exculpatory contracts in a contract of adhesion, at least to the extent that they operate to insulate a party from liability that otherwise would be imposed under California law, are generally unconscionable."[28]

2. Preemption by the FAA

Next, the court addressed the claim that Section 2 of the FAA preempts California law. The appellate court relied on *Perry v. Thomas* and determined that the FAA did in fact preempt California state law.[29] The supreme court, however, found:

> The Court of Appeal's conclusion is puzzling, because it ignores the critical distinction made by the Perry court between a "state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue," which is preempted by section 2 of the FAA, and a state law that "govern[s] issues concerning the validity, revocability, and enforceability of contracts generally," which is not.[30]

The majority found that the applicable California law in this case is general contract law, and is not aimed specifically at arbitration agreements.[31] The court further noted that nothing in the FAA precludes class arbitration.[32]

Discover Bank asserted that *Green Tree Financial Corp. v. Bazzle* supports the notion that a state law prohibiting class waiver is preempted by the FAA.[33] In *Bazzle*, Green Tree Financial Corp. failed to provide a form to its customers letting them know that they had a right to choose their own lawyer and insurance agent.[34] This was a violation of South Carolina state law, so several of their customers filed a class action suit.[35] Green Tree moved for arbitration and the court granted the class as well as compelled arbitration, finding that Green Tree's agreement was silent as to class arbitration.[36] The *Discover* court stated *Bazzle* "did not address whether a state court can, consistent with the FAA, hold a class action waiver appearing in a contract of adhesion for arbitration unconscionable or contrary to public policy, as a part of an arbitration-neutral law that finds all such waivers unenforceable."[37] *Bazzle* did not address whether "state courts may enforce general contract rules regarding unconscionability and public policy that preclude class action waivers."[38]

3. Choice of Law

After addressing the *Bazzle* decision, the choice of law provision was analyzed. Ultimately the court remanded the case to the appellate court to decide the choice of law issue. It did, however, provide some guidance for the lower court to aid it in making its determination.[39] The court cited Section 187(2) of the Restatement 2nd of Conflict of Laws, stating that to analyze the choice of law issue, a court must decide "whether the chosen state has a substantial relationship to the parties or their transaction, or whether there is any other reasonable basis for the parties' choice of law."[40] If the party seeking the enforcement of the choice of law provision cannot meet either of these two tests then his choice of law will not be enforced.[41] However, if the party can meet either of these two tests, then the parties' choice of law must be examined to see if it is contrary to California's public policies and interests.[42] If the law is contrary to California's public policy, it will not be enforced if California has a "materially greater interest than the chosen state."[43] The Discover court did not make these determinations, but instead outlined the framework for the lower court to make its decision on remand.

The Dissent

Justice Baxter dissented from the majority on several grounds. He first asserted that the court of appeals did not address whether California has an anti-waiver policy.[44] Because that court did not address the existence of this policy, he argued that it should not be examined in further appeal.[45]

Next, Justice Baxter argued that the parties had both agreed to use Delaware law, and the unconscionability of the waiver under California law is "moot."[46] He noted that the plaintiff alleged Delaware causes of action and did not dispute the general validity of the choice of law.[47] Justice Baxter further noted that Delaware requires corporations domiciled in its state to use Delaware law.[48] Without enforcement of Delaware law, he argued that the reasonable expectations of the bargaining parties would be frustrated. He further argued that Delaware has a stronger interest in having its laws enforced in this matter than California because Discover Bank was domiciled there and because Delaware has the statutory requirement that its law must govern.[49] Justice Baxter went on to state that unconscionability is defined by state common law, and that Delaware's concept of unconscionability should govern.[50] Under Delaware's unconscionability standard, he contended, the waiver was valid.[51]

Baxter contended that the choice of law issue was the only real issue that needed to be addressed, and he was somewhat disconcerted that the majority concentrated on the validity of the waiver without deciding the choice of law issue.

Justice Baxter also made a point of noting that the majority had not actually decided the choice of law issue, but rather had gone into a lengthy discussion about the unconscionability of the waiver.[52] He contended that the choice of law issue was the only real issue that needed to be addressed, and he was somewhat disconcerted that the majority concentrated on the validity of the waiver without deciding the choice of law issue.[53]

Justice Baxter further disagreed with the majority's categorization of the class waiver as exculpatory.[54] He noted that there are a variety of remedies; both statutory and otherwise that would allow an individual plaintiff to proceed. He then contended that although lack of a class mechanism may make it less convenient for a plaintiff to proceed, it nevertheless does not bar the plaintiff's claim.[55]

Conclusion

The implications of *Discover* are unclear. While the court held that waivers of class arbitration can be held unconscionable and against public policy, it left it to the lower court to decide whether a choice of law provision that acted effectively as a class waiver should be struck down. If the lower court on remand decides to uphold the choice of law provision in Discover Bank's contract, it could strike a critical blow to class

arbitration by making Delaware, a corporate-friendly state, the final arbiter in whether the class waiver at issue is enforceable. Until the decision is made upon remand, class arbitration will remain a confusing and uncertain course of action in the state of California and beyond.

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1. 9 U.S.C. § 1 et seq.
2. Green Tree Financial Corp. v. Bazzle, 539 U.S. 444 (2003).
3. Discover Bank v. Superior Court of Los Angeles, 36 Cal. 4th 148 (Cal. 2005).
4. Discover Bank, 36 Cal. 4th at 153.
5. *Id.*
6. *Id.*
7. *Id.* at 154.
8. *Id.*
9. *Id.* at 153.
10. *Id.* at 152.
11. *Id.* at 154.
12. *Id.* The Delaware Consumer Fraud Act is codified at Del. Code Ann., tit. 6 §§ 2511-2527.
13. Discover Bank, 113 P.3d at 154.
14. Szetela v. Discover Bank, 118 Cal.Rptr.2d 862 (2002).
15. Discover Bank, 36 Cal. 4th at 155.
16. *Id.*
17. *Id.*
18. *Id.*
19. Keating v. Superior Court, 645 P.2d 1192, 1207 (1982)(internal quotes omitted).
20. Keating, 645 P.2d at 1194-1195.
21. *Id.* at 1195.
22. *Id.* at 1196.
23. *Id.* at 1195.
24. Discover Bank, 36 Cal. 4th at 159.
25. *Id.*
26. *Id.* at 160.
27. *Id.* at 161.
28. *Id.*
29. Perry v. Thomas, 482 U.S. 483 (1987)
30. Discover Bank, 36 Cal. 4th at 165 (quoting Perry, 482 U.S. at 493 fn. 9).
31. Discover Bank, 36 Cal. 4th at 165.
32. *Id.* at 167 (citing Blue Cross of California v. Superior Court, 67 Cal.App.4 th 42, 62-64, 78 Cal.Rptr.2d 779 (1998)).
33. Discover Bank, 36 Cal. 4th at 169; *Bazzle* supra note 2.
34. Discover Bank, 36 Cal. 4th at 169.
35. *Id.*
36. *Id.*
37. *Id.* at 171.
38. *Id.*
39. *Id.* at 173.
40. Restatement (Second) of Conflicts of Law § 187(2) (1971).
41. Discover Bank, 36 Cal. 4th at 174.
42. *Id.*
43. *Id.* (quoting Washington Mutual Bank v. Superior Court, 24 Cal.4th 906, 916-917, 103 Cal.Rptr.2d 320, 15 P.3d 1071 (2001)).
44. Discover Bank, 36 Cal. 4th at 175.
45. *Id.*
46. *Id.*
47. *Id.*
48. *Id.* at 176-177.
49. *Id.* at 177.
50. *Id.*
51. *Id.*
52. *Id.*
53. *Id.* at 182.
54. *Id.* at 178.
55. *Id.*