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ARBITRATION

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California High Court Weighs in on Class Action Waivers

Although the U.S. Supreme Court's rulings on predispute arbitration agreements are decidedly pro-arbitration, the extent to which this jurisprudence applies where plaintiffs attempt to bring classwide arbitration claims in the face of an express class action waiver provision remains unsettled.

In *Green Tree Financial Corp. v. Bazzle*,[1] the Supreme Court, in a plurality decision, held that where an agreement is silent on the possibility of classwide arbitration, it is for the arbitrator, not a court, to decide in the first instance whether classwide arbitration is permissible under the agreement. The response to *Bazzle* by many companies and employers has been to include class action waiver provisions in their predispute arbitration agreements.

In the recent decision of *Discover Bank v. Superior Court (Boehr)*,[2] the Supreme Court of California held that, in some situations, waivers of class action litigation or class action arbitration may be unconscionable and unenforceable under California law. The California high court defined its holding as narrow, applying to claims involving small sums of money under consumer contracts of adhesion, such as the one at issue in *Discover Bank*. Despite the ostensibly narrow holding, the possibility exists that the *Discover Bank* rule will be applied in other arbitration contexts. For example, although the *Discover Bank* court pointed out that significant differences exist between arbitration in an employment context and arbitration of small-stakes consumer claims, the question arises whether express class action waivers contained in predispute employment arbitration agreements are enforceable in California.



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'Discover Bank v. Superior Court (Boehr)'

The plaintiff, Christopher Boehr, was a California resident and credit card holder.[3] Mr. Boehr alleged that even though Discover Bank represented to cardholders that late payment fees would not be assessed if payment was received by a certain date, late fees were actually assessed if payment was received after 1:00 p.m. on the date of notice from the bank. Mr. Boehr alleged that although damages to any individual consumer were small, these damages were large in the aggregate. Plaintiff Boehr filed a putative class action against Discover Bank, alleging breach of contract and violation of the Delaware Consumer Fraud Act.[4]

Discover Bank moved to compel arbitration of plaintiff's claim on an individual basis and to dismiss the class action claim pursuant to the arbitration agreement's class action waiver which stated (in all capital letters): "NEITHER YOU NOR WE SHALL BE ENTITLED TO …ARBITRATE ANY CLAIM AS A REPRESENTATIVE OR MEMBER OF A CLASS OR IN A PRIVATE ATTORNEY GENERAL CAPACITY." Plaintiff's credit card agreement, which contained a choice-of-law clause providing for the application of Delaware and federal law, did not originally include an arbitration clause. Discover Bank added the arbitration clause by sending a notice to its existing cardholders (including the plaintiff), which recited the above-quoted waiver and also stated that the Federal Arbitration Act[5] (FAA) would govern the agreement.[6] Existing cardholders who did not wish to accept the new arbitration clause were required to notify Discover Bank of their objections and cease to use their credit card accounts. Plaintiff did neither.

Plaintiff opposed Discover Bank's motion to compel individual arbitration, contending that the class action waiver was unconscionable and unenforceable under California law. Although the plaintiff acknowledged that the credit card agreement was governed by Delaware and federal law, he alleged that the choice-of-law provision applied only to substantive claims, while California or other applicable law governed other issues related to the contract.

The trial court initially granted Discover Bank's motion. Plaintiff moved for reconsideration of the portion of the order enforcing the class action waiver, in light of the then-recent decision of *Szetela v. Discover Bank*,[7] which had found that a similar class arbitration waiver in consumer credit contract was unconscionable.[8] The trial court held that *Szetela* constituted new and controlling authority, and refused to enforce the class arbitration waiver. The Court of Appeal reversed, upholding the class action waiver on the grounds that any California rule prohibiting such waivers was preempted by the FAA and that *Szetela* had failed to analyze the FAA preemption issue adequately.

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On appeal, the California Supreme Court held that in some circumstances class action waivers in consumer contracts of adhesion are unenforceable and that the FAA does not preempt California law with respect to this issue. The court remanded the choice-of-law issue to the Court of Appeal. The court began its analysis by discussing the importance of class action litigation and arbitration, noting that individual actions by each defrauded consumer is often impractical because of the small amount of damages as to any single plaintiff. The court noted that allowing class action suits may prevent wrongdoers from going unpunished.

'America Online Inc.'

The court then reviewed California precedent on the issue of unconscionability. The court first discussed *America Online Inc. v. Superior Court*[9] (*AOL*), which held a forum selection and choice-of-law clause to be unenforceable where the clause provided for application of Virginia law, which did not permit consumer class action lawsuits.[10] The *Discover Bank* court distinguished *AOL* because the suit in *AOL* was brought, in part, under California's Consumer Legal Remedies Act (CLRA), which permitted class action relief and provided that any waiver of its provisions would be void as a matter of public policy. Plaintiff Boehr, by contrast, did not seek recovery under any California statute in which a class action remedy is essential.

Endorsing the unconscionability analysis in *Szetela*,[11] which found a similar class arbitration waiver unenforceable,[12] the *Discover Bank* court stated that amendments to cardholder agreements in the form of "bill stuffers," like the one sent to Mr. Boehr, possess an element of procedural unconscionability because the consumer is automatically presumed to accept the new terms if he or she continues to use the card. Moreover, class action waivers in consumer cases were considered to frequently be one-sided exculpatory clauses that are contrary to public policy. In the court's view, class action waivers in consumer cases may effectively exempt a company from liability for its deliberate wrongdoing because the small damages to any individual plaintiff do not warrant an individual suit. The court also said that class action waivers are one-sided because credit card companies do not typically sue their customers in class action suits. The court further noted that the availability of attorney fees, small claims litigation, government prosecution, or informal resolution may not provide adequate substitutes for class action litigation or arbitration.

Narrow Holding

The court noted that its holding on class action waiver unconscionability was narrow, stating:

> We do not hold that all class action waivers are necessarily unconscionable. But when the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then, at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party 'from responsibility for [its] own fraud, or willful injury to the person or property of another.' (Civ. Code §1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced.

On remand, the Court of Appeal found that class action waivers are "enforceable, and not unconscionable, under Delaware law," and thus held the class action waiver in the instant case was enforceable.

The California Supreme Court further rejected the Court of Appeal's finding of FAA preemption. The court held that under §2 of the FAA, a state court may refuse to enforce an arbitration agreement based on general contract principles or defenses, so long as these defenses are not used to discriminate against arbitration clauses. California's policy against class action waivers in some circumstances involved no such discrimination because it applied to any contract, not just arbitration agreements. The court held that unconscionability is a general contract principle, and thus neither the FAA nor the U.S. Supreme Court's decision in *Perry v. Thomas*[13] precluded the California state courts from applying its policy to class claim waivers in arbitration agreements.[14]

The *Discover Bank* court remanded the case to the Court of Appeal to decide the choice-of-law issue as to whether the Delaware choice-of-law provision in the credit card agreement required enforcement of the class arbitration waiver. On remand, the Court of Appeals "conclud[ed] that the parties' choice of Delaware law should be respected, and that under Delaware law the class action waiver is enforceable."[15] The Court of Appeal performed its choice-of-law analysis under §187, subdivision (2), of the Restatement Second of Conflict of Laws.[16] The court first found that Discover Bank is domiciled in Delaware, and by Delaware statute "[a] revolving credit plan between a [Delaware-chartered] bank and an individual borrower shall be governed by the laws of [Delaware;]" thus, Delaware had a substantial relationship to the parties' agreement and there was a reasonable basis for the choice of Delaware law.

Court of Appeal

In its decision on remand, the Court of Appeal did not read the Supreme Court's opinion in *Discover Bank* to hold that the class action waiver in this case was in fact unconscionable. It gave two reasons. First, Mr. Boehr did not bring any claim under California law and he conceded that Delaware law applies to both of his claims; hence, "the obligations at issue in Boehr's lawsuit are not governed by California law."[17] Second, the Supreme Court in *Discover Bank* did not explicitly hold the class action waiver was enforceable or unenforceable, rather "the court declined to decide the issue." The Court of Appeal concluded that the application of Delaware law did not violate any fundamental policy of California, declining to decide whether, in the abstract, the class action waiver itself violated any fundamental California policy (such as unconscionability). The Court of Appeal then held that Delaware has a "demonstrably greater" interest in the application of its law than California, and as such the choice-of-law provision would be honored.[18]

'Discover Bank' Implications

The California Supreme Court's *Discover Bank* decision is arguably a quite narrow ruling. First, it should be noted that the *Discover Bank* rule that waivers of classwide arbitration are unconscionable is particular to California courts. The California Supreme Court itself pointed out that other states may not agree with its view on the unenforceability of class action waivers.[19] Indeed, on remand, the Court of Appeal found that class action waivers are "enforceable, and

not unconscionable, under Delaware law," and thus held the class action waiver in the instant case was enforceable.[20]

Second, there is a basis for arguing that the *Discover Bank* court's language concerning the unconscionability of class arbitration waivers was, as the dissent pointed out, not necessary to decide the case and is essentially dicta. Two points should be borne in mind here. One, the Court of Appeal's initial decision did not address California's policy on class arbitration waivers and issues not decided below are ordinarily not reviewed on appeal. Two, the choice-of-law issue essentially rendered moot the question of whether class action waivers are unconscionable. By remanding the choice-of-law issue, the Supreme Court left open the possibility that the Court of Appeal would (as it had done originally) enforce the waiver anyway, which indeed it did.[21]

Nevertheless, since the Supreme Court of California apparently felt compelled to hold class arbitration waivers unconscionable even though that ruling was unnecessary to the decision, it appears unlikely that the court will ignore the *Discover Bank* rule in other cases. Following *Discover Bank,* the Court of Appeal has held similar class action waivers unconscionable in contracts of adhesion in suits brought under California law.[22]

Third, the applicability of the *Discover Bank* rule to nonconsumer claims in California remains an open question. The court specifically narrowed its holding to the circumstances of the case, explicitly stating that it did "not hold that all class action waivers are necessarily unconscionable."[23] One reason for the narrow holding is that "[u]nder California law, classwide arbitration is only justified when 'gross unfairness would result from the denial of opportunity to proceed on a classwide basis.'"[24] The high court did recognize significant differences between the typical consumer credit case and an employment dispute. Unlike plaintiffs in consumer credit cases, plaintiffs in employment cases can present significant claims for damages. When distinguishing *Gilmer v. Interstate/Johnson Lane Corp.*,[25] the *Discover Bank* court stated that "a party can still vindicate his or her rights under the ADEA even if no class action remedy is available. The ADEA is an employment discrimination statute in which large individual awards are commonplace."[26] By contrast, class action suits are often the only viable method in consumer credit cases where each individual consumer may suffer an infinitesimally small harm that simply will not be pursued on an individual basis in arbitration or litigation. This distinction may suggest that the California Supreme Court would not find a class action waiver unconscionable in an employment claim.

Prior to the Court of Appeal decision on remand in *Discover Bank,* in a suit concerning an employment agreement, *Ramirez v. Cintas Corp.*,[27] the U.S. District Court for the Northern District of California declined to read *Discover Bank* as holding that California precludes all waivers of classwide arbitration, especially in light of the fact that the *Discover Bank* court expressly narrowed its holding. The *Ramirez* court further held that the application of another state's law on waivers of class arbitration would not necessarily violate California policy on the issue, because the *Discover Bank* decision allowed class action waivers in some situations. Because the employment agreement at issue in *Ramirez* was silent as to class arbitration, the court held that it would be up to the arbitrator to determine whether class arbitration was permissible under the agreement.[28]

Conclusion

The question remains open whether the California Supreme Court will uphold the Court of Appeal conflicts of law analysis if there is an appeal. Some have argued that the Supreme Court's opinion on unconscionability in *Discover Bank* essentially decided that class action waivers in consumer contracts of adhesion violate California public policy to a degree dictating the application of California law in similar cases.[29] Furthermore, the Court of Appeal decision on remand was based, in part, on the fact that Mr. Boehr did not make any claims under California law,[30] indicating the court may have ruled differently if Mr. Boehr had brought suit under California law.[31] Pending further clarification by the California Supreme Court, litigation is likely to continue over the role of choice-of-law clauses and whether the distinctions expressly drawn in *Discover Bank* between consumer credit cases and employment cases indicate that employment agreements do not fall within the scope of the *Discover Bank* unconscionability rule.

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1. 539 U.S. 444 (2003).
2. 36 Cal. 4th 148 (Cal. 2005).
3. *Discover Bank,* 36 Cal. 4th at 152.
4. Id. at 154 (quoting Del. Code Ann., tit. 6 §2513, which prohibits misrepresentations "of any material fact with intent that others rely upon such concealment, suppression or omission in connection with the sale, lease, or advertisement of any merchandise.").
5. 9 U.S.C. §§1-16.
6. *Discover Bank,* 36 Cal. 4th at 153-54.
7. 118 Cal.Rptr.2d 862 (Cal. Ct. App. 2002).
8. *Discover Bank,* 36 Cal. 4th at 155.
9. 108 Cal.Rptr.2d 699 (Cal. Ct. App. 2001).
10. *Discover Bank*, 36 Cal. 4th at 158.
11. 118 Cal.Rptr.2d 862.
12. *Discover Bank*, 36 Cal. 4th at 159.
13. 482 U.S. 483 (1987).
14. *Discover Bank*, 36 Cal. 4th at 165-66.
15. *Discover Bank v. Superior Court (Boehr),* __ Cal.Rptr.3d__, 2005 WL 3304153 (Cal. Ct. App. Dec. 7 2005).
16. Under this analysis, the court first determines if the chosen state has a substantial relationship to the parties or their transaction, or if there is any other reasonable basis for the parties' choice of law. The court will not enforce the parties choice of law if neither test is met. If either test is met, the court must next determine whether the chosen state's law is contrary to the fundamental policy of California. If there is no such conflict, the court shall enforce the parties' choice of law. If there is a conflict with fundamental California policy, the court must then determine whether California has a materially greater interest in the determination of the issue. If California has a materially greater interest then its law shall be applied. Id.
17. Id. (noting that the California Supreme Court's holding on unconscionability in *Discover Bank* applied "to the extent the obligation at issue is governed by California law").
18. The Court of Appeal held that Delaware's interest was greater than California's because: "(1) Delaware is home to the sole defendant, not just (like California) home to some portion of the putative class, (2) Delaware has demonstrated by statute its concern that Delaware law should apply to claims between Delaware banks and their cardholders, and (3) Mr. Boehr is asserting claims under Delaware law alone." Id.
19. *Discover Bank,* 36 Cal. 4th at 161 (citing the following cases for the proposition that waivers of classwide arbitration are not unconscionable: *Strand v. U.S. Bank Nat'l. Assoc.*, 2005 N.D. 68 (N.D. 2005); *Blaz v. Belfer,* 368 F.3d 501, 504-05 (5th Cir. 2004); *Johnson v. W. Suburban Bank,* 225 F.3d 366, 369 (3d Cir. 2000); *Champ v. Siegle Trading Co., Inc.,* 55 F.3d 269, 277 (7th Cir. 1995)).
20. *Discover Bank v. Superior Court (Boehr),* __ Cal.Rptr.3d__, 2005 WL 3304153 (Cal. Ct. App. Dec. 7, 2005).
21. *Discover Bank v. Superior Court (Boehr),* __ Cal.Rptr.3d__, 2005 WL 3304153 (Cal. Ct. App. Dec. 7, 2005).
22. For example, in a suit brought under California law, the Second Appellate District of California in *Aral v. Earthlink, Inc.* held that an arbitration provision in a DSL service agreement was unconscionable where it forbade class actions brought by California consumers claiming small monetary damages. The court found the "take it or leave it" presentation of the agreement, coupled with the claim that multiple consumers suffered small monetary damages through deliberate behavior, fell squarely under the *Discover Bank* rule on unconscionability and the provision was unenforceable under California law. *Aral v. Earthlink Inc.*, __Cal.Rptr. 3d__ , 2005 WL 3164648 (Nov. 29, 2005). The Fourth Appellate District of California in *Independent Association of Mailbox Center Owners, Inc. v. Superior Court* held that franchise agreements are sometimes adhesive contracts like those in *Discover Bank,* and as such held that the class action waivers in the franchise agreements at issue were unconscionable under *Discover Bank. Indep. Assoc. of Mailbox Ctr. Owners, Inc. v. Superior Court,* 34 Cal.Rptr. 3d 659 (Cal. Ct. App. 2005).
23. *Discover Bank,* 36 Cal. 4th at 162.
24. Id. at 168 (citing *Keating v. Superior Court,* 31 Cal.3d 584, 613 (Cal. 1982)).
25. 500 U.S. 20 (1991).
26. *Discover Bank,* 36 Cal. 4th at 168.
27. 2005 WL 2894628 (N.D. Cal. Nov. 2, 2005).
28. Id. (citing *Green Tree Fin. Corp. v. Bazzle,* 539 U.S. 445, 453 (2003)).
29. See Barkely and Barbara Clark. In the latest battle of the 'Boehr War' California Supreme Court strikes down arbitration clause/class action waiver. 07-05 Clark's Bank Dep. & Pymt. Monthly 2 (2005) (arguing that "it seems crystal clear from the court's opinion that" class arbitration waivers violate fundamental California public policy).
30. *Discover Bank v. Superior Court (Boehr),* __ Cal.Rptr.3d__, 2005 WL 3304153 (Cal. Ct. App. Dec. 7, 2005).
31. This proposition is supported by the decision in *Aral v. Earthlink Inc.*, supra.