



State Court Enforcement of Arbitration Agreements

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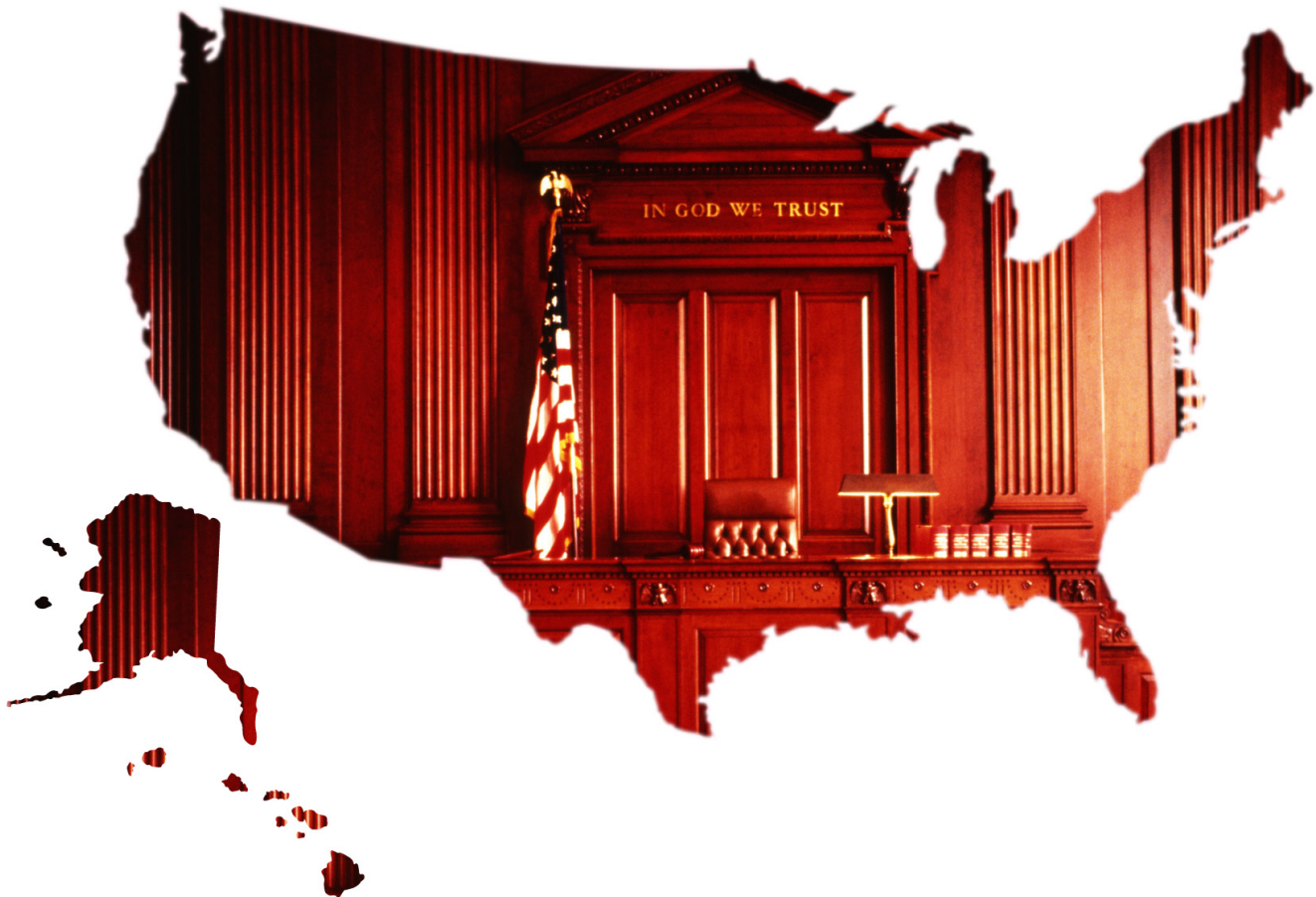


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STATE COURT ENFORCEMENT OF ARBITRATION AGREEMENTS: A REPORT TO THE U.S. CHAMBER INSTITUTE FOR LEGAL REFORM

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INTRODUCTION

Congress passed the Federal Arbitration Act (FAA) in 1925 to overcome judicial hostility to arbitration agreements.¹ Broadly speaking, if a contract dealing with interstate commerce contains an agreement to arbitrate, the FAA requires that the arbitration agreement be enforced, unless generally applicable contract principles render the agreement unenforceable.² The FAA thus forbids courts called upon to enforce agreements to arbitrate from imposing special burdens on arbitration agreements, but permits courts to hold those agreements to the same standards that all contracts must meet.

In 1984, the Supreme Court held that the FAA's mandates apply not only to federal courts, but also to state courts.³ The reaction of state courts varied, but many clung to their traditional hostility towards arbitration. The stiff resistance to application of the FAA in state courts came to a head in 1994, when the attorneys general of twenty states filed amicus briefs asking the Supreme Court to overturn its 1984 decision and to permit the states to enforce state anti-arbitration statutes.⁴ The Supreme Court declined to do so, and took the opportunity to spell out the obligations of the states with regard to arbitration clauses:

“States may regulate contracts, including arbitration clauses, under general contract law principles and they may invalidate an arbitration clause ‘upon such grounds as exist at law or in equity for the revocation of any contract.’ What states may not do is decide that a contract is fair enough to enforce all its basic terms (price, service, credit) but not fair enough to enforce its arbitration clause. The Act makes any such state policy unlawful, for that kind of policy would place arbitration clauses on an unequal ‘footing,’ directly contrary to the Act’s language and Congress’s intent.”⁵

¹ The Federal Arbitration Act was intended to “reverse centuries of judicial hostility to arbitration agreements.” *Scherck v. Alberto-Culver Co.*, 417 U.S. 506, 510 (1974). It is codified at 9 U.S.C. § 1 et seq.

² 9 U.S.C. §2.

³ *Southland Corp. v. Keating*, 465 U.S. 1 (1984).

⁴ *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 272 (1995).

⁵ *Id.* at 281 (citations omitted).

As the Supreme Court put it the following year, state rules that “undermine the goals and policies of the FAA” are preempted by that statute.⁶

PURPOSE AND FINDINGS OF THIS STUDY

The U.S. Chamber’s Institute for Legal Reform commissioned this study to inquire whether the mandate of the FAA and the Supreme Court decisions implementing it have now been fully accepted by the state courts. The good news is that, for the most part and in most states, courts have understood the message, and overt judicial hostility to arbitration has generally been overcome. We identified only two states—Alabama and California—in which the sheer number of decisions refusing enforcement might reasonably be thought to have been influenced by a lingering hostility to arbitration, and even in those states, resistance is far more circumspect than it was twenty years ago. Thus, while courts in those states appear somewhat readier to find reasons not to enforce arbitration agreements than courts in other states, they express themselves in terms of disapproval of particular features of arbitration agreements rather than in terms of hostility to arbitration itself. Indeed, the types of clauses that tend to arouse judicial hostility in Alabama and California are often met with suspicion by the courts of other states.

Broadly stated, the types of arbitration agreements most likely to encounter resistance from state courts are those that arise in the context of a perceived imbalance of bargaining power and that contain terms that appear to take advantage of that imbalance to achieve a procedural or substantive advantage. Arbitration clauses have become common in consumer and employee agreements in recent years, and these are contexts in which courts most readily perceive disparities in bargaining power. In such contexts, where the distinction between the stronger and the weaker party is clearest, the drafters of some arbitration clauses have included provisions that require the weaker parties not simply to arbitrate, but to arbitrate on unfavorable terms. It is this type of arbitration agreement that has, understandably, met with the greatest resistance from state courts.

Many of the arbitration clauses deemed unenforceable by state courts can only be described as overreaching. The benefits of arbitration may thus be lost or jeopardized if a party in a position to dictate the terms of a contract succumbs to the temptation to use the arbitration clause as an opportunity to tilt the scales in that party’s favor. That temptation can manifest itself in terms that favor the stronger party procedurally—such as allowing the stronger party to select the arbitrator or the rules unilaterally, imposing high costs on a party wishing to initiate arbitration, or forcing one party to arbitrate while giving the other party the option of a judicial forum. Or the contract may seek to favor the stronger party substantively—for example, by

⁶ *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 687 (1996) (“Montana’s § 27-5-114(4) directly conflicts with § 2 of the FAA because the State’s law conditions the enforceability of arbitration agreements on compliance with a special notice requirement not applicable to contracts generally.”).

limiting the remedies available to the weaker party.⁷ While some courts have attempted to correct one-sided clauses by simply removing the offending provision, others have refused to enforce arbitration clauses containing such provisions in their entirety. In either case, such decisions often appear to be motivated more by resistance to the perceived unfairness of the terms than by an underlying hostility to arbitration.

The balance of this report focuses on some of the contexts in which state courts—sometimes even in states otherwise friendly to arbitration—have been most inclined to scrutinize arbitration agreements closely.⁸ These pockets of resistance are the areas of: consumer disputes, homeowner disputes, employment disputes, health care disputes, and class actions. The lesson throughout is that those wishing to enjoy the benefits of arbitration in any of these contexts should be careful to craft arbitration agreements that avoid the types of terms that state courts have perceived as overreaching and unenforceable. Precisely what terms may be perceived as problematic will vary with context and by state, as discussed below.

THE POCKETS OF RESISTANCE TO ARBITRATION

The Supreme Court has made it clear that the FAA requires state courts to hold arbitration agreements to no more restrictive a standard than that to which they hold other contract provisions. On the one hand, the clarity of this rule has largely eliminated overt hostility to arbitration as a basis upon which state courts invalidate arbitration agreements. On the other hand, state courts inclined to resist presumptive enforcement of arbitration agreements may still employ a familiar arsenal of state contract law doctrines to mount such resistance.⁹ The weapon upon which state courts draw most often in invalidating arbitration agreements is the contract-law doctrine of unconscionability.

Different states have developed differing standards for determining when a contract or term will be deemed unconscionable and, therefore, unenforceable. In articulating the majority approach, the Restatement sets forth a flexible, context-sensitive standard that treats each of two factors—inequality of bargaining power and terms unreasonably favoring one party—as probative, but not dispositive, of unconscionability.¹⁰ Many states characterize these two factors as, respectively, procedural unconscionability and substantive unconscionability, and weigh their

⁷ An egregious example of a party's exploiting an imbalance to gain procedural and substantive advantages is described in *Hooters of America, Inc. v. Phillips*, 173 F.3d 933, 938-39 (4th Cir. 1999).

⁸ The information on which this paper is based was obtained by searching legal databases for state court decisions published between 2000 and mid-2006 discussing the enforcement of arbitration agreements. Generally, only decisions of the highest court in the state and some intermediate appellate decisions are published, so trial court decisions that were not appealed would often not have been examined.

⁹ See *Doctor's Assocs. v. Casarotto*, 517 U.S. 681, 687 (1996) ("generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements").

¹⁰ Restatement (Second) of Contracts § 208, cmt. d; see also U.C.C. § 2-302.

significance on a sliding scale—the more procedurally oppressive a contract, the less substantive oppression must be shown to support a finding of unconscionability, and vice versa.¹¹

When state courts measure arbitration agreements against this sliding scale of procedural and substantive unconscionability, certain classes or contexts of arbitration agreements face heightened scrutiny. In particular, because arbitration agreements in the consumer, homeowner, employment, and health care areas may be more likely to arise out of a context of unequal bargaining power (so-called procedural unconscionability), some state courts have shown a propensity to look closely at those agreements for terms that appear unreasonably favorable to one side (so-called substantive unconscionability). In these contexts, arbitration clauses containing elements such as limitations on statutory remedies, provisions for shifting costs to the weaker party, or requirements applicable to only one of the parties run the risk of being deemed unenforceable. In addition, courts that place particularly high value on the class action mechanism tend to resist enforcement of arbitration clauses that waive resort to that procedure.

Ultimately, the pattern of recent state court refusals to enforce arbitration agreements suggests a straightforward approach for businesses seeking to craft enforceable agreements to arbitrate. When drafting an agreement governing a relationship that courts may view as giving rise to a disparity in bargaining power, businesses should avoid any temptation to use the arbitration clause as a vehicle for creating substantive or procedural imbalances that could be perceived as unfair. The American Arbitration Association (AAA) has issued “due process protocols” that provide guidelines for fairness in the areas in which courts are most likely to scrutinize agreements to arbitrate.¹² Drafting arbitration clauses to conform to the AAA’s due process protocols is probably the most effective precaution that can be taken to shield arbitration agreements from state court hostility and thereby to preserve the benefits of resolving disputes in an arbitral forum.

Consumer Disputes

Consumer agreements often typify adhesion contracts, as they are usually offered on a “take it or leave it” basis, with little or no room for negotiation between the parties. Although such contracts are not per se unconscionable, the fact that they almost necessarily entail some degree of what is characterized as “procedural unconscionability” means that consumer agreements containing one-sided terms may be vulnerable. Arbitration clauses in consumer agreements will often face scrutiny for substantive bias. Courts may refuse to enforce arbitration clauses that reflect a purpose and effect beyond simply mandating that consumer disputes be resolved through arbitration, and that instead appear to stack the deck against the consumer.

¹¹ See, e.g., *Muhammad v. County Bank of Rehoboth Beach, Delaware*, 2006 WL 2273448, at *6 (N.J. Aug. 9, 2006); *Armendariz v. Foundation Health Psychcare Servs., Inc.*, 24 Cal. 4th 83, 113 (2000); *Cheshire Mortg. Serv., Inc. v. Montes*, 612 A.2d 1130, 1135 (Conn. 1992).

¹² *A Due Process Protocol for Mediation and Arbitration of Statutory Disputes Arising Out of the Employment Relationship*, *Consumer Due Process Protocol*, and *Health Care Due Process Protocol*, available at <http://www.adr.org/Protocols>.

Recent decisions reflect the reluctance of state courts to enforce arbitration agreements that shift or increase the burden of pursuing arbitration to the consumer, attempt to limit available remedies under the contract, or make arbitration mandatory for only the consumer.

a. Cost Shifting Provisions

Several recent decisions reflect reluctance by courts to enforce consumer arbitration agreements that have the effect of deterring aggrieved consumers from pursuing claims. Courts have found such deterrent effects in a number of arbitration clauses that provide for shifting the costs of arbitration or increasing the financial burden of pursuing a claim in arbitration to the consumer-plaintiff. Finding support in the Supreme Court's consideration (albeit inconclusive) of a "prohibitive costs" defense, several state courts have declared unconscionable or otherwise unenforceable arbitration clauses that create cost barriers to consumer claims.¹³ Decisions from Pennsylvania and Washington illustrate the context-sensitive analysis applied by courts refusing enforcement of cost-shifting arbitration agreements.

In *McNulty v. H&R Block*,¹⁴ a Pennsylvania Superior Court affirmed a lower court's refusal to enforce arbitration agreements against customers of H&R Block who sought to recover fees paid (\$34 or \$37) for electronic filing of their tax returns. In addition to affirming the lower court's determination that the agreements did not govern the dispute, the Superior Court noted that the unconscionability of the arbitration agreements provided alternative grounds for affirming. The arbitration agreements required a party wishing to make a claim to pay a filing fee of \$50 as well as any costs exceeding \$1,500. The court acknowledged that these terms did not, on their face, unreasonably favor either party. However, considered in the context of the relief sought by the claims at issue (less than \$40), the court concluded that cost-shifting provisions effectively precluded the individual presentation of claims.¹⁵ Accordingly, the court concluded that the arbitration agreements could not be enforced.¹⁶

The decision by a Washington appellate court in *Medez v. Palm Harbor Homes, Inc.*¹⁷ demonstrates that provisions that have the effect of shifting costs may be subject to scrutiny even when the shifting of costs is neither explicit nor for a fixed amount. In *Medez*, the retail installment contract signed in connection with a consumer's purchase of a mobile home provided for arbitration by a three-member panel appointed by the American Arbitration Association (AAA).¹⁸ Although the agreement did not specify how costs would be allocated, the consumer-

¹³ See *Green Tree Financial Corp. v. Randolph*, 531 U.S. 79, 121 (2000).

¹⁴ 843 A.2d 1267 (Pa. Super. Ct. 2004).

¹⁵ *Id.* at 1273.

¹⁶ *Id.*

¹⁷ 45 P.3d 594 (Wash. Ct. App. 2002).

¹⁸ *Id.* at 598.

plaintiff submitted an affidavit to the court that the AAA would require him to pay a \$2,000 filing fee to initiate arbitration by a three-arbitrator panel. Taking into account other costs associated with commencing arbitration, the court found that the consumer-plaintiff “would have been required to spend up front well over \$2,000 to try to vindicate his rights under a contract to buy a \$12,000 item in order to resolve a potential \$1,500 dispute.”¹⁹ While recognizing the laudable goals served by arbitration, the court refused to enforce the arbitration agreement based on the reasoning that “avoiding the public court system in a way that effectively denies citizens access to resolving everyday societal disputes is unconscionable.”²⁰

Together, *McNulty* and *Medez* demonstrate the willingness of some state courts to scrutinize and decline enforcement of consumer arbitration agreements that shift costs of access to arbitration to the consumer. Such scrutiny may arise even when the costs allocated to the consumer are facially negligible or when the costs are not explicitly defined by the agreement.

b. Provisions Limiting Remedies

Just as financial barriers to consumer commencement of arbitration are greeted with suspicion by some state courts, barriers to consumers’ full recovery in arbitration are also likely to elicit scrutiny. Generally the provisions that run afoul of state unconscionability law impose limitations on the relief an arbitrator may award or seek to waive particular remedies available in litigation or under a statute. Recent decisions in Alabama and Ohio exemplify the sometimes aggressive analysis applied by state courts that start from the premise that it is unconscionable to require a weaker party to forgo substantive remedies and conclude that any limits on remedies render an arbitration clause unenforceable.

In *American General Finance*, the Alabama Supreme Court reviewed an arbitration clause in a loan agreement that expressly limited the arbitrator’s ability to award punitive or other damages to five times “the economic loss suffered by the party.”²¹ The court determined that the provision not only limited the availability of punitive damages, but also limited the availability of all non-economic losses (*i.e.*, mental anguish) that would otherwise be recoverable in litigation.²² Finding the provision unconscionable because it “so grossly favored the lender,” the court stated, “[u]nder these contracts, the arbitrator cannot award the full panoply of relief available in state courts under Alabama law.”²³ The Alabama Supreme Court refused to enforce

¹⁹ *Id.* at 605.

²⁰ *Id.*

²¹ *Am. Gen. Finance v. Branch*, 793 So. 2d 738, 741 (Ala. 2000).

²² *Id.* at 749.

²³ *Id.* at 749 (internal quotation omitted).

the arbitration agreement and suggested that any agreement restricting the range of relief available to a consumer claimant would meet the same fate.²⁴

The decision of an Ohio appellate court to invalidate an arbitration provision in *O'Donoghue v. Smythe, Cramer Co.* suggests the confluence of the two issues of cost shifting and limitations on available relief.²⁵ The Ohio court assessed the validity of a provision in a home inspection contract limiting the inspector's liability to the cost of the inspection (\$256). Considering the costs of arbitration (filing fees and arbitrator fees), in addition to the requirement to pursue arbitration of all claims under the contract, the court determined that the contract was unconscionable.²⁶ Specifically, the court concluded that the limitation on remedies effectively denied the plaintiff any meaningful redress or incentive to pursue her claim, especially since the cost of filing for arbitration exceeded the amount recoverable.²⁷

These decisions illustrate the hostility that arbitration agreements that attempt to limit the substantive relief available to consumer claimants are likely to encounter. Agreements that simply specify an arbitral forum, without attempting to influence what can be recovered in an arbitration, should avoid such hostility.

c. Provisions Reserving Unilateral Control Over The Dispute-Resolution Process

State courts frequently exhibit hostility to arbitration agreements in the consumer context that assign unilateral control over the process to the corporate party, or which allow only that party access to the courts. The strong form of that hostility is exemplified by the pronouncement of a Pennsylvania court that reservation in a consumer arbitration agreement of one party's access to the courts creates a presumption of unconscionability.²⁸ Decisions from courts in California, Alabama, Wisconsin, and Tennessee illustrate varying degrees of hostility to arbitration agreements that provide for one-sided control of the dispute-resolution process.

A recent decision from the Wisconsin Supreme Court exemplifies the type of analysis that courts may apply to arbitration agreements that compel the consumer to arbitrate, but reserve to the other party the right of access to the courts. In *Wisconsin Auto Title Loans, Inc. v. Jones*, the court refused to compel arbitration under a loan agreement containing language reserving

²⁴ *Id.*

²⁵ *O'Donoghue v. Smythe, Cramer Co.*, No. 80453, 2002 Ohio App. LEXIS 3571, at *1 (Ohio Ct. App. July 3, 2002).

²⁶ *Id.* at *6-7.

²⁷ *Id.* at *6-7, *14-15.

²⁸ See *Lytle v. CitiFinancial Servs., Inc.*, 810 A.2d 643, 665 (Pa. Super. 2002). The *Lytle* court noted that some courts in other jurisdictions disagreed with this approach. *Id.* at 665 n.13.

access to a judicial forum for the defending loan company only.²⁹ Pursuant to the terms of the loan agreement, any claims or disputes arising between the borrower and lender were to be resolved by binding arbitration.³⁰ However, the agreement reserved to the lender the right to enforce the borrower's obligations under the contract through the judicial system.³¹ Evaluating the validity of the provision, the court stated, "[t]he doctrine of substantive unconscionability limits the extent to which a stronger party to a contract may impose arbitration on the weaker party without accepting the arbitration forum for itself."³² The court found that the clause excused the lender (the stronger party) from arbitrating claims against the borrower, reserving to itself "full access to the courts, free of arbitration," while requiring the borrower (the weaker party) to arbitrate any and all claims against the lender.³³ The court found this to render the clause unconscionable, because of the perceived benefit to the lender and disadvantage to the borrower.³⁴ Courts in California, Alabama, and Tennessee have similarly found such one-sided clauses unconscionable.³⁵

Another situation in which state courts have struck down provisions reserving one party's access to the courts is when the stronger party attempts to delineate specific causes of action subject to arbitration and those that are exempt. In *Armendariz v. Foundation Health Psychcare Services, Inc.*, a frequently cited decision by the Supreme Court of California, the court concluded, in the context of an employment agreement, that "[a]n agreement may be unfairly one-sided if it compels arbitration of the claims more likely to be brought by the weaker party but exempts from arbitration the types of claims that are most likely to be brought by the stronger party."³⁶ In *Flores v. Transamerica Homefirst, Inc.*, a California appellate court applied the principle stated in *Armendariz*.³⁷ The parties to a mortgage contract disputed the enforceability of the arbitration provision. The provision provided that all disputes arising from

²⁹ 714 N.W.2d 155 (Wis. 2006).

³⁰ *Id.* at 160-161.

³¹ *Id.* at 161.

³² *Id.* at 173.

³³ *Id.* at 172.

³⁴ *Id.* at 176.

³⁵ See *Taylor v. Butler*, 142 S.W.3d 277 (Tenn. 2004) (invalidating arbitration clause as unconscionable when the seller retained the choice to pursue a claim against the buyer through litigation, while the buyer was required to adhere to arbitration); *Rocha v. Central Valley RV Outlet, Inc.*, No. F046584, 2005 Cal. App. Unpub. LEXIS 11152 (Cal. Ct. App. Dec. 1, 2005) (similar grounds for finding clause unconscionable); *Am. Gen. Finance, Inc. v. Branch*, 793 So. 2d 738 (Ala. 2000) (finding unconscionable a provision exempting a lender from arbitration of claims against a borrower, but requiring the borrower to arbitrate all claims against the lender).

³⁶ 6 P.3d 669 (Cal. 2000).

³⁷ 93 Cal. App. 4th 846 (Cal. Ct. App. 2001).

the agreement were subject to arbitration *except* an action to foreclose on the property, and went on to reserve additional remedies to the lender.³⁸ The court stated that it was unconscionable for a party to “impose the arbitration forum on the weaker party without accepting that forum for itself.”³⁹ Further, the “unilateral obligation to arbitrate is so one-sided as to be substantively unconscionable.”⁴⁰

In addition to rejecting one-sided requirements to arbitrate, some state courts have expressed hostility to contract terms granting one side disproportionate control over the process once it begins. Unilateral arbitrator selection is one example of such a term. In *Harold Allen's Mobile Home Factory Outlet, Inc. v. Butler*, the Alabama Supreme Court refused to enforce a clause in a mobile home sales agreement that gave the seller the sole right to select an arbitrator to decide potential disputes under the agreement, as long as the arbitrator had not provided legal services for the seller at any previous time.⁴¹ Despite the seller’s attempt to provide for an unbiased arbitrator, the Alabama Supreme Court found the clause unconscionable and severed it from the contract.⁴² The Court sent the dispute to arbitration, but before a court-appointed arbitrator.⁴³ Chief Justice Moore dissented in part, believing that the court should have refused to enforce the entire arbitration clause.⁴⁴

These decisions seem to arise primarily from judicial concern about perceived overreaching in dealings with consumers. Starting from the presumption that all consumer adhesion contracts are procedurally unconscionable, courts will hold terms of arbitration agreements to an exacting standard if they appear to be unduly restrictive of a consumer’s ability to bring or recover on claims. When dealing with form contracts as to which consumers have little or no bargaining power, businesses wishing to secure the benefits of an arbitral forum for disputes should avoid the temptation to craft arbitration clauses that appear to tilt the process against the consumer.

³⁸ *Id.* at 849.

³⁹ *Id.* at 854 (quoting *Armendariz* at 118).

⁴⁰ *Id.* at 855.

⁴¹ 825 So. 2d 779 (Ala. 2002).

⁴² *Id.* at 785.

⁴³ *Id.* at 785.

⁴⁴ *Id.* at 786.

Homeowner Disputes

Homeowner contracts are perceived by the courts as closely akin to consumer contracts.⁴⁵ Courts recognize that contracts concerning home ownership—including home-building, home-purchase, and home-inspection contracts—often arise in situations of unequal bargaining power. Homeowner contracts are not, however, necessarily subject to the same presumptions of procedural unconscionability as are consumer product and service contracts; evaluation of arbitration clauses in homeowner agreements tends to involve more use of the sliding scale of bargaining power and fairness of terms. A number of state courts have nevertheless demonstrated a bias towards construing arbitration agreements in homeowner contracts narrowly, to avoid extending them to disputes not expressly contemplated by the terms of the agreements, and two states—California and New York—have enacted statutes that disfavor arbitration agreements in the homeowner context.

a. Unconscionability

The unconscionability analysis applied by state courts to arbitration agreements in the homeowner context largely mirrors their approach in the consumer context. In recent decisions, courts in several states have found provisions unenforceable because they unilaterally reserved access to the judicial system while requiring another party to arbitrate all claims under the contract,⁴⁶ or limited liability and recovery,⁴⁷ or permitted unilateral selection of the arbitrator,⁴⁸ or unreasonably shifted the costs of arbitration.⁴⁹ In addition, in applying the sliding-scale unconscionability analysis, courts may find inadequate notice of the terms of an arbitration agreement suggestive of procedural unconscionability, thereby reducing the showing of substantive unconscionability required to hold the agreement unenforceable.⁵⁰

⁴⁵ The AAA's *Consumer Due Process Protocol* extends to homeowner disputes. See <http://www.adr.org/sp.asp?id=22019>.

⁴⁶ See *Harlamert v. Fischer Attached Homes, Ltd.*, No. C-020462, 2003 Ohio App. LEXIS 641 (Ohio Ct. App. Feb. 14, 2004) (refusing to enforce an arbitration clause in a homebuilding contract when the builder reserved the right to file suit, but required the purchasers to arbitrate).

⁴⁷ See *O'Donoghue*, 2002 Ohio App. LEXIS 3571 (refusing to enforce arbitration clause limiting home inspector's liability to the cost of the contract); *Davidson v. Robinson Orchards, Inc.*, No. H-99-020, 2000 Ohio App. LEXIS 1624 (Ohio Ct. App. April 14, 2000) (refusing to enforce arbitration clause limiting arbitration award in home warranty agreement).

⁴⁸ See *State ex rel. Vincent v. Schneider*, 194 S.W.3d 853 (Mo. 2006) (severing provisions in home building contract permitting the president of the Home Builder's Association to select the arbitrator and shifting the fees to the weaker party due to unconscionability); *Burch v. Kosach*, 49 P.3d 647 (Nev. 2002) (finding home buyer's warranty unconscionable because it permitted the builder's insurer to select the arbitrator).

⁴⁹ See *Vincent*, 194 S.W.3d at 860.

⁵⁰ See *Burch*, 49 P.3d 647 (finding buyers did not have a meaningful opportunity to accept the terms of the home builder's warranty, including the arbitration provision).

In *Vincent*, the Missouri Supreme Court reviewed a contract between a homebuilder and purchasers that included an arbitration agreement permitting the president of the Home Builder's Association to select the arbitrator and requiring all costs of arbitration to be born by the purchasers.⁵¹ The court held the cost-shifting provision unenforceable because, "[i]t is unconscionable to have a provision in an arbitration clause that puts all fees for arbitration on the consumer. This is particularly true when the cost-shifting terms could work to grant one party immunity from legitimate claims on the contract."⁵² Additionally, the court found the arbitrator selection clause to be unconscionable, because of the potential for bias in the selection.⁵³ However, instead of invalidating the agreement to arbitrate altogether, the court chose to sever the objectionable provisions and compelled arbitration, pursuant to the remaining contract terms.⁵⁴

The interplay between procedural and substantive unconscionability in the homeowner context is demonstrated by the Nevada Supreme Court's reasoning in *Burch*.⁵⁵ The court found that the contract in question, a home buyer's warranty signed in connection with the purchase of a newly constructed home, was a contract of adhesion, because it was offered on a "take it or leave it" basis.⁵⁶ In concluding that the warranty presented a strong case of procedural unconscionability, the court was heavily influenced by the inconspicuous placement of the arbitration clause on the sixth page of the agreement and by the complexity of the language.⁵⁷ Accordingly, the court held that "[b]ecause the procedural unconscionability of this case is so great, less evidence of substantive unconscionability is required to establish unconscionability."⁵⁸ Finding the arbitration clause's reservation to the homebuilder's insurer of the exclusive right to select both the rules and the arbitrator, the court held the agreement unenforceable.

An example of a refusal to enforce a one-sided term in an arbitration clause contained in a home buyer's warranty is the Ohio appellate court decision in *Davidson*.⁵⁹ The arbitration clause in that warranty limited available recovery to the lesser of the home's value, \$1 million, or such lesser amount as the warranty company might, with *or without* the homebuyer's knowledge,

⁵¹ *Vincent*, 194 S.W.3d at 859

⁵² *Id.* at 860.

⁵³ *Id.* at 859.

⁵⁴ *Id.* at 860.

⁵⁵ 49 P.3d at 650.

⁵⁶ *Id.* at 649.

⁵⁷ *Id.* at 650.

⁵⁸ *Id.*

⁵⁹ 2000 Ohio App. LEXIS 1624, at *1.

have communicated to the builder.⁶⁰ The effect of the provision was to potentially limit recovery to an amount below what the homebuyer could expect and which the arbitrator could otherwise award.⁶¹ Accordingly, the court held the agreement unenforceable. A similar approach was taken in *Carll v. Terminix International Company, L.P.*, in which a Pennsylvania court found a provision in an extermination contract requiring arbitration of all claims, but prohibiting special, incidental, consequential, exemplary or punitive damages, to be against public policy in a personal injury case.⁶²

The cases applying unconscionability analysis in the homeowner context support conclusions similar to those reached in the consumer context. The types of arbitration provisions most likely to encounter judicial resistance are those that have the purpose or effect of placing the homeowner at a disadvantage.

b. Narrow Construction

State courts may also avoid enforcing arbitration agreements in the homeowner context by construing the agreements narrowly to confine them to a limited set of disputes. This approach essentially stops enforcement at the threshold, because a court may determine whether or not a valid agreement to arbitrate the dispute exists without first determining whether such an agreement would be enforceable.⁶³

Strictly interpreting the language of the arbitration clause, a Washington appellate court refused to enforce an arbitration agreement between a homebuilder and a buyer when the buyer sued, among other things, for personal injuries allegedly caused by defective construction.⁶⁴ The court concluded that the personal injury claim was outside the scope of the arbitration agreement, which stated that someone with “working knowledge of residential construction” would decide the issues presented in arbitration.⁶⁵ Furthermore, the court determined that the language of the clause was inconsistent and ambiguous because it limited arbitration to construction disputes in one sentence and in a second sentence broadened the application of the arbitration clause to all disputes under the contract.⁶⁶ In light of the ambiguity and the specific language of the

⁶⁰ *Id.* at *3.

⁶¹ *Id.*

⁶² 793 A.2d 921 (Pa. Super. Ct. 2002).

⁶³ See, e.g., *Woodhaven Homes, Inc. v. Alford*, 143 S.W.3d 202 (Tex. App. 2004); *Burgess v. Jim Walter Homes, Inc.*, 588 S.E.2d 575 (N.C. Ct. App. 2003).

⁶⁴ *Pearson v. Adair Homes, Inc.*, 128 Wash. App. 1045 (Wash. Ct. App. 2005).

⁶⁵ *Id.*

⁶⁶ *Id.*

agreement, the court determined that the parties had not agreed to arbitrate personal injury claims.⁶⁷

Another variation on the narrow construction approach can be found in two similar recent decisions from Texas and North Carolina, where the courts carefully parsed contracts potentially governing the dispute to determine if the parties were bound to arbitrate.⁶⁸ Both courts found that while one agreement between the homebuilder and the buyers contained an arbitration clause, a second agreement failed to mention binding arbitration.⁶⁹ The courts construed the agreement containing the arbitration clause narrowly and the second contract broadly and thereby concluded that the claims arose under the second contract and were thus not subject to arbitration.

c. California and New York Statutory Resistance to Homeowner Arbitration Agreements

In the context of homeowner disputes, courts in California and New York have recently relied on statutes that effectively create hurdles to enforcing agreements providing for mandatory arbitration of such disputes.⁷⁰ Whereas California has imposed heightened requirements for enforcement of mandatory arbitration provisions in the homeowner context, New York has taken a more aggressive approach, effectively creating a presumption that such provisions will not be enforced. Courts in both states characterized the types of homebuilding contracts covered by their statutes as not involving interstate commerce, in order to counter the argument that the statutes were preempted by the FAA.⁷¹

Section 7191 of California's Business and Professions Code imposes mandatory disclosure and formatting requirements for arbitration provisions in contracts involving work on residential property of one to four units. Invoking this statute, a California appellate court recently refused to enforce an arbitration award, because the applicable agreement failed to provide adequate notice to the consumer that she was waiving her right to resolve her dispute in court according to the requirements of the statute.⁷²

⁶⁷ *Id.*

⁶⁸ *Woodhaven Homes, Inc.*, 143 S.W.3d at 204; *Burgess*, 588 S.E.2d at 492.

⁶⁹ 143 S.W.3d at 204; 588 S.E.2d at 493.

⁷⁰ See *Ragucci v. Professional Construction Servs.*, 25 A.D.3d 43 (N.Y. App. Div. 2005); *Baronoff v. Kean Development Co., Inc.*, 818 N.Y.S.2d 421 (N.Y. Sup. Ct. 2006); *Woolls v. Superior Court of Los Angeles County*, 127 Cal. App. 4th 197, 205 (Cal. Ct. App. 2005).

⁷¹ See *Baronoff v. Kean Development Co., Inc.*, 818 N.Y.S.2d 421 (N.Y. Sup. Ct. 2006); *Woolls*, 127 Cal. App. 4th at 213.

⁷² *Woolls*, 127 Cal. App. 4th at 200.

Section 399-c of New York's General Business Law forbids contracts for the sale or purchase of consumer goods from incorporating mandatory arbitration clauses. Although this statute has not often been invoked, New York courts have recently determined that contracts for services related to home construction are consumer contracts subject to the terms of the statute.⁷³

In *Ragucci*, a 2005 case of first impression, a New York appellate court refused to compel the arbitration of a home construction dispute between a homeowner and an architectural firm.⁷⁴ The court determined that the services provided by the defendant firm in connection with the plaintiff's home fell within the meaning of consumer goods as defined by General Business Law §399-c. Specifically, the court determined that statute's broad definition of consumer goods, which included "services purchased or paid for by a customer, the intended use or benefit of which is intended for the personal, family or household purposes of such consumer," covered the services provided by the architectural firm to the homeowner.⁷⁵ The arbitration clause was therefore held invalid and void under the statute.⁷⁶ The *Ragucci* court explained that the law "was 'designed to prevent sales contracts from including clauses pre-committing consumers to arbitrate disputes rather than resort[ing] to ... other remedies.'" ⁷⁷ The court also interpreted the statute to provide that "no contract 'should deprive a consumer of the right to take the dispute further and seek judicial redress' ... as well as 'the ability to choose between arbitration or judicial resolution of their disputes after the time when a dispute arises.'" ⁷⁸

Employment Disputes

The U.S. Supreme Court has made it clear that the FAA applies to employment contracts in businesses in interstate commerce, and that the statute generally requires courts to enforce arbitration clauses in such contracts.⁷⁹ As arbitration clauses in employment contracts and employee policy handbooks become increasingly common, state courts must contend with an increasing number of challenges to their enforceability.⁸⁰ Arbitration clauses in employment

⁷³ See *Ragucci*, 25 A.D.3d at 48; *Baronoff*, 818 N.Y.S.2d at 425.

⁷⁴ 25 A.D.3d 43 (2005).

⁷⁵ *Id.* at 48.

⁷⁶ *Id.* at 50.

⁷⁷ *Id.* at 46.

⁷⁸ *Id.* at 46-47.

⁷⁹ E.g., *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 27-28 (1991). See also *Adler v. Fred Lind Manor*, 103 P.3d 773, 779 (Wash. 2004).

⁸⁰ Arbitration agreements in the collective bargaining context are primarily governed by the Labor Management Relations Act, 29 U.S.C. §185(a), rather than by the FAA, see 9 U.S.C. §1, and will not be discussed here.

agreements are generally enforced, but certain elements can place enforcement of the agreement or a resulting award in doubt.

Arbitration clauses in employment agreements tend to be subject to scrutiny under an unconscionability analysis. The likelihood that a court will find inequality of bargaining power to support the procedural unconscionability of an employment arbitration agreement means that most of the analysis focuses on substantive unconscionability.⁸¹ In addition, agreements to arbitrate employment disputes are also subjected to scrutiny based on public policy concerns.

a. Unconscionability

Much as with consumer disputes, the courts scrutinize arbitration agreements for provisions that favor the employer to the disadvantage of the employee. Employment arbitration agreements that limit an employee's remedies, require shifting or sharing the cost of arbitration, unilaterally restrict judicial access, or otherwise appear to limit the scope of arbitration unfairly have been deemed by state courts to be unconscionable or otherwise unenforceable.

In addition to these indicia of substantive unconscionability, employment arbitration agreements may also be called into question if they unreasonably impair an employee's ability to vindicate a statutory right. This emphasis on statutory rights finds its most widely cited expression in the decision of the California Supreme Court in *Armendariz v. Foundation Health Psychcare Services, Inc.*⁸² In *Armendariz*, employees sued their employer for wrongful termination under the California Fair Employment and Housing Act. The employer claimed that the dispute was subject to arbitration pursuant to the terms of a pre-employment application and employment contract signed by the parties. The arbitration agreement in each contract contained clauses that (a) limited recoverable damages to back pay, (b) allowed only the employer to go to court, (c) required sharing the costs of arbitration, and (d) restricted the scope of discovery.⁸³ The employees argued that the terms of the agreement were unconscionable.

Analyzing the terms of the agreement, the court emphasized the importance of protecting an employee's ability to vindicate his or her statutory claims in an arbitral forum.⁸⁴ The court "held that California courts must perform a separate analysis in addition to the unconscionability analysis to determine if the arbitration agreement satisfies specific minimum requirements."⁸⁵

⁸¹ See, e.g., *Wilson v. Bally Total Fitness Corporation, Inc.*, D039355, 2003 Cal. App. Unpub. LEXIS 5892, at *1, *10 (Cal. Ct. App. June 18, 2003) ("The fact the Agreement is an adhesion contract is sufficient to establish that the Agreement is procedurally unconscionable....").

⁸² 6 P.3d 669 (Cal. 2000).

⁸³ *Id.* at 675.

⁸⁴ *Id.* at 681.

⁸⁵ *Id.*; see *Abramson v. Juniper Networks, Inc.*, 115 Cal. App. 4th 638, 652 (Cal. Ct. App. 2004).

Pursuant to this separate analysis, now known as an *Armendariz* analysis, California courts will not compel employees to arbitrate their claims if the arbitration agreement does not (1) provide for adequate discovery, (2) require a written decision subject to limited judicial review, (3) permit the types of relief available in court, (4) limit the employee's forum costs and (5) provide for a neutral arbitrator.⁸⁶

Applying this analysis, the *Armendariz* court found the terms of the agreement before it to be unconscionable and unenforceable, because the provisions (a) compelled the employees to arbitrate statutory claims "without affording the full range of statutory remedies, including punitive damages and attorneys fees...available under the [California Act],"⁸⁷ (b) required the employees to bear expenses not applicable in courts,⁸⁸ and (c) required the employees, but not employer, to arbitrate.⁸⁹

In the wake of the *Armendariz* decision, California and Washington courts have struck down similar terms in other employment contracts. In *Abramson*, an employee claiming wrongful termination challenged terms in his employment agreement requiring him to pay half of the arbitration fees and excluding claims by the employer from arbitration (unilaterally reserving access to the courts), while requiring all claims by the employee to be submitted to arbitration.⁹⁰ Finding the terms unconscionable and unenforceable, the appellate court relied on the principle that an arbitration agreement may not present obstacles to the vindication of claims involving statutory or non-statutory public rights.⁹¹

Similarly, in *Gonlugur v. Circuit City Stores, Inc.*, an employee disputing statutory overtime payments claimed that his employment contract was unenforceable because it imposed a unilateral obligation to arbitrate, reserved to the employer access to the courts, shortened the statute of limitations, required fee shifting, and barred class actions.⁹² The appellate court agreed, concluding that the employment agreement lacked mutuality and fairness, and effectively deprived the employee of the full range of benefits provided by the state statute.⁹³

⁸⁶ See *Armendariz*, 6 P.3d at 682.

⁸⁷ *Id.* at 683.

⁸⁸ *Id.* at 678.

⁸⁹ *Id.* at 694.

⁹⁰ *Abramson*, 115 Cal. App. 4th at 665.

⁹¹ See *id.* at 653.

⁹² *Gonlugur v. Circuit City Stores, Inc.*, No. G033351, 2004 Cal. App. Unpub. LEXIS 8140, at *1 (Cal. Ct. App. Sept. 2, 2004).

⁹³ *Id.* at *8-14. See also *Wilson v. Bally Total Fitness Corp.*, D039355, 2003 Cal. App. Unpub. LEXIS 5892, at *10 (Cal. Ct. App. June 18, 2003) (California courts must ensure "fairness in arbitration so that employees subject to mandatory arbitration agreements can vindicate their public rights in an arbitral forum").

The decision in *O'Hare v. Municipal Resource Consultants* illustrates the effect of the *Armendariz* standard on features of arbitration clauses that might not, in other contexts, support a finding of unconscionability.⁹⁴ There, a California appellate court invalidated an arbitration agreement in an employment contract that required an employee to pay an equal share of the expenses of arbitration. The court ruled that arbitration agreements “imposing mandatory arbitration as a condition of employment...cannot generally require the employee to bear any type of expense” they would not incur in a court action.⁹⁵ Additionally, despite the employer’s offer to pay the costs of arbitration in an effort to cure the problem, the court refused to sever the offending clause, stating that the term’s “unconscionability permeate[d] the arbitration provision.”⁹⁶ The California courts now generally find provisions requiring employees to share the costs of arbitration unenforceable.⁹⁷

Finally, in *Fitz v. NCR Corporation*, a California appellate court considered an employee dispute resolution policy that listed several types of disputes between employers and employees that were subject to arbitration, and others that were not.⁹⁸ The court found that the disputes subject to arbitration were solely of the type that employees would bring against employers, but not the reverse. Finding the provision unlawful for lack of mutuality, the court refused to enforce the arbitration clause, stating “[the provisions] indicate a systematic effort to impose arbitration on an employee not ... as an alternative to litigation, but as an inferior forum that works to the employer’s advantage.”⁹⁹

Washington state courts have adopted much of the reasoning of the *Armendariz* decision. In *Zuver v. Airtouch Communications, Inc.*, the Supreme Court of Washington decided the enforceability of a provision in an employment agreement requiring the waiver and release “of all rights to recover punitive or exemplary damages in connection with common law claims, including claims arising in tort or contract....”¹⁰⁰ The court held the provision unconscionable because it “blatantly and excessively favor[ed] the employer” and did not allow the employee any significant recourse while permitting the employer full access to the remedies.¹⁰¹

⁹⁴ 107 Cal. App. 4th 267 (Cal. Ct. App. 2003).

⁹⁵ *Id.* at 279.

⁹⁶ *Id.* at 282.

⁹⁷ *See, e.g., Abramson*, 115 Cal. App. 4th 638; *Wilson*, 2003 Cal. App. Unpub. LEXIS 5892.

⁹⁸ 118 Cal. App. 4th 702, 725 (Cal. Ct. App. 2004).

⁹⁹ *Id.* at 727. *See also Wilson*, 2003 Cal. App. Unpub. LEXIS 5892 (exempting certain employer claims from arbitration found unconscionable).

¹⁰⁰ 103 P.3d 753, 767 (Wash. 2004). The provision did not preclude the employer from seeking these remedies in an action against the employee.

¹⁰¹ *Id.*

In *Adler v. Fred Lind Manor*, another Supreme Court of Washington decision, the court severed provisions of an arbitration agreement requiring parties to pay their own attorneys fees and prescribing a shorter statute of limitations when arbitrating state statutory employment discrimination claims, finding the provisions unconscionable.¹⁰² The court determined that the provisions undermined the protections provided in the statute to the disadvantage of the employee and were thus not enforceable.

The *Armendariz* line of cases illustrates the determination of some state courts to apply heightened scrutiny to arbitration agreements in the employment context. Courts following this type of analysis are more likely to conclude that even modest indicia of substantive unconscionability are enough to defeat enforcement of an arbitration agreement. At the same time, these cases do not create a *per se* rule against employment arbitration. As in other contexts, those wishing to avoid invalidation of an agreement to arbitrate in the employment context will do well to avoid including terms that could be viewed by a court as one-sided. Once again, the AAA has provided guidelines in the form of due process protocols to help employers avoid the pitfalls of enforcing agreements to arbitrate employment disputes.¹⁰³

b. Public Policy

Public policy is sometimes treated by courts as an independent standard against which to evaluate agreements to arbitrate employment disputes and has also been employed in considering enforcement of arbitral awards. While courts are generally not permitted to disturb arbitral awards except on narrow statutory grounds, the U.S. Supreme Court has authorized some judicial review, at least of labor arbitration awards, on public policy grounds.¹⁰⁴ Of the states that have relied on public policy considerations to decline enforcement of arbitral awards, Connecticut has taken the most aggressive approach and has done so primarily in the area of arbitral awards reinstating public employees.

In *Board of Police Commissioners of the City of Ansonia v. Stanley*, a city police officer appealed the lower court's decision to vacate an arbitration award reinstating him with the city's police force.¹⁰⁵ The officer had been terminated for making false statements during an internal investigation into complaints about the harassment and sexual intimidation of four women.¹⁰⁶ At the conclusion of arbitration, despite finding the claims substantiated, the arbitrator ruled that the

¹⁰² 103 P.3d 773 (Wash. 2004).

¹⁰³ See <http://www.adr.org/sp.asp?id=28535>.

¹⁰⁴ *W.R. Grace & Co. v. Int'l Union of United Rubber, Cork, Linoleum & Plastic Workers*, 461 U.S. 757, 766 (1983). The statutory grounds are set forth in 9 U.S.C. §10.

¹⁰⁵ 887 A.2d 394 (Conn. App. Ct. 2005).

¹⁰⁶ *Id.* at 398-400.

City lacked just cause to terminate the officer and called for his reinstatement.¹⁰⁷ The City moved to vacate the award.

In order to vacate an arbitration award on the grounds of a public policy violation, the court had to identify “well defined and dominant [public policy], as is to be ascertained by reference to the laws and legal precedents and not from general considerations of supposed public interests,” and determine whether or not the award violates the expressed policy.¹⁰⁸ The court stated, “[a]rbitrators exceed their authority if their award orders a party to engage in conduct that is ... in clear violation of public policy.”¹⁰⁹ Finding that expressed state and federal law prohibited the behavior of the officer,¹¹⁰ the court vacated the award reinstating the officer as against public policy, because it appeared to signify endorsement of his behavior by the City.¹¹¹

Similar cases in which state courts have refused to enforce an arbitration award on public policy grounds include *City of Torrington v. AFSCME Council 4 Local 1579*, where a Connecticut court vacated an arbitration award reinstating a state building inspector suspected of taking bribes while on duty and falsifying his employment application.¹¹² The court stated, “[t]he public has a right to expect honesty, good faith and fair dealing from its government employees... a truism that is obvious and grounded in common sense... [and] may, in and of itself, constitute a public policy.”¹¹³ Based on this interpretation of public policy, the court vacated the award.

In *State v. AFSCME. Council 4, Local 2663, AFL-CIO*, the court vacated an arbitration award reinstating a driver for the Department of Children and Families who was terminated after a conviction of possession of drugs with the intent to sell.¹¹⁴ Relying on state policy concerning the state’s duty to protect and nurture children, the court found that the arbitrators’ award conflicted with the public policy.¹¹⁵ Specifically, the court stated, “[c]ommon sense commands that it is utterly inappropriate to place potentially troubled children in daily contact with a convicted drug offender. An arbitrator’s award that undermines the department’s responsibility

¹⁰⁷ *Id.* at 400-401.

¹⁰⁸ *Id.* at 404; *see also United Paperworks Int’l Union, AFL-CIO v. Misco, Inc.*, 484 U.S. 29 (1987).

¹⁰⁹ 887 A.2d at 406.

¹¹⁰ *Id.* at 405.

¹¹¹ *Id.* at 406-07.

¹¹² No. CV000083909S, 2002 Conn. Super. LEXIS 2290, at *1 (Conn. Super. Ct. July 11, 2002).

¹¹³ *Id.* at *34.

¹¹⁴ 758 A.2d 387 (Conn. Ct. App. 2000).

¹¹⁵ *Id.* at 390.

to protect children in such a dramatic way violates a compelling public policy, and we will not allow it to stand.”¹¹⁶

These cases do not suggest a broad trend or often-used basis for invalidating arbitral awards, nor do they suggest that courts will wield public policy as a weapon to invalidate pro-employer awards (indeed, the opposite appears to be the case in Connecticut). However, weighing arbitral awards against public policy may not always yield predictable results, especially if the trend moves from the collective bargaining context into other employment disputes.

Health Care Disputes

In the area of health care disputes, as in the employment context, state courts appear inclined to scrutinize agreements that appear to impair statutory rights. Public policy favoring protection of those placed at a disadvantage by illness tends to play a significant role in the analysis of agreements to arbitrate health care disputes. Various terms in arbitration agreements have been determined to violate state public policy in this field.

First, courts have found provisions limiting remedies under health care agreements to be unenforceable as violations of state public policy, especially if they attempt to alter statutorily guaranteed protections. The courts tend to reject these alterations based on the principle, articulated by the U.S. Supreme Court, that an agreement to arbitrate statutory claims incorporates all provisions of the statute, substantive and remedial.¹¹⁷ Accordingly, provisions that seek to limit the protections of a statute are considered contrary to public policy and unenforceable.

In *Blankfield v. Richmond Health Care, Inc.*, the parties disputed whether or not the nursing home had violated the deceased’s rights under a state statute and had negligently cared for her while she was alive. The parties had signed a nursing home admission agreement containing an arbitration clause that required arbitration under the rules of the National Health Lawyers Association, which precluded awarding damages absent proof to a clear and convincing standard.¹¹⁸ The Florida court determined that the clear and convincing standard effectively eliminated recovery for negligence, and was contrary to the state’s Nursing Home Residents Act,

¹¹⁶ *Id.* at 395. See *Chicago Firefighters Union Local No 2 v. City of Chicago*, 751 N.E.2d 1169, 1174 (Ill. App. Ct. 2001) (vacating an award reinstating a firefighter found drinking alcohol while on duty and responding to a call, because it was contrary to public policy).

¹¹⁷ *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth*, 473 U.S. 614, 628 (1985); see also, e.g., *Armendariz*, 6 P.3d at 682.

¹¹⁸ 902 So. 2d 296 (Fla. Dist. Ct. App. 2005). Pursuant to the NHLA arbitration rules, an arbitrator is prevented from awarding consequential, exemplary, incidental, punitive or special damages absent “clear and convincing evidence that ...[a party]...is guilty of conduct evincing an intentional or reckless disregard for the rights of another party.” *Id.* at 298.

which provided for a preponderance of the evidence standard.¹¹⁹ The damages clause in the agreement “defeated the remedial provisions of the statute” and was therefore found to be a violation of public policy.¹²⁰

Other circumstances that tend to lead courts to refuse to enforce an arbitration agreement include failing to provide notice of the arbitration clause in a health care contract. A recent decision from a Tennessee appellate court considered not only whether the parties were alerted to the existence of an arbitration clause in a contract, but also whether the circumstances under which the clause was bargained for were reasonable. In *Howell v. NHC Healthcare-Fort Sanders, Inc.*, the court refused to enforce a clause, in spite of the nursing home having explained it to the patient.¹²¹ The court found that the nursing home representative failed to explain the meaning and implications of the arbitration clause, because she failed to explain that the signatory waived his right to a jury trial, and it was clear that the signatory had a limited education.¹²² Furthermore considering the urgency of the admission to the nursing home, and the “take it or leave it” basis under which the patient was admitted, the court determined that the parties did not mutually agree to arbitrate.¹²³

Some states have codified an arbitration notice requirement. As a general matter, states are prohibited from adopting legislation or other policies that restrict the enforcement of arbitration agreements based on criteria not applicable to other contracts—including notice and formatting requirements. In *Doctor’s Associates, Inc. v. Casarotto*, the U.S Supreme Court struck down a Montana statute requiring special formatting requirements for arbitration agreements.¹²⁴ The Montana statute required contracts to give notice that they contained arbitration clauses in “underlined capital letters on the first page of the contract.”¹²⁵ The Supreme Court found that the statute undermined the goals of the FAA—to put arbitration agreements on equal footing with other contracts—and held that the Montana statute was pre-empted by the federal Act.¹²⁶ The Court stated, “[c]ourts may not...invalidate arbitration agreements under state laws applicable only to arbitration agreements,” nor may they condition

¹¹⁹ *Id.* at 298.

¹²⁰ *Id.* at 299. See also *Flyer Printing Co. v. Hill*, 805 So. 2d 829 (Fl. Dist. Ct. App. 2001) (arbitration clause limiting remedies available under Title VII unenforceable).

¹²¹ 109 S.W.3d 731 (Tenn. Ct. App. 2003).

¹²² *Id.* at 733.

¹²³ *Id.* at 735.

¹²⁴ 517 U.S. 681 (1996).

¹²⁵ *Id.* at 684.

¹²⁶ *Id.* at 687.

“the enforceability of arbitration agreements on compliance with a special notice requirements not applicable to contracts generally.”¹²⁷

Overall, states seem to be complying with the *Casarotto* rule. However, California and Colorado courts have struck down arbitration clauses under state statutes dictating formatting and disclosure requirements in insurance agreements.¹²⁸ The viability of such statutes is premised on the theory that the McCarran-Ferguson Act “reverse preempts” the FAA by reserving to the states the power to regulate terms in insurance contracts.¹²⁹ Pursuant to this exemption, these states created legislation requiring health care contracts containing arbitration clauses to meet specific formatting and disclosure requirements.

Class Actions

In its 2003 decision in the *Bazze* case, the Supreme Court held that it is for an arbitrator to decide whether a claimant may pursue a claim on a class basis if the claim is governed by an arbitration clause that is silent on the subject.¹³⁰ Since then, arbitration clauses in consumer and employment contracts have become less silent, and many now contain explicit waivers of the right to proceed on a class basis. State courts have differed as to the enforceability of such class action waivers, and the Supreme Court recently declined an opportunity to clarify the law in this area when it denied *certiorari* in a case in which the California courts had held such waivers to be unconscionable in consumer agreements.¹³¹

The typical argument against class action waivers is that such clauses prevent potential plaintiffs with financially insignificant individual claims from joining together to pursue their claims on a class basis. Courts adopting this argument reason that, without the benefit of class actions, cases that do not offer the potential financial gains needed to attract a lawyer could not be pursued, with the result that conduct that harms society in the aggregate could go unchecked.¹³² Courts following this line of reasoning perceive class action waivers as impermissibly one-sided, because it is defendants who benefit from the reduced threat of

¹²⁷ *Id.*

¹²⁸ *E.g., Robertson v. Health Net of California, Inc.*, 132 Cal. App. 4th 1419 (Cal. Ct. App. 2005); *Imbler v. Pacificare of California, Inc.*, 103 Cal. App. 4th 567 (Cal. Ct. App. 2002); *Smith v. Pacificare Behavioral Health of California, Inc.*, 93 Cal. App. 4th 139 (Cal. Ct. App. 2001); *Allen v. Pacheco*, 71 P.3d 375 (Colo. 2003).

¹²⁹ The McCarran-Ferguson Act is codified at 15 U.S.C. §1012(b). *See Allen*, 71 P.3d at 382.

¹³⁰ *Green Tree Fin. Corp. v. Bazze*, 539 U.S. 444 (2003).

¹³¹ *Cingular Wireless v. Mendoza*, 126 U.S. 2353 (2006), denying a writ of certiorari to review *Parrish v. Cingular Wireless*, No. A105518, 2005 Cal. App. LEXIS 978 (Cal. Ct. App. June 17, 2005).

¹³² *See, e.g., Lytle v. CitiFinancial Servs., Inc.*, 810 A.2d 643, 665 (Pa. Super. Ct. 2002).

aggregate action. Accordingly, many courts view these waivers as unconscionably restrictive both of a claimant's ability to redress wrongdoing and of her or his right to vindicate a claim.¹³³

In the last five years, courts in Alabama, California, Illinois, Missouri, New Jersey, North Carolina and West Virginia have struck down arbitration clauses incorporating class action waivers. In Alabama, the Supreme Court voided the entire arbitration agreement in a home inspection contract on grounds of unconscionability for precluding class actions.¹³⁴ The court concluded that the agreement was unconscionable because it “restrict[ed] [the plaintiffs] to a forum where the expense of pursuing their claim far exceed[ed] the amount in controversy...by foreclosing...an attempt to seek practical redress through a class action and restricting them to...individual arbitration.”¹³⁵

New Jersey state courts have also refused to give effect to arbitration agreements containing class action waivers. In *Discover Bank v. Shea*, a New Jersey trial court refused to compel arbitration upon finding the class action waiver clause in a credit card agreement to be unconscionable.¹³⁶ The court explained its disapproval of the clause: “Discover can use the provision to preclude class actions and therefore, effectively immunize itself completely from small claims, [while] individual cardholders gain nothing, and in fact, are effectively deprived of their small individual claims.”¹³⁷ The New Jersey Supreme Court recently adopted this reasoning in *Muhammad v. County Bank of Rehoboth Beach, Delaware*, declaring that a class-arbitration waiver found in a consumer contract involving a “predictably small amount of damages” was unconscionable.¹³⁸

In 2005, in another action challenging the validity of an arbitration agreement forbidding class wide arbitration involving Discover Bank, California's Supreme Court found prohibitions on class actions unconscionable.¹³⁹ The court held that, in the face of the one-sidedness and effective insulation from “liability otherwise imposed under California law,” class action waivers “are generally unconscionable.”¹⁴⁰ As did the New Jersey court, the California court narrowly tailored its holding to apply only to consumer contracts of adhesion involving potentially small

¹³³ *Whitney v. Alltel Communications, Inc.*, 173 S.W.3d 300, 314 (Mo. Ct. App. 2005).

¹³⁴ *Leonard v. Terminix Int'l Co., L.P.*, 854 So. 2d 529 (Ala. 2002).

¹³⁵ *Id.* at 539.

¹³⁶ 827 A.2d 358 (N.J. Super. Ct. 2001).

¹³⁷ *Id.* at 366.

¹³⁸ 2006 WL 2273448, at *9-10 (N.J. Aug. 9, 2006).

¹³⁹ *Discover Bank v. Sup. Court of Los Angeles*, 113 P.3d 1100 (Cal. 2005).

¹⁴⁰ *Id.* at 1109.

amounts of damages.¹⁴¹ In the months following that decision, a California court of appeals followed the state supreme court's lead and invalidated an arbitration clause in a credit card contract containing a class action waiver. In *Klussman v. Cross Country Bank*, the court stressed that *Discover Bank* did not hold that all class action waivers are unconscionable, but rather that the facts in *Klussman* fit the narrowly defined circumstances presented by the California Supreme Court.¹⁴²

On remand from the California Supreme Court's *Discover Bank* decision, however, the court of appeals conceded that California law was more demanding on this subject than the law of other states.¹⁴³ Concluding that the agreement in question was governed by Delaware law, the court found that class action waivers in credit card agreements were enforceable under that state's law, while noting that class action waivers had been found unconscionable in eight other states. The court enforced the arbitration clause containing the waiver, because the class that the plaintiff sought to certify was not limited to California consumers.

Courts in Missouri and West Virginia have also nullified arbitration agreements with class action waivers, but each court relied on additional provisions to support its determination of unconscionability. In *Dunlap v. Berger*, the West Virginia Supreme Court of Appeals, reviewing a consumer contract, held that the FAA did not prohibit the state from considering whether or not clauses that limit a party's ability to enforce their rights or obtain relief under state law can be held unconscionable.¹⁴⁴ The court went on to refuse to enforce an arbitration clause containing provisions waiving class actions and limiting remedies, finding that the clauses significantly limited a party's remedial rights.¹⁴⁵ The Missouri Court of Appeals applied similar reasoning in refusing to enforce an agreement with a similar class action waiver and fee shifting provision.¹⁴⁶

Most recently, the Illinois Supreme Court declared unconscionable a class action waiver in a cellular telephone service agreement's arbitration clause.¹⁴⁷ Starting from the premise that class action waivers in arbitration clauses are not *per se* unconscionable, the court surveyed decisions from other jurisdictions to distill a pattern to the circumstances in which such waivers

¹⁴¹“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...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.” *Discover Bank*, 113 P.3d at 1110.

¹⁴² 134 Cal. App. 4th 1283, 1297 (Cal. Ct. App. 2005).

¹⁴³ 134 Cal. App. 4th 886 (Cal. Ct. App. 2005).

¹⁴⁴ 211 W. Va. 549, 564 (W. Va. 2002).

¹⁴⁵ *Id.* at 564.

¹⁴⁶ *Whitney v. Alltel Communications, Inc.*, 173 S.W.3d 300 (Mo. Ct. App. 2005).

¹⁴⁷ *Kinkel v. Cingular Wireless LLC*, No. 100925, 2006 WL 2828664 (Ill. Oct. 5, 2006).

will be enforced.¹⁴⁸ The court found that “a class action waiver will not be found unconscionable if the plaintiff had a meaningful opportunity to reject the contract term or if the agreement containing the waiver is not burdened by other features limiting the ability of the plaintiff to obtain a remedy for the particular claim being asserted in a cost-effective manner.”¹⁴⁹ Because the class action waiver was contained in an adhesion contract that did not explicitly set forth the costs associated with arbitration, the court concluded that the plaintiff lacked a meaningful opportunity to reject the term.¹⁵⁰ Similarly, because the plaintiff’s claim—that a \$150 early termination fee operated as an illegal penalty—could not result in individual recovery exceeding the costs of arbitration, the court found that the class action waiver limited the plaintiff’s ability to vindicate her claim.¹⁵¹ The court refused to enforce the class action waiver, but held that the remainder of the agreement to arbitrate could be severed and enforced.¹⁵²

Another recent state court decision discussing class waivers offers a slightly different analysis. A North Carolina court of appeals held, in *Tillman v. Commercial Credit Loans, Inc.*, that contracts that require parties to waive their rights to bring class actions may be enforceable if the agreement provides for the recovery of attorney’s fees.¹⁵³ According to the court, the general apprehension that class action waivers would make it impossible to obtain legal representation becomes inapplicable when the arbitration agreement contains language stating that the parties continue to be entitled to the remedies provided by law, because the consumer protection statute under which the claim was made expressly provided for the recovery of a plaintiff’s costs.¹⁵⁴ Therefore, the plaintiffs’ argument “that without the ability to join claims, they [were] deterred from bringing lawsuits against defendants due to the amount of money at stake being too small to justify an attorney’s involvement” was rejected.¹⁵⁵

The enforceability of class action waivers in arbitration agreements remains a live issue, as the law continues to be defined and interpreted in the courts. Most of the decisions do not find that a class action waiver renders an arbitration agreement *per se* unconscionable, and a number of courts have upheld such waivers.¹⁵⁶ Nonetheless, such waivers carry a risk that they will not

¹⁴⁸ *Id.* at *18-19.

¹⁴⁹ *Id.* at *20.

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at *23.

¹⁵³ 629 S.E. 2d 865 (N.C. Ct. App. 2006).

¹⁵⁴ *Id.* at 872-73.

¹⁵⁵ *Id.* at 872.

¹⁵⁶ *E.g., Hutcherson v. Sears Roebuck & Co.*, 793 N.E.2d 886 (Ill. App. Ct. 2003) (Arizona law) (“Because the arbitration provision in this case provides financial protections to card holders with the burden of costs falling

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only be rejected, but also that they will take the entire arbitration agreement out with them. As with other terms that may jeopardize the enforceability of an arbitration agreement, the benefits of including a class action waiver must be weighed against the risk that such a provision will lead to a finding that the agreement is unenforceable.

The AAA has again provided a possible middle position, by adopting *Supplementary Rules for Class Arbitrations*.¹⁵⁷ Those rules are not designed to tilt the playing field for or against class actions or class action waivers, but rather to provide an alternative for those who may wish to provide for resolution of disputes on a class basis within the framework of arbitration, rather than in competition with it.

CONCLUSION

Twenty-two years after the Supreme Court held that the FAA applies in and must be enforced by state courts, parties who have agreed to resolve disputes between them by arbitration can generally depend on those agreements being enforced in state court. Overt judicial hostility to arbitration now represents the exception rather than the rule, and it is rare for an agreement that simply provides for arbitration to be refused enforcement.

Difficulties arise, however, when parties add provisions to arbitration agreements that go beyond providing for arbitration. Courts in many states feel that they have an obligation to scrutinize closely contracts between parties of unequal bargaining power, especially take-it-or-leave-it contracts between large corporate entities and consumers, employees, homeowners, and users of health care services. Federal law may require that arbitration clauses in such contracts be enforced, but it also allows a state judge to refuse enforcement on grounds applicable to contracts in general, such as unconscionability. Terms in arbitration clauses that appear to a state judge to be unfair to a party perceived to be weaker may well be refused enforcement, particularly if the terms appear designed to tilt the outcome or to limit access to remedies provided by statute. As long as the party drafting the arbitration clause takes care to keep the process fair, it should be able to enforce the agreement to arbitrate.

A special problem is presented when an arbitration clause contains a waiver of the right to proceed on a class basis. Such waivers affect the economics of the dispute resolution process, and are treated by some state courts as unconscionable if they appear to make it impossible for

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primarily on SNB, we do not find the no-class-action provision to be so one-sided or oppressive as to render the agreement unconscionable."); *Tillman v. Commercial Credit Loans, Inc.*, 629 S.E.2d 865 (N.C. Ct. App. 2006) (N.C. law); *Spann v. American Express Travel Related Services Co., Inc.*, No. M2004-02786-COA-R3-CV, 2006 Tenn. App. LEXIS 582 (Tenn. Ct. App. Aug. 30, 2006) (Utah law); *Delta Funding Corp. v. Harris*, No. A-44, 2006 N.J. LEXIS 1155 (N.J. Aug. 9, 2006) (N.J. law) (class arbitration waiver enforceable under facts of the case, in which plaintiff was seeking more than \$100,000 in damages and was not seeking class certification).

¹⁵⁷ See <http://www.adr.org/Classarbitrationpolicy>.

an individual to pursue a claim. If care is taken to address that concern, by providing other mechanisms to make pursuit of small claims possible (such as fee shifting, or payment of the costs of arbitration by the stronger party, or class arbitration), this is an obstacle that can be dealt with in many states by careful drafting. In some states, however, the class waiver issue represents the last bastion of determined resistance to arbitration, and the enforceability of such waivers will probably remain a state-by-state question until the Supreme Court decides to resolve it.



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