

News from our Commercial Class Action Litigation Group

Avoiding Potential Pitfalls in Arbitration Provisions

Arbitration clauses in contracts are intended to serve important goals, including minimizing the costs of disputes, maintaining confidentiality of proceedings, dictating a preferred venue or choice of law, and deterring non-meritorious class action lawsuits. Recent court decisions, however, have undermined these intended benefits and created an unsettled legal landscape fraught with potential pitfalls. For example, some courts have invalidated clauses intended to bar class claims, resulting in class actions proceeding in arbitration without meaningful judicial review. In other instances, courts have found a designated arbitration forum to be unreasonable, striking the arbitration clause in its entirety and requiring claims to be litigated in court. It is essential that companies evaluate their arbitration clauses carefully to avoid these sorts of unanticipated results and to take advantage of opportunities presented by careful drafting.

Key issues and recent decisions impacting arbitration provisions

Recent cases on arbitration provisions have addressed the following key issues:

Class action waivers

In an effort to avoid class actions, some companies have tried to contractually bar consumers from pursuing class claims in arbitration. Some courts have refused to enforce these “class action waivers,” finding them to be unconscionable under state law. In California, for example, class action waivers are unenforceable where the

dispute involves (i) a consumer contract of adhesion, (ii) predictably small amounts of damages, and (iii) allegations that a defendant has intentionally cheated a large number of consumers out of individually small sums of money.¹

The application of this standard has been anything but clear, and courts have reached divergent results on the following issues:

- ▶ Whether the amounts in dispute are sufficient to make individual claims viable so that a class action waiver can be enforced. Compare *Oestreicher v. Alienware Corp.* (class action waiver unenforceable where individual claims worth approximately \$4,000)² with *Carideo v. Dell, Inc.* (class action waiver enforced where individual claims worth between \$1,300 and \$1,700).³
- ▶ Whether an arbitration clause provides procedural protections sufficient to warrant enforcement of a class action waiver. Compare *Stiener v. Apple Computer, Inc.* (class action waiver unconscionable despite terms allowing individual claimants to seek attorneys’ fees and premiums on recovery)⁴ with *Guadagno v. E*Trade Bank* (enforcing class action waiver in light of opt-out and other procedural protections) (discussed further below).⁵
- ▶ Whether class action waivers will be enforced in claims involving product defects. Compare *Omstead v. Dell, Inc.* (enforcing waiver and noting that “[i]t makes no sense to claim that Dell had a ‘deliberate scheme’ to sell four computer

models that did not work”)⁶ with *Oestreicher* (class action waiver unenforceable in case involving defective computers).⁷

These uncertainties have made it all the more important for companies doing business in California to evaluate how their arbitration clauses may be construed under California law.

In contrast to California law, class action waivers are enforced as a matter of course under several other states’ laws, without regard to the types of issues above. For example, class action waivers will generally be enforced under Delaware, Texas, and Virginia law, among others, even in circumstances involving consumer contracts of adhesion or small disputed amounts.

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Choice of law provisions

This stark divide in state laws has led companies to include choice of law clauses intended to apply a specific state law that favors enforcement of class action waivers. Predictably, this has spawned further litigation over whether the choice of law itself is enforceable.

In general, courts will enforce a choice of law provision where the state law has some reasonable connection to the parties or the dispute, so long as enforcement does not undermine the public policy of the forum state. Applying this standard, California courts have rejected choice of law provisions that would lead to enforcement of a class action waiver, particularly where the dispute involves California parties and/or claims under California statutes.⁸ Most federal district courts applying California law have ruled similarly, and the Ninth Circuit is expected to rule on the issue in 2009 in a case involving DirectTV.

In contrast to this trend, the Central District of California in *Guadagno v. E*Trade Bank* recently enforced a choice of law provision applying Virginia law, which enforces class action waivers, even though the plaintiff resided in California and had brought claims under California's consumer protection statutes.⁹ The Court found the arbitration clause did not conflict with California law, relying on an opt-out clause and other specific terms in the contract. *Guadagno* is notable because it runs counter to several California district court decisions and shows how arbitration clauses can be structured to maximize the odds that choice of law provisions and class action waivers will be enforced.

Choice of forum

Choice of forum clauses can also be subject to challenges similar to those above. Recently, the Ninth Circuit held that a contract requiring disputes to be resolved in Virginia state court cannot be enforced against California consumers raising

California law claims.¹⁰ As in the cases dealing with choice of law clauses, the Ninth Circuit was concerned that requiring a California plaintiff to litigate in Virginia (which does not permit certain class actions) would undermine California public policy. The same rationale has been applied to invalidate a provision requiring disputes to be resolved in the National Arbitration Forum (NAF). Because NAF rules prohibit class actions, the court struck the arbitration clause in its entirety and allowed the plaintiffs to proceed with their class action claims in court.¹¹

Judicial review of arbitration rulings

The recent judicial trend has not, however, been restrictive of all arbitration clauses. In 2008, the California Supreme Court in *Cable Connection, Inc. v. DirectTV, Inc.* opened the door for parties to expand the scope of judicial review of arbitration rulings in a decision likely to have significant impact.¹² Prior to *Cable Connection*, the Federal Arbitration Act (FAA) and state arbitration statutes generally limited parties to an extremely narrow scope of judicial review, allowing it only in circumstances involving fraud, clear conflict of interest, and similar circumstances.¹³

In *Cable Connection*, in contrast, the California Supreme Court held that contracting parties can agree to allow judicial review of arbitration rulings for legal error.¹⁴ Notably, the court's holding was based on specific language in the California Arbitration Act (CAA) and may not apply to arbitration not governed by the CAA.¹⁵

Navigating the minefield created by the case law

In combination, the rulings above create a significant risk that arbitration clauses as currently drafted may be ineffective or even lead to unexpected negative results. The risk is particularly great where arbitration provisions have not been reviewed in the past few years. To avoid surprises

and ensure that the intended purposes of arbitration are achieved, companies should carefully review their arbitration clauses for the following key issues:

Does the arbitration clause allow class actions? If an arbitration clause is silent on the issue, class claims will generally be allowed.¹⁶ In many cases, this will run counter to a company's expectations. If a company intends to bar arbitration of class actions, it must include specific language to that effect.

What can be done to maximize the odds of enforcement of a class action waiver?

Given the potential legal hurdles identified above, careful drafting is needed to maximize the chances that a class action waiver will be enforced. The *E*Trade* case illustrates one form of arbitration clause that has been upheld in federal district court. Companies should explore the available alternatives, while being mindful that there are no guarantees that a class action waiver will be enforced.

What happens if a class action waiver is not enforced?

It is important to know that severe negative consequences can result if a class action waiver is not enforced. In these circumstances, some courts have struck *only* the waiver provision and enforced the remainder of the arbitration clause – meaning the company must then defend against the class claims in arbitration. This result is likely to be directly contrary to a company's interests, given the limited scope of judicial review allowed (under default rules) and the fact that the enforcement of arbitration rulings and settlements against absent class members is largely untested. Several defendants have found themselves in precisely this situation when their class action waivers were found unenforceable.¹⁷ This worst-case scenario can be avoided through language clarifying that an arbitration clause is to be voided in its entirety if the class action waiver is found unenforceable. As such, all companies that opt to include a class action waiver should

consider including this protection in their arbitration clauses.

What is the best choice of law? Given the issues above, there are likely to be countervailing factors in determining the most appropriate choice of law. For example, where California law is an option, a company would need to carefully weigh the benefits of expanded judicial review versus the stringent scrutiny of class action waivers, among other considerations. For companies that want to include a class action waiver, it will be important not only to select a specific choice of law that favors enforcement of the waiver but also to evaluate whether the choice of law provision itself will be enforced under the standards discussed above.

What is an appropriate choice of forum?

As with choice of law clauses, a choice of forum provision should be evaluated for both the potential benefits and the likelihood of enforceability. Further, it should not be assumed that the same jurisdiction's law must apply to both the choice of law and choice of forum provisions. There may be benefits to selecting different states for the forum and choice of law, which should be considered.

Is expanded judicial review desirable?

While the *Cable Connections* case opens up new opportunities for judicial review, companies need to determine whether expanded review makes sense given their particular circumstances. In particular, a company should weigh the protections provided by judicial review against the added burden and costs of allowing courts to review arbitration rulings. If a company opts to expand the scope of judicial review, it will need to

do so with clear contractual language that specifically defines the review process.

Cooley's Commercial Class Action Litigation practice has extensive experience in counseling clients on arbitration clauses and enforcing arbitration clauses in litigation. Cooley was counsel of record in *Guadagno v. E*Trade Bank*, 2008 WL 5479062 (C.D. Cal. 2008). If you have any questions about arbitration clauses or this *Alert*, please contact one of the attorneys listed above. ■

NOTES

1 See *Discover Bank v. Super. Ct.*, 36 Cal.4th 148, 162-63 (Cal. 2005); *Shroyer v. New Cingular Wireless Serv.*, 498 F.3d 976, 983-85 (9th Cir. 2007).

2 502 F.Supp.2d 1061, 1067-68 (N.D. Cal. 2007).

3 520 F.Supp.2d 1241, 1247 (W.D. Wash. 2007).

4 556 F.Supp.2d 1016, 1022 (N.D. Cal. 2008).

5 2008 WL 5479062, *4 (C.D. Cal. December 29, 2008).

6 473 F.Supp.2d 1018, 1024-25 (N.D. Cal. 2007)

7 502 F.Supp.2d at 1071-72.

8 See, e.g. *Klussman v. Cross-Country Bank*, 134 Cal. App.4th 1283, 1294 (2005). Compare *Discover Bank v. Super. Ct.*, 36 Cal. Rptr. 3d 456 (2005) [*Discover Bank II*] (Delaware choice of law enforced where claims brought under Delaware law).

9 2008 WL 5479062 at *8 (C.D. Cal. 2008).

10 *Doe v. AOL L.L.C.*, 552 F.3d 1077, 1084 (9th Cir. 2009).

11 *Klussman*, 134 Cal.App.4th at 1300 (2005).

12 44 Cal.4th 1334 (2008).

13 See *Hall Street Associates, L.L.C. v. Mattel, Inc.*, 128 S.Ct. 1396, 1403 (2008) (FAA does not allow parties to expand the scope of judicial review by agreement).

14 *Cable Connection*, 44 Cal.4th at 1354(2008)

15 *Id.*

16 See *Keating v. Super. Ct.*, 31 Cal.3d 584 (1982).

17 See *Kristian v. Comcast Corp.*, 446 F.3d 25 (1st Cir. 2006), *Szetela v. Discover Bank*, 97 Cal.App.4th 1094 (2002).