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## Preserving Judicial Recourse for Consumers: How to Combat Overreaching Arbitration Clauses

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# FEATURE ARTICLES

## Preserving Judicial Recourse for Consumers: How to Combat Overreaching Arbitration Clauses

by Michael D. Donovan  
and David A. Searles

### I. Introduction

Our society is known for its litigious nature. Courtroom dramas are staples of television and movies. The media, from specialized cable shows to mainstream news stories and print journalism, seem to revel in the coverage of lawsuits and the litigants involved. Among the consequences of this increased focus on our legal system is the average person's assumption that his or her rights can be vindicated in a court of law, complete with a jury of one's peers, a fair and impartial judge, certain procedural safeguards and the right to appeal from an adverse decision. Such an assumption, however, may well be misplaced.

Unknown to most consumers is that, by entering into many standard form contracts today - consumer financing, employment, insurance, health plans - they may have given up rights to seek redress in a judicial forum and, instead, have bound themselves to an arbitration process. Although forgoing litigation in favor of arbitration may seem, at first glance, merely substituting one objective forum for

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another, or opting for an equally fair yet more efficient process, that is often not the case.<sup>1</sup>

For example, a consumer entering into a financing contract may be bound to arbitrate while the lender retains the right to go to court.<sup>2</sup> An arbitration clause in an employment agreement may provide that the employer chooses the arbitrator and excludes the employee from the selection process.<sup>3</sup> A health care plan may permit the care provider to unilaterally reject an arbitration award if it does not like the result.<sup>4</sup>

Thus, arbitration clauses are often biased in favor of the business entity party to the contract. This is not surprising in view of the fact that it is the business that drafted the contract.

These contracts are classic examples of adhesion contracts in that they are (1) in standardized format, using boilerplate provisions, (2) drafted by the party in a stronger bargaining position, and (3) imposed on consumers on a take-it-or-leave-it basis. The effect of such clauses is often to deprive or discourage consumers from enforcing their common law and statutory rights in judicial forums. As a result, consumers risk being bound by unreviewable decisions reached without most of the procedural and substantive safeguards that are available in a court setting.

This article will examine the status of arbitration clauses in general under recent Supreme Court case law and in particular in consumer cases. It will then discuss a number of theories for invalidating arbitration clauses in consumer cases so as to preserve the right to judicial redress for grievances.

## II. The Federal Arbitration Act

In 1925, Congress enacted the Federal Arbitration Act ("FAA").<sup>5</sup> The FAA represented an attempt to put arbitration agreements on an equal footing with, and make them just as enforceable as, other contracts. As Section 2 of the FAA states, written arbitration agreements "shall be valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."<sup>6</sup>

Although lenders or other business entities are quick to cite to the FAA as

governing their arbitration agreements with consumers, such agreements were not the focus of the FAA when it was enacted.<sup>7</sup> The legislative history of the FAA shows that the purpose of the FAA was to settle disputes between businesses in the context of commercial disputes involving entities with relatively equal bargaining power and working knowledge of the kinds of disputes likely to arise in that context.<sup>8</sup> There is nothing in the FAA that indicates an intention that adhesive agreements between a business and a consumer be included within the reach of the Act.<sup>9</sup>

Some commentators are of the view that the Supreme Court has interpreted the FAA in such a way as to create a national policy favoring arbitration agreements and giving them a special and protected status in the law of contract.<sup>10</sup> This preference for arbitration was announced by the Court in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*<sup>11</sup> That case involved two business entities, a contractor and a hospital, and their broad binding arbitration agreement purporting to cover all disputes arising from or relating to construction of the hospital. Without providing any historical or policy justification, the Court concluded that federal policy favored arbitration over litigation: "Courts of Appeal have ... consistently concluded that questions of arbitrability must be addressed with a healthy regard for the federal policy favoring arbitration. We agree."<sup>12</sup> Since *Moses H. Cone*, the Court and lower

courts have repeated the notion that federal policy favors arbitration, but have never explained the source of that policy.<sup>13</sup>

More recently, however, the Supreme Court decided the case of *First Options of Chicago, Inc. v. Kaplan*.<sup>14</sup> In *First Options*, the Court held that the issue of who (arbitrator or court) should decide arbitrability is a question for the courts, unless there is "clear and unmistakable evidence" that the parties agreed otherwise.<sup>15</sup> The Court emphasized that the initial issue of the *existence* of a valid agreement is different from the subsequent question of "*the scope* of a valid arbitration agreement."<sup>16</sup> As to the former issue, whether an agreement to arbitrate exists, ordinary state law principles that govern the formation of contracts should control.<sup>17</sup> It is *only* with respect to the latter question, the scope of the agreement, that the law "reverses the presumption" so that the federal policy in favor of arbitration will apply to resolve any doubts about the issues to be arbitrated.<sup>18</sup> Accordingly, the Court has made it clear that the federal policy favoring arbitration does not apply to issues concerning the validity, revocability and enforceability of contracts containing arbitration clauses.

The Court's holding in *First Options* has led other courts to question the continuing vitality of a thirty-one year old Supreme Court case, *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*<sup>19</sup> In *Prima Paint*, the Court held that a claim of fraud in the inducement of the entire

contract is for the arbitrator to decide, while such a claim directed at the arbitration clause itself is for a court to decide.<sup>20</sup> Several courts have now recognized that, since the assumption that an agreement to arbitrate was made voluntarily is essential to the *First Options* inquiry, the related and antecedent question of whether the agreement is the product of fraud, unconscionability or coercion must be an issue for the courts as well.<sup>21</sup>

This is especially true where the contract at issue involves a typical consumer because the contract is generally one of adhesion. In such situations, arbitration clauses are subject to heightened judicial scrutiny.<sup>22</sup> As the Court has emphasized, "arbitration is simply... a matter of contract between the parties."<sup>23</sup> Arbitration is a matter of informed consent, not hidden coercion or blind acquiescence.<sup>24</sup> When the parties to a contract are fully informed, possess equal bargaining power and reasonably expect certain provisions or terms, as is typically the case in commercial transactions among merchants, arbitration agreements are routinely enforced and, in fact, enjoy a preferred status in the courts. But when such clauses are buried in the fine print of complex legal documents that are offered on a take-it-or-leave-it basis to less sophisticated consumers who typically do not even understand either the nature or the significance of mandatory arbitration, general contract principles require a closer scrutiny of the process and the fairness of the

purported bargain.<sup>25</sup> Where there is an unreasonably high likelihood of misapprehension, unfairness or one-sidedness, courts have not hesitated to invalidate arbitration clauses based, for example, on findings of fraud in factum, fraud in the inducement, lack of mutuality and unconscionability.<sup>26</sup>

### III. Arbitration Clauses in Consumer Cases

Arbitration clauses in consumer contracts reflect a wide variety of substantive inequities. For one, the clauses may be obscured in fine print and buried deep in multi-copy standard forms. For another, even assuming that a consumer could find the clause, it may be written in dense, often contradictory and inconsistent language. The following is an example of a typical arbitration clause found on the reverse side of a consumer loan contract, printed here in slightly larger type than its actual size:

ARBITRATION — All disputes, claims or controversies arising from or relating to this contract or the relationships which result from this contract, or the validity of this arbitration clause or the entire contract, shall be resolved by binding arbitration by one arbitrator selected by us with consent of you. \* \* \* . The parties agree and understand that they choose arbitration instead of litigation to resolve disputes. The parties understand that they have a right or opportunity to litigate disputes through a court, but that they prefer to resolve their disputes through arbitration, except as provided herein. THE PARTIES VOLUNTARILY AND KNOWINGLY WAIVE ANY RIGHT THEY HAVE TO A JURY TRIAL, EITHER PURSUANT TO ARBITRATION UNDER THIS CLAUSE OR PURSUANT TO A COURT

ACTION BY US (AS PROVIDED HEREIN).

The parties agree and understand that all disputes arising under case law, statutory law, and all other laws including, but not limited to, all contract, tort, and property disputes, will be subject to binding arbitration in accord with this contract. The parties agree and understand that the arbitrator shall have all powers provided by the law and the contract. These powers include all legal and equitable remedies, including, but not limited to, money damages, declaratory relief, and injunctive relief. Notwithstanding anything hereunto the contrary, we retain an option to use judicial or non-judicial relief to enforce a mortgage, deed of trust, or other security agreement relating to the real property secured in a transaction underlying this arbitration agreement, or to enforce the monetary obligation secured by the real property, or to foreclose on the real property. Such judicial relief would take the form of a lawsuit. The institution and maintenance of an action for judicial relief in a court to foreclose upon any collateral, to obtain a money judgment or to enforce the mortgage or deed of trust, shall not constitute a waiver of the right of any party to compel arbitration regarding any other dispute or remedy subject to arbitration in this contract, including the filing of a counterclaim in a suit brought by us pursuant to this provision.

The above clause illustrates many of the unfair, overreaching and deceptive characteristics of arbitration clauses. The clause is in fine print and located upside down on the reverse side of a multi-copy standard form. Substantively, the clause is totally one-sided. While it begins by stating that all disputes are to be resolved by arbitration, well into the clause is a provision allowing the lender, but not the consumer, the option to resort to a judicial forum for relief by filing a lawsuit. Further, the clause provides

that even if the lender opts to enforce certain rights under an action for judicial relief, it does not waive its right to compel arbitration as to other disputes under the contract, including any counterclaim of the consumer in a lawsuit initiated by the lender. Thus, the clause would permit the lender to file a lawsuit in court, but relegates the consumer's counterclaims to arbitration.

The clause also allows the lender to select the arbitrator.<sup>27</sup> There is no indication of what institution, if any, would oversee or operate the arbitration process, no information concerning what kind of discovery rights, if any, are available, no information about the costs, what deadlines might be applicable, how or with whom to initiate the arbitration, where it might be held or even whether the consumer has the opportunity to appear before the arbitrator. Beyond the inherent substantive unfairness of the clause, the limited discovery permitted in most arbitrations<sup>28</sup> makes a fair resolution even less likely for the average consumer. As Professor Budnitz points out, many consumers may wish to assert claims based on consumer protection statutes such as the Truth in Lending Act,<sup>29</sup> the Equal Credit Opportunity Act,<sup>30</sup> the Fair Credit Billing Act,<sup>31</sup> or state unfair and deceptive acts or practices laws. Often, the consumer's claims will be based on the documents used in the transaction: disclosure statement, note, security instrument, etc. Some or all of the

relevant documents may not be in the consumer's possession. Because the parties are generally limited to subpoenas duces tecum in an arbitration, the documents may be difficult to obtain from the financial institution in time to adequately prepare a case. Seeing documents at a hearing for the first time does not permit a consumer the opportunity for adequate analysis and presentation of his case. An arbitrator may be reluctant to postpone the hearing to allow enough time to study the documents because that would result in delay.<sup>32</sup>

Further, raising claims under consumer protection statutes presupposes an arbitrator qualified to evaluate the claims. That may not be a correct assumption. Consumer protection statutes are complex; adequate evaluation requires knowledge not only of the statute, but of regulations, official commentary and case law, all of which may change periodically. Arbitrators may be more likely to rely on their own notions of fairness or justice, which will not necessarily lead to results intended by the drafters of the consumer protection legislation.<sup>33</sup>

A number of theories are available to challenge the enforceability of arbitration clauses such as the one set forth above. The following section will discuss some of those theories.

#### **IV. Theories for Invalidating Arbitration Clauses in Consumer Cases**

## A. Burdens of Proof

Before reviewing the various legal grounds on which arbitration clauses can be challenged, it might be helpful to emphasize that, under most state laws,<sup>34</sup> the burden of demonstrating the existence of an enforceable arbitration agreement is on the party seeking to compel arbitration. There are two reasons that the burden should rest on that party.

1. *Risk shifting terms or exclusions must be plain, clear and conspicuous.*

The drafters of a contract may have a substantial burden of proof due to the “take it or leave it” nature of the contract containing an arbitration clause.<sup>35</sup> The burden is on the drafter of the standard form contract to show that the consumer had knowledge of any unusual, unexpected or inconsistent term,<sup>36</sup> risk-shifting terms or exclusions must be plain, clear and conspicuous.<sup>37</sup> A significant factor is whether the consumer, in light of his or her sophistication, the nature of the agreement and the complexity of the relationship, reasonably expected that they would be subjected to an arbitration clause that would deprive them of the ability to resolve any disputes in an impartial, public forum with all the due process rights and duties to follow the law as are available in a court.<sup>38</sup>

Also, when scrutinizing adhesion contracts, courts are empowered to ensure that the enforcement of clauses that materially impinge on substantial

rights of the weaker party does not result in oppression or unfair surprise. For example, Section 2-302(a) of the Uniform Commercial Code (“UCC”) allows the court to refuse to enforce the contract as a whole or any single clause or group of clauses that is permeated by unconscionability.<sup>39</sup> Similarly, the Restatement Second, Contracts, § 208 directs the court to determine as a matter of law whether a standardized contract or a term therein is unconscionable and therefore unenforceable. Both the Restatement and the UCC strongly suggest that the court should hold an evidentiary hearing before ruling on the validity of the arbitration clause.<sup>40</sup>

2. *The proponent of a contractual provision that effects a waiver of the other party’s constitutional rights must prove the existence of the agreement and that there was a knowing, intelligent and voluntary waiver.*

The proponent of an arbitration clause will often proceed from the false premise that the consumer has the initial burden of proof before a court on a motion to compel arbitration. In fact, *First Options* makes it clear that it is the proponent of the clause that has the initial burden of proving the existence of a valid agreement. In *First Options*, the Court emphasized that “arbitration is simply a matter of contract between the parties; it is a way to resolve those disputes — but only those disputes — that the parties have agreed to submit to arbitration.”<sup>41</sup> Since

ordinary state law principles governing the formation of contracts apply to the question of whether a valid agreement exists, those principles likewise assign the burden of proof.<sup>42</sup>

Both federal law and ordinary contract principles establish that the proponent of any clause that effects a waiver of the other party's constitutional rights has the burden of proving both the existence of a valid agreement and that there was a knowing, intelligent and voluntary waiver.<sup>43</sup> Under federal law, courts must "indulge in every reasonable presumption against waiver of fundamental constitutional rights and . . . [may] not presume acquiescence in the loss of such rights."<sup>44</sup> Likewise, most state contract law specifically provides that any waiver of a right must be knowing, intelligent, voluntary, unequivocal and clearly evinced.<sup>45</sup> It is equally well settled that a party seeking to compel arbitration bears the burden of showing that the party opposing arbitration "knowingly, intelligently, and voluntarily" waived his right to a trial in court by a jury of his or her peers.<sup>46</sup>

The Supreme Court has declared that "a waiver of constitutional rights in any context must, at the very least, be clear."<sup>47</sup> In *Fuentes*, the Court distinguished its earlier decision in *D. H. Overmyer Co. v. Frick Co.*<sup>48</sup> *D. H. Overmyer* involved a corporate party that had waived its rights by signing a confession of judgment in exchange for a release of mechanic's liens and certain monetary benefits on future

payments. By contrast, the situation in *Fuentes* presented a waiver by a much weaker party to a contract:

There was no bargaining over contractual terms between the parties who, in any event, were far from equal in bargaining power. The purported waiver provision was a printed part of a form sales contract and a necessary condition of the sale. The appellees made no showing whatever that the appellants were actually aware or made aware of the significance of the fine print now relied upon as a waiver of constitutional rights.<sup>49</sup>

Supreme Court case law implicitly adopts a four-factor balancing test for when courts should accept or reject a claim of waiver in the civil context.<sup>50</sup> The courts should examine 1) "the visibility and clarity of the waiver itself, 2) the relative knowledge and economic power possessed by the parties, 3) the degree of voluntariness of the purported agreement, and 4) the substantive fairness of the purported agreement."<sup>51</sup>

Proponents of arbitration may contend that the case of *Doctor's Associates, Inc. v. Casarotto*<sup>52</sup> precludes application of these principles to arbitration clauses. That contention is mistaken. While it is true that arbitration clauses may not be subjected to positive state law requirements that are different from general contract principles, there is nothing in the Supreme Court's jurisprudence, including *Doctor's Associates*, which exempts arbitration



clauses that purport to waive constitutional rights from the basic waiver principles that apply to all contracts.

*Doctor's Associates* does not overrule the general contract requirement of a plain, clear and conspicuous statement for terms that are beyond the reasonable expectations of the weaker party. In that case, the Supreme Court considered a state statute that singled out arbitration clauses for special treatment. That statute was applicable only to arbitration provisions, not to enforcement of contracts generally and thus ran afoul of the FAA's requirement that arbitration clauses not be placed on an unequal footing.<sup>53</sup> But the Court, while invalidating the state statute, reiterated that generally applicable contract defenses may be applied to invalidate the state statute, reiterated that generally applicable contract defenses may be applied to invalidate arbitration agreements without contravening the FAA.<sup>54</sup>

**B. Unconscionability - The Absence of Meaningful Choice Together With Terms Unreasonably Favorable to Other Party**

A leading ground for attacking arbitration clauses in consumer contracts is their unconscionability. An arbitration clause must be viewed "in the light of its setting, purpose and effect," and invalidated or interpreted to "avoid unconscionable results."<sup>55</sup> An arbitration clause that is so one-sided as to be unconscionable should not be enforced.<sup>56</sup>

Courts recognize that a term or a contract is unconscionable when there is "an absence of meaningful choice on the part of one of the parties together with contract terms which are

*Courts recognize that a term or a contract is unconscionable when there is "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."*

unreasonably favorable to the other party."<sup>57</sup> In determining whether an agreement is unconscionable, courts focus not only on the process whereby the agreement was made, to see whether the parties lacked meaningful choice, but also on the substantive terms of the agreement, to see whether the terms

unreasonably favor one party.<sup>58</sup> Arbitration clauses may be tainted both because they result from an unfair process characterized by a massive disparity in bargaining power in which the consumer had no meaningful choice and because the terms are unreasonably favorable to the company.<sup>59</sup>

1. *Adhesion contracts are subject to a higher level of judicial scrutiny*

Adhesion contracts are subject to a higher level of judicial scrutiny, and courts will deny enforcement if the contract or provision is outside the reasonable expectations of the weaker party.<sup>60</sup> As the Supreme Court has explained:

Ordinarily, one who signs an agreement without full knowledge of its terms might be held to assume the risk that he has entered a one-sided bargain. But when a party of little bargaining power, and hence little real choice, signs a commercially unreasonable contract with little or no knowledge of its terms, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all of the terms. In such a case the usual rule that the terms of the agreement are not to be questioned should be abandoned and the court should consider whether the terms of the contract are so unfair that enforcement should be withheld.<sup>61</sup>

An adhesion contract that is based on a lack of meaningful choice and contains terms that are so one-sided as to be oppressive is invalid.<sup>62</sup> Courts have frequently found "the absence of a meaningful bargain" in an adhesion contract because it "usually involves a party whose circumstances, perhaps his unworldliness or ignorance, when

compared with the circumstances of the other party, make his knowing assent to the fine-point terms fictional."<sup>63</sup>

When a sophisticated party has drafted a standard form fine print contract and the weaker party lacks a meaningful choice, courts have been especially vigilant in preventing any unconscionability resulting from enforcement of the agreement.<sup>64</sup> Courts have recognized, for example, that the "need for application of this standard [unconscionability] is most acute when the professional seller is seeking the trade of those most subject to exploitation—the uneducated, the inexperienced and the people of low income."<sup>65</sup>

The requisite higher level of judicial scrutiny is demonstrated by the factors utilized by the court in *John Deere Leasing Co. v. Blubaugh*.<sup>66</sup> First, the contracts were "printed form or boiler plate contracts drawn skillfully by the party in the strongest economic position, which establish industry-wide standards offered on a take it or leave it basis to the party in a weaker economic position." Second, the circumstances surrounding the execution of the contract, its commercial setting, purpose and effect showed that the plaintiffs were duped into agreeing to the standard form contracts without any understanding of their essential terms or character through the device of the two contract deceit utilized by the defendants. Third, the arbitration clause deprived plaintiffs of their right to go to court,

preserves that right for defendants and yet was hidden in "a mass of fine print trivia" and in an inconspicuous place.<sup>67</sup> Fourth, the arbitration clause was phrased so as to be ambiguous and "incomprehensible to the layman or [to] divert his attention from the problems raised by [it] or the rights given up through [it]." Fifth, the arbitration clause manifested an overall imbalance in the obligations and rights of defendants vis-a-vis plaintiffs. Sixth, the contracts containing the arbitration clause exemplified "exploitation of the underprivileged, unsophisticated and uneducated." And seventh, the contracts rested on a gross inequality of bargaining or economic power, in that plaintiffs did not have the resources to bargain regarding any of the terms relating to the arbitration clause.

A similar analysis led to a finding of unconscionability in an employment arbitration agreement in *Hooters of America, Inc. v. Phillips*.<sup>68</sup> In that case, the court applied the six factor analysis of unconscionability required by the Fourth Circuit Court of Appeals.<sup>69</sup> (1) the nature of the injuries suffered by the party sought to be held to the contract; (2) whether that party is a substantial business concern; (3) disparity in the parties' bargaining power; (4) the parties' relative sophistication; (5) whether there is an element of surprise in the contract's terms; and (6) the conspicuousness of the terms.

In applying that test, the court found as to the first factor that the injuries

suffered by the female employee who sought to bring suit for sexual harassment were substantial because she would be stripped of numerous substantial remedies under Title VII, such as rights to compensatory damages, back pay relief, preemptory relief, punitive damages and attorney fees. Further, she would be faced with numerous unfair procedural rules: limitations on discovery, one-way witness disclosure and sequestration, employer control over the official record and sharply curtailed judicial review. As to the other factors, the employee was obviously not a "substantial business concern" and there was clearly a marked disparity in the parties' bargaining power and in their relative sophistication. Finally, the court considered that there was an "extreme element of surprise to the harshness" of the arbitration agreement because the procedural rules governing arbitration were not available to the employee at the initial orientation meeting when the agreement was signed.<sup>70</sup>

## 2. Arbitration clauses as procedurally unconscionable

The process by which a consumer enters into a contract may involve elements that courts have identified as demonstrating procedural unconscionability.<sup>71</sup> First, due to the gross disparity in the level of sophistication and business understanding of a consumer as compared with other parties, it may be

clear that the consumer did not have a reasonable opportunity to understand the terms and conditions of the agreement. Second, there may be no opportunity for meaningful negotiation over the terms of the arbitration clause. Third, the agreement containing the arbitration clause may be printed in fine print inconspicuously placed on the reverse side of a boilerplate form drafted solely by the party in the strongest bargaining position. Fourth, the terms of the contract may not have been explained to the consumer, and the arbitration clause, in particular, may not have even been pointed out to the consumer. Fifth, a consumer may not feel he or she has a meaningful choice, but instead understands the agreement to be on a "take it or leave it" basis. Sixth, the stronger party may have used deceptive practices to obscure not just the terms of the contract, but also its essential character.<sup>72</sup>

In *Sosa*, for example, an arbitration clause that was contained in an agreement thrust upon a patient just "minutes away" from surgery, on a printed form drafted by the doctor seeking to enforce it, was signed by the patient when she was in a state of anxiety and felt rushed to sign, and which was never discussed with the patient at any time, was found to be procedurally unconscionable.<sup>73</sup> In *Stirlen v. Supercuts, Inc.*, the court also found that procedural unconscionability invalidated an arbitration clause because the plaintiff had no "realistic ability to modify the

terms of the employment contract," that were presented to him as standard, non-negotiable terms after he accepted employment.<sup>74</sup> The plaintiff in that case was a business executive commanding an annual salary of \$150,000, not an unsophisticated consumer. The plaintiff, who brought a wrongful discharge action that his employer sought to stay on the basis of the arbitration clause, said that the contract was presented to him on a "take-it-or-leave-it basis." The court found that the agreement to arbitrate was part of a contract of adhesion and was procedurally unconscionable.<sup>75</sup>

### *3. Arbitration clauses as substantively unconscionable*

An arbitration clause may also be fatally flawed because its terms are substantively unconscionable. Such clauses are often structured to be manifestly unfair to consumers, who are forced to irrevocably relinquish their right to a day in court while the stronger party retains the right to seek a judicial remedy whenever it chooses. As such, consumers are presented with a classic case of "heads I win, tails you lose."<sup>76</sup> In *Saika v. Gold*, a medical malpractice action, the court found an arbitration agreement invalid because it allowed the doctor to obtain a trial de novo if the patient won, but afforded no such right to the patient if the doctor won. Therefore, according to the court, the agreement rendered an illusory remedy to one party to the benefit of the other. A court of equity

would not enforce such a substantively unconscionable agreement, which "contravene[d] the strong public policy in favor of arbitration."<sup>77</sup>

Similarly, in *Fritz v. Nationwide Mut. Ins. Co.*,<sup>78</sup> the Delaware Chancery Court refused to enforce an arbitration clause in an insurance contract because its terms were substantively unconscionable. In that case, an arbitration award automatically bound the insured but the insurer was bound only if it gave its written consent. The court stated:

The effect of this one-sided consent to arbitration, therefore, allows Nationwide to avoid any award it chooses not to consent to while prohibiting [the insured] any discretion as to the acceptance of an award. Nationwide cannot have it both ways. It cannot require compulsory binding arbitration then treat it as non-binding to it. In reality, under the contract Nationwide had not agreed to binding arbitration at all, but merely provided that it might later require [the insured] to submit to binding arbitration. These terms unreasonably favor Nationwide and are therefore unconscionable. The compulsory arbitration clause in the insurance policy is therefore void.<sup>79</sup>

In *Germantown Manufacturing Co. v. Rawlinson*,<sup>80</sup> the court found that a contract which caused a party to assent to a confession of judgment clause was unconscionable because the clause was "the essence of a material, risk-shifting

term...which dispense[d] with the signer's day in court." The clause was contained in a contract that the wife, in a weakened and emotionally depleted condition, was misled into signing.

The substantive unconscionability of an arbitration clause is magnified in view of the wide disparity in the status and the business understanding of the consumer as compared with the company representatives. In *Wagner v. Rummel*,<sup>81</sup> the plaintiff sought specific performance of an agreement to buy land at a price that was roughly 100 times less than its value. The agreement had been signed by a decedent who was "unsophisticated, at best, if not illiterate, regarding business matters and legal documents," with "little or no schooling."<sup>82</sup> The trial court had refused to consider the defense of unconscionability to the contract because it had not been affirmatively pleaded. The appellate court reversed, remanding so that evidence regarding the decedent's status could be considered in light of the doctrine of unconscionability.<sup>83</sup>

### C. Fraud in Factum - Clause Unenforceable When Material Terms Misrepresented

It is well settled that a contract procured by fraud in factum is void and cannot be enforced. Fraud in factum occurs "where there is misrepresentation of the character or essential terms of a proposed contract."<sup>84</sup> When such essential terms are misrepresented, the other party's

manifestation of assent is ineffective because that party believed he was agreeing to something different from what was presented.<sup>85</sup> A material misrepresentation is one that "would be likely to induce a reasonable person to manifest his assent, or the maker knows that it would be likely to induce the recipient to do so."<sup>86</sup> A failure to disclose material terms is tantamount to a misrepresentation.<sup>87</sup> Courts have noted that fraud in factum includes instances in which a party is told one thing but the actual written contract says something else and where there is "a surreptitious substitution of one document for another and the innocent party sign[s] it without knowledge or a reasonable opportunity to know the character or essential terms of the substituted document."<sup>88</sup>

One example of fraud in factum is the classic two-contract deceit where a contractor, for example, will first have a consumer agree to the repair work — in the form of a work contract — and then later force him or her to agree to the financing in the standard form contract under the guise that the two agreements were essentially the same. However, the second contract, containing the arbitration clause, not only was not the same, but it bore no relation to the agreement the consumer had been promised. Because of the contractor's misrepresentations regarding the essential character and terms of the standard form contracts, the consumer's assent is ineffective, and the contracts should be void.<sup>89</sup> The consumer's signature on the contracts

has no meaning because the consumer did not assent to those contracts.<sup>90</sup>

Federal courts have refused to enforce arbitration clauses included in contracts obtained by fraud in factum. For example, in *Cancanon*,<sup>91</sup> the plaintiffs, unsophisticated and trusting consumers who lacked familiarity with financial matters, signed what was represented to be a money market account but turned out to be a general securities account with a binding arbitration clause. Their stockbroker then engaged in high volume, speculative trades that resulted in substantial losses. The court held that where the allegation "is one of fraud in the factum, i.e., ineffective assent to the contract, the issue is not subject to resolution pursuant to an arbitration clause contained in the documents."<sup>92</sup>

In another case, the plaintiff spoke a bare minimum of English, but was required to sign documents in English for a commodities account that contained a binding arbitration clause.<sup>93</sup> Her account sustained serious losses. The defendant sought to compel arbitration pursuant to the arbitration clause. The plaintiff resisted, alleging the defendant knew she could not read English and that the agreement was presented for her "signature as a mere 'administrative' document." She also contended that the fact that the document was a "contract setting forth the terms of a binding agreement" was affirmatively concealed from her. The court held that arbitration could not be compelled because fraud in the factum as to the entire agreement voided the

contract. Further, the court said, the majority of courts "confronting this question directly have held that a bona fide claim of fraud in the factum as to the entire contract takes a case outside the rule of *Prima Paint*."<sup>94</sup>

#### **D. Lack of Mutuality - One-Sided Agreements Subject To Nullification**

##### *1. Lack of mutuality of remedy*

Arbitration clauses may also be unenforceable where they are unilateral and lack mutuality. While such a clause binds unsophisticated, trusting consumers and commits them to an irrevocable waiver of their day in court, it leaves powerful and more sophisticated businesses completely free to choose a judicial forum for the enforcement of the contracts. Courts have routinely invalidated such one-sided agreements that bind one party to the arbitral forum while leaving the other free to pursue judicial remedies.

For example, in *Northcom, Ltd. v. James*,<sup>95</sup> the Alabama Supreme Court directly confronted the issue whether an arbitration clause contained in an adhesion contract that binds one party to arbitration while leaving the other party free to choose litigation should be enforced. That court concluded that such a clause should not be enforced:

...we hold that, in a case involving a contract of adhesion, if it is not shown that the party in an inferior bargaining position had a meaningful choice of agreeing to arbitration or not, and if the

superior party has reserved to itself the choice of arbitration or litigation, a court may deny the superior party's motion to compel arbitration based on the doctrines of mutuality and unconscionability.

The court also based its conclusion on the doctrine that a court of equity should not compel specific performance of an arbitration agreement in the context of a consumer contract of adhesion where "the party in the superior bargaining position has given itself a choice of arbitration or litigation, but has reserved a right to compel the weaker party to submit to arbitration."<sup>96</sup>

The court in *Lopez v. Plaza Finance Co.*<sup>97</sup> faced an analogous situation and invalidated an arbitration clause in a consumer finance contract on the grounds that it lacked mutuality. *Lopez* was a class action challenging the terms of an installment loan agreement. Though the clause appeared to require the parties to submit to arbitration any claim "arising out of the contract," in fact the clause exempted the finance company from arbitration with respect to "whether or not the Debtor has committed an act of default."<sup>98</sup> The court said that the creditor defendant had "failed to identify any class of legitimate claims it might bring which would not relate to plaintiff's breach or default," thus rendering the creditor's promise to arbitrate illusory.<sup>99</sup> The court then denied the motion to compel arbitration, stating that "where only one party is bound to arbitrate, the

agreement is unenforceable."<sup>100</sup>

In *Hull v. Norcom*,<sup>101</sup> a terminated former employee challenged an employment contract containing a binding arbitration clause. The clause one-sidedly permitted the employer to seek injunctive relief and damages in any court for a breach of the non-compete covenant. The defendant employer sought to compel arbitration. The employee resisted, claiming that the clause was invalid because the parties lacked a mutual agreement to arbitrate. The court agreed, stating that the employer's obligation to arbitrate was illusory, and that an arbitration agreement "is not mutually binding where one party reserves the option to raise and resolve any and all disputes that it may have against the other party in a court of law rather than through arbitration."<sup>102</sup>

Some courts do not find lack of mutuality in and of itself sufficient to preclude arbitration. For example, in *Lackey v. Green Tree Financial Corp.*,<sup>103</sup> the South Carolina Court of Appeals reversed an order finding unconscionable and unenforceable an arbitration clause in an admittedly adhesive contract. The clause at issue allowed the lender to choose a judicial forum while denying the borrower the right to raise a counterclaim in any such legal action. The court reasoned, however, that nothing in the clause prevented the borrower from asserting the counterclaim, only that the counterclaim would be subject to arbitration. The court relied on the absence of proof that the borrower

would be prejudiced by arbitration, or unable to get the same relief available in a judicial setting. The court believed it was required to defer to the legislative policy behind the FAA and not "view arbitration as an inherently less beneficial form of dispute resolution."<sup>104</sup>

Several days before the *Lackey* decision, a federal court sitting in the same state invalidated an employment arbitration agreement because, among other things, the clause lacked mutuality in the "bindingness" of the arbitration award: the award was fully appealable by the employer, but not by the employee.<sup>105</sup> An even more recent decision by the Pennsylvania Superior Court, *Zak v. Prudential Property & Casualty Insurance Company*,<sup>106</sup> invalidated an arbitration clause in an insurance contract because it gave the insurer more rights than the insured: "It is fundamentally unfair for an insurer to obtain a trial any time an award it does not like is made while the claimant or insured is not afforded a similar right. The procedure offends notions of due process and equal protection."<sup>107</sup>

A related issue is whether there was mutual consideration underlying the contract that made the less sophisticated party's promise to submit claims for arbitration enforceable. In the case of *Gibson v. Neighborhood Health Clinics, Inc.*,<sup>108</sup> an employee sued her former employer for discrimination in violation of Title VII<sup>109</sup> and the Americans with Disabilities Act.<sup>110</sup> The district court had dismissed the



employee's claims on the grounds that she had contractually agreed to submit her claims for arbitration. On appeal, the Seventh Circuit Court of Appeals reversed. The court reviewed the enforceability of the employment contract under Indiana law, the site of the relevant events in the dispute, and concluded that there was no consideration supporting the employee's promise to arbitrate. Consideration was not supplied by the employer's promise to hire the employee or to continue to employ her because the offer of the employment was not made in exchange for the promise to arbitrate; the employee had already been hired at the time of the promise. Also relevant to the court's analysis was that the contractual language at issue reserved to the employer the right to modify, defend or otherwise change any or all terms of the employment contract at any time, without notice. As pointed out by the concurring opinion, whatever "promise" was made by the employer was illusory because it was subject to the disclaimer language contained in the employee manual.<sup>111</sup>

## 2. *Lack of consideration for giving up constitutional rights*

Arbitration clauses, by their nature, require consumers to give up certain basic constitutional rights, including the right to a jury trial and the right to adequate notice and opportunity to be heard. The Supreme Court has clearly held that there must be bargained-for

consideration where a consumer has given up such rights in an adhesion contract.

The starting point for this analysis is the case of *D.H. Overmyer Co. v. Frick Co.*,<sup>112</sup> a case that did not involve a contract of adhesion. In that case, the Court held that a contractor, who repeatedly failed to make payments due for installation of a refrigeration system and then negotiated and agreed to a confession of judgment clause in order to continue the contractual relationship, received sufficient consideration for abandoning the due process right it would otherwise have to a prejudgment notice and hearing. The Court pointedly observed, however, that:

Our holding, of course, is not controlling precedent for other facts of other cases. For example, where the contract is one of adhesion, where there is great disparity in bargaining power, and where the debtor receives nothing for the cognovit provision, *other legal consequences may ensue*.<sup>113</sup>

On the same day that *Overmyer* was decided, the Court issued a ruling in a companion case that involved low-income consumers giving up the same rights.<sup>114</sup> In *Swarb v. Lennox*, the Court affirmed a lower court ruling that the consumers did not knowingly and intentionally give up their constitutional rights. The Court suggested that this was the type of case it had alluded to in the *Overmyer* decision where "other legal consequences may ensue" as a result of the contract being one of

adhesion, the disparity in bargaining power and the absence of any consideration received in return for the relinquishment of due process rights.<sup>115</sup>

Later in the same term, the Court issued the decision in *Fuentes v. Shevin*.<sup>116</sup> In that case, the consumer had signed a conditional sales contract that allowed the seller, Firestone Tire and Rubber Co., to immediately repossess the merchandise in the event of default. After a dispute over servicing a gas stove, Mrs. Fuentes allegedly failed to make some of the payments and Firestone seized the disputed goods. The Court rejected Firestone's argument that Mrs. Fuentes waived her due process rights by signing the sales agreement, observing that the facts of the case were a "far cry from those of *Overmyer*."<sup>117</sup>

Thus, in appropriate cases, consumer advocates should highlight the lack of consideration flowing to their clients where those clients are compelled by one-sided arbitration clauses to abandon constitutional rights.

#### **E. Fraudulent Inducement - Inducing the Consumer Into an Arbitration Agreement Through Material Misrepresentations**

It is well settled that an arbitration agreement that was fraudulently induced may not be enforced.<sup>118</sup> Under Pennsylvania law, for example, fraudulent inducement to a contract or term thereof is shown when there is (1) a misrepresentation, (2) a fraudulent utterance thereof, (3) an intention by

the maker that the recipient will thereby be induced to act, (4) justifiable reliance by the recipient upon the misrepresentation and (5) damage to the recipient as the proximate result.<sup>119</sup> A key element of fraudulent inducement is to induce a party to enter into a contract by means of fraud or a material misrepresentation, when the party was under no duty to enter into the contract.<sup>120</sup>

Further, where a contract is a standard form adhesion contract, the argument should be made that the stronger party is obligated to point out terms which were unusual or surprising, such as a unilateral arbitration clause.<sup>121</sup> The failure to affirmatively disclose the arbitration clause amounts to a material misrepresentation, which serves to nullify it.<sup>122</sup>

In *CBS Employees Federal Credit Union v. Donaldson, Lufkin and Jenrette*,<sup>123</sup> the court relied on the Supreme Court's decision in *Prima Paint*<sup>124</sup> to hold that arbitration is not to be compelled where the agreement itself has been fraudulently induced. The plaintiffs alleged that their assent to a margin agreement and the arbitration agreement it contained was fraudulently induced to coerce plaintiffs into ratifying the unauthorized trading in their accounts, which had suffered serious losses.<sup>125</sup> The court said that because plaintiff's fraud claim involved the arbitration clause, *Prima Paint* mandated that a court, not an arbitrator, should determine whether the clause was used to further a

fraudulent scheme.<sup>126</sup>

More recently, the California Supreme Court ruled that an arbitration clause in a health plan agreement between a hospital and a patient could be unenforceable due to fraud in the inducement.<sup>127</sup> Evidence supported the patient's claims that the hospital misrepresented the speed of its arbitration program, a misrepresentation on which the patient's employer relied by selecting the hospital's plan for its employees and that the patient suffered delay in the resolution of his malpractice dispute as a result of that reliance despite the patient's own diligence. The court remanded the case to the trial court to resolve conflicting factual evidence.<sup>128</sup>

#### **F. Arbitration Clauses Contravene Public Policy**

In analyzing arbitration clauses, the consumer advocate should keep in mind that the FAA was not intended by Congress to force consumers who are at a decided disadvantage when dealing with sophisticated and experienced business entities to surrender their right to a jury trial. Rather, Congress intended the FAA to apply to ordinary contract disputes "between merchants."<sup>129</sup> The FAA's legislative history evinces an "implicit assumption that it would be invoked by commercial actors having relatively equal bargaining power."<sup>130</sup> In circumstances where there is a marked imbalance in sophistication,

knowledge and financial resources as between the parties, an application of the FAA is contrary to the intent of Congress and does not further the federal policy of favoring arbitration.

Many states recognize public policy violation as a defense to contract enforcement. The Delaware Supreme Court in *Worldwide Ins. Group v. Klopp*,<sup>131</sup> refused to enforce an arbitration agreement so unfairly structured that the insurer could appeal and get a trial de novo if the arbitrator's award exceeded the state financial responsibility limits but the insured had no corresponding right to appeal an award below those limits. The court said that though the agreement permitted either party to appeal if the award was greater than the state financial responsibility limits, and both parties were bound by a low award, in reality, the agreement gave the insurer an "escape hatch" for the avoidance of high arbitration awards, whether or not the award was fair and reasonable.<sup>132</sup> As such, the court refused to enforce the arbitration agreement as unconscionable and contrary to public policy, stating that "the policy provision at issue here promotes litigation, circumvents the arbitration process and provides an arbitration escape device in favor of the insurance company."<sup>133</sup>

More recently, in the *Hooters of America, Inc. v. Phillips* case, the court found that the employer's arbitral scheme was void as a matter of public policy because it supplanted numerous, well-defined dominant Title

VII policies.<sup>134</sup> The court noted that the Supreme Court, in *Gilmer v. Interstate/Johnson Lane Corporation*,<sup>135</sup> had recognized that statutory claims could be effectively vindicated in an arbitral forum. However, where the arbitration process would preclude such vindication, the clause was void as a matter of public policy.<sup>136</sup>

### **G. The Magnuson-Moss Act - Preserving Judicial Forum for Consumer Warranty Claims**

Congress enacted the Magnuson-Moss Act (the "Act") in 1974 "in order to improve the adequacy of information available to consumers, [and] prevent deception."<sup>137</sup> The Act specified clear and comprehensive requirements regarding disclosures, duties and remedies associated with warranties on consumer products. The products covered by the Act include any "tangible personal property which is distributed in commerce and which is not only used for personal, family or household purposes."<sup>138</sup>

Courts that have considered the application of the Act to arbitration clauses in consumer contracts have ruled that where such contracts provide for binding arbitration, consumers cannot be compelled to arbitrate their claims under the Act.<sup>139</sup> The intent of the Act was to preserve a judicial forum for consumers, providing that "a consumer who is damaged by the failure of a supplier, warrantor, or service contractor to comply with an obligation under this

title or under a written warranty, implied warranty, or service contract, may bring suit for damages and other legal and equitable relief."<sup>140</sup> The only exception recognized to the entitlement to seek relief in a judicial forum is where the Act provides for the establishment of "informal dispute settlement mechanisms"<sup>141</sup> or "informal dispute settlement procedures."<sup>142</sup> The Act states that warrantors may establish such informal dispute settlement procedures and that such procedures must comply with certain minimum requirements to be promulgated by the Federal Trade Commission.<sup>143</sup> Further, the Act makes clear that such dispute resolution procedures and mechanisms are non-binding on the consumer and must be resorted to before the consumer may resort to a legal remedy, such as going to court. As such, the Act provides for informal settlement procedures as a prerequisite, not a bar, to seeking relief in a judicial forum.<sup>144</sup> And, thus, where arbitration clauses contained in such contracts are binding, rather than non-binding, such clauses conflict with the Act and are unenforceable.<sup>145</sup>

### **V. Conclusion**

While the trend to insert unfair and overreaching arbitration clauses into standard form consumer contracts appears to be on the rise, there do remain a number of grounds for invalidating such clauses, particularly when consumers' claims are based upon violations of statutory rights.

Attempts to prevent consumers from asserting those rights in court should be vigorously resisted.

## Endnotes

<sup>1</sup> Although proponents of arbitration clauses often benevolently describe the supposed advantages of arbitration, they also harbor another agenda: the erection of hurdles to meritorious consumer claims, especially class actions. See Alan Kaplinsky, *Banks Can Use Arbitration Clauses as a Defense*, BUSINESS LAW TODAY, May-June 1998, at 24: (“Consumers have been ganging up on banks. But now the institutions have found a way to defend themselves. ... [L]enders have discovered that the potential for class action litigation is significantly reduced if the consumers have agreed to arbitrate their disputes with the lenders. Arbitration is a method of dispute resolution in which a neutral third party is chosen to hear both sides of a case and then resolve it by rendering an award. Arbitration is a powerful deterrent to class action lawsuits. ... Stripped of the threat of a class action, plaintiffs’ lawyers have much less incentive to sue.”)

<sup>2</sup> See *Lopez v. Plaza Finance Co.*, 1996 U.S. Dist. LEXIS 5566 (N.D. Ill. 1996).

<sup>3</sup> See *Hooters of America, Inc. v. Phillips*, 1998 U.S. Dist. LEXIS 3962 (D.S.C. 1998).

<sup>4</sup> See *Beynon v. Garden Grove Medical Group*, 100 Cal. App. 3d 698 (Cal. App. 1980).

<sup>5</sup> 9 U.S.C. §§ 1-16 (1994).

<sup>6</sup> 9 U.S.C. § 2 (1994).

<sup>7</sup> See David S. Schwartz, *Enforcing*

*Small Print to Protect Big Business: Employee and Consumer Rights Claims in an Age of Compelled Arbitration*, 90 WIS. L. REV. 33, 75-78 (1997).

<sup>8</sup> See *id.*

<sup>9</sup> See *id.* at 36.

<sup>10</sup> See *id.*; see also, Jean R. Sternlight, *Rethinking the Constitutionality of the Supreme Court’s Preference for Binding Arbitration: A Fresh Assessment of Jury Trial, Separation of Powers, and Due Process Concerns*, 72 TULANE L.REV. 1, 9 (1997) (“The Court, far from engaging in neutral legal analysis that simply allows parties to contract for arbitration that is mutually advantageous, has in recent decisions stretched and twisted traditional canons of construction to favor arbitration over litigation.”). The author opines that the application of a federal preference to establish the existence of a valid arbitration agreement constitutes state action that results in the deprivation of constitutional rights. See *Id.*, at 40-47, 78-100.

<sup>11</sup> 460 U.S. 1 (1983).

<sup>12</sup> See *id.* at 24, citing *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967). The appellate cases cited by the Court offer little support for a policy of preference for arbitration. See Sternlight, *supra*, n. 10, at 18, n. 57.

<sup>13</sup> Sternlight, *supra* n.10, at 18.

<sup>14</sup> 514 U.S. 938 (1995).

<sup>15</sup> See *id.* at 947.

<sup>16</sup> See *id.* at 944-45 (emphasis added).

<sup>17</sup> See *id.* at 944; see also *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 281 (1995) (arbitration clauses are regulated

“under general contract law principles”).

<sup>18</sup> *Id.* at 944.

<sup>19</sup> 388 U.S. 395 (1967).

<sup>20</sup> *See id.* at 403-404.

<sup>21</sup> *See Aviall, Inc. v. Ryder System, Inc.*, 913 F. Supp. 826, 831 (S.D.N.Y. 1996). *See also* *Berger v. Cantor Fitzgerald Sec.*, 942 F. Supp. 963, 965 (S.D.N.Y. 1996); *Maye v. Smith Barney, Inc.*, 897 F. Supp. 100, 106 n.3 (S.D.N.Y. 1995); *Investment Management & Research, Inc. v. Douglas Hamilton*, 1998 Ala. LEXIS 92 (Ala. March 20, 1998) (invalidating arbitration clause on grounds of fraudulent inducement); *Allstar Homes, Inc. v. Rex Waters*, 1997 Ala. LEXIS 454 (Ala. Nov. 21, 1997) (ordering judicial proceedings to determine validity of arbitration clause in mobile home purchase contract).

<sup>22</sup> *See Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 599 (1991) (“the common law...subjects terms in contracts of adhesion to scrutiny for reasonableness”).

<sup>23</sup> *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995).

<sup>24</sup> *See Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 479 (1989).

<sup>25</sup> *See In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864 (E.D. Pa. 1966); *Moscatiello v. Pittsburgh Contractors Equipt. Co.*, 595 A.2d 1190 (Pa. Super. 1991); *Germantown Mfg. Co. v. Rawlinson*, 491 A.2d 138 (Pa. Super. 1985); *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807 (Cal. 1981).

<sup>26</sup> *See C.B.S. Employees Federal Credit Union v. Donaldson, Lufkin and Jenrette Securities Corp.*, 912 F.2d 1563 (6<sup>th</sup> Cir. 1990); *Hull v. Norcom*, 750 F.2d 1547 (11<sup>th</sup> Cir. 1985);

*Par-Knit Mills, Inc. v. Stockbridge Fabrics Co, Ltd.*, 636 F.2d 51 (3d Cir. 1980); *John Deere Leasing Co. v. Blubaugh*, 636 F. Supp. 1569 (D. Kan. 1986); *Stirlen v. Supercuts, Inc.*, 51 Cal. App. 4<sup>th</sup> 1519 (Cal. App. 1997); *Worldwide Ins. Group v. Klopp*, 603 A.2d 788 (Del. 1992).

<sup>27</sup> The clause does pay lip service to the consumer’s role in the selection by stating that one arbitrator “selected by us with consent of you” shall resolve disputes. It is exceedingly doubtful that the “consent” of the borrower would be real or informed. Most consumers are not in a position to adequately evaluate the individual arbitrators that the financial institution would offer. *See e.g.*, *Rosenberg v. Merrill, Lynch, Pierce, Fenner & Smith*, 1998 U.S. Dist. LEXIS 877 (D. Mass. 1998) (defendant’s structural dominance of the New York Stock Exchange arbitration rendered it an inadequate forum for the vindication of civil rights claims). Consumer contracts do not generally involve evenly matched commercial entities both of whom are privy to the same information about potential arbitrators and could make informed decisions. Further, the clause does not provide for a non-profit, neutral arbitrator; it is quite likely that the arbitrator chosen by the lender would be predisposed towards that party by reason of his or her natural inclination to want more business in the future. *See Moore v. Conliffe*, 871 P.2d 204, 222-23 (Cal. 1994) (Baxter, J., dissenting) (“Institutional litigants whose contracts relegate all disputes to arbitration are the major source of income for many arbitrators. Many serve repeatedly as arbitrators for institutional clients. Neutral decisionmaking is not, and cannot be, guaranteed under these circumstances.”) (citations omitted); *Richard C. Reuben, The Dark Side of ADR*, 14 CAL. L. REV. 53, 54 (1996) (“For-profit arbitrations ... generate inherent conflicts of interest, including the ADR provider’s

pursuit of repeat business from high-volume customers.”)

<sup>28</sup> See Mark E. Budnitz, *Arbitration of Disputes Between Consumers and Financial Institutions: A Serious Threat to Consumer Protection*, 10 OHIO ST. J. ON DISP. RESOL. 267, 283, 313-314 (1995).

<sup>29</sup> 15 U.S.C. §§ 1601 *et seq* (1996).

<sup>30</sup> 15 U.S.C. §§ 1691-169(1)(f) (1996).

<sup>31</sup> 15 U.S.C. §§ 1666-1666(j) (1996).

<sup>32</sup> See Budnitz, *supra*, n. 28.

<sup>33</sup> See *id.* at n. 28, at 315-318. For example, a claim made under the Truth in Lending Act is based less on fairness or justice than whether the creditor has complied with disclosure requirements.

<sup>34</sup> See *e.g.*, *Wilson Fertilizer & Grain v. ADM Milling Co.*, 654 N.E. 2d 848, 849 (Ind. Ct. App. 1995).

<sup>35</sup> See *Barajas v. PHP*, No. 97-0954 (D. Ariz. Nov. 13, 1997) (arbitration clause in home financing pyramid scheme adhesion contract declared invalid).

<sup>36</sup> See *Tonkovic v. StateFarm Mutual Auto Ins. Co.*, 521 A.2d 920, 926 (Pa. 1987) (the burden is on the drafter to point out unusual or changed provisions in contracts of adhesion); *A&M Produce Co. v. FMC Corp.*, 135 Cal. App. 3d 473, 490 (Cal. App. 1982).

<sup>37</sup> See *Moscatiello* 595 A.2d at 1193-95 (Pa. Super. 1991) (an inconspicuous risk-shifting provision is unconscionable); *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 820 (Cal. 1981) (provisions contrary to the reasonable expectations of the adhering party will be denied enforcement in the

absence of “plain and clear notification” and “an understanding consent” (citations omitted.)). See also, *Keblish v. Thomas Equipment Ltd.*, 628 A.2d 840, 846 (Pa. Super. 1993) (disclaimer not conspicuous where language embedded within body of contract and was same size and color as remainder of contract, citing 13 Pa. C.S.A. § 1201), *rev'd on other grounds*, 660 A.2d 38 (Pa. 1995).

<sup>38</sup> See *A&M Produce Co. v. FMC Corp.*, 135 Cal. App. 3d at 490.

<sup>39</sup> See *e.g.*, *Moscatiello*, 595 A.2d at 1195; *Standard Venetian Blind Co. v. American Empire Ins. Co.*, 469 A.2d 563, 566 (Pa. 1983).

<sup>40</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981); U.C.C. § 2-302(b) (1995).

<sup>41</sup> 514 U.S. at 943.

<sup>42</sup> The likely argument from the proponent of an arbitration clause that –the FAA establishes a presumption that a valid arbitration agreement exists is incorrect. The FAA only favors arbitration *after* it has been established, or it is undisputed, that the parties intended to enter into a valid arbitration agreement. See *First Options*, 514 U.S. at 943-44.

<sup>43</sup> See *Fuentes v. Shevin*, 407 U.S. 67, 94-95 (1972); *Erie Telecom. v. Erie*, 853 F.2d 1084, 1094-1096 (3d Cir. 1988).

<sup>44</sup> *Erie Telecom.*, 853 F.2d at 1095 (3d Cir. 1988) (quoting *Johnson v. Zerbst*, 304 U.S. 458, 468-69 (1938)). “[T]he Supreme Court has stated that whether a constitutional right has been waived ‘depends in each case upon the particular facts and circumstances surrounding that case, including the background, experience and conduct’ of the waiving party.” *Id.* quoting *Edwards v.*

Arizona, 451 U.S. 477, 482 (1981).

<sup>45</sup> See *Botsko v. Donegal Mut. Ins. Co.*, 620 A.2d 30, 33 (Pa. Super. 1993); *Motorists Ins. Cos. v. Emig*, 664 A.2d 559, 564 (Pa. Super. 1995).

<sup>46</sup> See *Gibson v. Neighborhood Health Clinics*, 121 F.3d 1126 (7<sup>th</sup> Cir. 1997) (applying Indiana law); enforceability requires a clear recitation when the parties knowingly waive their right to a jury trial"); *cf.* *Howard v. Bank*, 433 S.E. 2d 625 (Ga. Ct. App. 1993), *aff'd on other grounds*, 444 S.E. 2d 799 (Ga. 1994); *Broemmer v. Abortion Services of Phoenix, Ltd.*, 840 P.2d 1013 (Ariz. 1992) (noting that "the issues of knowing consent and reasonable expectations are closely related and intertwined" and holding that a consumer of medical services did not reasonably expect to be subjected to an arbitration clause); *Titan Group, Inc. v. Sonoma Valley County Sanitation Dist.*, 164 Cal. App. 3d 1122, 1129 (Cal. App. 1985) (an arbitration clause that waives fundamental rights must appear in "clear and unmistakable form"); *Roberts v. McNamara*, 360 N.W.2d 279, 281 (Mich. App. 1984) (proponent of arbitration bears burden of proof). See also *National Equipment Rental Ltd. v. Hendrix*, 565 F.2d 255, 258 (2d Cir. 1977) (holding that clause waiving right to jury was invalid because it was "set deeply and inconspicuously" in a form contract).

<sup>47</sup> *Fuentes*, 407 U.S. 67, 95 (1972) (holding that consumers did not waive due process rights by signing a conditional sales contract).

<sup>48</sup> 5 U.S. 174 (1972).

<sup>49</sup> *Fuentes*, 407 U.S. at 95; see also *Swarb v. Lennox*, 405 U.S. 191 (1972) (companion case to *D.H. Overmyer* in which the Court affirmed a three-judge district court decision which had held that confession of judgment

clauses in consumer credit contracts did not constitute a waiver of the right to notice and a hearing).

<sup>50</sup> See *Sternlight*, *supra* n. 10 at 57; see also *Erie Telecom.*, 853 F.2d at 1095-96.

<sup>51</sup> See *id.* at 57-58 (citations omitted).

<sup>52</sup> 517 U.S. 681 (1996).

<sup>53</sup> See *Doctor's Associates*, 517 U.S. at 687.

<sup>54</sup> See *id.*

<sup>55</sup> RESTATEMENT (SECOND), OF CONTRACTS § 208 (1981), Comment a; See also *Standard Venetian* 469 A.2d at 566 (Pa. 1983) (when there is "manifest inequality of bargaining power," the court may refuse to enforce a contract or a term as a matter of law if it deems it to have been unconscionable when made).

<sup>56</sup> See *Stirlen v. Supercuts, Inc.*, 51 Cal. App. 4<sup>th</sup> 1519, 1541, 60 Cal. Rptr.2d 138, (Cal. App. 1997).

<sup>57</sup> *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965).

<sup>58</sup> See *Ferguson v. Lakeland Mutual Ins. Co.*, 596 A.2d 883, 885 (Pa. Super. 1997); *A&M Produce Co. v. FMC Corp.*, 135 Cal. App. 3d 473, 489 186 Cal. Rptr. 114, 121 (Cal. App. 1982).

<sup>59</sup> See *Moscatiello*, 595 A.2d at 1195; *Germantown Mfg.*, 491 A.2d at 144.

<sup>60</sup> See *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 599 (1991).

<sup>61</sup> *Id.*



<sup>62</sup> See *Strange v. Nationwide Mutual Ins. Co.*, 867 F. Supp. 1209, 1220 (E.D. Pa. 1994).

<sup>63</sup> *In Re Elkins-Dell Manufacturing Co.*, 253 F. Supp. 864, 871 (E.D. Pa. 1966).

<sup>64</sup> See *Moscatiello* 595 A.2d at 1194-96; see also *Stirlen*, 51 Cal. App.4th at 1532 (procedural unconscionability focuses on oppression, which arises from an inequality of bargaining power resulting in absence of meaningful choice, and surprise, which is manifested when the "supposedly agreed upon terms of the bargain are hidden in the prolix printed form drafted by the party seeking to enforce the disputed terms"); see also *Sarchett v. Blue Shield of California*, 729 P.2d 267, 275, 277 (Cal. 1987) (failure to inform insured of an arbitration clause amounts to "implied misrepresentation" which is a breach of the duty of good faith and of fair dealing).

<sup>65</sup> *Germantown Mfg.*, 491 A.2d at 145.

<sup>66</sup> 636 F. Supp. 156, 1572-1573 (D. Kan. 1986).

<sup>67</sup> See *id.*; see also *Keblish v. Thomas Equipment, Ltd.*, 628 A.2d 840, 846 (Pa. Super. 1993) (disclaimer not conspicuous where language was embedded within body of contract and was same size and color as remainder of contract, *rev'd on other grounds*, 660 A.2d 38 (Pa. 1995).

<sup>68</sup> 1998 U.S. Dist. LEXIS 3962 (D.S.C. 1998).

<sup>69</sup> *Carlson v. General Motors Corp.*, 883 F.2d 287 (4<sup>th</sup> Cir. 1989).

<sup>70</sup> *Hooters*, 1998 U.S. Dist. LEXIS 3962 at \*89-93. See also, U.C.C. § 2-302, Comment 1 (1995).

<sup>71</sup> See e.g., *Sosa v. Paulos*, 924 P.2d 357, 362 (Utah 1996).

<sup>72</sup> See *id.*

<sup>73</sup> See *id.*

<sup>74</sup> See *Stirlen*, 51 Cal. App. 4th at 1534.

<sup>75</sup> See *id.*

<sup>76</sup> *Saika v. Gold*, 49 Cal. App. 4th 1074, 1080, 56 Cal. Rptr. 2d 922 (Cal. App. 1996); See also, *Beynon v. Garden Grove Medical Group*, 100 Cal. App. 3d 698, 704-6, 161 Cal. Rptr. 146, 149 (1980) (provision in arbitration clause allowing health care plan to unilaterally reject arbitration award weighed in favor of health care plan and against members, transforming arbitration into "heads I win, tails you lose" proposition).

<sup>77</sup> *Saika*, 49 Cal. App. 4<sup>th</sup> 1074, 56 Cal. Rptr. 2d 922 (1996).

<sup>78</sup> 1990 Del. Ch. LEXIS 193 (Del. Ch. Nov. 26, 1990).

<sup>79</sup> *Id.* at \*12.

<sup>80</sup> *Germantown Mfg.*, 491 A.2d, at 145.

<sup>81</sup> 571 A.2d 1055, 1059 (Pa. Super. 1990).

<sup>82</sup> *Id.*

<sup>83</sup> See *id.*

<sup>84</sup> *Cancanon v. Smith, Barney, Harris, Upham & Co.*, 805 F.2d 998, 999 (11<sup>th</sup> Cir. 1986).

<sup>85</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 163, Comment a (1981).

<sup>86</sup> RESTATEMENT (SECOND) OF CONTRACTS §

162(2) (1981); *see also*, *Germantown Mfg.*, 491 A.2d at 142; *First Fed. Sav. & Loan Ass'n of Pittston v. Reggie*, 546 A.2d 62, 66 (Pa. Super. 1988) (material misrepresentation voids contract).

<sup>87</sup> RESTATEMENT (SECOND) OF CONTRACTS §160 (1981); *see also*, *Wilson v. Donegal Mut. Ins. Co.*, 598 A.2d 1310, 1315 (Pa. Super. 1991) (the elements of misrepresentation are a fraudulent misrepresentation, an intention to induce action thereby, justifiable reliance, and damages).

<sup>88</sup> *Germantown Mfg.*, 491 A.2d at 141.

<sup>89</sup> RESTATEMENT (SECOND) OF CONTRACTS §163 (1981) ("if a misrepresentation as to the character or essential terms of a proposed contracts induces conduct that appears to be a manifestation of assent by one who neither knows nor has reasonable opportunity to know of the character or essential terms of the proposed contact, his conduct is not effective as a manifestation of assent").

<sup>90</sup> *See Langley v. Federal Deposit Ins. Corp.*, 484 U.S. 86, 108 S. Ct. 396, 402, (1987) (fraud in factum is "the sort of fraud that procures a party's signature to an instrument without knowledge of its true nature or contents"); *Par-Knit Mills, Inc. v. Stockbridge*, 636 F.2d at 54 (mere execution of a document does not negate factual assertion that such signature was not intended to be contractual undertaking).

<sup>91</sup> *See Cancanon*, 805 F.2d at 998.

<sup>92</sup> *Id.* at 1000.

<sup>93</sup> *See Kyung in Lee v. Pacific Bullion (New York), Inc.*, 788 F. Supp. 155 (E.D.N.Y. 1992).

<sup>94</sup> *Id.* at 157, citing cases; *see also* *PMC, Inc. v. Atomergic Chemetals Corp.*, 844 F.

Supp. 177, 181 (S.D.N.Y. 1994).

<sup>95</sup> 1997 Ala. LEXIS 133 (Ala. May 9, 1997).

<sup>96</sup> *See id.* at \*13. Applying those principles, the court declined to stay arbitration between two business interests because a contract of adhesion was not involved, and because both of the parties had been represented by counsel and had the opportunity to negotiate the terms of the contract.

<sup>97</sup> 1996 U.S. Dist. LEXIS 5566 (N.D. Ill. 1996).

<sup>98</sup> *Id.* at \*11.

<sup>99</sup> *Id.* at \*14.

<sup>100</sup> *Id.*, citing *Hull v. Norcom*, 750 F.2d at 1549.

<sup>101</sup> 750 F.2d 1547 (11<sup>th</sup> Cir. 1985).

<sup>102</sup> *Id.* at 1549; The Eleventh Circuit in *Hull* applied New York law. Thereafter, the New York Court of Appeals held that mutuality of remedy is not required in arbitration contracts. *See Sablosky v. Edward S. Gordon Co.*, 73 N.Y. 2d 133, 535 N.E. 2d 643, 646 (1989).

<sup>103</sup> 1998 WL 131396, ( S.C. App. March 16, 1998).

<sup>104</sup> *Id.*, slip op. at 9.

<sup>105</sup> *Hooters*, 1998 U.S. Dist. LEXIS at \*106.

<sup>106</sup> No. 3678 (Pa. Super. June 8, 1998).

<sup>107</sup> *Id.*, slip. op. at 6.

<sup>108</sup> 121 F.3d 1126 (7<sup>th</sup> Cir. 1997).

109 42 U.S.C. § 2000(e) (1994), *et. seq.*

110 42 U.S.C. § 12130 (1994), *et. seq.*

111 *Gibson*, 121 F.3d at 1133.

112 405 U.S. 174 (1972)

113 *Id.* at 188 (emphasis added).

114 *See Swarb v. Lennox*, 405 U.S. 191 (1972).

115 *See id.* at 201.

116 407 U.S. 67 (1972).

117 *Id.* at 95.

118 *See Mitsubishi Motors, Inc. v. Soler Chrysler Plymouth*, 473 U.S. 614, 627 (1985) (“courts should remain attuned to well-supported claims that the agreement to arbitrate resulted from the sort of fraud or overwhelming economic power that would provide grounds for the revocation of any contract,” citing FAA); *Southland Corp. v. Keating*, 465 U.S. 1, 16 n.11 (1984).

119 *See Moffatt Enterprises, Inc. v. Borden, Inc.*, 807 F.2d 1169, 1174 (3d Cir. 1990), citing *Scaife v. Rockwell Standard Corp.*, 446 Pa. 280, 285 A.2d 451, 454 (Pa. 1971).

120 *See In re Allegheny Int’l, Inc.*, 954 F.2d 167, 178 (3d Cir. 1992).

121 *See Section IV.A.1., supra.*

122 *See Roadmaster Ind., Inc. v. Columbia Mfg. Co.*, 893 F. Supp. 1162, 1172-73 (D. Mass. 1995) (rescission of contract warranted due to material nondisclosure at time of formation of contract); *In re Joseph M. Massello*, 1997 Del. Ch. LEXIS 23 (Del. Ch. Feb. 24, 1997) (applying Pennsylvania

law and voiding antenuptial agreement as fraudulently induced due to nondisclosure).

123 912 F.2d 1563 (6<sup>th</sup> Cir. 1990).

124 *Prima Paint v. Flood & Conklin Mfg., Co.*, 388 U.S. 395, 403-04 (1967). *See also, supra* Section II, (for a discussion of the current vitality of *Prima Paint*).

125 *See CBS Employees*, 912 F.2d at 1568.

126 *See id.* *See also Hooters*, 1998 U.S. Dist. LEXIS 3962 at \*85 (claim of fraud in the inducement is a matter for federal court to decide, not the arbitrator, where the agreement to arbitrate constituted the entire agreement between the parties).

127 *See Engalla v. Permanente Medical Group, Inc.* 97 C.D.O.S. 5206 (Cal. July 1, 1997).

128 *Id.* at 5213.

129 Julius H. Cohen & Kenneth Dayton, *The New Federal Arbitration Law*, 12 VA. L. REV. 265, 281 (1926); Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court’s Preference for Binding Arbitration*, 74 WASH. U. L. Q. 637, 645, n. 43 (1996) (“most commentators have concluded that the FAA was envisioned as applying to consensual transactions between two merchants of roughly equal bargaining power, and not necessarily to transactions between a large merchant and a much weaker and less knowledgeable consumer,” citing *Prima Paint*, 388 U.S. at 409 (Black, J., dissenting)).

130 Jeffrey W. Stempel, *A Better Approach to Arbitrability*, 65 TUL. L. REV. 1377, 1380 (1991).

131 603 A.2d 788 (Del. 1992).

132 *See id.* at 790.

<sup>133</sup> *Id.* at 791. *See also* *Zak v. Prudential Property & Casualty Insurance Company*, No. 3678 (Pa. Super. June 8, 1998) (voiding similar arbitration clause on grounds that it was unconscionable and violated public policy); *O'Neill v. Berkshire Mutual Ins. Co.*, 786 F. Supp. 397, 398 (D. Vt. 1992) (invalidating "escape hatch" arbitration clause in insurance policy, noting that courts in several other states have invalidated such clauses on public policy grounds).

<sup>134</sup> *Hooters*, 1998 U.S. Dist. LEXIS at \*93-98.

<sup>135</sup> 500 U.S. 20, 28 (1991).

<sup>136</sup> *Hooters*, 1998 U.S. Dist. LEXIS at \*93-98. *See also* *Duffield v. Robertson, Stephens & Co.*, 1998 U.S. App. LEXIS 9284 (9<sup>th</sup> Cir. May 8, 1998) (employers may not require employees to waive right to judicial forum for Title VII claims); *but see*, *Seus v. John Nuveen & Co.*, 1998 U.S. App. LEXIS 11907 (3d. Cir. June 8, 1998).

<sup>137</sup> 15 U.S.C.A. § 2302(a) (1994).

<sup>138</sup> 15 U.S.C.A. § 2301(1) (1994).

<sup>139</sup> *See Wilson v. Waverlee Homes, Inc.*, 954 F. Supp. 1530, 1537 (N.D. Ala. 1997), *aff'd*, 127 F.3d 40 (11<sup>th</sup> Cir. 1997).

<sup>140</sup> 15 U.S.C.A. § 2310(d) (1994).

<sup>141</sup> 15 U.S.C.A. § 2310(a)(1) (1994).

<sup>142</sup> 15 U.S.C.A. § 2310(a)(3) (1994).

<sup>143</sup> *See id.*

<sup>144</sup> Section 2310(a)(3)(A) provides that if a warrantor establishes such a procedure, and if the procedure meets the commission's rules under Section 2310(a)(3)(B), and if the warrantor requires in the written warranty that the consumer resort to such procedure before pursuing any legal remedy, under Section 2310(a)(3)(C), then a consumer is precluded from commencing a civil action unless he first resorts to the informal procedures.

<sup>145</sup> *See Wilson v. Waverlee Homes, Inc.*, 954 F. Supp. at 1538. The *Wilson* court later had occasion to consider the enforceability of arbitration clauses in the context of consumer claims for breach of implied or statutory, that is non-written, warranties. *See Boyd v. Homes of Legend, Inc.*, 981 F. Supp. 1423 (M.D. Ala. 1997). In *Boyd*, the court drew a distinction between written and non-written warranties, holding that, while Congress did intend to preclude binding arbitration in the context of written warranties, it stopped short of doing so with respect to implied, non-written warranties. *See Boyd* 981 F. Supp. at 1436-37.

CLR