

Proving Unconscionability: Recent Developments in California Law

By Claire Prestel

California plaintiffs with legitimate claims continue to face the hurdle of abusive mandatory arbitration clauses. This article reviews recent developments in the area of unconscionability, including new contract terms and legal arguments offered in defense of arbitration clauses that would otherwise be held unconscionable under California law.

The Issue of Who Decides Unconscionability

Now that plaintiffs have had some success proving abusive clauses unconscionable in California courts, more corporate defendants have begun to argue that in their particular cases, unconscionability is an issue to be decided by an arbitrator, not a judge. This argument usually takes one of two forms: (1) unconscionability must be decided by an arbitrator because the plaintiff's unconscionability arguments apply to the parties' entire contract, not just to the arbitration clause; or (2) specific language in the clause at issue sends unconscionability to the arbitrator, even though that is not the default rule.

The first of these "arbitrator decides" arguments purports to rely on *Buckeye Check Cashing, Inc. v. Cardegna* (2006) 546 U.S. 440, which held that a challenge to the validity of an entire contract – as opposed to a challenge to an arbitration clause within that contract – must be sent to arbitration under a broadly worded arbitration clause. Because proving procedural unconscionability in California often involves evidence related to the entire contract (e.g., evidence that the contract is adhesive, meaning that it is a take-or-leave-it agreement drafted by the stronger party),¹ some corporate defendants have argued that any consideration of such evidence must be left to the arbitrator under *Buckeye*.

Fortunately, this argument has been rejected in decisions issued by the Ninth Circuit Court of Appeals and the First District Court of Appeal.² As these cases explain, when a plaintiff raises unconscionability solely as a defense to arbitration, without any attempt to void the parties' entire contract, nothing in *Buckeye* requires a court to parse (and possibly exclude) individual evidentiary facts relevant to proving unconscionability – particularly when those facts are paired with substantive unconscionability arguments that relate only to the arbitration clause.

The principal practice tip that emerges from these cases is the importance of avoiding loose language that could be read as a challenge to the parties' overall contract, such as language to the effect that the parties' "agreement" or "contract" is unconscionable or void.

The second type of "arbitrator decides" argument depends on language in the specific agreement at issue. More and more companies have added language to their arbitration clauses that is intended to make "enforceability" or "unconscionability" an issue for the arbitrator.

Several Court of Appeal decisions have held these provisions unenforceable, although for slightly different reasons. In *Murphy v. Check 'N Go of California, Inc.* (2007) 156 Cal.App.4th 138, the First District held that language sending "unconscionab[ility]" to the arbitrator was unenforceable because it was contained in a procedurally unconscionable adhesion contract and was both beyond a reasonable plaintiff's expectations and so one-sided as to be substantively unconscionable. In *Bruni v. Didion* (2008) 160 Cal.App.4th 1272, the Fourth District held that similar language sending "enforceability" to the arbitrator could not



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be applied because the plaintiff denied reading the arbitration clause or knowingly agreeing to arbitration. (See also *Ontiveros v. DHL Express (USA), Inc.* (2008) 164 Cal.App.4th 494, 503-08, relying on both *Murphy* and *Bruni*.)³

Proving Procedural Unconscionability Notwithstanding an "Opt Out" Clause

Another source of ongoing litigation is the issue of whether plaintiffs and class members had a meaningful opportunity to negotiate or "opt out" of arbitration – an issue that may be relevant to proving adhesiveness or procedural unconscionability. Corporations have raised this issue in several different contexts, including in cases where: (1) the arbitration clause is silent on the issue of negotiability, but the company argues that the consumer failed to prove it was actually non-negotiable; (2) the arbitration clause is silent, but the defendant presents evidence that at least some consumers have been able to negotiate; or (3) the arbitration clause includes explicit language that purports to make it optional.

Even within the last category of cases there is significant room for variation. Some arbitration clauses simply state that agreement is “voluntary,” without providing a clear mechanism for opting out. Others state that the individual will be assumed to have agreed unless an opt-out form is returned within a specified period. Others state that the individual may opt out, but that if they do, the agreement will not be renewed after its scheduled expiration date.⁴

No single rule has emerged to govern these various scenarios, and this is clearly an area where California law continues to develop. In cases involving arbitration clauses that are silent on the issue of negotiability, courts are often able to infer adhesiveness from the contract and surrounding circumstances.⁵ A plaintiff can support this conclusion with a declaration stating (as applicable) that the arbitration provision was not explained; that it was never identified as negotiable; that no one ever suggested contacting a lawyer; or that the plaintiff believed agreement was required.

In cases where the defendant offers some indicia of negotiability, the following evidence may also be helpful: evidence that the product at issue is unique or that most competitors require arbitration, so that class members had very few arbitration-free alternatives;⁶ evidence that the agreement involves a third party (e.g., a home warranty provider) who would have to have been present to negotiate the clause;⁷ or evidence that the seller includes the clause in a standard-form contract for all of its products.⁸

In cases where the defendant has included language purporting to make arbitration voluntary, California decisions suggest that a variety of additional facts could be helpful. These include evidence that very few people have actually exercised the opt-out option;⁹ that class members would not know to opt out because the company’s contract does not describe the negative aspects of arbitration;¹⁰ that the clause does not explain *how* to opt out;¹¹ that the named plaintiff was rushed or was not given a reasonable period of time in which to opt out;¹² that the plaintiff was pressured into agreeing to arbitration;¹³ or that class members would have felt pressured into agreeing (e.g., because the company had superior bargaining

power and made its preference for arbitration clear).¹⁴

Proving the Substantive Unconscionability of Class Action Bans

As nearly all plaintiffs’ lawyers already know, many corporations have inserted terms in their standard-form contracts that bar their employees or customers from ever filing or participating in a class action. The June 29, 2008 unanimous decision of the New Mexico Supreme Court in *Fiser v. Dell Computer Corp.* (N.M. 2008) 188 P.3d 1215, is the latest in a series of cases in which state supreme courts have struck down these class action bans.¹⁵ *Fiser* followed by several months the California Supreme Court’s decision in *Gentry v. Superior Court* (2007) 42 Cal. 4th 443, *cert. denied*, (2008) 128 S. Ct. 1743, which expanded on the Court’s earlier decision in *Discover Bank v. Superior Court* (2005) 36 Cal.4th 148, and held that class action bans may be unenforceable in a variety of contexts.

This section reviews the development of California law in this area, as well as two recent corporate responses: (1) choice-of-law clauses providing that disputes will be governed by the law of states that enforce class action bans; and (2) a renewed attempt to argue that the Federal Arbitration Act (“FAA”) preempts state law striking down such bans.

The development of California law on class action bans

The Ninth Circuit Court of Appeals first held a class action ban substantively unconscionable under California law in *Ting v. AT&T* (9th Cir. 2003) 319 F.3d 1126. *Ting* reasoned that AT&T’s class action ban was unconscionably “one-sided” because the company was unlikely ever to file a class action against its own customers (and, indeed, failed to allege that it had ever or would ever do so). (*Id.* at 1150; see also *Shroyer v. New Cingular Wireless Servs., Inc.* (9th Cir. 2007) 498 F.3d 976, 982-84.)

The California Supreme Court then addressed a class action ban in the consumer context in *Discover Bank*. *Discover Bank* held that class action bans in consumer contracts will often be unconscionable,

but the court’s analysis emphasized that the ban at issue was employed in a contract of adhesion against consumers with very small claims – factors that rendered the clause effectively “exculpatory.” (*Discover Bank*, 36 Cal.4th at 161-63.) After *Discover Bank*, several courts interpreted its holding narrowly to apply only in the context of very small claims.

In *Gentry*, the California Supreme Court rejected these narrow readings of *Discover Bank*. The Court made clear that actions involving small individual damages are *not* the only cases in which class action bans will be unenforceable. (*Gentry*, 42 Cal.4th at 457.) The size of potential awards is one factor to be considered, but trial courts must also consider other signs that a ban is effectively exculpatory, including the potential for retaliation against identified plaintiffs, the fact that absent class members may not realize that their rights have been violated, and any other real world obstacles that may make individual arbitrations difficult. (*Id.* at 457-63.) Trial courts must also consider whether a class action is needed to ensure “effective enforcement” (as opposed to “random and fragmentary enforcement”) of a defendant’s statutory obligations. (*Id.* at 462; internal quotation marks omitted.)

After articulating these factors to be considered, *Gentry* remanded the class action ban in that case for further consideration by the trial court. In light of *Gentry*’s remand, it seems likely that the case’s key lesson will be the importance of developing a factual record to prove that a particular class action ban is exculpatory – particularly in cases that do not fit easily within *Discover Bank*’s framework for small consumer claims.¹⁶ Declarations may be offered to establish that individual recoveries would be modest, that plaintiffs’ lawyers in the area would be unlikely to take the case on an individual basis, that absent class members are likely ignorant of their rights, or that the corporate defendant will evade significant liability if class recovery is not permitted. Although it will probably be unnecessary to cover all or most of these issues in many cases, plaintiff’s counsel did offer much evidence along these lines on remand in *Gentry*, including declarations from the named plaintiff, from counsel with many years’ experience representing employees and employers, and from a former

state wage-and-hour enforcement official.

When possible, declarations may also be offered on the issue of feared retaliation. Although retaliation was a particularly obvious concern in *Gentry*, which involved employee wage-and-hour claims, consumers in other contexts might fear retaliation as well (e.g., in the nursing home context, where a resident might reasonably fear that quality of care could be affected if a complaint is made).

Defeating choice-of-law clauses

In response to decisions striking down class action bans in California and elsewhere, a growing number of standard-form contracts provide that disputes will be governed by the laws of a state that generally enforces such bans. Several courts (including some in California) have enforced these clauses,¹⁷ but recent case law provides California plaintiffs a good chance of defeating choice-of-law provisions if the class action ban at issue would otherwise be held unenforceable.¹⁸

A California court's first step when considering a contractual choice-of-law provision is to determine whether the chosen state has a substantial relationship to the parties or the transaction, or whether there is any other reasonable basis for the stated choice of law. Assuming there is a reasonable basis for the chosen state's law, the court must next determine whether applying that law would violate a "fundamental" California public policy. If so, the choice-of-law clause cannot be enforced if California has a "materially greater interest" than the chosen state. (*Wash. Mutual Bank, FA v. Super. Ct.* (2001) 24 Cal. 4th 906, 916-17.)

After the California Supreme Court issued its *Discover Bank* decision, there was some initial confusion (particularly in federal district courts) over whether that case stated a *fundamental* California policy against certain class action bans. That confusion has now been largely resolved, with both Ninth Circuit and California Court of Appeal cases holding that California has a fundamental policy in favor of providing plaintiffs a viable method for dispute resolution and against unconscionable or exculpatory class action waivers.¹⁹

This means that if an arbitration clause can be shown to be unenforceable (and,

therefore, to violate fundamental California policy), the only remaining question is whether California has a "materially greater interest" than the state identified in the defendant's choice-of-law provision. On this issue, the case law is fairly clear that California has a materially greater interest than the defendant's home state in cases involving California plaintiffs (i.e., in statewide class actions), particularly when those plaintiffs rely entirely or primarily on California causes of action.²⁰ California has also been held to have a materially greater interest in cases involving at least some California class members and some California claims.²¹ Finally, given California's strong interest in protecting consumers and in regulating in-state companies, a choice-of-law clause that would exculpate a California defendant may well be unenforceable.

Defeating FAA preemption arguments

For a number of years, corporations have argued that the Federal Arbitration Act ("FAA") preempts application of any state law that would invalidate a class action ban embedded in an arbitration clause. In a long line of authority stretching back more than a decade, the vast majority of courts have rejected this argument, including federal and state courts in California.²² Given these federal and state court decisions rejecting FAA preemption theories, it is unlikely that a renewed preemption argument will get very far in California; however, corporate defendants did win a recent victory in this area in *Gay v. CreditInform* (3d Cir. 2007) 511 F.3d 369, which stated in dicta that at least some state law limiting class action bans may be preempted.

If a corporate defendant attempts to raise the issue of preemption again in light of *Gay*, it will be important to point out that *Gay* is distinguishable from controlling California decisions in a critical respect.

The key issue in *Gay* was whether the FAA preempted Pennsylvania law on unconscionability, and the Third Circuit interpreted Pennsylvania law as prohibiting any provision in an arbitration clause that would limit class actions *in court*. In other words, the Third Circuit understood Pennsylvania law to express a clear preference for court over arbitration; under

the Third Circuit's reading, a provision expressly permitting class arbitration would be unconscionable under Pennsylvania law unless it also permitted "*judicial* class actions." (*Gay*, 511 F.3d at 394; emphasis added.)

If it were true that Pennsylvania courts insist that parties have the right to class actions in court, the Third Circuit might be correct that Pennsylvania law is preempted as discriminating against the arbitral forum. But whether or not the Third Circuit correctly interpreted Pennsylvania precedent, it is clear that California law embodies no such discrimination. California insists only on the availability of class proceedings, not on the availability of judicial class actions as opposed to class arbitration. Indeed, in both *Gentry* and *Discover Bank*, the California Supreme Court made clear that parties may be ordered to class *arbitration* if a waiver of class proceedings is held unenforceable. Because California law in this area does not discriminate against the arbitral forum, there is no basis for finding FAA preemption. (Cf. *Lowden v. T-Mobile USA, Inc.* (9th Cir.) 512 F.3d 1213, 1221 n.3 [distinguishing *Gay* on this basis in a case applying Washington unconscionability law], *cert. denied* (2008) 129 S.Ct. 45.)

Other Ways to Prove Substantive Unconscionability

Although much recent case law has focused on the substantive unconscionability of class action bans, many other unfair and one-sided arbitration provisions have been held unconscionable by California courts. A complete list is beyond the scope of this article, but there are California decisions holding that fee-splitting, secrecy, damage-limiting, and one-sided appeal provisions (among others) are substantively unconscionable.²³ The California Supreme Court also recently agreed to hear a case raising the issue of whether an arbitration provision shortening the applicable statute of limitations is unenforceable. (See *Pearson Dental Supplies, Inc. v. Super. Ct.* (2008) 82 Cal.Rptr.3d 154, *review granted* (2008) 85 Cal.Rptr.3d 693).

These cases mean that there will often be a route to proving substantive unconscionability in the absence of a class action ban. And for plaintiffs who want to

avoid arbitration altogether, even on a class-wide basis, it may be a good idea to advance as many of these additional unconscionability arguments as can be supported by case law and the evidentiary record. If an arbitration clause is "permeated" with unconscionability, i.e., if it contains many unconscionable terms, California courts will often refuse to enforce the arbitration clause altogether, which means that the plaintiff's claims are much more likely to remain in court. (See *Armendariz v. Foundation Health Psychcare Servs., Inc.* (2000) 24 Cal.4th 83, 124.) ■

¹ Unconscionability has both procedural and substantive elements in California, as in many states. The more substantively oppressive a contract term, the less evidence of procedural unconscionability is required, and vice versa. (*Gentry v. Super. Ct.* (2007) 42 Cal.4th 443, 468-69, cert. denied (2008) 128 S. Ct. 1743.)

² See *Nagrampa v. MailCoups, Inc.* (9th Cir. 2006) 469 F.3d 1257, 1268-77 (en banc); *Net Global Marketing, Inc. v. Dialtone, Inc.* (9th Cir. 2007) 217 Fed.Appx. 598, 600; *Murphy v. Check 'N Go of Cal., Inc.* (2007) 156 Cal.App.4th 138, 146; cf. *Higgins v. Super. Ct.* (2006) 140 Cal.App.4th 1238, 1250-52. Although one non-citable First District decision did hold that certain evidence regarding procedural unconscionability related to the parties' overall contract and should not have been considered by the court (*Frog Creek Partners, LLC v. Vance Brown, Inc.* (Cal. Ct. App. Dec. 27, 2007) 2007 WL 4533527), that case involved unique factual circumstances indicating that the plaintiff's procedural unconscionability evidence could only have been persuasive in a challenge to the entire contract, not in a challenge to the arbitration clause.

³ But see *Anderson v. Pitney Bowes, Inc.* (N.D. Cal. May 4, 2005) 2005 WL 1048700, *3-*5 (distinguished in *Murphy*).

⁴ Cases are divided on the effect of this type of provision. Compare, e.g., *Firchow v. Citibank (S. Dakota), N.A.* (Cal. Ct. App. Jan. 10, 2007) 2007 WL 64763 (non-citable, review granted but then dismissed; clause unconscionable), with, e.g., *Citibank (S. Dakota), N.A. v. Walker* (Cal. Ct. App. Sept. 11, 2008) 2008 WL 4175125 (non-citable; clause not procedurally unconscionable), and *Jones v. Citigroup, Inc.*, 135 Cal.App.4th 1491 (same), review granted (Cal. 2006) 43 Cal.Rptr.3d 749, and remanded for reconsideration (Cal. 2007) 68 Cal.Rptr.3d 530; see also *Hoffman v. Citibank (S. Dakota)* (9th Cir. 2008) 546 F.3d 1078 (per curiam remanding for additional fact-finding).

⁵ See *Discover Bank v. Super. Ct.* (2005) 36 Cal.4th 148, 160 (procedural unconscionability present when clause is added in "bill stuffer" and consumer is assumed to have agreed if she does not cancel her account); *Murphy*, 156 Cal.App.4th at 144-45 (adhesiveness could be inferred where plaintiff received arbitration clause in inter-office mail, the terms were never explained, and plaintiff was never told they were negotiable); cf. *Bruni*, 160 Cal.App.4th at 1292-93 (describing a series of home purchase cases where courts have been willing to assume non-negotiability in some contexts but not in others).

⁶ *Hoffman*, 546 F.3d at 1085; *Stiener v. Apple Computer, Inc.* (N.D. Cal. 2008) 556 F.Supp.2d 1016, 1026; *Pardee Constr. Co. v. Super. Ct.* (2002) 100 Cal.App.4th 1081, 1087 (emphasizing "uniqueness of a home"). Although this evidence may be helpful, several California decisions hold that evidence of a lack of market alternatives is not required to prove procedural unconscionability. See, e.g., *Shroyer v. New Cingular Wireless Servs., Inc.* (9th Cir. 2007) 498 F.3d 976, 985-86.

⁷ *Bruni*, 100 Cal.App.4th at 1293.

⁸ *Pardee*, 100 Cal.App.4th at 1087.

⁹ See *Hoffman*, 546 F.3d at 1085; cf. *Hicks v. Macy's Dep't Stores, Inc.* (N.D. Cal. Sept. 11, 2006) 2006 WL 2595941, *1 (noting that 10% of employees had exercised opt-out right).

¹⁰ *Gentry*, 42 Cal.4th at 470-71.

¹¹ *Kaltwasser v. Cingular Wireless LLC* (N.D. Cal. 2008) 543 F.Supp.2d 1124, 1130 n.5.

¹² Cf. *Higgins*, 140 Cal.App.4th at 1252.

¹³ *Circuit City Stores, Inc. v. Mantor* (9th Cir. 2003) 335 F.3d 1101, 1106-07.

¹⁴ *Gentry*, 42 Cal. 4th at 471-72.

¹⁵ In addition to state supreme courts, several federal courts and mid-level state appellate courts have reached the same result, although it is also true that many federal and state courts have upheld these bans. Citations to cases on both sides of the issue may be found in *Consumer Arbitration Agreements: Enforceability and Other Topics* (5th ed.), published by the National Consumer Law Center (www.consumerlaw.org). A relatively recent list of cases striking down class action bans may be found in appellant's November 19, 2007 opening brief in *Homa v. American Express Co.*, pending in the Third Circuit Court of Appeals. The brief is available under the heading "Briefs & Documents" at www.publicjustice.net.

¹⁶ *Gentry* was not decided on the basis of unconscionability, but it discussed the doctrine and its principles and should be equally applicable in unconscionability cases.

¹⁷ See, e.g., *Omstead v. Dell, Inc.* (N.D. Cal. 2007) 473 F.Supp.2d 1018, reconsideration

denied, (N.D. Cal. 2008) 533 F.Supp.2d 1012.

¹⁸ See *Davis v. Chase Bank USA, N.A.* (9th Cir. Nov. 3, 2008) 2008 WL 4832998, *1; *Tamayo v. Brainstorm USA* (9th Cir. Sept. 21, 2005) 154 Fed.Appx. 564, 566; *Kaltwasser*, 543 F.Supp.2d at 1128-30; *Brazil v. Dell Inc.* (N.D. Cal. Aug. 3, 2007) 2007 WL 2255296, *3-*7; *Oestreicher v. Alienware Corp.* (N.D. Cal. 2007) 502 F.Supp.2d 1061, 1065-69; *Van Slyke v. Capital One Bank* (N.D. Cal. 2007) 503 F.Supp.2d 1353, 1359-62; *Klussman v. Cross Country Bank* (2005) 134 Cal.App.4th 1283, 1291-1300.

¹⁹ See, e.g., *Hoffman*, 2008 WL 4554925, *4; *Klussman*, 134 Cal. App. 4th at 1294-98.

²⁰ Compare, e.g., *Davis*, 2008 WL 4832998, *1 (California had materially greater interest in case involving statewide class with California claims), *Oestreicher*, 502 F.Supp.2d at 1068-69, and *Klussman*, 134 Cal.App.4th at 1299 (California had materially greater interest in case involving *interalia*, statewide class with "primarily" California claims), with *In re Jamster Marketing Litig.* (S.D. Cal. Nov. 10, 2008) 2008 WL 4858506, *3 (California did not have materially greater interest in case involving *interalia*, non-California plaintiffs), *Provencher v. Dell, Inc.* (C.D. Cal. 2006) 409 F.Supp.2d 1196, 1204 n.10 (stating, in dicta, that California did not have materially greater interest in case involving nationwide class, mostly Texas claims, and a Texas defendant), and *Discover Bank v. Super. Ct.* (2005) 134 Cal.App.4th 886, 894-95 (enforcing choice-of-law clause in case involving nationwide class, claims under Delaware law, and Delaware defendant).

²¹ See *Douglas v. U.S. Dist. Ct.* (9th Cir. 2007) 495 F.3d 1062, 1067 n.2 (per curiam) (California had materially greater interest in case involving California subclass where chosen state was not defendant's home); *Van Slyke*, 503 F.Supp.2d at 1361-62 (California had a materially greater interest in case involving several California claims and at least some California class members where defendant was a major bank operating nationwide).

²² See *Shroyer*, 498 F.3d at 987-93; *Ting*, 319 F.3d at 1152; *Discover*, 36 Cal. 4th at 163-73; see also, e.g., *Kinkel v. Cingular Wireless LLC* (Ill. 2006) 857 N.E.2d 250, 260-63; *Scott v. Cingular Wireless* (Wash. 2007) 161 P.3d 1000, 1008.

²³ See *Ting*, 319 F.3d at 1151-52; *Higgins*, 140 Cal.App.4th at 1254; *Pinedo v. Premium Tobacco Stores, Inc.* (2000) 85 Cal.App.4th 774, 781; see also *Armendariz v. Foundation Health Psychcare Servs., Inc.* (2000) 24 Cal.4th 83, 115-21 (arbitration agreement unconscionable because it required only employee, not employer, to arbitrate claims).