

# CLASS ARBITRATION: DISCOVER BANK V. SUPERIOR COURT

by

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## I. Introduction

On June 27, 2005, in a 4-3 decision the California Supreme Court took another important (and much anticipated) step in the development of the law pertaining to arbitration of so-called class actions. Since the mid to late 1990's, credit card companies, lending institutions and other consumer-oriented enterprises have been amending their agreements with consumers by inserting increasingly sophisticated arbitration agreements. Many, if not all, of these agreements currently provide for arbitration as the exclusive forum to settle disputes, and exclude the right to bring class actions. The California Supreme Court has held that, at least under some circumstances, class-action waivers are unenforceable, thereby opening the door for class-wide claims to be brought in arbitration in spite of an explicit provision in the credit card agreement that excludes such class actions.

In *Discover Bank v. Superior Court of Los Angeles*,<sup>1</sup> the California Supreme Court held that “at least under some circumstances, the law in California is that class-action waivers in consumer contracts of adhesion are unenforceable, whether the consumer is being asked to waive the right to class action litigation or the right to class-wide arbitration.”<sup>2</sup> The Court further concluded that the Federal Arbitration Act does not pre-empt California law in this respect.<sup>3</sup>

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<sup>1</sup> *Discover Bank v. Superior Court of Los Angeles*, -- Cal. 4th --, 2005 Cal. LEXIS 6686.

<sup>2</sup> Opinion, p. 2.

<sup>3</sup> *Ibid.*

One issue was left undecided: whether the credit card agreement was subject to California law or the law of Delaware. The Court sent the case back to the Court of Appeal for the limited purpose of deciding this choice-of-law issue.<sup>4</sup>

Counsel for the credit card industry will almost certainly interpret this development as a setback. Whenever possible, credit card companies will want to avoid the type of responsibility that allows credit card holders to conduct proceedings against them for very small amounts per member that add up to very substantial sums when aggregated among millions of members. But, as is made clear in the California Supreme Court's opinion, that is precisely one of the reasons to find exclusion of the class action procedure to be unenforceable.

Will the credit card industry be tempted in the future to litigate rather than arbitrate class actions in California and the other states that have ruled the same way? Not necessarily. If the arbitral procedure is carefully thought out, credit card companies will find that class action arbitration is preferable to litigation, by providing in the arbitration clause that

(i) the arbitrator's decision as to whether or not, and how, to certify the class will be made in the form of an interim award, and

(ii) that either party may take a direct appeal from that interim award to a panel of arbitrators, which has the authority to review that decision *de novo*.

This eliminates one of the biggest disadvantages of class arbitration, i.e. that (absent such a provision) would force the parties to wait until a final award is rendered (assuming the arbitration clause provides for appeal to another arbitral panel in the first place). Meanwhile the suggested procedure preserves all the traditional advantages of arbitration over litigation.

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<sup>4</sup> Opinion, pp. 2, 32-35.

## II. Background

### A. Adhesion Contracts

Ever since the “form contract” was first developed in the early 1900s, how to deal with contracts of adhesion<sup>5</sup> has been the subject of much debate. Few judges appear to admit that adhesion contracts are not really contracts at all, at least not in the traditional sense that a contract is created by negotiations followed by a process of offer and acceptance between two parties who freely enter into such a relationship, after having considered available alternatives. Nonetheless, it was clear that something needed to be done in order to preserve an acceptable degree of fairness and of the absence of oppressive and unconscionable clauses in adhesion contracts.<sup>6</sup>

Nowadays, most contracts people enter into are adhesion contracts. From credit card loan and security agreements to insurance policies, from shrinkwrap, clickwrap and browsewrap agreements in the internet services and software industries, to real estate brokerage and house, car and durable goods purchase or lease agreements, and (not to forget) government contracts, - all of these are essentially contracts that are presented to the consumer on a take-it-or-leave-it basis. The legislature and courts have barely begun to deal with the fact that the normal rules of contract law do not really fit the requirements of a fair and equitable framework surrounding adhesion contracts.

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<sup>5</sup> The term adhesion contract is defined as “a standardized contract, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it.” *Armendariz v. Foundation Health Psychcare Services*, 24 Cal. 4th 83, 113 (2000).

<sup>6</sup> In what appears to be one of the earliest cases involving an adhesion contract (an insurance policy), *Raulet v. Northwestern Ins. Co.*, 157 Cal. 213 (1910), the court noted:

It is matter almost of common knowledge that a very small percentage of policy-holders are actually cognizant of the provisions of their policies and many of them are ignorant of the names of the companies issuing the said policies. The policies are prepared by the experts of the companies, they are highly technical in their phraseology, they are complicated and voluminous ... and in their numerous conditions and stipulations furnishing what sometimes may be veritable traps for the unwary ...

The courts, while zealous to uphold legal contracts, should not sacrifice the spirit to the letter nor should they be slow to aid the confiding and innocent. 157 Cal. at 230. *Quoted in* William M. Shernoff, 1-1 INSURANCE BAD FAITH LITIGATION 1.03, at 1 (1994).

This paradigm has extended to the field of arbitration law. When the drafters of the Revised Uniform Arbitration Act came together, serious consideration was given to developing a separate regime for arbitration clauses in adhesion contracts. For reasons unknown, the Commissioners adopted a model that deals with implications for adhesion contracts only in the auxiliary notes following each relevant provision of the RUAA.<sup>7</sup>

*B. Section 2 FAA*

In 1925, the US Congress adopted the Federal Arbitration Act (“FAA”)<sup>8</sup> to contravene the then prevailing trend among the judiciary to refuse to enforce pre-dispute arbitration agreements. The wording of Section 2 of the FAA appears to be in direct response to this trend. It reads as follows:

**§ 2. Validity, irrevocability, and enforcement of agreements to arbitrate**

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, *shall be valid, irrevocable, and enforceable*, save upon such grounds as exist at law or in equity for the revocation of any contract.  
[emphasis added]

By its terms, Section 2 FAA measures the validity of arbitration agreements by the general law of contracts. As the law of contracts is not part of federal law, it is

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<sup>7</sup> See generally, Matthew E. Braun, *RECENT DEVELOPMENT: The Revised Uniform Arbitration Act*, 18 Ohio St. J. on Disp. Resol. 237, 243-44 (2002). (“In the end, the drafters decided on an option by which the inequities of adhesion contracts were to be discussed in the auxiliary notes to the act, but where state substantive law would be left free to react to claims of unconscionability and to develop individual schemes to handle such claims. Thus, given an opportunity to take a bolder stance denouncing boilerplate arbitration agreements that force weaker parties to accept terms on a take-it-or-leave-it basis, the drafters chose a road that clarified their views but did not expressly advocate state prohibition of certain adhesion arrangements. While supporters of the drafters' ultimate decision note that the multiple non-waivable provisions of the RUAA encourage arbitration arrangements that are not unconscionable, critics of the drafters' action see their benign stance as an opportunity lost in the battle for fundamental fairness in arbitration. Both sides, however, agree that the main problem underlying the question of how to handle adhesion situations in the RUAA is the reality of federal pre-emption.”)

<sup>8</sup> 9 USC Sections 1 et seq.

reserved to the states. Thus, generally, the determination as to whether an arbitration agreement in an adhesion contract is unconscionably unfair or oppressive is to be determined by the law of the state that is applicable to the contract.

C. *Who decides arbitrability, the court or the arbitrator?*

Interpreting the language of Section 4 FAA (which refers to an agreement to arbitrate and not an agreement containing an arbitration clause),<sup>9</sup> the Supreme Court has developed a complex and often confusing system as to *who is to decide* the threshold issue whether an agreement to arbitrate is “valid, irrevocable and enforceable,” the court or the arbitrator.

In 1967, the US Supreme Court held in *Prima Paint Corporation v. Flood & Conklin Manufacturing Company*,<sup>10</sup> that when the arbitration clause is included in a larger contract, and the challenge to validity goes to the larger contract and not to the unenforceability of the *arbitration clause itself*, the arbitrator and not the court will

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<sup>9</sup> Section 4 FAA reads in relevant part:

**§ 4. Failure to arbitrate under agreement; petition to United States court having jurisdiction for order to compel arbitration; notice and service thereof; hearing and determination**

A party aggrieved by the alleged failure, neglect, or refusal of another to arbitrate under a written *agreement for arbitration* may petition any United States district court which, save for such agreement, would have jurisdiction under Title 28 [28 USCS §§ 1 et seq.], in a civil action or in admiralty of the subject matter of a suit arising out of the controversy between the parties, for an order directing that such arbitration proceed in the manner provided for in such agreement. ... If *the making of the arbitration agreement or the failure, neglect, or refusal to perform the same* be in issue, the court shall proceed summarily to the trial thereof. If no jury trial be demanded by the party alleged to be in default, ... the court shall hear and determine such issue. ... If the jury find that no agreement in writing for arbitration was made or that there is no default in proceeding thereunder, the proceeding shall be dismissed. If the jury find that an agreement for arbitration was made in writing and that there is a default in proceeding thereunder, the court shall make an order summarily directing the parties to proceed with the arbitration in accordance with the terms thereof. [emphasis added]

<sup>10</sup> *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 US 395, 403-04 (1967). Many cases have distinguished *Prima Paint*, essentially limiting its holding to voidable (as opposed to potentially void) contracts. See, e.g., *Spahr v. Secco*, 330 F.3d 1266, 1272 (10th Cir. 2003); *Sphere Drake Ins. Ltd. v. All Am. Ins. Co.*, 256 F.3d 587, 591 (7th Cir. 2001); *Sandvik AB v. Advent Int'l Corp.*, 220 F.3d 99, 110 n.9 (3d Cir. 2000); *Chastain v. Robinson-Humphrey Co.*, 957 F.2d 851, 855 (11th Cir. 1992); *Three Valleys Mun. Water Dist. v. E.F. Hutton & Co.*, 925 F.2d 1136 (9th Cir. 1991). See also, *Cardegna v. Buckeye Cash Checking, Inc.*, 894 So. 2d 860 (2005). Recently, the US Supreme Court granted certiorari (by *Buckeye Check Cashing v. Cardegna*, 2005 US LEXIS 4859 (US, June 20, 2005)), which may give the Supreme Court the opportunity to either clarify, limit or overturn *Prima Paint*.

decide on the enforceability of the agreement, and thus indirectly on the validity of the arbitration clause. In other words, under *Prima Paint*, the arbitration clause in the contract is "separable" from the rest of the contract and allegations that address the validity of the contract in general rather than the arbitration clause in particular, will be decided by the arbitrator, not the court.

Arguably, *Prima Paint* concerned itself strictly with the question of who decides defenses to the enforcement of a contract. Without citing *Prima Paint*, the Supreme Court decided in 1995, in *First Options of Chicago v. Kaplan*,<sup>11</sup> that where an arbitration clause was contained in an agreement between First Options and a company owned by the Kaplans, and not signed by the Kaplans individually, the question whether the Kaplans had agreed to arbitrate their dispute with First Options was for the court and not the arbitrator to decide.

In the 2002-2003 term, the Supreme Court had the opportunity to refine the doctrine espoused by *First Options*,<sup>12</sup> when it decided three more cases concerning the

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<sup>11</sup> *First Options of Chicago, Inc. v. Kaplan*, 514 US 938 (2002) ("We believe the answer to the "who" question (*i. e.*, the standard-of-review question) is fairly simple. Just as the arbitrability of the merits of a dispute depends upon whether the parties agreed to arbitrate that dispute, so the question "who has the primary power to decide arbitrability" turns upon what the parties agreed about *that* matter. Did the parties agree to submit the arbitrability question itself to arbitration? If so, then the court's standard for reviewing the arbitrator's decision about *that* matter should not differ from the standard courts apply when they review any other matter that parties have agreed to arbitrate. That is to say, the court should give considerable leeway to the arbitrator, setting aside his or her decision only in certain narrow circumstances. See, *e. g.*, 9 USC. § 10. If, on the other hand, the parties did *not* agree to submit the arbitrability question itself to arbitration, then the court should decide that question just as it would decide any other question that the parties did not submit to arbitration, namely, independently. These two answers flow inexorably from the fact 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.") 514 US at 943 [internal citations omitted].

<sup>12</sup> See generally, June Lehrman, *On the Threshold of Arbitration: Whether a Court or Arbitrator Decides a Threshold Arbitration Issue Hinges on Whether the Issue Involves a Question of Arbitrability*, 26 LOS ANGELES LAWYER 20 (2003). ("*First Options* and its progeny address the question of who--the court or the arbitrator--has the power to decide various precursors to arbitration, including: 1) questions of arbitrability (*First Options*), 2) whether contractual statutes of limitations stated as conditions precedent to arbitration have run (*Howsam v. Dean Witter Reynolds, Inc.*, 537 US 79 (2002)), 3) the meaning of contractual terms that arguably render a particular claim not subject to arbitration (*Pacificare Health Sys., Inc. v. Book*, 538 US 401 (2003)), and 4) the meaning of contractual terms that determine the availability of arbitral class actions (*Green Tree Fin. Corp. v. Bazzle*, 539 US 444 (2003)). Perhaps more important than the particular issues addressed, however, is the emerging methodology for deciding the balance of power over other threshold issues that will arise in the future.") 26 LOS ANGELES LAWYER at 22.

issue of who decides threshold issues, the court or the arbitrator. In essence, while the Supreme Court decided in each of these cases that the issue presented was one for the arbitrator to decide rather than the court, the focus of inquiry appeared to go into the direction of an analysis of the “reasonable expectations of the parties.”<sup>13</sup>

*D. Who decides whether a contract permits class arbitration?*

The third of these three cases, *Green Tree v. Bazzle*, concerns us, as it dealt with the question of who decides whether a standard agreement that is silent about class actions allows class-wide arbitration.<sup>14</sup> The majority opinion in *Bazzle* found that the lower court had erred by deciding the arbitrability issue itself, interpreting an ambiguous provision in the arbitration clause, rather than leaving that decision to the arbitrator.

Lynn and Burt Bazzle had brought a putative class action in a South Carolina state court, alleging that the lending contracts Green Tree entered into in South Carolina violated a state consumer protection statute. The trial court both certified the class action and entered an order compelling arbitration. The arbitration clause in the contracts did not specifically address the question of arbitral class actions but did say that disputes "shall be resolved ... by one arbitrator selected by us with consent of you."<sup>15</sup>

The South Carolina Supreme Court had held

(1) that the arbitration clauses are silent as to whether arbitration might take the form of class arbitration, and

(2) that, in that circumstance, South Carolina law interprets the contracts as permitting class arbitration.

The US Supreme Court restated the issue by asking whether the contracts are in fact silent, or whether they forbid class arbitration (as petitioner Green Tree Financial Corporation contended). The Court held that it could not answer that question “not simply because it is a matter of state law, but also because it is a matter for the arbitrator

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<sup>13</sup> Lehrman, *supra* note 12, at 23.

<sup>14</sup> *Green Tree Fin. Corp. v. Bazzle*, 539 US 444 (2003).

<sup>15</sup> 539 US at 448.

to decide.”<sup>16</sup> Accordingly, the Court vacated the judgment of the South Carolina Supreme Court and remanded the case so that this question may be resolved in arbitration.<sup>17</sup>

The *Bazze* Court held that whether the contracts forbid class arbitration is not, under *First Options*, a question of “whether the parties wanted a judge or an arbitrator to decide whether they agreed to arbitrate the matter. Rather the relevant question here is what kind of arbitration proceeding the parties agreed to.”<sup>18</sup> In the absence of clear and unmistakable evidence to the contrary, courts do not assume that the parties would have expected a court rather than an arbitrator to resolve a particular arbitration-related matter.<sup>19</sup>

*E. Who decides the issue of “unconscionability,” the court or the arbitrator?*

The most recent issue in the development of the arbitrability wars is who will decide the issue of “unconscionability” of all or part of an arbitration clause.

Many courts have analyzed whether or not an adhesion contract that includes an arbitration clause is to be deemed unconscionable.<sup>20</sup> Under Section 2 FAA, this analysis needs to take place under applicable state law, as the law of contracts is a matter of state

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<sup>16</sup> *Id.* at 447.

<sup>17</sup> *Ibid.*

<sup>18</sup> 539 US at 452.

<sup>19</sup> “In certain limited circumstances, courts assume that the parties intended courts, not arbitrators, to decide a particular arbitration-related matter (in the absence of “clear and unmistakable” evidence to the contrary). These limited instances typically involve matters of a kind that “contracting parties would likely have expected a court” to decide. They include certain gateway matters, such as whether the parties have a valid arbitration agreement at all or whether a concededly binding arbitration clause applies to a certain type of controversy.” [citations omitted]. *Ibid.*

<sup>20</sup> See, e.g., *Cole v. Burns Intern. Security Services*, 105 F.3d 1465 (D.C. Cir. 1997); *Armendariz v. Foundation Health Psychcare Services*, 24 Cal. 4th 83 (2000); *Mercuro v. Superior Court*, 96 Cal. App. 4th 167 (2002); *Nyulassy v. Lockheed Martin Corp.*, 120 Cal. App. 4th 1267 (2004); *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094 (2002); *Kinkel v. Cingular Wireless, LLC*, 828 N.E.2d 812 (Ill. App. 5th Dis. 2005); *Walther v. Sovereign Bank*, 386 Md. 412 (2005); *Parrish v. Cingular Wireless, LLC*, 129 Cal. App. 4th 601 (2005), just to name a few.

law rather than federal law. As the US Supreme Court pointed out in *Doctor's Associates v. Casarotto*,<sup>21</sup> Section 2 FAA provides:

“for revocation of arbitration agreements only upon ‘grounds as exist at law or in equity for the revocation of any contract.’ State law, whether of legislative or judicial origin, is applicable *if* that law arose to govern issues concerning the validity, revocability, and enforceability of contracts generally. ... A state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue does not comport with the text of § 2.” 517 US at 685. [citations omitted]

Recently, the Federal Court of Appeals for the Ninth Circuit (which includes California), in *Nagrampa v. Mailcoups*,<sup>22</sup> followed the reasoning of the Second,<sup>23</sup> Fifth<sup>24</sup> and Sixth<sup>25</sup> Circuits, which have

“squarely held that *Prima Paint* requires the arbitrator to determine whether an agreement containing an arbitration clause is a contract of adhesion” ... “because this issue pertains to the making of the agreement as a whole and not to the arbitration clause specifically.”<sup>26</sup>

Importantly, the Ninth Circuit Court of Appeals announced on June 28, 2005 that it has vacated the decision in *Nagrampa*, and granted a rehearing *en banc*,<sup>27</sup> pursuant to which an 11-judge panel will revisit the ruling that only an arbitrator and not a judge can decide whether an arbitration clause in an adhesion contract amounts to an unconscionable contract of adhesion.

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<sup>21</sup> *Doctor's Associates v. Casarotto*, 517 US 681 (1996).

<sup>22</sup> *Nagrampa v. Mailcoups Inc.*, 401 F.3d 1024 (9th Cir. 2005).

<sup>23</sup> *JLM Industries, Inc. v. Stolt-Nielsen SA*, 387 F.3d 163, 170 (2d Cir. 1004).

<sup>24</sup> *Rojas v. TK Communications, Inc.*, 87 F.3d 745, 749 (5th Cir. 1996).

<sup>25</sup> *Burden v. Check Into Cash of Kentucky, LLC*, 267 F.3d 483, 492 n.3 (6th Cir. 2001). *Cf. Hawkins v. Aid Association for Lutherans*, 338 F.3d 801 (7th Cir. 2003).

<sup>26</sup> 401 F.3d at 1029.

<sup>27</sup> 2005 USApp. LEXIS 12782 (9th Cir., June 28, 2005).

### III. Discover Bank v. Superior Court

#### A. *The Underlying Dispute*

In the underlying dispute in *Discover Bank v. Superior Court of Los Angeles*, plaintiff Christopher Boehr had obtained a credit card from defendant Discover Bank in 1986. The cardholder agreement had a choice-of-law clause providing that Federal and Delaware law applied.<sup>28</sup>

In July 1999, Discover Bank sent a “bill stuffer” to its cardholders (including Boehr) adding an arbitration clause to the cardholder agreement. The arbitration clause precluded both sides from participating in class-wide arbitration, consolidating claims, or arbitrating claims as a representative or in a private attorney general capacity. It further provided that since the cardholder’s account involves interstate commerce, the Federal Arbitration Act would govern the agreement. The arbitrator had to follow applicable (Delaware) substantive law to the extent consistent with the FAA. A cardholder’s continued use of the card would constitute acceptance of the amended terms.

On August 15, 2001, Boehr filed a putative class action complaint in a California superior court<sup>29</sup> against Discover Bank, alleging breach of contract and violation of the Delaware Consumer Fraud Act,<sup>30</sup> alleging that Discover Bank wrongfully imposed a \$29 late fee on payments it received on the payment due date, but after an undisclosed 1:00 p.m. “cut-off time.”<sup>31</sup> Discover Bank moved to compel arbitration of plaintiff’s claim on an individual basis and to dismiss the class action pursuant to the arbitration agreement’s class-action waiver.<sup>32</sup>

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<sup>28</sup> Opinion, p. 3.

<sup>29</sup> The “Superior Court” is the court of first instance in the State of California.

<sup>30</sup> The Delaware Consumer Fraud Act (Del. Code Ann. Sections 2511-2527) in part prohibits misrepresentations “of any material fact with intent that others rely upon such concealment, suppression or omission in connection with the sale, lease or advertisement of any merchandise.” Opinion, p. 4.

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

The trial court initially granted Discover Bank’s motion under Delaware law. But shortly afterwards, the Fourth District Court of Appeal decided *Szetela v. Discover Bank*,<sup>33</sup> which held that a virtually identical class-action waiver was unconscionable. On plaintiff’s motion for reconsideration, the trial court treated *Szetela* as controlling and accordingly denied Discover Bank’s motion to dismiss the class action. In addition, again following *Szetela*, the trial court found that enforcing the class-action waiver under Delaware law would violate a fundamental public policy under California law.<sup>34</sup>

Discover Bank appealed<sup>35</sup> the trial court’s order to the Court of Appeal, which held that any California rule prohibiting class-action waivers was pre-empted by the Federal Arbitration Act, and that *Szetela* had failed to adequately analyze the federal pre-emption issue.<sup>36</sup>

*B. The Supreme Court’s Opinion*

Justice Carlos R. Moreno, writing for the majority of the California Supreme Court, noted that both the California<sup>37</sup> and the US Supreme Courts have endorsed a policy that lies at the core of the class-action mechanism “to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights. A class action solves this problem by aggregating the relatively paltry potential recoveries into something worth ... an attorney’s labor.”<sup>38</sup>

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<sup>33</sup> 97 Cal. App. 4th 1094 (2002).

<sup>34</sup> Opinion, p. 5-6.

<sup>35</sup> In fact, following the Court of Appeal’s procedural decision in *Szetela*, *supra* note 20, as the trial court’s order was not appealable (for reasons that go beyond the scope of this article), Discover Bank filed a writ of mandate seeking relief from an order issued by respondent Los Angeles County Superior Court, which the Court of Appeal granted. *See Szetela*, 97 Cal. App. 4th at 1098 (“... we exercise our discretion to treat the appeal as a petition for a writ of mandate.”)

<sup>36</sup> *Id.*, p. 6.

<sup>37</sup> *Vasquez v. Superior Court*, 4 Cal.3d 800, 808 (1971); *Blue Chip Stamps v. Superior Court*, 18 Cal. 3d 381, 387 (1976, concurring opinion); *Linder v. Thrifty Oil Co.*, 23 Cal. 4th 429, 445 (2000).

<sup>38</sup> Opinion, p. 8, quoting *Amchem Products, Inc. v. Windsor*, 521 US 591, 617 (1997).

In fact, it was the California Supreme Court that devised the hybrid procedure of class-wide arbitration in the 1982 case of *Keating v. Superior Court*.<sup>39</sup> *Keating*'s endorsement of class-wide arbitration was echoed by subsequent Court of Appeal decisions.<sup>40</sup> But *Keating* judicially authorized class-wide arbitration in a case in which the arbitration agreement was silent on the matter. It did not involve a class-action waiver.

It is well settled that the principles of unconscionability contain both a procedural and a substantive element. This doctrine appears to be similar, if not identical, across most states of the United States.<sup>41</sup> The procedural element addresses the manner in which agreement to the disputed provision was sought or obtained, such as unequal bargaining power and hidden terms in contracts of adhesion.<sup>42</sup> It generally takes the form of a contract of adhesion, which, imposed and drafted by the party of superior bargaining strength, relegates to the subscribing party only the opportunity to adhere to the contract or reject it.<sup>43</sup>

The substantive element addresses the impact of the provision itself, such as whether the provision is so harsh or oppressive that it should not be enforced.<sup>44</sup> Substantively unconscionable provisions may take various forms, but may generally be described as “unfairly one-sided.”<sup>45</sup>

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<sup>39</sup> *Ibid.*, citing 31 Cal. 3d 584, 613-614 (1982), *overruled on other grounds* in *Southland Corp. v. Keating*, 405 US 1 (1984). Interestingly, when a British Columbia court was presented with the dilemma of a class-action waiver, rather than considering the possibility of class-wide arbitration, it construed this dilemma as having to choose between the policies underlying the Commercial Arbitration Act and the Class Proceedings Act. As a result, the court declared the arbitration clause “inoperative” so that the action could proceed as a consumer class proceeding. *MacKinnon v. Instalcoans Financial Solution Centres (Kelowna) Ltd.* (2004 BCCA 473), reported in an International Law Office report by Borden Ladner Gervais LLP, [www.internationallawoffice.com/ld.cfm?r=9098&I=14122](http://www.internationallawoffice.com/ld.cfm?r=9098&I=14122) (November 18, 2004).

<sup>40</sup> Opinion, p. 9, citing *Sanders v. Kinko's*, 99 Cal. App. 4th 1106 (2002); *Blue Cross of California v. Superior Court*, 67 Cal. App. 4th 42 (1998).

<sup>41</sup> See, e.g., the cases cited in note 20, *supra*.

<sup>42</sup> *Szetela v. Discover Bank*, 97 Cal. App. 4th 1094, 1099 (2002).

<sup>43</sup> *Discover Bank v. Superior Court of Los Angeles*, Opinion, p. 13 (quoting *Little v. Auto Stiegler, Inc.*, 29 Cal. 4th 1064, 1071 (2003)).

<sup>44</sup> *Szetela v. Discover Bank*, 97 Cal. App. 4th at 1099.

<sup>45</sup> Opinion, p. 13 (quoting *Little v. Auto Stiegler, Inc.*, 29 Cal. 4th 1064, 1071 (2003)).

The California Supreme Court said that “although adhesive contracts are generally enforced, class-action waivers found in such contracts may also be substantively unconscionable inasmuch as they may operate effectively as exculpatory contract clauses that are contrary to public policy.” Thus, the Court went on to say, “one-sided, exculpatory contracts in a contract of adhesion, at least to the extent they operate to insulate a party from liability that otherwise would be imposed under California law, are generally unconscionable.”<sup>46</sup>

The Court acknowledged that there is considerable case law in other states that believes that a class-action waiver is not unconscionable.<sup>47</sup> On the other hand, several state courts have found class-action waivers to be unconscionable.<sup>48</sup>

Some of these courts have viewed class actions as a merely procedural right, the waiver of which is not unconscionable. But the Court believed that class actions are often inextricably linked to the vindication of substantive rights, so that “affixing a ‘procedural’ label on such devices understates their importance and is not helpful in resolving the unconscionability issue.”<sup>49</sup>

The Court emphasized that it does not hold all class-action waivers to be necessarily unconscionable. It went on to say:

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<sup>46</sup> *Id.*, p. 14.

<sup>47</sup> The Court cited cases applying the law of North Dakota, Texas, and Illinois, in addition to a Third Circuit case relating to the Federal Truth in Lending Act and the Electronic Fund Transfer Act (*Johnson v. West Suburban Bank*, 225 F.3d 366 (3d Cir. 2000)). Opinion, p. 15. One can add to these a recent case by the highest court in Maryland, *Walther v. Sovereign Bank*, 386 Md. 412 (2005), the 11th Circuit applying Georgia law (*Jenkins v. First American Cash Advance of Georgia, LLC*, 400 F.3d 868 (2005), and (in addition to the Court of Appeal case from which an appeal was taken that led to this case) another California Court of Appeal case, *Parrish v. Cingular Wireless, LLC*, 129 Cal. App. 4th 601 (2005), which was rendered on May 18, 2005, after the Supreme Court heard the *Discover Bank* case (on April 7, 2005).

<sup>48</sup> The Court cited cases from Alabama, West Virginia and Florida. Opinion, p. 15.

<sup>49</sup> *Ibid.*

“But when the waiver is found in a consumer contract of adhesion in a setting in which disputes between the contracting parties predictably involve small amounts of damages, and when it is alleged that the party with the superior bargaining power has carried out a scheme to deliberately cheat large numbers of consumers out of individually small sums of money, then at least to the extent the obligation at issue is governed by California law, the waiver becomes in practice the exemption of the party ‘from responsibility for its own fraud, or willful injury to the person or property of another.’ (Civ. Code, Section 1668.) Under these circumstances, such waivers are unconscionable under California law and should not be enforced.”<sup>50</sup>

The California Supreme Court also rejected the Court of Appeal’s argument that California law prohibiting class-action waivers is pre-empted by Section 2 of the FAA. The California Supreme Court found that the Court of Appeal had misconstrued *Perry v. Thomas*,<sup>51</sup> because it ignored the critical distinction made in *Perry* between a “state-law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue,” which is pre-empted by Section 2 FAA, and a state law that “governs issues concerning the validity, revocability, and enforceability of contracts generally, - which is not pre-empted by the FAA.”<sup>52</sup>

The principle that class-action waivers are, under certain circumstances, unconscionable is a California law principle that does not specifically apply to arbitration agreements, but to contracts generally because it applies equally to class-action litigation waivers.<sup>53</sup> The Court added that “agreements to arbitrate may not be used to harbor terms, conditions and practices that undermine public policy.”<sup>54</sup>

In addition, Section 4 FAA, in providing that federal district courts petitioned to compel arbitration will do so in accordance with the terms of the agreement, does not

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<sup>50</sup> *Id.*, p. 17.

<sup>51</sup> *Perry v. Thomas*, 482 US 483 (1987).

<sup>52</sup> Opinion, p. 21.

<sup>53</sup> *Ibid.*

<sup>54</sup> Opinion, p. 22.

preclude class-wide arbitration, and does not override the principle embodied in Section 2 that state courts can refuse to enforce arbitration agreements or portions thereof on general contract principles.

The Court also rejected Discover Bank's argument that somehow *Bazzle*<sup>55</sup> supports the position that a state law rule against class arbitration waivers is pre-empted by the FAA. Discussing the *Bazzle* case in detail, the Court noted that the plurality of the US Supreme Court wrote that the South Carolina court neither said nor implied that it would have authorized class arbitration had the parties' arbitration agreement forbidden it. Justice Stevens' concurring opinion added that there is nothing in the FAA that precludes either of the South Carolina court's determinations (that as a matter of state law class action arbitrations are permissible if not prohibited by the applicable arbitration agreement, and that the agreement between these parties is silent on the issue). Reading the two together, the Court concluded that the most that might be derived from *Bazzle* is that when the question of whether a class action arbitration is available depends on whether or not the arbitration agreement is silent on the matter or expressly forbids class action arbitration. Then it is up to the arbitrator, not the court, to interpret the arbitration agreement.<sup>56</sup>

More significantly, the *Bazzle* court did not address whether a state court can, consistent with the FAA, hold a class action arbitration waiver in an adhesion contract unconscionable or contrary to public policy, as part of an arbitration-neutral law that finds all such waivers unenforceable.<sup>57</sup>

Nor did the *Bazzle* court address the question whether the determination of unconscionability should be made by a court or an arbitrator.<sup>58</sup> Interestingly, the Court said, in dictum, that under California law, the question whether an arbitration agreement

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<sup>55</sup> *Green Tree Financial Corp. v. Bazzle*, 539 US 444 (2003), discussed *supra*, at notes 12 to 14.

<sup>56</sup> Opinion, pp. 26-29.

<sup>57</sup> *Id.*, p. 29.

<sup>58</sup> *Ibid.* See the discussion, *supra* notes 20 to 27 and accompanying text.

should be revoked based on “grounds as exist for the revocation of any contract” is for the courts to decide, not an arbitrator. This is the exact opposite of what the 3-judge panel decided in *Nagrampa*, a case that is now up for a rehearing *en banc* by an 11-judge panel of the Ninth Circuit (Federal) Court of Appeals.<sup>59</sup>

Since the Court of Appeal had concluded that any California rule against class arbitration waivers was pre-empted by the FAA, it did not address the question whether the Delaware choice-of-law clause nonetheless requires enforcement of the waiver. Accordingly, the California Supreme Court remanded the case to the Court of Appeal in order to decide on that issue. However, it offered certain comments for the Court of Appeal’s guidance.<sup>60</sup>

Assuming that it finds that the choice of law provision is not to be set aside for other reasons, the Court of Appeal must determine on remand whether the chosen state’s law is contrary to a fundamental policy of California. If there is such a conflict, it must determine whether “California has a materially greater interest than the chosen state in the determination of the particular issue, and if it does, the choice of law clause shall not be enforced.”<sup>61</sup>

The Court of Appeal will also have to address plaintiff Boehr’s contention that the court must enforce the Delaware Consumer Fraud Act and Delaware contract law with a California unconscionability rule against class-action waivers that arguably is not found under Delaware law. In addition, the appeals court will need to address plaintiff’s argument that class arbitration rules are procedural rules that California courts are to apply even when admittedly the substantive law of another state governs the contract.

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<sup>59</sup> See *supra* notes 26-27 and accompanying text.

<sup>60</sup> Opinion, p. 33.

<sup>61</sup> *Ibid.*

C. *The Dissenting Opinion*

Justice Marvin R. Baxter concurred with the majority's conclusion that federal law does not compel enforcement of contractual class-action waivers simply because they are contained in arbitration agreements.<sup>62</sup>

But since the Court of Appeal did not address the substance of California's policy regarding such waivers, the Supreme Court should not have addressed it either. Besides, since the parties "reasonably" agreed that Delaware law would govern and plaintiff has asserted only Delaware causes of action, the majority's decision to deem the class-action waiver to be unconscionable by California standards is simply moot.<sup>63</sup>

Justice Baxter lamented that California now positions itself in the minority, since Delaware along with the "vast majority of decisions, applying federal law or the law of other states" uphold[s] the validity of class-action waivers in adhesion contracts.<sup>64</sup>

Anticipating the Court of Appeal's decision on remand, Justice Baxter went into great detail as to why the contractual class-action waiver is not so contrary to fundamental California policy that California should invalidate it despite contrary Delaware law.<sup>65</sup> Justice Baxter did not accept the majority's argument that because cardholders and their attorneys have no incentive to pursue such small claims except by aggregating them, Discover Bank will escape liability or punishment for its improper practices, and he came up with six other means by which Discover Bank could be called to account for the mis-charges plaintiff alleges.<sup>66</sup>

Finally, Justice Baxter pointed out that to the extent plaintiff seeks to vindicate rights of a nationwide class under the Delaware consumer protection laws, California has

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<sup>62</sup> Dissenting Opinion, p. 1.

<sup>63</sup> *Ibid.*

<sup>64</sup> Citing a long list of cases, Dissenting Opinion pp. 3-4 n.1.

<sup>65</sup> Dissenting Opinion, p. 5.

<sup>66</sup> *Id.*, pp. 7-10.

no greater interest than any other jurisdiction, including Delaware, in protecting the interests of its resident class members.<sup>67</sup> In contrast, Delaware has a specific regulatory economic and business interest in applying its own laws and policies to its locally chartered banks, whereby it seeks to minimize Discover Bank’s exposure to the varying and possibly conflicting laws of 49 sister states.<sup>68</sup> In fact, Delaware specifically requires that credit card agreements issued by Delaware-chartered banks be governed by Delaware law. This requirement serves to ensure the uniform construction of credit card agreements issued by Delaware banks no matter where disputes might arise.<sup>69</sup>

If California would refuse to enforce the parties’ agreement for individual arbitration under Delaware law, the state may well become a forum of choice for putative nationwide class suits like this one. Justice Baxter would not join the majority’s “willingness to countenance such result.”<sup>70</sup>

#### **IV. Conclusion**

It is not at all certain that the Court of Appeal will follow the Supreme Court’s “guidelines” on remand such that California will apply its own fundamental policy of declaring certain class-wide arbitration waivers to be unenforceable in spite of the conceded applicability of the laws of another state. After all, the Supreme Court left it to the Court of Appeal to determine whether California has a materially greater interest. The Court of Appeal may well rely on the dissenting opinion for arguments that no such materially greater interest exists.

It should be noted, however, that this case may have greater implications for situations in which the plaintiff does not have national ambitions for his class, but contents himself instead with merely representing cardholders from California, perhaps augmented by cardholders from states that follow California’s stance on the

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<sup>67</sup> *Id.*, p. 10.

<sup>68</sup> *Id.*, p. 11.

<sup>69</sup> *Id.*, p. 12.

<sup>70</sup> *Id.*, p. 15.

unconscionability of class-action waivers in adhesion contracts. Plaintiff Boehr and his attorneys must realize that they are severely diminishing their chances, in fact virtually reaching for the moon in their attempts to combine a substantive challenge of the applicable Delaware consumer laws with the benefit of California's position on class-action waivers.

Nonetheless, credit card companies and other companies that currently seek to exclude class actions in their arbitration clauses will need to come up with another procedure in states that hold such waivers to be unconscionable. As stated at the outset,<sup>71</sup> rather than revert to class action litigation in such states, much is to be said for preserving class-wide arbitration, provided that the arbitration agreement creates the possibility of an interim appeal to an arbitral appellate panel from the arbitrator's decision concerning class certification. This will remove the principal disadvantage of class-wide arbitration while preserving its advantages of reduced cost, relative speed and efficiency, and adjudication by a (potentially) knowledgeable panel of neutrals.

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<sup>71</sup> *Supra*, text following note 4.