THE COST OF ARBITRATION: A DEFENSE TO THE ENFORCEABILITY OF ARBITRATION AGREEMENTS?

Debra D. Burke, Western Carolina University
Devon M. Green, Western Carolina University

ABSTRACT

Arbitration clauses in contractual arrangements are fairly standard today. By agreeing to arbitrate, the parties to a contract waive their rights to seek redress of their claims in a court in favor of an arbitration tribunal. While litigation is criticized as being expensive and time-consuming, costs associated with arbitration are far from inconsequential. If the parties have waived their right to go to court, even in situations in which fees and costs may be awarded to the prevailing party, and if arbitration costs are cost-prohibitive, could there be a defense to the arbitration contract based upon unconcionability? This paper explores situations in which such an argument could be successful, and suggests ways to make arbitration clauses less susceptible to such a challenge.

INTRODUCTION

The Federal Arbitration Act (FAA) provides for the enforceability of a written arbitration provision in any maritime transaction or contract involving interstate commerce, and declares that such agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract" (9 U.S.C. § 2, 2007). Supreme Court precedent sanctions arbitration as a dispute resolution mechanism, as well (Carrington, 2002). Commercial business, consumer, and employment disputes are arbitrated by organizations such as the National Arbitration Forum (NAF) and the American Arbitration Association (AAA).

Initially, arbitration was touted as a cheaper and more efficient alternative to litigation. Additionally, advantages to arbitration over the primary alternative (civil litigation) presumably include control, confidentiality, cost and time savings, finality, and more predictability for managing risk than litigation (Leasure, 2009). Some studies suggest that the time period from the commencement of the dispute to its resolution is shorter in arbitration than litigation (Rutledge, 2008). Others suggest that whether or not arbitration is cheaper than litigation or more expensive, or which forum provides greater access to justice, may be dependent upon the type of dispute (Drahozal, 2008). Nevertheless, many disputants today are disenchanted with arbitration as a means of resolving disputes, and complain that the complex process shares many of the characteristics of litigation (Stipanowich, 2010). Arbitration has become more formal, and arbitrators follow traditional rules of procedure and evidence, resulting in the arbitration process

المنارة للاستشارات
www.manaraa.com

looking and costing about the same as litigation (Sternlight, 2000). Arbitration as a means of dispute resolution now can be quite expensive as well, particularly since attorneys' should be included in the calculation of costs (Rutledge, 2008).

The American Arbitration Association charges a filing fee per case that ranges anywhere from $125-$7,000 depending upon the amount of the claim. The AAA also requires a hearing fee that can be as much as $250 per party, per case. Public Citizen's statistics in 2002 revealed that an $80,000 consumer claim brought to the Circuit Court of Cook County, Illinois carried a forum fee of $221. However, the same claim brought to the National Arbitration Forum would cost approximately $11,625, and if brought to the American Arbitration Association would result in estimated payments in excess of $6,600. Additionally, many costs associated with arbitration, such as the administrative fees as well as the compensation of the arbitrators, must be paid up-front, which can be a substantial financial burden, making it less likely that some disputants will be able to proceed in that forum (Alleyne, 2003). Comparatively, court costs are relatively insignificant to the cost of arbitration proceedings, many expenses associated with litigation need not be paid in advance, and the salary of the judges are paid by the government in the civil justice system.

In addition to filing and hearing fees, the arbitrator(s) who hear the case charge their own individual service fees. In the state of North Carolina, the average compensation for an AAA arbitrator is $1,225.00 per day (Tillman v. Commercial Credit Loans, Inc., 2008). If a panel of three arbitrators is specified in the arbitration clause, as under AAA complex commercial rules, then that amount is trebled. Arguably, contingent fee contracts provide a mechanism for overcoming possible liquidity and risk aversion problems caused by arbitration costs (Drahozal, 2006). However, if the transaction costs of hiring arbitrators become astronomical in protracted proceedings, and that likelihood is foreseeable, then the contingency arrangement is meaningless as an incentive.

Moreover, contingency arrangements, while lucrative and enticing in tort actions, are not a sufficient incentive in the relatively small recovery world of consumer complaints. In these cases the statutory recovery of attorneys' fees and or mandatory treble damages, such as in some deceptive trade practices statutes, provides the impetus for representation. While these fees and damages presumably can be awarded by arbitrators, arbitrators are not strictly bound by precedent, and any failure to order the appropriate relief, is not reviewable on appeal. Thus, not only must litigants pay substantial sums for the process of arbitration, they usually must pay for representation in that forum as well, since the normal mechanism for inciting attorneys to take cases in the civil justice system does not necessarily transfer to the arbitral forum.

The AAA has a fee waiver procedure, in which fees may be waived in whole or in part, on the basis of a claimant's financial situation; yet there is a general lack of standards governing the granting of fee waivers under its rules and policies, and often substantial funds have been expended before the decision is reached (Budnitz, 2004). The AAA does not provide formal standards for granting hardship, and its accounting department actually determines who is

المنارة للاستشارات
www.manaraa.com

afforded "extreme hardship" status (Camacho v. Holiday Homes, Inc., 2001). While arbitrators can shift fees to one party in their discretion (Rutledge, 2008), such a remote possibility would not necessarily inspire an attorney to take the case, or a party to pursue the claim on a gamble that fees ultimately will be paid.

Since arbitration clauses foreclose litigation as an option, they effectively force the parties to settle their dispute through arbitration. Therefore, if the cost of arbitration is prohibitively high, some litigants effectively may be denied an opportunity to pursue any remedy at all. “The purpose of arbitration is not to preclude a person from bringing claims but to provide an alternate forum for redress” (Hutchens, 619, 2002). Yet in reality, the party in the superior bargaining position consciously may include an arbitration clause “to deter individuals from filing claims, to prevent them from securing legal representation, and to decrease their chance of securing significant relief if they do bring claims” (Sternlight, 838, 2002). While such a strategy may deter frivolous claims (Gregg v. Hay-Adams Hotel, 1996), valid claims also are deterred, and whether or not a claim is valid or invalid cannot be discerned until the case is heard. Often times this strategy forecloses class action litigation, as well in an attempt to stifle the pursuit of legal remedies (Sternlight & Jensen, 2004). To enforce an arbitration clause to the exclusion of the right to seek redress in the court system in certain contexts arguably raises constitutional concerns (Sternlight, 1997).

The existence of an arbitration agreement is a matter of contract between the parties, which identifies a way to resolve those disputes that the parties have agreed to submit to arbitration (Avedon Engineering, Inc. v. Seatex, 1997). Therefore, while the FAA provides that mandatory arbitration contracts are enforceable, certain contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening that statute (Doctor's Assocs., Inc. v. Casarotto, 1996; Plourde, 2003). In fact, over the period from 1990 through 2008, not only did the annual number of unconscionability claims in mandatory arbitration contract cases show a consistent increase beginning in 1997, their relative rate of success also increased over the first years of the new century (Knapp, 2009).

Most employees and consumers do not enter into these clauses voluntarily (Sternlight, 2002). This reality, coupled with the substantial fees associated with arbitration, could make arbitration agreements subject to challenges of substantive unconscionability. Procedural unconscionability can be an issue as well, for example, by printing a mandatory arbitration clause inconspicuously on the back of the contract (Rollins v. Foster, 1998). Most state law requires proof of both elements, procedural and substantive unconscionability, in order to invalidate an agreement (Tillman v. Commercial Credit Loans, Inc., 2008). This paper will discuss arbitration clauses in employment, consumer and franchise contracts in which courts and commentators have examined if the *cost* of arbitration could render the clause unconscionable and unenforceable. It also will present options to make such clauses less subject to that challenge.

المنارة للاستشارات
www.manaraa.com

FEDERAL LAW

Federal statutory and case law supports alternate dispute resolution forums, such as arbitration. The FAA provides that "[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 . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract" (9 U.S.C. § 2 (2009). The Supreme Court acknowledges that the purpose of the statute is "to reverse the longstanding judicial hostility to arbitration agreements . . . and to place arbitration agreements upon the same footing as other contracts" (Gilmer v. Interstate/Johnson Lane Corp., 24, 1991). As passed in 1925, the FAA was viewed as being applicable primarily to contract disputes between business entities, and initially interpreted as not being relevant to state law or federal statutory claims designed to protect consumers, employees, investors, and other such disputants, unless the parties agreed to arbitrate after their dispute arose (Wilson, 2004).

Today, however, the policy favoring arbitration has been interpreted as being applicable to a variety of state and federal claims for which pre-dispute agreements provide for mandatory arbitration. Federal statutory claims, such as those involving securities law and consumers, can be resolved through arbitration (Shearson/American Express Inc. v. McMahon, 1987). In determining whether or not federal statutory claims may be arbitrated, courts must first examine if the parties agreed to submit their claims to arbitration, and then decide if Congress intended to preclude a waiver of judicial remedies for the statutory rights at issue (Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 1985). In addition to permitting the arbitration of federal statutory claims, the Court also recognizes that the FAA’s liberal policy favoring arbitration withstands any state substantive or procedural policies to the contrary (Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 1983).

While the Supreme Court as a matter of policy favors the enforceability of mandatory arbitration clauses in contracts, it has not directly confronted the issue of costs. In *Green Tree Financial Services Corp. v. Randolph* (2000) a consumer challenged the arbitration clause in a financing agreement for the purchase of a mobile home, contending that it was unenforceable due to potentially prohibitive costs. The consumer argued that the arbitration agreement's silence with respect to costs and fees created a risk of prohibitively high arbitration costs which would result in the inevitable abandonment of any right to assert her statutory rights. The Court determined that, while the existence of substantially arbitration costs could preclude litigants from effectively vindicating federal statutory rights under the Truth in Lending Act (TILA) in the arbitral forum, the record in the case failed to show the amount of such costs. The Court suggested that the party seeking to avoid arbitration bears the burden of establishing that arbitration would be prohibitively expensive, as well as the likelihood of incurring such costs, dicta that is at least applicable to the arbitration of federal statutory claims.

المنارة للاستشارات
www.manaraa.com

However, the standard for establishing prohibitively excessive fees remains unspecified. Most federal and state courts adopt a case-by-case determination that focuses on a combination of factors such as the claimant's ability to pay, the difference between the costs of litigation and those of arbitration, and the likelihood that the cost of arbitration will deter the bringing of claims (Randall, 2004). For example, the Fourth Circuit examines "the claimant's ability to pay the arbitration fees and costs, the expected cost differential between arbitration and litigation in court, and whether that cost differential is so substantial as to deter the bringing of claims" (Bradford v. Rockwell Semiconductor Systems, Inc., 556, 2001). A state court, in deciding whether or not an arbitration agreement is unconscionable, considered factors such as the filing fees for arbitration compared to the filing fees in state district courts, as well as the amount of the arbitrators' fees (Barrett v. McDonald Investments, Inc., 2005).

In a case involving a mortgage loan transaction brought under the federal Truth in Lending Act (TILA), *Phillips v. Associated Home Equity Services* (2001), the borrower contended that the arbitral forum was prohibitively expensive, and provided evidence that she could not pay the costs of arbitration, which appeared to be at least twelve times what it would cost to file a case in federal court. The federal district court concluded that the borrower had carried her burden of proving that the costs associated with arbitration would effectively preclude her from vindicating her federal statutory rights, and denied the lender's motion to compel arbitration. So although there is precedent in state and federal courts for invalidating arbitration agreements on the grounds of costs, the standard is neither uniform nor certain, and the procedure for evaluating the merits of the argument adds yet another hurdle to the process for vindicating substantive claims (DeBenedetti, 2004). In sum, while federal law preempts state law, and while the FAA endorses arbitration as a means of resolving disputes, both state and federal courts will not necessarily compel arbitration under circumstances that would be considered unconscionable under state contract law (Stempel, 2004).

CONSUMERS

Since the federal judicial policy favors arbitration as per Supreme Court precedents, the initial response of courts is to enforce arbitration clauses in consumer contracts. For example, court have held that consumer claims under the Magnuson-Moss Warranty Act, a federal law which requires written warranties of consumer products to disclose, fully and conspicuously, in simple and readily understood language, the terms and conditions of the warranty, may be submitted to arbitration pursuant to a contract's arbitration provision. In *Hill v. Gateway 2000, Inc.* (1997) computer purchasers, who were dissatisfied product's performance, filed suit alleging various claims, including a violation of the Magnusson Moss Act. The computer suppliers sought enforcement of the arbitration agreement contained in the materials they shipped to the customers as part of the packaged product. The appeals court held that a contract did not have to

المنارة للاستشارات
www.manaraa.com

be read in order for it to become effective, and that the terms inside a box of software were binding on a consumer, including the arbitration clause.

Most consumer agreements are contracts of adhesion, which are written by business and presented to the consumer on a take it or leave it basis (Scarpino, 2002; Hilverda, 2007). Arbitration provisions are an accepted reality in consumer contracts, and exist in a myriad of contexts including credit card agreements, retail sales contracts and the provision of cell phone service (Schmitz, 2008). In the credit card context, arbitration clauses are not mutually beneficial in that they allow credit card issuers to go to court for collection purposes (but do not provide similarly for consumers), favor creditors (including the limiting of discovery and the inability to prosecute class actions), and provide a dispute resolution forum that is often inconvenient for consumers (Smith, 2009). Pre-dispute binding arbitration agreements are becoming common even in nursing home admission contracts, thrust upon vulnerable senior citizens at one of the weakest times in their lives, when they are sick or injured and have no alternative housing or care facility (Tripp, 2009).

In light of the actual lack of meaningful choice, the state law doctrine of unconscionability is often summoned as an argument for striking down mandatory pre-dispute arbitration agreements (Bruhl, 2008). The fact that such clauses are thrust upon consumers repeatedly on a take-it-or-leave-it basis, along with the relatively small amounts of money typically involved in consumer disputes, could make mandatory pre-dispute arbitration clauses subject to a challenge of procedural and substantive unconscionability (Gavin, 2006). Substantive unconscionability may focus on the fee arrangement of the clause, if it makes arbitration cost-prohibitive and is imposed unilaterally in the absence of any real bargaining.

For example, in *Rollins v. Foster* (1998), the consumer signed an extermination services contract for a term of two years. She challenged the arbitration clause based on costs, and while the district court made no finding of fact with respect to her ability to pay, it acknowledged "that there may actually be circumstances in which such an argument would preclude a court from enforcing an arbitration clause against a low-income consumer." Likewise, in *Tillman v. Commercial Credit Loans*, the North Carolina Supreme court struck down an arbitration clause in a loan agreement, which was intertwined with a life insurance policy as collateral, in light of evidence that the agreement not only made resolution financially inaccessible, but historical evidence suggested this deterrent effect was successful.

Similarly, the enforceability of mandatory arbitration clauses, and the resulting costs associated with their enforcement, has arisen in the context of mobile home sales and financing agreements. In *Mendez v. Palm Harbor Homes, Inc.* (2002), a Washington state appeals court allowed a legal defense when the party opposing arbitration reasonably established that prohibitive costs were likely to render the arbitral forum inaccessible. On the facts of the case, the court concluded that purchaser met the burden of showing that the anticipated filing and administrative costs of the arbitration ($2000 for the three person arbitration panel required by

المنارة للاستشارات

www.manaraa.com

the agreement) would be prohibitively high, noting that the purchaser was poorly educated, had a large family, worked two jobs, and had very little money.

Also, in *Camacho v. Holiday Homes, Inc*. (2001), the purchaser executed a retail installment contract with the seller for the installment purchase of a new manufactured home, which contained an arbitration clause. The purchaser argued that the arbitration provision was unconscionable because excessive fees prohibited her from accessing the arbitral forum. The court agreed, and concluded that the purchaser's limited income afforded no margin for expenses of the magnitude required to pay an arbitrator to consider her claim. According to the terms, the commercial rules of the AAA applied, and those rules specified a $2000 start-up fee, which could not be recovered unless she ultimately prevailed on her claim, and as a practical matter, could not be paid by the purchaser anyway. The court noted that, even if the administrative fees were waived or deferred, the purchaser demonstrated that the additional costs of the arbitration process itself amounted to an insurmountable financial barrier, as she would be responsible for paying one-half of the anticipated fee and expenses of the arbitrator, who likely would have to travel to adjudicate the dispute. Thus, the arbitration clause prevented her from effectively vindicating the rights afforded her under federal law, although the court noted that, if the retailer agreed to bear the costs associated with the arbitration, it would entertain a motion to reconsider its ruling on that basis.

In a different context, in *Ting v. AT&T* (2003), the Ninth Circuit examined whether or not California law would allow AT&T to impose an arbitration agreement upon its customers. AT&T's Consumer Services Agreement (CSA) required consumers to split the arbitration fees with AT&T for any claim brought against the company. The district court found that "while the majority of complainants would be handled satisfactorily either by customer service representatives or subsidized arbitration, some complainants would hypothetically face prohibitive arbitration costs, effectively deterring them from vindicating their statutory rights" (Ting v. AT&T, 1151, 2003). In reviewing the case, the court held that "parties that agree to arbitrate statutory claims still are entitled to basic procedural and remedial protections so that they can effectively realize their statutory rights, and found the legal remedies provisions unenforceable and unconscionable under California law." Although a step in the right direction, *Ting* still does not grant the consumer the choice of whether or not to arbitrate, does not cut the cost of the arbitration, barely speeds up the arbitration process, and allows the inclusion of binding arbitration provisions in future consumer service agreements (Weiner, 2002).

In *Brower v. Gateway 200, Inc.,* consumers who purchased computers and software products from Gateway through a direct-sales system, sought damages for warranty, breach of contract, false advertising and deceptive sales practices based upon their alleged inability to access the around-the-clock free technical support promised. An arbitration clause in the sales contract required the arbitration of any "dispute or controversy arising out of or relating" to the agreement in Chicago before the International Chamber of Commerce (ICC). The ICC's rules required advance fees of $4,000, including a $ 2,000 nonrefundable registration fee payable even

المنارة للاستشارات
www.manaraa.com

if the consumer prevailed. The court concluded that, while the possible inconvenience of the chosen site alone did not rise to the level of unconscionability, the "excessive cost factor that is necessarily entailed in arbitrating before the ICC is unreasonable and surely serves to deter the individual consumer from invoking the process" (Brower v. Gateway 200, Inc., 574, 2001). As a result, the court vacated that portion of the arbitration agreement that required arbitration before the ICC, and remanded the case to determine an appropriate substitution of an arbitrator pursuant to the FAA.

Another area in which consumer disputes develop over arbitration clauses is the landlord/tenant relationship. In *Omni v. Apartment Investment & Management Company* (2003), tenants filed a class action lawsuit challenging landlord's practice of charging late fees on overdue rent payments. The landlord moved to compel arbitration pursuant to the lease, and the tenants sought to invalidate the arbitration agreement on the grounds of unconscionability. The tenants challenged the arbitration agreement on four grounds: 1) it was hidden within the fine print, 2) it required the tenants to arbitrate all claims, no matter the amount of the claim, while the landlord was only required to arbitrate certain claims, 3) it required tenants to pay one-half of the arbitrator's fees and bear their own costs of arbitration, and 4) it provided that the arbitrators had no authority to award punitive, exemplary, consequential, special, indirect or incidental damages or attorneys' fees. While the trial court instinctively enforced the agreement to arbitrate as acceptable policy, the appeals court remanded the case to more completely evaluate all of the facts before rendering a judgment to compel arbitration.

Still, many courts customarily enforce arbitration clauses give the public policy that supports alternate dispute resolution. In *James v. McDonald's Corp.* (2005) a consumer alleged that the company induced her to purchase food products by a contest when it knew that the odds of winning were less than represented, and that it wrongfully refused to honor her winning game card. According to contest rules, the customer, presumably by participating in the game, agreed to arbitrate disputes arising under the contest. The consumer contended that the arbitration clause should not be enforced because the high up-front costs of arbitration, estimated by consumer to be between $38,000 to $ 80,000 in fees and service costs, would prohibit her from pursuing a remedy. The court, however, determined that the consumer failed to establish that the expenses that she necessarily and definitely would incur would make arbitration prohibitive, and failed to provide any evidence concerning the comparative expense of litigating her claims.

Typically consumer complaints involve small sums of money, and potentially can be costly for the other party to litigate on a mass scale; the temptation to discourage such litigation by businesses is comprehensible. However, our civil justice system recognizes claims for small sums, and that recognition is an important mechanism for enforcing public policy (Bingham, 2004). Blocking such access to justice by a formidable arbitration clause is indefensible, particularly since the risk businesses face by such suits can be shifted in part through insurance, and the expense of premiums passed along to consumers in an equitable fashion without precluding the adjudication of tort or contract claims through pre-dispute mandatory arbitration

www.manaraa.com

clauses. While arbitration clauses are valid in consumer contracts, it arguably is advisable for the business to pay the costs of the procedure in order to ensure that consumers are not precluded from vindicating their claims (Scarpino, 2002).

EMPLOYMENT

In *Gilmer v. Interstate/Johnson Lane Corp* (1991) the Supreme Court upheld, in the employment context, a pre-dispute arbitration agreement signed by a non-union employee as a condition of employment, eve when a federal statutory employment claim, the Age Discrimination in Employment Act, was at issue. Although the holding in *Gilmer* expressly applied only to claims brought under the ADEA, lower federal courts have compelled arbitration of employment claims arising under other federal employment statutes, as well as state employment statutes and common law doctrines. Nevertheless, the Equal Employment Opportunity Commission (EEOC) has the independent statutory authority to pursue in court a discrimination claim against an employer, even if the employee signed an arbitration agreement (EEOC v. Waffle House, Inc., 2002).

Admittedly, the allocation of arbitration costs certainly can be a factor in determining the enforceability of such clauses in the employment context. Given that precedent permits employment related dispute to be submitted to mandatory arbitration, can such an agreement be modified or stricken because of excessive costs? Courts seem to be open to that argument. In considering a dispute resolution agreement, which required the employee to split the arbitrator's fees with the employer, the Ninth Circuit concluded that the fee allocation scheme alone would render the arbitration agreement unenforceable. (Circuit City Stores, Inc. v. Adams, 2001).

Additionally, in a case that was decided before Supreme Court's decision in *Green Tree*, *Cole v. Burns International Security Services* (1997), an employee filed suit against his employer for wrongful termination. The employer moved to compel arbitration, and the appeals court found that, while the agreement to arbitrate was valid, the cost distribution required by the arbitration agreement was not fair to the employee, and required the employer to pay all of the arbitrator's fees and expenses. In dicta, the court indicated that an employee could not be required to agree to arbitrate his statutory claims as a condition of employment if the arbitration agreement required him to pay all or part of the arbitrator's fees and expenses. Subsequently, in *Brown v. Wheat First Sec., Inc*., the same appeals court limited its pro-employee disposition in *Cole* to statutory claims. Other courts also have refused to permit fee splitting arrangements when statutory claims were at issue (Morrison v. Circuit City Stores, Inc., 2003; Shankle v. B-G Maintenance Management of Colorado, Inc., 1999). One federal district court, applying a "likelihood" of incurring prohibitive arbitration costs standard, recognized that an employee had satisfied that burden and could not compelled to arbitrate her federal statutory claims (Ball v. SFX Broad., Inc., 2001). On the other hand, some federal circuit courts of appeal have rejected

www.manaraa.com

employee cost challenges to arbitration clauses, while others take a case-by-case approach (LeRoy & Feuille, 2002).

Scholars have conducted several research projects on employment and mandatory arbitration. One study found that courts were most likely to enforce cost-allocation clauses against high-income employees and less likely to enforce such clauses against low-income employees, and that courts were willing to order arbitration for plaintiffs who seem able to afford forum fees, even if they were expensive (LeRoy & Feuille, 2002). Certainly a shared fee arrangement avoids the potential for arbitrator bias associated with a unilaterally imposed employer-paid fee, which almost invariably generates an appearance of partiality (Alleyne, 2003). However, another empirical study suggested that arbitrators are biased in favor of employers because they are repeat players in an arbitration system that they subsidize, while employees are only one-time players (Bingham, 1997). Evidence also suggests that "some employers have used their superior bargaining power to impose on employees lopsided agreements that make it all but impossible for employees to pursue valid claims and that deter many employees from even trying to do so" (Bales, 394, 2006).

FRANCHISES

Arbitration clauses remain fairly standard in franchise agreements with respect to the resolution of disputes between the franchisor and franchisee (Drahozal& Wittrock, 2008). Yet, in addition to consumers and employees, franchisees have questioned the fairness of agreements to arbitrate, as well. In *Ticknor v. Choice Hotels International, Inc*. (2001), an arbitration clause in an EconoLodge franchise agreement stated that every dispute that arose between the parties, which was related to the agreement, would be resolved by binding arbitration at the chain's headquarters in Maryland. In response to a motion to compel the arbitration of a dispute that arose, the franchisee raised the state law defense of unconscionability. The appeals court concluded that "an unconscionable arbitration clause in an adhesion contract is unenforceable in Montana as a matter of public policy" (Ticknor v. Choice Hotels International, Inc., 939, 2001).

On the other hand, some courts are less willing to strike mandatory arbitration clauses in franchise contracts. In *Wasserman v. We the People Forms & Services Centers USA, Inc*. (2007), the claimants alleged that the franchisor failed to satisfy its contractual obligations, and argued that the arbitration provision was substantively and procedurally unconscionable. The district court disagreed and highlighted the disclosure made in the arbitration provision, to wit, that arbitration will be binding under the rules of the AAA, that each party was to bear its own costs and expenses in preparing for and participating in the arbitration, and that the parties would split the costs of the arbitrators' fees. The court also noted that claimants could access a complete list of the AAA's commercial arbitration rules, including the specific costs, on the association's website. As such, the court compelled arbitration of the dispute.

المنارة للاستشارات
www.manaraa.com

Similarly, in *Singh v. Choice Hotel International, Inc.* (2007), the franchisee alleged breach of contract and violations of deceptive trade practices legislation, and asserted that the arbitration provision was void as unconscionable. Although Choice Hotels did not dispute that the arbitration costs could exceed $ 30,000, the court held that the franchisee did not meet his burden of proving that the fees for arbitration were excessive when compared with potential litigation costs, because the evidence presented did not contain a real cost-differential analysis. While franchisees are typically small business owners and in a bargaining position similar to consumers and employees, courts tend to assume that these business disputants in the franchise context are on equal footing, notwithstanding the prevalence of a form contract and the domination of the relationship by the franchisor.

One justification of arbitration as a means of dispute resolution is an economic one that focuses on the concern for the allegedly high cost of litigation in courts. However, the results of one study suggest that deterrence factors outweigh concerns about litigation costs in the design of dispute resolution in franchise agreements, and that the probability of arbitration is significantly higher when the parties relied on implicit contract terms for governance, and compliance with those terms was difficult to ensure (Drahozal & Hylton, 2003). Further, franchising parties most concerned about the risk of excessive damages in court, who also included provisions in their contracts limiting damages, were highly likely to opt for arbitration over litigation (Drahozal & Hylton, 2003). That deterrent affect arguably is designed to discourage a vindication of franchisee rights, more than anything else, and to insure a pro-franchisor interpretation of the implicit contract terms in the arbitral forum, if accessible.

RECOMMENDATIONS

There is no evidence, neither empirical nor anecdotal, to suggest that mandatory arbitration of consumer, employment and some business disputes, is fair; the fact that it is imposed in contracts of adhesion tends to suggest that fairness is anything but the motivating factor for its selection as a forum (Schwartz, 2009). While imposing arbitration is more justifiable in business-to-business dealings in order to control costs, that goal is less justified in consumer-business relationships, given the reality that costs serve to foreclose avenues for dispute resolution all together for consumers (Satz, 2007). Arbitration provisions rarely are favorable to the consumer, employee or franchisee, frequently necessitating travel, involving excessive costs, and continuing the cycle of bias and prejudice towards minorities and low-income individuals; commensurately, arbitration provisions should be limited to those parties who are on equal footing and mutually consent to its application (Larson, 2003).

Legislation exempting consumer and employment disputes from arbitration is a possible solution, as "there is little opposition today to arbitration between sophisticated commercial parties" (Bruhl, 1489, 2008). The FAA could be amended to overturn the pre-arbitration decisions of the Supreme Court by removing consumer and employee contracts from the

المنارة للاستشارات
www.manaraa.com

coverage of the statute and by providing that pre-dispute arbitration agreements in such contracts will not be enforced (Schwartz, 2007). Another suggested legislative reform of the system is to eliminate the problems inherent in pre-dispute mandatory arbitration clauses in consumer transactions by amending the FAA to permit mandatory arbitration agreements only after a dispute arises so the disputants may assess its viability in a more informed manner (Alderman, 2001). Pre-dispute arbitration provisions inherently disadvantage the consumer, and fail to consider all possible alternatives, such as litigation (Weiner, 2002). As one observer notes, …decisions about our system of justice should be made by our legislature, and not by individual companies…we should consider what kind of dispute resolution is desirable within the broader context of how laws are enforced in the United States" (Sternlight, 863, 2002).

The Arbitration Fairness Act of 2009 (S. 931/H.R. 1020), originally introduced in 2007 and subsequent sessions of Congress, would amend the FAA such that "no predispute arbitration agreement shall be valid or enforceable if it requires arbitration of (1) an employment, consumer, or franchise dispute; or (2) a dispute arising under any statute intended to protect civil rights." The act, if passed, would transform the process from one that businesses can impose upon consumers, employees, and franchisees, to one that parties must voluntarily agree to after the dispute arises (Mandelbaum, 2009). If only post-dispute arbitration clauses were valid, then businesses would bear the burden of persuading consumers, and others, that it was in their best interest to arbitrate rather than litigate (Budnitz, 2004). Predictably, consumers would be less likely to choose arbitration if costs had to be paid up-front, if they were disclosed and viewed as being substantial, particularly if attorneys for the prevailing party could recover statutory fees and/or court costs in litigation.

Another proposed solution is a post-dispute opt-out provision, which recognizes the presumptive validity of a pre-dispute arbitration agreement, but only one that specifically permits a party to opt out of arbitration once the dispute arises, such as the arrangement utilized in some court-annexed ADR programs (Bingham & Wood, 2008). Along these lines, Professor Noyes (2007) suggests that litigation should be re-made by contract into arbitration's image through the enforcement of ex ante contracts to modify the rules of litigation, within acceptable limits, through forum selection clauses, waiver of due process rights to notice and a hearing, waiver of the Seventh Amendment right to jury trial, and choice of law clauses. Modified litigation can be superior to arbitration by providing a neutral decision-maker who is free of bias and free from the repeat-player syndrome of arbitration's judges-for-hire, while the parties also retain their right to full appellate review and the disputes remain in the public.

While most courts follow the Supreme Court's lead in *Green Tree Financial Services Corp. v. Randolph* for both state and federal claims, and require the party challenging the enforceability of the arbitration clause to prove that utilizing such a forum is cost prohibitive, another solution it might be to place that burden of proof on the party who had control over the dispute-system design (Bingham, 2004). Such a subtle shift could have a positive impact on access to justice. Allowing the parties to proceed to arbitration by severing a prohibitive cost

المنارة للاستشارات
www.manaraa.com

allocation provision at the time of the motion to compel and imposing costs on the party that mandated the arbitration agreement is another proposal (O'Hearn, 2007; Burton, 2006). Alternatively, Congress or state legislatures could create a regulatory scheme, which requires the agreement to specify one or more certified service providers for the arbitration of disputes pursuant to their rules, in conjunction with an independent organization that regulates those providers, including their costs (Budnitz, 2004).

Another remedial alternative is the creation of more *business courts*, a division of a larger court with its jurisdiction limited to certain kinds of business disputes, presided over by specialist judges, with an emphasis on aggressive case management and use of alternative dispute resolution, for example, the Delaware Court of Chancery (Drahozal, 2009). "The creation of business courts incorporates some of the preferred characteristics of arbitration (in particular, expert decision making and expedited case management) into litigation, making litigation a more effective competitor to arbitration" (Drahozal, 507, 2009). Such a remedy, of course, requires legislative action at the state and federal level.

For now, there are some risk management strategies and ethical considerations that require no legislative or judicial intervention to employ. Parties to a contract should carefully examine the potential risks involved if the contract is breached, and make a conscious decision as to whether or not arbitration is an appropriate remedy (Stipanowich, 2010). Although the typical mantra for business is to insert an arbitration clause, for a small business, it may not be wise. Entrepreneurs and small business owners should do a risk assessment that evaluates their most significant exposures to potential litigation, whether it is with suppliers, customers, or sub-contractors, and then ascertain if there is a fee-shifting statute favorable to their likely position in the dispute before automatically assuming that arbitration is the better route.

Attorneys representing companies in drafting or enforcing consumer arbitration clauses should remain committed to justice and ethical considerations that assess the real risks and impacts of onerous arbitration provisions, and refuse to draft provisions that squelch consumers' procedural and substantive rights (Schmitz, 2008). Drafters of arbitration clauses should thoughtfully consider best practices regarding such important issues as how to notify individuals of arbitration provisions, the location and identity of arbitration forums, forum rules, arbitration fees, and the availability of discovery and appeals to ensure that it continues to be available alternative to litigation that benefits individuals and businesses (Mogilnicki & Jensen, 2003). In the absence of voluntary compliance with an ethical obligation to provide relevant information, legislative bodies should mandate a comprehensive set of disclosures about the arbitration agreement, thereby establishing a framework for informed decisions (Mandelbaum, 2009).

As a practical suggestion, there are three generic problems with pre-dispute mandatory arbitration clauses: no choice, no notice, and no money to prosecute a claim. These three issues can be addressed in a more ethical manner, while concurrently fostering the inclusion of an arbitration clause. First, consumers, employees and franchisees can be afforded a choice. The agreement could allow for the selection of *binding arbitration*, in which the party seeking to

المنارة للاستشارات
www.manaraa.com

include the provision pays all costs and fees, exclusive of attorneys' fees, or alternatively *non-binding arbitration* in which the parties split the modest fees. The non-binding arbitration rules of the AAA provide parties with streamlined procedures for arbitrations that result in an advisory award rendered by an arbitrator after a brief hearing. The abbreviated process, as well as the advisory award resulting from the process, may aid parties at arriving at settlement of their case through further negotiation or mediation. Fees are relatively modest in contemplation of a streamlined, one-day (or less) telephonic or in-person hearing, or a documents-only hearing.

If binding arbitration is selected, then the contract should make it clear that attorneys' fees, costs and exemplary damages may be awarded by the arbitrator(s) in accordance with applicable statutory law. A pre-dispute mandatory arbitration clause should not be included with any other limitation of remedy. It should be sufficient that appeal is precluded, available only the narrow grounds of fraud, collusion or a lack of jurisdiction over the claim, and that fact should be recited in the agreement as well.

If the costs are not to be born by the party drafting the agreement, then the agreement also should allow for the parties to opt either for a panel of three arbitrators or alternatively for a single arbitrator, notwithstanding what the rules of the AAA or other service provider specify according to the amount in dispute. Reducing the number of arbitrators from three to one in binding arbitration will reduce costs substantially. The current fee schedule and the administrative costs should be listed in the contract, as well, along with adequate notice that these fees and costs may not be incurred in litigation. If consumers, employees and franchisees can be given some choice, along with sufficient information so as to make an informed choice, then pre-dispute mandatory arbitration becomes less unconscionable.

CONCLUSION

In sum, arbitration clauses are favored under federal and state law. However, in certain circumstances, such as those in which they are incorporated into contracts of adhesion, and in which the relative cost of arbitration is disproportionately related to the amount of money in dispute so as to foreclose the adjudication of the claim, the clause operates as a complete deterrent to seeking a redress of claims. Such an effect could result in courts declaring the arbitration agreement unconscionable and unenforceable. Therefore, in drafting such clauses for employment, consumer and some business agreements, careful attention should be paid to the allocation of costs for the arbitration proceeding and to the overall fairness of the agreement to arbitrate.

المنارة للاستشارات
www.manaraa.com

REFERENCES

Alderman, R.M. (2001). Pre-Dispute Mandatory Arbitration in Consumer Contracts: A Call for Reform. *Houston Law Review, 28,* 1237-1268.

Alleyne, R. (2003). Arbitrators' Fees: The Dagger in the Heart of Mandatory Arbitration for Statutory Discrimination Claims. *University of Pennsylvania Journal of Labor & Employment Law, 6*, 1-53.

Avedon Engineering, Inc. v. Seatex, (1997). United States Court of Appeals, 126 F.3d 1279.

Bales, R.A. (2006). Normative Consideration of Employment Arbitration at Gilmer's Quinceanera. *Tulane Law Review, 81*, 331-394.

Ball v. SFX Broad., Inc. (2001). United States District Court, 165 F. Supp. 2d 230.

Bingham, L.B. (1997).Employment Arbitration: The Repeat Player Effect. *Employment Rights & Employment Policy Journal, 1,* 189-220.

Bingham, L.B. (2004). Mandatory Arbitration: Control Over Dispute-System Design and Mandatory Commercial Arbitration. *Law and Contemporary Problems Law and Contemporary Problems, 67*, 221-251.

Bingham, L.B. & Good, D.H. (2009). A Better Solution to Moral Hazard in Employment Arbitration: It Is Time to Ban Predispute Binding Arbitration Clauses. *Minnesota Law Review 93*, 1-14,

Bradford v. Rockwell Semiconductor Systems, Inc. (2001). United States Court of Appeals, 238 F.3d 549.

Brown v. Wheat First Sec., Inc. (2001). United States District Court, 257 F.3d 821.

Brower v. Gateway 2000, Inc. (1998). New York Court of Appeals. 676 N.Y.S.2d 569

Bruhl, A.P. (2008). The Unconscionability Game: Strategic Judging and the Evolution of Federal Arbitration Law. *New York University Law Review, 83,* 1420-1490.

Budnitz, M.E. (2004). The High Cost of Mandatory Consumer Arbitration. *Law and Contemporary Problems, 67,* 133-166.

Burton, S.J. (2006). The New Judicial Hostility to Arbitration: Federal Preemption, Contract Unconscionability, and Agreements to Arbitrate. *Journal of Dispute Resolution, 2006*, 469-500.

Camacho v. Holiday Homes, Inc. (2001). United States District Court, 167 F. Supp. 2d 892.

Carrington, P. D. (2002). Unconscionable Lawyers. *Georgia State University Law Review, 19*, 361-393.

Cole v. Burns Int'l Sec. Servs. (1997). United States Court of Appeals, 105 F.3d 1465.

Circuit City Stores, Inc. v. Adams (1999). United States Court of Appeals, 194 F.3d 1070.

www.manaraa.com

DeBenedetti, M.B. (2004). Show Me the Money?: Washington Adopts the Cost Prohibitive Defense to Arbitration Clauses in Consumer Contracts. *The Seattle University Law Review, 27*, 899-940.

Doctor's Assocs., Inc. v. Casarotto (1996). United States Supreme Court, 517 U.S. 681.

Drahozal, C. R. (2001). "Unfair" Arbitration Clauses. *University of Illinois Law Review,* 695-790.

Drahozal, C.R. & Hylton, K.N. (2003). The Economics of Litigation and Arbitration: An Application to Franchise Contracts. *Journal of Legal Studies, 32*, 549-582.

Drahozal, C. R. (2006). Arbitration Costs and Contingent Fee Contracts. *Vanderbilt Law Review, 59*, 729-780.

Drahozal, C. R. (2008). Arbitration Costs and Forum Accessibility: Empirical Evidence. *University of Michigan Journal of Law Reform, 41*, 813-841.

Drahozal, C.R. & Wittrock, Q.R. (2008). Is There a Flight From Arbitration?, *Hofstra Law Review, 37*, 71-115.

Drahozal, C.R. (2009). Business Courts and the Future of Arbitration. *Cardozo Journal of Conflict Resolution, 10*, 491-507.

EEOC v. Waffle House, Inc. (2002). United States Supreme Court, 534 U.S. 279.

Gavin, S.F. (2006). Unconscionability Found: A Look at Pre-Dispute Mandatory Arbitration Agreements 10 Years After Doctor's Associates, Inc. v. Casarotto. *Cleveland State Law Review, 54,* 249-271.

Gilmer v. Interstate/Johnson Lane Corp., (1991). United States Supreme Court, 500 U.S. 20.

Green Tree Financial Services Corp. v. Randolph (2000). United States Supreme Court, 531 U.S. 79.

Hill v. Gateway 2000, Inc. (1997). United States Court of Appeals, 105 F.3d 1147.

Hilverda, B (2007). Protecting the Right to a Jury Trial: Idaho's Response to Mandatory Arbitration Clauses in Adhesion Contracts. *Idaho Law Review, 44,* 185-212.

Hutchens, M.B. (2002). At What Costs?: When Consumers Cannot Afford the Costs of Arbitration in Alabama. *Alabama Law Review, 53*, 599-619.

Iwen v. U.S. West Direct (1999). Montana Supreme Court, 293 Mont. 512.

James v. McDonald's Corp. (2005). United States Court of Appeals, 417 F.3d 672.

Kloss v. Edward D. Jones & Co. (2003). Montana Supreme Court, 310 Mont. 123.

Knapp, C.L. (2009). Blowing the Whistle on Mandatory Arbitration: Unconscionability as a Signaling Device. *San Diego Law Review, 46,* 609-628.

المنارة للاستشارات
www.manaraa.com

Larson, S.E. (2003). An Examination Of The Broad Scope Of The Federal Arbitration Act And Binding Mandatory Consumer Arbitration Agreements: Not The Answer To Racial Bias In The United States Legal System. *Hamline Journal of Public Law & Policy, 24*, 293-327.

Leasure, (2009). Arbitration After Hall Street v. Mattel: What Happens Next?. *University of Arkansas Little Rock Law Review, 31*, 273-313.

LeRoy, M.H. & Feuille P. (2002). When is Cost an Unlawful Barrier to Alternative Dispute Resolution? The Ever Green Tree of Mandatory Employment Arbitration. *University of California Law Review, 50*, 143-203.

Mandelbaum, J.T. (2009). Stuck in a Bind: Can the Arbitration Fairness Act Solve the Problems of Mandatory Binding Arbitration in the Consumer Context?. *Iowa Law Review, 94,* 1075-1105.

Mendez v. Palm Harbor Homes, Inc. (2002). Washington Court of Appeals, 111 Wash. App. 446.

Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., (1985). United States Supreme Court, 473 U.S. 614.

Mogilnicki, E.J. & Jensen, J.D. (2003). Arbitration and Unconscionability. *Georgia State University Law Review, 19*, 761-787.

Morrison v. Circuit City Stores, Inc. (2003). United States Court of Appeals, 317 F.3d 646.

Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., (1983). United States Supreme Court, 460 U.S. 1.

North American Van Lines, Inc. v. Collyer (1993). Florida Court of Appeals, 616 So.2d 177.

Noyes, H.S. (2007). If You (Re)Build It, They Will Come: Contracts To Remake The Rules Of Litigation In Arbitration's Image. *Harvard Journal of Law & Public Policy, 30*, 579-647.

O'Hearn, D. (2007). Beyond "Let Them Eat Cake": An Argument for the Armendariz Method of Cost Allocation in Mandatory Employment and Consumer Arbitration. *Journal of Dispute Resolution, 2007*, 541-565.

Onni v. Apartment Investment & Management Co. (2003). Illinois District Court, 344 Ill. App. 3d 1099.

Phillips v. Assocs. Home Equity Servs. (2001). United States District Court, 179 F. Supp. 2d 840.

Plourde, L.K. (2003. Analysis of Circuit City Stores, Inc. v. Adams in Light of Previous Supreme Court Decisions: An Inconsistent Interpretation of the Scope and Exemption Provisions of the Federal Arbitration Act. *Journal of Small & Emerging Business, 7*, 145-179.

Randall, S. (2004). Judicial Attitudes Toward Arbitration and the Resurgence of Unconscionability. *Buffalo Law Review, 52,* 185-223.

Rollins v. Foster (1998). United States District Court, 991 F. Supp. 1426.

Rutledge, P.B. (2008). Whither Arbitration?. *Georgetown Journal of Law and Public Policy, 6,* 549-589.

المنارة للاستشارات
www.manaraa.com

Rutledge, P.B. (2008). Arbitration Reform: What We Know and What We Need to Know. *Cardozo Journal of Conflict Resolution, 10,* 579-586.

Satz, M.A. (2007). Mandatory Binding Arbitration: Our Legal History Demands Balanced Reform. *Idaho Law Review, 44*, 19-62.

Scarpino, J. A. (2002). Mandatory Arbitration of Consumer Disputes: A Proposal to Ease the Financial Burden on Low-income Consumers. *American University Journal of Gender, Social Policy & the Law, 10,* 679-710.

Schmitz, A.J. (2008). Curing Consumer Warranty Woes Through Regulated Arbitration, *Ohio State Journal on Dispute Resolution, 23*, 627-686.

Schmitz, A.J. (2008). Ethical Considerations in Drafting and Enforcing Consumer Arbitration Clauses. *South Texas Law Review, 49*, 841-878.

Schwart, D.W. (2007). If You Love Arbitration, Set It Free: How "Mandatory" Undermines "Arbitration." *Nevada. Law Journal, 8,* 400-426.

Schwartz, D.S. (2009). Mandatory Arbitration and Fairness. *Notre Dame Law Review, 84*, 1247-1341.

Shankle v. B-G Maint. Mgmt. of Colo., Inc., 1999). United States Court of Appeals, 163 F.3d 1230.

Shearson/American Express Inc. v. McMahon, (1987). United States Supreme Court, 482 U.S. 220.

Singh v. Choice Hotels International, Inc. (2007). United States District Court, Civil Action No. 3:07-CV-0378-D LEXIS 50614.

Smith, J.M. (2009). Credit Cards, Attorney's Fees, and the Putative Debtor: A Pyrrhic Victory? Putative Debtors May Win the Battle But Nevertheless Lose the War. *Maine Law Review, 61*, 171-203.

Stempel, J.W. (2004). Arbitration, Unconscionability, and Equilibrium: The Return of Unconscionability Analysis as a Counterweight to Arbitration Formalism. *Ohio State Journal on Dispute Resolution, 19*, 757-860.

Sternlight, J. R. (1997). 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, *Tulane Law Review, 72*, 1-100.

Sternlight, J.R. (2000). Is Binding Arbitration a Form of ADR?: An Argument that the Term "ADR" Has Begun to Outlive Its Usefulness. *Journal of Dispute Resolution. 2000,* 97-111.

Sternlight, J. R. (2002). Is the U.S. Out on a Limb? Comparing the U.S. Approach to Mandatory Consumer and Employment Arbitration to that of the Rest of the World. *University of Miami Law Review,* 831-864.

Sternlight, J. R. & Jensen, E.J. (2004). Using Arbitration to Eliminate Consumer Class Actions: Efficient Business Practice or Unconscionable Abuse?. *Law & Contemporary Problems, 67*, 75-103.

Stipanowich, T. J. (2010). Arbitration: The New Litigation?. *University of Illinois Law Review, 2010,* 1-59.

المنارة للاستشارات
www.manaraa.com

Tillman v. Commercial Credit Loans, Inc. (2008). North Carolina Supreme Court, 362 N.C. 93.

Ticknor v. Choice Hotels International, Inc. (2001). United States Court of Appeals, 265 F.3d 931.

Ting v. AT&T (2003). United States Court of Appeals, 319 F.3d 1126.

Tripp, L. (2009). A Senior Moment: The Executive Branch Solution to the Problem of Binding Arbitration Agreements in Nursing Home Admission Contracts. *Campbell Law Review, 31*, 157-213.

Wasserman v. We the People Forms & Serv. Ctrs. USA, Inc. (2007). United States District Court, Civil Action No. 3:07-CV-0606-D LEXIS 56671.

Weiner, (2002). Even in Victory: Darcy Ting Defeated AT&T, Yet the Consumer-At-Large, Again Has Lost. *Cardozo Journal of Conflict Resolution, 4*, 2-20.

Wilson, J. (2004). "No-Class-Action Arbitration Clauses," State-Law Unconscionability, and the Federal Arbitration Act: A Case for Federal Judicial Restraint and Congressional Action. *Quinnipiac Law Review, 23,* 737-851.

www.manaraa.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com