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Hot Issues Alerts – Law Firms

Mandatory Consumer Arbitration

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The inclusion of mandatory arbitration clauses in an increasingly large number of consumer contracts has caught the attention of many academics and legislators. In the academic arena, consumer arbitration has been both deeply criticized and adamantly defended. Critics of consumer arbitration point out its many problems for consumers and society, such as unequal bargaining power and a potential usurpation of the role of the judiciary. Conversely, defenders of mandatory arbitration argue that it is an efficient way to resolve disputes, and that the cost savings it generates ultimately benefit consumers.

The controversy has also prompted legislators to consider the effects of consumer arbitration. These legislators, led by Representative Hank Johnson, introduced the Arbitration Fairness Act of 2009 (AFA), H.R. 1020, 111th Cong. (2009), to address some of the issues regarding mandatory consumer arbitration. If passed, the AFA would render inoperative the arbitration clauses that suffuse consumer contracts in an attempt to protect consumers from the problems associated with mandatory arbitration.

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I. The Background Of Consumer Arbitration

The rise of mandatory binding arbitration in the consumer context is a relatively recent phenomenon. Although Congress enacted the Federal Arbitration Act (FAA) in 1925, 9 U.S.C. §§ 1-16 (2006), it was not until significantly later in the century that a line of cases began to interpret the FAA in a way that made mandatory binding arbitration enforceable. These cases broadly favored arbitration as a national policy and served a critical role in interpreting the boundaries of the FAA.

In *Southland Corporation v. Keating*, 465 U.S. 1 (1984), the U.S. Supreme Court issued a landmark decision when it held that "Congress intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements." *Id*. at 16. Ten years later, the Court was presented with an opportunity to overrule *Southland* in *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265 (1995). The Court declined this opportunity, and instead gave the FAA preemptive force over state contract law. *Id*. at 272-73. The Court continued to expand the scope of arbitration provisions in *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440 (2006), where it held that arbitration provisions are severable from the remainder of the contract. *Id*. at 447. This means that when a party challenges the validity of a contract including an arbitration provision, the enforceability of the contract will be determined by arbitration as opposed to a judicial proceeding. The principles derived from these three cases demonstrate that courts should be extremely deferential toward arbitration rulings.

The FAA's expansive interpretation in *Southland* and its progeny led to an increase in the number of contracts that include binding arbitration provisions. In particular, arbitration became prevalent in consumer contracts because it could be of great advantage to manufacturers, distributors, and other businesses that face the potential for burdensome, costly litigation arising out of disputes with the consumers to whom they sell. During the 1980s, businesses and financial service providers began including arbitration provisions in their standard contracts as an alternative to defending lawsuits in court. The general use of arbitration clauses grew through the 1990s, and in 2004 a survey found that 69.2 percent of respondent businesses included arbitration clauses in their consumer contracts.

The increasing use of mandatory arbitration provisions in consumer contracts has also led to an ongoing debate about consumer rights. Although in theory the potentially short process, low costs and party control over the choice of the decisionmaker suggest that consumer arbitration should benefit both businesses and consumers, many consumer advocates argue that the benefits are one-sided. The debate persists because there are plausible arguments on both sides.

II. Assessing The Fairness Of Consumer Arbitration

Representative Hank Johnson and the other Congressmen who introduced the AFA noted that mandatory arbitration undermines consumer rights and the development of public law. Although a number of academics share this sentiment, it remains debatable whether a condemnation of consumer arbitration is warranted. The proponents of mandatory arbitration explain that this type of dispute resolution became favored by the courts and private parties because of the shortcomings of other alternatives, such as litigation.

A. The Benefits of Consumer Arbitration

Although corporations can use mandatory

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arbitration to take advantage of unsuspecting consumers, the procedure can also provide an advantageous system for the adjudication of claims. Consumer arbitration supporters explain that arbitration does not include extensive discovery or the numerous stages that are inherent in litigation, thereby affording both consumers and businesses a low-cost method to resolve their disputes. The cost savings render arbitration more accessible to lower-income claimants, allowing them actually to resolve their issues through arbitration. In many cases, arbitration is the only dispute resolution alternative to expensive lawsuits. Therefore, for many claimants it is arbitration or nothing.

Businesses and creditors with low-value claims face a similar situation. Consumer arbitration gives these companies a low-cost method to collect payments from debtors, which may not be possible through litigation. Arbitration benefits these companies because most debt cases are for fairly insignificant amounts; therefore, the companies will not undergo the expense of litigation to recover these small debts. If pre-dispute arbitration agreements are banned from consumer contracts, then many creditors will face difficulties collecting the debts that their customers have accumulated.

Another argument in favor of mandatory arbitration is that companies are able to reduce their own dispute resolution costs, which allows the firms to pass on the savings to their customers in the form of lower prices. This process works to lower prices because investors and entrepreneurs begin to notice above-normal profits, even though it is the arbitration clauses which cause those profits. The above-normal profits lead to an increase in output, which accordingly leads to lower prices. Although it is somewhat ironic, the arbitration clauses that restrict consumer rights can simultaneously provide consumers with less costly merchandise.

Still another benefit of consumer arbitration is the age-old principle that parties should be able to contract freely. This “laissez-faire” approach to consumer arbitration has some merit if the two parties are on equal footing. If corporations have included a burdensome and one-sided arbitration clause into a consumer contract though, this principle alone may not justify enforcement of the arbitration clause.

B. The Problems with Consumer Arbitration

While the proponents of consumer arbitration note the benefits the system provides, many critics cite the inherent problems in contracts with binding pre-dispute arbitration clauses. Consumer advocates claim that mandatory arbitration allows corporations to benefit at the expense of consumers and society in general. According to these advocates, the limited and unfamiliar procedures involved in arbitration impose a disadvantage on the less sophisticated party, namely the consumer. A business that has thousands of arbitrations a year will be familiar with the process. Most consumers have no experience with arbitration, however, and will not know when they have been deprived of their rights. This potential harm is exacerbated by the minimal role of judicial oversight over arbitration in practice.

In addition, consumer arbitration clauses further hinder the rights of consumer plaintiffs by imposing costs and prohibiting class actions. Companies may include one-sided provisions that impose costs on consumers and thereby discourage them from bringing claims against the company, such as selecting an arbitrator with high fees or locating the arbitration in a distant forum. Another method companies may use to increase consumers’ costs is to bar them from proceeding jointly with others in a class action. Consumer plaintiffs may not have the resources to individually bring suit if they have only been harmed by a small amount, but a group of plaintiffs could consolidate their claims to reduce the expenses that each individual plaintiff would have to pay. Given these benefits of class actions, it is clear that by eliminating the class action option, companies increase the costs and burdens on a consumer plaintiff.

Critics of mandatory arbitration also discuss its negative effect on society as a whole. Specifically, these critics state that the overwhelming use of arbitration proceedings to resolve disputes between consumers and businesses will prevent consumer law from adapting to changes in the country. The widespread use of consumer arbitration threatens the role and the efficacy of the common law in the American legal system. The prevalence of arbitration could “freeze” the common law, precluding courts from appropriately resolving consumer disputes and allowing businesses to manipulate the common law by litigating hand-picked cases that will set pro-business precedents. In addition, mandatory arbitration threatens the role of the jury trial.

III. The Potential Effectiveness Of The Arbitration Fairness Act Of 2009

Although there are some benefits to mandatory arbitration, a number of legislators have concluded that the positive attributes of consumer arbitration are outweighed by its potential for abuse. These legislators introduced the AFA to protect consumer rights. If passed, the AFA would ban pre-dispute arbitration agreements in consumer contracts and allow parties to enter into arbitration agreements only after a dispute arises. It would appear, however, that the proposed AFA would only address some, and certainly not all, of the problems associated with consumer arbitration.

The AFA would likely curb several potential abusive uses of mandatory arbitration, such as the use of arbitration as an efficient debt-collection and enforcement tool at the expense of the consumer. Instead of consumers unknowingly subjecting themselves to unfamiliar, one-sided arbitration proceedings, the AFA ensures that consumers would have a more involved role in deciding how to resolve their disputes. The AFA would also alleviate the concern about prohibitions on class action lawsuits. Because arbitration would be a post-dispute agreement, a consumer would not have signed a clause that prohibits class actions. In addition, the AFA would solve some of the larger problems for society that the widespread use of consumer arbitration creates. For example, because not every consumer dispute would be automatically funneled into arbitration, the common law would have the opportunity to continue to develop.

But the proposed AFA is not a panacea; there are several problems with mandatory arbitration that the AFA simply fails to address. One of these problems is the potential cost of arbitration. Even though a consumer must agree to arbitration, there is no requirement in the AFA that a post-dispute agreement will cost less than a pre-dispute agreement or that the consumer will receive any information about the cost of arbitration. Another issue is that the AFA does not devise a mechanism to help consumers understand arbitration clauses, which may lead to unsuspecting consumers entering into post-dispute arbitration agreements. If a consumer does not understand the arbitration clause, the consumer is not able to ferret out provisions designed to benefit the party that drafted the clause.

The AFA would significantly reduce the potential for businesses to take advantage of consumers in arbitration proceedings, but the AFA would not entirely eliminate this threat. Even though the AFA prevents businesses from forcing consumers into pre-dispute arbitration agreements, the AFA still does not provide enough assistance to consumers who may enter into post-dispute arbitration agreements.

IV. Conclusion

Today many standard consumer contracts contain arbitration clauses. In some instances, these clauses allow businesses and consumers to efficiently resolve disputes. Low-income consumers are able to bring claims that may have been too costly to litigate and businesses can reduce their own dispute resolution costs and pass those savings to consumers. The effects of consumer arbitration, however, are not always positive. Businesses can use arbitration clauses to deprive consumers of procedural safeguards and hinder the development of consumer law. Whether legislation such as the proposed AFA can enhance the benefits of mandatory consumer arbitration, without exacerbating the drawbacks or creating new problems, remains to be seen.